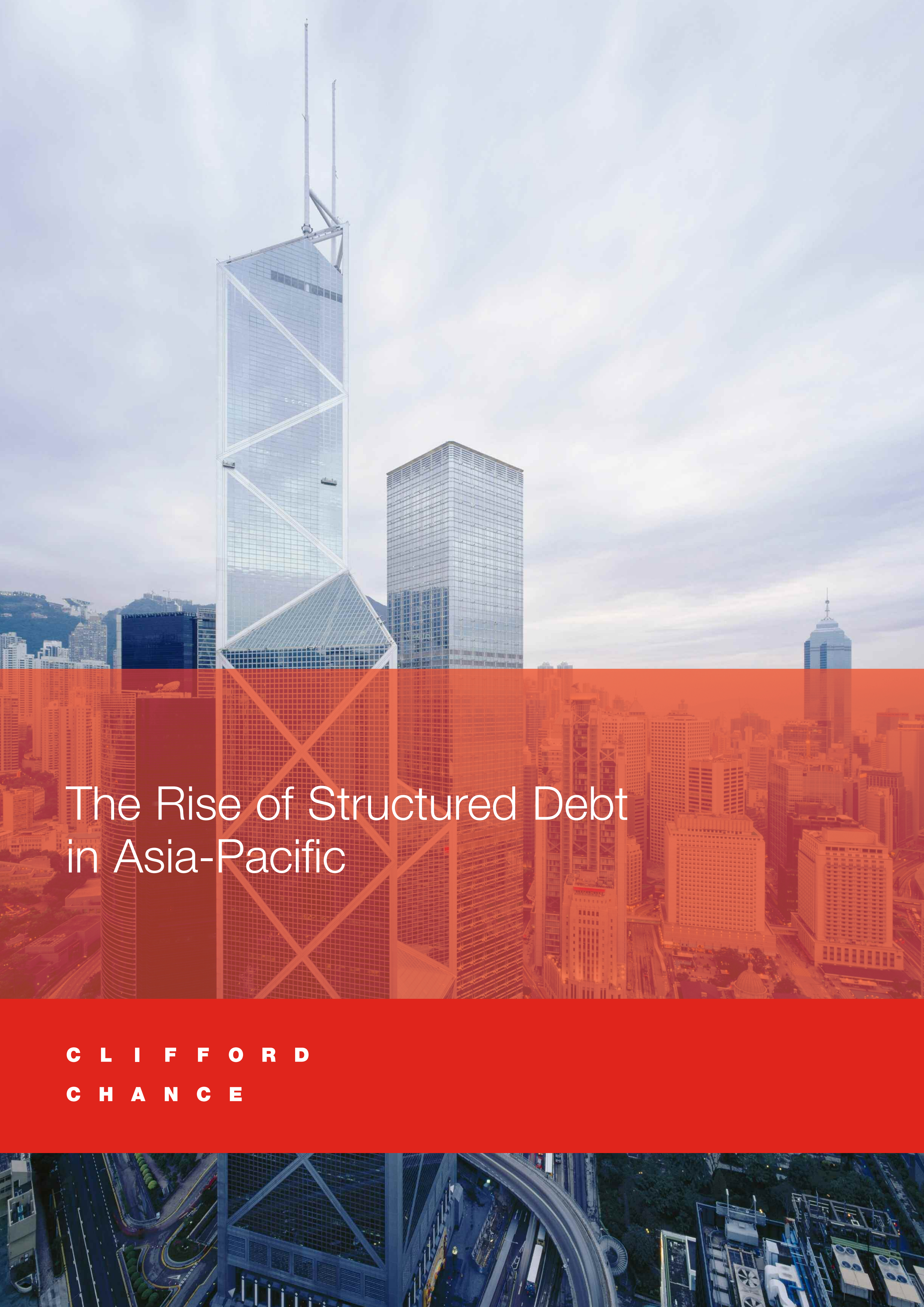

The Rise of Structured Debt in Asia-Pacific

CLIFFORD CHANCE

Introduction

The economies of the countries in Asia-Pacific are often in the news. Some stories are good – you might hear of massive growth – while others are bad; you might hear of drastic stock market plunges. But one thing that is clear is that they are dynamic and do not stand still. Banks, investors and corporates in the region are constantly developing the way they run their businesses. They look both externally – for instance, investing in Africa and South America – and internally; for instance, investing in local infrastructure to boost their trading links and feed internal demand for energy and raw materials.

An important part of any economy, however structured, is ensuring there is a robust and stable supply of credit available for companies that need it. Banks have traditionally dominated this space in the region but there has been a recent emphasis on developing other lines of credit delivery, in particular through the capital markets. Alongside that, banks and corporates with large pools of financial assets (such as auto loans in the case of banks or trade receivables in the case of corporates) are keen to access funding backed by their financial assets in those capital markets.

Legal and regulatory regimes have been adopted in some countries which assist with this and which take a sensible approach to helping these asset classes and investment products become more prevalent and transparent. In this work we look at some of these – amongst a range of topics we touch on new products in Australia, regulation in China, covered bonds in Singapore and considerations for Asia-Pacific banks and corporates who wish to issue in the U.S.

We look at the state of play and consider whether existing rules and practices can be optimised or whether alternative approaches might be favoured. Needless to say, in a region as dynamic as Asia-Pacific, laws and regulations must be flexible so they protect the overall economic stability of the region while allowing sufficient room for functional and beneficial financing transactions to help continue to fuel its continued growth and development.

We hope you find this publication useful and thought-provoking. Should you have any questions, comments or observations please get in touch with your usual Structured Debt contacts at Clifford Chance or one of the Structured Debt partners listed on pages 47 and 48.

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1. Uncovering the first Asian covered bond

In August 2015, DBS became the first bank to issue a covered bond under Singapore's Covered Bond Act following the introduction of covered bond legislation by the Monetary Authority of Singapore (MAS) in 2013.

The length of time it took for a Singaporean covered bond to come to market can in part be explained by the challenges faced by the counterparties and their respective counsel in formulating a structure that could cater for the intricacies of the Singaporean mortgage market as well as the array of regulatory matters currently faced by issuers of structured products, particularly those wishing to access the US market.

What has resulted is a structure comparable to that used in UK and Australian covered bond programmes, though with a unique 'dual-sale' structure. This had to be put in place due to specific practices used in the Singaporean mortgage market, pursuant to which borrowers are permitted by the Singapore Central Provident Fund Board (the CPF Board) to use a portion of the money they have paid in to the Singapore Central Provident Fund (the CPF) to buy residential property or repay a housing loan.

A dual sale structure

The covered bonds issued by DBS are irrevocably and unconditionally guaranteed as to payments of interest and principal by Bayfront Covered Bonds Pte. Ltd. (a special purpose vehicle established), specifically for use in the transaction with the obligation of Bayfront as the covered bond guarantor to make payments of guaranteed amounts under the covered bonds being triggered by a default by DBS as issuer. The guarantee by Bayfront is secured by a charge over the assets of Bayfront and two differing mechanics are used to transfer the mortgage loan assets from DBS to Bayfront.

The structure differentiates between CPF loans (where the approval of the CPF Board for the use of pension funds by a borrower for the financing of the purchase of a property and/or the repayment of such financing has been obtained or the borrower has indicated an intention to use such funds in this manner) and non-CPF loans (where such pension funds are not so used).

In the case of non-CPF loans, these are segregated from the rest of the assets of DBS through the sale by way of an equitable assignment to Bayfront, much like the transfer mechanism used in UK and Australian structures. Bayfront receives the consideration to purchase the mortgage loans that will comprise the cover pool from the proceeds of the intercompany loan granted to it by DBS.

Under the current Singapore legislation, for a residential property bought on or after 1 September 2002, when the property is sold, the proceeds are to be applied to repay the mortgagee and the CPF Board in a fixed order of priority under which the amount due to the mortgagee ranks in priority to payments to the CPF Board. The withdrawal by a borrower of CPF monies is subject to certain terms and conditions of the CPF Board and these include that the mortgagee must not effect a transfer or assignment of the mortgage without the prior written consent of the CPF Board. Any breach of these conditions may affect the order of priority described

"To overcome this obstacle, the structuring teams looked for inspiration from "originator trust structures" used in UK securitisations, usually in a scenario where terms of the mortgage loans prevent assignment."

above and as a result the assignment route used for the non-CPF loans was not available to achieve the transfer of the CPF loans to Bayfront.

To overcome this obstacle, the structuring teams looked for inspiration from "originator trust structures" used in UK securitisations, usually in a scenario where terms of the mortgage loans prevent assignment. In an originator trust securitisation, the originator sets up a trust of specified assets in favour of the issuer special purpose vehicle as the beneficiary. The issuer obtains the beneficial interest in the assets and in all rights arising from the assets, without transferring the legal ownership of the assets.

In the DBS structure, the CPF loans are segregated from the rest of the assets of DBS by DBS (in its capacity as asset trustee) declaring a trust over such mortgage loans for the benefit of the covered bond guarantor, pursuant to which the CPF Loans, and all such right, benefit and interest in and to any monies currently owed or to be owed in the future by a borrower will be for the benefit of the special purpose vehicle. Legal title to such CPF loans is retained by DBS.

The beneficial interest of the covered bond guarantor is an absolute undivided interest in the assets of the trust. The covered bond guarantor will use part of the initial advance received under an intercompany loan with DBS to pay to DBS (in its capacity as seller) an amount in respect of consideration for acquiring an interest in the CPF loans contributed by DBS to the trust. Likewise, the covered bond guarantor will use additional advances received under the intercompany loan to make additional contributions into the trust in order to acquire new CPF loans from DBS.

Summary of MAS requirements

The issuance of covered bonds is subject to requirements prescribed by the MAS, as set out in MAS Notice 648, which was issued on 31 December 2013 and revised on 4 June 2015.

In particular, MAS Notice 648 includes requirements:

(i) that the aggregate value of assets in cover pools for all covered bonds issued by a bank (or a special purpose vehicle (an "**SPV**") on behalf of that bank) and assets transferred to the SPV that are capable of being included in the cover pool but do not in fact form part of the cover pool shall not exceed 4% of the value of the total assets (subject to certain deductions) of that bank at all times;

(ii) that the cover pool asset class may only include (a) residential mortgage loans, (b) any other loans secured by the same residential property as the residential mortgage loans, (c) assets, including intangible properties that form part of all the security provided for the residential mortgage loans (such as guarantees and indemnities), (d) any interest held by the bank as trustee or replacement trustee for the SPV in relation to the residential mortgage loans or the assets referred to in (ii)(b) to (ii)(c), (e) derivatives held for the purpose of hedging risks arising from the particular issuance of covered bonds, (f) cash (including foreign currency), (g) Singapore Government Securities and (h) MAS Bills;

(iii) on minimum overcollateralisation the aggregate value of assets in a cover pool must be at least 103% of the outstanding nominal amount of the covered bonds secured by the assets at all times, subject to certain haircuts on valuation of residential mortgage loans included in the cover pool when calculating such overcollateralisation;

(iv) on the bank to conduct valuations on the residential properties used to secure the loans, on an annualised basis at the minimum; and

(v) on the bank to put in place adequate risk management processes and internal controls to manage the risks arising from the issuance of covered bonds. This includes performing regular asset coverage tests to ensure collateral quality and the proper level of overcollateralisation, appointing a cover pool monitor (being a qualified external auditor) for the programme to, among other things, verify annually that the bank or the SPV has complied with the requirements on the composition of the assets in the cover pool, obtaining a legal opinion that the assets in the cover pool are insolvency remote and when transferring the legal right to, or perfecting the assignment of assets comprising the cover pool, disclosing the consequences of such transfer or assignment to each borrower whose residential mortgage loan or asset is transferred.

A covered bond first

The DBS transaction is the first time the originator trust mechanic described above has been used in a covered bond transaction and a further test for the structure was whether appropriate mechanics could be incorporated in the structure to permit the transfer of legal title of the CPF loans in a DBS default scenario (such as insolvency). In particular, could the structure accommodate a sale of the cover pool to another Singaporean bank or entity should the cover pool ever be required to be liquidated in order to meet the claims of bondholders?

On the occurrence of such a DBS default, which would trigger notification of sale to borrowers in respect of non-CPF loans (and lead to the transfer of legal title in such mortgage loans to the covered bond guarantor from DBS) the covered bond guarantor and DBS are required to use reasonable endeavours to obtain the required regulatory approvals in order that the CPF loans can be transferred to a new trustee without breaching the terms of the CPF loans.

Noting this restriction on transfer, the fact that the required regulatory approvals may not be obtained, the restricted nature of banks or other entities in Singapore that could act as trustee and also taking into account the lack of a developed market in the sale of mortgage portfolios in Singapore, the structure also includes an alternative disposal mechanic should the covered bond guarantor and/or DBS fail to obtain any one of the required transfer approvals. Specifically, to provide a purchaser with the economic benefit of the CPF loans in the cover pool, the covered bond guarantor is permitted to assign absolutely its beneficial interest in all or any selected CPF loans to a purchaser. Each such assignee shall have all rights and remedies in relation to such selected CPF loans.

Other international influences

The structure incorporates an Asset Coverage Test, which is broadly comparable with that used in respect of UK and Australian programmes. As seen in Australian covered bond deals, collateralisation over and above that required to meet the Asset Coverage Test is provided by way of a separate Demand Loan provided by DBS. In order to ensure flexibility in the amount of such overcollateralisation, repayment of the Demand Loan is provided for in priority to amounts owed by the covered bond guarantor to the other secured creditors (including the bondholders); however, in order to protect bondholders the repayment of such Demand Loan, following the covered bond guarantor being called on to make payments on the bonds pursuant to the covered bond guarantee, can only be made by payment in kind, i.e. by the return of mortgage loans to DBS rather than a cash payment.

As the DBS programme is structured to permit issuances into the United States, further analysis had to be done in respect of certain US aspects. In particular, the originator trust mechanic had to be carefully formulated to ensure that the transaction continued to benefit from exception from the definition of 'investment company' under the US Investment Company Act and the extra compliance hurdles that this entails. As the US regulatory regime continues to evolve in respect of structured products, compliance matters (including with the Dodd-Frank Act) will remain on the radar for all structured transactions such as covered bond transactions wishing to issue into the U.S.

Conclusions

Though the first Singaporean covered bond transaction took longer than expected to come to market, a robust structure has been established to meet the unique challenges raised by the CPF's involvement in the Singaporean mortgage market. With the first transaction completed, the covered bonds market is expected to grow rapidly in the region with other issuers expected to follow the same structure.

As further support for the Singaporean market, DBS was also granted the ECBC Covered Bond Label on 29 June 2015. This was the first such quality label granted by The Covered Bond Label Foundation to an issuer outside the European Economic Area. It is also hoped that in time, an agreement can be reached with the CPF such that CPF loans can be assigned to the covered bond guarantor without breaching key terms and potentially impacting priority.

2. Prudential reform and the future of master trusts in Australia

On 11 November 2013, Charles Littrell, Executive General Manager of the Australian Prudential Regulation Authority ("**APRA**") spoke to the Australian Securitisation Forum ("**ASF**") Conference in Sydney about prudential reform in securitisation (the "**Conference**"). The statements which seemed to garner the most discussion in subsequent panels and on the Conference floor concerned APRA's general support for the establishment of master trusts in Australia. Since the Conference, APRA has released a Discussion Paper (*Simplifying the prudential approach to securitisation*, 29 April 2014) (the "**Discussion Paper**") which received widespread and thorough (from certain representatives of the industry) responses. Looking ahead, the end of this year is being tipped for the release of the draft of the revised Australian Prudential Standard 120 (Securitisation) ("**APS 120**").

The revised APS 120 is expected to elucidate how master trusts will operate in practice in Australia. As underscored at the Conference, master trusts "possess a near-mythical attraction" for some in the market and their implementation in Australia is hotly anticipated by many in the industry. Accordingly, we have sought to provide some guidance as to what is expected from the revised APS 120 in the master trust context.

Background

Master trust platforms are designed to facilitate securitisation funding via the issuance of multiple series of securities typically by the same issuing entity, backed by a single, dynamic collateral pool (i.e. a revolving pool of receivables that over time may include additional receivables acquired through reinvestment of principal receipts in respect of existing receivables, an increased seller share[1] and/or additional market financing[2]).

Appetite to put master trust platforms in place in Australia is tied very closely to perceived foreign investor interest, particularly in the residential mortgage-backed security ("**RMBS**") space where master trust issuance in key European markets has been less prevalent recently due to central bank lending schemes with competitive funding rates. Master trusts will also provide the opportunity for a segment of investor base that has not been able to participate in the market to date to participate (such as investors not permitted to invest in pass-through securities or otherwise sensitive to extension risk, particularly in offshore markets) and allow for the tailoring of liabilities to suit specific investor tastes as and when needed. Master trusts are also predicted to help reduce hedging costs when issuing foreign currency RMBS by way of limiting extension and prepayment risks[3] which is expected by some in the industry to serve as the primary catalyst for master trust issuance out of Australia along with the creation of further funding diversity.

APRA's comments on master trusts

APRA's comments at the Conference confirmed that it will permit master trusts in Australia but not if they are *de facto* covered bonds – with the core issue being that the seller's share in a master trust cannot become the equivalent of excess collateral in a covered bond

[1] The seller share is a 'non-sold' asset of the originator and funds the portion of the receivables not funded by the 'funding share'. In practice, the seller share typically partially funds the acquisition of receivables by the issuing entity and funds ongoing receivables purchases between issuances, including for the purposes of maintaining a 'minimum seller share'.
[2] Typically known as the 'revolving phase'. Should the revolving phase end then a master trust will enter the amortisation phase.
[3] Depending on the final bullet structure available with the lack of support on APRA's part for a 'hard' bullet option being a concern.

vehicle. In reality this will mean that the seller share must rank at least equal to the most senior instruments in the structure[4].

Both Mr Littrell's speech at the Conference and APRA's follow-up Discussion Paper focused on repayment mechanisms with APRA noting that a key benefit of master trusts is the ability to make bullet repayments; favoured by investors as they help to reduce extension risk. The key question is how to fund these 'bullets'[5].

According to APRA, master trusts are 'generally designed to be called on the maturity date of a bullet and are priced on the expectation that the originator will exercise the option to make the call' which helps create an expectation of payout in the mind of the investor and if such payout is not received that recourse will be available to the asset pool. Accordingly, APRA intends to permit soft bullet arrangements in such context but has raised particular concern around ensuring that such arrangements are not so firm that the originator is "on the hook for repayment", if the asset pool is insufficient to the task. In essence, this pushes the extension risk from the originator (issuer) to the investor.

The market has interpreted such comments to mean that, in effect, there will be no hard bullet option, much to the dismay of some commentators in the industry. Originators whose preference is for a hard bullet given the savings and simplicity it produces in respect of hedging will be forced down the amortisation path which will likely erode much of the cost-saving that could be obtained via a hard bullet component within a master trust structure.

While the above explicit comments have certainly led to some discussion, the impact of broader changes to the prudential regulation in the securitisation landscape are also worthy of note.

Prudential reform in securitisation and the likely impact on master trusts as implemented in Australia

Seller share

APRA announced at the Conference, with further support found in the Discussion Paper, that for funding-only securitisations a two-class structure will be mandated with the A class (*pari passu* in credit terms and as a practical matter likely to be all AAA-rated) able to contain a number of tranches including bullets and pass-throughs while the B class will comprise a single instrument, in which the entirety of the credit risk associated with the underlying assets will be concentrated. The B class will be held in its entirety by the originator.

The 'seller share' represents the excess assets where the securitisation vehicle holds more assets than are needed to back the securities sold to third-party investors. APRA noted in its Discussion Paper that the operation of the 'seller share' will not attract an additional capital charge or deduction from Common Equity Tier 1 Capital provided it is not structurally subordinated in any way to the most senior class in the structure meaning that the 'seller share' and the most senior class would amortise at the same rate so both shares would reach zero at the same time. When this two-class structure is considered in the context of the specific requirement for the seller share to rank at least equal to the most senior instruments in the structure it removes the ability of the payment to the originator of the seller share to be time subordinated upon originator insolvency (which is different to the position in the United Kingdom for example where time subordination is possible).

Questions surround precisely how the seller share will be implemented and whether it will allow for sufficient cash to be accumulated to repay bullets at future points. One moderator noted during the Conference that the seller share at present appears to exist as a kind of class A which seems inconsistent with the way industry thinks it should operate which is probably a vertical slice (although one possible solution proposed would be to collapse both the funding share and seller share). It is uncertain at this stage whether this is just a question of semantics in respect of APRA's comments or whether this will be a pitfall when it comes to actually structuring master trusts in Australia.

Date-based calls

APRA intends to remove the current 20 per cent. holding limit on instruments and instead allow a date-based clean-up

> "APRA noted in its Discussion Paper that the operation of the 'seller share' will not attract an additional capital charge or deduction from Common Equity Tier 1 Capital provided it is not structurally subordinated."

[4] Notes issued under a master trust would thus be non-recourse to the originator (with legal opinions to this effect). No rights would be given to investors in the event of originator insolvency allowing investors to force the liquidation of assets. All support requirements of the master trust would also be at the option of the originator.

[5] In this context repayments are typically classified as either hard or soft bullets. Adopting APRA's explanation at page 19 of its Discussion Paper, a soft bullet, involves an option but not an obligation on the paper of the issuer to repay a given debt tranche or class on a given date. Hard bullets lock in the repayment date.

call in respect of funding-only securitisations. Under a date-based call, an originator has an option, but not an obligation, to repurchase exposures from a special purpose vehicle on a specified date, which is determined at the beginning of the securitisation.

A key take away from the Conference was that APRA does not propose to allow other date-based calls, on the basis that such an option to the originator could too easily become a *de facto* obligation on the originator. Accordingly, such a restriction has been interpreted to mean that date-based calls on individual tranches will not be permissible (again, different to the situation under mortgage master trusts in the United Kingdom).

The implementation of a date-based clean-up call appeared to be received positively by those at the Conference although its precise nature will need to be settled and provided to industry before final judgment can be made. One expert speaking on 'The Case for Master Trusts' panel (the "**Panel**") noted that the implementation of a date-based clean-up call into the master trust structure, particularly in the context of RMBS achieves a balancing of both investor and issuer interests and is fundamental in order to allow residential mortgages to be securitised effectively in master trust structures. Concerns have already been flagged by the ASF in its response to APRA's intention revealed in its Discussion Paper to 'set at inception of a securitisation a date no earlier than the projected 10 per cent. clean-up point' for date-based calls. The ASF has asserted that this will reduce significantly the potential value the date-based call mechanic will provide.

Asset triggers

Asset triggers are another feature of master trusts and are noted by APRA as having the purpose of accelerating the unwinding of a securitisation by amortising the investors' interest prior to the originally anticipated amortisation date. Early amortisation triggers are designed to stop the revolving phase of a master trust and force it into its amortisation phase after which no new assets can be sold into the structure.

One of the suggested benefits of such triggers, as noted by APRA in its Discussion Paper, is the potential to reduce investors' exposure early, which may help to shift losses to the originator that would have fallen on investors had the revolving phase continued to the date originally scheduled for entering the amortisation phase. Based on commentary from the Basel Committee, noting that such early amortisation provisions typically result in limited transfer of risk to investors in practice, APRA does not propose to allow early amortisation triggers, whether associated with asset or non-asset triggers, as such triggers could in their view also create a surrogate covered bond.

Such thinking has met with criticism from the Australian Bankers' Association Inc. ("**ABI**") who have noted in their response to APRA's Discussion Paper that 'early amortisation triggers are critical in protecting an authorised deposit-taking institution ("**ADI**") from having to continue to replenish a master trust with new assets', particularly in times of stress in addition to preventing any cascading effect on performing loans. ABI disputed the comparison to covered bonds as investors still have no recourse to the sponsoring ADI in such stressed master trust situations. By example, ABI noted the failing of Northern Rock, whereby, despite such failure, its Granite Master Trust Program was able to be amortised and 'entirely exercised' from the bank resolution process, unlike what took place with its covered bond programme.

Simplicity

A key theme of APRA's presentation at the Conference was the need for simplification and prevention of unnecessarily complex structures going forward. APRA's goal of forcing simplification in securitisation structures will have a follow on effect on the eventual form and operating function of master trusts in Australia. In particular, as postulated by one industry expert while speaking on the Panel, any proposed structure is likely to be vanilla with only a few 'bells and whistles' to draw in target investors. Any master trust that pushes the envelope even remotely may raise the ire of APRA.

Simplicity in the master trust context is unlikely to be controversial, however. The Panel's discussions in particular reflected the point that foreign investors will be most interested in structures that they understand and are familiar with (with the United Kingdom form of master trust serving as the global benchmark). Given that familiarity is likely to be a big selling point, prudence dictates that originators seek to implement simpler master trust structures appropriated from the rest of the world, and adapted as necessary to comply with specific Australian regulatory/prudential requirements.

The question which remains outstanding however is the extent to which APRA's prudential reform of securitisation will allow for such mirroring/adoption of overseas master trust platforms even in their simplest form – as noted by the Panel, the devil will be in the detail. It already appears that certain elements such as time subordination of the seller share and date-based calls on individual tranches while permissible under mortgage master trusts in the United Kingdom will not be available in Australia, in addition to the prohibition on the use of 'hard' bullets as discussed earlier. Time will tell what precisely is permitted and therefore what can be appropriated from overseas platforms but the general consensus amongst those within the industry appears to be that APRA's concerns are duly noted and that the envelope is unlikely to be pushed very far, if at all, when master trusts are finally established in Australia (if only for selfish reasons on the part of originators to provide investors with familiarity and ensure ease of investment).

Looking ahead

Overall, APRA's position in respect of master trusts in Australia is a continued step in the right direction but, as noted by a number of panelists throughout the Conference, there are widespread industry concerns over when master trusts in Australia will actually see the light of day, concerns which are still playing out in 2015. Recent announcements have however renewed optimism of a 2015 resolution by way of the expected publication of a revised APS 120 conducive to the operation of master trusts in Australia.

3. Shadow banking and recent regulatory developments in China

Following the 2008 financial crisis, regulators around the world have been looking closely at the regulation of shadow banking activities in order to ensure that systemic stability is maintained. As a significant emerging economy, Chinese regulators are also tackling risks arising from shadow banking activities that have developed unique characteristics within China's controlled lending environment. This briefing examines the driver of shadow banking and regulatory trends in China, and introduces the most notable developments in the relevant non-banking sectors such as trust companies, money market funds (MMFs), "internet finance", securitisation, as well as the implications that shadow lending may have on China's stock market.

What is shadow banking?

"Shadow banking" is an imprecise term. It generally refers to the system of financial intermediation which creates credit across institutions or a financial market outside, or in ways only loosely linked to, the traditional banking system. The Financial Stability Board (FSB) has defined it as "the system of credit intermediation that involves entities and activities (fully or partially) outside the regular banking system", or non-bank credit intermediation for short. The FSB then identified five areas where oversight and regulation need to be strengthened, namely mitigating risks in banks' interactions with shadow banking entities, reducing the susceptibility of MMFs to "runs", improving transparency and aligning incentives in securitisation, dampening pro-cyclicality and other financial stability risks in securities financing transactions such as repos and securities lending, and assessing and mitigating financial stability risks posed by other shadow banking entities and activities (other than MMFs). The term is not, therefore, intended to designate a group of identifiable entities, but rather to identify a group of activities or techniques as a precursor to potentially regulating the entities which engage in those activities or techniques.

Features of Intermediaries

A financial intermediary that engages in shadow banking activities usually possesses one or two of the three key features of a traditional banking institution. The three key features are: (i) the ability to process payments; (ii) the capacity to handle liquidity mismatch such as borrowing short term and lending long term; and (iii) the capability to make credit investments so as to gain profits from the interest rate spread between borrowing and lending. Aside from these features, shadow banking activities or techniques (i.e. maturity/liquidity transformation and credit mismatch) and shadow banks in China also have some unique characteristics of their own.

Driver for China's shadow banking

For a long time the growth of shadow banking in China has been very much attributed to the controlled interest rate market and lending environment which exist in China.

- Although Chinese policy makers have announced their intention to further remove restrictions on interest rate levels, the RMB interest rate market in China is still not fully liberalised. Benchmark interest rates are one of the monetary policy tools deployed by the People's Bank of China (PBoC) in order to monitor the interest rate levels for both lending and deposits. PBoC has full discretion to adjust the benchmark interest rates so as to implement its changing monetary policies. Historically, PBoC has strictly restricted the lower limit for bank loan interest rates and the upper limit of bank deposit interest rates to a specific proportion of applicable benchmark interest rates. Such tight controls have inevitably restrained the competitive edge of traditional banking business in terms of extending loans and absorbing deposits, and thus ignited the demand for shadow banking business.
- In addition, as Chinese regulators have used deposit-to-loan ratios and sometimes give guidance (which is usually understood as mandatory) to banks as to how much they may lend, and other policy instruments such as open market operations (e.g. repos, central bank note issuance and short- or mid-term liquidity operations) to control the amount of credit injected by banks into the Chinese economy, Chinese banks tend to lend more money to State-owned enterprises and projects

endorsed by the government than to the private sector. Lending between corporate entities is required under the PRC lending regulations to be intermediated through a bank, which is referred to as "entrustment loans", and Chinese regulators now intend to further enhance the regulation in this aspect, clarify the restrictions on entrustment loans and impose corresponding duties on the banks to monitor the use of the entrustment loans. This has led to a strong demand from the private sector for credit provided by non-bank entities. Alternative credit channels have therefore been created to support borrowers that are not favoured by traditional commercial banks.

Against the above background, shadow banking has evolved in China as a parallel credit intermediation system outside the traditional banking system.

However, most recently, great progress has been made in the following regards:

- As phase-in efforts of PBoC to liberalise the interest rate market, since late 2013 PBoC has successively lifted restrictions on interest rates for bank loans (except for loans to individuals for residential real property), launched a deposit insurance scheme and removed the upper limit on term deposit rates for maturities of over a year (exclusive). As a result, only the interest rates for demand deposits and term deposits for maturities of less than a year (inclusive) are subject to a cap of 150% of the corresponding PBoC benchmark rates as last adjusted on 25 August 2015.
- To accord with the Basel III requirements, Chinese policy makers eventually decided to remove the deposit-to-loan ratios as of 1 October 2015 and adopt Basel III-compliant liquidity risk monitoring tools instead.

"Shadow banking has evolved in China as a parallel credit intermediation system outside the traditional banking system."

Less restricted interest rates and the removal of deposit-to-loan ratios are anticipated to have an effect of easing pressures of traditional banking business and constraining wild expansion of shadow banking. However, due to the existence of other regulatory restrictions in bank capital and lending, shadow banking sector may still have an advantage in its flexible and diversified operating models (with less regulatory burden) and thus have great potential to grow.

Concerns raised by shadow banking in China

Generally speaking, concerns raised by shadow banking in China are less complex than those in developed countries. The primary reason for this is that complex structures created by sophisticated financial engineering techniques are still uncommon in China. Furthermore, as Chinese banks have long dominated the credit intermediation market in China, there is a strong connection between shadow banks and the traditional commercial banks. For instance, shadow banks often leverage the client base of commercial banks, sourcing funds and support from commercial banks; in some cases, shadow bank platforms may even be established or invested in by commercial banks. To prevent any spillover as a result of this close connection, PBoC, the China Banking Regulatory Commission (CBRC), the China Insurance Regulatory Commission, the China Securities Regulatory Commission (CSRC) and the State Administration of Foreign Exchange jointly issued the *Circular on Regulating Inter-bank Business of Financial Institutions* on 24 April 2014 to lay down prudential measures regarding investment and financing activities between financial institutions. The CBRC further issued the *Circular on Regulating the Governance of Inter-bank Business of Commercial Banks* on 8 May 2014, which imposes even greater requirements on commercial banks in relation to the conduct of their inter-bank businesses, such as requiring separate departments to engage in inter-bank businesses, maintain a list of eligible counterparties and set up credit limits for each counterparty.

The Regulation of shadow banking in China

Circular 107

In spite of the market discussion on shadow banking, the State Council of the PRC has only recently begun to devise a regulatory framework specifically for shadow banking in China.

At the end of 2013, the General Office of the State Council issued an internal document known as the *Circular Relating to the Issues on Shadow Banking Regulation* (Circular 107). Subsequently, Circular 107 became public (albeit only informally) in early 2014.

Although Circular 107 does not clearly define "shadow banking" or what a "shadow bank" is, it identifies the following three types of shadow banking entities in China:

- credit institutions that do not hold any financial licence and are not subject to any regulation (*e.g.* new Internet-based financial companies and third-party wealth management institutions);
- credit institutions that do not hold any financial licence and are not sufficiently regulated (*e.g.* financial guarantee companies and micro-credit companies); and
- licensed financial institutions which carry out certain businesses that are not subject to any proper regulation or which circumvent the relevant regulations (*e.g.* money market funds (MMFs), securitisation and certain wealth management services).

While Circular 107 recognises the function of shadow banking as a helpful supplement to the traditional banking sector, it also warns of the systemic risks associated with shadow banking.

Bank-trust cooperation arrangement

There are several aspects of shadow banking that involve risks, among which the "bank-trust cooperation" arrangement has probably attracted the greatest amount of attention and therefore is now most closely regulated.

Under the "bank-trust cooperation" model, a bank launches a wealth management product to raise money from end investors, and uses the proceeds of such product to invest in a trust scheme launched by a trust company. Although banks are subject to restrictions on credit extension as discussed above, they have, by investing in the trust schemes of trust companies, been effectively able to get around various investment rules in terms of utilising wealth management funds or other assets as well as capital restraints. Trust companies offer the advantage of having a generally wider investment scope whilst being subject to lower capital requirements than banks. Furthermore, credit financing under a bank-trust cooperation arrangement will not be counted towards bank credit lines. This advantage has provided good potential for the bank-trust cooperation arrangement to develop in China, which has facilitated credit creation and expansion outside the normal banking system.

Accordingly, the CBRC has been gradually strengthening the monitoring and regulation of bank-trust cooperation arrangements. Concrete measures that have been implemented by the CBRC include:

- prohibiting banks from providing guarantees or repurchase undertakings for the assets underlying the trust schemes;
- imposing capital requirements on trust companies to ensure that their capital is compatible with the assets held under their trust schemes;
- imposing a 30% cap on trust companies allocating assets under a bank-trust cooperation arrangement to credit assets (for example loans and bonds); and
- requiring that all assets held by a bank through a bank-trust cooperation arrangement be reflected in the bank's balance sheet and therefore subject to capital adequacy and other applicable requirements.

The rise of money market funds

During the winter of 2013, MMFs became a hot topic for retail investors in China. One of the MMFs in the spotlight was Yu'E Bao. Legally speaking, Yu'E Bao is a MMF launched and distributed by Tian Hong Asset Management Co., Ltd. (Tian Hong), which itself is a fund management company licensed by the CSRC. Tian Hong engages Alipay (the payment services arm of China's e-commerce company, Alibaba) as its payment service provider in connection with fund sales and redemptions. Alipay includes the Yu'E Bao MMF within its payment service portal and enables its users to subscribe for Yu'E Bao by using their spare cash in Alipay accounts, by virtue of which Yu'E Bao is able to leverage Alipay's vast client base. As of 30 September 2014, the assets under management of Yu'E Bao reached RMB535 billion (approximately USD87 billion) after only 16 months following its establishment.

As discussed, given the close connection between China's banking and non-banking credit sector, it is not surprising that nearly 90% of Yu'E Bao's portfolio consists of bank deposits and cash deposited with depositary and clearing agencies for settling and clearing money market instruments. While limiting their participation in securitisation deals and other money market instruments, many other MMFs also invest the majority of their portfolios with banks as deposits so as to earn more interest. This is because MMFs' deposits are not subject to the interest rate cap as discussed above and banks may therefore offer MMFs a relatively higher interest rate, in particular at times when the inter-bank market is short of liquidity. In fact, some investors are withdrawing their deposits from banks to subscribe for MMFs in order to obtain a higher return.

In China, MMFs typically have a constant net asset value (NAV) (i.e. the NAV per unit remains a constant at RMB1 and the profits generated each day being distributed as new fund units). As discussed above, currently MMFs mainly allocate their portfolios with banks as deposits, while funds in the form of other money market investment (rather than deposits) are maintained in the same pool. As Yu'E Bao and many MMFs offer T+0 redemption for any amount not exceeding a specific threshold, there is a liquidity risk that an MMF's constant NAV may not reflect the real value of the MMF (in particular where there is significant redemption request which requires the MMF to realise its investments on an expedited basis to meet the cash payout requirement, which may therefore instigate runs considering MMF investors' low tolerance in absorbing losses). Therefore, systemic risk is increased due to MMFs' higher susceptibility to "runs" given that investors treat them as deposits (resulting from constant NAV and T+0 redemption features) and there is a significant retail investor base.

While foreign regulators are considering the need for floating NAV in order to ensure that the asset value of a MMF is reflected accurately, or the imposition of mandatory buffers for potential runs, Chinese regulators are still assessing the risks involved with the rapid growth of MMFs and have yet to take any concrete measures to address the susceptibility of MMFs to "runs". So far it is only reported that the *Interim Measures on the Regulation of Money Market Funds* might be amended to address the systemic risks associated with MMFs.

The PRC State Council has long proclaimed an intention to develop a "multi-layered capital market" which is yet to unfold through any detailed proposals. We believe that the shadow banking function of MMFs will further develop in China and become more complex as they participate in securitisations and other structured products. It is very likely that Chinese regulators will implement more prudential measures to regulate the activities of MMFs, so as to ensure that the rapid growth of MMFs is properly monitored.

"Internet finance"

Regulatory Framework

"Internet finance" has emerged as another recent phenomenon in China's financial market. It commonly refers to any financial or quasi-financial activities involving the use of the internet. Among various innovations of "internet finance", peer-to-peer online lending platforms (P2P Platforms) seem to underlie the greatest shadow banking concern.

On 18 July 2015, PBoC, together with nine other competent regulators, released a long-awaited document "Guiding Opinions on Promoting the Healthy Development of Internet Finance" (Guiding Opinions), laying down the regulatory framework for broad internet finance sector. In the Guiding Opinions, "internet finance" is defined as "traditional financial institutions and Internet companies that use Internet technology for: payments, internet lending (including P2P Platforms), public equity financing, internet fund markets, internet insurance, internet trust and consumer finance".

As general principles, the regulators encourage internet finance operators to service the real economy and vitalise the "multi-layer" financial market, in a bid to satisfying the financing need of SMEs and middle-class individuals. The regulators also support various financial institutions to cooperate with Internet companies and construct a well-rounded internet finance platform to fend off risks.

The Guiding Opinions assign jurisdictions for each segment of the internet finance business to the appropriate regulators. In particular, CBRC is authorised to regulate P2P Platforms and other internet lending business. This is anticipated to start a new era where P2P Platforms cannot run wild easily by warding off regulatory oversight.

Red Lines for P2P Platforms

Before the promulgation of the Guiding Opinions, P2P Platforms in China had operated in an unregulated manner. There are several P2P Platform operating models, including:

- a platform for simply matching lending and borrowing information (Model 1);
- a platform with guarantee or other credit support facilities from the P2P Platform operator or its affiliates (Model 2);
- a repackaging and sale of credit assets through securitisation and other financial engineering techniques (whereby a P2P Platform issues "wealth management products" to raise money for purchasing the credit assets of the P2P Platform's affiliates such as micro-credit loans, with the relevant "wealth management products" being issued as standalone products or on a rolling basis for an asset pool) (Model 3); and
- a transfer of credit assets created by a P2P Platform operator or its affiliates to end investors (whereby the P2P Platform or its affiliates extend certain loans to borrowers first and then sell these loans through the P2P Platform to end investors) (Model 4).

"The shadow banking function of MMFs will further develop in China and become more complex as they participate in securitisations and other structured products."

With the exception of Model 1, the other models raise concerns over shadow banking risks – Model 2 and Model 4 may facilitate credit creation by leveraging the creditworthiness of the P2P Platform and its affiliates, while Model 3 additionally involves liquidity mismatch if it uses "asset pool" techniques to fund long-term assets by taking in short-term investments from clients on a rolling basis. They may also face regulatory risks associated with unlicensed crowd funding and lending business.

Previously CBRC officials had, on various occasions, emphasised that P2P Platforms should only play a pure intermediary function and are not permitted to employ cash pooling or other financial engineering techniques involving credit mismatch, so as to ensure that P2P Platforms fall outside the scope of shadow banking. After the promulgation of the Guiding Opinions, the definition and legal nature of P2P Platforms are further clarified. Accordingly, P2P Platforms refer to direct borrowing and lending between individuals through Internet platforms. Direct borrowing and lending taking place on a P2P Platform shall be treated as "private loans", which are governed by the PRC Contract Law, the General Civil Law Provisions and other laws and regulations, as well as judicial guidelines of the Supreme People's Court. A P2P Platform shall confine its role as an "intermediary" and thus can only provide lending information services, such as information exchange, borrowing/lending match and credit assessment, through its platform. In any event, a P2P Platform shall not provide credit enhancement or engage in illegal fund raising.

CBRC is drafting detailed rules to regulate P2P Platforms and other internet lending business, which, as we understand, are still in the consultation stage. CBRC officials have stated openly that CBRC will stick to the principles underpinned in the Guiding Opinions and draw up "red lines" for P2P Platforms including among others:

- P2P Platforms cannot provide credit conversion, term conversion or liquidity conversion for any lending or cash pool;
- P2P Platforms should arrange for third-party custody and ring-fencing of client funds;
- P2P Platforms should be subject to a certain market access threshold, such as registered capital, qualified senior officers, corporate structure, IT facilities, risk control and cash management etc.; and
- there is a sufficient disclosure regime.

It is anticipated that these restraint measures (once they have come into effect) would suppress the business of P2P Platforms, especially those operating beyond the permitted "intermediary" role.

Securitisation

Before the global financial crisis, there were only a limited number of securitisation transactions in China, all mainly driven by policy considerations. Deals driven by commercial considerations have only started in recent years. Generally speaking, securitisation is less of a shadow banking issue in China. One reason for this is that although there is an overall trend towards deregulation, securitisation in China is still subject to stricter regulation than in most developed markets. The other reason is that the current structures used in securitisation deals in China are relatively straightforward.

The most significant component of China's securitisation market is the credit asset securitisation regime, under which banking and financial institutions approved by PBoC and the CBRC can legally securitise their credit assets (e.g. loans). Securities institutions regulated by the CSRC may also launch securitisation programmes under another regime called the "corporate asset special management regime," which involves broader underlying assets (which, apart from credit assets under the credit asset securitisation regime, may include commercial receivables, lease agreements, trust interests as well as infrastructure and other real properties) and invites more opportunities to be listed on the stock exchange. China's insurance regulator also launched a programme in 2013 which allows insurance asset managers to participate in securitisations.

As for non-financial institutions, they may issue asset-backed notes in the inter-bank market through a registration system administrated by the National Association of Financial Market Institutional Investors, which apparently may accept innovative structures similar to traditional securitisation deals. However, the current main methods of securitisation in China remain the credit asset securitisation regime and the corporate asset special management regime. The scale of securitisations in China is growing rapidly. For example, the total issuance size of the credit asset securitisation regime was about RMB10 billion (approximately USD1.78 billion) in 2013, while the issuance size as of April 2015 rocketed to nearly RMB450 billion (approximately USD70.7 billion).

We expect that China's securitisation market will continue to grow in terms of both issuance levels and transaction structures. With the introduction of more complex structures involving maturity/liquidity transformation and leverage, and thus resulting in higher risks, regulators will need to pay closer attention to the shadow banking issues in the context of securitisation, such as whether there is sufficient transparency and whether risk retention rules should be imposed.

Shadow Lending Tied to China's Stock Market

China's stock market crashed at the end of June 2015. By early July, around a thousand of the shares listed on PRC stock exchanges were suspended for trading and the A share index fell by a third in a few weeks, losing over RMB20 trillion (roughly USD3.5 trillion). In investigating the causes of the stock market turmoil, the regulators have among others noticed "leveraged bets" which are mainly sourced from the shadow banking sector.

Increasingly wary of lending to the real economy, shadow banking operators have been attracted to China's stock market, fuelling a surge in unregulated margin lending with a high leverage.
In a regulated margin lending framework, only eligible investors (e.g., with cash and stock worth RMB500,000 in account) can seek margin lending from securities companies to trade eligible stocks, and the leverage is no more than 3:1. However, in unregulated margin lending, there is no restriction on investors or stocks, and the leverage can reach 5:1 or even higher. This is deemed to have partially contributed to the market turbulence.

Now CSRC is working with other regulators to crack down on shadow lending to stock investors outside the regulated margin lending framework. This tight control is expected to continue with the goal of sustaining a stablised securities market in the long run. As a result, the shadow lending tied to China's stock market can be scaled down in the near future.

Conclusion

It is clear that Chinese regulators now have more insight into the shadow banking sector and are taking steps to regulate it, although it remains to be seen how the relevant regulatory policies will be adopted into concrete regulatory measures. We can certainly expect, as instructed by Circular 107 and the Guiding Opinions, as well as learned from the recent stock market crash, that the different PRC regulators will collaborate to introduce new rules to regulate businesses which have operated in a regulatory vacuum, such as the P2P Platforms and other shadow lending as a start. Understanding the current regulatory thinking around these matters is crucial when considering the launch of any innovative financial product that could be captured within the deliberately imprecise definition of "shadow banking".

4. Regulatory developments impacting cross border offers of ABS to US investors

In recent years, US regulators including the US Securities and Exchange Commission (the "**SEC**") have been developing and adopting regulations that implement reforms mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**"). Some of these reforms directly impact Asia-Pacific cross border offerings of asset-backed securities ("**ABS**") to US investors and apply to private placements of ABS to US institutional investors pursuant to Rule 144A as well as public offerings registered pursuant to the Securities Act of 1933, as amended (the "**Securities Act**"). For this reason issuers and arrangers of transactions in the Asia-Pacific region need to be aware of these regulations if they are contemplating issuances to US investors. The chart below provides a brief overview of these developments, which are each discussed in more detail below.

Rule	Summary	Application	Compliance Date
Regulation AB II	A series of amendments to the disclosure-based rules contained in Regulation AB, the most prominent of which is the addition to the disclosure requirements for SEC-registered ABS detailed asset-level data.	SEC-registered ABS	Nov. 23, 2015, except for the requirement to provide asset-level information, which will begin on Nov. 23, 2016
Risk Retention	Requires that the sponsor of an ABS transaction or one of its majority owned affiliates retain an interest in the transaction's overall credit risk.	Sponsors of public and private ABS	RMBS: Dec. 24, 2015 All other types of ABS: Dec. 24, 2016
Volcker Rule	Prohibits certain financial institutions from taking proprietary trading positions or having certain relationships with "covered funds."	"Banking entities", which means any entity within the same group as a bank that has a US branch or agency	Currently applicable
Rule 15Ga-1	Requires ABS issuers to disclose publicly underlying asset repurchase data for outstanding ABS.	All securitizers of public and private ABS and Nationally Recognized Statistical Rating Organizations ("**NRSROs**")	Currently applicable
Rule 17g-7	Requires rating agencies to include information about the representations, warranties and enforcement mechanisms available to investors in any report accompanying an ABS credit rating.	NRSROs in public and private ABS	Currently applicable
Rule 17g-5	Requires NRSRO that is hired to provide a credit rating for a structured finance product to obtain commitments from an issuer, sponsor or underwriter to maintain a password-protected website containing rating-related information and provide access to the website to other non-hired NRSROs that may also seek to provide a credit rating.	NRSROs, issuers, sponsors and underwriters in public and private ABS	Currently applicable
Rule 15Ga-2	Imposes public disclosure requirements on issuers and underwriters of ABS of the findings and conclusions of third party diligence reports.	Issuers and underwriters of public and private ABS	Currently applicable
Rule 17g-10	Requires third party due diligence service providers, such as accounting firms, to make certain representations to NRSROs regarding third party diligence reports.	Third party due diligence service providers in public and private ABS	Currently applicable

Regulation AB II. Regulation AB II is an expansion and continuation of Regulation AB, the primary regulatory disclosure framework for SEC-registered ABS in the United States. While Regulation AB does not apply to unregistered offerings, market participants generally regard disclosure regulation promulgated by the SEC, including Regulation AB, as important guidance for the preparation of offering memoranda for unregistered offerings of securities, including offerings of ABS. Regulation AB II implements provisions of the Dodd-Frank Act, introduces a requirement to provide detailed asset-level data varying by the asset type underlying the ABS (for example, the SEC requires the disclosure of only 72 data points for auto loans while it requires 152 data points for commercial mortgage loans), and contains forms and schedules geared toward standardizing and expanding the information provided to investors about underlying assets in ABS. Issuers of SEC-registered ABS will be required to comply with these new requirements beginning on November 23, 2015, except for the requirement to provide asset-level information, which will begin on November 23, 2016.

Regulation AB II will require asset-level disclosures for ABS registered with the SEC that is backed by residential mortgage loans, commercial mortgage loans, auto loans and leases, debt securities, and resecuritizations of ABS. No asset-level disclosure requirements have been adopted for ABS backed by equipment loans or leases, student loans, credit cards or floorplan loans, and an exemption is provided for resecuritizations of ABS issued prior to the compliance date.

In addition, the SEC adopted the following amendments related to prospectus disclosure requirements for ABS offerings:

- expanded disclosure about transaction parties, including disclosure about a sponsor's retained economic interest in an ABS transaction and financial information about parties obligated to repurchase assets;
- statistical information regarding whether pool assets were originated in conformity with (or as exceptions to) disclosed underwriting/origination criteria, or modified after origination;
- a description of the provisions in the transaction agreements about modification of the terms of the underlying assets; and
- a requirement to file the transaction documents in connection with shelf takedowns by the date of the final prospectus.

Risk Retention. Section 941 of the Dodd-Frank Act requires securitizers to retain at least 5% of the credit risk of any asset pool that is securitized, including in connection with unregistered offerings of ABS. The policy purpose of risk retention is to align the interests of those who originate assets that will be securitized and those who securitize those assets with the interests of investors in the resulting ABS. The implementing rules require that the sponsor of an ABS transaction or one of its majority owned affiliates retain an interest in the transaction's overall credit risk. These rules include restrictions, which vary by asset class, on hedging and transferring retained interests. Permitted forms of risk retention include eligible vertical interests (percentage of each class of ABS interests issued in the securitisation transaction), horizontal interests (fair value of the eligible horizontal residual interest divided by the fair value of all ABS interests) and combinations thereof. Under certain circumstances, a sponsor may rely on a third party to retain the required amount of credit risk. Exemptions are available for securitisation transactions collateralized by qualified residential mortgages, pass-through resecuritizations, qualifying securitizations of seasoned loans, and non-US securitizations. Compliance with the risk retention requirements will be required as of December 24, 2015 for residential mortgage backed securities ("**RMBS**") and December 24, 2016 for all other types of ABS. Any ABS issued before the applicable compliance dates are not subject to these risk retention requirements, but refinancing and amendment provisions may be subject to risk retention if they take effect after the effective date.

"Some non-US risk retention regimes recognize unfunded forms of risk retention, such as standby letters of credit, which US regulators do not believe provide sufficient alignment of incentives and have rejected as eligible forms of risk retention under the US framework."

Compliance issues may arise if an applicable non-US risk retention regime has dissimilar requirements. US federal regulators considered comments that requested the establishment of a mutual recognition framework that would permit substituted compliance for ABS that complied with a comparable non-US risk retention regime. In declining to permit substituted compliance, these regulators noted that other non-US jurisdictions with risk retention requirements had generally not adopted mutual recognition frameworks. In addition, some non-US risk retention regimes recognize unfunded forms of risk retention, such as standby letters of credit, which US regulators do not believe provide sufficient alignment of incentives and have rejected as eligible forms of risk retention under the US framework.

It is, therefore, unclear whether Asia-Pacific risk retention regimes (such as the CBRC risk retention rules in China) once compatible with the US rules. These will need to be analysed on a case-by-case basis.

In implementing the risk retention provisions of the Dodd-Frank Act, the federal agencies adopted a "safe harbor" provision for qualifying non-US transactions. Specifically, this provision excludes from US risk retention requirements transactions for which:

- neither the sponsor nor the issuing entity is chartered, incorporated or established under US law;
- no more than 10% of the value of all classes of ABS interests in the securitisation transaction are sold or transferred to US persons or for the account or benefit of US persons; and
- no more than 25% of the underlying assets underlying the ABS issue were acquired from a majority owned affiliates of the sponsor or issuing entity that is chartered, incorporated or organized under US law or from an unincorporated branch or office of the issuing entity that is located in the United States.

This non-US transaction safe harbor is narrowly tailored to capture only those transactions in which the effects on US interests are sufficiently remote so as not to significantly impact US underwriting standards and risk management practices or the interests of US investors. The relatively narrow scope of the foreign safe harbor provision may have a negative effect on non-US sponsors that seek US investors because they may need to satisfy risk retention requirements of two jurisdictions (their home country and the United States).

> "We want the securitisation market to come back, but in a way that is characterized by strong disclosure requirements for investors, good loan quality, accurate documentation, better oversight of servicers, and incentives to assure that assets are managed in a way that maximizes value for investors as a whole."
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> Remarks by Sheila C. Bair, FDIC Chairman, in a press release of the FDIC, "FDIC Board approves Final Rule regarding Safe Harbor Protection for Securitizations" (Sept. 27, 2010).

Volcker Rule. The "Volcker Rule" is a new Section 13 to the Bank Holding Company Act of 1956 (inserted by Section 619 of the Dodd-Frank Act). This provision applies to any "banking entities," which means, generally, any entity within the same group as a bank that has a US branch or agency. The Volcker Rule generally prohibits banking entities from: (1) engaging in proprietary trading or (2) acquiring or retaining any ownership interest in, or sponsoring, certain types of funds, which can include structured finance issuers, unless an appropriate exemption is available. The Volcker Rule also prohibits banking entities from engaging in "covered transactions" (under Section 23A of the US Federal Reserve Act) with a related sponsored, advised or managed covered fund or a covered fund that is offered as a permitted activity in connection with bona fide trust, fiduciary or investment advisory services. This prohibition is known as the "Super 23A" prohibition and mainly prevents banking entities from executing loans, derivatives and other transactions that would expose the banking entity to the credit risk of a related covered fund. The definition of a "covered fund" set out in the implementing regulations includes an entity that relies on the exclusions from the definition of "investment company" provided in Sections 3(c)(1) and 3(c)(7) of the US Investment Company Act of 1940, which are commonly used by private equity funds and hedge funds and are based on the composition and status of the investors in the fund rather than the nature of assets held by, or activities undertaken by, the fund.

Since the Volcker Rule's implementing regulations were adopted in December 2013 (the "**Implementing Regulations**"), structured finance underwriters have been evaluating on a case-by-case basis whether the transactions they underwrite present Volcker Rule compliance issues. Often they request assurances that exemptive relief would apply to them in the form of a contractual representation and warranty in the underwriting agreement and/or a memorandum from underwriters' or issuer's US counsel. In some cases, US counsel may be asked to provide a legal opinion to the effect that the issuer qualifies for an exclusion from the definition of "investment company" for purposes of the US Investment Company Act of 1940 other than the exclusions provided in Sections 3(c)(1) and 3(c)(7). A variety of exclusions from the definition of covered fund may be applicable to structured finance transactions, often depending on the types of assets being securitized. In addition, non-US structured finance underwriters may be able to rely on the "solely outside the United States," or "SOTUS", exemption provided by the Implementing Regulations.

The SOTUS exemption only provides relief to a limited subset of non-US entities and must therefore be evaluated on an entity-by-entity basis. Specifically, this exemption is only available to entities that are not: (1) organized under US law, or (2) directly or indirectly controlled by a banking entity that is organized under US law; and only so long as such entity exceeds specified US bank regulatory thresholds regarding the relative size of its non-US business (in broad terms, total assets or revenues outside the United States should be greater that total assets or revenues inside the United States).

Issuers that are not banking entities but possibly are "covered funds" for the purposes of the Volcker Rule are not expected to be responsible for policing whether the banking entities that buy their securities are doing so in compliance with the Volcker Rule. In other words, a "covered fund" issuer would not be expected to implement transfer restrictions on its securities to prevent transfers to banking entities that are subject to the Volcker Rule. These issuers should consider, however, whether they are providing sufficient disclosure in their offering materials to permit potential investors that are banking entities to comply with the Volcker Rule. Depending on the facts and circumstances of a particular offering, that an issuer may be considered to be a "covered fund" for the purposes of the Volcker Rule, which would restrict banking entities from owning the issuer's securities, may be considered material information that would be prudent to include in the offering materials provided to potential investors. Asia-Pacific issuers need to be cognisant of this when crafting their disclosure.

Rules 15Ga-1 and 17g-7 – Disclosures concerning representations and warranties. To implement Section 943 of the Dodd-Frank Act, the SEC adopted Rule 15Ga-1, which – together with related amendments to Regulation AB – requires "securitizers" to disclose specified information concerning repurchase demands to the extent the underlying transaction documents include a covenant to repurchase or replace an underlying security for breach of a representation or warranty. The SEC adopted Form ABS-15G as the form for securitizers to use for initial and quarterly reporting of any repurchase demands for securitized assets as required by this rule. The form must be publicly filed on EDGAR, the SEC's electronic document retrieval system. The definition of "securitizer" for purposes of this rule is not specifically limited to entities that undertake transactions that are registered under the Securities Act or conducted in reliance upon any particular exemption. The rule applies to all offerings of NRSRO-rated ABS to investors in the United States, whether they are publicly or privately offered. This would clearly cover an issuance into the US of an Asia-Pacific covered bond or other structured finance instrument by an obligor in the Asia-Pacific region. It would not apply to offshore offerings by non-US persons made only to investors outside of the United States that are not registered (and are not required to be registered) under the Securities Act.

To further implement Section 943 of the Dodd-Frank Act, the SEC also adopted Rule 17g-7, which requires an NRSRO to include in any report accompanying an ABS credit rating a description of the representations, warranties and enforcement mechanisms available to investors and how they differ from the representations, warranties and enforcement mechanisms in issuances of similar securities. In response to commentators' suggestions that this rule should not apply to foreign issuers that are not issuing securities into the US market, the SEC noted that the relevant statutory text did not support drawing such distinction in connection with reports issued by NRSROs subject to the SEC's oversight.

Rule 17g-5 – Password protected website for posting ratings-related information. Rule 17g-5 requires an NRSRO that is hired to provide a credit rating for a structured finance product to obtain commitments from an issuer, sponsor or underwriter of ABS to maintain a password-protected website containing rating-related information and provide access to non-hired NRSROs that may also seek to provide a credit rating. This

"The definition of "securitizer" for purposes of this rule is not specifically limited to entities that undertake transactions that are registered under the Securities Act or conducted in reliance upon any particular exemption."

requirement is intended to mitigate the conflict of interest that is created when an NRSRO is paid by an arranger to issue or maintain a credit rating on a structured finance product. The website should display all information that the arranger provides (or contracts with a third party to provide) to any hired NRSRO for the purpose of determining the initial credit rating or for rating surveillance. This rule also specifies the certifications that other NRSROs must provide in connection with accessing such websites.

In 2010, the SEC conditionally exempted NRSROs from these website posting requirements with respect to ratings of structured finance products issued by non-US persons where the NRSRO rating the transaction "has a reasonable basis to conclude" that the structured finance product will be offered and sold upon issuance, and that any arranger linked to the structured finance product will effect transactions of the structured finance product after issuance, only in transactions that occur outside the United States. In response to continued concerns about potential disruptions of non-US securitisation markets, the SEC has extended this conditional temporary exemption until December 2, 2015. Market practices subsequent to the adoption of the temporary conditional exemption have not imposed any additional restrictions on the secondary market activities of arrangers, other than those required by Regulation S.

Rules 15Ga-2 and 17g-10 – Disclosure requirements regarding third party due diligence reports. Rule 15Ga-2 requires any issuer or underwriter of registered or unregistered ABS rated by an NRSRO to publicly file a Form ABS-15G on EDGAR in connection with any third party due diligence reports an issuer or underwriter obtains, which discloses the findings and conclusions of any such third-party due diligence report.

A "third-party due diligence report" for purposes of Rule 15Ga-2 and Form ABS-15G means any report that contains the findings and conclusions of any due diligence services performed by a third party. Issuers and arrangers in the Asia-Pacific region will need to take advice from US counsel as to whether reports obtained in connection with ABS transactions would be a "third party due diligence report".

Some, but not all, services performed by accounting firms as agreed-upon procedures ("**AUP**") may be considered "due diligence" services, and would be subject to these rules. AUP services consisting of comparison by accountants of data on a loan tape to a sample of loan files are an example of a service that must be disclosed. This type of review is typically reflected in AUP letters that are delivered to underwriters or initial purchasers for ABS offerings, and can also be provided in connection with Rule 193 letters provided by accountants. If the primary purpose of the service is to assist issuers and underwriters in verifying the accuracy of disclosures, the service will not be subject to the new rules. Examples of this type of service include performing procedures that tie information included in the offering documents to the loan tape or the financial statements, or recalculations of projections of future cash flows.

The Form ABS-15G disclosure must contain the actual findings and conclusions expressed in the report or refer to that section of a related publicly filed prospectus that contains such findings and conclusions. While third-party due diligence services with respect to loan level data may be subject to disclosure, issuers and third-party providers generally have been working together to limit the publication of personally identifiable information. Redaction of personally identifiable information has been generally viewed as permissible even without an official confidential treatment request so long as the findings and conclusions of the due diligence services can be reported without reference to such information.

This form must be filed on EDGAR at least five business days prior to the first sale in the offering, but it need only be provided with respect to the initial rating of ABS. It has become market practice

"***Due diligence services***" includes evaluations of any of the following:

- The accuracy of the information or data about the assets provided, directly or indirectly, by the securitizer or originator of the assets
- Whether the origination of the assets conformed to, or deviated from, stated underwriting or credit extension guidelines, standards, criteria, or other requirements
- The value of collateral securing the assets
- Whether the originator of the assets complied with federal, state, or local laws or regulations
- Any other factor or characteristic of the assets that would be material to the likelihood that the issuer of the asset-backed security will pay interest and principal in accordance with applicable terms and conditions

for issuers to bear the responsibility for this filing. Filing on EDGAR, while simple and straightforward, requires at least 2-3 days of lead time for issuers that have not previously obtained the requisite passcodes and identifiers. A failure to file such a Form ABS-15G in a timely manner may cause an inadvertent delay in the pricing of an offering.

A Form ABS-15G filing would not be required if an NRSRO engaged to provide an ABS credit rating provides the issuer or underwriter with a representation that it will publicly disclose the findings and conclusions of the relevant third-party due diligence report. If the issuer or underwriter reasonably relies on the NRSRO to make this disclosure and the NRSRO fails to do so in a timely manner, the issuer or underwriter will have until two business days prior to the first sale of such ABS to file a Form ABS-15G.

Rule 17g-10 requires a third-party provider of due diligence services in connection with an ABS offering to US investors to deliver a written certification on Form ABS Due Diligence-15E disclosing who paid for such services, a detailed description of the manner and scope of the due diligence services provided and a summary of the findings and conclusions of the due diligence.

The requirements of Rule 15Ga-2 will not apply to a non-US offering of ABS where the following conditions are satisfied:

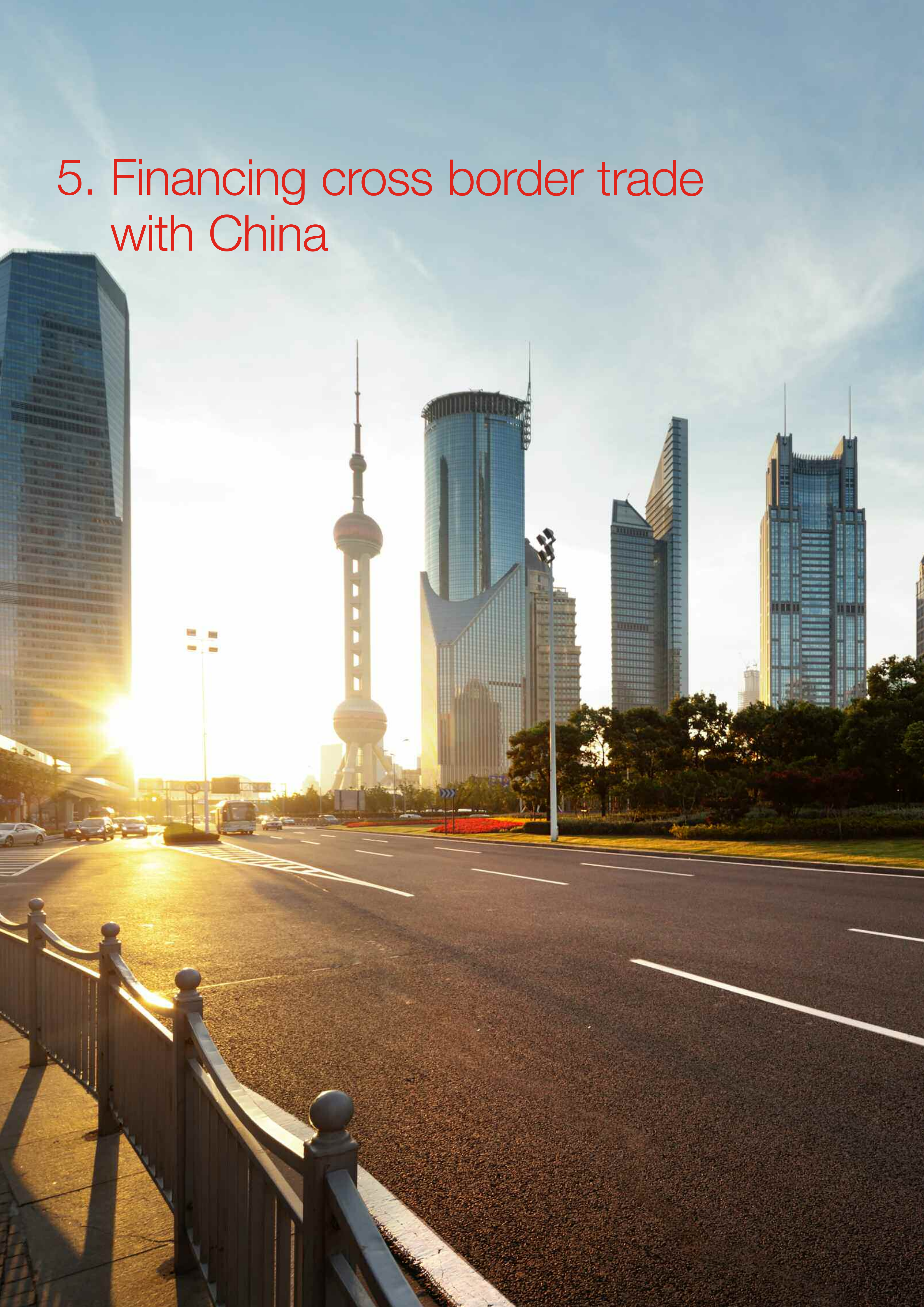
- the offering is not registered (and is not required to be registered) under the Securities Act;
- the issuer is not a US person; and
- the security will be offered and sold upon issuance only in transactions outside the United States (this applies to transactions effected by underwriters/arrangers after issuance as well).

The current industry view is that the restrictions that are customarily implemented for an offshore offering pursuant to Regulation S should generally be sufficient to satisfy the last of these three conditions.

Conclusion

The Dodd-Frank Act and numerous ABS-related US implementing regulations impact Asia-Pacific cross border offerings of ABS to US investors. Many of these reforms apply to private placements as well as public offerings in the United States. While non-US issuers may qualify for regulatory relief, the relatively narrow scope of the exceptions will often require non-US sponsors seeking US investors for cross border ABS offerings to navigate potentially conflicting regulatory requirements of more than one jurisdiction.

5. Financing cross border trade with China



China's economy is continuing to grow, even if at a slower rate than historic highs according to some measures, and a significant contributor to that growth is the level of trade enjoyed by China with its trading partners, both near and far. Those seeking to help finance that trade often structure their financing packages around the receivables which arise from that cross border trade. In this article we explore the current state of Chinese law and the extent to which receivables and companies in China have been able to take advantage of this type of financing to date.

As is the case for all international law firms licensed in China, we are authorised to provide information concerning the effect of the Chinese legal environment, however we are not permitted to engage in Chinese legal affairs in the capacity of a domestic law firm. Should the services of such a firm be required, we would be glad to recommend one.

In understanding the different ways Chinese law might be relevant in such a transaction we have set out our thoughts by reference to the key legal concepts considered as part of a trade receivables financing, being:

- where debtors of receivables are located in China;
- where suppliers (called, in the context of securitisations, originators) are located in China; and
- where suppliers which, although not located in China, have some level of presence in China.

Debtors located in China

For a trade receivables transaction, where a debtor is located in China, there are, as with other jurisdictions, a number of key factors to take into account. These include:

- whether a foreign judgment against that debtor would be recognised by China courts;
- whether a foreign law governed assignment of the receivable would be recognised against the debtor were the debtor to be sued directly in China;
- whether there are any local law perfection requirements; and
- whether there are any exchange control rules restricting payments out of China.

Enforceability of foreign judgments

Chinese courts only consider foreign judgments where there is a treaty or reciprocal arrangement in place, however, there are only a handful of these treaties in place (for instance, with Hong Kong and Macau). There are no such treaties are in place with most Western jurisdictions which means where a Western bank is seeking to claim a receivable from a Chinese debtor the ability to directly enforce against the debtor in the Chinese courts, and the extent to which a Chinese court will recognise the foreign law governed receivables and transfer become more important.

By contrast, enforcement of foreign arbitral awards should be easier. Chinese courts review foreign arbitral awards under the New York Convention. If a Chinese court intends to refuse enforcement of a foreign arbitral award, it will have to report to the Supreme People's Court for final review.

Recognition of foreign law governed transfer

Chinese law recognises that parties can choose a foreign law as the governing law of an agreement and Chinese courts would respect this if the agreement has foreign elements (such as, for instance, the originator is not Chinese or certain acts under the agreement take place outside of China).

There are exceptions to this rule, but they are not unique to Chinese law and are common in most other jurisdictions – for instance, if the choice of law attempts to circumvent mandatory provisions of Chinese law.

If the assignment is therefore valid as a matter of its own governing law, it would usually be recognised in China.

Local perfection requirements

For an assignment to be enforceable against a debtor in China it must have been notified to that debtor. The notification could be in English (or another language) as there is no requirement for it to be in Chinese.

In China, the assignment of foreign law governed trade receivables would be recognised against third parties (e.g., creditors of the originator) even before the notification of the assignment to the debtor.

There are no particular Chinese rules or laws requiring notification to be served on a debtor immediately and such notifications can be sent, for instance, upon the occurrence of the typical termination events – such as insolvency of the originator. Where Chinese debtors are therefore included in the context of a broader, global financing, there is no need to make special arrangements for them from that perspective.

Exchange control rules

Where there is a non-Chinese law governed trade receivable (and "*trade receivable*" is an important concept – distinct from a finance or loan receivable) the debtor should already have registered with the State Administration of Foreign Exchange (otherwise known as SAFE) and will have been categorised as A, B or C. A is the default category (and the least restrictive). In order to remit a payment offshore, a Category A debtor needs to provide supporting documents to its account bank through which it would remit the payment – the precise documentation required is a matter of discretion for the account bank, but would generally consist of the relevant invoice or, following assignment, a copy of the notice of assignment and/or assignment document. In such a case, there are no additional filing requirements with SAFE (just the documentary requirements of the relevant account bank).

In most cross border transactions involving Chinese debtors to date, the relevant debtors have all been Category A debtors – and the originator is typically required to provide a representation that that is the case.

Category B and C debtors are more problematic as a pre- or post- payment filing would need to be made with SAFE itself every time a payment is remitted out of the country.

Originators located in China

Importantly, due to existing exchange controls, it would be difficult for a Chinese originator to sell receivables owed by Chinese debtors to an offshore purchaser. That restriction does not, however, apply to non-Chinese originators (wherever their debtors are located) or Chinese originators to the extent their receivables are owed by non-Chinese debtors provided that foreign exchange registrations on filings, relating to the assignment of receivables, are duly completed.

Exchange control

As the interruption of cash flows on a trade receivables financing can cause significant issues, exchange control rules needs to be carefully considered to ensure that the expected cash flows are operating within the remit Chinese regulation permits.

Under Chinese law, an originator (whether it is assigning its receivables or not) has obligations to complete certain formalities (data filing, reporting, etc.) as imposed by SAFE. Under SAFE rules, (as with Chinese debtors) Chinese originators engaging in cross border trading activities will be put into one of three categories – Category A, Category B or Category C.

Category A is the default status while Categories B and C are subject to more restrictive rules.

With Category A exporters, regulators will only normally check the consistency between the aggregate value of exported goods and money received (evidence supporting the money received must be provided to the originator's account bank). This means incorporating Category A Chinese exporters into trade receivables financings as originators can be fairly straight forward from an exchange control perspective.

Insolvency Proceedings

Key to a trade receivables securitisation is the fact that upon the insolvency of the originator, the receivables which have been sold or transferred do not constitute part of the originator's insolvent estate – i.e., that there has been a "true sale" of those receivables. Whether or not there has been a true sale will depend on whether an insolvency official of the originator is able to challenge the sale.

There are a range of challenges an insolvency official can make to a transaction under Chinese law, most of which are familiar concepts to other jurisdictions. For instance:

- disposal without consideration;
- transaction at an evidently unfair price;
- using property to provide security for unsecured debts;
- prepaying debts; and
- waiver of debts.

Where receivables are sold at a discount there is also a risk that the transaction may be challenged as being at an undervalue (i.e., an evidently unfair price) – however, in the market, receivables are usually discounted so (depending on the level of discount) that might be a hard argument to make. It would be fact dependent in each case, however.

Chinese law has a typical "recharacterisation" challenge too – in order to achieve a "true sale" Chinese law requires (i) material risks associated with the assets that are assigned to have been transferred to an independent third party and (ii) the originator must no longer have direct or indirect control over the asset that is assigned.

Given there is a degree of uncertainty around how Chinese insolvency laws will be enforced in practice, one structural mechanism which can be used is for the Chinese originator to first transfer its receivables outright to a group company in a jurisdiction which has more certain insolvency treatment for this type of transaction (e.g., Hong Kong or Singapore) and the transaction can then be done with the group company selling the receivables to the bank or an SPV.

Bank Accounts – Security

Control of cash is very important in trade receivables financing and the ability to take control of the cash flows, particularly in the context of a default or originator insolvency is uppermost in the minds of lenders.

With that in mind, it is difficult for a Chinese entity to grant robust security over its bank accounts. It is possible to set-up escrow accounts, in the names of third parties, which provide for payment to different people in different circumstances, but are often difficult operationally to arrange.

For this reason, transactions involving Chinese originators are easier when the bank accounts over which a bank may wish to have security are already located outside of China. Where that is not the case, reserves are often set-up and daily sweeps made from the Chinese accounts to those in another jurisdiction in which more robust security can be taken.

Bank Accounts – Use of Account

As noted above, from a bank account perspective, transactions involving Chinese originators are more straight-forward when the accounts are outside of China. One particular issue arises when a Chinese originator wishes to assign receivables, but continue to have the debtors pay into Chinese located collection accounts.

This is because Chinese law prohibits one person "renting" or "lending" their Chinese account to another person. For instance, if a Chinese originator assigned some trade receivables to an offshore SPV and then serviced those receivables by directing the debtors to continue paying to the originator's account in China, that would be prohibited, as the originator is essentially using its bank account to receive payments on behalf of the offshore SPV – it is lending the SPV the use of its bank account.

This adds to the complexity of trying to structure a transaction which involves a Chinese collection account.

"Transactions involving Chinese originators are easier when the bank accounts over which a bank may wish to have security are already located outside of China."

A Few Tax Points

Withholding tax

Generally, withholding tax should apply to a receivable relating to the supply of goods and the supply of services. However, with respect to a non-Chinese originator, whether a withholding tax would be applied would depend on whether the Chinese tax authority treated the income as being derived from China.

Stamp duty

You would not expect there to be Chinese stamp duty on the transfer of trade receivables owed by Chinese obligors.

VAT

Generally, you would not expect there to be Chinese value added tax or business tax on the transfer of trade receivables owed by Chinese obligors to offshore suppliers (or an assignee).

Originators not located in China

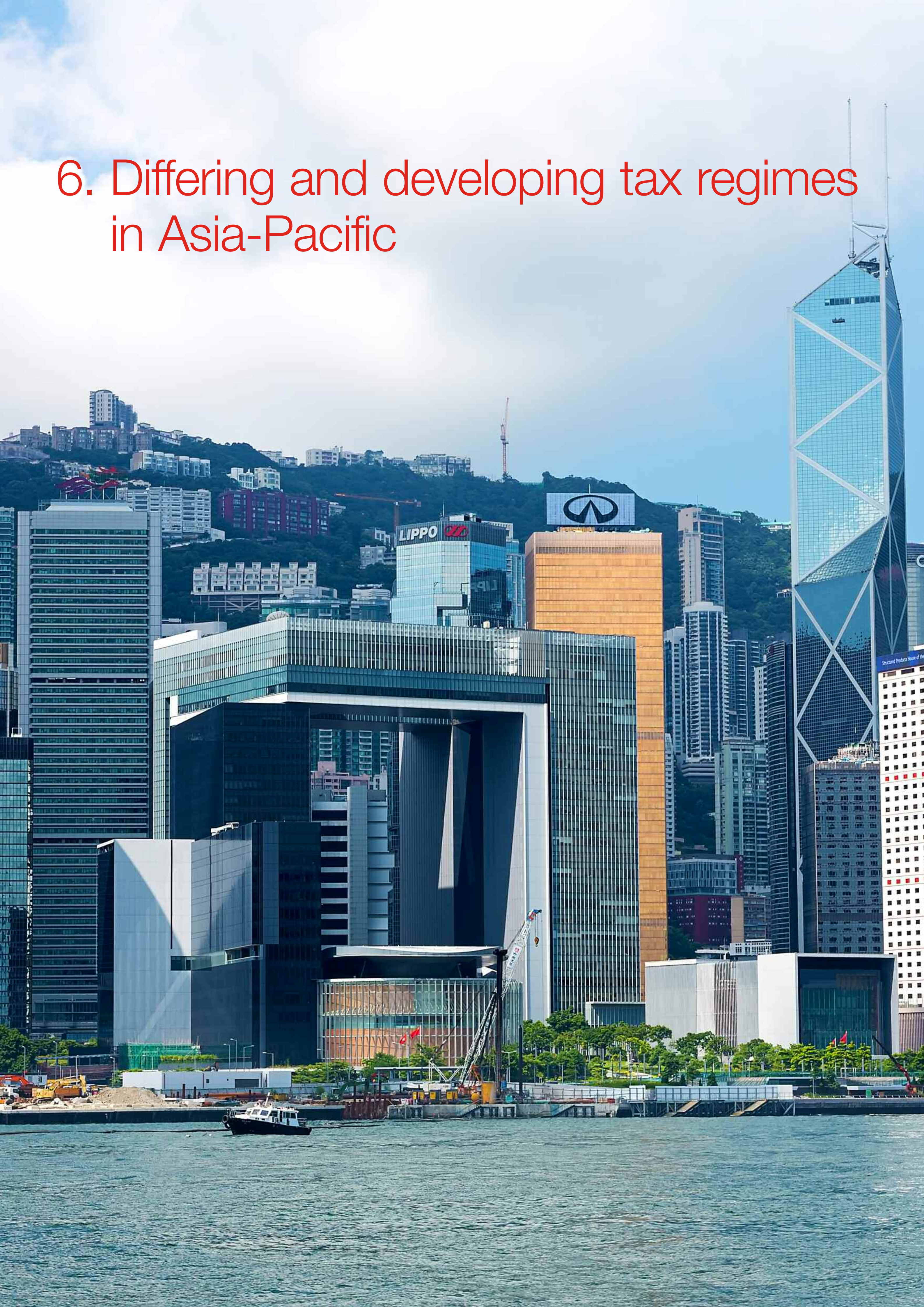
It is worth noting that originators which are not located in China cannot become the subject of Chinese bankruptcy proceedings. This is helpful as it means any Chinese insolvency analysis can be dispensed with unless the originator is based in China.

Similarly, the presence of a representative office of an originator in China is not a particular cause for concern – such offices can only provide liaison support or non-revenue-generating services for their parent companies and cannot be the subject of Chinese insolvency proceedings.

Conclusion

While a number of Chinese laws and rules (e.g., those relating to bank accounts) mean that trade receivables financing transactions are very difficult in some contexts, there are a broad range of fact patterns where transactions with a large Chinese element do fit neatly into the existing legal regime. The most commonly seen of these is where there is a large originator with customers around the world, including in China, which already has collection accounts outside of China which the Chinese customers pay into. Such transactions prove no more problematic (and, in many cases, are more straight forward) than looking at an equivalent fact pattern in many other jurisdictions.

6. Differing and developing tax regimes in Asia-Pacific



As an important factor to take into account in any transaction, tax must be considered early on in any securitisation debt transaction. If those transactions have a cross border element that can also add to the complexity and a thorough understanding of the applicable rules and the way they interact with each other is essential. In this article we ask some important questions and examine how the tax regimes in jurisdictions around Asia-Pacific differ and the ways they are developing as the economies in the region continue to grow.

Does tax treatment differ significantly in the different jurisdictions in Asia-Pacific?

Asia-Pacific jurisdictions adopt different approaches to taxing and encouraging securitisation transactions. Moreover, assessment positions on critical tax issues such as transfer pricing, permanent establishments, and anti-avoidance rules also vary significantly across Asia-Pacific. For taxpayers, this means the level of tax uncertainty and risk can differ across markets.

On one hand, there are jurisdictions such as Singapore with well aligned and clear tax policies to encourage securitisations. Likewise, Hong Kong's territorial tax regime, which does not tax capital gains or impose withholding tax on interest or dividends, simplifies certain tax considerations. On the other hand, there are jurisdictions such as India where unfavourable tax policies combined with aggressive tax audits create strong headwinds for securitisation transactions.

Keeping pace with rapid changes in regulatory and market developments presents a key tax challenge across all Asia-Pacific markets.

Are there any jurisdictions which have special tax treatment for securitisation or covered bonds?

Regulators realise that tax certainty is important to the development of securitisation in their countries. In response, many Asia-Pacific jurisdictions provide special tax treatment to support securitisation transactions. The scope of tax relief varies by country, with tax neutrality of special purpose vehicles ("SPVs") a key consideration. Provided below is a snapshot of relevant tax policies across key Asia-Pacific markets:

- *China*. In 2006, China issued "Circular of the Ministry of Finance and the State Administration of Taxation on Relevant Taxation Policy Issues concerning the Securitisation of Credit Assets", Cai Shui (2006) No.5 ("Circular 5"). Circular 5 addresses the Chinese Enterprise Income Tax, Business Tax, and Stamp Duty implications in a credit asset securitisation. Business Tax is being replaced by an expanded Value Added Tax ("VAT") regime, raising uncertainty on future tax treatment as discussed later below. In terms of special tax treatment, Circular 5 exempts SPV proceeds from Enterprise Income Tax if distribution requirements are met, and also provides provisional exemption from Stamp Duty on securitisation documents.
- *Singapore*. In Singapore, securitisations using Approved Special Purpose Vehicles ("ASPV") enjoy special tax treatment. Singapore first introduced the ASPV scheme in 2004 and has extended the incentive every five years, with the current incentive effective through 2018, subject to further renewal. Under the scheme, proceeds realised by ASPVs and qualified payments to non-residents are exempt from tax. The tax incentive also remits stamp duties on securitisation documents and provides goods and services tax ("GST") recovery on the ASPV's business expenses at a fixed rate of 76%.
- *Japan*. SPVs can be structured tax efficiently under Japanese tax laws through the use of fiscally transparent vehicles or special purpose corporate entities – one alternative being a *Tokutei Mokuteki Kaisha* ("TMK"). Japan's Special Taxation Measures Law permits qualified TMKs to

"[Hong Kong's] territorial tax regime does not differentiate between onshore or offshore SPVs."

deduct their dividends paid provided, among other requirements, that 90% or more of their distributable income is paid as dividends.

- *Korea*. Korea's Corporate Tax Act provides tax relief for SPVs formed under Korea's Asset Backed Securitisation Act. Similar to Japan, provided a qualified SPV distributes 90% or more of its distributable income as dividends, the Corporate Tax Act permits the deduction of the dividend amount against the SPV's taxable income.
- *Malaysia*. In 2014, Malaysia issued the "Income Tax (Asset-Backed Securitisation) Regulations 2014" which is effective from the 2013 assessment year. Among others, the regulations permit originators to defer gain realised on the transfer of trade receivables or stock in trade across the period of the securitisation transaction. Losses incurred are similarly recognised over the securitisation period.

What approach is generally taken to WHT?

Withholding tax is generally applied on domestic-sourced income paid to offshore persons, such as interest paid by onshore SPVs to offshore bondholders. Withholding tax rates vary by jurisdiction and nature of income. Hong Kong's territorial tax regime does not impose withholding tax on interest and dividends. Singapore has a tax regime similar to Hong Kong but imposes withholding tax on interest paid to non-residents. However, Singapore, like a number of other Asia-Pacific jurisdictions, offers opportunity for withholding tax relief on certain qualified interest paid to non-residents. Double tax treaties can also apply to reduce withholding taxes; however, enjoying such relief will require satisfaction of increasingly aggressive beneficial ownership and other anti-treaty shopping rules across Asia-Pacific.

What tax issues do you need to be aware of when incorporating an SPV?

Securitisation structures aim to maximise tax neutrality at the SPV level. The location of the SPV – whether it should be onshore or offshore – is a key consideration in the structure. Jurisdictions that lack special tax treatment for SPVs will encourage incorporation of offshore SPVs in tax efficient locations, subject to regulatory constraints.

However, offshore SPVs must structure their servicing and other arrangements with the originator and other onshore parties carefully to avoid creating an onshore permanent establishment ("PE"). Domestic tax rules and provisions under applicable double tax treaties must be considered. Overriding regulatory considerations, together with the risk than an onshore PE may be created, may argue for the use of onshore SPVs.

A number of Asia-Pacific jurisdictions such as Singapore have tax policies that encourage the use of onshore SPVs. Hong Kong stands relatively unique in this regard. Its territorial tax regime does not differentiate between onshore or offshore SPVs; rather, liability to Hong Kong profits tax is predicated on whether the SPV is considered to carry on a trade or business in Hong Kong.

Offshore SPVs also raise withholding tax issues, in respect of domestic-sourced receivables paid to the offshore SPV. Domestic tax rules and applicable double tax treaties may provide opportunities for relief.

China focus

What are the concerns in respect of a cross border transaction involving China?

China has increased its scrutiny of cross border transactions, especially those involving related party transactions. As a member of the G20, China has embraced and supports the OECD Base Erosion and Profit Shifting ("BEPS") initiative. This manifests through new rules targeting transfer pricing, treaty shopping, and offshore disposals of Chinese assets. Taxpayers bear a higher burden in demonstrating their cross border transactions are arm's length and supported by commercial purpose and substance.

China is also entering the final stages of its turnover tax reform, which will merge the current Business Tax regime into a comprehensive VAT system. The VAT reform raises significant questions on the future VAT treatment of securitisations. Circular 5, China's current tax guidance on securitisations, only addresses Business Tax implications.

Under the current Business Tax regime, Business Tax is levied at a rate of 5%, generally on gross income with some exceptions, for most in-scope financial services income. The shift to VAT raises the key question whether the turnover tax burden will remain neutral on securitisation transactions going forward. This will depend on two key variables – the calculation methodology and VAT rate – for each item of income. VAT also raises administration issues, namely, in implementing required VAT invoicing processes, the failure of which puts VAT credits at risk.

China aimed to complete full transition to VAT by the end of 2015. However, transitioning financial services to VAT presents the most challenges, especially given China's desire to maintain stability in domestic financial markets. Thus, it would not be surprising if there were delays in extending VAT to financial services this year.

What is the current state of FATCA in the Chinese market?

Being one of the most important trading partners of the US, China closed an important gap when an agreement in substance was reached with the US effective 26 June 2014 for a Model 1 Intergovernmental Agreement ("IGA"). However, a formal IGA with the US remains pending according to the latest US Treasury list. The Model 1 IGA allows foreign financial institutions in China to comply with FATCA by reporting specified account information to the IRS through the Chinese tax authority. Despite a slow start, there are now over 1,000 Chinese Foreign Financial Institution ("FFI") registrations, according to the IRS's FFI register. Given China's "in substance" IGA status, Chinese FFIs should monitor developments closely, as failure to conclude a formal IGA with the US could impact existing FFI registrations.

Conclusion

The evolving and diverse nature of Asia-Pacific taxation requires close examination of local regulations and practices. Asia-Pacific tax authorities are also at different stages of maturity in understanding complex financial instruments and structures. Moreover, initiatives such as BEPS and FATCA will add to tax risk, uncertainty and compliance cost, especially for cross border transactions. However, Asia-Pacific regulators are cognisant that they must balance the need to protect their tax base with the desire to develop and diversify domestic capital markets. Consequently, tax regulations and practices in Asia-Pacific can change rapidly and unexpectedly and should be closely analysed early in any transaction.

7. Trade receivables financings in Asia-Pacific

As companies grow, their customer bases often rapidly expand across different legal jurisdictions. This is particularly true in Asia-Pacific, where international trade is very much the norm with customers located all around the world – from Europe to the US to South America, among others. In order to be able to meet the needs of all its customers a company needs to adapt its corporate structure to deal with the tax, accounting or legal constraints of operating in different jurisdictions. This may involve opening a local branch, creating a local subsidiary, obtaining local licences or getting local tax rulings.

The question of how the company is financed must also be considered. It may be possible to finance the company's operations locally, in each jurisdiction, but in the modern globalised world, CFOs of many companies look for a single funding option for all their operations, all around the world.

One financing technique, a trade receivables financing, is a funding option for many companies, often sitting in those companies' capital structures alongside an unsecured revolving facility and a high yield bond.

A lender's objectives

A key reason why trade receivables financings are popular is because they provide recourse for a lender to a company's customers. That means the bank's risk is not as correlated to the company's credit as with a straight forward loan. If the company becomes insolvent the lender will collect the receivables from the company's customer itself, and given low historic default rates in trade receivables financings, the likelihood of full payment is high. An additional important protection which lenders have is that trade receivables financings are nearly always structured as a sale by the company of its receivables to the lender (or an SPV funded by the lender). This means that if the company does go insolvent the lender will not be fighting with the other creditors of that company for the company's remaining assets – it already has title to the receivables and can, as mentioned above, collect those directly.

For trade receivables financings to operate effectively, however, there needs to be a robust legal framework in place which can be used to provide the protections a lender is seeking. Understanding what those protections are and what legal systems will be relevant in a particular transaction is a fundamental starting point for any lender.

"A key reason why trade receivables financings are popular is because they provide recourse for a lender to a company's customers."

To aid us in considering what legal systems are relevant, let us consider briefly a typical trade receivables financing:

- a company will have a business with customers located in a number of different legal jurisdictions;
- the lender (or an SPV funded by the lender) will purchase receivables at a discount from the company; and
- the lender will want to ensure the accounts the customers pay in to are controlled, or can be controlled, by it.

In general, the key private international legal issues this type of transaction faces fall into three categories:

- recognition of foreign law and judgments;
- divorcing of credit risk; and
- control of bank accounts.

Recognition of Foreign Law and Judgments

A lender will always want comfort that, if it needs to, it (or the SPV that purchased the receivables) can go to the country a particular underlying customer is in and ask that underlying customer to pay it the receivable directly. This principally involves the local court in the jurisdiction where that customer is located needing to (i) recognise a foreign judgment saying that the underlying customer owes the money directly to the lender (or SPV) or (ii) recognise the sale of the receivables to the lender (or the SPV) under the relevant sale agreement and consequently that the lender (or SPV) is the correct person the underlying customer should be paying. The lender (or SPV) would also need to ensure any local law perfection requirements were complied with (e.g., notification or registration).

To address these issues, which should be considered in the jurisdiction where the customers are located, It is necessary to consult the body of law in that jurisdiction referred to as "*conflict of laws*" or "*private international law*".

Outside of Europe, in the absence of a bilateral agreement between two countries to recognise each other's judgments, there are likely to be difficulties in enforcing a foreign judgment against a customer in the jurisdiction where it is located. For this reason, in Asia-Pacific trade receivables financings, it is usually assumed that if a receivable does need to be enforced directly against a customer that there would be local legal proceedings against the customer in its home jurisdiction.

On this front, in the majority of jurisdictions around the world, local proceedings are less problematic. Most jurisdictions will accept the fact that parties to a cross border transaction may choose a foreign law to govern their dealings and they will apply foreign law in working out what the obligations of the parties are. In the context of a trade receivables financing, this may be done by the local court looking at either or both of (i) the law governing the receivable owed by the customer and/or (ii) the law governing the sale agreement between the company and the lender (or SPV) and considering whether either or both of those transactions is valid under its respective laws. In any case, this particular private international law question is usually well settled in most jurisdictions encountered so can be checked with relatively little difficulty by a local lawyer.

Divorcing Credit Risk

Transactions are structured using a sale of receivables in order to divorce the credit risk of the receivable from that of the relevant company. In an insolvency of the company the lender would want the receivable to fall outside the company's insolvent estate which would allow the lender (or SPV) to collect it directly from the customer without being concerned about the other creditors of the company. The location of the company's insolvency, and therefore which court has jurisdiction over this question, is key.

Most jurisdictions have fairly settled rules over whether insolvency proceedings can be opened and those rules usually revolve around the level of presence a company has there – in terms of offices, real estate, employees and customers and whether strategic decisions are taken there. The permanence of each of these things in that jurisdiction can also make a difference. However, the fact that each jurisdiction has its own rules does not mean that a company might only go insolvent in one place – there might be numerous jurisdictions in which insolvency proceedings could be opened.

Whether or not the sale of receivables to the lender (or SPV) would be recognised in a company's insolvency needs to be asked in each jurisdiction where the company might be subject to insolvency proceedings otherwise there is a risk the transaction will not be valid.

The company's corporate structure is therefore an important aspect which should be checked early in a transaction. Where a company operates in foreign jurisdictions through subsidiaries, without having a presence in each jurisdiction itself, that means only a single analysis needs to be done (i.e., in its home jurisdiction). Where branches are opened and the company operates directly overseas then a more detailed legal analysis is needed as it might be subject to multiple insolvency proceedings. This can involve a complex matrix of considering local insolvency proceedings and the likelihood of certain jurisdictions recognising foreign insolvency proceedings.

Control Over Bank Accounts

Obtaining control over the bank accounts is one area where private international legal principles are not yet so uniform. For instance, in a number of common law jurisdictions (such as Hong Kong and Singapore), declaring a trust over a bank account will essentially

"Obtaining control over the bank accounts is one area where private international legal principles are not yet so uniform."

protect the cash in that account from an insolvency of the company. However, in other jurisdictions a pledge or charge may need to be granted and detailed account control provisions agreed to ensure the local bank will act in accordance with the instructions of the lender or its security trustee. Putting these local arrangements in place involves local lawyers drafting local law security documents and complying with local law formalities. Cross border recognition of this sort of security is not yet common place and putting this local account security in place is often very costly and time consuming.

One solution some lenders have adopted is simply opening up local bank accounts in the name of the lender (or SPV) and notifying the underlying customers to pay directly into these accounts. In the event of a company insolvency, the cash is then safely in an account already controlled by the lender. However, this mechanism is sometimes resisted as companies often have sensitive relationships with their local collection account banks and customers.

Another protection that is typically included in transactions is the ability to notify underlying customers to pay into a non-company account if the company appears to be getting into financial difficultly. If the underlying customer then pays into the wrong account the receivable is not properly discharged and (although very rare in practice), provided the local court recognises the relevant purchase document (as to which see "*Recognition of Foreign Law and Judgments*" above), the lender (or SPV) could go after the underlying customer directly for payment.

Conclusion

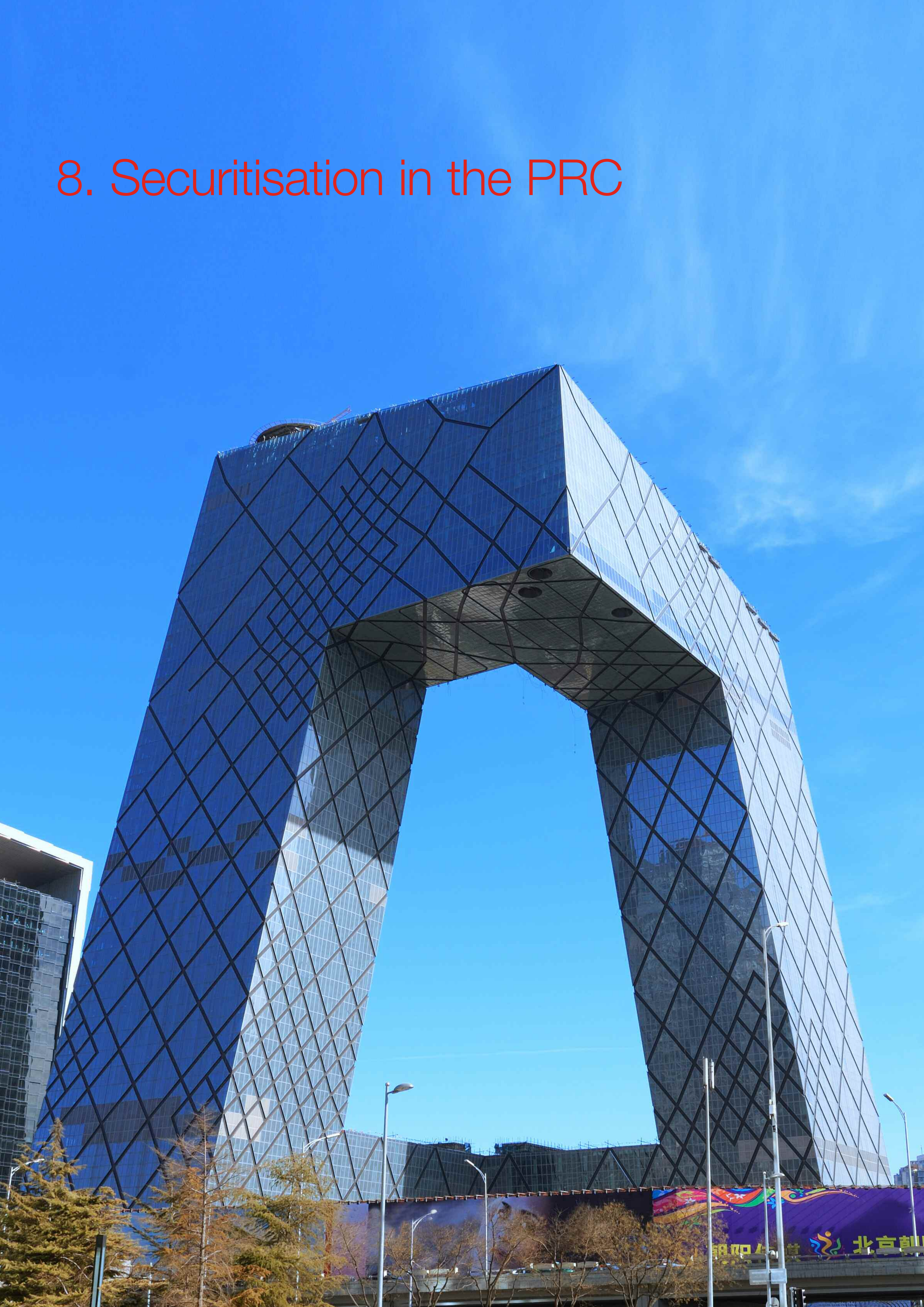
Foreign laws are generally recognised adequately in the Asia-Pacific region to an acceptable degree for undertaking this type of financing transaction. Similarly, although control of cash and accounts is still the more complex and expensive aspect of a trade receivables financing, using the structural mitigants described above often provide sufficient comfort for lenders.

It is the insolvency aspect where improvements could be made, but those improvements would need to arise out of multilateral initiatives between the jurisdictions in the region. If a system could be developed where it was agreed that insolvency proceedings would be opened only in the jurisdiction where a company is incorporated (or perhaps where its head office is located) and those proceedings be recognised abroad then the legal analysis would be far simpler. The UNCITRAL Model Law on Cross-Border Insolvency (1997) sought to achieve this, but has had little take-up in the region with only Australia, Japan, New Zealand, the Philippines and South Korea adopting it. There is now, particularly through ASEAN, closer co-operation between a number of nations in the region so it is hoped there will be a harmonisation of some key legal principles.

Improved legal robustness would generally help reduce the execution cost of implementing these transactions by minimising the scope and quantum of work needed to be undertaken in multiple jurisdictions. This would then open trade receivables transactions up to a wider variety of companies, including some smaller than those traditionally used to undertaking financings.

Nevertheless, the current level of legal certainty still provides access to this type of financing to a wide variety of companies and, given the benefits of trade receivables financing over direct loans mentioned above, lenders are able to focus more on commercial rather than legal risks thereby better serving the companies which take advantage of it.

8. Securitisation in the PRC



We published a client briefing in June 2013 examining the notable developments in the areas of the credit assets securitisation (CAS) regime, the corporate assets special management regime and the asset backed notes (ABN) of non-financial enterprises. With the benefit of the continuing policy support, the last couple of years have seen dramatic growth and expansion of assets securitisations in China. Meanwhile, the Chinese government has shown meaningful signs to open up domestic securitisation market to foreign participants in due course. In this update we will introduce the most significant developments in this market since June 2013 and the potential implications they may have on foreign participants.

CAS Regime Moving Towards Normalisation

High-level Policy and Market Overview

On 2 July 2013, the State Council released the *Guidance on Financial Support of Adjustment, Transformation and Upgrading of Economic Structure* (State Council Order [2013] 67), indicating that the domestic CAS regime will gradually move towards the process of normalisation. Generally, this move is aimed to effectively manage credit assets, optimise the asset-liability structure of financial institutions and encourage the use of securitisation to support the real economy. In August 2013, the State Council made a further announcement to further expand the CAS pilot program. Since then, the CAS business has advanced by leaps and bounds. In 2014, the issuance of CAS products rose tenfold from a year earlier to more than RMB 280 billion, which was also more than the total issuance size between 2005 and 2013.

Breakthrough in Regulations

Shift from Approval Regime to Filing/Registration Regime

Previously, the issuance of CAS products required approval from the China Banking Regulatory Commission (CBRC) and the People's Bank of China (PBOC), which involved burdensome administrative procedures and substantial regulatory review for each issuance. To promote the normalisation of the CAS issuance underpinning the State Council Order [2013] 67, CBRC and PBOC have worked to improve efficiency and transparency of administrative procedures by introducing the new filing/registration regime for the issuance of CAS products. The milestones include:

- In November 2014, CBRC issued the *Circular on Working Procedures for CAS Filing and Registration* (CBRC Circular 1092), allowing domestic banks that have obtained CAS licenses from CBRC to issue CAS products by submitting the pre-issuance filing to CBRC instead of seeking approval for each issuance. In January 2015, CBRC granted CAS licences to the first batch of 27 domestic banks (foreign funded banks not included).
- In March 2015, PBOC announced the launch of the CAS registration regime (PBOC Bulletin [2015] 7). Accordingly, a financial institution may register with PBOC and issue one or more CAS products during the term of such registration, provided that such financial institution has obtained the CAS licence from CBRC and has issued CAS products in the domestic securitisation market.

"In 2014, the issuance of CAS products rose tenfold from a year earlier to more than RMB 280 billion."

Diversified Trading Platforms

Previously, the CAS products could only be issued and traded on the interbank market. According to the PBOC Bulletin [2015] 7, CAS issuers can now choose trading platforms based on considerations of investor suitability and market conditions. As a result, domestic stock exchanges can be used as another trading platform for CAS products. Stock exchanges are regulated by the China Securities Regulatory Commission (CSRC) and have different rules, as opposed to the interbank market, in terms of listing, trading, depositary and settlement, disclosure and investor eligibility to name a few. Therefore, the expansion of CAS trading platforms will entail coordination between different regulators to harmonise various trading mechanisms and the regulatory framework for CAS products.

The Ping An Bank No. 1 Micro Consumer Loan Assets Backed Securities were listed on the Shanghai Stock Exchange

(SSE) on 25 June 2014 and became the first CAS transaction of this kind. All eligible investors specified in the offering documentation and the SSE Securitisation Guideline (2014), including Qualified Foreign Institutional Investors and Renminbi Qualified Institutional Investors, are permitted to invest in this CAS product. SSE has stated that with the guidance of relevant regulators, SSE will make all-round preparation to welcome more CAS issuances on the stock exchange.

More Flexible Risk Retention Requirement

Pursuant to the previous risk retention requirement (PBOC Circular [2012] 127), an originator must retain a proportion of the most junior tranche of CAS and, in principle, such proportion cannot be less than 5% of the total CAS issuance size. In December 2013, PBOC issued a circular (PBOC Circular [2013] 21) to introduce more flexible risk retention requirements such that:

- an originator shall retain a proportion of CAS, which is no less than 5% of the total CAS issuance size;
- where an originator retains the most junior tranche of CAS, the retention proportion is no less than 5% of the junior tranche size;
- where an originator retains other CAS tranches (not the most junior tranche), it shall retain each tranche in the same proportion (i.e. vertical slice);
- the retention period shall not be less than the existing term of each tranche; and
- PBOC and CBRC may provide other risk retention requirements in due course.

An originator is allowed to determine its risk retention mechanism. It is also mentioned that the regulators will continue working on the exemption mechanism under the risk retention requirement and may adjust the risk weighting of the most junior tranche held by commercial banks in due course.

Market Outlook

With the benefit of the above policy support, the CAS market has seen a surge of issuance in Q1 2015, whereby 112 CAS products have been issued and the total issuance size has reached RMB 450 billion. In May 2015, the State Council made an announcement to add RMB500 billion quota for future CAS issuances and stated that future regulatory focus will be on issues including:

- dynamic, standard and transparent disclosure regime;
- prevention of over-securitisation;
- perfection of true sale and insolvency ring-fencing system, as well as risk retention requirements; and
- aim to re-launch non-performing loans securitisations.

CSRC's Efforts to Revitalise Corporate Asset Securitisation Regime

New Framework

In November 2014, CSRC released the *Administrative Provisions on the Asset Securitisation Business of Securities Companies and the Subsidiaries of Fund Management Companies* (CSRC Circular [2014] No. 49), along with guidelines relating to due diligence and disclosure obligations (2014 CSRC Provisions), to replace the 2013 regulation. Accordingly, an asset backed specific plan (ABSP) shall serve as the special purpose vehicle of corporate assets securitisations.

Under the guidance of the 2014 CSRC Provisions, the Asset Management Association of China (AMAC) is authorised to conduct self-disciplinary management on post-filing and risk control of ABSP transactions and determine the scope of permissible underlying assets in these transactions. For this purpose, AMAC issued the *Measures for Filing of Asset-backed Special Plans, the Negative List of Underlying Assets of Asset Securitisation Plans,* the *Guideline on Risk Control of Asset Securitisation Plans,* the *Explanatory Note on Self-disciplinary Rules of Asset Securitisation Plans,* the *Trial Guideline on the Content and Format of Prospectuses of Asset Securitisation Plans,* and the *Template Subscription Agreement and Risk Disclosures for Asset Securitisation Plans* (for individual investors and institutional investors respectively) (AMAC Bulletin [2014] No.459).

The 2014 CSRC Provisions, together with the AMAC rules, constitute the new regulatory framework for corporate assets securitisations.

Key Changes

Whilst the 2014 CSRC Provisions have largely followed the transaction structure and legal relationship of special asset management plans under the 2013 regulation, CSRC has made efforts to revitalise the regime in the following key aspects:

- the scope of programme managers is extended to asset management subsidiaries of fund management companies; and
- it initiates the post-closing and negative-list administration regime in pursuit of easier market access and expanded underlying assets.

Insolvency Ring-fencing

The 2014 CSRC Provisions have made great progress. However, the concern surrounding the ring-fencing of the ABSP assets from the programme manager's insolvency estate is not fully settled in the 2014 CSRC Provisions, which may make the ABSP structure less attractive to foreign investors if such structure was to be rated. More specifically, given the lack of a special purpose issuer under the ABSP products, the plan managers will act as "buyers" in the purchase of underlying assets from originators and therefore own the assets. In some circumstances, the assets under the ABSP products would not be insolvency remote from plan managers as under a trust structure.

Low Hierarchy of CSRC Rules

The 2014 CSRC Provisions have provided requirements in segregation of assets and cashflow under ABSP to assure that from an operational perspective the ABSP assets can be ring-fenced from the proprietary assets of the programme manager. While these rules may provide some guidance for future court rulings, uncertainties continue on how the courts will enforce the CSRC rules which do not constitute laws enacted by the National People's Congress. As a result, questions may continue over whether investors in securitisations under the ABSP framework will be protected agencies claims made on the ABSP assets by creditors of the insolvent project manager.

Having said that, it does not mean ring-fencing arrangements under ABSP cannot be achieved or recognised by PRC courts in any circumstance. This will need to be considered carefully in combination of the PRC insolvency laws, judicial guidelines and contract arrangements.

Trust or Principal-Agency?

Characterisation of the legal relationship between the programme manager and investors under an ABSP is a long-debated issue, which has a direct impact on the effect of the ring-fencing regime. Some legal practitioners have argued that, since the 2014 CSRC Provisions are based on the SIF Law which is in turn based on the *PRC Trust Law,* the legal relationship under ABSP should be treated as a trust and thus it can achieve the effect of ring-fencing as in the CAS regime. In the consultation draft of the 2014 CSRC Provisions, it was provided that the ABSP assets are trust assets and shall be segregated from the proprietary assets of the programme manager. However, in the official version of the 2014 CSRC Provisions (Article 5), the reference to the "trust assets" is removed and it is merely provided that the ABSP assets shall be segregated from the proprietary assets of the programme manager. In CSRC's announcement for the promulgation of the 2014 CSRC Measures, it has explained that creating a trust on the ABSP assets is not appropriate in the context of existing laws and administrative regulations and therefore should not be provided in department rules issued by CSRC.

In the absence of a trust arrangement, a legal analysis on the effectiveness of the contractual ring-fencing arrangement would hinge on a related analysis of the rationale of a legal relationship between the plan manager and investors. For the time being ABSP products are often established under a broader concept of principal-agency relationship pursuant to the PRC civil law and contract law principles, which is not as strong as trust in the effect of insolvency ring-fencing.

Market Highlight

Despite the legal concerns, the ABSP market has experienced a rapid growth since the promulgation of the 2014 CSRC Provisions. The issuance size has exceeded the total size of corporate assets securitisation transactions over the past years.

New Regulation

Based on the experience of the pilot programme, in early September 2015, CIRC released the *Interim Measures for the Administration of Asset Backed Plan Business* (CIRC Circular [2015] No.85)

CIRC's Initiative on Project Asset Backed Plans

Pilot Programme

A pilot programme of project asset backed plans (PABP) was started in the insurance sector since 2012. In this process, the China Insurance Regulatory Commission (CIRC) has circulated several rules among the selected participants to explore the PABP structure. In particular, in July 2014, CIRC issued a circular (CIRC Bulletin [2014] 197) to set up the generic framework of PABP business. Accordingly, insurance asset managers that are qualified to manage infrastructure investment plans can submit an application to CIRC to launch PABP products. The permissible underlying assets include credit assets, financial leasing receivables and eligible equity assets. Only domestic investors can invest in PABP products. It is also interesting to note that PABP is operated in accordance with the PRC Trust Law and in CIRC's expectation, the legal relationship between the insurance asset management company and investors should be characterised as a trust, pending judicial review. This is different from the ABSP framework.

Currently, nine insurance asset management companies have participated in the pilot program and set up 22 PABP products with a total size of RMB81.2 billion.

with an aim to "normalise" the securitisation business undertaken by insurance asset management companies by establishing an overarching regulatory framework. The new regulation continues to use the trust structure to procure insolvency remoteness from the originator and trustee. It also introduces the following developments (among others):

- in respect of underlying assets, CIRC only sets out general eligibility requirements and will adopt the negative-list administration regime;
- in respect of approval procedures, only the first issuance of PABP product requires prior verification by CIRC and for the subsequent issuance of similar PABP products, post-closing filing will be sufficient;
- it is clarified that PABP products can be issued, registered and transferred on the designated "insurance asset registration and trading platforms"; and
- the PABP certificates can be issued to domestic insurance institutions and other "eligible investors". CIRC will define investor suitability depending on the market condition. It is yet to be seen whether the scope of "eligible investors" will be expanded to cover foreign investors.

NAFMII Regime – Trust-type ABN on the Way?

So far, more than 20 ABN products have been registered with the National Association of Financial Market Institutional Investors (NAFMII). Unlike typical securitisation transactions, under ABN rules no special purpose vehicle is established to hold the underlying assets and there will be no true sale. Instead, the originators pledge the receivables or the revenues to the ABN holders to ensure the repayment of the notes.

Following an event of default, the ABN holders will be regarded as secured creditors. In other words, the existing ABN structures do not have an effect of bankrupt remoteness from originators.

Having said this, NAFMII is going to explore a new "trust-like" structure for the ABN.

Cross border Asset Securitisation Regime in the Making

In our previous client briefing, we have discussed the feasibility of foreign investor participation in the domestic securitisation market (CAS, ABSP and ABN products) as investor (through QFII/RQFII quota or qualification of "three-type foreign financial institutions"). We have seen active foreign investments in several auto asset securitisation transactions.

More recently, with the pace of RMB internationalisation and the opening up of the domestic capital market, regulators and market practitioners have started discussing some more aggressive ideas, i.e., cross border debt or asset securitisation transactions. The intention is to enable foreign entities to access the domestic market as both issuer and investor and potentially play more roles (such as providing credit enhancement). However, to achieve this, the regulators will need to address the following key issues:

- eased exchange controls over currency conversion and cross border fund transfer;
- effective registration, depositary and settlement system;
- well-established accounting and tax policies; and
- effective cross border enforcement regime.

Due to the complexity and sensitivities of this process, it is anticipated that such cross border asset securitisation regime may be launched in a relatively sophisticated market (such as the interbank bond market) or through the international financial asset trading platform contemplated in several pilot zones (such as free trade zones in Shanghai, Guangdong and Tianjin) as a first trial. Especially relating to the international financial asset trading platform in the China (Shanghai) Pilot Free Trade Zone, we have heard that the regulators are considering the following ideas:

- through the "free trade account" system, facilitating easier cross-border flow of Renminbi and foreign currency funds under capital account; and
- through the international financial asset trading platform, (i) setting up trading connectivity between onshore and offshore institutions, (ii) launching international financial products and introducing diverse roles of participating parties, and (iii) building up a global trading system.

Although it remains unclear when these developments can be materialised, we appreciate that the Chinese government will go farther along the road to open up the domestic capital market and expand foreign participation.

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