

Prospects for Asset Securitization within China's Legal Framework: The Two-Tiered Model

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Prospects for Asset Securitization Within China's Legal Framework: The Two-Tiered Model

Kevin T.S. Kong*

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Introduction

The People's Republic of China ("China") has been championed by commentators as the next ideal market for applying a financing technique called asset-backed securitization.¹ China's huge demand for capital is evi-

* J.D., Cornell Law School, 1999; B.A., Columbia University, 1995. I would like to thank William A. Wilson III, Professor Muna Ndulo, Yu Yan, and Mitchell M. Wong for their inspiration and advice on the development of this Note. I dedicate this Note to my father, Yuey Fang Kong, and my mother, Look Fu Kong, for their love and support. *Ming ji yang yu zhi en*. A son could not ask for better parents.

1. See, e.g., George Yu, *Securitization Gives One-Two Punch to China's Debt Mess*, ASIAN WALL ST. J. WKLY, Sept. 8, 1997, at A18; Colin Gailey, *The Lure of Cash Flow*, ASIAMONEY, June 1997, at 47. Commentators have also championed asset-backed securitization as an ideal method of capital financing for Asian countries in general. See, e.g., *Asia The Place for Existing ABS*, EMERGING MARKETS DEBT REP., Dec. 2, 1996, at 1; *Asia - Time to Consider Securitization*, ASIAMONEY, Sept. 1997, at 26; *Asia's Cash Crunch Creates* 32 CORNELL INT'L L.J. 237 (1998)

dent. The country's ongoing expansion to modernize its highways, bridges, and power plants has pressured it to continually seek new sources of capital.² Consequently, China needs alternate sources of capital, such as asset-backed securitization, because Chinese banks are straddled with huge non-performing loans provided to state industries.³

The recent liquidity crisis in Asia's economy highlights the importance of China's access to a stream of economic resources. In 1997, the Thai baht plummeted in value, setting off a regional chain reaction that depressed the valuation of the Malaysian ringgit, the Korean won, and the Japanese yen.⁴ As a result, the Hong Kong Stock Exchange fell 35.4% from its twelve-month peak as of October 1997.⁵

Asset securitization is a flexible financing technique that frees up illiq-

Hot Product, WALL ST. J. EUR., Dec. 9, 1997, at 10; *Troubles Could Prompt Rises in Asian ABS*, EUROWEEK, Sept. 5, 1997, at 15. *But see Asia Cos, Banks Can't Offload Risk By Securitizing: Moody's*, DOW JONES INT'L NEWS SERV., Nov. 25, 1997, at 04:24:00, available in 1997 WL FarNews Database; Cecile Gutscher & Betty W. Liu, *Asia Debt: Securitization Cure Easier Said Than Done*, DOW JONES INT'L NEWS SERV., Jan. 1, 1998, at 21:09:00, available in 1998 WL FarNews Database. *See generally* Harinder Kohli et al., *Making the Next Big Leap: Systematic Reform for Private Infrastructure in East Asia*, in CHOICES FOR EFFICIENT PRIVATE PROVISION OF INFRASTRUCTURE IN EAST ASIA I (Harinder Kohli et al. eds., 1997). Asset-backed securitization is a financing technique that, among other functions, liquifies current assets to raise new capital. *See discussion infra* Part I.B. This paper uses the terms asset-backed securitization, asset securitization, and securitization interchangeably.

2. *See* Kohli, *supra* note 1, at 3 (discussing China's future status as the dominant user of international capital for infrastructure development and China's recent experimentation with securitization as an additional source of raising capital).

3. *See* Colin Galloway, *Are the PRC's State-owned Banks on the Verge of Collapse?*, CHINA L. & PRAC., Mar. 1997, at 56, 56 ("[T]hese are all very sick banks in need of complete recapitalization and overhaul. Because they have no liquidity, they are dependent on deposits for their very existence . . . if everyone wanted their deposits back, the whole system would collapse."); Kohli, *supra* note 1, at 3.

4. *See* Brian Brenner et al., *Rescuing Asia*, BUS. WK., Nov. 17, 1997, at 116 (discussing the currency devaluations throughout Asian countries and the need for an infusion of capital by the International Monetary Fund to bailout Asian countries). While China's national currency, the yuan, also would have fallen in value following the Asian liquidity crisis, the conditional convertibility of the yuan to foreign currencies sheltered the yuan from devaluation. *See Chinese Yuan Unaffected By Currency Turmoils*, ASIA PULSE, Dec. 16, 1997, at *1, available in 1997 WL 13576084.

5. *See Guarantors Jockey For Position In Asia*, MORTGAGE-BACKED SEC. LETTER, Jan. 5, 1998, available in 1998 WL 10104071 ("[Amid the 1997 Asian economic crisis,] for many companies in Asia, securitization may be the only method of raising capital . . ."); *A Global Reality Check*, BUS. WK., Nov. 10, 1997, at 40-41. Asia's 1997 economic crisis sparked other economic crises throughout the world in 1998. 1998 marked Japan's worst economic downturn since World War II, Russia's economic meltdown and the devaluation of the ruble, Indonesia's depression that plunged 100 million people below the poverty line, and Latin America's fear of capital flight. *See* David E. Sanger, *As Economies Fail, the I.M.F. Is Rife With Recriminations*, N.Y. TIMES, Oct. 2, 1998, at A1. The United States faced economic problems as well. The Federal Reserve Bank intervened to avert the collapse of Long Term Capital Management L.P., a hedge fund based in Greenwich, Connecticut. *See* Richard W. Stevenson, *Fed Chief Defends U.S. Role in Saving Giant Hedge Fund*, N.Y. TIMES, Oct. 2, 1998, at A1; *see also* Joseph Kahn, *Merrill Cites \$1.4 Billion Exposure to Long-Term*, N.Y. TIMES, Oct. 2, 1998, at C1.

uid assets or receivables⁶ while providing lower interest rates to borrowers, greater liquidity to investors, lower funding costs to banks, and a lower cost of capital to the economy.⁷ The marvel of asset-backed securitization is that it transforms illiquid assets into freely tradable liquid assets and thereby provides another means of raising capital to supplement the traditional methods of issuing debt or equity.⁸

Many Asian countries have successfully raised capital through asset-backed securitization.⁹ As a vote of confidence on the maturity of Asia's asset-backed securitization market, Asian Securitization and Infrastructure Assurance Ltd. (ASIA Ltd.) recently started business in Singapore as Asia's first monoline financial guarantee company.¹⁰ Its purpose is to provide country-specific expertise in the structuring of asset-backed securitization transactions in Asia.¹¹ In 1995, one commentator predicted that the Asian asset-backed securitization market would reach \$10 billion within three

6. See Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. L.J. BUS. & FIN. 133, 135 (1994) [hereinafter Schwarcz, *Asset Securitization*]. Schwarcz succinctly describes the "alchemy" of asset securitization:

In securitization, a company party "deconstructs" itself by separating certain types of highly liquid assets from the risks generally associated with the company. The company can then use these assets to raise funds in the capital markets at a lower cost than if the company, with its associated risks, could have raised the funds directly by issuing more debt or equity. The company retains the savings generated by these lower costs, while investors in the securitized assets benefit by holding these investments with lower risk.

Id.

Assets refer to a fixed tangible commodity like a house or car. Receivables refer to the rights to future payments such as mortgage payments on a house or lease payments on a car. Sometimes the term "assets" is used expansively to include receivables as a subset of assets. *Id.* In this Note, the distinction between assets and receivables is not an important factor; both are used to designate a source base for securitization, although receivables increasingly have been the dominant source base for asset securitization.

See also STEVEN L. SCHWARCZ, *STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION* 5-7 (2d ed. 1993) [hereinafter SCHWARCZ, *STRUCTURED FINANCE*] (discussing the nature of the source of payment and the importance of predictability of payment for receivables).

7. See James A. Rosenthal & Juan M. Ocampo, *Analyzing the Economic Benefits of Securitized Credit*, 1 J. APPLIED CORP. FIN. 32 (1988) (analyzing the quantitative, economic, and empirical benefits of asset securitization).

8. See Schwarcz, *Asset Securitization*, *supra* note 6, at 143. In addition to providing a source of raising capital, asset securitization is useful in other respects, such as an accounting management tool for off-balance sheet financing, a risk management tool, and a tax planning tool. See *id.* This Note, however, will focus on China's primary interest — the ability to liquify current assets to raise new capital for investment.

9. See STANDARD & POOR'S, *STRUCTURED FINANCE ASIA* 1-2 (1997) (discussing the use of securitization in Hong Kong, Indonesia, Thailand, Korea, and Singapore).

10. See SCHWARCZ, *STRUCTURED FINANCE*, *supra* note 6, at 13-15 (explaining that the role of financial guarantee companies such as Financial Security Assurance Inc. (FSA), Capital Markets Assurance Corp. (CapMAC), and Financial Guaranty Insurance Co. (FGIC) is to provide financial guarantees and credit supports). A financial guarantee company serves as an independent third party credit enhancement agency that provides guarantees to transactions backed by its own credit. In pricing the fee charged for its guarantee service, the financial guarantee company provides the important function of measuring the level of risk associated with a transaction. See *id.*

11. See Kevin Hamlin, *Asia Ltd. to Reduce Cost of Raising Money*, ASIA TIMES, Dec. 21, 1995, at 14 ("By guaranteeing bonds issued by concerns involved in infrastructure

years and \$25 billion within five years.¹² More recently, investors and financiers have championed asset-backed securitization as a financing tool to ease, if not cure, the 1997 Asian economic liquidity crisis.¹³

In April 1997, China pioneered its first asset-backed securitization.¹⁴ China Ocean Shipping Company (COSCO), a shipping company owned by the Chinese government, completed an asset-backed securitization transaction that securitized COSCO's future shipping revenues derived from U.S. and European operations.¹⁵ By December 1997, COSCO announced plans for a second securitization for \$500 million in future shipping revenues.¹⁶ The successful completion of the COSCO transaction sparked interest in raising more capital with domestic Chinese asset-backed securitization transactions despite China's lack of a comprehensive legal system.¹⁷

This Note examines whether the COSCO transaction was an anomaly or whether the current Chinese legal system is mature enough to sustain an asset-backed securitization market.¹⁸ Part I introduces the history and basic structure of the U.S. and Japanese models for asset securitization. Part II examines the ability of the current Chinese legal system to support a viable asset securitization transaction. Part III offers suggestions on the development of Chinese asset securitization in the near future.

This Note argues that while the Chinese legal system cannot currently accommodate an asset securitization styled after the U.S. common law model, the Japanese civil code model offers instructive guidance. Instead of directly adopting either the U.S. or Japanese models, China should use a two-tiered model to satisfy the country's asset securitization needs.

I. Asset Securitization Legal Structures

A comparative review of different legal structures is helpful in analyzing the prospects for asset securitization in China. First, China can learn from the historical development of asset securitization in the United States and the subsequent adoption of this financing technique in other nations. Sec-

projects, Asia [sic] Ltd. expects to provide Asian borrowers with improved access to big institutional investors.”).

12. *See id.* Unless otherwise noted, all currency figures in this Note are in U.S. dollars.

13. *See supra* note 1 and accompanying text.

14. *See China's COSCO Returns*, EMERGING MARKETS DEBT REP., Dec. 15, 1997, at 1.

15. *See id.* *See also CapMAC Provides US\$200 Million Guarantee for COSCO; People's Republic of China's First Future Flow Transaction*, BUS. WIRE, Sept. 4, 1997, at 10:31:00, available in 1997 WL AllNewsPlusWires Database.

16. *See China's COSCO Returns*, *supra* note 14.

17. *See discussion infra* Part II (discussing the ability of the Chinese legal system to support an asset-backed securitization).

18. The U.S. asset-backed securitization transaction is a natural model because the United States hosts what is by far the largest asset-backed securitization market in the world. *See infra* Part I.A. The exportation of the asset-backed securitization transaction to other nations has proceeded by using the U.S. model as the basic reference structure. *See generally* ASSET-BACKED SECURITIZATION IN EUROPE 3-7 (Theodor Baums & Eddy Wymeersch eds., 1996) (discussing the development of U.S. securitization in comparison with European securitization programs).

ond, a comparative analysis of asset securitization legal structures within a common law and a civil law context is useful to determine what type of legal framework is suitable for China.

A. History of Asset Securitization in the United States, Europe, and Asia

Asset securitization originally developed in the common law legal environment of the United States.¹⁹ Mortgage-backed securities, the precursor to modern asset-backed securities, was developed in the 1930s with the critical support of the U.S. government during the infancy of the U.S. residential mortgage industry.²⁰ With active governmental support, a secondary market in the trading of mortgage-backed securities slowly developed in the 1950s and 1960s.²¹ In the 1970s, under the auspices of the Federal Home Loan Mortgage Association (Freddie Mac), the Federal National Mortgage Association (Fannie Mae), and the Government National Mortgage Association (Ginnie Mae), the United States witnessed explosive growth in the secondary market for mortgage-backed securities.²² In the

19. See Michael H. Schill, *Uniformity of Diversity: Residential Real Estate Finance Law in the 1990s and the Implications of Changing Financial Markets*, 64 S. CAL. L. REV. 1261, 1267-71 (1991); Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1380-82 (1991).

20. See Schill, *supra* note 19, at 1263-65; Shenker & Colletta, *supra* note 19, at 1383-84. Federal entities such as the Federal National Mortgage Association (Fannie Mae), the Government National Mortgage Association (Ginnie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac), provided crucial initial support in the early growth of the U.S. asset-backed securitization market. See Schill, *supra* note 19, at 1263-71; Shenker & Colletta, *supra* note 19, at 1383-85. Residential mortgages were the ideal asset to securitize because U.S. mortgages have historical documented data on default rates and repayment schedules. Thus, residential mortgages in the United States have the quality of statistically predictable payment schedules that is the hallmark of an ideal source for asset securitization. See SCHWARCZ, *STRUCTURED FINANCE*, *supra* note 6, at 3-4 (discussing the importance of predictability of payment in asset securitization and noting that trade receivables, automobile loans, and credit card receivables have this quality).

21. See Shenker & Colletta, *supra* note 19, at 1384. After the U.S. real estate collapse in the 1930s, government-related agencies actively supported the availability of funds for housing finance. The Federal Housing Administration, created in 1934 by Congress, provided government guarantees on certain mortgages; the Veteran's Administration in 1944 provided a mortgage insurance program to enhance the marketability of veteran's mortgages; the Federal National Mortgage Association (Fannie Mae), created in 1938, provided a secondary market for government guaranteed mortgages. A secondary market in the trading of mortgage securities enhances the liquidity in the mortgage financing markets. See *id.*

22. See Schill, *supra* note 19, at 1268-70. Starting in the 1970s, U.S. federal agencies bought qualifying home mortgages from lenders, pooled the mortgages, issued securities backed by the mortgage pool, resold these securities in capital markets, and provided guarantees for the timely servicing and payment of principal and interest. Ginnie Mae guaranteed the timely payment of principal and interest in privately originated mortgage-backed securities backed by pools of government guaranteed mortgages. Fannie Mae provided a secondary market in mortgage-backed securities for the private sector. Freddie Mac broadened the authority of Fannie Mae to enable the purchasing of conventional and variable-rate loans. See Shenker & Colletta, *supra* note 19, at 1384. The federal agencies not only provided guarantee assurance to foster liquidity in the private sector, but also standardized legal documentation for the mortgage-backed secur-

1980s, innovations in the mortgage-backed securities industry introduced the "stripped" mortgage-backed securities, or the collateralized mortgage obligation, which global markets widely received. This began the exportation of the U.S. asset securitization technique to other countries.²³

In addition to the "stripped" mortgage-backed securities, other variations of the asset securitization technique including the use of other asset types instead of the residential mortgage.²⁴ Again, U.S. governmental agencies provided the critical support in expanding the securitization technique to include other assets. For example, the Student Loan Marketing Association securitized student loans, and the Farm Credit Banks securitized farm loans.²⁵ As testament to the versatility and aggressiveness of the U.S. asset securitization market, in 1997, the "Bowie Bonds" successfully securitized the future royalty income stream of rock star David Bowie's record albums.²⁶

The common quality for a successful asset type, whether it is a mortgage, student loan, or the future royalty payments of a rock star's record albums, is predictability of payment in the asset.²⁷ A typical asset-backed securitization transaction requires the backing of an asset or a receivable with a historically proven record of payments and default rates such that investors are assured of consistent and timely payments.²⁸ While the United States succeeded in using residential mortgages as its bedrock

ities market. *See id.* at 1385. The U.S. mortgage-backed securities market remains the most important and largest asset securitization market with capitalization valuation totaling over \$900 billion in 1990. *See* TAMAR FRANKEL, *SECURITIZATION, STRUCTURED FINANCING, FINANCIAL ASSETS POOLS, AND ASSET-BACKED SECURITIES* (1991).

23. *See* Pittman, *Economic and Regulatory Developments Affecting Mortgage Related Securities*, 64 NOTRE DAME L. REV. 497, 511-12 (1989). "Stripped" mortgage-backed securities separate the interest-only payment from the principal-only payment. Sellers would sell each "strip" separately to different types of investors. Fannie Mae is credited as the first entity to offer stripped mortgage-backed securities. *See id.* *See generally* Henry A. Fernandez, *Symposium: Globalization of Mortgage-Backed Securities*, 1987 COLUM. BUS. L. REV. 357 (1987) (discussing the importance of the collateralized mortgage obligation in launching asset securitization financing to the world).

24. *See* SCHWARCZ, *STRUCTURED FINANCE*, *supra* note 6, at 4 (listing more traditional variations including commercial mortgage loans, trade receivables, automobile loans, and credit card receivables as well as even more innovative variations used in private offerings such as franchise fees, equipment leases, subrogation claims, junk bonds, health care receivables, future media revenues, and utility surcharges).

25. *See* Edward J. Park, *Allowing Japanese Banks to Engage in Securitization: Potential Benefits, Regulatory Obstacles, and Theories for Reform*, 17 U. PA. J. INT'L ECON. L. 723, 725 (1996).

26. *See* *Rock Royalties Prove a Sound Investment*, FIN. POST, Feb. 12, 1998, at 42. The "Bowie Bonds" securitized the future cash flow income stream of rock star, David Bowie, for \$55 million. Eager financiers and lawyers heralded exotic securitizations such as the David Bowie transaction as a hallmark to the broad applications of asset-backed securitization. *See id.* Japan's Nomura Securities Co. announced hopes to complete a \$10 million asset securitization deal on the music publishing income of singer Rod Stewart. *See id.*

27. *See* SCHWARCZ, *STRUCTURED FINANCE*, *supra* note 6, at 5.

28. *See id.* at 4-5; *Rock Royalties Prove a Sound Investment*, *supra* note 26, at 1 ("We're looking at artists who've been around for long enough to prove their music has lasted, and for us to predict how it's likely to sell in the future.").

asset, other countries might not have the right combination of indigenous legal, regulatory, and economic structures to provide an environment supportive of residential mortgages. Therefore, other countries may have to identify different assets to serve as underlying securities.²⁹

Like the United States, the United Kingdom succeeded in nurturing a viable asset securitization market backed by mortgages. Other European countries, however, have not favored asset securitization transactions.³⁰ With the exception of the United Kingdom, which shares a common law system similar to the United States, other European countries have failed to successfully adopt asset securitization because their civil code legal systems burden the free development of asset securitization with inflexible implementing legislation and regulatory control. The civil code system has slowed Europe's assimilation of asset securitization.³¹

Austria, Denmark, Finland, Greece, and the Netherlands do not have a legal structure capable of supporting asset securitization and also lack the economic incentives to promote such legislation.³² Germany and Italy have passed implementing legislation, but asset securitization remains

29. See, e.g., ORRICK, HERRINGTON & SUTCLIFFE LLP, *INVEST IN INDONESIA 2-9* (1997) (explaining that Indonesia's burdensome residential mortgage registration requirements make the mortgage unfeasible to securitize, thereby resulting in Indonesians favoring credit card and auto-loan receivables). *But see* STANDARD & POOR'S, *supra* note 9, at 3 (noting that Indonesia recently introduced the Mortgage on Land and Land-Related Objects law to facilitate lending secured by land). The Chinese residential mortgage market is similarly resistant to securitization because of registration burdens and a lack of national uniformity in the regulation of residential mortgages. See *infra* Part II.B; see also *infra* note 101 and accompanying text (listing some provincial mortgage loans). Instead, China has passed targeted laws and regulations to facilitate the securitization of huge infrastructure assets such as highways and project finance. See *infra* Part II.C.

30. See generally *ASSET-BACKED SECURITIZATION IN EUROPE*, *supra* note 18, at 4-6 (surveying 14 European countries and concluding that only the United Kingdom, with its common law system, has the legal structure and the economic incentives to foster a viable market for asset-backed securities). In the United Kingdom, the asset-backed securitization market developed in the mid-1980s. The United Kingdom focused primarily on securitizing residential mortgages by unregulated mortgage lending companies that competed with the licensed deposit takers under the 1987 Banking Act or the 1986 Building Societies Act. While the U.K. asset-backed securitization market is the most mature of the European nations, it still lags far behind the dynamic growth of the United States. See *id.* at 99-100.

31. See *id.* at 5-6 (discussing the effects of a civil code system that requires implementing legislation as opposed to the flexibility of the common law system.) Factors other than the European civil code legal tradition are important to the slow spread of asset securitization in Europe. A lack of uniformity in accounting rules, bank regulatory restraints, less social acceptance for exotic financing techniques, and the inability to attain a sustainable asset securitization market size for the smaller European countries have collectively impaired the development of a significant asset securitization market in Europe (except for the United Kingdom). *But see* Adam Reinebach, *Securitizing Europe: After years of hype about overseas potential, the asset-backed market is finally going global*, *INV. DEALERS' DIG.*, Dec. 8, 1997, at 14. See generally *ASSET-BACKED SECURITIZATION IN EUROPE*, *supra* note 18, at 5-6 (analyzing the prospects of any significant asset securitization developments in 14 European countries).

32. See *ASSET-BACKED SECURITIZATION IN EUROPE*, *supra* note 18, at 9-23 (analyzing Austria); *id.* at 51-53 (analyzing Denmark); *id.* at 55-69 (analyzing Finland); *id.* at 123-32 (analyzing Greece); *id.* at 143-96 (analyzing the Netherlands).

unattractive because of business and regulatory obstacles.³³ France and Spain have passed implementing legislation, but the small size of their economic markets lack the depth in asset resources to make securitization an economically attractive financing technique.³⁴ Although France and Spain have successfully completed and issued asset-backed securities transactions, the volume of such activity is woefully small.³⁵

The civil code system also poses similar problems for many Asian countries.³⁶ Unlike European countries, however, Asian countries have a great need to generate new capital. Consequently, Asian governments have spurred the development of implementing legislation for asset securitization.³⁷ In fact, several Asian countries have already adopted implementing legislation.³⁸ For example, Indonesia introduced the Mortgage on Land and Land-Related Objects Law to facilitate secured lending based on land assets.³⁹ Thailand introduced implementing legislation to create insolvency and trustee laws that parallel the U.S. legal structure.⁴⁰ Japan is successfully developing a strong asset securitization market within its civil code system by integrating implementing legislation with the guidance of a competent regulatory agency.⁴¹ Despite differences between the American, European, and Asian legal systems, it is likely that government officials and private entrepreneurs will mold existing legal and regulatory structures to facilitate asset securitization transactions if the economic need is great.

33. See *id.* at 87-98 (analyzing Germany); *id.* at 133-142 (analyzing Italy). In Germany, no specific legal or regulatory framework exists to structure asset-backed securitization transactions. However, investors can manipulate existing structures to support an asset-backed securitization program in Germany. On the other hand, restrictive banking regulations still make asset securitization in Germany unfeasible. See *id.* at 87-98. But see Reinebach, *supra* note 31, at 14 ("In Germany . . . regulations were passed [in 1998] that allow German banks to securitize their assets.").

34. See ASSET-BACKED SECURITIZATION IN EUROPE, *supra* note 18, at 71-85 (analyzing France); *id.* at 207-25 (analyzing Spain). In France, due to excessive legal restrictions that were partly reduced by the French government, the volume of asset-backed securitization transactions has been low. See *id.* at 71-85.

35. See *id.* at 5, 84-85, 207-11.

36. See STANDARD & POOR's, *supra* note 9, at 3 (noting that Asian countries such as Indonesia and Thailand with civil law jurisdictions need to first enact implementing legislation).

37. For example, China has enacted implementing legislation to specifically target asset securitization in infrastructure developments such as highways and project finance. See *infra* Part II.C.

38. See, e.g., STANDARD & POOR's, *supra* note 9, at 3 (identifying Indonesia and Thailand as examples of countries that have enacted implementing legislation specifically to facilitate asset securitization).

39. See ORRICK, HERRINGTON & SUTCLIFFE LLP, *supra* note 29, at 7-8. Indonesia also attracted the International Finance Corp.'s (IFC) attention to actively develop the Indonesian asset securitization market. See Betty W. Liu, *IFC Arranging Auto-Debt Bond in Indonesia*, ASIAN WALL ST. J., Nov. 27, 1997, at 13.

40. See STANDARD & POOR's, *supra* note 9, at 3.

41. See Yoshiki Shimada & Shinji Itoh, *Japanese Asset Securitization: A Guide for Practitioners*, 38 HARV. INT'L L.J. 171, 173-75 & n.9 (1997); *infra* Part I.C.

B. U.S. Legal Structure

The legal structure of U.S. asset securitization is the most advanced and has had tremendous influence on the development of similar laws in Europe and Asia.⁴² Thus, a review of the U.S. model offers lessons for the future of asset securitization under Chinese law. The U.S. asset securitization model is derived from a cross-disciplinary application of several areas of jurisprudence, including security interest law, bankruptcy law, tax law, regulatory requirements, and accounting rules.⁴³ The following describes a typical U.S. asset securitization structure, while acknowledging that there is often flexibility in application, depending on the specific needs of private parties.

The U.S. model transaction revolves around two primary parties: the originator and the issuer.⁴⁴ The originator begins the asset securitization process by gathering a pool of similar assets.⁴⁵ After gathering and pooling the assets or receivables, the originator retains ownership of the receivables but transfers its beneficial interest in the receivables to the issuer.

The primary purpose of the issuer is functionally to sever the ties between the legal interest and beneficial interest in the receivables. While the originator retains legal ownership, the issuer, as a separate entity, retains the beneficial interest and manages the securitization's pooling and servicing operations. To ensure the separateness of the originator and the issuer, the issuer is usually created as a bankruptcy remote special purpose vehicle via a true sale⁴⁶ of the assets.⁴⁷ The issuer receives the pool of receivables, enhances the marketability of the receivables, and then sells them to investors.⁴⁸ These final product securities are called asset-backed

42. See *ASSET-BACKED SECURITIZATION IN EUROPE*, *supra* note 18, at 100 (“[T]he USA has been the pace setter and all other countries have tried to follow the US example. The US’s market is by a long way the most matured market . . .”).

43. See *SCHWARCZ, STRUCTURED FINANCE*, *supra* note 6, at xiii-xv. This Note will focus on the security interest and bankruptcy aspects necessary for any asset securitization transaction. Tax and accounting law are important for business profitability and marketability reasons. However, this Note will not address tax, accounting, or regulatory requirements.

44. See *id.* at 5-6.

45. See Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 *WASH. U. L.Q.* 1061, 1067-68 (1996) (describing the asset pooling process that usually seeks to include receivables with similar terms, maturities, and salient characteristics); see also Lyn Perlmuth, *Pumping up the ABS*, *INSTITUTIONAL INV.*, May 1995, at 36 (discussing the increase of heterogeneous pooling that may later be segregated by issuing different tranches of asset-backed securities).

46. See *SCHWARCZ, STRUCTURED FINANCE*, *supra* note 6, at 28-29. A true sale severs the legal and beneficial interests of an asset whereby the legal interest is retained by the originator and the beneficial interest is transferred to the issuer. See *id.* The issuer and originator must perfect the transfer of the receivables under registration laws to satisfy a true sale. See *id.* at 28-34.

47. See *id.* at 16. The special purpose vehicle serves as the issuer and must maintain its independence from the originator by achieving bankruptcy remoteness. See *id.* at 16-28.

48. See *id.* at 13-15. A third party guarantee enhances the credit rating and thus the marketability of the receivables so investors will have confidence in buying the securitized notes backed by the receivables. After credit enhancement, the credit rating of the

securities.

Investors in capital markets buy these asset-backed securities for cash, and the proceeds of the sale are then transferred to the issuer.⁴⁹ The issuer usually converts this cash in a currency exchange swap and forwards the swapped cash funds back to the originator.⁵⁰ For the term of the asset-backed security, the originator acts as the agent responsible for servicing and collecting payments on the underlying receivables.⁵¹ Asset securitization provides benefits to all the parties involved in the transaction – the originator is provided with an additional source of capital, the issuer receives a fee for transactional services, and investors have the opportunity to participate in another type of security interest.⁵²

C. Japan's MITI Law

In 1993, Japan's National Diet enacted the MITI Law, named after its original proponent, the Ministry of International Trade and Industry (MITI),⁵³ to implement legislation encouraging the use of the asset securitization technique within the structure of the Japanese civil code system.⁵⁴ Japan derived the MITI Law from prior efforts to create an asset securitization structure within the Japanese Civil Code.⁵⁵ The MITI Law has become the

originator no longer has any effect on the credit rating of the receivables. Only a few entities provide credit enhancement by financial guarantees including: Financial Security Assurance Inc. (FSA), Capital Markets Assurance Corp. (CapMAC), Financial Guaranty Insurance Co. (FGIC), and ASIA Ltd. After credit enhancement, a credit rating agency such as Standard & Poor's Corp. or Moody's Investor Service, Inc. would assign a credit rating to the asset-backed securities. *See id.* at 14.

49. *See id.* at 33 (noting that one of the functions of the issuer is to administer the collection of account receivables from the investors).

50. *See Shimada & Itoh, supra* note 41, at 176 & n.12 (explaining the currency swap mechanism and its importance primarily to international cross-border securitization transactions).

51. *See id.* at 176; SCHWARCZ, STRUCTURED FINANCE, *supra* note 6, at 47.

52. *See Shimada & Itoh, supra* note 41, at 171-72.

53. *See id.* at 174 & n.9 ("MITI has regulatory and supervisory jurisdiction over non-bank financing companies such as leasing and credit card companies.")

54. Tokutei Saiken to ni Kakaru Jigyo no Kisei ni Kansuru Horitsu [The Law Relating to the Regulation of Business Concerning Specified Claims, Etc.], Law No. 77 of 1993 [hereinafter MITI Law].

55. Minpo, Law No. 89 of 1896 [hereinafter Japanese Civil Code]. Article 467 of the Japanese Civil Code specifies procedures for perfecting the assignment of receivables for securitization. Japanese Civil Code, *supra*, art. 467, translated in Shimada & Itoh, *supra* note 41, at 179 n.22. Article 467 states the following:

Article 467. Assignments of Designated Claims (Shimei Saiken).

(1) The assignment of a designated claim shall not be effective against the underlying debtor or any third party, unless the assignor has provided notice of such assignment to the underlying debtor or the underlying debtor has consented to such assignment.

(2) The notice or consent referred to in the preceding paragraph shall not be effective against a third party other than the underlying debtor, unless such notice or consent is set forth in a kakutei hizuke (certified date) certificate.

Id.

Securitization under Article 467 of the Japanese Civil Code requires a more cumbersome receivables perfection process. Assignment of the receivables from the originator to the issuer under Article 467 can be accomplished by either (1) notifying the assign-

legal structure of choice in originating asset-backed securities in Japan and has spurred an explosive growth of activity in Japanese asset-backed securities transactions.⁵⁶

The MITI Law initially targeted the expansion of asset securitization to broad sectors of the Japanese economy.⁵⁷ However, after jurisdictional skirmishes with the Ministry of Finance (MOF), MITI settled on a more limited version of the original MITI Law.⁵⁸

The current MITI Law applies only to certain originators with receivables falling within the MITI Law, such as credit card companies, leasing companies, and other non-bank finance companies.⁵⁹ The MITI Law also applies only to certain types of receivables called "Specified Claims."⁶⁰

ment to the underlying debtors with a *kakutei hizuke* (certified date) certificate, or (2) presenting to the underlying debtor the *kakutei hizuke* to prove the date of assignment. Both methods under Article 467 of the Japanese Civil Code are administratively more cumbersome and costly compared to the MITI Law procedures for assignment to perfect a security interest. See Shimada & Itoh, *supra* note 41, at 179-80.

56. See STANDARD & POOR'S, *supra* note 9, at 9 (listing over ¥100 billion of asset securitization transactions rated by Standard & Poor's in 1996 and 1997). Despite the preference for using the MITI Law, the Japanese Civil Code is still an available option and is sometimes a required procedure for asset securitization in Japan. See Shimada & Itoh, *supra* note 41, at 179-80.

57. See *Non-Banks to Bank on Asset-Backed Securities*, NIKKEI WKLY., Jan. 25, 1992 (discussing MITI's efforts to encourage non-bank finance companies to diversify their funding sources through asset securitization).

58. See Shimada & Itoh, *supra* note 41, at 174 n.9.

59. See MITI Law, *supra* note 54, art. 7.

60. *Id.* art. 2, para. 1, translated in Shimada & Itoh, *supra* note 41, at 180 n.26.

Article 2. Definitions.

The term "Specified Claims" as used in this Law shall mean the following claims:

Any claims to receive payment of money (the "Monetary Claims") in consideration of the license for usage of machinery or any other goods under a certain agreement pursuant to which the usage of such machinery or other goods is licensed, having the term of such usage in excess of one (1) year (the "Term of Usage") and without any provisions to the effect that one party or both parties may elect the termination thereof at any time (i) on or after the commencement date of the Term of Usage (the "Usage Commencement Date") or (ii) after the lapse of a certain period from the Usage Commencement Date;

Any Monetary Claims accrued to the User referred to below under a certain agreement pursuant to which the parties thereto have agreed that a voucher and the like in exchange for which, or the presentment of which, goods may be purchased from a specified vendor (the "Voucher and the Like") will be delivered to a person who wishes to purchase such goods by utilizing the same (the "User") and, in cases where such User purchases goods from such specified vendor in exchange for or by presenting the Voucher and the Like, the amount equal to the purchase price thereof will be paid to such vendor and such amount will be recovered from such User over a two (2)-month or greater period in three (3) or more installments;

Any Monetary Claims accrued to the purchaser referred to below under a certain agreement pursuant to which the parties thereto have agreed that, on the condition that, without utilizing the Voucher and the Like, a specified vendor has sold goods to a purchaser, the amount equal to the whole or a portion of the purchase price thereof will be paid to such vendor, and such amount will be recovered from such purchaser over a two (2)-month or greater period in three (3) or more installments;

The scope of "Specified Claims"⁶¹ includes lease receivables,⁶² credit card receivables,⁶³ and installment loans.⁶⁴

The MITI Law requires that the issuer be a recognized "Specified Claim Purchaser" before receiving the assignment of receivables from the originator and the subsequent selling of the asset-backed securities in the markets.⁶⁵ To achieve the status of a "Specified Claim Purchaser," licenses must be obtained from both MITI and MOF.⁶⁶

To add another level of regulatory oversight, the MITI Law augments the standard U.S. model of asset securitization with the "Basic Claim."⁶⁷ The "Basic Claim" is a cross-receivable that the issuer gives to the originator to represent the issuer's obligation to pay the purchase price of the receivable or "Specified Claim."⁶⁸ The "Basic Claim" is then divided into "Individual Claims"⁶⁹ that are then sold to investors through an "Individual Claims Dealer."⁷⁰

By creating these entities, the MITI Law reserves regulatory oversight over the entire asset securitization transaction.⁷¹ Both the "Specified Claims Purchaser" and the "Individual Claims Dealer" must jointly file the

Any Monetary Claims accrued to the User referred to below under a certain agreement pursuant to which the parties thereto have agreed that the Voucher and the Like will be delivered to the User and, in cases where such User purchases goods from a specified vendor in exchange for, or by presenting, the Voucher and the Like, the amount equal to the purchase price thereof will be paid to such vendor and such amount will be recovered from such User for each such period of time as is agreed to in advance for such installment of amount and as calculated in the manner agreed to in advance based upon the aggregate of such purchase price; or

Any Monetary Claims generated pursuant to such agreement as is set forth in a Cabinet Order or agreement similar to the agreement referred to in each of the preceding five subparagraphs.

Id.

61. See Tokutei Saiken to ni Kakaru Jigyo no Kisei ni Kansuru Horitsu Seko-rei [The Enforcement Order Promulgated Under the Law Relating to the Regulations and Business Concerning Specified Claims, Etc.] art. 1 [hereinafter MITI Law Enforcement Order]. Under Article 1 of the MITI Law Enforcement Order, the term "Specified Claims" also includes credit card receivables involving the purchase of services and credit card receivables or loan receivables where the vendor of goods or provider of services extends credit to finance the purchase by its customers of goods or services. See *id.* art. 1.

62. See *id.* art. 2, para. 1, subpara. 1 (lease receivables).

63. See *id.* art. 2, para. 1, subpara. 2 (credit card receivables of a fixed installment type); *id.* art. 2, para. 1, subparas. 2-4 (credit card receivables of a revolving repayment type and other receivables stipulated by the Cabinet Order).

64. See *id.* art. 2, para. 1, subpara. 3 (installment loans extended for the purpose of financing purchases of merchandise).

65. MITI Law, *supra* note 54, art. 2, para. 5 & art. 30; MITI Law Enforcement Order, *supra* note 61, art. 13.

66. MITI Law, *supra* note 54, art. 2, para. 5 & art. 30.

67. *Id.* art. 2, para. 4, subpara. 1.

68. *Id.* art. 2, para. 1.

69. *Id.* art. 2, para. 6.

70. Shimada & Itoh, *supra* note 41, at 181 & n.30.

71. See *id.* at 182-83.

assignment of the "Specified Claim" and "Basic Claim" with MITI.⁷² MITI must then review the asset securitization transaction within sixty days and may order modification of the transaction.⁷³ Finally, both MITI and MOF must grant licenses to either the "Specified Claims Purchaser" or the "Individual Claims Dealer."⁷⁴

The MITI Law has proven to be a success.⁷⁵ There are limitations and regulatory controls inherent in the MITI Law asset securitization process. However, the high volume of transactions completed under the MITI Law is a testament to the possibility of creating an efficient legal structure under a civil code system while retaining strong regulatory oversight.⁷⁶ Even during the 1997 Asian economic crisis, Japanese investors completed several asset securitizations "including deals backed by catastrophe bonds, equipment leases, apartment loans, and auto loans."⁷⁷

II. Applicable Chinese Laws

China already has a patchwork system of laws relevant to asset securitization. While legal modernization is an ongoing process, the past three years have marked the introduction of several landmark laws and regulations applicable to Chinese asset securitization, followed by additional clarification and application of these laws and regulations.

A. Chinese Legal Environment

Chinese law differs fundamentally from Western law in many respects. For example, China lacks an independent judiciary. Moreover, judicial decisions merely serve as guidance and have no binding precedential value either to other Chinese courts or to the issuing court itself.⁷⁸ The judiciary is merely a functional arm of the Chinese political bureaucracy that faith-

72. MITI Law, *supra* note 54, art. 6.

73. See MITI Law Enforcement Order, *supra* note 61, art. 4, paras. 1 & 2.

74. See MITI Law, *supra* note 54, arts. 30, 52.

75. MITI has disclosed that transactions valued at over one trillion yen have already been completed under the MITI Laws. See Sasho Tomoko, *Shisan no Shokenka/Ryudoka ni Okeru Shisan no Genboyusha ni yoru Shisan Naiyo ni Kansuru Joho Teikyo Koi to Himitsu Hoji Gimu* [Information Disclosure and Confidentiality Obligations Concerning the Assets Owned by the Originators of such Assets in the Case of Securitization], 2 *SHISAN RYUDOKA KENKYU*, Aug. 1996, at 86, 102 n.4. Japanese securitization issuances totaled \$1.95 billion in 1997 and commentators predict that Japanese securitization issuances will exceed \$20 billion in 1998. See Matthew Davies, *Better Times Ahead in Asia*, PRIV. PLACEMENT REP., Jan. 26, 1998, at 1, available in 1998 WL 5034620.

76. See Davies, *supra* note 75, at 1 ("Japanese regulators had finally realized the benefits of securitization and were working to make issuance easier."); see also Reinebach, *supra* note 31, at 17 (reporting that Japanese "legislation is becoming more pro-securitization").

77. Reinebach, *supra* note 31, at 17. "[Japan's] plan is to eventually securitize mortgages originated by the Housing Loan Corp., Japan's government mortgage lender." *Id.*

78. See Jerome A. Cohen & John E. Lange, *The Chinese Legal System: A Primer for Investors*, 17 N.Y.L. SCH. J. INT'L & COMP. L. 345, 350 (1997); Jonas Alsen, *An Introduction to Chinese Property Law*, 20 MD. J. INT'L L. & TRADE 1, 18-19 (1996).

The legal system is still weak in China and there exists no true rule of law. As long as the CCP (Chinese Communist Party) holds absolute power, the courts

fully executes the laws.⁷⁹ China has no internal restraints similar to the American principles of "checks and balances" or "separation of powers."⁸⁰

Chinese law is, therefore, an inherently politicized system more correctly characterized as an amalgamation of administrative decrees reflecting official commands.⁸¹ Since legal decisions have no precedential value, one cannot rely on a court's interpretation of Chinese law as an authoritative decision.⁸² Even published laws and regulations may not reassure investors because those rules are subject to repeal without warning or notice.⁸³ Additionally, the Chinese legal system lacks transparency. For-

will never be strong, independent organs. Regional protectionism makes it difficult to enforce a claim from another part of the country.

Id. at 60 (parenthesis added); see Stanley B. Lubman, *Emerging Functions of Formal Legal Institutions in China's Modernization*, 2 CHINA L. REP. 195, 245-49 (1983); see also Stanley Lubman, *Mao and Mediation: Politics and Dispute Resolution in Communist China*, 55 CAL. L. REV. 1284, 1325-28 (1967) (describing politicization of judicial mediation).

79. See Alsen, *supra* note 78, at 18 ("Within a genuine socialist legal system, it is evident that the judiciary cannot be granted independence in the same way as the West. The state embodies the will of the proletariat, and the courts are subordinate to the highest organs of state power."); Todd R. Benson, *Taking Security in China: Approaching U.S. Practices?*, 21 YALE J. INT'L. L. 183, 194-95 (1996) (citing WILLIAM C. JONES ET AL., LAW OF THE PRC III (Dec. 28, 1993)); Cohen & Lange, *supra* note 78, at 351 ("[D]espite constitutional and legislative language that confers the power to decide cases independently, the courts, like all other governmental institutions, are subject to tight political control . . ."). Chinese legal policies are formulated by Communist Party members who intertwine their political role with positions of high authority in the Chinese judiciary. *Id.* ("Party policy in legal affairs is usually formulated and coordinated by the Political-Legal Committee of the Party Central Committee, whose leading members include the President of the Supreme Court, the Procurator General, the Minister of Justice, the Minister of Public Security and the Minister of State Security.")

80. Benson, *supra* note 79, at 194; Alsen, *supra* note 78, at 18-19.

Although there is no separation of powers, a certain degree of specialization does exist. According to article 126 of [China's] Constitution, the courts exercise judicial power independently and are not subject to interference by any administrative organ, public organization or individual. Theoretically, the courts are therefore independent from all other organs excluding the NPC (National People's Congress). In reality, the courts are weak institutions under heavy influence from party and regional interests.

Id. at 18 (parenthesis added).

81. See Benson, *supra* note 79, at 191.

82. While Chinese courts are urged to follow guidance from prior court opinions, the lack of binding precedential power detracts from the reliability of past court opinions. See *supra* note 78 and accompanying text.

83. See Y.M. Elaine Lo, *New Procedures Expand International Borrowings by Domestic Organizations*, CHINA L. & PRAC., Jan.-Feb. 1998, at 66 [hereinafter Lo, *International Borrowings*]. A recent example of the willingness of Chinese officials to repeal prior laws and regulations is the September 24, 1997 promulgation of the Administration of Borrowing of International Commercial Loans by Domestic Organizations Procedures ("1998 International Loans Procedures"). The 1998 International Loans Procedures repealed: (1) the 1991 Administration of Borrowing of International Commercial Loans by Domestic Organizations Procedures; (2) the July 14, 1995 Conceiving Project Finance Conducted by PRC Enterprises Circular issued by the People's Bank of China; (3) the April 17, 1996 Raising of Finance Overseas by Overseas Branches of the PRC Domestic Banks which Conduct Foreign Exchange Business Provisions promulgated by SAFE; and (4) the January 16, 1997 Further Strengthening the Monitoring of the Raising of Finance by Overseas Branches of PRC Domestic Enterprises issued by the State Administration of Foreign Exchange (SAFE). See *id.*

eigners and even Chinese citizens cannot easily access many internal regulations.⁸⁴

Instead, official statements from the government are more indicative of Chinese law. For example, a defendant can use official policy statements to predict with greater accuracy the Chinese government's position in an enforcement action where the defendant is charged with breaching the law.⁸⁵ Thus, analyzing Chinese "law" essentially becomes an exercise in analyzing Chinese politics.⁸⁶

Laws and regulations promulgated by the central government (the National People's Congress) override local provincial laws.⁸⁷ While the central government has the power to issue overriding legislation, often such legislation is in the form of general principles and guidelines that permit broad interpretation.⁸⁸ Local implementing regulations by specialized government agencies and local government officials provide the details of the actual law.⁸⁹ Finally, political struggles between the provinces and the national government can often create inconsistencies in the implementation of laws.⁹⁰ Thus, the viability of an asset securitization within the context of Chinese law hinges upon both national laws and the interpretive rules and regulations of the relevant authorities.

B. General Laws and Regulations

China currently lacks a comprehensive national legal system for the successful transplantation of the U.S. model of asset securitization. Instead, a patchwork of related Chinese laws and regulations on the creation of a security interest provides only an ad hoc framework for supporting domes-

Another example is the September 25, 1996 promulgation of the Administration of the Provision of Security to Foreign Entities by Domestic Institutions Inside China Procedures by the People's Bank of China, which repealed the 1991 Administration of Domestic Organizations Providing Foreign Exchange Guarantees to Foreign Entity Procedures. See Y.M. Elaine Lo, *Security Provision Rules Give Government Tighter Control Over Lending Issue*, CHINA L. & PRAC., Dec. 1996-Jan. 1997, at 34 [hereinafter Lo, *Security Rules*].

84. See Benson, *supra* note 79, at 192.

85. See *id.* at 192-93. This is why connections, or *guanxi*, are so important to garner support from relevant bureaucratic officials. See *id.* For a concise discussion on *guanxi* and network building, see MIN CHEN, *ASIAN MANAGEMENT SYSTEMS: CHINESE, JAPANESE AND KOREAN STYLES OF BUSINESS* 52-65 (1995).

86. See Peter Howard CORNE, *Lateral Movements: Legal Flexibility and Foreign Investment Regulation in China*, 27 CASE W. RES. INT'L L. 247, 247-48 (1995) (discussing the vagueness of Chinese laws, the vast discretionary power of administrative authorities to interpret and reinterpret law, and the constant change of law in China).

87. See Benson, *supra* note 79, at 195-97. Although the National People's Congress is formally the highest central government body, the de facto enactors of legislation within the National People's Congress are the Standing Committee of the National People's Congress and the members of the Chinese Communist Party that control the Standing Committee. See *id.*

88. See *id.*

89. See *id.* at 193.

90. See Cohen & Lange, *supra* note 78, at 349 ("Often investors are caught in the middle, between the more investor-friendly local authorities and the more macro-oriented central authorities, each offering their own - often sharply divergent - visions of the applicable regulatory framework and the proper way to proceed.").

tic Chinese based asset securitization transactions.⁹¹

1. Laws on Creating a Security Interest

Asset-backed securitization must have a legal structure capable of creating a security interest.⁹² Originally, China attempted to adapt its Civil Law to the needs of creating a security interest.⁹³ The Civil Law serves as China's national gap-filling code and permits freedom of contract within its stipulated limitations.⁹⁴ Article 89 of the Civil Law explicitly recognizes security interests and permits a debtor or a third party on the debtor's behalf to pledge certain types of assets as guarantees.⁹⁵ In addition to recognizing security interests, section 2 of the Civil Law also offers rudimentary recognition of creditor's rights and the legal concept of priority in the case of insolvency.⁹⁶ Although recognizing security interests and priority rights, the Civil Law remained silent regarding the application of a security interest holder's priority rights in a dispute involving multiple security interest

91. See *supra* Parts II.B.1-2, II.C. In this Note, a domestic transaction refers to a transaction within China's legal jurisdiction as opposed to an offshore issuance of asset-backed securities under the jurisdiction of the laws of another country.

92. See *supra* Part I.B (discussing the U.S. legal structure).

93. See Zhonghua Renmin Gongheguo Minfa Tongze [General Provisions of Civil Law of the People's Republic of China] (Jan. 1, 1987), translated in William C. Jones, *A Translation of the General Provisions of Civil Law of the People's Republic of China*, 13 REV. SOCIALIST L. 357, 376-78 (1987) [hereinafter Civil Law].

94. See Jerome A. Cohen, *China Adopts Civil Law Principles*, CHINA BUS. REV. 48 (Sept.-Oct. 1986) (discussing the overarching role of the Civil Law as a national gap filler when local rules and regulations do not provide clarity); see also Christopher G. Oechsli, *The Developing Law of Mortgages and Secured Transactions in the People's Republic of China*, 5 CHINA L. REP. 1, 3 (1988) ("The Civil Law implicitly endorses freedom of contract within boundaries allowed by statute.").

95. Civil Law, *supra* note 93, art. 89. The following are some relevant clauses from the Civil Code relating to the creation of a security interest:

2) The obligor or a third party may tender designated property as collateral. If the obligor does not perform the obligation, the obligee has a priority right to obtain compensation according to the provisions of the law from the value of the collateral converted into money or out of the proceeds received from selling off the collateral;

3) One party may give the other party a deposit within the scope provided by law. After the obligor performs, the deposit will either be deducted from the price or returned. When the party that has given the deposit does not perform the obligation, he has no right to demand the return of the deposit. When one receiving the deposit does not perform, he must return double the deposit;

4) When, according to contract, one party occupies the other's property and the other party does not pay the agreed upon sum within the time agreed upon, the party in possession has a lien on the said property, and, according to the provisions of law, has a priority right to be compensated out of the value of the lien property converted into money or out of the amount received when the lien property is sold off.

Id. The Civil Law, however, explicitly excludes land and mortgages from being a security interest. See *id.* art. 89(ii).

96. See Oechsli, *supra* note 94, at 3 ("Creditors shall have the 'right to receive priority payment by, according to the provisions of the law, converting the security to its value or by selling the secured assets.'").

holders.⁹⁷

In an effort to clarify the concept and application of security interests in China, the Supreme People's Court issued several opinions regarding the Civil Law.⁹⁸ These opinions offered cursory elaboration on some details regarding the interpretation of the Civil Law and the relationship of a security interest with priority rights and insolvency laws.⁹⁹ However, due to the vagueness of the Civil Law and the lack of binding precedents, the Civil Law and the Supreme People's Court opinions interpreting it provided insufficient reliability for investors of security interests.¹⁰⁰ Thus, even before the enactment of a specific national law on security interests, provinces and localities such as Beijing, Guangdong, Guangzhou, Fujian, Shanghai, Shenzhen, and Tianjin independently took initiatives to issue local regulations and insolvency procedures to clarify the law on the application and use of security interests.¹⁰¹

In 1995, the Standing Committee of the National People's Congress

97. See Benson, *supra* note 79, at 219-20 (commenting that Chinese courts lack the sophistication to recognize or understand the concept of priority rights); see also Oechli, *supra* note 94, at 3-4 (detailing the function of priority to third party creditor claims).

98. See, e.g., Opinion of July 14, 1992 (Civil Procedure Law), *Zuigao Renmin Fayuan Gongbao* [Supreme People's Court], reprinted and translated in GRAHAM MORRISON, *TAKING AND ENFORCING SECURITY IN CHINA* 89, 89, art. 241 (Graham Morrison et al. eds., 1993) [hereinafter *TAKING AND ENFORCING SECURITY IN CHINA*]; Opinion of Nov. 7, 1991 (Enterprise Insolvency Law (Trial Implementation)), *Zuigao Renmin Fayuan Gongbao* [Supreme People's Court], reprinted and translated in *TAKING AND ENFORCING SECURITY IN CHINA*, *supra*, at 110, 111, art. 4(3); Opinion of Aug. 13, 1991 (Handling of Loan Cases by People's Courts), *Zuigao Renmin Fayuan Gongbao* [Supreme People's Court], reprinted and translated in *TAKING AND ENFORCING SECURITY IN CHINA*, *supra*, at 123, 126, art. 18; Opinion of Jan. 26, 1988 (Civil Law General Principles), *Zuigao Renmin Fayuan Gongbao* [Supreme People's Court], reprinted and translated in *TAKING AND ENFORCING SECURITY IN CHINA*, *supra*, at 84, 86, art. 115.

99. See *TAKING AND ENFORCING SECURITY IN CHINA*, *supra* note 98, at 84-91, 110-26.

100. See *supra* notes 78, 82 and accompanying text.

101. See, e.g., Beijing Shi Fangdichan Diya Guanli Banfa [Beijing Municipality Measures for the Administration of Real Estate Mortgages] (Apr. 20, 1994) [hereinafter Beijing Mortgage Loans]; Beijing Shi Waishang Touzi Qiye Qingsuan Chengxu [Liquidation of Foreign Investment Enterprises Procedures, Beijing Municipality] (June 1, 1992) [hereinafter Beijing Foreign Investment Liquidation]; Dongguan Shi Diya Daikuan Tonggao [Secured Loans Circular, Dongguan Municipality] (Aug. 28, 1992) [hereinafter Dongguan Secured Loans]; Fujiansheng Diya Daikuan Tiaoli [Secured Loan Regulations, Fujian Province] (May 1, 1991) [hereinafter Fujian Secured Loans]; Guangdong Sheng Diya Daikuan Guanli Tiaoli [Administration of Secured Loan Regulations, Guangdong Province] (Dec. 20, 1992) [hereinafter Guangdong Secured Loans]; Guangzhou Shi Fangdichan Diya Guanli Banfa [Administration of Real Property Mortgage Procedures, Guangzhou Municipality] (June 6, 1990) [hereinafter Guangzhou Mortgage Loans]; Shanghai Shi Waishang Touzi Qiye Qingsuan Tiaoli [Shanghai Municipality Regulations for the Liquidation of Foreign Investment Enterprises] (Oct. 1, 1991) [hereinafter Shanghai Foreign Investment Liquidation]; Shanghai Renminbi Daikuan Zanzing Guanli Banfa [Provisional Regulations of Renminbi Loan Administration, Shanghai Municipality] (June 9, 1988) [hereinafter Shanghai Renminbi Loans]; Tianjin Jingji Jishu Kaifagu Fangdichan Diya Daikuan Guangli Banfa [Administration for Real Property Mortgage Loan Procedures, Tianjin Economic and Technical Development Zone] (1991) [hereinafter Tianjin Mortgage Loans]; *TAKING AND ENFORCING SECURITY IN CHINA*, *supra* note 98, at 3, 11, 32, 35, 44, 55, 127, 137.

passed the national Security Law.¹⁰² The Security Law preempted all previous contrary local laws and consolidated the treatment of security interests in China. The passage of the Security Law provided a major step in the uniformity of security interest law in China. Also, the endorsement of the Security Law by the Standing Committee of the National People's Congress significantly elevated the political importance of security interest law.¹⁰³

Under the Security Law, China only recognizes five types of security interests: guarantee, mortgage, pledge, lien, and deposit.¹⁰⁴ Each of these security interests serve different purposes. In a guarantee, a third party undertakes the full liability of the obligor if the obligor fails to perform its obligation.¹⁰⁵ A mortgage is used as a security interest for certain types of land transfer.¹⁰⁶ A pledge creates a security interest for an obligee by physical possession of movable property from the obligor to the obligee.¹⁰⁷ A lien creates a security interest over the obligator's collateral property if an obligation is not paid within a stipulated time period.¹⁰⁸ A deposit is a twenty percent maximum transfer of cash to secure performance of an obligation.¹⁰⁹ Of these five types of security interests, the most commonly used is the guarantee.¹¹⁰ While the passage of the Security Law was itself a great achievement in 1995, refinements soon helped make Chinese security interests more attractive to the foreign investor.

2. Laws on Creating a Foreign-Related Security

For foreign investor participation, Chinese law limits investment by use of regulations for "foreign-related security."¹¹¹ On September 25, 1996, the People's Bank of China promulgated the Foreign Security Procedures,¹¹²

102. See Zhonghua Renmin Gongheguo Danbao Fa [Security Law of the People's Republic of China], 8th Nat'l People's Cong., 14th Sess., Standing Comm. (Oct. 1, 1995) (promulgated by Pres. Order No. 50 (June 30, 1995)) [hereinafter Security Law], reprinted and translated in CHINA L. & PRAC., Aug. 1995, at 21.

103. See Benson, *supra* note 79, at 197 ("The recent issuance of a national security law by the Standing Committee of the National People's Congress elevated the status of security in China considerably.")

104. See Security Law, *supra* note 102, arts. 2-10; Conrad Chan, *Security Changes*, ASIA L., June 1996, at 26. Upon challenge, the validity of a pledge as a security interest was recently upheld by the Tianjin Municipal Higher People's Court. See *Chinese Court Aligns Itself to International Standards*, CHINA L. & PRAC., July-Aug. 1997, at 40.

105. See Security Law, *supra* note 102, arts. 17-20.

106. See *id.* arts. 33-37.

107. See *id.* arts. 63, 81.

108. See *id.* arts. 82-87.

109. See *id.* arts. 89-91.

110. See Chan, *supra* note 104, at 26 ("[G]uarantees are by far the most common method of security.")

111. Jingnei Jigou Duiwai Danbao Guanli Banfa [Administration of the Provision of Security to Foreign Entities by Domestic Institutions Inside China Procedures], art. 2 (promulgated Sept. 25, 1996) [hereinafter Foreign Security Procedures], reprinted and translated in CHINA L. & PRAC., Dec. 1996-Jan. 1997, at 43.

112. See Zhonghua Renmin Gongheguo Waihui Guanli Tiaoli [The PRC Foreign Exchange Control Regulations] (effective Apr. 1, 1996), reprinted and translated in CHINA L. & PRAC., Mar. 1996, at 37.

which added more guidelines to the Security Law for foreign investors seeking to purchase security interests sold by domestic Chinese entities.¹¹³ On January 12, 1998, the State Administration of Foreign Exchange (SAFE)¹¹⁴ issued the Foreign Security Implementing Rules, further clarifying the Foreign Security Procedures.¹¹⁵

Under the Foreign Security Procedures, only three forms of security interests are recognized by the Security Law as foreign-related security: guarantees, mortgages, and liens.¹¹⁶ In addition, the range of assets and receivables available for a foreign-related security interest is limited to financings, financial leases, compensation trade, overseas contracted projects, or any other form of security with foreign indebtedness.¹¹⁷

Article 4 of the Foreign Security Procedures addresses who may serve as the issuer, or the "Security Provider," and limits the Security Provider to the vague designations of "financial institutions" and "enterprise legal persons."¹¹⁸ The requirements for a Security Provider is complicated by requirements under Articles 4, 6, and 7 of the Foreign Security Procedures. First, Article 4 denies Security Provider status to any State organization or public institution except with the approval of the State Council.¹¹⁹ Second, Article 6 denies Security Provider status unless an assets-ratio test is satisfied to ensure that the Security Provider is financially healthy to serve as an issuer of foreign-related security.¹²⁰ Finally, Article 7 denies the Secur-

113. See Foreign Security Procedures, *supra* note 111, art. 1; Lo, *Security Rules*, *supra* note 83, at 34; Wang Wai Li & Robert Caldwell, *Provision of Security Procedures Create Paradox in Financing*, CHINA L. & PRAC., Dec. 1996-Jan. 1997, at 40.

114. SAFE was formerly known as the State Administration for Exchange Control, "SEAC."

115. See Jingnei Jigou Duiwai Danbao Guanli Banfa Shishi Xize [Administration of the Provision of Security to Foreign Entities by Domestic Institutions Inside China Procedures Implementing Rules] (Jan. 12, 1998) (effective retroactively on Jan. 1, 1998) [hereinafter Foreign Security Implementing Rules], reprinted and translated in CHINA L. & PRAC., Apr. 1998, at 22; Ian Tokley & Wylie O'Yang, *New Rules on PRC Security Providers Raise Comfort Level for Foreign Lenders*, CHINA L. & PRAC., Apr. 1998, at 19.

116. See Foreign Security Procedures, *supra* note 111, art. 2. Article 2 of the Foreign Security Procedures limits the scope of recognized "security to foreign entities" to:

- 1) letters of guarantee, standby letters of credit, promissory notes, drafts and any other form of guarantees in favour of a foreign party;
- 2) mortgages over property specified by Article 34 of the PRC, *Security Law*;
- 3) pledges over moveable property or rights as specified in Section 1 of Chapter Four and Article 75 of Section 2 of Chapter Four of the PRC, *Security Law* respectively.

Id.; see Li & Caldwell, *supra* note 113, at 40; Rongwei Cai & Zheng Zhenwu, *China Tightens Rules on Foreign-Related Security*, ASIA L., Nov. 1996, at 36.

117. Foreign Security Procedures, *supra* note 111, art. 2; see also Li & Caldwell, *supra* note 113, at 40.

118. Foreign Security Procedures, *supra* note 111, art. 4. Article 4 of the Foreign Security Procedures specifies that the Procedures govern the following Security Providers: (1) Financial institutions authorized to operate the business of providing security to foreign entities (other than foreign financial institutions), and (2) Non-financial enterprise legal persons, including domestic enterprises or foreign investment enterprises, with the ability to repay debts and discharge liabilities on behalf of other persons. See *id.*

119. See *id.* art. 4.

120. See *id.* art. 6. Article 6 of the Foreign Security Procedures provides:

ity Provider the power to issue foreign-related security on behalf of an originator that is operating at a loss.¹²¹ Thus, due to the qualifications of Articles 4, 6, and 7 and the vague definition of the Security Provider as a “financial institution” or “enterprise legal person,” legal commentators regard the application of the law to specific issues as confusing.¹²²

One rule that is certain, however, is that SAFE, the specialized regulatory agency that issued the Foreign Security Procedures, must approve the foreign-related security.¹²³ Any foreign-related security that fails to satisfy the requisite SAFE approval is void.¹²⁴ In addition, Article 3 of the Foreign Security Implementing Rule expressly reiterates the requirement of SAFE approval to provide security interests to foreign parties.¹²⁵

The Foreign Entities Provision even extends the scope of SAFE approval beyond the limited security types. Security Providers cover all Chinese legal entities that seek to extend guarantees, pledges, security, and “also mortgages and pledges” in favor of foreign creditors and foreign beneficiaries.¹²⁶ Thus, since uncertainties regarding the letter of the law remain, SAFE approval is the only assurance an investor can obtain that the foreign-related security is in compliance with the law.¹²⁷

The January 1998 Foreign Security Implementing Rules reconfirm SAFE’s prominent regulatory role.¹²⁸ These rules generally require SAFE approval for the provision of foreign-related security.¹²⁹ Parts 2, 3, and 4 of the Foreign Security Implementing Rules provide the approval and registration procedures for guarantees, mortgages, and pledges, respectively.¹³⁰ Assignments of security rights require prior consent of the Security Provider and SAFE approval.¹³¹ Even if SAFE approval is not required, SAFE registration is required in all circumstances.¹³²

Domestic enterprises shall only provide security to foreign entities for their direct subsidiaries or for a proportionate share of the external debt of the enterprise in which it has invested as the Chinese Party.

When a domestic non-trading enterprise is to provide security to foreign entities, the value of its net assets should, in principle, be not less than 15 percent of its total assets.

When the provision of security to foreign entities is offered by a non-trading enterprise using domestic investment, the value of its net assets shall, in principle, be not less than 30 percent of its total assets.

Id.

121. *See id.* art. 7.

122. *See* Lo, *Security Rules*, *supra* note 83, at 34.

123. *See* Foreign Security Procedures, *supra* note 111, arts. 12, 17; Lo, *Security Rules*, *supra* note 83, at 34.

124. *See* Foreign Security Procedures, *supra* note 111, art. 17.

125. *See* Foreign Security Implementing Rules, *supra* note 115, art. 3.

126. *See* Li & Caldwell, *supra* note 113, at 40.

127. *See id.* at 42.

128. *See* Tokley & O’Yang, *supra* note 115, at 19.

129. *See id.*

130. *See* Andrew Goodwin, *New Procedures for the Provision of Security to Foreign Entities by PRC Institutions*, CHINA L. & PRAC., Mar. 1998, at 70.

131. *See* Tokley & O’Yang, *supra* note 115, at 21.

132. *See id.* at 19. In the absence of a mortgage registration registry as required in the Security Law, a mortgagor should register with SAFE. *See id.* at 20.

In addition, all amendments to the principal contract require the consent of the Security Provider and SAFE examination and approval.¹³³ Finally, the Foreign Security Implementing Rules grant SAFE broad administrative powers to supervise the costs associated with foreign loans, examine the ability of wholly Chinese owned financial institutions to provide security, and approve the performance of the Security Provider in its obligations.¹³⁴

Perfection of foreign-related security also requires SAFE's approval to ensure compliance with Chinese laws.¹³⁵ Technically, China's system of perfection by mandatory registration of security interests is simple.¹³⁶ However, China's perfection by registration system is complicated since there is a lack of an accessible and uniform national registration system.¹³⁷ Often, the registration process involves an administratively burdensome multiple approval and registration process that might include practical difficulties of locating the interested parties, obtaining their approval, locating appropriate government departments, and obtaining access to appropriate government officials.¹³⁸

One growing development, however, is SAFE's dominance as the central approval agency in laws relevant to an asset securitization transaction. It is increasingly common to require registration and approvals from both the local SAFE office and the SAFE central head office.¹³⁹ As Chinese laws

133. *See id.* at 21.

134. *See id.*

135. *See supra* notes 46-47 and accompanying text for a brief discussion of perfecting an asset securitization.

136. *See Benson, supra* note 79, at 198-200. Registration is mandatory for real estate mortgages, properties, patents, trademarks, and guarantees. *See id.* at 199; e.g., Beijing Mortgage Loans, *supra* note 101, art. 35 ("Mortgage of real estate shall be deemed invalid if it is not registered with the registration department."). The "date of registration" is the date of perfection and some Chinese lawyers believe that the "date of priority" easily solves the issue of priority by the rule of first-in-time to register equals first-in-priority. *See Benson, supra* note 79, at 198-200.

137. *See Benson, supra* note 79, at 199. Registration documentation can be very detailed and administratively burdensome. *See, e.g.,* Secured Loans Regulations, Fujian Province, *supra* note 101, art. 30. The following excerpt from Article 30 of the Fujian Secured Loans, which to the extent not contrary to the Security Law or the Foreign Security Procedures is still good law, is an example of the detailed registration required by some local municipalities:

When parties to a secured loan contract handle secured loan registration, the following documents must be submitted to the registration authority: (1) the registration application; (2) the secured loan contract; (3) proof of ownership of or proof of usage rights to the property securing the loan; and (4) certification of examination and approval by the relevant department or the consent of other parties regarding the establishment of the security, as required by the Regulations.

Id.

138. *See Benson, supra* note 79, at 201. Security interests by foreign enterprises in China should always seek approval from the appropriate investment authorities as well as the State Administration of Industry and Commerce. The State Land Bureau should approve security interests over land. *See id.* at 202.

139. *See Lo, Security Rules, supra* note 83, at 36-39 (requiring submission of government approval document, audited financial statements of the security provider, audited

related to asset securitization developed greater uniformity through the passage of national laws, SAFE emerged as the a recurrent regulatory agency that shapes the legal developments for future Chinese asset securitizations.¹⁴⁰

C. Targeted Laws and Regulations

To focus the application of foreign-security interest financing via the Security Law and Foreign Security Procedures, China has issued targeted laws to encourage and facilitate swift development in key areas of particular public interest.¹⁴¹ In 1997, SAFE and the State Planning Commission jointly issued the Highway Law and the Project Finance Procedures.¹⁴²

1. Highway Law

The Highway Law is China's first national law dedicated to providing legal certainty on the planning, construction, maintenance, and administration of highways. It also signals the central government's eagerness to implement laws to facilitate financing and development in this field.¹⁴³ Prior to the Highway Law, several highway development projects were approved and financed without the guidance of national law. These projects included the Zhuhai Highway in the Zhuhai municipality, the Guangzhou-Shenzhen Superhighway in the Guangdong Province, and the Shanghai-Hangzhou-Ningbo Expressway in the Zhejiang Province.¹⁴⁴ All three projects involved securitizing future revenue streams from toll charges or vehicle registration charges to finance the construction and maintenance of highways.¹⁴⁵

The Zhuhai Highway transaction indicates how lawyers and financiers can innovatively complete an asset securitization even without relevant

financial statements of the obligor, a letter of intent to provide security to foreign entities, a principle contract, and other information requested by SAFE).

140. See *China's COSCO Returns*, *supra* note 14, at 1. Due to the ambiguity in Chinese law, even if SAFE approval is not needed, vigilant lawyers would still consult with SAFE to ensure that SAFE approval is, in fact, not necessary. In a recent private issuance of asset-backed securitization by COSCO, lawyers and financiers sought a statement by SAFE indicating that SAFE approval is not needed. See *id.* SAFE's recent issuance of the 1998 Administration of Borrowing of International Commercial Loans by Domestic Organizations Procedures was of sufficient political strength to repeal a prior regulation by the People's Bank of China, the Conceiving Project Finance Conducted by PRC Enterprises Circular. See Lo, *International Borrowings*, *supra* note 83, at 66.

141. See e.g., Stephen Harder & Alexandra Daintith, *What the Traffic Will Bear: Toll Roads and the PRC, Highway Law*, CHINA L. & PRAC., Dec. 1997, at 43.

142. See Zhonghua Renmin Gongheguo Gonglu Fa [PRC, Highway Law] (Jan. 1, 1998) [hereinafter Highway Law], *reprinted and translated in* CHINA L. & PRAC., Dec. 1997, at 46; Jingwai Jinxing Xiangmu Rongzi Guanli Zanzing Banfa [Administration of Project Financing Conducted Outside China Tentative Procedures] (Apr. 16, 1997) [hereinafter Project Finance Procedures], *reprinted and translated in* CHINA L. & PRAC., Jun. 1997, at 55; see also Harder & Daintith, *supra* note 141, at 43.

143. See Harder & Daintith, *supra* note 141, at 43; see also Toll Collection and Concession Rights Under the PRC, Highway Law, CHINA L. & PRAC., Jan.-Feb. 1998 (offering practitioner's advice on applying the Assignment Procedures issued by the Ministry of Communications in conjunction with the Highway Law in structuring a transaction).

144. See Harder & Daintith, *supra* note 141, at 43.

145. See *id.*

Chinese laws.¹⁴⁶ In August 1996, the Zhuhai Highway Company, acting as both originator and issuer, successfully completed a \$200 million bond offering.¹⁴⁷ The bond placement secured fees derived from toll roads, bridges, and tunnels collected by the Zhuhai municipal government, annual fees for registered vehicles, and entry tolls to the city of Zhuhai.¹⁴⁸ In China, infrastructure receivables are the assets of choice to spearhead the introduction of asset-backed securitization deals because these infrastructure projects tend to generate a predictable and continuous income stream from future infrastructure use charges.¹⁴⁹

Many factors made the Zhuhai Highway deal unique. First, the City of Zhuhai completed the construction of the Zhuhai Highway before the issuance of the asset-backed receivables. Thus, the securitization merely liquified the present value of the Zhuhai Highway's receivables for use in other Zhuhai infrastructure projects.¹⁵⁰ Additionally, both local and national governmental agencies issued the requisite regulatory approvals.¹⁵¹

Utilizing the Security Law, all stock in the Zhuhai Highway Company were pledged to secure the Zhuhai Highway asset-backed securities interest bearing notes.¹⁵² China's lack of a legal infrastructure did not pose a crippling obstacle as long as SAFE and other regulatory authorities approved Zhuhai Highway's self-made contracts stipulating investment terms, priority rights, and bankruptcy rights.¹⁵³ At the time of the Zhuhai Highway

146. See Hsiao-chiung Li & Stella S. Leung, *Zhuhai Highway - A Blueprint for Future Asian Infrastructure Projects?*, CHINA L. & PRAC., Dec. 1996-Jan. 1997, at 50.

147. See *id.* The issuer/special purpose vehicle, Zhuhai Highway Company, was incorporated in the Cayman Islands. See *id.*

148. See *id.* at 51.

149. Compare Part I.A. with Li & Leung, *supra* note 146, at 52. The toll-related revenue was stable because it was not subject to the level of actual road usage. Instead, the steady annual fees from the Zhuhai registered vehicles funded the receivables. In a sense, the Zhuhai Highway deal securitized the tax revenue arising from automobile ownership. See Li & Leung, *supra* note 146, at 52.

150. See Li & Leung, *supra* note 146, at 50.

151. See *id.* at 51. SAFE approved the foreign currency conversion of the revenue receivables. The foreign exchange component is very important to a Chinese asset-backed securitization deal since the Chinese yuan is not a freely convertible currency and foreign investors demand to receive their payments from their security interests in their own currency. For credit enhancement, the parent company of Zhuhai Highway Company, the Zhu Kuan group, arranged to provide \$50 million in currency conversion credit support to bolster the servicing of debt if there was a currency devaluation of the Chinese yuan against the U.S. dollar. See *id.*

152. See *id.*; see also *Asian Securitization*, EUROWEEK, Apr. 17, 1998, at 22 ("Precedent for true sales of assets is scanty in China, but the legal provisions are available for an irrevocable transfer of the usance [sic] right of assets."); *supra* note 46 and accompanying text (describing the use of a "true sale" in a U.S. securitization).

153. See Li & Leung, *supra* note 146, at 51. The parties to the Zhuhai Highway transaction crafted ad hoc contract agreements to provide priority and bankruptcy protection. These contractual provisions provided Western-style covenants, warranties, and representations familiar to U.S. investors. Although China lacked the legal framework to provide these Western-style rights, the assurance by all relevant regulatory agencies provided an alternative to reliance on the law. *Id.* On April 1, 1998, the Bankruptcy (Amendment) Ordinance 1996 and the Bankruptcy (Amendment) Rules 1998 became effective. These new laws modernized Hong Kong's bankruptcy laws to emphasize rehabilitation over punishment and may serve as a precursor for adoption by mainland

transaction, China also lacked the legal framework to create a trust to serve as the issuer or the Security Provider. However, the parties constructed ad hoc trust accounts, with the blessing of the China Construction Bank, to serve as issuer or Security Provider.¹⁵⁴

While the Zhuhai Highway transaction proved successful, the extensive use of ad hoc procedures to substitute as a gap filler for China's lack of laws highlights the enormous inefficiencies that result from creating privately contracted new law with each transaction. The Highway Law, while hardly tested, provides hope that increased legal certainty in the approval process for the operation and maintenance of highways and toll roads will ease the procedures for securing financing development of such projects.¹⁵⁵

2. Project Finance Procedures

The Project Finance Procedures is another targeted law that reflects the Chinese government's attempt at fast-track infrastructure development.¹⁵⁶ The importance of the Project Finance Procedures was underscored by the fact that they were issued not only by SAFE, but also jointly by the powerful State Planning Commission.¹⁵⁷

The Project Finance Procedures provide clear guidelines regarding the approval process for "project financing" transactions.¹⁵⁸ The State Plan-

China. See Simon Powell, *The New Bankruptcy Ordinance & Rules*, CHINA L. & PRAC., May 1998, at 59 (describing Hong Kong's new bankruptcy laws).

154. See Li & Leung, *supra* note 146, at 52. The China Construction Bank in Zhuhai created an escrow arrangement called a "special purpose trust account" to act as an ad hoc solution to providing assurance that the receivables were kept in a bankruptcy remote structure. *Id.*

155. See Highway Law, *supra* note 142, part 3. Part Three of the Highway Law explicitly encourages foreign investment in highway projects and also recognizes financing techniques such as loans, equity, bonds, and toll fees. See *id.* Part Six limits securitization of future income streams of toll fees to certain designated types of highways including:

Roads built by departments in charge of communications of local people's governments above the county level with loans, or with funds raised from enterprises or individuals;

Roads for which domestic or foreign economic organizations have been assigned the right pre-project to collect tolls in accordance with the law; and

Roads built with investment from domestic or foreign economic organizations.

Id. art. 59.

In June 1998, Merrill Lynch closed a Chinese highway securitization under the issuer name "Traffic Streams," which securitized the tolls from several Chinese highways into U.S.-dollar denominated bonds and then sold the resulting bonds to American investors. See *Securitization/Asian-2: Despite Challenges, Deals Emerge*, CAP. MARKETS REP., JUN. 25, 1998, at 13:37:00, available in WL, AllNewsPlus Database.

156. See Project Finance Procedures, *supra* note 142, art. 2.

157. See *id.* art. 11 (stressing the importance of support from the State Planning Commission, a central government regulatory agency, as opposed to lower level municipal governments).

158. See Project Finance Procedures, *supra* note 142, art. 1 (defining "project financing" as "a method of financing whereby foreign exchange funds are raised outside China in the name of a construction project within China and only the projected revenues of the project itself and its assets are liable to be used for the repayment of debt to foreign entities").

ning Commission, however, noted that, despite the intention of the Project Finance Procedures to increase legal certainty for foreign investors, the Chinese government intends to approach each project finance proposal with caution.¹⁵⁹ This type of give-and-take approach is characteristic of the cautious development of Chinese laws. While new implementing laws are passed to encourage freer investments, regulatory oversight and scrutiny provide the vanguard against unforeseen problems accompanying the increased exercise of freedom to contract.¹⁶⁰

The effect of the Project Finance Procedures is to contain the costs of the project so that there is no disturbance in China's balance of payments and foreign exchange reserves.¹⁶¹ This fear of cost overruns is expressed in Article 1 of the Project Finance Procedures, which severely limits the use of security interests to provide financing.¹⁶² Similar to the Foreign Security Procedures and the Highway Law, the Project Finance Procedures also require SAFE approval of the project as well as approval by the State Planning Commission at the central government level.¹⁶³

159. See John E. Lange & Lester Ross, *New Project Finance Measures Further Limit Lender's Room for Manoeuvre*, CHINA L. & PRAC., June 1997, at 51. The State Planning Commission promulgated the Project Finance Procedures in accordance with the requirements of the State Council's Concerning Further Tightening of Macro-control Over the Borrowing of International Commercial Loans Circular ("International Commercial Loans"), set forth on September 27, 1995. The International Commercial Loans stated that investors must pursue overseas financing of domestic projects "gradually because it presents complex risk-sharing and security issues and is relatively costly and involves large amounts of funding." *Id.*; see also Guanyu Jinyibu Jiaqiang Jieyong Guoji Shangye Daikuan Hongguan Kongzhi De Tonggao [Concerning Further Tightening of Macro-control Over the Borrowing of International Commercial Loans Circular] (Sept. 27, 1995) [hereinafter International Commercial Loans].

160. See Lange & Ross, *supra* note 159, at 51.

161. See *id.* A project finance undertaking is particularly sensitive to Chinese policy because it is usually highly capital intensive and costs hundreds of millions – even billions – of dollars while the revenue generated upon completion is mostly in local non-convertible currency. See *id.*

162. See Project Finance Procedures, *supra* note 142, art. 1. Article 1 of the Project Finance Procedures provides:

- (1) creditors have no recourse against assets or revenue other than those of the construction project;
- (2) no institutions in China effect any mortgage, pledge or debt payment with assets, rights, interests or revenue other than those of or in the construction project; and
- (3) no institutions in China provide financing guarantees in any form.

Id. Non-recourse financing does not have guarantees from the project sponsors. Future income streams generated from the project produce all payments for the initial construction and future operation and maintenance. See Lange & Ross, *supra* note 159, at 54. The investors may not use the guaranty-security interest type for project finance. See Project Finance Procedures, *supra* note 142, art. 1(3).

163. See Project Finance Procedures, *supra* note 142, art. 11; Lange & Ross, *supra* note 159, at 52. To pass approval, a very detailed feasibility study must also be completed that details the qualification of the Project's principal investors, the method to balance foreign exchange payments, pricing formulas, project plan, letter of intent from foreign financial institutions, support documents by domestic institutions, drafts of main contract, and "other necessary documents." Project Finance Procedures, *supra* note 142, arts. 8-9.

III. Asset Securitization in China?

"China has challenged the assumption that there is but one route to economic production for transitional economies."¹⁶⁴

The most difficult aspect of asset securitization under China's current legal framework is securing all the necessary regulatory approvals to guarantee the transaction.¹⁶⁵ One commentator, echoing this frustration, has called for the adoption of "neutral rules."¹⁶⁶ The adoption of "neutral rules" entails normalizing and clarifying existing laws to encourage freedom of contract without requiring multiple approval requirements from disparate regulatory authorities.¹⁶⁷ In addition to "neutral rules," a "single unified program [rather] than . . . a patchwork of special regimes" is a proposed solution to standardizing the Chinese legal system's current difficulties in supporting an asset securitization.¹⁶⁸

Commentators in favor of the adoption of neutral rules and a single unified program have offered the securitization structures of the United States and Japan as possible models for China to follow. The United States and Japan have shown that an asset securitization legal structure is viable under either the common law or the civil law. In both the U.S. and Japanese models, elements of neutral rules and a single unified program exist to make asset securitization an efficient and attractive financing method.

Although wholesale adoption of neutral rules and a single unified program seems like a straightforward solution to the problems of Chinese asset securitization, such a view ignores the specific legal and economic climate of China. Techniques developed in the U.S. and Japan's mature legal systems and free market economies may prove inappropriate in the Chinese context.

A. U.S. Model: Neutral Rules and Flexibility

The United States distilled its current legal model for asset securitization after over seventy years of experimentation, experience, and develop-

164. Lan Cao, *The Cat that Catches Mice: China's Challenge to the Dominant Privatization Model*, 21 BROOK. J. INT'L L. 97, 178 (1995).

165. See Cohen & Lange, *supra* note 78, at 356-57 ("The task of obtaining all necessary governmental approvals is usually the greatest challenge in concluding any transaction in China. . . . The situation with respect to approvals is rendered particularly chaotic by struggles for power among governmental authorities, particularly the struggle between central and local authorities . . .").

166. George K. Miller, *Making Sense of Infrastructure Development*, CHINA L. & PRAC., Aug. 1998, at 78.

167. See *id.*

Private parties are not, as elsewhere [such as the U.S.], free to structure arrangements in accordance with neutral rules of general application. Instead, a separate rule is promulgated, if not for every occasion, at least for each different transaction structure receiving official sanction. . . . Far better to promulgate neutral rules of general application than to believe one can ever anticipate every possible specific transaction structure.

Id.

168. *Id.* For example, under the current patchwork of Chinese laws, at least four legal regimes apply to the raising of foreign project debt financing. See *id.*

ment.¹⁶⁹ Over this period, the United States shaped its asset securitization market and its attendant legal structures in response to the changing economic needs of a developing world power that vacillated in its need for this financing technique.¹⁷⁰ The U.S. asset securitization model today integrates the application of different regimes of neutral rule law including contracts, security interests, trusts, bankruptcy, and tax to provide flexibility and creativity under a single unified program.¹⁷¹ The key to the U.S. model is a strong and independent judiciary that has provided reliable guidance on the application of neutral rules.

Currently, China would have great difficulty adopting the U.S. model. First, the several regimes of law relied upon by the U.S. model to support asset securitization are not available in China. While China is continually modernizing its legal system, important legal doctrines such as insolvency laws and private ownership are not yet fully developed.¹⁷² Perhaps due to its ponderous size and increased complexity, China cannot embrace asset-backed securitization financing as quickly as other smaller Asian countries. For example, Indonesia and Thailand, two countries that have aggressively implemented asset securitization legislation in 1996, quickly tapped international capital funds with the asset securitization technique.¹⁷³

169. See *supra* Part I.A.

170. See *supra* Part I.A.

171. See *supra* Part I.B and note 43 and accompanying text.

172. See Alsen, *supra* note 78, at 60; Steven L. Toronto, *Bankruptcy of Foreign Enterprises in the PRC: An Interpretation of the "Rules Concerning Bankruptcy of Foreign Related Companies in the Shenzhen Special Economic Zone,"* 4 J. CHINESE L. 277, 277 (1990).

In the metropolitan areas of Beijing, Shanghai and Guangzhou (Canton), the enforcement of property rights will work better than in the interior regions. Even in these cities, the function of property law will not be comparable to Western standards in the foreseeable future. Protection of property rights will slowly be strengthened, but the PRC still has a long way to go

Alsen, *supra* note 78, at 60. But see Florence M. Li, *First National Mortgage Rules Fill Legal Gaps in Real Property Framework*, CHINA L. & PRAC., Oct. 1997, at 25 (reporting that the Ministry of Construction promulgated the Mortgage Procedures in an effort to consolidate and standardize local mortgage laws); Powell, *supra* note 153, at 59 (reporting the recent issuance of new laws to modernize the bankruptcy laws of the Hong Kong Special Administrative Region).

173. See STANDARD & POOR'S, *supra* note 9, at 2 (discussing the fast growth of securitization in Japan, Hong Kong, Indonesia, Thailand, Korea, and Singapore). Both Indonesia and Thailand witnessed an immediate and significant growth in capital raising potential after adopting legislation in 1986 to implement asset securitization. See *id.* at 3. Indonesia first introduced its Mortgage on Land and Land-Related Objects law to facilitate lending secured by land in 1996. See ORRICK HERRINGTON & SUTCLIFFE, LLP, *supra* note 29, at 7. In the 12 months from July 1, 1996 through June 30, 1997 alone, Standard & Poor's provided credit ratings to three viable Indonesian asset securitization transactions: Ongko International Finance Co. B.V., which securitized lease property valued at \$100 million; Rembrandt International Co. Holding Inc., which securitized auto loan receivables valued at \$60 million, and Automobile Securitised Finance No. 1 Ltd., which securitized auto loan receivables valued at \$200 million. See STANDARD & POOR'S, *supra* note 9, at 2.

Thailand also introduced new legislation on insolvency and issuer entity laws to fill gaps in the Thai legal framework for asset-backed securitization transactions in 1996.

Second, the Chinese judiciary, while making important progress in recent years, still suffers from a shortage of capable judges experienced in commercial law.¹⁷⁴ Thus, the Chinese judiciary cannot provide the necessary interpretive guidance to competently guide the development of asset securitization laws. Instead, China relies on the expertise of administrative state agencies to steer the current path of Chinese asset securitization. However, Chinese courts have recently shown hopeful signs of increased competency by developing specialized court divisions, such as intellectual property courts, that may prove better equipped to decide cases.¹⁷⁵

Third, China is still an authoritarian government controlled by the Communist Party.¹⁷⁶ Thus, the adoption of liberal "neutral rules" to promote a general right of freedom to contract is highly unlikely to survive in China's political landscape.¹⁷⁷ Even if China adopted free and open "neutral rules" for contracting, the possibility of international market forces wreaking havoc on China's developing economy poses a real danger. Realizing the lessons from the former Soviet Union's catastrophic decision to quickly embrace the openness of market capitalism practically overnight,¹⁷⁸ China has instead chosen a more cautious and controlled policy of "privatization with Chinese characteristics."¹⁷⁹

See id. at 3. In the 12 months from July 1, 1996, through June 30, 1997, Standard & Poor's provided credit ratings to three Thai asset securitization transactions: Rembrandt International Co. Holding Inc., which securitized auto purchases valued at \$120 million, SITCARS Funding Ltd., which securitized auto receivables valued at \$83 million, and Thai Cars which securitized auto receivables valued at \$250 million. *See id.* at 2.

174. *See* Cohen & Lange, *supra* note 78, at 351.

175. *See id.* ("The [Chinese] courts contain specialized divisions for different types of cases, usually including civil, economic, administrative and foreign-related business divisions.")

176. *See id.* ("The Communist Party of China has been the governing political party of China since the establishment of the People's Republic of China in 1949. The Communist Party plays a leading role (recognized in the Constitution) at all levels of government, although its specific legislative, executive and judicial functions are rarely spelled out . . .").

177. *See* Alsen, *supra* note 78, at 17-19.

The law in China may be considered as first and foremost an instrument of state power Twenty centuries of Imperial justice have not been conducive for the Chinese to accustom themselves to thinking in terms of rights. . . . The state embodies the will of the proletariat, and the courts are subordinate to the highest organs of state power.

Id. at 17-18.

178. *See* Steve Liesman & Andrew Higgins, *The Crunch Points: How Russia Staggered From There to Here*, WALL ST. J., Sept. 23, 1998, at A12 ("[In blaming the gap between theory and practice, the] idea of the invisible hand doing the job in two or three years . . . was not workable.")

179. *See* Cao, *supra* note 164, at 174 ("The Chinese model of privatization was designed to avoid the institutional vacuum associated with shock therapy reform."). "Privatization with Chinese characteristics" is a term used to describe China's unique path of retaining its Communist-era state sector while nurturing a growing non-state sector to harness the benefits of free market economic growth. *Id.* Recently, the International Monetary Fund was criticized for prescribing shock therapy treatment to Indonesia without fully appreciating the devastating social and political ramifications for such economic actions. *See* Sanger, *supra* note 5, at A10 ("Jakarta came to symbolize the I.M.F.'s twin troubles: Its inability to understand and reckon with the national politics

B. Japanese Model: Instructive Guidance for China

Japan's MITI Law is a good model to guide China in developing a solid Chinese legal foundation for asset-backed securitization.¹⁸⁰ The MITI Law integrates the U.S. model of the asset-backed securitization technique with the regulatory oversight of MITI and the legal rigidity of a civil law system.¹⁸¹ China's development of laws related to asset securitization already bears a resemblance to Japan's early experience with the MITI Law, and China would profit in learning from the Japanese experience.¹⁸²

Japan's MITI Law securitization structure has strong parallels with China's security laws. Japan, like China, follows a civil code system and thus permits strong government control over the development of asset securitization.¹⁸³ More importantly, the success of both civil code systems rely upon a competent regulatory agency. In Japan, MITI is the central agency; in China, SAFE has increasingly developed its role as the dominant agency while recognizing the continued participation of other agencies.¹⁸⁴ As the issuing and approval agency of many important national laws and regulations affecting Chinese asset securitization in the past three years, SAFE has the expertise and political influence to competently oversee China's future development of an asset securitization market. The importance of SAFE's function in China is similar to MITI's function in Japan: both serve as regulatory controls to harness the activity of asset securitiza-

of countries in need of reform, and its focus on economic stabilization rather than the social costs of its actions.”)

180. See Shimada & Itoh, *supra* note 41, at 175; *supra* Part I.C.

181. See Shimada & Itoh, *supra* note 41, at 176-78 (describing the steps involved with a MITI Law securitization structure). The MITI Law securitization structure is similar to the U.S. securitization structure with the additional mechanism of the Basic Claim cross receivable that is exchanged for the Specified Claim via the Specified Claim Provider. See *supra* Part I.C. This extra level of transaction permits MITI to impose regulatory oversight over all MITI Law transactions. The registration requirement of the Specified Claim with MITI and MOF also adds an extra layer of regulatory control over the transactions performed under the MITI Law. See *supra* Part I.C.

182. See, e.g., Henry A. Fernandez, *Globalization of Mortgage Backed Securities*, 1987 COLUM. BUS. L. REV. 357, 360-62 (1987) (detailing the historical development of the U.S. mortgage-backed securities market and its adoption and internationalization into Europe and Japan). Japan first participated in asset-backed securitization transactions by trading in U.S. mortgage-backed securities. The U.S. collateralized mortgage obligation has a significant market in Japan. See *id.* at 361. In October 1994, Nippon Shinpan, a Japanese consumer finance company, issued an asset-backed securitization backed with domestic auto loans. See *Nippon Shinpan Breaks Through with Japan's First Asset-Backed Securitization*, ASSET SALES REP., Oct. 31, 1994, at 1. In December 1994, Japan Leasing, which leases industrial and computer equipment, issued asset-backed securitization notes backed by Japanese equipment lease receivables in the United States. See Laura Lorber, *First Japanese Asset-Backed Deal to Debut in U.S. This Week*, BOND WK., Dec. 19, 1994, at 1.

183. See Shimada & Itoh, *supra* note 41, at 182-83 (The MITI Law requires MITI licensing of either the Specified Claim Purchaser or the Individual Claims Dealer; the eligible assigner and the eligible assignee must jointly file a plan of assignment to MITI, and a special category of receivables can be used, the Specified Claim.)

184. The history of Japan's MITI Law also underwent a period of political turf wars by governmental agencies, especially between MITI and MOF. See *id.* at 174 n.9.

tion while monitoring potential threats to the macroeconomic stability of the national economy.

As with the Security Law's limitation on five types of recognized security interests and the Foreign Security Provision's three types of recognized security interests, the MITI Law limits its security interest in asset securitization to Specified Claims.¹⁸⁵ Furthermore, both China and Japan have designated issuers, the Security Provider and the Specified Claims Provider. Similar to the Japanese MITI Law, the Chinese security laws can address issues related to insolvency and priority conflicts by mandating registration under its civil code system, which effectively addresses both perfection and priority concerns.¹⁸⁶

Following the MITI Law example, SAFE should streamline the asset securitization process by designating only one type of security interest and only one entity as issuer in an asset securitization. By creating a Chinese legal counterpart to the Japanese Specified Claim Provider, China can monitor all asset securitizations via a specialized regulatory agency such as SAFE while providing legal clarity to foreign investors who seek to funnel new capital into China's growing economy.

A major obstacle to adopting the Japanese MITI Law model is the existence of jurisdictional conflicts between SAFE, the State Planning Commission, and other national and provincial governmental agencies. The current situation of conflicting jurisdictional control may be best expressed by Article 11 of the Project Finance Procedures, which delegates to SAFE the responsibility over local expertise approvals and delegates to the State Planning Commission the responsibility over political approvals from the central government.¹⁸⁷ Ideally, China should follow the MITI Law example and designate one governmental agency with the most relevant expertise to control asset securitization in China.¹⁸⁸ However, until political and regulatory rivalries are settled, China must tailor its own model to serve Chinese interests.

185. See *id.* at 180 n.26 (defining Specified Claims). Specified Claims include lease receivables, credit card receivables of a fixed installment type, installment loans extended for the purpose of financing purchase of merchandise, credit card receivables of a revolving payment type, and other receivables created by Cabinet Order. See *id.* Specified Claims also include auto loans, equipment leases, shopping loans, and credit card receivables. See STANDARD & POOR'S, *supra* note 9, at 8.

186. See, e.g., Shimada & Itoh, *supra* note 41, at 180-84 (explaining the Japanese MITI Law's perfection procedures). Japan has a mature bankruptcy law that tracks the U.S. substantive equity powers to review and recharacterize transactions in determining true sale and priority. For example, similar to the U.S. Bankruptcy Courts, the Japanese courts may take several factors into consideration regarding a true sale, such as the intent of parties, perfection, pricing, repurchases, and off-balance sheet treatment. See *id.*

187. See Project Finance Procedures, *supra* note 142, art. 11; *supra* note 163 and accompanying text.

188. See Shimada & Itoh, *supra* note 41, at 182.

C. Chinese Model: A Brave New World

At both the national and the provincial levels, China welcomes asset securitization financing. The Vice-President of the State Development Bank of China advocates using asset securitization to fund China's massive infrastructure construction projects.¹⁸⁹ Chinese provinces have also eagerly voiced their interest in independently forging ahead to securitize provincial residential mortgages, despite the absence of national laws relating to residential mortgages.¹⁹⁰

While China is eager to welcome asset securitization financing, foreign investors are both leery of entering a legal and regulatory environment fraught with uncertainties and tantalized by the potentially vast opportunities in the Chinese asset securitization market.¹⁹¹

In the past five years, China has responded to its internal financing needs and the concerns of foreign investors by actively passing new laws and regulations to test the feasibility of asset securitization in China.¹⁹²

1. SAFE: Consolidation of Regulatory Control

China's laws and regulations are currently in a significantly better position to support asset securitization than they were just three years ago. Important national laws and regulations, such as the 1995 Security Law,¹⁹³ the 1996 Foreign Security Procedures,¹⁹⁴ the 1997 Highway Law,¹⁹⁵ the 1997 Project Finance Procedures,¹⁹⁶ and the 1998 Foreign Security Implementing Rules¹⁹⁷ have provided a framework to structure a Chinese asset-backed securitization. In the past three years, Chinese laws and regulations addressed issues such as security interest creation, perfection by registration, priority rights by registration, designation of which entities may act as the Security Provider or issuer, and the adaptation of ad hoc

189. See *China: Bank Sees ABS as New Finance Tool*, CHINA DAILY, Mar. 3, 1998, available in 1998 WL 7594394.

190. See Adam Reinebach, *China Regions May Develop MBS Market*, INV. DEALERS' DIG., Apr. 20, 1998, at 13; *supra* note 101 and accompanying text (noting past attempts to compensate for the inadequacy of national laws by adopting local mortgage laws).

191. See Reinebach, *supra* note 190, at 13 ("China has the longest way to go in legal reform but ultimately offers the greatest securitization opportunity [in Asia], due to its scale and diversity in asset type.") (brackets in original).

192. See *infra* Part III.C.2; Cohen & Lange, *supra* note 78, at 348-49 (describing the Chinese method of experimentation by trial and error).

Reform in China is not proceeding in accordance with a detailed master plan. There is a great deal of experimentation involved. In any given field there are frequent cycles of *laissez faire* - creating a sort of policy laboratory in which the government can study the effects of unbridled activity - followed by a tightening of regulation. Likewise, experimentation is frequently tolerated (or encouraged) at a local or regional level, followed by a tightening of regulation at the central level. There are frequent sharp turns and reversals as the government encounters the unexpected effects of new policies.

Id.

193. See *supra* Part II.B.1.

194. See *supra* Part II.B.2.

195. See *supra* Part II.C.1.

196. See *supra* Part II.C.2.

197. See *supra* Part II.B.2.

trust laws by State banks to serve as special purpose vehicles.¹⁹⁸

More importantly, the Chinese bureaucracy has increasingly consolidated its regulatory controls over issues relevant to asset securitization under one governmental agency, SAFE. This development offers the greatest potential to foster a legal foundation similar to the Japanese MITI Law model, which relies on MITI for regulatory control. SAFE has consistently acted as the regulatory agency spearheading and engineering the development of asset securitization laws.¹⁹⁹ The prevalence of SAFE as either the issuing or authorizing agency for all major laws and regulations related to asset-backed securitization evinces a consolidation of authoritative regulatory expertise in SAFE and heralds the dawn of China's national standardization of asset securitization laws.²⁰⁰

On January 1, 1998, SAFE issued the International Commercial Loans Procedures that clarified a broad spectrum of issues related to asset securitization.²⁰¹ Among other issues, the International Commercial Loans Procedures addressed the issuance of international commercial loans, the eligibility of domestic borrowers, the definition of short, medium, and long term loans, issues related to project finance, operations of overseas borrowings, and operations of offshore banking businesses.²⁰² Moreover, under the watchful guidance of SAFE, the International Commercial Loans Procedures consolidated past laws and regulations by repealing (1) the 1991 Procedures by the same name, (2) the 1995 Conceiving Project Finance Conducted by PRC Enterprises Circular, (3) the 1996 Raising of Finance Overseas by Overseas Branches of PRC Domestic Banks Which Conduct Foreign Exchange Business Provisions, and (4) the 1997 Further Strengthening and Monitoring of the Raising of Finance by Overseas Branches of PRC Domestic Enterprises.²⁰³

Also on January 1, 1998, the Foreign Debts Implementing Rules²⁰⁴

198. See *supra* Part II.B-C.

199. See discussion *supra* note 140 and accompanying text.

200. See Chengshi Fangdichan Diya Guanli Banfa [Administration of Urban Real Property Mortgage Procedures] (June 1, 1997) [hereinafter Mortgage Procedures], reprinted and translated in, CHINA L. & PRAC., Oct. 1997, at 28; see also Li, *supra* note 172, at 25 (discussing the national impact of the Mortgage Procedures and overlaps with the Security Law under the control of SAFE). Formerly, local regulations, such as those from Guangdong Province and Beijing, would control the use of mortgages. Now, the Ministry of Construction's promulgation of the Mortgage Procedures has consolidated and standardized local municipal mortgage laws. However, even the mortgage, which is directly controlled by the Ministry of Construction, is still within the sphere of influence of SAFE since a mortgage is one of the five enumerated security interests under the Security Law. See *id.*

201. Jingnei Jiyou Jieyong Guoji Shangye Daikuan Guanli Banfa [1998 Administration of Borrowing of International Commercial Loans by Domestic Organizations Procedures] (Jan. 1, 1998) [hereinafter International Commercial Loans Procedures] reprinted and translated in CHINA L. & PRAC., Jan.-Feb. 1998, at 67; see Lo, *International Borrowings*, *supra* note 83, at 63.

202. See Lo, *International Borrowings*, *supra* note 83, at 63-65.

203. See *id.* at 66.

204. Guojia Waihui Guanliju Waizai Tongji Jiance Shishi Xize [Statistical Monitoring of Foreign Debts Implementing Rules] (Jan. 1, 1998) [hereinafter Foreign Debts Implementing Rules]; see *Financing: State Administration of Foreign Exchange Statistical Moni-*

reinforced SAFE's role in national foreign exchange controls. The Foreign Debts Implementing Rules reaffirm the general requirement that the State must register all foreign debt.²⁰⁵ Moreover, Article 3 defines SAFE's role in greater detail: not only does SAFE monitor and supervise foreign debt statistics, but SAFE is now also responsible for debt registration, approving loan accounts, verifying and approving debt repayments, collecting and disseminating debt information, and managing the use of foreign debt funds.²⁰⁶ Since the foreign security interest of an asset securitization requires the issuance of foreign debt, the Foreign Debts Implementing Rules dramatically strengthen and expand SAFE's role and control over the future course of Chinese asset securitization. With such examples of consolidation in regulatory control, many hope that foreign investors can look to SAFE to gauge the direction of China's future development of asset securitization laws.

2. *Chinese Two-Tiered Model*

At present, China is not ready to directly adopt either the U.S. or Japanese model and should reject both. Instead, China should develop a two-tiered model that offers a legitimate alternative to both the flexible U.S. model and the more structured Japanese model.²⁰⁷ A Chinese two-tiered system would integrate the benefits of both models within the context of China's political goal of "socialism with Chinese characteristics" to create a model that best serves China's interests.²⁰⁸

The first tier consists of general laws and regulations that communicate the general principles and policies of asset securitization. The second tier permits experimentation and application of the general principles via targeted laws. For example, the 1995 Security Law and the 1998 Security Law Implementing Rules provide the basic first tier general principles for Chinese asset securitization.²⁰⁹ The 1997 Highway Law and the 1997 Project Finance Procedures provide the second tier of targeted laws that grant the Chinese government a macroeconomic tool to direct development in certain areas of high national importance.²¹⁰

The two-tiered approach has strong precedents in China's recent legal history. China used a two-tiered approach to permit provinces to develop provincial laws on private ownership of property and mortgages while the

toring of Foreign Debts Implementing Rules, CHINA L. & PRAC., Jan.-Feb. 1998, at 8; Andrew Goodwin, *New Rules for Debt Registration*, CHINA L. & PRAC., Apr. 1998, at 52.

205. See Foreign Debts Implementing Rules, *supra* note 204, art. 6.

206. See *id.* art. 3.

207. See Cao, *supra* note 164, at 120 ("[T]he Chinese experience challenges economic dogma and presents legitimate alternatives for other transitional economies.").

208. See generally *id.* at 110-11 (discussing the distinct features of "socialism with Chinese characteristics.").

209. See *supra* Part II.B.

210. See *supra* Part II.C. The two-tiered concept permits the Chinese Communist Party to exercise direct control analogous to a command economy, but the Party can do so with more flexibility because the State is merely encouraging growth in certain areas instead of actually undertaking the project via a State company.

national position was still undecided.²¹¹ China used the "one country, two systems" approach to integrate the Hong Kong Special Administrative Region into China pursuant to the Joint Declaration of 1984 between China and the United Kingdom.²¹²

The two-tiered system offers the dual benefit of stability and controlled change, two qualities that are compatible with asset securitization. The first tier offers a stable core legal structure that appeals to the desire for a "single unified system." The second tier offers targeted experimentation as a substitute for the creative exuberance encouraged by "neutral rules." These second tier laws also permit flexibility in designated targeted areas while confining the dangers of experimentation to those areas and serving as a structural bulwark against jeopardizing other sectors of the Chinese economy.

Unlike other Asian countries that have quickly adopted full implementing legislation for asset securitization, China's two-tiered model takes the cautious path of testing asset securitization financing only within the narrow fields of certain types of targeted infrastructure development and always under the regulatory scrutiny of government agencies such as SAFE.²¹³ Perhaps China is merely biding time to protect nascent domestic markets from the turmoil of increased linkages to the international economy.²¹⁴ China's lack of integration with the international markets shielded the Chinese economy from the 1997-1998 Asian regional currency devaluations.²¹⁵ Yet, despite China's protective walls against the vicissitudes of the international capital markets, investors have successfully completed at least three domestic Chinese originated asset securitization deals.²¹⁶ The increased consolidation of regulatory control by a single

211. See *supra* note 101 and accompanying text.

212. See Cohen & Lange, *supra* note 78, at 373.

213. See *supra* Part II.C.

214. The conditional convertibility of the Chinese yuan is one example of China's efforts to protect the Chinese market from the vagaries of international market conditions. See *Chinese Yuan Unaffected By Currency Turmoils*, *supra* note 4, at *1. Although China's currency is not freely exchangeable in international capital markets, China remains active in international economic relations. China adheres to most major multilateral treaties for economic cooperation including the Vienna Convention on Contracts for the International Sale of Goods, the Paris Convention for the Protection of Industrial Property Rights, various copyright and patent conventions, the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, and the Hague Convention on service abroad of civil and commercial documents. China has also developed an extensive network of bilateral treaties to promote trade and investment including tax treaties, mutual protection of investment agreements, and judicial assistance agreements. See Cohen & Lange, *supra* note 78, at 347.

215. See *China: Crisis Warns of Foreign Debt Danger*, CHINA DAILY, Nov. 23, 1997, available in 1997 WL 13648176; see also *China to Clamp Down on Illegal Capital Flow*, CHINA BUS. INFO. NETWORK, Jan. 8, 1998, available in 1998 WL 7560022; *Chinese Yuan Unaffected By Currency Turmoils*, *supra* note 4, at *1 (describing the concern that SAFE officials have in limiting the exposure of Chinese foreign exchange reserves to safeguard against currency devaluation pressures).

216. See *China's COSCO Returns*, *supra* note 14. These three deals are (1) the \$200 million Zhuhai Highway transaction, (2) the \$288 million Greater Beijing First Expressway transaction, and (3) the April 1997 COSCO transaction. See *id.*

governmental agency such as SAFE and the future development of the Chinese two-tiered model promise a stable Chinese asset-backed securitization legal structure in the near future.

Conclusion

In the past three years, China has made substantial changes to its laws and regulations. Within the context of these laws and regulations, asset securitization transactions are achievable. While China has already originated a few asset-backed securitization transactions, they were all made on a case-by-case basis with extensive involvement by Chinese governmental agencies.

The Chinese two-tiered model offers the hope of a more systematic and efficient system for asset-backed securitization that still permits flexibility and creativity. With SAFE's recent consolidation of control over the issuance of laws and regulations related to asset-backed securitization, SAFE offers the expertise and authority to effectuate the uniformity and standardization of future Chinese asset securitization laws.

Currently, the Asian economic environment is not favorable for SAFE to aggressively open Chinese markets to the complex financing technique of asset securitization. However, SAFE should instructively study the development of Japan's MITI Law securitization structure as a guide to strengthen the basic Chinese asset securitization legal structure to serve the future interests of China.

