

EY Insights: Securitization in China

Securitization is the issuing of asset-backed securities based on cash flow generated from specific underlying assets or portfolios as reimbursement support, which could be credit-enhanced through structuring. By the originator's transferring assets into securities via structural arrangement, asset securitization transfers the risks and benefits of the assets to a "special purpose vehicle" (SPV), resulting in an entire segregation from the originator.

Background

Originated from the residential mortgage-backed securities in the United States during the 1970s, securitization was soon widely applied to other assets, expanded and localized according to different countries' practice. Through asset-backed securitization transactions, this provides a way for issuers to raise funds or improve its financial structure, and at the same time for investors to expand their scope of investments. It is a catalyst in promoting the prosperity and development of financial market. Yet, the complexity in securitization may prevent investors' ability to monitor risks, resulting in events like the US subprime mortgage crisis. Securitization is, therefore, well-regarded as a double-edged sword.

While securitization is still new in China, it has become the spotlight in this round of financial reform which includes also the reform of interest rate and internationalization of Renminbi. On July 2, 2013, the State Council promulgated the "Guidance of the General Office of the State Council on Financial Support of Economic Structure Adjustment, Transformation and Upgrading" (Issue No. 67 of State Council), a phase-in for credit asset securitization. We believe this progress will have significant impacts on the development of China's financial market. At present, there are 3 types of asset-securitized products in China:

► Credit asset securitization in the national interbank bond market

Several credit asset-backed securities were issued as pilot in 2005. After years of suspension due to the subprime crisis, the People's Bank of China, China Banking Regulatory Commission and Ministry of Finance jointly promulgated the "Circular on Relevant Matters Concerning Further Expansion of the Pilot Securitization of Credit Assets" in May 2012, which marked the restarting of credit asset securitization. As of end of June 2013, RMB 89.6 billion worth of products of credit asset securitization were issued in the interbank market, according to reports issued in Xinhuanet.



► **Asset securitization of securities companies**

It is the specific asset management plan of securities companies traded in the stock exchanges, which began in 2005 and suspended in 2006. On March 15, 2013, China Securities Regulatory Commission issued the "Administrative Regulations on the Asset Securitization Business of Securities Companies", allowing securities companies which are qualified for securities assets management to apply for setting up specific plans, and issue asset-backed securities. It clearly signals the restarting of business for asset securitization.

► **Asset-backed notes (ABN)**

In August, 2012, National Association of Financial Market Institutional Investors formally promulgated the "Guidelines on Asset-backed Notes for Non-financial Enterprises on the Interbank Bond Market", to kick start the offering of ABN. The size of ABN remains relatively small as of now.

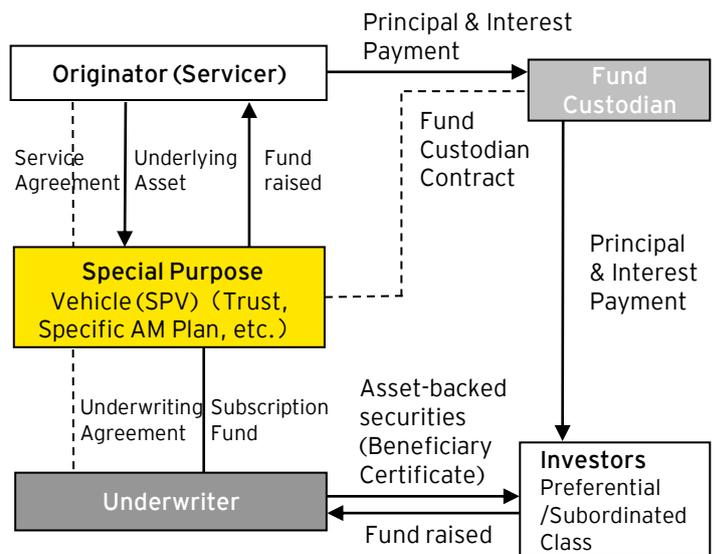
Due to the complexity in business and market structure, appropriate accounting and tax arrangement are crucial considerations during the design and implementation process. This article is intended to provide an overview of asset securitization from the accounting and tax aspects, and provide guiding information to some of the key issues, rather than aiming at an integrated illustration of asset securitization business.

General deal structure of asset securitization

Generally, asset securitization is a process that screens underlying asset, arranges deal structure, issues asset-backed securities and manages post-issuance matters. Main participants include:

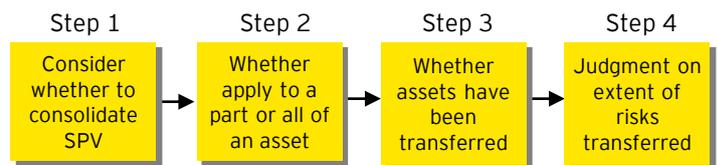
- Originator, i.e. issuer
- Special Purpose Vehicle (SPV)
- Underwriter
- Fund Custodian
- Investor

The following diagram is a general deal structure of asset securitization.



Consideration of accounting issues for asset securitization

Regarding the accounting of asset securitization business, corresponding requirements are listed in the "Chinese Accounting Standard for Business Enterprise No. 23 - Transfer of Financial Assets" and the "International Accounting Standard No. 39 - Financial Instruments: Recognition and measurement". The core part lies in the judgment of de-recognition of issuer's underlying asset, which is relatively complicated. The principles in the aforementioned standards shall be applied when making judgment on derecognition. The following diagram is a simplified flow chart for derecognition.



Major considerations in practice:

1、Consolidate SPV or not

Accounting standards for business enterprises state that:

- Business activity: whether the SPV is set up, directly or indirectly, for specific business needs
- Control: whether the entity retains or obtains decision-making power to control SPV or its assets
- Financial interests: whether the entity has the power to possess the majority of the interests of the SPV through bylaws, contracts or agreements etc.
- Risk: whether the entity assumes the majority risks of SPV through bylaws, contracts or agreements

2、Derecognize all or part of an asset?

We consider the following factors when determining whether to derecognize a part or all of a financial asset.

- ▶ Cash flow that can be specifically identified
- ▶ Certain proportion of the total cash flow
- ▶ Certain proportion of the specifically identifiable cash flow

3、An asset transferred?

“Pass-through principles”, together with 3 other conditions should be met for asset transfer:

- ▶ The transferring entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts of cash flow from the financial asset
- ▶ The transferring entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows
- ▶ The transferring entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay.

4、Judgment on extent of risks transferred

Situation		Standard requirements
Transfers substantially all the risks and rewards of ownership of a transferred financial asset		Derecognize the asset
Neither transfers nor retains substantially all the risks and rewards of ownership of a transferred financial asset	Control of the financial asset not retained	Continue to recognize relevant asset, liabilities and any retained interests to the extent of its continuing involvement in the financial asset
	Control of the financial asset retained	
Retain substantially all the risks and rewards of ownership of the transferred financial asset		Continue to recognize the asset and recognize income as liability at the meantime

In designing the deal structure of securitization, credit enhancement or liquidity arrangement is common. In practice, some typical terms for securitization should be noted:

- ▶ Issuer holding subordinated bonds
- ▶ Time lag and sequence of payment
- ▶ Liquidity support or deficiency payment
- ▶ Redemption or clearance buy-back
- ▶ Specific terms of the service contract

Consideration of tax issues for securitization

In 2006, Ministry of Finance and State Administration of Taxation issued the “Circular of Tax Policy Issues Relevant to the Securitization of Credit Assets”, mainly relating to business tax, stamp tax and corporate income tax on the transferred assets, during the process of credit asset securitization under trust method.

To keep up with the development of domestic asset securitization, detailed tax regulations in respect of the modes of corporate asset securitization and asset-backed notes are to be developed. Therefore, it is essential to communicate with tax authorities on tax issues relating to asset securitization and pay attention to the new tax rules that are yet to come.

Challenges in tax issues of asset securitization include:

- ▶ Invoice issuance and management
- ▶ Tax payer, tax obligation and withholding obligation
- ▶ Challenges arisen from imposing of value-added tax in lieu of business tax

EY China: your advisor in asset securitization

Financial services practice is one of the major industry sector in EY. Our global financial service team includes more than 46,000 people, with professionals in assurance, advisory, tax, risk management and valuation. We are experienced and have the insights on both international and domestic securitization markets.

In China, EY has provided services on asset securitization to a number of well-known banks and corporations. We are actively involved in the strategic development and implementation of our client's capital structure formulation, and have provided consultation on the key elements for finalization of the securitization deal, which include the design of deal structure, optimal selection of assets, risk management, cash flow model, capital utilization, accounting and tax impact. The insights and experience accumulated from these engagements enable us to provide our clients with recommendation which are considered on a cost-benefit basis.

Our services on asset securitization include:

- ▶ Performing due diligence on elements of underlying assets
- ▶ Performing cash flow forecast on the cash flow condition of underlying assets
- ▶ Providing professional advice on the application of accounting standards on asset securitization
- ▶ Providing professional advice on tax matters on asset securitization
- ▶ Providing advice on capital optimization to financial institutions conducting asset securitization

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