APSA
亚太结构融资公会
Asia-Pacific Structured Finance Association

www.apsa-asia.com | info@apsa-asia.com

Hong Kong: Building a PRC cross-border securitisation platform

A month ago, the Central Economic Work Conference was held in Beijing, setting out the priorities for the economic work in 2023. One of the strategic priorities is to "make greater efforts to attract and utilise foreign capital", which includes promoting high-quality opening up and expanding market access.[1] The topic to be discussed today is how to build Hong Kong into a PRC cross-border securitisation platform for the purposes of contributing to the PRC economic development.

I would like to address three items today. First, I will provide an introduction to securitisation and the development of the Mainland China securitisation market. Second, through the experience of the EU and US markets, I will discuss the significance of cross-border securitisation in the context of the PRC economic development. Finally, I will discuss Hong Kong's role in the PRC cross-border securitisation, the operation of the cross-border securitisation platform, and the required changes to relevant regulations and processes.

Part I: Introduction to securitisation

1. What is securitisation

In its most common form, securitisation is the pooling and packaging of one or more assets into a bond, using the assets' future cash flow to support the bond's repayment. There are many types of assets that can be securitised, such as corporate loans, housing loans, accounts receivable, etc. In 1997, British rock star David Bowie even securitised the intellectual property rights of his records.

A basic example of securitisation consists of three steps being taken: first, a company with loans or other income-generating assets ("**sponsor**") packages many assets into a "pool"; second, the sponsor sells the "asset pool" to a bond issuer, usually a bankruptcy remote "special purpose vehicle" ("**SPV**"); and third, the SPV uses the "asset pool" as collateral to issue tradable asset-backed securities ("**ABS**") in the capital markets.

2. The Mainland securitisation market

Mainland China has a dynamic and fast-growing securitisation market. Since the launch of its first securitisation pilot in 2005, the relevant market rules have been continuously improved, promoting a vigorous and steady development of the Mainland securitisation market. According to statistics, as of 31 December 2022, the total issuance size of Mainland securitisation was approximately RMB 15.7874 trillion (approximately US$ 2.3 trillion), with a total outstanding amount of about RMB 4.684 trillion (approximately US$ 0.7 trillion).[2]

Mainland China has the world's second largest bond market (including securitisation). According to the State Administration of Foreign Exchange, the total size of the Mainland bond market in the first half of 2022 was US$21 trillion. Foreign capital accounted for only about 3% of Mainland bond markets,[3] which shows that international participation (including securitisation) is extremely limited.

In order to further promote the development of securitisation in the Mainland, urgent attention should be given to promote the development of cross-border securitisation and enhance the participation of foreign investors in the Mainland's market.

Part II: The significance of cross-border securitisation to the development of the Mainland economy

Cross-border securitisation has many implications for the development of the Mainland economy.

1. Promote GDP growth

Cross-border securitisation can further expand the scale of Mainland securitisation, which can boost GDP growth.

A study by the Association for Financial Markets in Europe (AFME) shows that funds raised through securitisation have a significant positive impact on GDP growth in the European Union. A US Treasury report also noted that, in contrast to most other developed economies, US capital market provides a material proportion of financing to companies compared to the US banking system, making capital market a valuable resource for business development.

At the end of 2021, the US asset-backed securitisation (ABS) market size was about US$ 1.6 trillion, or about 6.8% of US GDP.[4] The US mortgage-backed securitisation (MBS) market (including agency transactions) is around US$ 12.2 trillion, or about 52.3% of US GDP.[5] The size of the entire EU securitisation market is about EUR 1 trillion, which is about 5.8% of EU GDP.[6]

A report prepared by European Systemic Risk Board stated that the US securitisation market is larger than the EU market. Additionally, the banking sector plays the role of major investors in the EU securitisation market.[7] AFME believes that the European economy is much more dependent on bank funding than the United States, which is one of the reasons for the widening of the economic growth gap between Europe and the United States after the 2008 global financial crisis.[8]

2. Expand financing channels for enterprises to help the real economy

Cross-border securitisation can provide additional source of funds for enterprises, especially to help small and medium-sized enterprises expand financing channels and reduce financing costs, thereby promoting growth and development of the real economy.

The Mainland securitisation market already serves all aspects of the Chinese economy. For example, residential mortgage securitisation ("**RMBS**") provides financial support for home ownership; supply chain financing securitisation and receivables financing help companies efficiently manage their working capital and expand production; securitisation of consumer finance (such as auto loans) can help promote consumption; and financial leasing securitisation has been successfully used for "green assets" such as carbon neutrality, contributing to China's emission reduction goals. The extensive introduction of international capital can promote the further development of securitisation in Mainland China.

3. Contribute to national strategies such as the Greater Bay Area, the "Belt and Road Initiative", and the RMB internationalisation

(1) Guangdong-Hong Kong-Macao Greater Bay Area

While it accounts for only 6.1% of China's population, the Greater Bay Area generates about 11.0% of China's GDP.[9] Cross-border securitisation can promote the further development of the economy of the Greater Bay Area and bring cross-border financing to other cities in the Greater Bay Area through Hong Kong.

There are a large number of SMEs in the Greater Bay Area. Financing difficulties have long been a problem for many SMEs because the banking system cannot provide sufficient low-cost financing for SMEs. Cross-border securitisation can help alleviate liquidity pressure on the banking system and provide direct financing for SMEs. SMEs which meet minimum qualifying criteria could also directly securitise their cash flows through cross-border securitisation to obtain additional financing channels for expanding production.

(2) "Belt and Road Initiative"

Since 2013, China has provided a large amount of financing for infrastructure projects under the Belt and Road Initiative. Infrastructure projects require substantial financial support, and using securitisation to refinance "Belt and Road" projects that meet international standards and have high transparency through the international capital markets can provide more funding for China's development and expansion of the scale of the "Belt and Road Initiative".

Securitisation can provide an effective financing channel for large-scale infrastructure projects. Singapore-based Clifford Capital, for example, has successfully issued three infrastructure loan securitisations, raising more than US$ 1 billion. STWD Investment Management and RREEF America in the United States have issued several infrastructure loan securitisations. In addition, Hong Kong's 2022/23 Budget announced that the Hong Kong Mortgage Corporation Limited will undertake a US$ 450 million infrastructure loan securitisation transaction in the first quarter of 2023.

(3) RMB Internationalisation

Cross-border securitisation can further expand international institutions' investment in RMB assets and help promote the realisation of the strategic goal of RMB internationalisation. As the importance of RMB as a global reserve currency continues to rise, the demand for RMB assets from international institutions is also increasing.

In March 2021, the Hong Kong Stock Exchange (HKEX) noted in its RMB Internationalisation Report that more diversified RMB products could support the development of the offshore RMB market. HKEX said that the offshore RMB market is a key and indispensable factor in supporting the internationalisation of RMB, and emphasised that RMB-denominated securitisation could be issued in the Hong Kong capital markets as an innovative product, thereby enhancing RMB liquidity, meeting the needs of mainland enterprises for offshore RMB financing, and providing more diversified RMB assets for the international capital markets to help better manage their RMB portfolios.

Part III: Build a PRC cross-border securitisation platform in Hong Kong

1. Hong Kong should play a unique role in cross-border securitisation

As an international financial centre and an important bridge between Mainland China and the international market, Hong Kong can, and should, play its role as a "super-connector" and build on the unique position it has in providing access into the Mainland securitisation market for international investors.

Hong Kong is not merely a financing hub for the Mainland. It is a strong economic engine – a furnace for development, delivering capital and driving growth. Hong Kong's unique social, economic and legal system under the "one country, two systems" policy underlies Hong Kong's competitiveness on the global stage.

Looking back on 1993, Tsingtao Beer issued H shares listed on the HKEX, becoming the first Mainland company listed in Hong Kong, opening a new stage in the development for Hong Kong as an international financial centre. One of the driving forces behind the proliferation of Hong Kong's status as an international financial centre is the unique legal system under the "one country, two systems" principle. Hong Kong’s financial markets are based on this foundation which creates a bridge connecting the civil law based Mainland market with the common law based international markets.

Cross-border securitisation would be similar to the establishment of the H-share structure.

Since the innovation of the H-share system, the gradual liberalisation of the Mainland capital market has favoured Hong Kong over other financial centres. In the 21st century, China introduced QFII in 2002, QDII in 2008, RQFII in 2012, Shanghai-Hong Kong Stock Connect in 2014, mutual recognition of funds in 2015, Shenzhen-Hong Kong Stock Connect in 2016, Bond Connect in 2017, Wealth Management Connect in 2021, and Swap Connect in 2022, connecting the international markets, through Hong Kong, to the Mainland’s bond, funds, foreign exchange and interest rate markets.

Cross-border securitisation can make full use of the existing financial infrastructure between the Mainland and Hong Kong. With some fine-tuning the existing regimes, cross-border securitisation pilots can be carried out.

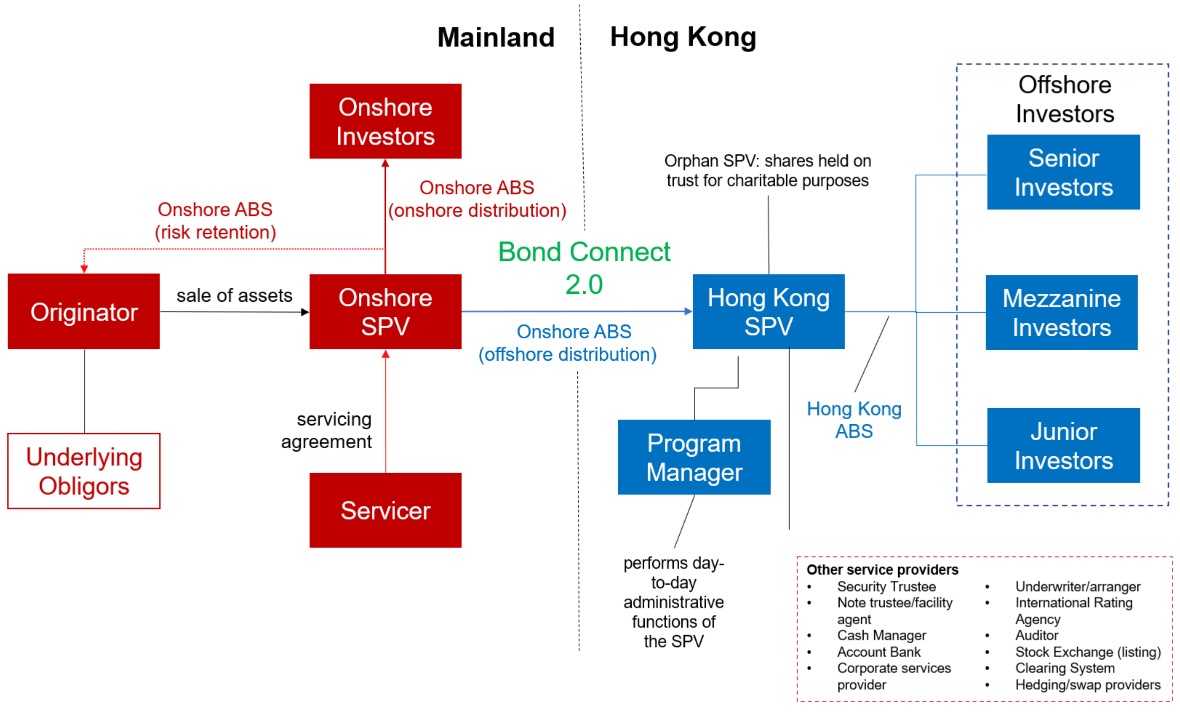
2. A Hong Kong SPV and Bond Connect 2.0 – the cornerstone of the cross-border securitisation platform

The two most important Mainland markets for asset-securitisation are the China Interbank Bond Market (CIBM) and the Exchange Market.[10] At present, most overseas investors participate in Mainland securitisation only through Bond Connect. Through Bond Connect, overseas investors can only participate in securitisation products issued in the CIBM, but not similar products issued on the Exchange Market, despite the Exchange Market constituting more than 50% of the entire mainland asset-securitisation market.[11]

While cross-border securitisation can be carried out in various forms, a pilot should be carried out through Bond Connect given it is already being used in the international markets. A pilot project would, however, require us to first establish a sound SPV regime in Hong Kong, along with a partial upgrade of the Bond Connect system ("**Bond Connect 2.0**"), would be the cornerstone of China's cross-border securitisation platform.

China's cross-border securitisation platform, simply put, would be a product issued by Mainland enterprises in the Mainland (referred to as "**Onshore ABS**"), which could be issued in the CIMB (or, in the future) on the Exchange Market. The Hong Kong SPV then subscribes for the Onshore ABS through Bond Connect 2.0 (or, in the future, ways to connect to the Exchange Market), and at the same time the Hong Kong SPV issues RMB or foreign currency-denominated products ("**Hong Kong ABS")** to international investors in Hong Kong.

The structure diagram of a transaction under the cross-border securitisation platform is illustrated below.



To build this cross-border securitisation platform in Hong Kong, there are two core prerequisites. First, it is necessary to introduce a Hong Kong SPV regime; Second, Bond Connect should be upgraded to Bond Connect 2.0.

1. A Hong Kong SPV regime

The structure of cross-border securitisation requires the establishment of an offshore SPV outside the Mainland. The establishment of a SPV in Hong Kong is the best choice for both the Mainland and Hong Kong. Hong Kong already has a well-established legal system to meet the basic legal needs of international securitisation transactions.

However, there are still some Hong Kong legislation that need to be amended in order for Hong Kong SPVs to be more widely used for securitisation transactions and compete with SPVs in other global financial centres. These laws, which require minor amendments, include the Inland Revenue Ordinance, the Money Lenders Ordinance and the Securities and Futures Ordinance. One of the most important legal updates is the tax arrangement for Hong Kong SPVs, clarifying that Hong Kong SPVs are only subject to profits tax on their retained earnings. This is a core consideration affecting the choice of location of offshore SPVs.

The wide application of a Hong Kong SPV regime will enable Hong Kong to obtain more service revenue from structured finance transactions, such as legal, finance, tax and corporate services business. Ireland, for example, has reaped significant economic benefits through the establishment of a friendly SPV regime. According to statistics, more than 3,000 local SPVs in Ireland manage more than EUR 1 trillion of assets. The SPV sector has created more than 3,900 localjobs and contributed an estimated €500 million to the Irish economy.[12] After the introduction of a formal of the Hong Kong SPV regime, the economic benefits that can be brought by the wide application of Hong Kong SPV will far exceed those of Ireland.

2. Bond Connect 2.0

Bond Connect 2.0 builds on the existing Bond Connect system as a bridge to cross-border securitisation, allowing international investors to effectively participate in cross-border securitisation through a system that they are familiar with. Considerations should be given to the following five adjustments to the current Bond Connect system to build Bond Connect 2.0.

(1) Hong Kong SPV as a qualified foreign investor under Bond Connect 2.0

The range of foreign investors permitted by Bond Connect mainly includes overseas financial institutions. SPVs are commonly used in the international securitisation market to achieve isolation of assets from the bankruptcy estate of the transaction parties, and realise cross-border distribution through the two-layer SPV model, outlined in the diagram above. Whether it is a civil law system (e.g. Korea, France, Italy, etc.) or a common law system (e.g. Hong Kong, Singapore, the United Kingdom, etc.), cross-border securitisation through a two-tier SPV model is very common. For example, The Hong Kong Mortgage Corporation Limited used the two-tier SPV model to set up an offshore SPV outside Korea to subscribe for MBS issued by a local SPV in Korea, and the offshore SPV issued Hong Kong securitisation bonds to investors in Hong Kong.

In order to achieve cross-border securitisation, Bond Connect 2.0 should, as a pilot approach, allow eligible Hong Kong SPVs to invest in Onshore ABS through Bond Connect and issue Hong Kong ABS to international investors at the same time. Through this structure, international investors who do not qualify for Bond Connect can invest directly in mainland asset-backed bonds through eligible Hong Kong SPVs without facing the credit risk of other intermediaries, thereby expanding the investor base of mainland asset-backed bonds.

(2) Expanding the scope of investment in the mainland securitisation market

The Mainland securitisation market includes the CIBM and the Exchange Market. At present, through Bond Connect, foreign investors can only invest in Onshore ABS issued in the CIBM, but cannot invest in Onshore ABS issued in the Exchange Market. Based on the notional size of the new products issued in 2022, the size of the Exchange Market is over half of the entire Mainland securitisation market.[13]

Expanding the investment scope of Bond Connect 2.0 and allowing eligible Hong Kong SPVs to invest in Onshore ABS issued in the Exchange Market can significantly enhance the participation of foreign investors in the entire Mainland securitisation market.

(3) Clarifying tax arrangements

Considering the differences between the tax regimes of the Mainland and Hong Kong, tax uncertainties should be avoided, including whether the Mainland and Hong Kong are subject to double taxation, and whether Onshore ABS subscribed through Bond Connect are exempt from withholding and VAT. These uncertainties will affect the enthusiasm of investors to participate in the Mainland securitisation market.

(4) Optimising the foreign debt registration process

Cross-border securitisation may lead to the incurrence of foreign debt, thereby triggering the foreign debt registration and filing obligation of onshore obligors. Considering that securitisation transactions involve a large number of onshore obligors, it is necessary to optimise the foreign debt registration process.

In this regard, reference can be made to the regime for cross-border transfer of non-performing loans. It is helpful for NDRC and SAFE and other relevant departments to clarify that if an onshore enterprise transfers onshore debt offshore for the purposes of financing, it should be managed under a more simplified system. In particular, the transferor (i.e. the onshore originator) should be permitted to make the relevant filings for foreign debt registration for all debt transferred offshore, without the need for the onshore obligors to make individual filings. It is also helpful if NDRC or SAFE manage this based on overall quota, which permits multiple issuances under the pre-approved quota, without the need for individual filings on a transaction by transaction basis.

(5) Lowering the threshold for Onshore ABS

Onshore ABS is required to meet a number of criteria for the purposes of protecting onshore investors. For cross-border securitisation transactions, the Hong Kong ABS issued by Hong Kong SPVs will be distributed to international investors and is required to meet the standards of international securitisation for the purposes of protecting the interests of international investors. Therefore, exemptions from some inapplicable onshore ABS criteria could be considered to avoid unnecessary and duplicative transaction costs.

(6) Friendly exchange rate policy support

If Hong Kong ABS is issued in foreign currency, the currency hedging cost may have a significant impact on the economics of the transaction. For cross-border transactions, the ability to adopt flexible currency hedging strategies and freely choose onshore/offshore foreign exchange markets for currency hedging transactions is beneficial.

Conclusion

Hong Kong can build the PRC cross-border securitisation platform to introduce international investors into the Mainland securitisation market in an orderly manner. In line with the priorities set by the Central Economic Work Conference, through the efficient use of foreign capital, it will boost China's GDP growth, expand financing channels for enterprises, inject strong momentum into the real economy, and provide important support for national strategies such as the Greater Bay Area, the "Belt and Road Initiative" and the RMB internationalisation.

Hong Kong is the best choice to build a cross-border securitisation platform. Through the introduction of a Hong Kong SPV regime and upgrade into Bond Connect 2.0, barriers to cross-border securitisation can be broken. Given Hong Kong's status as an international financial centre, cross-border securitisation relies on Hong Kong's strength as "super-connector", which also benefits many local industries such as legal, finance, taxation and corporate services, enhancing Hong Kong's key strength.

We are full of confidence in Hong Kong's capability to build a successful PRC cross-border securitisation platform. Let us work together and take actions to promote the implementation of various measures as soon as possible, so as to build Hong Kong into a cross-border securitisation platform with international standards linking the Mainland, Hong Kong, countries along the "Belt and Road Initiative" and international investors.

Endnotes

1 "Decoding the Central Economic Work Conference | Promoting High-quality Opening Up and Attracting Foreign Capital in 2023 Will Welcome Multiple Benefits", Xinhuanet, December 23, 2022: http://www.news.cn/fortune/2022-12/23/c_1129227150.htm

2 See the website of China Asset Securitization Analysis Network: http://www.cn-abs.com
The exchange rate of the renminbi against the US dollar is 6.90:1 calculation.

3 "Foreign Exchange Bureau: The Total Size of China's Bond Market is $21 trillion, Foreign Capital Will Still Steadily Increase Its Holdings of RMB Bonds", People's Daily Network 2July 22, 022: http://finance.people.com.cn/n1/2022/0722/c1004-32483101.html

4 See the website of the Securities Industry and Financial Markets Association,US Asset Backed Securities Statistics: https://www.sifma.org/resources/research/us-asset-backed-securities-statistics/
According to the World Bank, the GDP of the United States in 2021 is about $23.3151 trillion, see the World Bank website: https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=US

5 See the website of the Securities Industry and Financial Markets Association,US Mortgage Backed Securities Statistics: https://www.sifma.org/resources/research/us-mortgage-backed-securities-statistics/

6 See the website of the European Association for Financial Markets, AFME Securitisation Data Report Q4 2021 and 2021 Full Year, https://www.afme.eu/Publications/Data-Research/Details/AFME-Securitisation-Data-Report-Q4-2021-and-2021-Full-Year.
According to the World Bank, the EU's GDP in 2021 is about $17.1774 trillion, see the World Bank website: https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=EU

7 European Systemic Risk Board, Monitoring systemic risks in the EU securitisation market (July 2022).

8 See the website of International Monetary Fund, https://www.imf.org/external/datamapper/NGDP_RPCH@WEO/WEOWORLD/USA/EU.
During the four years after GFC, the US GDP growth is about 1% higher than the EU GDP for year.

9 See the HKTDC website: https://research.hktdc.com/en/article/MzYzMDE5NzQ5
According to the World Bank, China's GDP in 2021 was about US$ 177.7341 trillion and its population was about 1.412 billion. See the World Bank website:
https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=CN
https://data.worldbank.org/indicator/SP.POP.TOTL?locations=CN

10 The products issued in the CIBM include credit asset-backed securities initiated by banking financial institutions (ABS) and asset-backed notes (ABN) initiated by non-financial institutions. The products issued on the Exchange Market are asset-backed special plans initiated by non-financial institutions (commonly referred to as the ABSP). At present, eligible foreign investors can invest in ABS and ABN in the CIBM through Bond Connect and can also invest in the ABSP in the Exchange Market through QFII/RQFII (merged QFI).

11 See the website of China Asset Securitization Analysis Network: http://www.cn-abs.com/

12 See the Irish Bond Institute website: https://idsa.ie/industry-statistics/

13 See the website of China Asset Securitization Analysis Network: http://www.cn-abs.com