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## China's Securitization Market Will Sustain Its Stability In 2017

**Primary Credit Analyst:**

Aaron Lei, Hong Kong (852) 2533-3567; aaron.lei@spglobal.com

**Secondary Contacts:**

Kate J Thomson, Melbourne (61) 3-9631-2104; kate.thomson@spglobal.com

Jerry Fang, Hong Kong (852) 2533-3518; jerry.fang@spglobal.com

### Table Of Contents

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Issuance Volume Remained High In 2016 Despite Moderating Growth

2017 May See More Market-Driven Expansion

Deal Performance Could Diverge But Will Remain Stable Overall

Several Obstacles Remain

# China's Securitization Market Will Sustain Its Stability In 2017

Securitization could become a more regular funding channel in China this year, riding on the strong foundation of growth and success of the past five years.

S&P Global Ratings expects steady asset quality and structural protection in securitization transactions to underpin the stable performance of China's securitization market in 2017. The continued issuance of retail receivables with repeated structure, increasing participation of nonbank issuers, more flexible issuance schemes, and developing new asset sectors will be the main themes for the year.

The issuance activities in the China securitization market in 2016 indicated that securitization may have a solid foundation for sustainable development in China, albeit with challenges persisting. In 2017, the ability of securitization transactions to withstand macroeconomic deterioration will remain the area of focus. We believe deal performance may vary among issuers, regions, and asset sectors due to asset composition and sensitivity to macroeconomic changes. In addition, improving secondary market liquidity, deepening product understanding, and building market confidence are a few areas of development.

## Issuance Volume Remained High In 2016 Despite Moderating Growth

New issuances in 2016 grew by about 40% year on year with more than Chinese renminbi (RMB) 858 billion of new securitization notes issued (see chart 1). These issuances were under the credit asset securitization (CAS) scheme of China Banking Regulatory Commission (CBRC) and The People's Bank of China (PBOC), and the corporate securitization scheme of China Securities Regulatory Commission (CSRC). Although this growth was moderate compared to the 50% in 2014-2015, China remains the fastest growing securitization market among the major ones, most of which were affected by market volatility and regulatory uncertainty (see table 1).

Chart 1

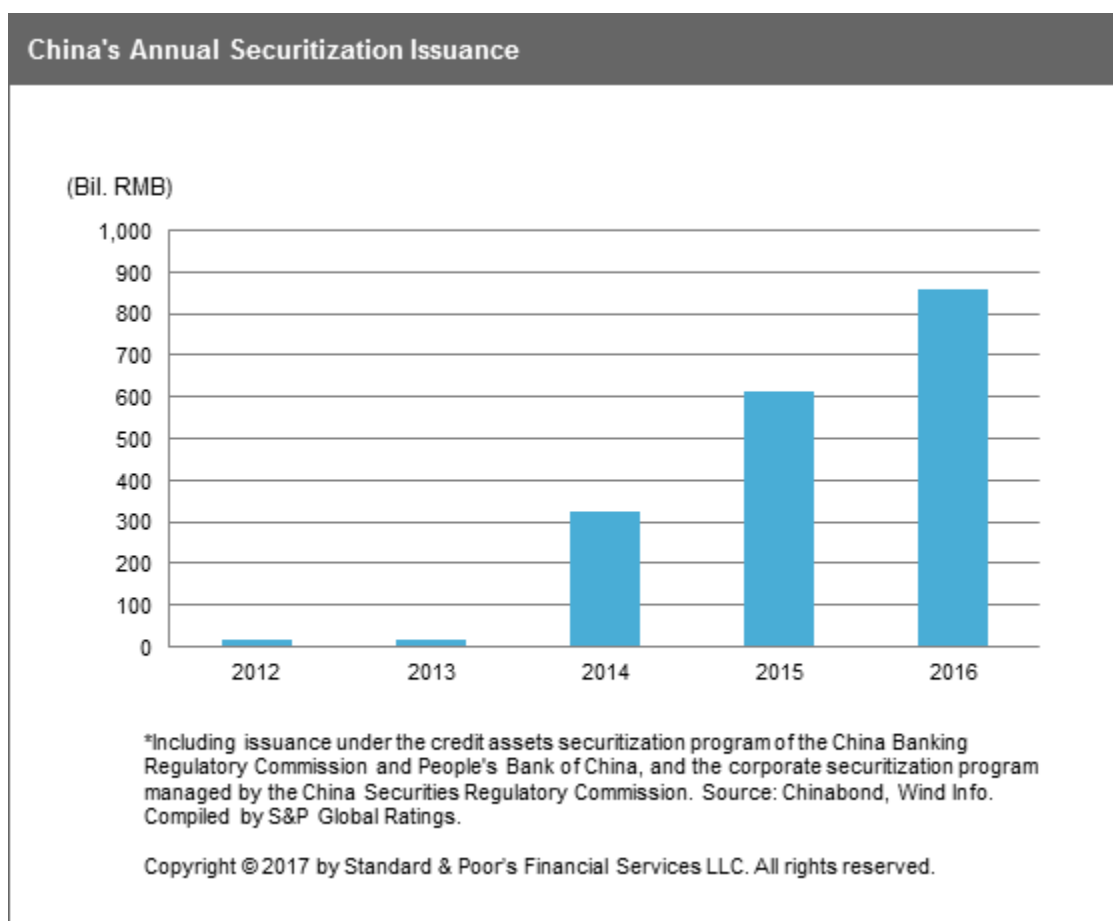


Table 1

**Global Securitization Issuance Summary**

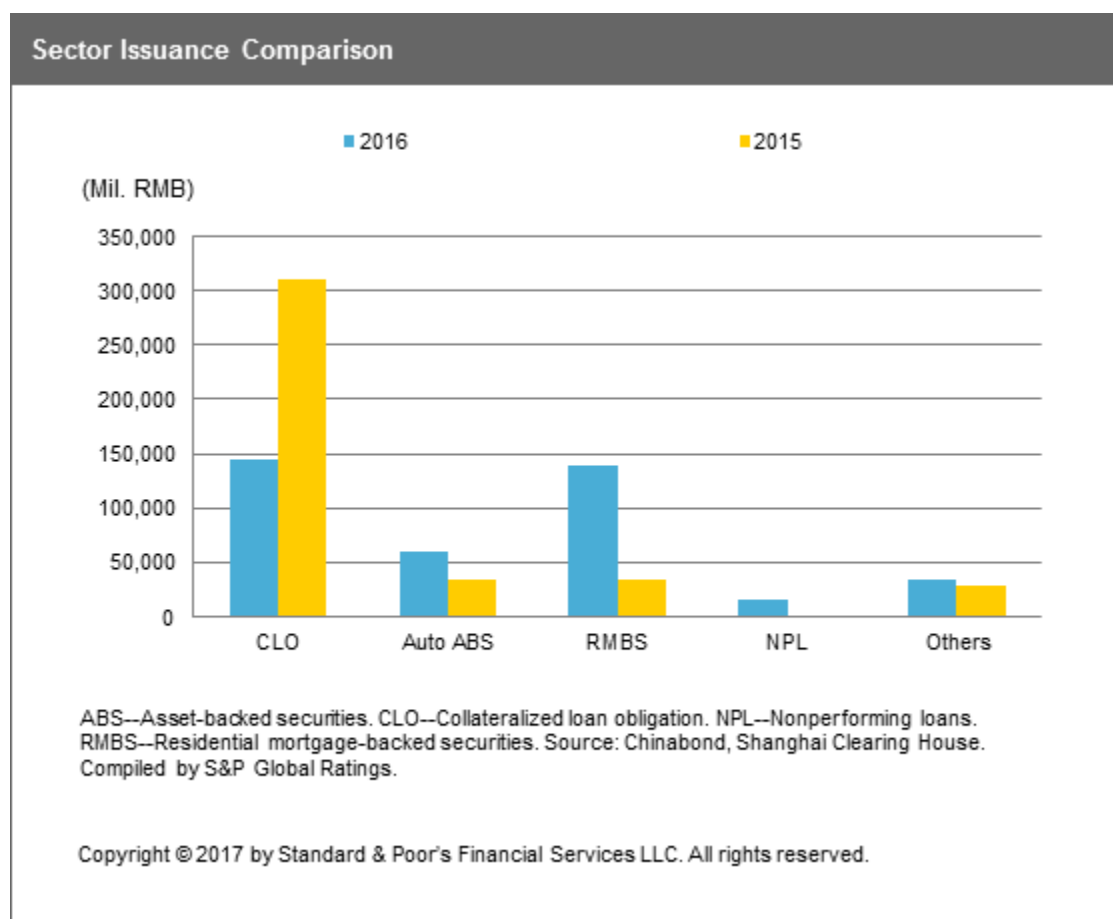
	2015	2016
U.S. (Bil. US\$)	436	372
Canada (Bil. C\$)	15	18
Europe (Bil. €)	75	80
Australia (Bil. A\$)	38	32
China (Bil. RMB)	612	858
Japan (Bil. \$)	38	44*

\*Through November 2016. Source: S&P Global Ratings.

**Nonbank issuers filled the gap left by reduced bank issuance**

Bank issuance fell to less than 40% of new securitization issuance in 2016, from more than 50% in previous years. Bank issuance declined in absolute terms as well. The primary reason for the decline was much lower collateralized loan obligation (CLO) transactions by banks (dropping to RMB144 billion in 2016 from RMB311 billion in 2015) (see chart 2). Accommodative liquidity conditions in the banking sector, reduced popularity of CLO products, and lower loan yields despite higher sensitivity to macroeconomic slowdown contributed to reduced CLO issuance by banks.

Chart 2



Nonbank entities issued over RMB500 billion securitization notes in 2016, more than offsetting the drop in contributions from the banking sector. Nonbank issuers include housing provident funds (HPFs), auto loan finance companies, leasing companies, micro loan finance players, and many other corporate entities. For these players, securitization is a viable funding channel because of improved demand and lower costs in an easing interest rate environment, and partly replaces these entities' bank borrowings.

The flexibility in assets securitized under the CSRC scheme, which is primarily used by corporate issuers, and the increasing proficiency of using it also contributed to the quick growth of nonbank issuers. As a result, issuance under the CSRC scheme surpassed that under the CAS scheme in 2016.

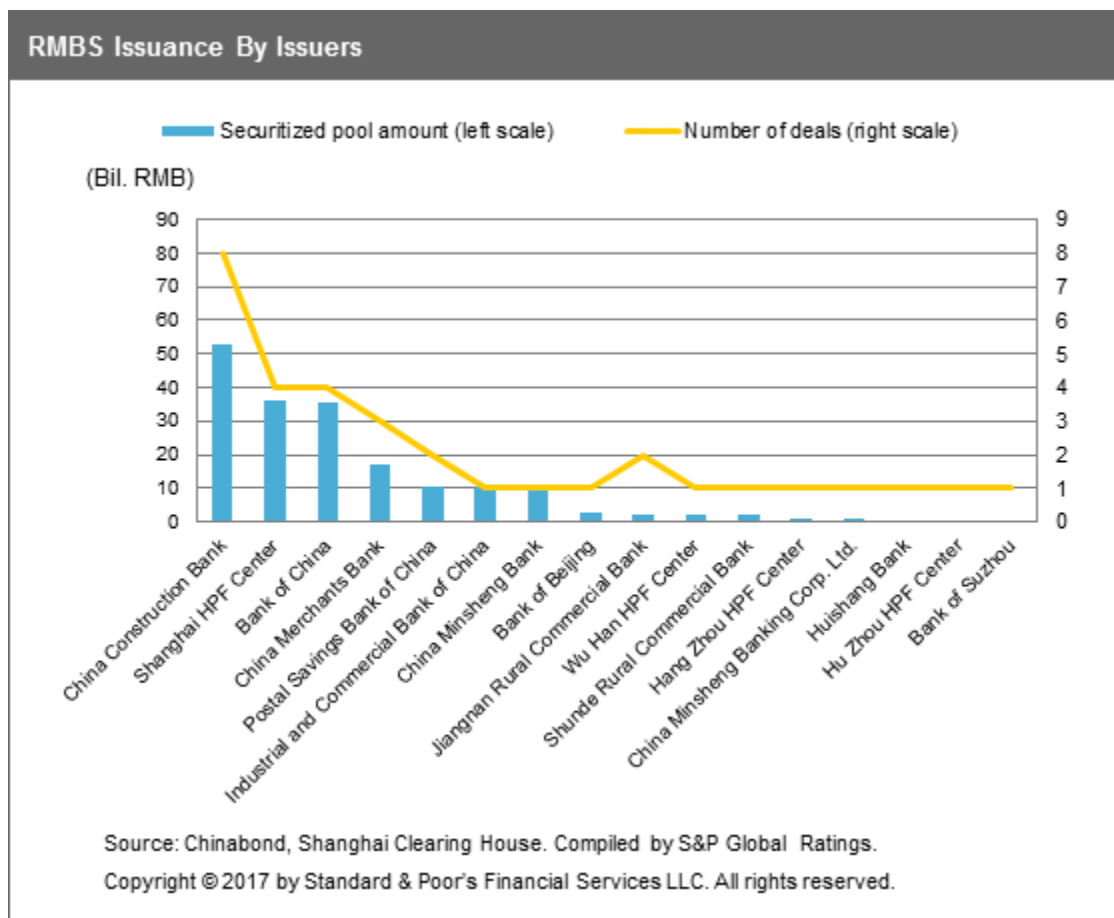
### HPFs' and Banks' RMBS offerings increased

Issuance of new residential mortgage-backed securities (RMBS) increased to RMB140 billion in 2016, from RMB33 billion in 2015. RMBS provides HPFs a much needed funding channel amid the increasing usage of HPF money for house purchase. For instance, Shanghai HPF issued RMB31 billion of RMBS in 2016 under the CAS scheme.

China's major banks in residential mortgages origination, such as China Construction Bank, Bank of China, and Postal Savings Bank of China, also participated in the market actively in 2016 (see chart 3). Although the liquidity and funding needs of commercial banks may not be as critical as for HPFs, balance sheet-sustainability and duration-matched

funding for the mortgage business have resulted in active participation from these issuers.

**Chart 3**

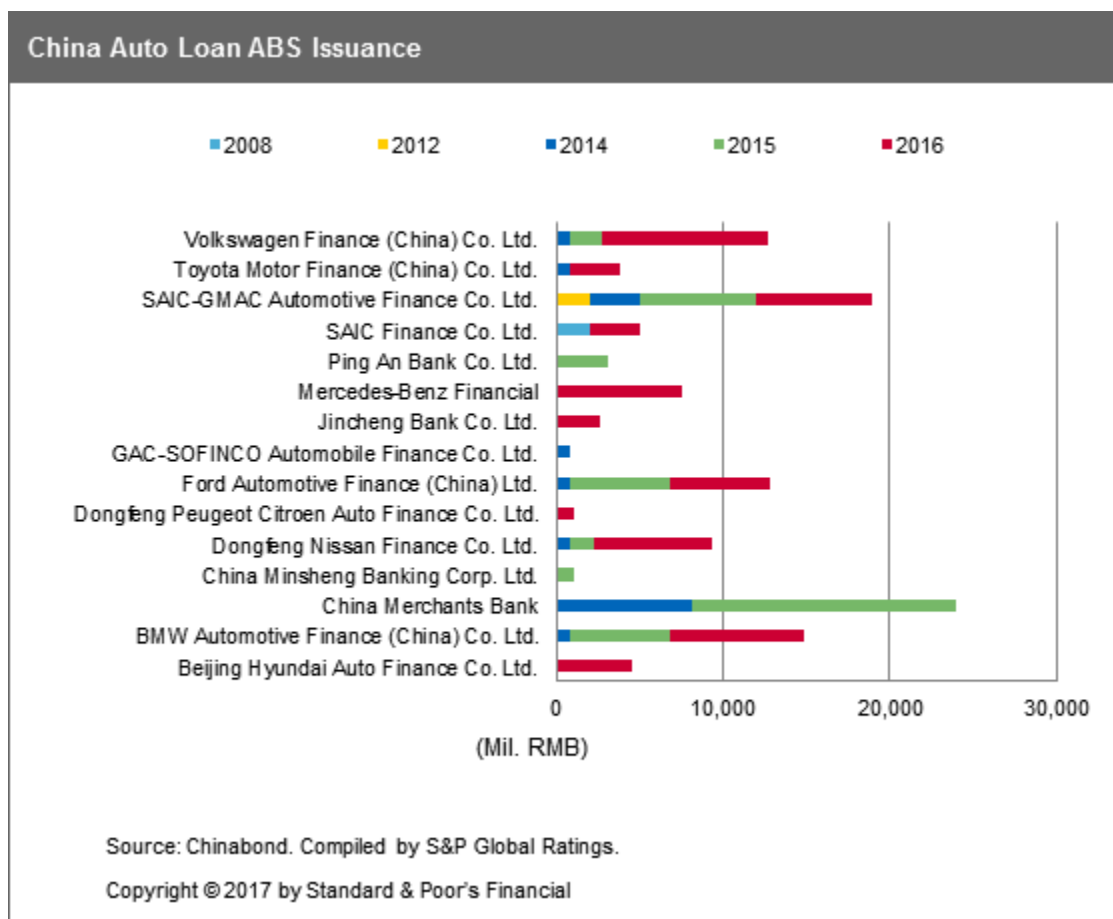


**New issuers entered the auto loan ABS market**

Several new entrants joined the auto loan securitization (ABS) issuance in 2016. These included Beijing Hyundai Auto Finance Co. Ltd., Mercedes Benz Financial, and Dongfeng Peugeot Citroen Auto Finance Co. Ltd.

Issuance of new auto loan ABS transactions had exceeded RMB122 billion by 2016 from 2008, when the product debuted. Among the 26 auto finance companies in China, 13 have issued at least one transaction and six have issued at least two transactions (see chart 4). Most issuers are captive auto finance companies related to various manufacturers, and repeated issuance is a promising sign that securitization has become a regular part of financiers' ongoing funding strategies.

Chart 4



### NPL securitization was an innovative response to the industry's needs

Nonperforming loans (NPL) securitization was the result of industries' search to help resolve Chinese banks' accumulated bad loans that have kept growing over the past few years. NPL securitization is an alternate solution in addition to the traditional sale of assets i.e., banks selling NPLs to asset management companies. What happened in this sector in China in 2016 was similar to what took place in Italy that year: it represented the market's intention to find systemic solutions to NPLs through capital market offerings instead of smaller-scale bank-specific resolutions.

Although historically NPL securitizations have involved mortgage assets, with increasing corporate leverage in a slowing economy, commercial loans are emerging in NPL pools in China. Among the 14 NPL securitization transactions in 2016, nine related to commercial loans extended to corporate or trade finance obligations (see table 2). The inherent volatility of the value of such loans was reflected in the large differences in loan-by-loan appraisal value within a transaction's portfolio.

Table 2

China Nonperforming Loan Securitization					
Transaction	Seller	Nonperforming asset securitized	Asset book value (mil. RMB)	Issuance amount (mil. RMB)	Asset value haircut (issuance amount/asset book value)
Zhong Yu 2016-1	Bank of China	Commercial: Corporate loans and trade finance	1,253.83	421.56	33.6%
He Cui 2016-1	China Merchants Bank	Retail: unsecured consumer receivables	2,097.70	296.85	14.2%
He Cui 2016-2	China Merchants Bank	Commercial: Micro loans	1,155.42	611.67	52.9%
Nong Ying 2016-1	Agricultural Bank of China	Commercial: Corporate loans and trade finance	10,726.68	4,372.81	40.8%
Jian Xin 2016-1	China Construction Bank	Commercial: Corporate loans and trade finance	2,445.53	1,032.84	42.2%
Jian Xin 2016-2	China Construction Bank	Retail: Mortgage loans	2,992.76	2,621.32	87.6%
Gong Yuan 2016-1	Industrial and Commercial Bank of China	Commercial: Corporate loans and trade finance	4,521.49	1,789.21	39.6%
He Cui 2016-3	China Merchants Bank	Commercial: Corporate loans and trade finance	2,362.46	1,034.83	43.8%
Jiao Cheng 2016-1	Bank of Communications	Commercial: Corporate loans	4,893.06	2,193.50	44.8%
Zhong Yu 2016-2	Bank of China	Commercial: Corporate loans	3,153.95	885.55	28.1%
Jian Xin 2016-3	China Construction Bank	Retail: unsecured consumer receivables	2,810.47	677.35	24.1%
Gong Yuan 2016-2	Industrial and Commercial Bank of China	Retail: unsecured consumer receivables	3,129.22	427.44	13.7%
He Cui 2016-4	China Merchants Bank	Commercial: Micro loans	1,153.97	611.70	53.0%
Gong Yuan 2016-3	Industrial and Commercial Bank of China	Retail: Mortgage loans and unsecured consumer receivables	7,529.86	6,020.74	80.0%

Source: Issuance documents published on Chinabond's website. Compiled by S&P Global Ratings.

Asset management companies and commercial banks are the main buyers of NPL securitization issuances, with participation from other fixed-income investors remaining limited. We believe this is due to the complexity of NPL processing. Commercial loan workout can be very volatile because it depends on complicated bankruptcy or restructuring processes, dynamic industry environments, and--in the case of the recently troubled resource sector-- the unpredictable price of the underlying commodities. Asset management companies and commercial banks typically have more experience with the process than other investors.

## 2017 May See More Market-Driven Expansion

We expect China's securitization market to further develop in 2017, supported by the solid foundation built in the past years. Notably, 2016 was a quieter year in regulatory changes for China's securitization market than the period from 2012 to 2015, but it still recorded high issuance growth and more participation, both of which may continue in 2017. During the four years prior to 2016, regulators adopted some major deregulations on issuance qualifications,

management guidelines for market-oriented operations, high-standard information disclosure, and increasing mandates on related market players. These regulatory measures encouraged many issuance trials and expanded the market size. 2016, therefore, has become an ideal period in which to assess how the market will proceed when regulatory support is reduced. In our view, the vigorous activities in the nonbank issuers and retail receivables sectors in 2016 underscored the argument that securitization may have found a place for sustainable development in China.

### **Auto loan ABS issuance will continue**

We expect issuance of auto loan ABS to continue. That's because of the likely growth in passenger cars sales, increasing use of financing to purchase vehicles, and track record of securitization being used as a regular funding source by finance companies. This sector has scored over RMB60 billion in new issuance in 2016 when passenger cars sales reached 24.38 million. The continued, although reduced, exemption of vehicle purchase tax in 2017 should support mild growth in new vehicle sales during the year, and increase financing needs. Also, more new issuers may join the market as it develops.

### **RMBS will become a major asset sector**

Major banks and HPFs will remain the primary issuers of RMBS. With the massive registration amount for RMBS issuance in the next two years and issuers' need for alternative funding, RMBS may remain the primary asset sector in China's securitization market. Chinese banks' official loan-to-deposit ratios look low and there seems no necessity for banks to go to wholesale financing. However, we estimate that these banks' adjusted loan-to-deposit ratios, which include off-balance sheet items, have climbed to about 80% due to rapid off-balance sheet credit creation in recent years. Securitization as an alternative and duration-matched funding tool may therefore support banks' mortgage funding strategies in the future.

### **Transactions secured by lease and trade receivables may see more issuance**

The increased participation of nonbank corporate issuers is compelling evidence for market sustainability. In 2017, such a trend may result in more issuance in transactions collateralized by lease and trade receivables, the two major asset types of these issuers. Unlike commercial banks that can take retail deposits, nonbank and corporate players typically face higher funding costs and the uncertainty of stable and consistent funding sources, when external environments deteriorate. What happened in China, particularly the repeated issuance and expanded participation from new issuers, has reflected the increasing use of securitization for regular financing needs. Based on our observations in other markets, we believe such use tends to be more sustainable because it addresses the fundamental needs of the issuers.

### **NPL securitization will continue to grow**

With an estimated US\$1.8 trillion of NPLs around the globe, we expect these loans will require significant amounts of debt financing and that rated securitizations will play a large role in bringing institutional funding to these troubled loans. In addition to Italy and Ireland, China will be the key market for this product due to the fundamental need and experience accumulation. The NPL securitization trials may be expanded to more banks in 2017 and we may see more variety in the assets underlying these transactions.

### **Use of the updated securitization issuance scheme could increase**

China's National Association of Financial Market Institutional Investors, the manager of China's inter-bank bonds market, announced updated ruling managing the asset-backed notes (ABN) securitization scheme in December 2016.



The updated scheme now allows the setup of special-purpose vehicles as the asset purchasers and notes issuers, removing the concerns over the lack of asset segregation in the previous version of the ABN scheme. The market welcomed the ruling; the ruling may create a new issuance channel for nonbank and corporate issuers not regulated by the CBRC. This is because most fixed-income capital market activities in China remain in the inter-bank bonds market, and the introduction of the special-purpose vehicle structure will address the concerns of many investors who had previously stayed outside the ABN offerings. As a result, we may see faster growth in issuance under the updated ABN scheme.

### **Market infrastructure will strengthen further**

Chinese regulators have put in plenty of effort in developing market infrastructure in recent years, such as the roll-out of more refined information disclosure requirements and a stricter deal review process. We believe these efforts will continue and more administrative measures will be strengthened in response to the market events and macroeconomic concern. All these factors will contribute to a more transparent and disciplined market, in our view.

### **Deal Performance Could Diverge But Will Remain Stable Overall**

The slowing economy and the government's continuing rebalancing efforts may result in varying impact on the many economic sectors in China; some may benefit yet others may suffer. This in turn may contribute to a divergence in the performance of financial or operational assets in China, affecting the credit performance of securitized assets. Also, securitization will be tested even more from the macro environment evolution when deal issuance grows and more performance data is available.

That said, overall we do not expect major negative changes in deal performance due to China's economic adjustment. The negative macro evolution and economic policy implementation will be largely offset by conservative assets and deal structures, improving household income, and in the CSRC scheme transactions, the strong parent support. We therefore expect most China securitization deals to continue their stable performance in 2017.

Transaction performance of retail receivables backed transactions (including auto loan ABS and RMBS) as measured by assets' payment delinquencies and pool payout speeds, didn't deviate much from past trends in 2016. The asset loss rate, as defined by individual servicers, generally was low (see charts 5 and 6). The severe payment delinquency rates in most securitization transactions are lower than those in the vintage pools--the mother pools of the originators--disclosed by originators. We believe this is due to stricter eligibility criteria and longer loan seasoning in securitization issuance.

Chart 5

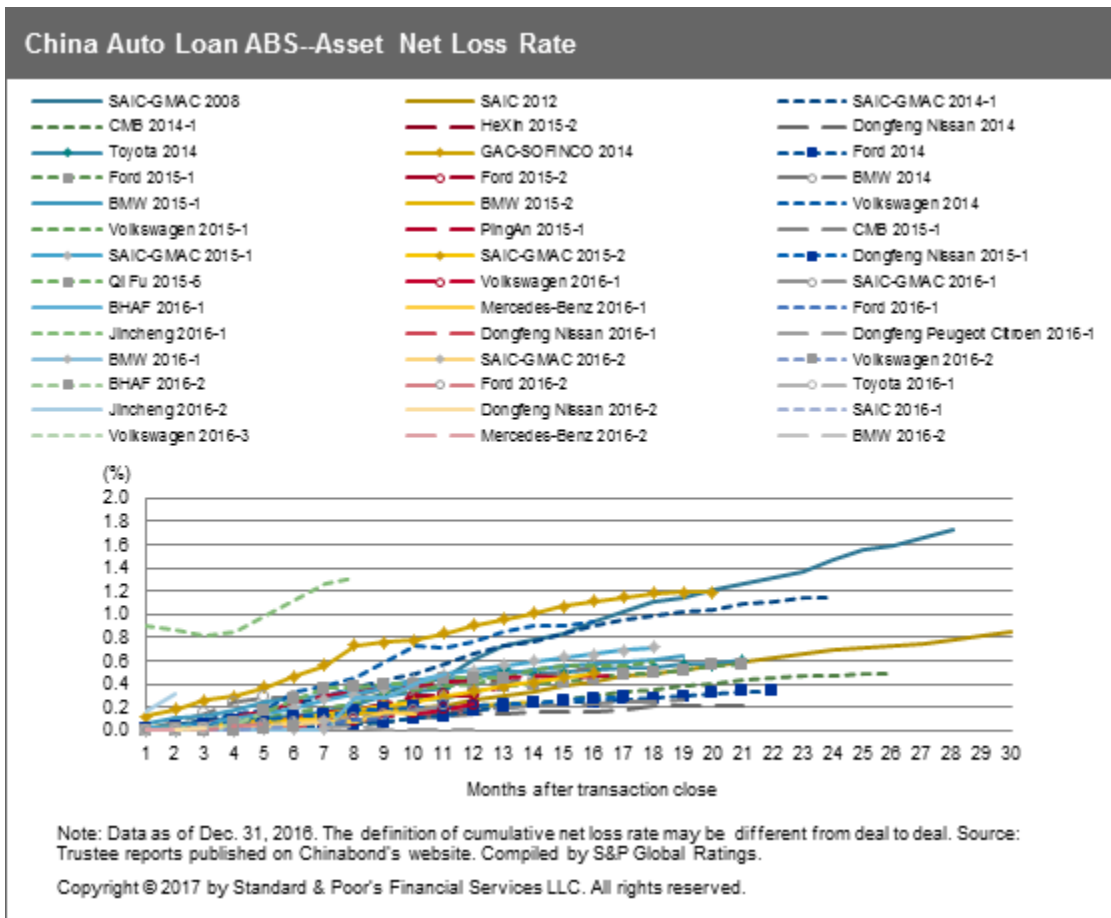
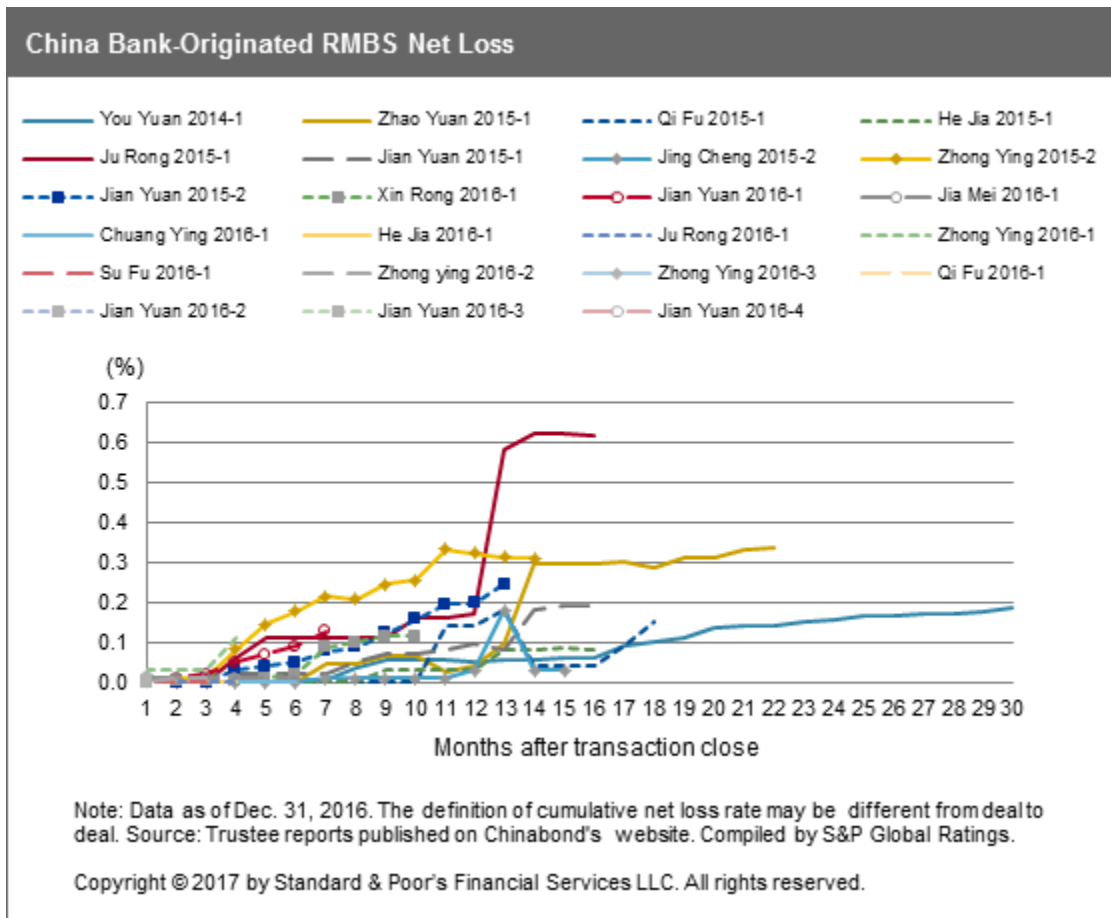


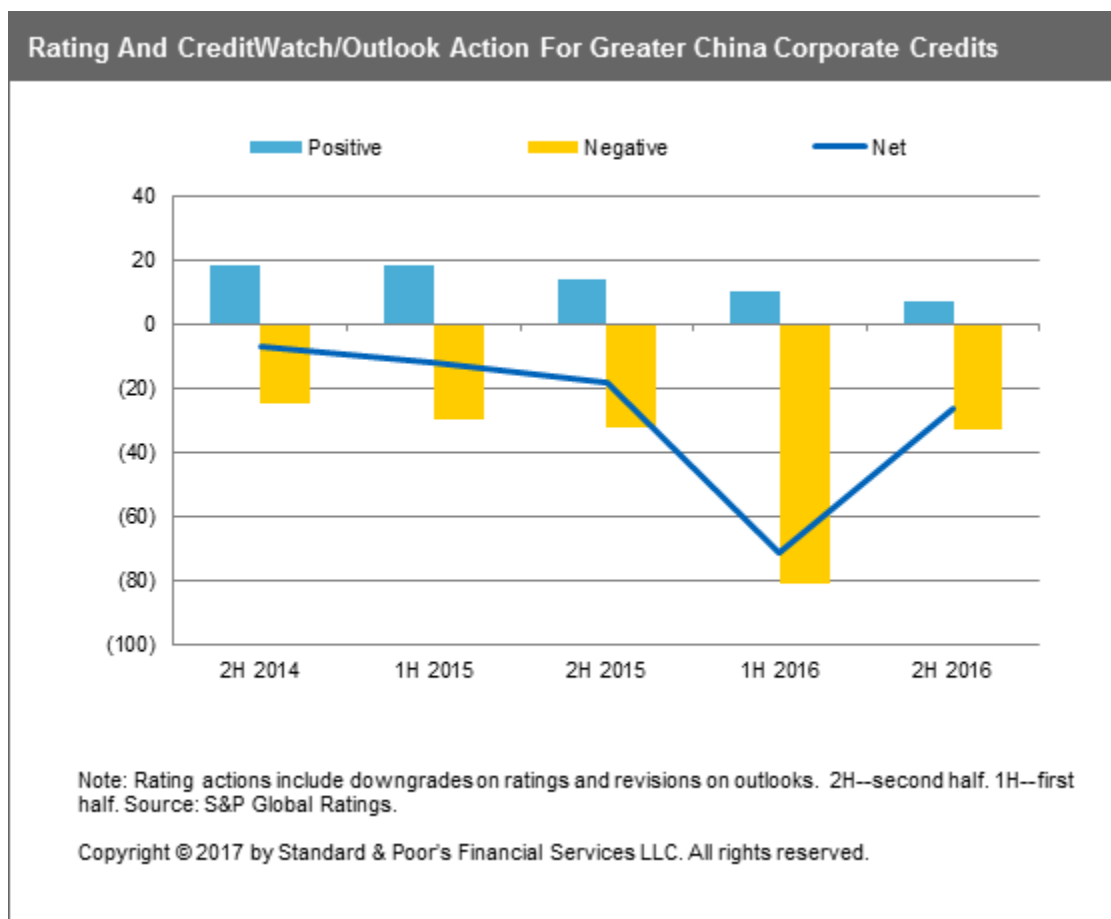
Chart 6



Despite slowing economic growth, we expect the performance of retail receivables backed transactions to be robust in the next one to two years. That's because of the mild competition in the industry and resultant stable product offering, the full-recourse nature of loans, the relatively low loan-to-value ratios, and structural features of the transactions such as sequential repayment. Household indebtedness is rising in China, but that is gradual and the debt burden remains low when compared with other economies. This will also encourage continued debt servicing.

On the other hand, transactions backed by corporate-related assets may face more headwinds in asset performance in 2017. This is due to these deals' direct exposure to corporate credits that are highly correlated with the macroeconomic slowdown and the typically more concentrated pools that make it more difficult to manage the risk of deterioration in particular economic sectors and geographic regions (see chart 7). In 2016, an operating asset supported transaction missed one interest payment due to weaker-than-expected operating conditions, and marked the first technical default in China's securitization industry history before the transaction resumed payments later. Such negative events may continue in 2017. However, we expect the sector to perform better than the general corporate industries, given the protection measures in securitization transactions and the selection of higher-credit-quality corporate credits upon deal origination.

Chart 7



## Several Obstacles Remain

We see a few impediments to market development, including weaker secondary market liquidity, insufficient product knowledge, and the uncertainty of continued participation from the larger players.

### Secondary market liquidity needs to improve

Except for the auto loan ABS sector, repeat issuance in China is limited. This makes it difficult to establish an efficient secondary market and pricing benchmarks because securitization transactions from different issuers or using different asset-selection criteria could exhibit different risk and return profiles. The turnover of securitization notes has been increasing in recent years, but the trading amount and frequency remain very limited compared with the outstanding amount.

Although lower secondary market liquidity is an almost universal characteristic across global securitization notes, this phenomenon has more implications in China. That's because investor segmentation for securitization notes is yet to develop in China. Investor groups focusing on, or specializing in, securitization notes are yet to form, and most real-money buyers are generally fixed-income investors that choose from a wide range of debt products. In such a selection process, product yields and secondary market liquidity usually become more important considerations than

product credit quality and duration match. For a nascent market like China's, such investment logic could limit the expansion of the investor base for securitization.

Market players have worked to address the issues through primary dealers' undertaking, trials in revolving structures to extend transaction lives, and increased market education. The information disclosure requirement stipulated by the related regulators also has been improving. We believe all these factors could help with deal tracing and whole-market comparisons, but investors' ability to adapt and respond quickly will be key.

### **New products address industry needs, but expansion rests on knowledge accumulation**

NPL securitization is a product that may eventually benefit the banking industry and the capital markets. It has the potential to provide more funding to bad loan resolution and bring in specialized teams to deal with the loan workout, hence redirecting banks back to their normal business. China's NPL securitization market has seen success in selling loans from a bank to other investors in the inter-bank bonds market, a resolution that brings in capital market resources to the banking system. However, the initial target of attracting more capital market investors has not been completely achieved and most participants remain the asset management companies and commercial banks that were already in the market before the roll-out of the products. This largely reduces the effect of the product.

The fact that many NPL securitization offerings in China are commercial loans also raises the level of complexity in assessing the products. In addition to the typical uneven cash flow profile and uncertainty associated with the timing of recoveries in NPL securitization, commercial loan NPL transactions may need loan-level analyses due to their much lesser granularity. We believe this market bears watching as there is plenty of NPL collateral to finance, and the experience accumulated in 2016 should help increase issuance in the future. This, however, will rest on continued knowledge and experience accumulation on addressing related difficulties.

### **Continued participation by large issuers is important to build market confidence**

The increasing participation of nonbank issuers in 2016 highlights the wider acceptance of the product for regular funding. But the drop in bank issuance volume could impede the buildup of market confidence and may eventually affect market expansion.

For a new market like China, the continued participation of large issuers is important. That's because the quality of securitization rests on the quality of initial loan underwriting and servicing. In addition, investors may find it much easier to assess such quality for a major and frequent player than for a less known and infrequent issuer due to the confidence on information disclosure and management practices. For example, it may be more difficult for an investor new to the market to assess an industry with a thousand small issuers that launch deals once a year, than to evaluate an industry with a hundred larger issuers each of which launches ten deals per year. Given that China's banks remain the major asset owners and they have more resources to manage through macro difficulties, a quick drop or discontinuation of such players' activities may eventually affect investors' confidence and slow down market development.

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