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Regulation of securitisation in China: Learning from the US experience



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ABSTRACT

With the issuance of the latest adjustment on the Chinese securitisation regulatory framework, the originating institution only needs to hold 5% capital for each class of the securitised assets. Previously, the originating institution needed to hold a certain percentage of the lowest class of the securitised assets in one single securitisation deal, and the percentage in principal, should not be less than 5% of the entire term of the securitisation deal. This adjustment of the reduction of the minimum risk retention (MRR) requirement has to large extent, addressed the limitation of financing in participating in securitisation for Chinese banks. However, it has increased the risk of securitisation failure or even a crisis in the Chinese banking sector compared with the previous regulatory framework.

In the light of the potential risks of this latest adjustment, the study critically examined the effectiveness of the regulatory framework of the current Chinese securitisation market drawing from the US experience during the global financial crisis (GFC). Overall, we evaluated the regulations on the current Chinese securitisation market as relatively effective, whilst we also raised concerns on the future of the regulations and thereby provided suggestions for improvements.

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1. Introduction

In June 2012, Chinese regulators (the People's Bank of China – PBC, the China Banking Regulatory Commission – CBRC and the Ministry of Finance – MOF) – issued the notice of restarting the securitisation pilot programme of 50 billion Yuan (\$7.9 billion), which was stopped for four years due to the 2008 global financial crisis (GFC) (Wong, 2012; Chen, 2012). Since the restarting of the securitisation experiment by mid-2012, the Chinese government has expanded the scale of asset securitisation via issuing a further pilot programme of 200 billion Yuan (\$31.6 billion) in August 2013 (Zhao, 2013). On 31st December 2013, the PBC and CBRC eased the national regulatory rules of asset securitisation in comparison with the initial one which was issued at the restarting notice in June 2012 (Wang, 2014). In addition, the latest international regulatory framework for banks, known as Basel III (scheduled from 2013 to 2019), introduced after the GFC to address the problems that occurred in the crisis and strengthen the global financial sector is already being implemented in China (CBRC, 2011a).

However, while the focus has been on the benefits of securitisation to the Chinese banking sector and economy (Zhao, 2013; CICC, 2014; Wang, 2014), limited attention has been paid to the inherent risks of this financial instrument, especially after the latest adjustment on 31st Dec 2013. This is important given the wide acknowledgement that such extensive use of securitisation fuelled the US sub-prime crisis and thereby led to the GFC (see Acharya and Richardson, 2009; Bessis, 2010;

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Danila, 2012). Indeed, during the GFC, regulatory failures especially the weaknesses of Basel I and II and the failures of US national regulators were noted as major contributory factors to the securitisation crisis (Moosa, 2010). As the 2007–2008 crisis was directly associated with the US housing bubble, there are concerns that there might be a potential threat of housing bubble in the Chinese property sector (Davies, 2011; Charlie, 2013; Robin, 2013; Economist, 2014). The need for more attention to the Chinese real estate sector is further strengthened by its increasing linkage to other sectors in both real and financial channels (Chan et al., 2016). While real estate fixed asset investment accounts for about 25% of the economy's total fixed asset investment, its share in the total economy value added has been on the increase. A survey in 2012 of 64 small-scale credit intermediaries by Morgan Stanley revealed that about 20% of their credits were given to real estate developers. According to IMF (2011) about 30–45% of loans provided by five biggest Mainland banks were based on provision of collateral of which real estate is the dominant form of collateral used. The implication of all these is that any shock in the real estate sector will affect not only the real estate and the financial sector but other sectors of the Chinese economy (see IMF, 2011; Stanley, 2012; Chan et al., 2016).

Arguably, the identification of securitisation as a key trigger of the GFC exposed its drawback of contagion effect during the crisis, which was considered as an advantage for risk diversification under normal circumstance. To avoid a repetition of the securitisation crisis, the effectiveness of regulation in minimising risks and losses is therefore the central element in securitisation risk management (Valdez and Molyneux, 2013). As the latest Chinese securitisation regulatory adjustment has significantly reduced the minimum risk retention (MRR) requirement which incidentally can increase the risk exposure of the banks, a critical evaluation of the effectiveness of the Chinese securitisation regulatory framework is pertinent.

The aim of this paper therefore is to evaluate the effectiveness of the current Chinese securitisation regulatory framework in preventing another securitisation crisis. As securitisation and the GFC originated from the USA, a critically examination of the securitisation in both USA (during the GFC) and China (currently) will be drawn from to offer suggestions on how to improve the Chinese framework. The remaining parts of the paper will proceed as follows: in addition to providing an overview of the rationale and development of securitisation, Section 2 will examine the benefits and drawbacks of securitisation. Section 3 analyses the circumstances of the US securitisation market during the GFC with a focus on the contributions of the regulatory rules to the GFC. Section 4 provides a brief overview of the Chinese banking sector and its emerging securitisation market. With a comparison to the US securitisation experience during the GFC, Section 5 provides a further critical examination of the Chinese current securitisation regulations with the key challenges and suggestions identified. Section 6 is the conclusion.

2. The rationale and development of securitisation

According to Liaw (2012: 173), asset securitisation can be described as “the selling of securities backed by cash flows from a pool of financial assets, in an integral part of the global capital markets”. To Fabozzi and Kothari (2008), the use of securitisation transaction is to pool assets together and in effect turn them into a tradable security. Altunbas et al. (2009) argues that the development of securitisation has changed the lending role of banks from an ‘originate and hold’ model to an ‘originate, repackage and sell’ model. Asset securitisation has two main categories which are asset-backed securities (ABS) and mortgage-backed securities (MBS). As Liaw (2006) explained, ABS is backed by receivables other than mortgage loans as the collateral of the cash flows.

As shown in Fig. 1.1, there are six key parties involved in the process of securitisation: originator, special purpose vehicle (SPV), credit rating agency (CRA), credit enhancer, underwriter and investors (Liaw, 2006; Fabozzi and Kothari, 2008; Zalewski, 2010; Valdez and Molyneux, 2013). In a securitisation transaction, the originator is the initial owner of the underlying assets and can be any financial institution, like a bank or a securities firm. The originator must complete a true sale to transfer the assets to the trust, which is called special purpose vehicle (SPV). The term true sale refers to the originator who will not possess any interest after this process. Thereafter, the SPV will package the assets and sell them as security (mainly MBS and ABS, depending on the type of the assets) to investors. In the meantime, the credit enhancer will be involved in this stage in order to create a better credit structure and reduce the risk for the securitisation programme. The credit rating agency (CRA) will offer a rating for the securitisation programme via analysing the risk of the assets and examining the legal and structural protections that investors will obtain. Finally, the securitisation product will be issued by an investment bank as the underwriter, and investors will gain the existing cash flows or future cash flows of the assets (Liaw, 2006; Fabozzi and Kothari, 2008; Zalewski, 2010; Valdez and Molyneux, 2013).

The use of asset securitisation started with the launch of MBS by the Bank of America in 1977. Initially, this new technique was not successful as every mortgage loan had a maturity of 30 years, which made the investment of the MBS to be easily influenced by the prepayment or default risks. Therefore, MBS was not attractive to investors at the initial period of securitisation market development. This issue led to the development of Collateralised Mortgage Obligation (CMO), which can separate the cash flow of each mortgage pool into a series of annual cash flows, and therefore create a range of unique products with different maturities. The CMO was first issued by Freddie Mac and was effective and successful in overcoming the previous difficulty of the MBS, and Investors could select their ideal length of maturity in securitisation product investment (see Liaw, 2012).

Afterwards, the technique of the securitisation transaction had been applied to other kinds of assets, like credit card receivables, corporate business loans and automobile loans. Expectedly, with a significant development in the USA, it spread to other regions of the global economy (Rita, 2006; Fabozzi and Kothari, 2008). From its establishment in 1970s until the

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