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**Client briefing**
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# China tightens up credit asset transfers

On 3 December 2010, the China Banking Regulatory Commission ("**CBRC**") promulgated the *Notice on Further Regulating the Credit Asset Transfer Business of Banking Financial Institutions* ("**Notice 102**"). Notice 102, which came into effect on the same day, marks China's continuing effort in strengthening the regulation of credit transfer activities in the secondary market.

This briefing highlights the salient points of Notice 102 and key issues that remain to be clarified and tested under Notice 102.

**Key Issues**


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## Key points under Notice 102

### *1. What does Notice 102 regulate?*

Notice 102 regulates the transfer of credit assets between banking financial institutions in China, including both domestic and foreign-funded banks established in China. Credit assets are defined as specific and transferrable credit assets that are regular in nature. The transfer and disposal of non-performing loans are expressly excluded from the application of Notice 102.

### *2. What has Notice 102 introduced?*

#### a. The "Three Principles"

Notice 102, for the first time, introduces a comprehensive set of guidelines to regulate credit asset transfer between banking financial institutions. The guidelines comprise three major principles:

- *The principle of authenticity*: transfers of credit assets must be "authentic" and clear from any repurchase arrangements, whether explicit or implicit.

  This principle has been mentioned in an earlier notice issued by CBRC in December 2009, namely the *Notice on Issues of Regulating Credit Asset Transfers Business and Financial Management Business Based on Credit Assets* ("**2009 Notice**"). In addition, banking financial institutions are expressly prohibited under both the 2009 Notice and Notice 102 from circumventing the credit supervision of CBRC by means of "spot purchase plus forward repurchase arrangements". Under such an arrangement, the transferor would, on one hand, enter into a spot purchase agreement with the transferee for the credit assets, and on the other, enter into a forward repurchase agreement with the transferee for the same credit assets in order to repurchase such credit assets within a certain period of time. As a result, such credit assets will be expunged from the balance sheet of the transferor, yet they will neither be reflected in the balance sheet of the transferee.


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From the regulator's perspective, the potential risk of this arrangement is that banks might indirectly increase their credit assets base and yet avoid credit supervision. For this reason, Notice 102 goes further to request that, as a requirement under the principle of clean transfer, transferees must enter into direct contractual relationship with the relevant debtors when credit assets are transferred to them. This is to ensure that transferees will not hold credit assets as agents of transferors.

- *The principle of entirety*: the transfer of credit assets must be an outright transfer and must cover all the outstanding principal and interest. In particular, none of the following transfer arrangements will be allowed: (a) where the outstanding principal is separated from the interest receivables; (b) where only a certain ratio of the outstanding principal or interest receivables are to be transferred; (c) where only a certain ratio of the aggregate amount of the outstanding principal and interest receivables are to be transferred; and (d) where the outstanding principal or interest receivables are to be transferred according to specified timelines.

  Similar to the principle of authenticity, this principle has also been stated in the 2009 Notice, but it was focusing on credit assets in which financial management products invest. Notice 102 now extends this principle to all credit asset transfers between banking financial institutions.

- *The principle of clean transfer*: the transfer of both credit assets and associated risks must be authentic and in entirety.

  Specifically, the principle of clean transfer requires all risks associated with the underlying credit assets to be transferred to the transferee. The transferee must enter into direct contractual relationship with the debtors, and all existing security must be transferred to the new transferees. Where there is an existing guarantee for the underlying loan, the guarantor's consent must be obtained for the loan transfer. If the guarantor does not consent to such a transfer, the transferor must negotiate with the debtor in order to seek a replacement guarantor or other security.

**b. Regular reporting to CBRC**

Notice 102 requires banking financial institutions, either as transferors or as transferees, to report to CBRC on details of their credit asset transfer within 30 working days after the end of each quarter.

This is more stringent than the 2009 Notice, which only requires the reporting duty to be observed "in a timely and accurate manner".

**c. Stricter prohibition on using asset management funds to purchase credit assets**

According to Notice 102, banking financial institutions are prohibited from using asset management funds to purchase credit assets directly. This is a broader prohibition than that under earlier notices of CBRC. For example, the *Notice on Further Regulating the Issues Concerning the Cooperation of Banking and Trust Business*, which was promulgated by CBRC in December 2009, prohibited financial management products that arise from the cooperation of banking and trust business from being invested in credit assets or instrumental assets of banks that issue such financial management products.

## Issues to be clarified

**a. Is debtor's consent required for loan transfer?**

According to Notice 102, debtor's consent is required for loan transfer unless otherwise agreed in the original facility agreement.

This appears stricter than the *PRC Contract Law*, which only requires the transfer of credit rights to be ***notified*** to the debtor. It remains to be tested as to how these provisions reconcile with each other.

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**b. Does Notice 102 impose additional requirements on the transfer of syndicated loans?**

Yes, it does. Under Notice 102, transfers of syndicated loans must first be offered to other syndicate members. Only when all syndicate members refuse to take up the loan and agree to the transfer of the loan to a third party could such a loan be so transferred. The transferee will then become a new member of the syndicate.

However, Notice 102 does not provide a specific mechanism for the exercise of such a "pre-emptive" right by the syndicate members. Questions then arise as to whether the syndicated loans should still be transferred to a syndicate member who offers less favourable terms than a third party for the purchase; and how a deadlock situation could be resolved if a syndicate member refuses to take on the loan yet also blocks the proposed transfer to a third party.

It is worth noting that under the *Guidelines for the Business of Syndicated Loans* ("**Guidelines**") promulgated by CBRC in 2007, where any member of a syndicated loan intends to assign its portion of the loans, it must notify the borrower and the agent bank in advance. The Guidelines did not impose any obligation on the transferor to notify other syndicate member (except the agent bank) nor did it grant any pre-emptive rights to the syndicate members.

It remains to be tested as to how Notice 102 reconcile with the Guidelines.

## Conclusion

Notice 102 is the first set of comprehensive guidance on how banking financial institutions may transfer loan assets. It was issued against the background of China's clear determination in year 2011 to strengthen credit control and stabilise the financial market. Notice 102 is an effort aimed at controlling credit scale and maintaining a fine balance between financial market stability and healthy liquidity. How the regulatory authorities would, in practice, implement Notice 102 and other regulations to monitor credit asset transfer will determine whether such a balance could be effectively maintained.

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