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**Avenues to Foreign Investment in China's
Shipping Industry—Have lease financing
arrangements and the Free Trade Zones opened
markets for foreign non-bank investment?**

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Avenues to Foreign Investment in China's Shipping Industry—Have lease financing arrangements and the Free Trade Zones opened markets for foreign non-bank investment?

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China is an important center of ship finance. Financial liberalization has led to a great deal of growth to its shipping sector. In 2009, Industrial and Commercial Bank of China’s shipping portfolio grew to \$7.8 billion.¹ In that year alone, ICBC closed 45 new shipping transactions totaling \$2.3 billion.² Inching toward market openness by lowering entry requirement for financial entities, China is improving the conditions for domestic and foreign growth within its markets. Even small governmental adjustments to China’s heading have had vast effects on the giant nation’s track. With vessel lease arrangements still relatively novel to China, popularity has grown as the legal mechanics are tested and become better understood. This article will present a legal playbook for executing both a lease and a debt financing

¹ Rodricks Wong, *Dealmaker of the Year Award—ICBC*, MARINE MONEY, Feb./Mar. 2010, at 18.

² *Id.*

arrangement in China. Where possible, this article identifies opportunities through which foreign investors may enter the Chinese shipping market through these deals.

Beyond shipyards, many parties have a commercial interest in newbuilding projects.³ The purchaser will charter out the vessel in exchange for hire payments made to the purchaser for use of the vessel. The charterers will sub-charter the vessel or will use it to move cargo in exchange for freight payments. The lending company that provided the shipyard funds to construct the vessel will earn fees and interest on the loan. Upon delivery, the purchaser will give the lending company a ship mortgage over the vessel and make regular payments in exchange for the purchase price. There are many parties attempting to benefit commercially and transfer risk within the notoriously-volatile shipping markets. This article focuses on the financiers and vessel management companies that grease the wheels of shipping's newbuilding market through vessel purchases and leases.

³ While vessel resale is a vital component of the shipping sector, this paper focuses primarily on deals for newbuilding projects, or those in which shipyards construct and deliver new vessels to specifications designated by the purchaser.

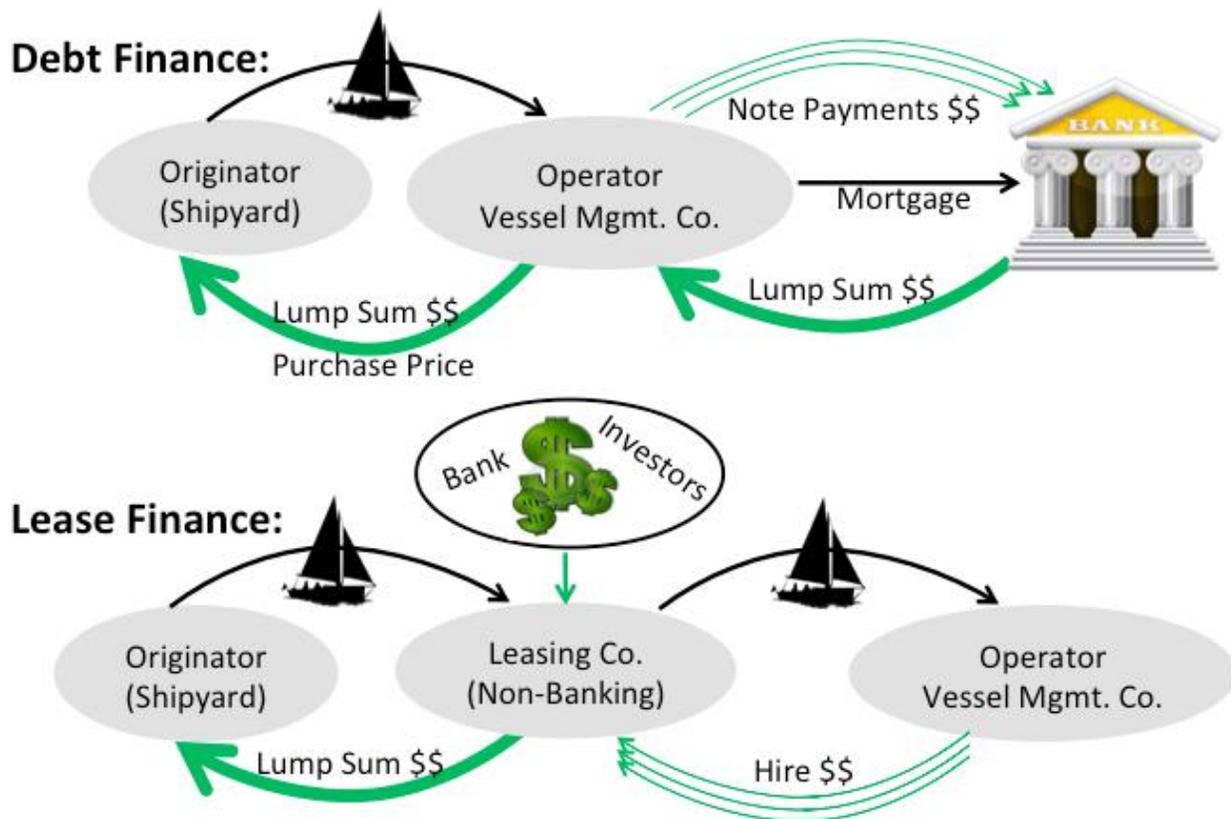


FIGURE 1. Showing the parties and relationships involved in each a debt finance purchase and a lease financing arrangement.

While both vessel purchases and vessel leases are traditional arrangements for ship acquisition, this paper will look at advantages and disadvantages of each arrangement in the burgeoning shipping markets of China where legal and regulatory developments are rapidly evolving. This article looks at the possibility of foreign investment into positions of both the financier and the purchasing vessel management company and will consider the extent to which the Shanghai (Pilot) Free Trade Zone is a welcoming environment for such investment.

I. WHAT IS VESSEL LEASE FINANCING AND HOW DOES IT COMPARE TO DEBT FINANCING?

A. *DEBT FINANCING*

Vessel debt financing—a loan from a bank secured by a mortgage—perhaps is the most straightforward method to acquire a vessel. A prospective shipowner will arrange with a shipyard to build a new vessel and with a bank to finance that purchase. During the construction phase, typically the purchase will be secured by assignment of a refund guarantee issued by the shipyard’s bank or by other traditional security and quasi-security mechanisms, such as share pledges and guarantees. The shipyard may require payments be made in installments under the building contract based upon elapse of time or upon achievement of construction objectives. Upon completed construction, payment will be fully transferred to the shipyard, and both possession and ownership will be transferred to the purchasing shipowner with the bank as secured creditor holding a mortgage over the vessel.

Transactions of this sort are costly. Moreover, tightened Chinese credit markets make bank debt an unrealistic option for much of the sector. While achievable by the largest shipping companies, many small and medium sized shipping companies lack access to the credit and the capital needed to arrange financing from a single bank positioned to accept a mortgage from a company with little to offer as collateral besides the vessel under construction. Worldwide, stricter capital requirements imposed by Basel III have caused banks to reduce exposure to the shipping sector and to replenish their capital buffers.⁴ Easy money from bank loans is scarce now

⁴ *Int’l Ship Finance Through Ireland*, MAPLES AND CALDER UPDATE (Nov. 11, 2013)

www.maplesandcalder.com.

causing investors and lenders alike to try new instruments to secure their investments.⁵ With less bank capital available, the sector has innovated and sought funding through alternative forms, such as debt capital markets. While bond issuance by shipping companies is not a new development to the shipping industry, tapping these capital markets is becoming more frequent, and shipping companies are relying more heavily upon bond issuance as a way fund asset acquisition.⁶

Identifying adequate security in order to finance a newbuilding project is problematic. Larger shipyards and shipping companies are in a very different position than smaller shipyards and shipping companies in this matter because they enjoy bulk purchasing power with suppliers and have ample assets to collateralize in exchange for sufficient credit lines.⁷ Small to medium sized shipping entities and vessel operating companies tend to be arranged as single-ship companies in order to minimize the risk of sister-ship arrest and otherwise limit their liability to any judgment creditors to the single asset.⁸ Thus, debt financing arrangements for newbuilding

⁵ Peter T. Leach, *An End to Easy Money?*, JOURNAL OF COMMERCE (July 4, 2013),

http://www.joc.com/maritime-news/ships-shipbuilding/end-easy-money_20130704.html.

⁶ Ben Rose, *Innovation in ship finance – tapping the capital markets*, NORTON ROSE FULBRIGHT (Jan. 2011), <http://www.nortonrosefulbright.com/knowledge/publications/33057/innovation-in-ship-finance-tapping-the-capital-markets>.

⁷ Email from Diran Majarian, Managing Dir., Amelia Tankers, to author (Apr. 19, 2015) (on file with author).

⁸ A shipowner's liability is limited to the assets it possesses. Because single-ship companies have few assets, judgment creditors may be unable to recover the full amount they are owed.

projects are primarily secured by the company's sole asset—the partly completed asset that's real value comes from its potential to do work.⁹ A vessel under construction is not a vessel until it is delivered and the shipyard's rights to payment arise only upon completion—“[t]he buyer has no liability to pay 90% of the price if the ship is 90% built. It only has a liability to pay if the ship is 100% completed.”¹⁰ A ship purchaser defaulting during the construction period thus leaves its creditor with an unfulfilled order for a vessel and an incomplete construction project for which it is difficult to find an alternate purchaser.

Securing a loan to purchase an existing vessel is much easier. The vessel purchaser will obtain financing through a bank and give the bank a mortgage over the asset to secure its loan. If the vessel owner defaults, the creditor must enforce the mortgage to gain possession and ownership over the asset, albeit an efficient judicial process, in commercial terms arrest is still

Obtaining redress from the debtor's affiliated entities may prove extremely difficult. The equitable doctrine of veil-piercing is warranted only under extraordinary circumstances, and South Africa is the only jurisdiction that practices associated-ship arrest where assets over which the debtor holds a controlling interest may be reached by the judgment creditor. See generally David Freedman, *Harpooning the Corporate Whale: A Federal Maritime Treatise on Veil-Piercing*, (FORTHCOMING).

⁹ QIAO LIU, PAUL LEJOT & DOUGLAS W. ARNER, *FINANCE IN ASIA* § 6.4 at 250-51 (Routledge Taylor & Francis Group eds., 2013).

¹⁰ Richard Henderson, *Understanding Ship Yard Securitization*, MARINE MONEY OFFSHORE (Mar. 1, 2000) (<https://www.marinemoneyoffshore.com/node/5880>).

often lengthy and expensive litigious process, and the risk is passed on to the purchaser in the form of higher borrowing costs.¹¹

In both situations—the newbuilding project financed through a non-recourse loan, and a vessel purchase financed through a loan secured by a mortgage—the creditor is without possession and without ownership beyond a security interest it may have in the property under construction.

A prospective purchaser, the beneficial owner of the vessel, may have difficulty accessing bank debt to finance an outright purchase because of volatility in demand for new capacity, because of the purchaser's creditworthiness and available collateral, because of limitations imposed upon the purchaser's own balance sheet by regulatory agencies, by its own corporate governance, or by existing creditors. These and other difficulties have all contributed to a rise in popularity of alternative arrangements. Prospective owners unable to attain bank debt may find lease financing is still a viable arrangement by which it may obtain additional cargo space for its fleet.

B. LEASE FINANCING

Lease financing arrangements are not unique to shipping markets but have been tested in contexts of heavy equipment leases and aircraft leases that are commonly arranged through a leasing company structure similar to these other equipment leasing deals. Vessel leasing falls within the general legal and economic arena of asset financing, but it retains certain features

¹¹ Herein, the paper will consider almost solely newbuilding projects.

unique to shipping.¹² What a leasing arrangement achieves is providing the creditor with ownership of the vessel while releasing its right to possession. Retaining ownership puts the creditor in a much more favorable position to regain possession should the lessee default. Often, lease financing will achieve favorable results for all parties because it balances the risks more evenly than other types of vessel financing, although this may cause the lessee to incur higher costs than under traditional mortgage financing.¹³

New building projects require a great deal of capital. A vessel management company in the business of operating vessels may see capital diluted if it is forced to raise the vessel price itself. A leasing company in the business of financing rather than managing or operating vessels, and with greater access to available credit markets—i.e. a bank—or a company with greater control over the transaction costs—i.e. a shipyard—is positioned better than an operator to lower transaction costs and fund the new build project more cheaply, and the lessee can devote its working capital to vessel management projects.¹⁴ The bank's return is through fees and interest, the shipyard's return is through selling the vessel, and the beneficial owner's return is through operating the vessel, chartering it and earning hire payments.

Leasing arrangements are typically easier transactions, albeit more expensive, to complete for a beneficial owner than debt financing because the beneficial owner is not asked to

¹² *Id.*

¹³ Ying Li, The Pros and Cons of Leasing in Ship Financing, 5 WMU JOURNAL OF MAR. AFFAIRS, no. 1, (2006) at 62.

¹⁴ See id. at 67.

deviate from its specialty of earning income from chartering the vessel. Instead, debt deals require the vessel operating company have greater expertise in asset management than do leasing deals. The vessel management company remains focused upon pairing charters with shipping capacity to pay its lease, and the special purpose leasing company remains solely focused upon capitalization concerns in order to acquire ownership of new vessels. To accomplish this funding, the SPV may be capitalized by its parent, by bond markets, or by equity markets.¹⁵ In any event, the SPV must raise the full price itself in order to remain bankruptcy remote meaning that the sale and purchase agreement must be a real true sale and transfer both ownership and possession. Doing so also places the SPV in a position to securitize the asset or to sell the vessel and the leasing rights without disturbing the underlying vessel operating and charter agreements. Through sale or securitization of certain rights, beneficial ownership of charter agreements can transfer without disturbing the underlying charter party. The vessel management company can remain focused upon matching charters with shipping capacity.

In addition to ease of closing the deals due to lowered collateralization requirements, leasing arrangements can make a deal commercially viable because of tax and accounting advantages. These are non-trivial advantages available to the documented vessel owner that

¹⁵ First Ship Lease Trust is a Singapore-registered company that owns a portfolio of 23 ships, 16 of which are engaged in long-term lease finance arrangements and the 7 remaining ships are on shorter-term operational leases. This company is funded in part publically via the Singapore Exchange Security's main board.

subsequently leases out its vessel.¹⁶ Both parties to the leasing arrangement can utilize these advantages to offset limitations imposed by itself, by regulators, or by creditors. Accounted for as debt, the leased vessel is not a taxable asset to the vessel operator. To the creditor, instead of lending the vessel management company funds to purchase its vessel, the leasing company owns the vessel and realizes the asset as equity on its balance sheet. Also as owner, the vessel operating company is entitled to claim a significant tax benefit due to depreciation of the asset over its commercial life.¹⁷

These advantages are related to tax deferral schemes that the parties may utilize under leasing arrangements but are not available for vessel sales. The registered owner may be able to take advantage of tax credits unavailable to a less-solvent operator—vessel management companies often operate with a tight margin and rarely turn a profit. A company without yearly profits greater than the tax credit cannot benefit in the same way by owning the vessel that a more profitable company can. So the right to offset vessel depreciation is worth more to the leasing company than it is to the less-solvent operating management company.

A vessel management company in the business of pairing sub-charterers and operators with vessels may arrange for a long-term bareboat charter spanning the expected commercial life of the asset. Under a leasing arrangement, instead of purchasing the vessel, the beneficial owner leases the vessel wherein the charterer's hire over time will cover the entire cost of the vessel and

¹⁶ Ying Li, The Pros and Cons of Leasing in Ship Financing, 5 WMU JOURNAL OF MAR. AFFAIRS, no. 1, (2006) at 63.

¹⁷ See id.

the leasing company's margin. The lessor will be a special purpose vehicle (SPV), set up for the purpose of owning the asset and being bankruptcy remote in order to protect other assets over which the company may have rights.¹⁸ Thus, the vessel's owner will be an SPV and will be an arm of a bank, be controlled by a shipyard, or otherwise be mostly a privately owned company or subsidiary of a larger bank or leasing company positioning the SPV lessor to receive a high credit rating.¹⁹ The SPV can assign the right to be paid hire on its charter agreement directly to its creditors in order to receive credit enhancement.

Though typically more expensive than debt financing, vessel lease financing arrangements have advantages for the lessee over traditional equity deals beyond the higher rates. Among them, the party remitting the purchase price, the lessor/leasing company, retains ownership of the asset. Because it retains ownership of the asset, the leasing company is better positioned following default than a mortgagee who must have perfected its security interest only then to foreclose, and physically repossess the asset in order to exercise its security rights. Leasing may mean lower costs incurred by a trustee in bankruptcy because leased assets are

¹⁸ Entities are commonly used to isolate certain risks and legal liability in order to preserve the economic and legal structure needed to sustain the asset wholly apart from its originator. Risk incurred or insolvency of the originator will not affect the SPV. Likewise, risk incurred or insolvency of the SPV will not affect the originator.

¹⁹ Rodricks Wong, *Ship Leasing Takes Flight in China*, MARINE MONEY INT'L (Oct. 2011) Vol. 27 No. 6, at 4; MARINE MONEY OFFSHORE (<http://www.marinemoneyoffshore.com/node/6868>).

easier to repossess than mortgaged assets.²⁰ In addition to less risk for the leasing company, the lessee can find greater certainty through a lease financing arrangement than is available through bank debt financing where, as owner of the asset, it would be exposed to volatility.

Beyond simplifying legal processes to obtain a secure position, shipowners may find entering ship leasing arrangements to be prudent business decisions. The leasing company, as owner of the asset and obligee of the lease, can securitize and sell these rights in order to take advantage of market fluctuations and to manage its own portfolio by selling its ownership rights leaving intact any underlying charter parties.

The leasing company can securitize its vessels and the right to collect payment on the lease arrangements. Securitization allows a company to transfer assets off the company's balance sheet and issue to investors the right to receivables generated by the vessel under charter parties. In order for the leasing company to achieve such benefits, the securitized asset must be transferred to a bankruptcy-remote vehicle that has acquired ownership of the ship through a legal true and irrevocable sale, and receivables owed through its rights to collect lease payments may be assigned to investors but may not be reached by a parent company.

Vessel lease financing arrangements also have application where a prospective owner is limited by company charter or by law to a maximum amount of equity, or it may find itself already party to a loan that restricts further borrowing. In either situation, the vessel owning

²⁰ Ying Li, The Pros and Cons of Leasing in Ship Financing, 5 WMU JOURNAL OF MAR.

AFFAIRS, no. 1, (2006) at 64.

company may be unable to pursue a debt financing arrangement and find lease financing still to be a viable arrangement by which it may obtain additional cargo space for its fleet. One of the primary reasons to participate in ship lease financing arrangements rather than purchasing a ship through a debt financing arrangement is for ease of balance sheet management. Lease financing is a tool by which a company can control ratios on its balance sheet. Vessel leasing allows the company access to additional vessels and cargo capacity from a debt position.²¹ The lease appears as debt rather than as equity for the party possessing the vessel. The lessor vessel management company may account for the lease as a credit asset or an account receivable. The lease arrangement puts both parties at a tax advantage over a vessel sale position. Sale-leaseback arrangements may be undertaken by entities such as shipyards to take advantage of this tax credit. The sale-leaseback arrangement may also attract shipyards in need of immediate capital to fund their next build project.

II. VESSEL FINANCE IN CHINA.

²¹ Of course, for additional short-term cargo demands, a ship management company may pursue an operational leasing arrangement. Such leasing arrangements are uncommon in the shipping industry because a lease that is for a period shorter than the commercial life of the vessel creates a great deal of uncertainty in the volatile shipping markets, and this arrangement is better suited for a time charter than to a lease. A key difference between operational leases and time charters is that the former is subject to an amortization schedule, so while it may appear as debt for tax deferment, the lessee incurs front-loaded interest expenses. The time charter is not amortized, and offers a consistent payment schedule, but it increases balance-sheet assets and liabilities.

A. *DEBT FINANCING ARRANGEMENTS IN CHINA.*

With less capital available to close newbuilding deals, traditional debt financing is reserved for only the top credit risks in China—typically the largest state-owned entities. Debt financing deals in the PRC typically require a shipbuilding refund guarantee to secure the purchaser against the shipyard’s failure to deliver in accordance with the contract. The shipyard’s bank or its insurer underwrites the guarantee. However, due to the poor credit rating of many small and midsized shipyards, providing a refund guarantee makes the transaction prohibitively expensive. Thus, the smaller privately owned entities must bare great risks or pursue innovative security schemes.

An alternative to the shipbuilding refund guarantee is the construction mortgage.²² The Maritime Law of China recognized the right of a creditor to hold a mortgage interest over a vessel under construction.²³ Pursuant to Article 14, in order for the mortgage to give the creditor

²² This approach is not straightforward. The approach to securing its rights requires a creditor to comply with provisions from the Maritime Law of the PRC, the Regulations of the People’s Republic of China Governing the Registration of Ships, the Guaranty Law of the People’s Republic of China, the Registration of Mortgages by Notaries Public Procedures, 2002, and the Security Law of the People’s Republic of China.

²³ [Maritime Law of the PRC 1992] (promulgated by Order No. 64 of the President of the PRC, Nov. 7, 1992, effective July 1, 1993) 28TH MEETING OF THE STANDING COMM. OF THE SEVENTH NAT’L PEOPLE’S CONG. Article 14 (China). “Mortgage may be established on a ship under construction. In registering the mortgage of a ship under construction. In registering the

a secured interest, the shipbuilding contract must be registered with the Maritime Safety Administration of China, otherwise the creditor holds an unsecured interest over the construction project. The purchaser and the shipyard must meet citizenship requirements similar to those US requirements for coastwise trade under the Jones Act.²⁴ The relevant ship registration procedures are described in the SRRC 1994 and for the ship to be registered in China require: (1) the ship be owned by a PRC citizen with its principle place of business located in China, or (2) the ship be owned by a legal person established under laws of PRC with its principal place of business in China, and may involve foreign investment but requires at least 50% capital contribution from Chinese investors.²⁵

The Guaranty Law of the People's Republic of China, by way of Article 34(1)(6) outlines the procedure a creditor must follow in order to charge its security interest through a mortgage.²⁶ The mortgage contract is not effective until the registration is complete.²⁷ The authority to deal

mortgage of a ship under construction, the building contract of the ship shall as well be submitted to the ship registration authorities.”

²⁴ 46 U.S.C. §§ 50501, 55101 (2006).

²⁵ Article 2 [Regulations of the PRC Governing the Registration of Ships] (promulgated by Decree No. 155 of the State Council, Jun. 2, 1994, effective Jan. 1, 1995) (China).

²⁶ Articles 41-43 [Guaranty Law of the PRC] (promulgated by Order No. 50 of the President of the PRC on Jun. 30, 1995) 14TH MEETING OF THE STANDING COMM. OF THE EIGHTH NAT'L PEOPLE'S CONG. (China).

²⁷ Id. at Article 41.

with the mortgage registration is the same body that deals with registering the asset.²⁸ An unregistered mortgage is worthless in effect, so the creditor must follow the registration procedures in order to secure its position. A party registering its mortgage is secured from the date of execution, but a party failing to register its mortgage remains unsecured and may not defend claims raised by third parties.²⁹ Article 43 of the Guaranty Law must be read in conjunction with the Registration of Mortgages by Notaries Public Procedures, 2002 to ensure that the scope of “other property” includes property beyond that specified in the PRC Security Law.³⁰

While a creditor’s substantive right to charge a construction mortgage over a vessel under construction exists pursuant to the Maritime Law of China, the Property Law of the People’s Republic of China 2007 also reaffirms the right to secure a shipbuilding project with a construction mortgage. In a priority contest, a mortgage made pursuant to the Property Law 2007 primes a mortgage entered into under the Maritime Law of China because:

This Law is enacted in accordance with the Constitution for the purpose of upholding the basic economic system of the State, maintaining the order of the socialist market economy, defining the

²⁸ Id. at Article 42(4).

²⁹ Id. at Article 43.

³⁰ Article 3(4) [Registration of Mortgages by Notaries Public Procedures] (promulgated by the Ministry of Justice on Feb. 20, 2002, effective Feb. 20, 2002) (China).

attribution of things, giving play to the usefulness of things and protecting the property right of obligees.³¹

The Property Law derives its authority directly from the Constitution out of a basic interest for upholding economic order, while the Maritime Law arose from an interest in regulating, promoting, and developing maritime transport relations and securing the rights of parties concerned.³²

Under the Property Law, Article 180 lists vessels as “property which the debtor or the third party is entitled to dispose of may be mortgaged.”³³ In the alternative, a vessel under construction may be construed as “production equipment, raw and semi-finished materials, semi-finished products and finished products” and falling within the purview of Article 180(4).³⁴

Under a bank debt financing arrangement, the purchaser both owns and possesses the vessel subject to their creditor’s security interest. Discussed herein has been a procedure for securing a creditor’s rights to a vessel through a registered construction mortgage over the vessel to give the lender executable rights over the property in case of the purchaser’s default. To

³¹ Article 1 [Property Law of the PRC 2007] (promulgated by Order No. 62 of the President of the PRC on Mar. 16, 2007, effective Oct. 1, 2007) 5TH SESSION OF THE TENTH NAT’L PEOPLE’S CONG. (China).

³² Cf. Article 1 [Maritime Law of the PRC 1992].

³³ Article 180(5) [Maritime Law of the PRC 1992].

³⁴ Id. at Article 180(4).

enforce its rights, the creditor bank must understand and apply the PRC laws regarding default, foreclosure, and repossession of the property in order for it to enforce its rights secured by the mortgage.

B. LEASE FINANCING ARRANGEMENTS IN CHINA.

1. Lease Financing in China—now a viable option, soon a popular one.

Debt financing arrangements being almost exclusively available to state-owned entities, the smaller privately owned shipping companies benefit from innovative risk-allocating arrangements such as lease financing. Despite China's global importance to import and export markets and its growing shipping sector, small and medium Chinese shipowners are considered "un-bankable" by state-owned banks, so these companies benefit from alternative forms of ship acquisition arrangements like lease financing.³⁵ Leasing agreements allow prospective purchasers to avoid certain commercial and legal complications—such as obtaining a shipbuilding refund guarantee—incumbent with newbuilding projects.

A vessel leasing arrangement provides for a more streamlined legal approach to debt financed acquisition of vessels that puts less strain upon vessel managers to negotiate legally complex financing arrangements with banks and instead can devote greater resources to pairing charters with appropriate vessels.

Since first being permitted in 2007, a significant amount of vessel leasing deals have been arranged in the Chinese shipping sector. Minsheng Financial Leasing Co., rapidly becoming one of the most important lease financing companies in China's domestic market,

³⁵ Rodricks Wong, *The Changing Topography of Ship Finance in China*, MARINE MONEY

OFFSHORE (2013) (<http://www.marinemoneyoffshore.com/node/3889>).

entered an agreement with Shanghai Guodian Shipping Co. Ltd, a subsidiary of Fujian Guohang Ocean Shipping Co. Ltd. to deliver eighteen Panamax bulk carriers under a financial leasing arrangement.³⁶ Rongsheng Heavy Industries Group Holdings Ltd. a Chinese heavy industries group and shipbuilder announced that the first of the Minsheng-commissioned Panomax bulkers took delivery after three years on Oct. 28, 2011.³⁷ Before taking delivery, the Tianjin FTZ-based Minsheng placed a bullish order for ten additional Panomax vessels in 2010 and subsequently sought Chinese candidates for lease financing.³⁸ ICBC is still one of the largest Chinese vessel leasing companies, offering an array of solutions applicable to the shipping sector including: 1) financial lease for new equipment; 2) operating lease for new equipment; 3) sale and leaseback financing; 4) international synthetic lease; 5) trust lease and securitization.³⁹

Leasing companies can be funded by capital markets. Shanghai-based Sinochem owns a subsidiary—Far East Horizon—that provides financial leasing services supporting major Chinese industries. The Securities Regulatory Commission in 2011 permitted the Chinese-owned subsidiary to access global equity by listing publicly in Hong Kong.⁴⁰

³⁶ *A Cooperation Agreement Inked Among CCS, Fujian Guohang Group and Minsheng Financial Leasing Co. Ltd.*, CHINA CLASSIFICATION SOCIETY HEADLINES, Sept. 5, 2008.

³⁷ *China: RHI Christens First Panamax Bulk Carrier Ordered by Minsheng Financial Leasing*, WORLD MARITIME NEWS (Oct. 30, 2011) www.worldmaritimeneews.com.

³⁸ Neil Connor, *Minsheng seeks leasing clients for latest orders*, TRADEWINDS, May 27, 2010.

³⁹ *ICBC Leasing Solutions*, ICBCLEASING (2008) www.icbcleasing.com.

⁴⁰ *Chinese finance leasing firm debuts in Hong Kong*, CHINA L. & PRAC., Apr. 2011.

Chinese banks are becoming shipowners by creating leasing arms that fund new build projects and maintain ownership over the asset. The leasing arm can permit ship managers to charter the vessel out, putting the bank-owned asset to work and receiving the benefit through contracts for hire rather than through complicated procedures for mortgage. Maintaining ownership of the asset minimizes judicial intervention to repossess the vessel. Leasing companies may be an arm of a bank, and thus positioned to obtain favorable credit ratings or credit enhancement. Leasing companies may be an arm of a shipyard or shipbuilding company, and thus take advantage of favorable pricing over the asset and collapse its profit margin with the shipbuilder's margin.

In China, leasing companies must be licensed in order to engage in vessel leasing arrangements. In 2007, the China Banking Regulatory Commission (CBRC) began granting non-bank financial entities licenses to lease ships.⁴¹ In 2009, leasing companies registered under the CBRC Scheme offer finance leasing solutions across industries reaching RMB 20 billion (\$2.9 billion) in volume.⁴² By 2011, seventeen bank-affiliated financial leasing companies had been issued licenses and were supervised by the CBRC, but these seventeen were not limited to ship leasing and instead included licenses to lease aviation, heavy machinery, medical equipment, and the like.⁴³

⁴¹ Rodricks Wong, *Ship Leasing Takes Flight in China*, MARINE MONEY INT'L (Oct. 2011) Vol. 27 No. 6, at 4; MARINE MONEY OFFSHORE (<http://www.marinemoneyoffshore.com/node/6868>).

⁴² *Id.* at 4.

⁴³ *Id.*

With leasing's popularity has come innovative leasing arrangements that include a cross-border vessel finance lease through an SPV established in the Tianjin FTZ to act as the vessel's owner contracting for construction with a Korean shipyard, and a Marshall Islands bareboat charterer.⁴⁴ The Chinese leasing company that arranged the deal will own the vessel and lease it to a Chinese operator, but the parties benefit from accessing the most advanced shipyards in Korea and by flying the Marshall Islands flag, a favorable shipping jurisdiction. The possibility of cross-border deals is among the most exciting innovation to Chinese vessel finance, which has long been state-sponsored and off-limits to citizens.

The leasing company may be an arm of a bank, and thus positioned to obtain high credit ratings or credit enhancement. The CBRC scheme contains strict requirements ensuring that transactions between related parties proceed with no more favorable terms than those between non-related parties undertaking similar transactions.⁴⁵ The leasing company can be an arm of a shipyard or shipbuilding company and thus take advantage of favorable pricing over the asset and collapse its margin with the shipbuilder's margin. Shipyards or builders will likely obtain licensing for finance leasing from the Ministry of Commerce (MOFCOM) and avoid the strict requirements of the CBRC Scheme requiring favorable terms for transactions between related parties.

⁴⁴ Id. at 6.

⁴⁵ *Finance Leasing with Chinese Characteristics*, EUROMONEY TRADING LIMITED, Jul./Aug. 2007, at sec. 2.

It is worth noting that there are two types of leases typically arranged for assets such as ships, aircraft, heavy equipment and the like: finance leases, and operational leases. Finance leases are arranged for the commercial life of the asset, they end in a transfer of ownership from the lessee to the lessor, they conclude with a lessor's option to purchase the asset at fair market value, and the finance lease lasts for the span of the asset's functional life. Operational leases are short term and the same asset may be leased out once again after a lease is concluded. Operational leases may solve immediate capacity shortfalls or be used to bridge other issues caused by uncertainty. Insofar as it is concerned with leases, this paper is concerned primarily with finance leases.

2. Two Competing Schemes for PRC Financial Leasing Companies.

There are two competing schemes in the PRC under which companies may register to conduct finance leasing transactions. The CBRC issued the "Measures for the Administration of Lease Financing Companies" which became effective on March 1, 2007, was revised by Order [2014] No.3 of the CBRC and entered effect on March 13, 2014. Herein, it will be called the CRBC Scheme. The Ministry of Commerce issued the "Measures for the Administration of Foreign-capital Lease Industry" which became effective on March 5, 2005, herein will be called the MOFCOM Scheme.

The CBRC scheme targets large financial entities, requiring its Principal Investors to hold at least 50% of the company's registered capital on hand, while the MOFCOM scheme is more investor-friendly and is better suited for manufacturers and privately funded financial leasing companies, requiring still at least \$5 million in assets and three years experience in lease

financing.⁴⁶ Under the MOFCOM Scheme, small to mid-sized non-bank leasing companies may engage in ship leasing operations more easily without need for a license from the CBRC. Neither the CBRB scheme nor the MOFCOM scheme places any cap on foreign investor shareholdings in a finance leasing company.

The two schemes differ in the types of foreign investment vehicles each scheme permits, and each scheme has different capital requirements for the leasing company. Both schemes are alike in that neither places a cap on foreign investment.

The two schemes have drastically different capital requirements. Likely structured to control few assets, a vessel management company seeking to undertake a lease financing enterprise is better suited for the MOFCOM Scheme's lower capital requirements.⁴⁷ While there is nothing in the CBRC Scheme to make investors concerned that vessels are not an asset suitable for lease financing under the scheme, the MOFCOM Scheme specifically names

⁴⁶ *Finance Leasing with Chinese Characteristics*, EUROMONEY TRADING LIMITED, Jul./Aug. 2007, at sec. 2.

⁴⁷ Compare the MOFCOM Scheme's capital requirement of at least US \$5 million in assets or capital (Article 7), with the CBRC Scheme's capital requirement of at least RMB80 billion (approximately \$12.9) (Article 9(3)), RMB5 billion (approximately \$806 million) (Article 10(2)), or RMB10 billion (approximately \$1.6 billion) (Article 11(2)).

“vessels” as a type of property that may be leased under the scheme.⁴⁸ Attractive to companies seeking to manage their balance sheets, sale-leaseback arrangements are specifically permitted under both the CBRC Scheme,⁴⁹ and the MOFCOM Scheme.⁵⁰

There being no cap on foreign investor shareholdings,⁵¹ foreign investors can take part in either scheme. However, the MOFCOM Scheme applies only to foreign-capital enterprises that establish a limited liability company or a joint-stock limited company within China and must take the form of a Chinese-foreign equity joint venture, a Chinese-foreign contractual joint venture, or a solely foreign-capital enterprise.⁵² Certain foreign entities may utilize the CBRC Scheme as well. While banks are specifically prohibited from becoming lease financing

⁴⁸ Article 6(2) [Measures for the Administration of Foreign-capital Lease Industry] (promulgated by the 1st executive meeting of the Ministry of Commerce on Jan. 21, 2005, effective Mar. 5, 2005) (China).

⁴⁹ See Article 5 [Measures for the Administration of Lease Financing Companies] (promulgated by the CBRC on Mar. 13, 2014, effective Mar. 13, 2014) (China).

⁵⁰ Articles 5 [Measures for the Administration of Foreign-capital Lease Industry] (promulgated by the 1st executive meeting of the Ministry of Commerce on Jan. 21, 2005, effective Mar. 5, 2005) (China).

⁵¹ With the caveat that Promoter requirements must be satisfied, discussed *infra* nn.64-71.

⁵² Articles 2-3 [Measures for the Administration of Foreign-capital Lease Industry] (promulgated by the 1st executive meeting of the Ministry of Commerce on Jan. 21, 2005, effective Mar. 5, 2005) (China).

companies under the CBRC Scheme,⁵³ commercial banks may be the major investor in a lease financing company, and may be registered in China or abroad.⁵⁴ The CBRC Scheme also permits the major investor to be a leasing company registered in China or abroad,⁵⁵ or a large domestic manufacturer of products suitable for leasing.⁵⁶ Thus, the CBRC Scheme is attractive to domestic or foreign banks, to domestic or foreign companies already in the business of lease financing, and to domestic manufacturers of products suitable for lease financing arrangements, such as state-owned shipyards, seeking to invest in a lease financing arm.

Entities with foreign equity interest exceeding 50% of total capital are prohibited from registering vessels on the PRC registry.⁵⁷ Either the CBRC Scheme or the MOFCOM Scheme can be used in order to circumvent this restriction by having the registered vessel owner be a leasing company with more than 50% of its registered capital in the PRC.⁵⁸ While both schemes are still in effect, it appears that the PRC has chosen to develop the CBRC Scheme over the

⁵³ Article 2 [Measures for the Administration of Lease Financing Companies] (promulgated by the CBRC on Mar. 13, 2014, effective Mar. 13, 2014) (China).

⁵⁴ *Id.* at Article 9.

⁵⁵ *Id.* at Article 9(2).

⁵⁶ *Id.* at Article 9(3).

⁵⁷ Article 2(2) [Regulations Governing the Registration of Ships] (promulgated by Decree No.155 of the State Council of the PRC on June 2, 1994, effective Jan. 1, 1995) (China).

⁵⁸ *Finance Leasing with Chinese Characteristics*, EUROMONEY TRADING LIMITED, Jul./Aug. 2007, at *2.

MOFCOM scheme by providing recent revisions to the measures and by issuing guiding documentation clarifying or extending the legal purview of the scheme.

3. Lease financing under the CBRC's revised scheme—The 2014 Measures.

The CBRC's pilot project began in 2007.⁵⁹ By its end in September 2013, twenty-three lease financing companies had been established on China's mainland and these companies held assets totaling RMB95.6 billion (US\$15.3 billion) and earned profits of RMB1.18 billion (US\$189.3 million).⁶⁰ Newly revised measures replaced the 2007 measures and marked a more flexible regulatory scheme open to project-based special purpose vehicles commonly relied upon in the shipping industry.⁶¹

Lease financing companies are non-bank financial entities primarily engaged in financial leasing as their core business.⁶² Only fixed assets are eligible as leased items for financial

⁵⁹ [Measures for the Administration of Lease Financing Companies] (promulgated by the CBRC on Jan. 23, 2007, effective Mar. 1, 2007) [EXPIRED] (China).

⁶⁰ Xin Zhang & Miller Wang, *Opinion: Aircraft and ship lease financing opens up*, CHINA L. & PRAC., Apr. 2014.

⁶¹ See Xin Zhang & Miller Wang, *Opinion: Aircraft and ship lease financing opens up*, CHINA L. & PRAC., Apr. 2014.

⁶² Article 2 [Measures for the Administration of Lease Financing Companies] (promulgated by the CBRC on Mar. 13, 2014, effective Mar. 13, 2014) (China). The term “lease financing company” must be indicated in the company's name and no entity may include such words in its name unless approved by the CBRC.

leasing,⁶³ and for assets that require ownership to meet certain registration requirements, the lease financing company must register according to the appropriate procedures.⁶⁴ Sale-leaseback arrangements—where the lessee and the supplier are one and the same party—are explicitly permitted,⁶⁵ but the leasing company shall not accept for leaseback an asset subject to any mortgage.⁶⁶ In order to establish a lease financing company, the company, established in compliance with the *Company Law of the PRC* must apply to the CBRC and an eligible applicant must have, inter alia, minimum registered capital of RMB 100 million or its equivalent and 50% of the company's employees must have a minimum of three years experience working in financial or financial leasing businesses.⁶⁷

Lease financing companies must have an eligible promoter in order to gain CBRC approval,⁶⁸ and the promoter shall contribute at least 30% of the total capital for the proposed lease financing company.⁶⁹ Eligible promoters may be a commercial bank registered within or outside of China,⁷⁰ be a large enterprise registered within China,⁷¹ or be a lease financing

⁶³ Article 4 [CBRC Scheme] (2014) (China).

⁶⁴ Article 33 [CBRC Scheme] (2014) (China).

⁶⁵ Article 5 [CBRC Scheme] (2014) (China).

⁶⁶ Article 34 [CBRC Scheme] (2014) (China).

⁶⁷ Article 7(3-4) [CBRC Scheme] (2014) (China).

⁶⁸ Article 7(2) [CBRC Scheme] (2014) (China).

⁶⁹ Article 12 [CBRC Scheme] (2014) (China).

⁷⁰ Article 9 [CBRC Scheme] (2014) (China).

⁷¹ Article 10 [CBRC Scheme] (2014) (China).

company registered outside of China with total assets of not less than RMB 10 billion in freely convertible currency and it pledges in its application not to transfer its equity holdings in the CBRC lease financing company for five years.⁷² Foreign financial entities other than lease financing companies eligible under Article 11 shall qualify to be a promoter of a CBRC lease financing company if it has, inter alia, not less than \$1 billion or its equivalent in total assets or freely convertible currency and it pledges not to transfer its equity holdings in the CBRC lease financing company for five years.⁷³ Whoever the promoter may be, the promoter must agree to provide liquidity to the financial leasing company in the event of payment difficulties (insolvency) and to promptly replenish any of the financial leasing company's eroding capital due to operating losses.⁷⁴

In several ways, the 2014 Measures are open to foreign investment. The 2014 Measures may accommodate foreign direct investment, as they contain no provision restricting the 70% non-promoter capital being contributed from foreign investors—if the promoter is a foreign entity under Article 11 or 14, then, subject to CBRC approval, the CBRC lease financing company could be entirely foreign owned. Subject to CBRC approval, a registered lease financing company may transact its business in either RMB or in foreign currency.⁷⁵ It may engage in the business of fixed-return securities investment.⁷⁶ The lease financing company may

⁷² Article 11 [CBRC Scheme] (2014) (China).

⁷³ Article 14 [CBRC Scheme] (2014) (China).

⁷⁴ Article 16 [CBRC Scheme] (2014) (China).

⁷⁵ Article 26 [CBRC Scheme] (2014) (China).

⁷⁶ Article 26(3) [CBRC Scheme] (2014) (China).

engage in overseas borrowing.⁷⁷ Subject to CBRC approval, a registered lease financing company may issue bonds in either RMB or in foreign currency,⁷⁸ and it may securitize its assets,⁷⁹ but fixed-return securities investment shall not exceed 20% of the leasing company's net capital.⁸⁰

In July 2014, the CBRC promulgated the Interim Provisions on the Administration of Specialized Subsidiaries of Financial Leasing Companies in order to supplement and add clarity to certain aspects of the CBRC scheme.⁸¹ Through the Interim Provisions, the CBRC Scheme specifically permits financial leasing companies to establish overseas subsidiaries for specific fields that include vessel leasing.⁸² Financial leasing companies can directly establish specialized

⁷⁷ Article 26(8) [CBRC Scheme] (2014) (China).

⁷⁸ Article 27(1) [CBRC Scheme] (2014) (China).

⁷⁹ Article 27(3) [CBRC Scheme] (2014) (China).

⁸⁰ Article 46 [CBRC Scheme] (2014) (China).

⁸¹ [Interim Provisions on the Admin. of Specialized Subsidiaries of Fin. Leasing Companies] (promulgated by Yin Jian Ban Fa [2014] No.198 of the General office of the CBRC on July 11, 2014, effective July 11, 2014) (China).

⁸² Article 2 [Interim Provisions on the Admin. of Specialized Subsidiaries of Fin. Leasing Companies] (promulgated by Yin Jian Ban Fa [2014] No.198 of the General office of the CBRC on July 11, 2014, effective July 11, 2014) (China).

subsidiaries domestically, overseas, and within Mainland free trade zones and bonded areas.⁸³ By setting up specialized subsidiaries, a mature financial leasing company can leverage its advantages by experimenting with new or riskier ventures separate from the parent.⁸⁴ The promoter of the overseas subsidiary shall be a financial leasing company established under the CBRC Scheme.⁸⁵ In order to establish an overseas subsidiary, the financial leasing company must establish that it has a genuine business development need and maintains clear overseas development strategies.⁸⁶ The leasing company must also demonstrate that it has internal management and risk control capabilities suitable for overseas business development.⁸⁷

⁸³ Article 2 [Interim Provisions on the Admin. of Specialized Subsidiaries of Fin. Leasing Companies] (promulgated by Yin Jian Ban Fa [2014] No.198 of the General office of the CBRC on July 11, 2014, effective July 11, 2014) (China).

⁸⁴ Shu Wang & Jun Zhu, *CBRC Issues Interim Provisions on the Admin. of Specialized Subsidiaries of Fin. Leasing Companies*, CHINA PRACTICE GLOBAL VISION (Han Kun Law Offices, Beijing, China) 8th Ed. of 2014, at §2.

⁸⁵ Article 10 [Interim Provisions on the Admin. of Specialized Subsidiaries of Fin. Leasing Companies] (promulgated by Yin Jian Ban Fa [2014] No.198 of the General office of the CBRC on July 11, 2014, effective July 11, 2014) (China).

⁸⁶ Article 11(1) [Interim Provisions on the Admin. of Specialized Subsidiaries of Fin. Leasing Companies] (promulgated by Yin Jian Ban Fa [2014] No.198 of the General office of the CBRC on July 11, 2014, effective July 11, 2014) (China).

⁸⁷ Article 11(2) [Interim Provisions] (2014) (China).

As with all aspects of the CBRC Scheme, these application conditions are examined and interpreted by the CBRC. Once established, the overseas subsidiary must report to the CBRC its place of registration, its registered overseas capital, the currency of the capital injected, and other reporting formalities.⁸⁸ Subsidiaries established in China's Special Administrative Regions are considered overseas specialized subsidiaries for purposes of the Interim Provisions.⁸⁹ Under special circumstances, foreign companies may invest in domestic specialized subsidiaries established under the Interim Provisions, but the parties must establish there is a need for foreign investors, the domestic financial leasing company shall control at least 51% of the domestic subsidiary, and the foreign investors must satisfy all the conditions to be a promoter under the CBRC Measures.⁹⁰

III. SECURITIZATION IN THE SHIPPING SECTOR.

A. SECURITIZING NEWBUILDING PROJECTS AND LEASE FINANCING AGREEMENTS.

Securitization is attractive to shipyards looking for off-balance sheet financing for construction projects, and it is attractive to lease financing companies. Securitization allows the originator to realize assets up front and shift liabilities off its own balance sheet by selling the credit risk to investors.

⁸⁸ Article 15 [Interim Provisions] (2014) (China).

⁸⁹ Article 33 [Interim Provisions] (2014) (China).

⁹⁰ Article 5 [Interim Provisions] (2014). See *supra* nn.64-71 for discussion of the requirements to become a promoter under the CBRC Scheme.

Securitization is attractive to shipbuilders as an alternative method to finance newbuilding projects that otherwise would rely upon the buyer's installment payments or upon the shipyard's own balance sheet, putting a heavy strain on the shipyard's own resources and access to cheap credit.⁹¹

Under a buyer's installment ship financing plan, the primary source of construction capital is the shipyard's own balance sheet as the shipyard must first pay the costs of construction to meet a progress goal, and the buyer pays the shipyard only after (and not before) portions of construction have been completed, replenishing the shipyard's ability to pay the continuing costs of construction. The problem that securitization solves is the shipyard's inability to get ahead of the buyer's installment payments—instead, the shipyard sells in one lump sum the right to receive the buyer's installment payments before any installments are actually collected.

Sale of the rights to collect the buyer's installment payments can be outright and final. Because the sale is final rather than contingent upon performance, the credit risk shifts to the investor and the shipyard holds no liability on its own balance sheet—instead, the shipyard can realize gains from the deal before it completes the newbuilding project and in this way achieve off-balance sheet financing for construction.⁹²

⁹¹ Richard Henderson, *Understanding Ship Yard Securitization*, MARINE MONEY OFFSHORE (Mar. 1, 2000) (<https://www.marinemoneyoffshore.com/node/5880>).

⁹² Richard Henderson, *Understanding Ship Yard Securitization*, MARINE MONEY OFFSHORE (Mar. 1, 2000) (<https://www.marinemoneyoffshore.com/node/5880>).

Selling upfront the right to collect a buyer's future payments, investors will discount the shipyard's right to collect over time and the shipyard will collect a lower total payment for the vessel under construction through securitization than it would have had it collected installments directly from the buyer. However, the shipyard will be paid in advance and can use its clean balance sheet to begin the next project or to close another deal—leverage.

Similarly, securitization is also attractive to leasing companies engaged in vessel lease financing agreements for the commercial life of a vessel because it is a mechanism to generate the capital required to pay for the deal outright, freeing up the leasing company's own balance sheet for additional deals. In order to raise upfront the capital necessary for the leasing company to first purchase a vessel to then lease out, the leasing company can securitize the right for investors to receive regular future proceeds, such as hire, paid upon the vessel lease financing agreement.

B. SECURITIZATION IN CHINA.

While securitization has been used widely in Western shipping markets, securitization in China is relatively new and untested, but increasingly popular under two distinct securitization schemes. Securitization in China relies upon the special purpose trust which is a contractual arrangement created by the trust contract pursuant to statutory authority—the special purpose trust is not an independent legal entity, by law the trust property is not property belonging to the estate of the trustee, and by contract the originator entrusts credit assets to the special purpose trust. While new regulations in 2014 aspire to add clarity to and interest in the PRC, such securitization schemes may establish uncertain rights for investors in cross-border securitization

deals because of how Western investors are likely to view legal isolation of the entity issuing securities, “from a constitutional point of view it is a case of sending a boy to do a man’s job.”⁹³

The CBRC Scheme launched in 2005 pursuant to a pair of CBRC and PBOC regulations permitting banks and non-bank financial entities to entrust loan receivables to a trust company for administration as trustee of those assets.⁹⁴ CBRC licensing and approval is required every step of the way: the banks and non-bank financial entities must be licensed by the CBRC;⁹⁵ the loan receivables must constitute “credit assets” under CBRC guidelines;⁹⁶ the trust must be

⁹³ Jefferey H. Chen & Liu Haiping, *Securitization in China – overview and issues*, DENTONS, 1, 9 (Feb. 9, 2015),

http://www.dentons.com/~media/PDFs/Insights/2015/February/Securitization_in_China.pdf.

⁹⁴ [Measures for the Supervision and Admin. of Pilot Projects of Credit Asset Securitization of Fin. Inst.] (promulgated by Decree [2005] No.3 of the CBRC on Nov. 7, 2005, effective Dec. 1, 2005) (China); [Admin. Rules for Pilot Securitization of Credit Assets] (promulgated by the Admin. Rules for Pilot Securitization of Credit Assets [2005] No.7 jointly of the People’s Bank of China and the CBRC) (China).

⁹⁵ Article 2 [Measures for the Supervision and Admin. of Pilot Projects of Credit Asset Securitization of Fin. Inst.] (promulgated by Decree [2005] No.3 of the CBRC on Nov. 7, 2005, effective Dec. 1, 2005) (China).

⁹⁶ Article 3 [Measures for the Supervision and Admin. of Pilot Projects of Credit Asset Securitization of Fin. Inst.] (promulgated by Decree [2005] No.3 of the CBRC on Nov. 7, 2005, effective Dec. 1, 2005) (China).

licensed by the CBRC;⁹⁷ and any securities the trustee may issue requires specific approval both by the CBRC,⁹⁸ and by the PBOC.⁹⁹

As of February 2015, the CBRC Scheme has been used to establish eighty-five domestic securitization transactions in China since the program launched in 2005—sixty-eight of those transactions were concluded since 2012.¹⁰⁰

Under the CBRC Scheme, the sponsor, who originates the receivable credit assets, enters into a trust contract with the trustee, thus establishing a special purpose trust.¹⁰¹ Pursuant to the Trust Law, the sponsor entrusts credit assets by contract, and the trustee issues securities.¹⁰²

⁹⁷ Article 7 [Measures for the Supervision and Admin. of Pilot Projects of Credit Asset Securitization of Fin. Inst.] (promulgated by Decree [2005] No.3 of the CBRC on Nov. 7, 2005, effective Dec. 1, 2005) (China).

⁹⁸ Article 5 [Measures for the Supervision and Admin. of Pilot Projects of Credit Asset Securitization of Fin. Inst.] (promulgated by Decree [2005] No.3 of the CBRC on Nov. 7, 2005, effective Dec. 1, 2005) (China).

⁹⁹ Article 10 [Admin. Rules for Pilot Securitization of Credit Assets] (promulgated by the Admin. Rules for Pilot Securitization of Credit Assets [2005] No.7 jointly of the People's Bank of China and the CBRC) (China).

¹⁰⁰ Jefferey H. Chen & Liu Haiping, *Securitization in China – overview and issues*, DENTONS, 1, 2 (Feb. 9, 2015),

http://www.dentons.com/~media/PDFs/Insights/2015/February/Securitization_in_China.pdf.

In addition to the CBRC Scheme, the PRC saw fit to establish another securitization mechanism under the China Securities Regulatory Commission (CSRC Scheme). The CSRC Scheme is well suited for the shipping industry because the underlying assets must be specific and be able to generate independent and predictable cash flow.¹⁰³ Thus, a lease financing company wishing to securitize the regular proceeds generated by hire payments in accordance with underlying lease financing agreements and a shipyard wishing to securitize proceeds generated by buyers' installment payments will find these are suitable underlying assets for securitization by the CSRC Scheme.¹⁰⁴

¹⁰¹ Articles 20 & 21 [Admin. Rules for Pilot Securitization of Credit Assets] (promulgated by the Admin. Rules for Pilot Securitization of Credit Assets [2005] No.7 jointly of the People's Bank of China and the CBRC) (China).

¹⁰² Articles 6 to 13 [Trust Law of the PRC] (promulgated by the Standing Comm. of the Nat'l People's Cong. [2001] Order No.50 of the Pres. of the PRC on Apr. 28, 2001, effective Oct. 1, 2001) (China); Jefferey H. Chen & Liu Haiping, *Securitization in China – overview and issues*, DENTONS, 1, 2 (Feb. 9, 2015), http://www.dentons.com/~media/PDFs/Insights/2015/February/Securitization_in_China.pdf. At least two classes of securities are created—a senior class of securities is issued to investors and a subordinate class of securities is held by the sponsor.

¹⁰³ Article 3 [Admin Provisions on the Asset Securitization Bus. of Securities Companies & the Subsidiaries of Fund Mgmt. Companies] (promulgated by the CBRC Announcement [2014] No.49 of CSRC on Nov. 19, 2014, effective Nov. 19, 2014) (China).

¹⁰⁴ Article 3 specifically includes “account receivables[and] creditors' right under lease.”

Under the CSRC Scheme, investors entrust funds to securities company¹⁰⁵ pursuant to a fund contract.¹⁰⁶ The fund manager uses the entrusted funds to purchase assets, and the manager issues asset backed securities to a maximum of 200 investors.¹⁰⁷ The asset backed securities evidence the purchaser's beneficial interest in the underlying assets, and the securities can be traded and purchased by qualified foreign and domestic investors alike on stock exchanges such as the Shanghai and Shenzhen exchanges and over-the-counter market places approved by the CSRC.¹⁰⁸

The 2014 CSRC regulations are established upon the PRC Securities Investment Funds Law,¹⁰⁹ which incorporates the Trust Law of the PRC.¹¹⁰ Under the CSRC Scheme, Article 5

¹⁰⁵ Article 2 [Law of the PRC on Securities Inv. Funds] (promulgated by the Standing Comm. of the Nat'l People's Cong. [2012] Order No.71 of the Pres. of the PRC on Dec. 28, 2012, effective June 1, 2013) (China); Jefferey H. Chen & Liu Haiping, *Securitization in China – overview and issues*, DENTONS, 1, 3-4 (Feb. 9, 2015),

http://www.dentons.com/~/_media/PDFs/Insights/2015/February/Securitization_in_China.pdf.

¹⁰⁶ Article 3 [Law of the PRC on Securities Inv. Funds] (2013) (China).

¹⁰⁷ Article 38 [Admin Provisions on the Asset Securitization Bus. of Securities Companies & the Subsidiaries of Fund Mgmt. Companies] (promulgated by the CBRC Announcement [2014] No.49 of CSRC on Nov. 19, 2014, effective Nov. 19, 2014) (China).

¹⁰⁸ *Id.*

¹⁰⁹ Article 1 [Admin Provisions on the Asset Securitization Bus. of Securities Companies & the Subsidiaries of Fund Mgmt. Companies] (promulgated by the CBRC Announcement [2014]

asserts that assets entrusted into the scheme are legally isolated, however there is reason to question how courts, as well as foreign investors, will interpret the status of assets entrusted into the CSRC Scheme which is premised upon a set of administrative regulations not constituting statutory law. While the regulations assert that assets are isolated from their originator's estate for insolvency purposes, the statutory law is less clear.¹¹¹

No.49 of CSRC on Nov. 19, 2014, effective Nov. 19, 2014) (China) incorporating [Law of the PRC on Securities Inv. Funds] (promulgated by the Standing Comm. of the Nat'l People's Cong. [2012] Order No.71 of the Pres. of the PRC on Dec. 28, 2012, effective June 1, 2013) (China).

¹¹⁰ Article 2 [Law of the PRC on Securities Inv. Funds] (promulgated by the Standing Comm. of the Nat'l People's Cong. [2012] Order No.71 of the Pres. of the PRC on Dec. 28, 2012, effective June 1, 2013) (China), incorporating the [Trust Law of the PRC] (promulgated by the Standing Comm. of the Nat'l People's Cong. [2001] Order No.50 of the Pres. of the PRC on Apr. 28, 2001, effective Oct. 1, 2001) (China).

¹¹¹ See Jefferey H. Chen & Liu Haiping, *Securitization in China – overview and issues*, DENTONS, 1, 4-5 (Feb. 9, 2015), http://www.dentons.com/~media/PDFs/Insights/2015/February/Securitization_in_China.pdf *comparing* Article 5 [Admin Provisions on the Asset Securitization Bus. of Securities Companies & the Subsidiaries of Fund Mgmt. Companies] (promulgated by the CBRC Announcement [2014] No.49 of CSRC on Nov. 19, 2014, effective Nov. 19, 2014) (China), *with* Article 2 [Trust Law of the PRC] (promulgated by the Standing Comm. of the Nat'l People's Cong. [2001] Order No.50 of the Pres. of the PRC on Apr. 28, 2001, effective Oct. 1, 2001) (China).

Assets become legally isolated upon a legal true sale when the previous owner has discharged both ownership and possession of the assets. Translations of the PRC Trust Law contemplate entrustment as a discharge of possession, but do not clearly and undisputedly discharge ownership. While courts in the PRC have interpreted the Trust Law to provide legal isolation to assets entrusted under Article 2, it is less certain whether Western investors will find assets to be isolated from the estate in bankruptcy when those assets have been discharged for purposes of possession but not for ownership.¹¹²

While securitization is a helpful and popular device used in the Western shipping markets, the two schemes available for investment in China do not provide the certainty and wide accessibility necessary for securitization to be useful to PRC shipping markets. Amendments to the PRC Trust Law clarifying that both ownership and possession transfer with entrustment, as well as providing that trusts establish separate and identifiable legal entities rather than a set of contractual rights would go a long way to increase the viability of securitization in PRC shipping markets for shipyards and for vessel lease financing companies. Furthermore, subjecting every step to approval by the requisite commission adds uncertainty to the process that would better be removed.

IV. OPPORTUNITY FOR FOREIGN INVESTMENT IN THE FREE TRADE ZONES.

¹¹² See Jeffrey H. Chen & Liu Haiping, *Securitization in China – overview and issues*,

DENTONS, 1, 4-5 (Feb. 9, 2015),

http://www.dentons.com/~/_media/PDFs/Insights/2015/February/Securitization_in_China.pdf.

By a major decision of the central government, the PRC established certain geographic Free Trade Zones (FTZ) in order to accelerate the national transformation of government functions and actively explore innovative administrative models to promote and facilitate trade and investment in China.¹¹³ The FTZs were designed to attract and develop foreign leasing companies, and were established to facilitate industries such as international shipping and shipping finance, and international vessel management.¹¹⁴ While Tianjin—and more recently, its free trade zone—has long been an attractive forum for single-ship companies, special purpose vehicles, and novel leasing ventures, the CBRC Scheme has given rise to strong competition from the Shenzhen Wianhai Economic Zone and the Shanghai Pilot Free Trade Zone where financial leasing is a stated priority.¹¹⁵

Under the CBRC Scheme, unlike the general policy throughout China where all business actions are prohibited except for those the government has occasioned to specifically permit, the Shanghai FTZ operates on the more practical “negative list” approach wherein business and foreign investment actions are permitted unless specifically restricted by the government.¹¹⁶

¹¹³ Art. 1 [General Plan for the China (Shanghai) Pilot Free Trade Zone] (promulgated by Guo Fa [2013] No.38 of the State Council on Sept. 18, 2013) (China).

¹¹⁴ Art. 5-6 [General Plan for the China (Shanghai) Pilot Free Trade Zone] (promulgated by Guo Fa [2013] No.38 of the State Council on Sept. 18, 2013) (China).

¹¹⁵ Xin Zhang & Miller Wang, *Opinion: Aircraft and ship lease financing opens up*, CHINA L. & PRAC., Apr. 2014.

¹¹⁶ See *Update on Incentives for Companies to enter the Shanghai FTZ – The Jury is still out*, RHK LEGAL CORPORATE ADVISORS (Oct. 13, 2014).

Foreign investment into the leasing industry is regulated in order to promote healthy development and to minimize business risk.¹¹⁷ The PRC's MOFCOM procedures regulating and administering foreign investment into the PRC leasing industry specifically permit foreign investment into China's ship-leasing industry because the regulations govern leased property for transportation such as vessels and motor vessels.¹¹⁸ MOFCOM is responsible for examining and administering foreign investment into the leasing industry,¹¹⁹ which should be made through limited liability companies or limited through share purchase.¹²⁰

Under the MOFCOM Scheme, foreign investors must have assets grossing at least \$5 million in order to enter a foreign-invested leasing company. But under the PRC's General Scheme for the Shanghai FTZ, there is no minimum registered capital requirement for stand-alone single ship SPV's that have been established by financial leasing companies located in the FTZ.¹²¹ Foreign-invested companies may participate in several different forms of lease financing such as direct leasing, subleasing, and trust leasing (i.e. securitization).¹²² It is suspected that

¹¹⁷ Article 1 [MOFCOM Scheme] (2005) (China).

¹¹⁸ *Id.* at Article 6(2).

¹¹⁹ *Id.* at Article 4.

¹²⁰ *Id.* at Article 3.

¹²¹ King & Wood Mallesons, *Changes to the financial services market in Shanghai FTZ*, SHANGHAI FTZ SERIES (Nov. 2013) NO. 3, at 3; Ernst & Young, *A milestone for China's new wave of economic reform – Shanghai Pilot Free Trade Zone*, CHINA TAX & INVESTMENT NEWS (Sept. 30, 2013) No. 2013005, at 4.

¹²² Article 5 [MOFCOM Scheme] (2005) (China).

financial leasing companies registered under the CBRC Scheme may establish SPVs in the Shanghai FTZ, however the industry awaits more detailed announcements from the CBRC regarding non-bank financial entities operating in the FTZ.¹²³

Ship-leasing companies operating in the PRC can lease vessels to foreign owned companies. In fact, the PRC has encouraged exportation of leased ships as a means to encourage development of local harbors, the vessel construction industry, and the financial leasing industry.¹²⁴ In 2010 the State Administration of Taxation of the PRC offered a one-year export tax refund to those leasing companies registered in Tianjin and licensed to conduct financial leasing.¹²⁵ Tianjin-based leasing companies engaged in financial leasing arrangements—those in which the terms are for the commercial life of the vessel and by which the lessee is transferred ownership at the expiration of the term—may apply also for export valued added tax refunds.¹²⁶ In the Shanghai FTZ, a pilot export tax refund is available as a project subsidiary to finance leasing companies incorporated in the FTZ.¹²⁷ An import-level value added tax exemption is

¹²³ King & Wood Mallesons, *Changes to the financial services market in Shanghai FTZ*, SHANGHAI FTZ SERIES (Nov. 2013) NO. 3, at 3.

¹²⁴ *Breaking the ice of post-VAT reform*, CHINA L. & PRAC., June 2010.

¹²⁵ See *Breaking the ice of post-VAT reform*, CHINA L. & PRAC., June 2010. (Citing PRC's State Administration of Taxation Circular on Carrying out Export Tax Refund in Tianjin (Trial) for Vessels Exportation under Financial Leasing Arrangement. Cai Shui [2010] No. 24, Circular 24.)

¹²⁶ *Id.*

¹²⁷ Ernst & Young, *A milestone for China's new wave of economic reform – Shanghai Pilot Free Trade Zone*, CHINA TAX & INVESTMENT NEWS (Sept. 30, 2013) No. 2013005, at 6.

available specifically for aircraft finance leasing companies for overseas purchases, but the VAT exemption has yet to be extended to other sectors.¹²⁸

Financial leasing was an activity removed from the restricted category of MOFCOM's 2011 guidance catalogue for foreign investors, and thus the activity is now permitted for foreign investors to partake.¹²⁹ Minsheng's leasing arm, China's "most ambitious lessor" is based in the Tianjin FTZ.¹³⁰ Financial leasing companies have been permitted in the Shanghai (Pilot) Free Trade Zone as well. Foreign-invested banks may qualify to set up enterprises in the Shanghai FTZ.¹³¹ Qualifying non-bank and private capital entities may set up finance leasing companies in the Shanghai FTZ.¹³² Cross-border financing entities may be established in the Shanghai FTZ for purposes of offshore vessel financing.¹³³ While these individual entities and activities are permitted in the Shanghai FTZ, it is yet to be seen whether a foreign-invested entity may establish a finance leasing company for purposes of ship-leasing, and whether that foreign-invested entity would be subject to the same CBRC regulations and licensing requirements.

¹²⁸ *Id.*

¹²⁹ See Catalogue for the Guidance of Foreign Investment Industries (Amended in 2011), Ministry of Commerce, PRC.

¹³⁰ Neil Connor, *Minsheng seeks leasing clients for latest orders*, TRADEWINDS, May 27, 2010.

¹³¹ Circular on China Banking Regulatory Commission on Issues Concerning Banking Supervision in China (Shanghai) Free Trade Zone, Article 3, Yin Jian Fa [2013] No. 40.

¹³² *Id.* at Articles 2, 4.

¹³³ *Id.* at Article 5.

China's FTZ's are incubators for transformation. MOFCOM approval is no longer needed to establish foreign representative offices in FTZs.¹³⁴ This is a step to streamline foreign investment and remove uncertainty from an opaque administrative process subject to internal approval. Now, all the foreign entity must do is follow a set of published registration procedures. Similar steps to promote certainty will attract foreign investment and should be adopted more widely. Currently, every step toward establishing a leasing company under the CBRC Scheme is subject to CBRC approval.¹³⁵ The PRC should continue to step in the direction of certainty and establish procedures that will continue to open markets to foreign non-bank investment.

¹³⁴ Laetitia Tjoa, Neal Stender & Zhou Jingwen, *Foreign Representative Office Procedures Consolidated*, CHINA L. & PRAC. (Jul./Aug. 2004).

¹³⁵ See supra nn.88-90, 94-98.