

Research on ABS Project Financing and SPV Establishment in China

Zixun Wang^{1,a,*}

*¹North China University of Technology Tangshan City, Hebei, 06300, China
a, 178147191@qq.com*

**corresponding author*

Abstract: Due to the impact of the COVID-19, there is a shortage of funds in all countries. As a new project financing mode, Asset-Backed Securitization(ABS) is undoubtedly the most dynamic one. At the same time, the existence of Special Purpose Vehicle(SPV) makes ABS project financing mode become the most reliable one. This paper mainly introduces the operation process of ABS project financing mode and the influencing factors of SPV establishment and countermeasures in China. In short, ABS financing mode is to collect those stable cash flows that lack liquidity but can generate forecasts, and then issue securities in the market through SPV rating and credit enhancement to obtain a large amount of funds. As the most important part of ABS project financing mode, SPV determines whether the project can proceed smoothly. SPV can be a professional financing institution, and it can also be a shell company. The main purpose of SPV is to carry out credit rating and upgrading of issued securities so as to enter the high-level securities trading market and obtain more funds.

Keywords: ABS (Asset-Backed Securitization), SPV (Special Purpose Vehicle), credit rating, investment market

1. Introduction

Affected by the epidemic, the world economy is at a low ebb. However, economic globalization has become a trend. All countries are vigorously developing their economies. Project financing has become the most favorable way to develop economy in the 21st century. As we know, there are many kinds of project financing modes [1], such as Public-Private Partnership (PPP), Build-Operate Transfer (BOT), and Asset-Backed Securitization (ABS). Among these financing modes, ABS project financing, as a new financing mode, can absorb more funds. At the same time, ABS project financing has a part that other financing modes do not have, that is Special Purpose Vehicle (SPV), which makes ABS financing mode more reliable than other financing modes [1]. With the acceleration of urbanization, countries began to vigorously develop infrastructure construction. More and more countries hope to obtain more investment funds for their countries by using ABS project financing, so as to promote economic development and achieve the goal of becoming an economic power. This paper introduces the operation process of ABS project financing mode in China, discusses the selection of the SPV establishment place should be established and the conditions that the SPV establishment place should have.

2. Operation Process of ABS Financing Mode

Based on the assets of the project and guaranteed by the expected income of the project, ABS financing mode is a project financing mode that raises funds by issuing high-end securities in the international capital market. In short, ABS financing mode is to collect those assets that lack liquidity but can generate predictable and stable cash flow, separate risk and income through series of structural arrangements, conduct credit rating and upgrading, and then issue securities in the financing market on this basis for financing. ABS financing is a technically complex process shown below [2].

(1) Determine the asset securitization objects and integrate them into an asset pool. In ABS financing, one should first have a general understanding of the future cash stability, risk size, and credit rating of his or her own capital.

(2) Establish special purpose financing vehicle (SPV). The establishment of SPV is the key to the success of ABS project financing. As an ad hoc legal carrier, SPV mainly purchases securitized assets and issues securities with the receivable interests of the assets as the guarantee.

(3) The “real sale” of securitized investment assets means that the original beneficiary transfers the ownership of the assets to SPV.

(4) Credit rating and upgrading of securitized assets. In order to ensure that securitized assets can be issued smoothly in the financial market and achieve good financing effect, the rating and upgrading of securitized assets have become important factors affecting the financing effect. The higher the credit rating of the securities, the lower the risk of the securities, and the easier it is to successfully issue in the financial market.

(5) Issuance and trading of securities. After completing the credit rating of the credit institution and obtaining the approval of the securities regulatory authority, SPV can hand over the securities to the underwriter for sale, so that the securities can circulate freely in the market.

(6) SPV uses the proceeds from securities sales to pay the purchase price to the original beneficiary. SPV pays the proceeds of the securities to the original beneficiary as the purchase price of the “real sale” of the assets. In this process, the original income talents really get their own external financing resources.

(7) Implement the management of assets and funds. After the original beneficiary delivers the securities to SPV, SPV will hire a professional service provider or financial institution to manage the assets of the asset pool. The cash income generated from the assets will be deposited into the special collection account of the trustee to pay the principal and interest to the capital.

(8) Securities liquidation. After the securities have been fully compensated according to the issuance instructions, if there is any remaining cash in the asset pool, it will be distributed between the original beneficiary and the SPV according to the provisions. After the distribution is completed, the entire ABS financing process will be completed.

3. Influencing Factors of SPV Establishment and Countermeasures

SPV is a credit rating institution specially established to realize asset securitization. And the full name of SPV is Special Purpose Vehicle. The main function of SPV is to isolate the risk. The establishment of SPV is an important step in ABS project financing, since it decides whether the project could be carried out smoothly [3].

3.1. Selection of SPV Establishment Site

When the ABS financing mode is applied to the project, the selection of the place where SPV is established is very important. The establishment place of SPV can be the place where the initiator is located or other regions. However, the key to the selection of the place where SPV is established depends on whether the local tax system, legal system and accounting law system are favorable.

Generally speaking, the place of establishment of SPV shall meet the following conditions: first, the Interest payment shall be exempt from withholding tax; second, the bankruptcy law stipulates that such institutions shall not go bankrupt; third profits or capital gains shall be exempt from income tax [4].

3.2. Credit Rating and Improvement Measures

Establishing a legal SPV with high credit rating as the main body or securitization financing is the key to the successful operation of ABS financing mode, which is also the main reason why ABS financing mode cannot be successfully implemented in many countries. However, under normal circumstances, the establishment of SPV can only be carried out in countries with high national sovereign credit rating, such as the United States, Japan and economically developed countries in Western countries. These countries have strong economic strength and good asset quality, thus obtaining a higher credit rating granted by international authoritative credit rating agencies. However, for developing countries such as China, some financial institutions and investment institutions with relatively strong comprehensive strength can be chosen to settle in international credit guarantee institutions, investment insurance companies and trust institutions in the form of joint ventures, and to specially carry out ABS financing and become the shareholders or sponsors of SPV in these companies. This way lays a foundation for ABS Project Financing in developing countries.

Generally speaking, if the sponsor can obtain a higher credit rating granted by a higher credit rating agency, it can easily enter the authoritative credit rating agency to obtain a higher credit rating, and then enter the high-end investment securities market to issue securities [5]. This move will greatly reduce the financing cost. Therefore, as a developing country, in order to obtain a higher credit rating, China can first establish SPV with international famous financial institutions through joint ventures and cooperation. Second, international famous financial institutions can be hired as SPV. However, these are all trade-offs. There is a need to start to train domestic financial institutions to become SPVs and lay a solid foundation for the large-scale development of ABS on international high-end securities. In the long run, this is the ultimate solution to the problem.

4. Application and Development of ABS Financing in China

Affected by the epidemic, the world economy is at a low ebb. However, China has put forward some policies, such as “One Belt, One Road” [6] to promote economic development. As an innovation financing mode, ABS (Asset-Backed-Securitization) has been effectively used in many fields in many developed countries. For example, the United States, Japan, and some Western European countries. As a developing country, China wants to speed up its economic development and urbanization. The shortage of funds has become a major problem in China’s development. As a brand-new financing mode, ABS project financing mode has become the first choice in China. More than 20 years of reform and opening up have enabled China’s economy to achieve tremendous development and made remarkable achievements. After entering the 21st century, in order to achieve the strategic goal of economic development, China must invest a large amount of funds to adapt to the rapid development of China’s economy [7]. However, the traditional ways of attracting investment and existing financing channels can not meet China’s large demand for funds. ABS financing mode injects vitality into China’s capital market and become China’s best choice. China has met the requirements for introducing ABS project financing mode. In other words, ABS financing mode is feasible in China.

(1) The huge capital demand of China’s economic construction and a large number of high-quality investment projects provide broad application space and economic foundation for ABS. With the rapid, healthy and stable development of China’s economy, a large number of investment projects

with stable income and high return rate are constantly emerging. These excellent investment projects are the most ideal choice for ABS financing objects. At present, many large foreign financial institutions are optimistic about China's ABS financing market and want to open the Chinese market.

(2) China has initially established the legal environment for ABS financing mode. For a long time, due to China's imperfect financial laws, mature financing instruments and financing models in the international capital market cannot operate in China, which makes China lose many opportunities to use international funds. However, with the promulgation of series of laws and regulations in China, it indicates that China's investment legal environment is constantly improving, and also builds a necessary legal framework for ABS financing.

(3) ABS broke away from the traditional credit rating restrictions and broadened the existing financing channels. If the issued securities want to enter the international high-end securities investment market, they must obtain the credit rating of several internationally recognized rating agencies. As a socialist country, China has always been considered by western countries to have a large national political risk. In addition, due to other economic reasons, China's national sovereign credit rating has been low, and credit rating of enterprises is lower. Chinese enterprises cannot enter the international market for financing. The ABS financing mode strengthens the credit rating of Chinese enterprises by establishing SPV, so that Chinese enterprises and projects can enter the market.

(4) Using ABS for financing will help China enter the high-end project financing field as soon as possible. Since ABS is financed securitization in the national high-end financing market, China has the opportunity to directly participate in the international high-end financing market, learn the operation and supervision experience of foreign securities markets, and understand the latest trends of the international financial market. This move will accelerate the integration of China and foreign capital markets and promote China's economic development.

5. Current Situation and Countermeasures of SPV Establishment in China

As an innovation financing mode, ABS has become a new way to solve the problem of capital shortage in China. As it is known to all, as the most important part of ABS project financing, the development of SPV in China lags for behind other developed countries. SPV is an ad HOC purpose vehicle. Its main function is to isolate risks and predict the trend of cash flow. The purpose of establishing SPV is to minimize the impact of bankruptcy risk of the sponsor on the securitized assets. SPV is an institution with a high credit rating set up specifically to realize asset securitization [3]. Through credit enhancement, the securities rating is improved, and then it is issued in the international financing market to obtain funds. Therefore, the successful establishment of SPV is the prerequisite and key condition for the development of ABS financing mode. The first SPV in China was established in Chongqing, in 1997. But some of developed countries such as Japan established complete SPV in 1970s. So there is a need to establish suitable SPV for China. And how to establish SPV suitable for China's national conditions is an important issue. However, China is different from the international tax in terms of tax, value-added tax, stamp tax, business tax and other taxes, which will affect the sponsor's choice of the place where SPV is established. Therefore, China has formulated the following requirements according to its own national conditions, so as to establish a complete SPV suitable for its own national conditions [8]:

(1) Establishing SPV in a real sense is the fundamental way to help franchise project financing and realize isolation, and is also the core element of franchise management. Franchised SPV is the carrier of project implementation. Different from ordinary companies, other rights and obligations of company are limited to a certain extent, so as to ensure that the income of the project covers the investment of project and restrict it from engaging in other business.

(2) Under certain preconditions, investors can be allowed to trade equity and bonds, but it is necessary to ensure that the actual controller of SPV will not change.

(3) Ensure that the operation and service of project will not be affected by changes in shareholders and institutions, and public interests will not be damaged. But for the transfer of equity or creditor's rights caused by abnormal circumstances or force majeure, the social capital party shall make fair compensation.

(4) It is allowed to sign a third-party agreement to specify the intervention rights and boundary conditions of financing institutions in the franchise relationship in detail, and strictly limit the exercise of the intervention rights, so as to restrict the abuse of the intervention rights by law.

To sum up, China needs to draw on international practices and combine its own national conditions to formulate a set of legal systems that are suitable for China's national conditions and can promote the smooth development of ABS project financing mode.

6. Conclusion

ABS financing mode has become one of the most popular financing modes in the world. ABS project financing mode raises funds by issuing securities, which is the biggest difference between ABS and other project financing modes. The biggest advantage of ABS project financing mode is that it obtains funds through the securities issued in the international market, and the bond interest rate is generally low, so the initial investment cost of ABS financing is small. The operation mode of ABS project financing mode is clear and easy for users to operate. AS the most important part of ABS financing model is SPV. SPV effectively helps investors isolate risks, which makes the whole financing process smooth. As a developing country, China lags behind western developed countries in ABS research. At the same time, China still lacks the research and management of ABS. There is also a lack of relevant teams and legal knowledge conducive to the establishment of SPV. Therefore, China must speed up the training of ABS related personnel and deeply study the methods and experience of ABS financing mode, so as to promote the faster development of ASB financing mode in China [9].

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