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In-Sight Newsletter
China Factoring Industry: Current State and Future Developments

As most of you know, the factoring industry in China declined in 2016 by 15%, and if you include the decline in 2015, the market has seen a reduction of close to 30% since the industry's peak in 2014. For nearly 15 years, China has been on a tear, increasing at unparalleled rates of growth compared to most other markets, and surpassing the United Kingdom as the largest factoring market in the world. This Chinese "miracle" has been reported on numerous occasions in our past newsletters. So it is not surprising to report for the first time that the factoring market in China has issued its first major distress signal. And like most periods of economic malaise, risk increases, and the experience from this disruption in China was no exception. The market experienced a dramatic increase in fraudulent activity, and nearly every member in China was impacted.

The outcome from the crisis was multiple. Some banks hit the hardest focused on correcting credit metrics and installing best practices, critiquing past credit and risk procedures and adopting new ones with an effort to improve overall asset quality. In factoring for example, one bank must approve sellers using similar metrics when approving other types of loans, with less emphasis on debtor analysis. Another bank experienced large fines in their overseas branch stemming from KYC/AML issues, and now most of its offshore business will be brought back inside China. As a result, many banks have invested heavily to upgrade their systems and procedures to protect against money laundering. Numerous banks experienced significant fraudulent activity, but most of it was from domestic cases. Hence, many of the banks have developed plans to build on their international strategy and expand their factoring operations overseas. In fact, Chinese banks in general are going abroad and are following their corporate and retail clients by expanding overseas, bucking a global banking industry trend of retrenchment. China's state-directed "One Belt, One Road" initiative has forced Chinese banks to enter emerging markets in the Middle East, Africa and parts of Southeast and Southwest Asia where the banks otherwise wouldn't venture. That's a major reason the largest Chinese banks have been ahead of smaller banks in expanding overseas. Besides branch openings in markets around the world by the top four state banks, we have seen as well major investment announcements by Chinese banks and investment funds in SE Asia, Africa and Latin America, and FCI can expect to see more Chinese banks as members in markets located outside of the Greater China region.

But the biggest impact to the industry was the rise in defaults stemming from fraud, almost all driven by domestic transactions. One finding is that the market experienced over US$ 15 Billion in losses stemming from fraudulent activity in the past two years. Domestic factoring in China has more inherent risks due to the limited transparency compared to cross border trade, as there is no official third party verification such as a customs check neither is there any kind of shipment investigation in the domestic market, therefore it is difficult to prove the authenticity of the underlying transaction, increasing the risk of fraud domestically. It was reported that there were at one time over 400 domestic fraud cases sitting in the lower courts in China. In fact, the system could not grapple with the demand for juris prudence to render prudent decisions. China operates under a continental legal system, top down, based on legal policies as enacted by the National Peoples Congress and interpreted by the Peoples Supreme Court. Factoring, specifically the rules relating to assignment, prioritization and third party effectiveness are embedded under contract, property and securities laws in China. Today, there is no centralized codified law on factoring or policy that has been handed down by the People's Supreme Court. Instead nearly every provincial court in China has over time had to create their own policies created based on their own experiences from judgements in past years, and not always in harmony with each other from court to court, from province to province. Several High Courts like the People's High Court of Tianjing and Beijing or Shanghai or High Court of Jiangsu Province is believed to have developed their own best practices and have published guidance for their respective courts to follow. The problem is that the guidance may contradict with each other from region to region..

China recently may be considering adopting the UNCITRAL model law on secured transactions which just passed by the UNCITRAL in the early of this year in New York which the Chinese delegation voted in favour, and several departments of the Central Government of China including PBOC and Department of Commerce and other government bodies just issued a NOTICE which has been approved on April 25th 2017 entitled "The Working Plan for Task Force on Receivable Financing for Small and Micro Enterprise (SME) （from 2017-2019）("Plan"). This plan will expand the Registration Offices Registries System to include all SMEs. But from a factoring perspective, the country is in need of fundamental change and it is obliviously clear that this country is still undergoing much change!

As one legal expert put it succinctly:

The problems in the factoring market in China will need both operational and legislative fixes. The industry needs to advocate for more legal reforms. The Chinese government has embarked on a course to develop the first Civil Code in the country. The first part -- General Principles –has passed by the People's Congress in March 15 2017 and will take effect at October 1st 2017. After that, specific Chapters will be developed, maybe including a Secured Transactions Chapter. The other issue in

China is definitions. There is a 99% chance for simple words like "Secured Transactions" or "collateral registry" to be translated into very different things. For example, the word "collateral" is often wrongly translated as "mortgage". The secured transactions law in China is called the 2007 Property Law (which is likely to be translated back into Chinese wrongly, unfortunately); and the registry is under the central bank (Credit Reference Center of People's Bank of China, or CRC -- "credit reference" will most likely be translated wrongly too).

This is certainly an opportunity to fix the problems. The China Factoring Association, in association with the CBA have raised these issues and have developed strategies to tackle them. But as one Chinese Lawyer stated, "*In this process, we deeply feel the scarce and lack of Chinese uniform regulations, self-discipline rules and training materials of the Chinese factoring industry*."

So what can FCI do to assist the Chinese members?

- Though the Supreme People's Court may not directly adopt international practices or rules , they may adopt the GRIF rules to cover both international and domestic factoring transactions as well by making specific Justice Interpolation (Sifa Jieshi) on Trial of Factoring Cases, which the Supreme People's Court has already empowered to make by the People's Congress in 1981. This can be compared to changes that occurred over two decades ago, when the PBOC developed rules governing domestic letters of credit transactions (LC) in 1997. The rules governing international LCs obviously is subject to ICC rules of the UCP600. And the Supreme People's Court has made a special "Sifa Jieshi" on international LC cases in 2005 which took effect in 2006, and the reported latest decision made by the Supreme People's Court about domestic LC case show this LC "Sifa Jieshi" will also apply in a domestic LC disputes. The same could be done both for international and domestic factoring conducted between banks and commercial factors.
- FCI has invited a Chinese lawyer who was referred to us by one of our good members, to sit as an observer on the FCI Legal Committee later this year. This will give the members of the legal committee an opportunity to learn more about the legal system in China but also allow them to educate this person on the global legal landscape regarding factoring in general, and cross border factoring and the GRIF in particular, and at the same time support this person's effort to reform the legal system in China.
- We are also working closely with the CBA and some of the other newer regional factoring associations in a concerted effort to support the development of a healthy industry backed by a strong legal framework. FCI will hold workshops and devleop educational events to target important the supreme and provincial courts by organizing regional legal workshops,

in conjunction with the CBA and World Bank/IFC. We are already in discussion with the CBA regarding joint education programs.

- And lastly, we could develop a joint Chinese arbitration procedure for domestic factoring transactions together with the CBA. As one of our members recently requested, "*FCI should 1) raise level of awareness of the legal issues in China (like replicating the domestic LC rules for factoring) 2) increase advocacy regarding basel and capital requirements relating to factoring and 3) create a Chinese arbitration experts committee.*"

The 19th Peoples National Congress will take place in the 3rd Quarter 2017, and one fundamental question will be on economic stability, including the focus on a positive and healthy financial sector. The growth of factoring in China is expected to come back to a steady level, as FCI is witnessing in the 2-factor volume figures for the first four months of 2017, up slightly compared to the previous year. The growth in the next few years is not expected to be as fast as it was in the past 5 years, nor like the dramatic drop witnessed in the past 2 years, but will stabilize as the recovery continues. As business begins to pick up, in part from the ever-expanding impact from the One Belt, One Road (OBOR) initiative, our members in China will continue to be challenged, but we hope that with their support we can together support the growth of a healthy and robust factoring sector in China, and at the same time support the evolution of a more robust legal and regulatory framework to instil confidence in the further development of factoring in China into the future.