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## China's new Property Rights Law—an important step towards improving access to credit for small and medium enterprises

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After a record 14 years of consultation, China's long awaited new Property Rights Law was finally passed on March 16, 2007 and came into effect on October 1 of that year. Referred to as "China's next revolution" by *The Economist*,<sup>1</sup> the law offered equal protection to socialist public property and private property, stated explicitly for the first time. This was a huge step in reforming secured lending and building a modern secured transactions system.

Previously, despite China's dynamic economic growth, inadequate laws were still obstacles to investment and business development. According to a joint World Bank (WB)—People's Bank of China (PBOC) report, while 70% of small-business financing was secured by movable property in the U.S., the figure for China was less than 15%.<sup>2</sup> Overall, only 4% of China's commercial loans were financed by movable assets. It was estimated that China had 16 trillion Yuan (approximately \$2 trillion) in dead capital—i.e., assets which could be used to generate loans to fund investment and growth,<sup>3</sup> owned by private firms, small and medium enterprises (SMEs) and farmers. At the same time, 80% of firms in China said "access to credit" was their top business constraint.

Before the new Property Rights Law, China scored only 4 out of 10 on the *Doing Business* "Legal Rights" index. After the reform, that score was a 6. Studies show that countries scoring higher on this index tend to have greater access to credit, more stability in their financial system, fewer non-performing loans and lower costs for credit. Accordingly, reforms boosting China's score should be positive steps towards a healthy lending market and more productivity growth.<sup>4</sup> China's 2007 reform was therefore necessary to help stimulate its local economy, which was growing increasingly dependent on private investment.

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### Before the reform

Before the new property rights law, there was a patchwork of regulations and restrictive laws governing secured transactions in China. Several laws—such as the General Principles of the Civil Law, Security Law and the Land Administration Law—dealt separately with various aspects of property ownership, creating confusion and increasing bureaucratic procedures. The result was inefficiency. The process of creating, registering and enforcing a security interest was costly,

time-consuming and uncertain. The new Property Rights Law was a crucial step towards merging all of the laws in a uniform code.

Modern secured transactions laws enable borrowers to use movable property of any kind—tangible or intangible, presently owned or to be acquired in the future—as collateral; thereby giving contracting parties more flexibility to structure their commercial transactions. Unfortunately, the situation was quite different in China before the Property Rights law.

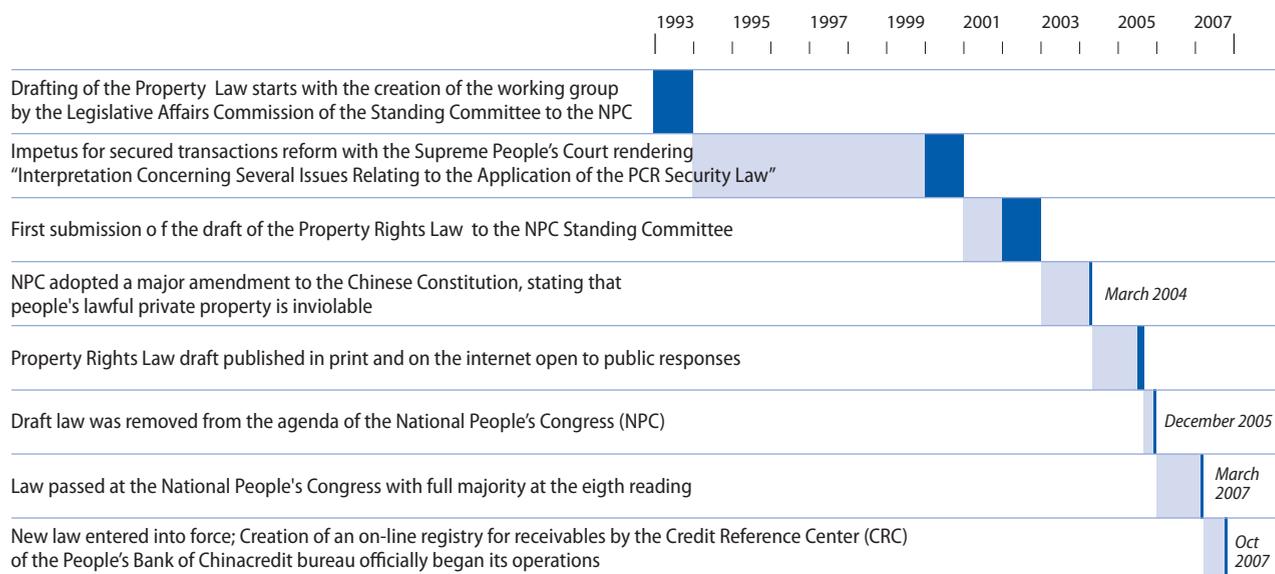
Previously, under Article 34 of the 1995 Security Law, non-possessory security interests were only allowed for equipment and motor vehicles. This meant that many fluctuating assets—such as accounts receivables and inventories—could not be used as collateral.<sup>5</sup> SMEs suffered the most from this restriction: 90% of China's SMEs (which comprise 80% of all enterprises in China<sup>6</sup>) are rural township and village enterprises with little to offer in terms of real property collateral.<sup>7</sup> Their inventories and receivables—which tend to account for 50% of SME assets—simply could not be used to secure loans.

In addition, under China's 1995 Security Law, a security interest had to be registered with a government-run registry to be legally valid. Due to the absence of one centralized registry for all types of movable assets, lenders had to navigate through more than a dozen individual registries, depending on the types of

FIGURE 1

**China's property rights law reform**

Source: Doing Business database.



assets. As certain specialized registries handled very specific types of assets (i.e. farm tractors), multiple registrations were sometimes required. At times it took more than a year for lenders to register all of their interests in the appropriate registries.<sup>8</sup> This delay opened the possibility for multiple loans to be taken out on the same assets and made priority rules for creditors unclear. Uncertainty ultimately led to higher loan costs—or even limited lending.

Another flaw in the old system was the cost to lenders. Registry officials used to determine whether the secured loan amount exceeded the value of the collateral, regardless of whether lenders were satisfied with their valuation.<sup>9</sup> Valuation by registry-appointed appraisers were routinely required and their fees borne by lenders. According to some lenders, registration-related costs could rise up to a third of the loan amount. Also, registry officials had the power to accept or reject registration applications. Such obstacles in the registration process were reflected by records in Shanghai where an average of only 1,000 registrations a year were being filed for pledges on movable property.

Inadequate enforcement procedures also impacted loan rates before the reform. If a debtor was not willing to cooperate upon default, enforcement of the security was a very slow and costly process. In advanced economies, such as Singapore, loan enforcement takes about a week and costs less than 1% of secured debt. In China, in contrast, 75% of enforcement actions took a year or longer and court fees and judicial actions could consume more than 20% of an outstanding claim. Prolonged enforcements rendered claims on many movable assets meaningless, because movable assets tend to depreciate faster than fixed property. As a result, majority of Chinese banks did not pursue defaults. They would simply write them off as a bad debt instead.

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## The reform process

The new Property Rights Law is one of a series of important legal reforms undertaken by President Hu Jintao and his Prime Minister Wen Jiabao. As China's leaders shifted their emphasis from growth to development, they realized that revenues to finance “pro-poor investment” come increasingly from a better investment climate for private firms. To improve China's investment climate, its legal framework needed to be transformed.

The concept of the new Property Rights Law was born with the drafting of a new civil code—one of the symbols of China's great economic transformation. The official legislative work on the Property Rights Law itself started in 1993 when the National People's Congress's Legislative Affairs Commission (NPCLAC) set up a working group. The new Property Rights Law was intended to address 3

main issues: 1) property ownership, 2) the rights one has over one's property and the obligations assumed by others in respect of this property, and 3) how to protect these rights and the remedies available if these rights are violated.

The need to also modernize collateral laws then gained impetus when the Supreme People's Court rendered an "Interpretation Concerning Several Issues Relating to the Application of the PRC Security Law" in 2000, recognizing the need to bring the 1995 Security Law more in line with modern secured transactions practices.

All in all, the consultative process for the new Property Rights Law was notable for two reasons. First, it was the lengthiest drafting procedure in the history of Chinese legislation at 14 years. Second, as a bill, it was published in print and on the internet on 8 July 2005, and the public was invited to respond to it by 20 August 2005. This was only the second time the public was invited to participate in the Chinese legislative process. It was an innovation. The public response was enormous with 11,543 submissions. Many raised concerns about the provisions pertaining to private property ownership and land rights.

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### **Opposition to and support for the reform**

As might be expected, the drafting of the law suffered setbacks and delays as a consequence of political debate. An open letter by Professor Gong Xiantian, a reputed professor of jurisprudence at Beijing University Law School, was particularly influential during the public comment period. Professor Gong Xiantian argued that the new Property Rights Law betrayed the fundamental principles of Marxism and the socialism of the Chinese Communist Party. As a result of the outcry, the draft law was removed from the agenda of the National People's Congress (NPC) in December 2005.

Eventually, after 3 more readings by the Standing Committee of the National People's Congress (the "Standing Committee"), the constitutionality of the law was settled and the bill was presented to the NPC in March 2007. The Property Rights Law was finally passed on March 16, 2007 with a spectacular 99.1% of NPC's 2,889 legislators backing the law.

Such sweeping support for the new Property Rights Law was helped by the involvement of the People's Bank of China (PBOC), which was a strong advocate of the secured financing reform. The PBOC believed that a reform of China's movable secured financing would be a boom for domestic Chinese banks' profitability while also increasing SMEs access to credit. Accordingly, the PBOC worked to gain support and collaboration so as to ensure a successful reform.

As an active supporter of the new law, the PBOC closely collaborated with the World Bank regarding modern secured financing principles. Results from the World Bank–PBOC Lender Survey,<sup>10</sup> the first ever to survey Chinese financial institutions on secured lending practices, indicated that lenders in China strongly supported modernization of the 1995 Security Law. In fact, 98% of the banks agreed that laws should provide for bulk-receivables financing. They also overwhelmingly supported a unified and electronically accessible registry of secured movable property with clear priority rules. More than 80% stated that commercial banking would benefit from non-judicial enforcement of security—if creditors automatically had rights to the proceeds of collateral and if current requirements for government valuation of collateral were eliminated. All banks surveyed said enforcing security took too long, and 85% stated that the high costs of enforcement were an obstacle.

The PBOC, jointly with the World Bank, then moved to build awareness among key stakeholders in the financial sector through a series of high-level seminars. The seminars were a forum to share knowledge, comparing the current Chinese secured transaction system with international best practices. Members of the NPC Legislative Affairs Commission (NPCLAC), responsible for drafting the law, were also invited to the seminars. This helped stakeholders ensure that the new draft law correctly reflected the modern necessities (and realities) of China's credit market.

Another effective learning tool for the law's drafters was a World Bank sponsored study tour to Canada and the U.S. The study tour brought PBOC and NPCLAC officials into direct contact with advanced secured transaction law systems and collateral registries.<sup>11</sup>

Bringing together stakeholders and international experts was a success, as was reflected in the last draft of the New Property Rights law. This final draft incorporated an immense amount of public input—by international organizations (including NGOs), scholars, lawyers, academics.

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### **After the reform: Indisputable benefits but shortcomings still remain**

China's new Property Rights Law is a laudable achievement for 2 main reasons. First, it is ground-breaking with its emphasis on the equal protection of state, collective and individual property. Second, it also provides a detailed framework for the protection of real (immovable) and movable properties. As a result, it improves China's secured transaction structure while bringing it more in line with international best practices.

More specifically, the law expands the scope of movable collateral that can be used by borrowers to secure a loan. It enables borrowers to use present and future-acquired equipment inventory, accounts receivable and a combination of assets. It also simplifies the formalities required for creating security interests in tangible, movable assets—such as equipment and inventory. At the same time, it gives creditors more control over defaults by allowing events in default to be defined by contract.

Finally, another notable feature of the Property Rights Law is that it allowed the PBOC to establish a single, centralized receivables registry. The online receivables registry was launched October 8, 2009 by the Credit Reference Center of the PBOC—an important first step towards centralizing all asset registries.

In effect, these improvements helped China's score on the *Doing Business* "Legal Rights" index climb to 6 out of 10 in 2008. They also helped China move up 20 places on the "Getting Credit—Legal Rights" ranking. China now sits within the top third, at number 59 out of 181 economies measured in the 2009 *Doing Business* report.

According to Sevi Simavi,<sup>12</sup> Project Leader in Secured Transactions Law Reform Project (implemented jointly by WB and PBOC), it is still too early to talk about the significant impacts on the ground of the 2007 law at this stage. "It would take a couple of years before we would see the impact in mainstream financing liberalization," Simavi says. "However, the initial data suggests that banks have started to lend more," Simavi adds. The Credit Reference Center of the PBOC also reports that by June 2009, 20 months after the creation of an on-line registry for receivables, a total of 74,453 lending transactions using receivables as a security have been recorded for an estimated cumulative amount of over 5 trillion Yuan. More than 52% of these transactions were made to the small and medium Chinese enterprises. By now, practically, all middle and large lenders in China have developed receivables lending products.

Despite initial success, improvements are still needed. One area for concern is the new law's lack of clarity.

"The new Property Rights Law is intentionally vague on many important issues," wrote Daniel Harris, legal expert in a published comment. "The vagueness was the price paid to allow any form of Property Law to be adopted," Harris adds. At the time even the name of the law was deemed controversial.

Another concern is that the new Property Rights law does not specifically repeal old rules. Jurists are supposed to know which provisions should prevail over others. Unfortunately, this creates confusion as to which law is in force and

hinders a simple application of the law. At the implementation level, the new law may fall subject to personal interpretation by local officials. Therefore, it is critical that the Supreme Court issues “implementation guidelines” to provide the specifics on any vaguely stated provisions and direct the implementation of the law.

Furthermore, the newly created receivables registry is a step towards a larger, electronic movable collateral registry, but there is still much work to be done. The reform has not yet consolidated the 15 or so movable collateral registries into a single system. A single registry is an indispensable part of any modern secured transaction law. The maintenance of multiple registries with different rules and practices inevitably leads to confusion and lack of priority rules for secured creditors.

Finally, out-of-court enforcement of security interests is still not permitted. That means the value of time-sensitive assets still depreciates in lengthy court proceedings.

Nevertheless and despite some shortcomings, China has taken a huge leap in the right direction with this reform. The initial data is already promising and there’s reason to hope that future reforms will continue to modernize China’s secured lending framework.

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## Notes

1. *The Economist*, print edition, March 10, 2007.
2. *Secured Transactions Law Reform in China*, Han Su Lin, July/August 2007.
3. “*Reforming Collateral Laws and Registries: International Best Practices and the case of China*”, FIAS/IFC PEP report, March 2007.
4. “*Reforming Collateral Laws and Registries: International Best Practices and the case of China*”, FIAS/IFC PEP report, March 2007.
5. Per the People’s Republic of China Security Law, Article 39. assets had to be fixed at the time of the contract.
6. According to a study by the People’s Bank of China in 2004.
7. PBOC, “*Survey of the Financing Mechanisms for China’s Small and Medium Enterprises*”, China CITIC Press (2005) (hereinafter referred to as the “PBOC SME Report”).
8. Su Lin Han, *Secured Transactions Law Reform in China*, August 2007, available online at [http://findarticles.com/p/articles/mi\\_qa5352/is\\_/ai\\_n21292030](http://findarticles.com/p/articles/mi_qa5352/is_/ai_n21292030).
9. Under Article 35 of the Security Law, a secured loan may not exceed the value of the mortgage property. Many registries interpreted this provision as requiring third-party appraisals even if parties have agreed to the value of the collateral.
10. “*Reforming Collateral Laws and Registries: International Best Practices and the case of China*”, FIAS/IFC PEP report, March 2007.

11. FIAS Draft Case Study Reforming China's secured Financing System – Collaborative Effort from Key Stakeholder Pays Off.
12. Personal communication.