Day of reckoning for China trusts

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Summary

3Q14 and 4Q14 represent a turning point in the trust industry, as repayments of interests and principal of trust products are expected to peak during these two quarters and remain high for 2015 as a whole. The conjunction of mounting payoffs and non-performing loans are likely to rattle the whole trust sector. The maximum amount of losses absorbable by trust companies, taking into account their level of capital, amounts to RMB 255.5 bn, representing a default rate of 2.3% on their assets. Yet the average default rate of trust products between 2007 and 2009 was above 3%, implying several trust companies are likely to default in the coming months. Investors will therefore have to assume losses on their investments in trust products, as a break-off of the unconditional payoff rule is likely given insufficient capital and provisions among trust companies. Because of higher default rates, larger assets and leverage as well as increasingly stern regulations, investors will have to accept bigger haircuts compared to previous episodes of distress in the trust fund industry. However, the biggest impacts will be felt by trust companies and banks.

- The trust sector will be exposed to a significant wave of reshuffling. Due to insufficient capital buffers, trust companies could be exposed to bankruptcy, M&A or absorption of their assets by the big four asset management companies. In parallel with a declining size of aggregate AUM, the trust fund industry will register an increasing degree of concentration.
- Banks will have to absorb the bulk of losses in single trust products. Assuming an average default rate of 5% in the assets of single trusts in 2014, the amount of losses would reach RMB 0.2 tn, representing 0.2% of banks' total assets. Despite this capacity to absorb significant losses, banks will see the size of their non performing loans increase significantly and their profitability will be significantly eroded. The most toxic assets of these banks could also be taken over by the big four asset management companies under the government umbrella.
- A freezing of the interbank market represents the real risk as a ripple effect of increasing defaults on single trust products, of which beneficiary rights have played a growing role as collateral of liquidity transactions. The different sources of risk are highly diverse and non-easily foreseeable ranging from maturity mismatch, collateral depreciation, shock of liquidity credit events and even bank runs.

The upcoming and growing difficulties of trust funds urgently call for better supervision of trust businesses. Supervision of trust funds, internet financing, leasing companies, credit-guarantee outfits and money market funds should be integrated. Separately, diversifying financing channels by promoting development of the bond market, shortening as well as easing the IPO listing process and allowing full access to infrastructure projects by private capital are necessary to deal with the ongoing financing difficulties of small and medium-size companies.

The day of reckoning is undoubtedly approaching for China's trust fund industry. The bulk of principal and interest payments linked to trust products will take place in 2014 and 2015, with reimbursements expected to peak in 3Q14, after the trusts due as a percentage of outstanding increased to 34.2% in 2013 from 29.8% in 2011. A total of RMB 1.51 tn of principal was due in 2Q14 with RMB 95 bn of interest, both of which will further rise to RMB 1.99 tn and RMB 132.8 bn in 3Q14, respectively, according to our estimations based on issuance data and samples from the China Trust Association and WIND. RMB 1.03 tn are also due in 4Q14, this amount being expected to rise, should debt being rolled over in 3Q14 due to mounting difficulties to repay. Hazardous and risky investments in increasingly less profitable projects, coupled with decelerating growth, tightening liquidity conditions and stricter control of the government to rein in overcapacities and shadow banking have made the coming rise of default rates unavoidable for trust fund products. This is likely to be accompanied with mounting risks of default as the large size of assets under management exceeds the bailout capacity of trust companies.

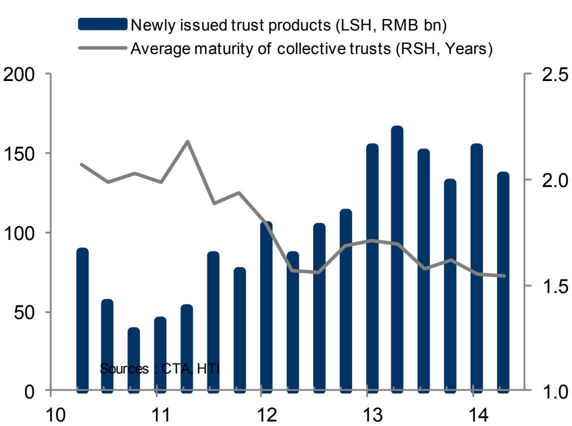
Trusts due in 2014-2015 (RMB tn)

	Principal due	Interest payment	Total
2014	4.90	0.34	5.24
1Q	0.54	0.04	0.58
2Q	1.42	0.09	1.51
3Q	1.99	0.13	2.12
4Q	0.95	0.08	1.03
2015	5.80	0.51	6.31

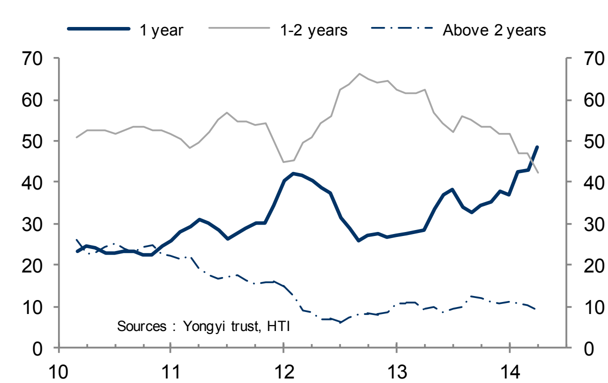
Source: CTA, Wind, Yongyi trust, HTI

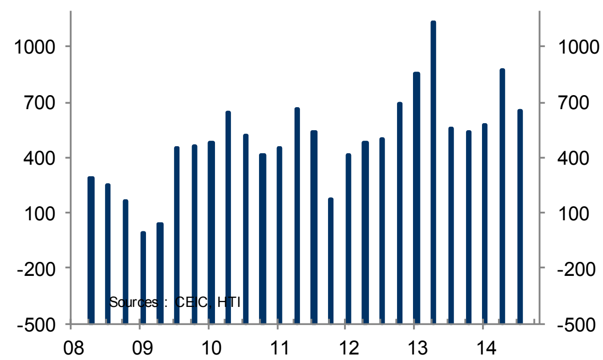
Several warning signs highlighting the mounting difficulties of the trust fund sector are already visible. The average maturity of trust fund products is oriented on the downside as investors are increasingly eager to be paid back quickly. The volume of issuance of trust products has significantly declined since 2H13, as investors have adopted prudent strategies toward these risky assets. Despite lower issuance of trust products, shadow banking assets have continued to build up, mirroring a continued accumulation of risks (with heightened possibilities of ripple effects on trust products) at the level of risky products. Overall, the question is not whether or not defaults will occur, but when, where, by how much and who will absorb the losses. It is therefore necessary and urgent to provide a precise estimate of the trust products' risk in terms of size and structure to thereafter anticipate the impact on China's financial system and economy.

Newly issued trust products and average maturity



Percentage of collective products in different maturities (%, 3mma)





1. The brisk development of trust funds is leading to a dead-end

The brisk development of trust products and uncertainties surrounding their regulatory requirements has led to an accumulation and concentration of risk in this sector. The AUM of the trust sector broadly increased tenfold in 5 years as it reached RMB 10.9 tn in 2013 compared to RMB 1.2 tn in 2008. This progression significantly outpaced all other major financial players including security houses, banks and insurance companies. The trust sector is now the second largest financial sector in China. The volume of trust product issuances surged to RMB 6 tn in 2013, representing 71.3% of aggregate financing when excluding bank loans. Trust products have been the major contributor to the brisk growth of shadow banking in China. Large financing needs following the implementation of the 2009 RMB 4 tn stimulus package and large constraints weighing on banks (high Reserve Requirement Ratios, stringency of capital adequacy ratios, control of credit via quotas of loan / deposit ratios) fostered off-balance sheet activities of banks, nurturing shadow banking and the trust sector in particular. The real estate sector, infrastructure projects of local governments and mining projects were the main beneficiaries of this liquidity binge.

Outstanding trusts by source of funds (RMB tn)

	Total	Single trust					Collective trust	Others
		Total	Bank-security-trust cooperation	Bank-trust cooperation	Government-trust cooperation	others		
1Q14	**11.7**	**8.1**	2.9	2.5	1.1	1.7	**2.9**	0.7
2013	**10.9**	**7.6**	2.7	2.2	1.0	1.7	**2.7**	0.6
2012	**7.5**	**5.1**	1.9	2.0	0.5	0.7	**1.9**	0.5
2011	**4.8**	**3.3**	0.8	1.7	0.3	0.6	**1.4**	0.2
2010	**3.0**	**2.3**	0.1	1.7	0.4	0.1	**0.6**	0.1
2009	**2.0**	**1.6**	0.2	1.0	0.3	0.1	**0.3**	0.1
2008	**1.2**	**0.9**	N/a	0.8	N/a	0.1	**0.2**	0.1

Source: Wind, CTA, HTI

Banks and rich individuals are the main investors in trust products

Major investors in trust products are banks and wealthy individuals, who are particularly active in single and collective trusts respectively. Single trusts are solely funded by one institutional investor; while collective trusts are jointly funded by a limited number of individual investors. Stricter restrictions on collective trusts explained the fact that single trusts developed more quickly and now have a bigger weight in the trust business.

- A cap of 50 wealthy individual investors is set for collective funds. Regulations by the CBRC on collective trusts published in 2009 set up a cap of 50 for wealthy individual investors with less than RMB 3 mn of investment.
- Restrictions on non-local sales. Collective trusts can only be promoted in two non-local cities with a minimum requirement of RMB 1 mn on contract value, according to regulations by the CBRC. And one trust firm can promote a maximum of two non-local trust products. Furthermore, non-local trust products are subject to approval of local CBRC branches five days prior to the start of sales.
- High requirements and long procedures in setting up collective trusts. Set up of collective trusts are subject to the CRBC's approval with various requirements on documents such as contracts, due diligence reports, trust proposals, legal opinions, etc. On the other side, single trusts are more similar to off-the-counter contracts and subject to no disclosure requirements or approval from the regulatory body.

Bankers are the ultimate lenders in most trust products, which totaled RMB 7.6 tn by the end of 2013. The single trust business includes bank-trust, bank-security firms-trust and government-trust cooperation. Banks are the ultimate lenders for the first two types of trusts. They increasingly had recourse to trust products to continue lending to risky companies amid increasing regulatory constraints imposed by the government. By using trust companies as a channel and other financial institutions as bridge actors, banks were able to circumvent the regulation related to capital adequacy ratios, loan/deposit ratios and to profit from regulatory arbitrage. In most cases of single trust funds, and despite the complex financial architecture of the products, banks remain exposed to assets of particularly risky borrowers.

The bulk of trust products are concentrated in real estate, local government sponsored infrastructure and mining projects

End users of trusts funds are companies developing capital intensive projects and facing difficulties in obtaining new bank loans. Real estate projects, local government sponsored infrastructure projects, and mining activities represent the main destinations of funds originating from trust products. At the end of 2013, the three sectors represented 53.6% of trusts' total AUM.

Trust products outstanding across destinations (RMB, tn)

	Total	of which:		
		Real estate projects (estimate)	Local government sponsored infrastructure projects	Mining projects
1Q14	11.7	3.5	2.6	0.15
2013	10.9	3.2	2.6	0.14
2012	7.5	2.1	1.6	0.09
2011	4.8	1.4	1.0	0.06
2010	3.0	0.8	1.0	0.01

Source: CTA, Wind, Yongyi trust, HTI

- **Trusts for real estate projects in "Land King" competition.** Originally, real estate developers solicited trust companies to acquire land, which was required by banks as collateral to fund new developments. Trust products quickly contributed to the emergence of "Land Kings" in major cities of China and fueled a new bubble in the housing market. As an illustration of this, developers saw their average Debt-to-Asset ratio climb to 70-80% in 2011-2013 compared to 30-40% before the 2007-2009 financial crisis. Large SOEs helped increase this leverage as they were able to borrow at cheap conditions (around 6%) from national commercial banks and lend the money to developers at 12-18% via direct lending or via the purchase of single trust products. According to data provided by the China Trust Association, enterprise trusts (as opposed to real estate trusts) hit RMB 2.9 tn in 2013. We estimate that 75% of these trusts are in fact indirectly related to real estate projects. In sum, the outstanding amount of real estate trusts reached 3.2 tn by 2013, representing twice the amount reached in 2011 (RMB 1.4 tn). Risks in the real estate sector have markedly increased amid tightening liquidity conditions, higher requirements for banks lending to developers and the upcoming property tax after installation of the national housing registration system.

- **Trusts for local government sponsored infrastructure projects under a boom of subway, express, airport, port projects pushed by the stimulus package.** One fourth of public infrastructure projects are sponsored by local governments. An aggressive wave of infrastructure projects initiated under the 2008-2009 RMB 4 tn stimulus packages targets the construction of subways in 40 cities by 2020 representing 7000 km of rail, the installation of 85,000 km of railway lines by 2015, and the renovation and creation of 230 airports by 2015. All of these projects have high capital requirements, but the resulting high funding needs of local governments could not be satisfied by banks. The so-called government-trust cooperation quickly developed on the basis of these high funding needs and the 1994 budget law, which forbids regional governments to issue bonds. 50% of trust-government cooperation implicates local government financing vehicles (LGFVs), while 50% of them are officially attributed to local government infrastructure projects. In February 2012, the CBRC required commercial banks to classify commercial loans to LGFVs into so called "support, maintain, compression and exit" categories. Regarding the two first categories, commercial banks could continue supporting credit or maintain it at its at current level. For the two other categories (compression, exit"), banks have to tighten their credit conditions or completely stop lending. Local governments then turned to "urban construction investment bonds" (China's quasi-municipal bonds) or trust funds to fund their activities. However, higher requirements on "urban construction investment bonds" made trust products more attractive. Outstanding trusts for local government sponsored projects soared to RMB 2.6 tn by 2013.

- **Trusts for mining projects driven by a wave of M&A.** A M&A wave in the mining sector, supported by the central government's goal to consolidate resources, promote energy efficiency and better protect the environment, ignited large financing demand starting from 2010. Trust structures quickly developed in this sector. The fever lasted for three years and then quickly cooled down due to rapidly falling coal prices from 2012. The lack of transparency in collateralization of coal mines, excessive leverage with relatively short maturity of debt, and high yields have all turned mining trusts into dangerous assets. Worries over the debt servicing capacity of mining trusts have rapidly grown after several products were revealed to be on the verge of default.

2. Current payment difficulties of trust fund companies are only the tip of the iceberg

The strong development of trust products in the real estate sector, in relation with infrastructure projects of local governments and in the mining industry, was unavoidably accompanied with increasing default rates, which expose final investors to potential losses. This increasing probability of default is concomitant with a wave of payoffs, which are due in 2014 and 2015, amid shortened maturities and higher interest rate charges.

Increasing default rates have increased the charge of interest payments and shortened the maturity of trust products

Trust products are concentrated in sectors which saw a rapid increase of nonperforming loans. For the real estate sector, tightening credit and liquidity conditions, as well as macro-prudential policies of the government have triggered a deceleration of price and activity in the housing market and negatively impacted the collateral value of loans issued by trust companies. Regarding the cooperation between governments and trusts, the low profitability of infrastructure projects and overstatements of their future cash-flows have led to rising concerns among domestic rating agencies, which have growingly envisaged downgrades of LGFV credit ratings. In the mining sector, the context of economic deceleration and reining in of overcapacities by the government triggered corrections on commodity prices at a global level, highlighting a risk of collateral over-valuation.

Distribution by sector of trust credit events in 2012-13

Sector	Amount (RMB bn)	Percentage
Mining	9.1	47.6%
Real estate	7.3	38.3%
Construction material	2.0	10.3%
Other	0.7	3.7%

Source: Wind, HTI

Real estate trust products suffered from cooling housing market

The recent deceleration of the housing market amid falling real estate investment in China raised market concerns on risks linked to real estate collective trusts. Real estate trusts represent 40% of all troubled trusts in the past two years, being ranked right after mining trusts. Alongside shrinking market confidence and tighter credit conditions, real estate companies are facing increasing difficulties on fundraising to sustain their activities amid declining operating cash flows. Higher risk linked to the real estate sector led to suspension of real estate development loans by some banks. Their rising financing costs have in turn contributed to further deteriorate financial conditions of real estate companies. This tightening of financing conditions also mirrored increasing doubts on the real value of collaterals.

- Inflated collateral value. Taking one troubled real estate trust product, the collective trust loans of Qingdao Kaiyue center, as an example, the collateral was initially valued at about RMB 1 bn, which later was valued at RMB 0.6 bn only after the default of the developer. The price of collateral further declined to RMB 370 mn in the third round of auction, falling to less than 40% of the original assessed value.
- Land collateral≠housing collateral. Newly built houses on the land are not part of the collateral even though the land is collateralized, according to Article 35 of the Guarantee Law. Trust firms therefore only get proceeds from the sale of land but not the sale of houses in the auction of collaterals.
- Immediate processing of land collateral required. 20% of land value is charged by the government if a piece of land is not developed within 2 years, according to “Regulations regarding promoting efficient use of land” published by the State Council in 2008. Any land that has been idle for more than 2 years would be taken over by the government. In case of default, the trust companies may need to accept a large discount on the price of land in order to sell fast.

The analysis of a RMB 80 bn sample of collective real estate trusts due in 2014 revealed that the eastern region is relatively more exposed. Half of the collective trusts linked to real estate due in 2014 are invested in the provinces of Guangdong, Jiangsu, Chongqing, Zhejiang and Sichuan (trust companies in Guangdong and Beijing issued about 40% of real estate collective trust products due 2014). Generally, most tier-1 and tier-2 cities require 8-14 months to liquidate their inventories of real estate properties, while tier-3 and tier-4 cities take 20-100 months. Default risks of real estate trusts in tier 3-4 cities in these areas should therefore be highlighted.

Collective real-estate-related trust products due in 2014 across regions

Issuing place	%	Projects location	%
Guangdong	25.1	Guangdong	13.8
Beijing	13.4	Jiangsu	13.7
Zhejiang	8.4	Chongqing	7.7
Sichuan	8.2	Zhejiang	7.0
Chongqing	6.8	Sichuan	5.8
Hubei	5.9	Fujian	5.8
Jiangxi	5.2	Shanghai	5.3
Shaanxi	4.9	Shaanxi	5.0
Heilongjiang	4.4	Tianjin	4.4

Source: Company data, HTI

The risk of local-government-related trust products remains under control

Total local government-related collective trusts due in 2014 are expected to reach RMB 300 bn. Despite its large scale, associated risks are under control due to implicit guarantees from the governments. Only a few troubled trust products were related to local-government financing vehicles or investment companies in the past two years.

- Fraud capital injection. Some LGFVs injected non-owned land or public assets such as public hospitals or government buildings, which led to overestimation of the solvency situation of certain LGFVs by trust companies.
- Non-transparent debt levels of local governments make it difficult for trust companies and investors to assess actual risks.

A RMB 70 bn sample of collective local government related trusts due in 2014 was analyzed and revealed the following structure of risks:

- Jiangsu province is the most exposed, accounting for 36.6% of our sample. Tianjin, Chongqing, Liaoning and Sichuan also occupy relatively high percentages.
- Trust products are concentrated in Beijing, Guangdong, Shanghai and Chongqing in terms of issuance place. These four provinces or cities take about 40% of the all the local government related collective trusts.
- Questionable securitized account receivables by LGFVs. Account receivables were used by many LGFVs as collaterals in establishment of trust products. Two examples are “Suzhou new district SOE accounts receivable trust” and “MinHui No 4 Xiangcheng district accounts receivable trust” in Jiangsu, totaling more than RMB 1 bn. These accounts receivables may be subject to liquidation difficulties in the event of auctions when related trust products default.

Collective local-government-related trust products due in 2014 across regions

Issuing place	%	Projects location	%
Beijing	20.7	Jiangsu	36.6
Guangdong	12.0	Tianjin	12.0
Shanghai	7.5	Chongqing	6.5
Chongqing	6.6	Liaoning	6.3
Jiangxi	5.1	Sichuan	5.6
Jiangsu	5.0	Inner Mongolia	4.9
Zhejiang	4.8	Zhejiang	4.6
Sichuan	4.8	Anhui	4.0
Anhui	4.1	Guangxi	3.1

Source: Company data, HTI

Mining trust products are exposed to valuation risks from collateral

The case of "Zhichengjinkai No.1" in January was only the beginning of the crisis impacting mining trusts. Collective mining trusts due are expected to hit a record high of RMB 17 bn in 2014. Despite its relatively small size, mining trusts accounted for almost half of all troubled trusts over the past 2 years. Higher frequency of default for mining trusts was primarily due to the following reasons:

- Limited exits on collateralized mining rights. Trust firms have to resell collateralized mining rights in the event of liquidation as they are not qualified to explore mines due to high entry requirements and restrictions in the mining sector. Limited number of qualified mining companies means limited exit options and liquidity for collateralized mining rights, which may be subject to a large discount.
- Overestimated collateral value. Valuation of mines in the trust set up was generally based on all potential output of mines regardless of difficulties and costs arising in the mining process, which suggests an overestimation of value.
- Declining commodity prices in recent years. Prices of coal and ferrous metal have declined by about 30% and 25% respectively since 2012, which directly led to further decline in the value of collaterals.
- Large average size. The average size of mining products is over RMB 200 mn, which exceeds the bailout capacity of most trust firms.

A RMB 12.1 bn sample of collective mining trusts due in 2014 was analyzed, revealing the following risks.

- Mining trusts concentrated in central and western regions. Most of the mining trusts were linked to provinces with rich mining resources, such as Shanxi, Inner Mongolia, Henan and Shaanxi. These four provinces accounted for more than half of all outstanding mining trust products in China.
- Nearly 80% of mining trust products were issued in Beijing, Guangdong and Gansu. As non-local sale of collective trust products involves more tedious procedures and restrictions, investors from the above-mentioned regions are more exposed to default risks of mining trust products.
- Several mining trusts due in 2014 issued by Jiangxi international trust, China Jiantou trust and Changan trust, valued at RMB 1.5 bn, 0.6 bn and 0.2 bn respectively, are at risk as its beneficiary Liansheng Group (a resource company located in Shanxi) is on the verge of bankruptcy.

Collective mining-related trust products due in 2014 across regions

Issuing place	%	Projects location	%
Beijing	38.9	Shanxi	24.9
Guangdong	20.8	Inner Mongolia	11.4
Gansu	20.5	Henan	11.2
Tianjing	9.8	Shaanxi	8.9
Jiling	3.3	Anhui	8.3
Heilongjiang	1.9	Guizhou	5.7
Chongqing	1.7	Hebei	5.5
Sichuan	1.4	Tianjing	5.0
Shaanxi	1.4	Qinghai	5.0

Source: Company data, HTI

3. This time will be different

The rule of unconditional payoff, which implicitly promises the absence of default on trust products, should be broken in the two coming years due to insufficient capital and provisions compared to the size of potential losses. An important reshuffling of the trust sector is likely to take place, embodied by a wave of bankruptcies and M&As, leading to a higher concentration in this industry. Banks will mainly assume the burden of losses in single trust products. They will therefore assume higher levels of non-performing loans as well as see their profitability significantly decline in a context already unfavorable to them.

A break-off of the unconditional payoff rule is likely given insufficient capital and provisions in trust companies

The trust sector has a long history of “no default” due to the protection by the government or the reimbursement by trust companies of defaulting trust products. In a recent past, the unconditional payoff rule has prevailed. The PBOC, CBRC, CSRC and Ministry of Finance jointly published two regulations in 2004 and 2006 respectively, setting up a fund to buy back defaulting debt obligations (individual deposits, bonds issued by financial institutions, other debt obligations such as trust products) for individual investors. The first batch of regulation voted in 2004 followed difficulties of a trust fund, which incited the government to officially back all trust products issued before September 2004. Another batch of regulation was issued and ensured the backing of trust products issued between September 2004 and January 2006. This system already featured a less generous system of loss compensation with various degrees of reimbursement being inversely proportional to the size of the investment (small investors being favored). These temporary regulations and the recent intervention of a “third party” to pay the principal of “Zhichengjinkai No 1” trust product to investors have contributed to establish a consensus on the existence of an implicit guarantee by the government or trust companies, which is equivalent to an unconditional payoff rule.

2004 - 2006 bailout rule for collective trust products

Value of the contract (RMB)	Proportion of principal reimbursed
< 100K	100%
100K ~ 200K	90%
200K ~ 500K	80%
500K ~ 1 mn	70%
1 mn ~ 2 mn	60%
2 mn~ 3mn	50%
X > 3 mn	0%

Source: News, CBRC, HTI

From 2H14 onward, the unconditional payoff rule is likely to be broken, while the system of compensation of losses should be less generous compared to the 2004-2006 period. Given the fact that losses are expected at a significantly higher level, there is a high probability that only investments below RMB 100K could benefit from a reimbursement, while "larger" investors could be exposed to losses without any compensation. Three factors could explain a higher amount of losses compared to previous periods including size effects of the trust industry (AUM and leverage), levels of default rates and stringency of authorities.

Firstly, the implicit guarantee of trust products may no longer be valid in 2014 due to likely higher default rates to come, higher size of AUM and leverage in the trust sector, and higher stringency imposed by the government compared to the 2004 – 2006 period. Larger size of AUM and higher leverage both foreshadow larger losses. The rapid growth of AUM was not accompanied with similar progression of paid-in capital or loss provisions, reducing the capacity of trust companies to absorb potential losses. This capacity to absorb losses is inversely proportional to the leverage ratio, which has increased to 42.7 in 2013 from 23 in 2010 for the sector as a whole. In this context, an average default rate of 2.35% would require an external bailout due to trust companies lacking enough resources to pay back such an amount.

Size and leverage of trusts sector (RMB, bn)

	Sector AUM (1)	Paid in capital	Loss provision	Retained profit	Total equity (5)	Leverage ratio (1)/(5)
2013	10907.1	111.7	9.1	84.9	255.5	42.7
2012	7470.6	98.0	6.2	61.2	203.0	36.8
2011	4811.4	87.1	4.3	42.4	163.0	29.5
2010	3040.5	73.8	2.9	27.2	132.0	23.0

Source: CTA, HTI

Secondly, default rates are likely to be higher compared to 2004 – 2006. In the past, the non-performing ratio of the trust sector has regularly exceeded the threshold of 2.3%, reaching values above 4% between 2007 and 2009. For the whole banking sector, the bad loan ratio reached 1% in 4Q13 (the highest since 2008) and is expected at 1.2% for 2014. The most recent estimates on non-performing ratios of the trust sector mention levels close to 1.6% in 2013. There is therefore a potential for a significant and quick increase of default rates among trust products. The rise of default rates will probably be explained by a tightening of funding conditions, which will reduce the capacity of final borrowers to roll-over their debt. The determination of the government to better control shadow banking, the deceleration of the economy and the difficulties of the real estate sector will contribute to significantly increase the difficulties of final borrowers to roll-over their debt. In these circumstances, default rates of trust products are likely to rapidly increase to levels above 4%.

Non-performing ratio of trust sector (%)

	Average	Median	Max
2009	4.2	1.6	15.7
2008	4.3	1.7	37.4
2007	5.5	1.5	33.7

Source: Company data, HTI

Thirdly, the government could be more stringent in establishing bailout rules amid official calls for better control over shadow banking activities. The proportion of contracts being reimbursed could be reduced, with only nominal amounts below RMB 100K possibly being covered. The CBRC published the “File No 99” on April 8, 2014 imposing stricter regulations on the trust sector and suggesting an exit from the bailout philosophy. The “File No 99” requires all trust firms to closely monitor likely-to-default trust products, establish asset disposal mechanisms beforehand and provide liquidity buffers when necessary. All newly issued trust products are required to be declared to the relevant regulatory body. The “File No 99” also highlighted the concept of “self-responsibility” for investors of trust products, suggesting an end to the bailout philosophy. The PBOC pointed out the same view in its “China Financial Stability Report 2014” published on April 29, 2014, when it stated that the bailout rule should cease along with better control of systemic risk, strengthening of investor education and better perception of risk in the public.

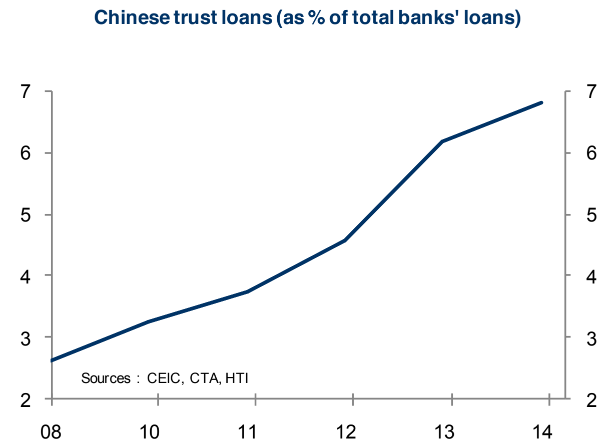
The trust fund sector to undergo a wave of drastic reshuffling

Trust firms, a large number of which adopted overly aggressive strategies, may inevitably face bankruptcy in the coming months. “Regulations on trust firms” require trust firms to bail out trusts products if they are considered as having been negligent in terms of due diligence. Recent reports suggest that reckless background checks and obvious over-valuation of assets are common practice in the trust sector. Trust firms with insufficient capital are likely to be acquired by large trust firms which have solid capital backing and parent companies with deep pockets. Consolidation in the trust sector is therefore expected alongside increasing default rates. Pudong development bank announced in March 2014 that it will acquire Shanghai Trust, becoming the fourth trust firm under commercial banks following the Bank of Communications international trust, CCB trust and China industrial international trust. Taikang insurance also bought in SDIC trust via private placement in January, doubling its capital from RMB 1.8 bn to RMB 4 bn. The most fragile trust companies are those characterized by high leverage, which is generally above 100 in the most risky cases. These trust companies have also undergone an overly quick development of their AUM, which sometimes more than doubled in less than one year. Finally, trust companies with non-performing loans above 4% (largely above the current average) are also likely to face growing difficulties as there is a higher probability that credit quality will worsen.

Intervention from the government via asset management companies or via the investor protection fund is likely to be adopted once the wave of defaults becomes too large. In 1999, China created four AMCs (Asset management Companies, namely Cinda, Huarong, Great Wall and Orient) to take over the bad debt of Chinese commercial banks. The same strategy could be adopted with the trust fund industry. AMC companies could acquire troubled assets from trust funds and gradually liquidate them. This “Time for liquidity” strategy would benefit from the support of the government and PBOC.

Banks to bear the bulk of losses

Given that regulatory bodies are unlikely to bailout single trust products, and that single products represent 73% of the trust sector’s outstanding AUM, banks are the most exposed to losses in the case of a quick deterioration in asset quality. Commercial banks are generally the real final owners of single trust products. They will therefore have to assume the losses linked to single trust products. The bailing-in capacity of the banking sector is unquestionable due to the huge size of capital and provisions. Assets of the commercial banking sector totaled RMB 125 tn in 1Q14. On the other hand, the current amount of single trust products due in 2014 amounts to RMB 4.1 tn. Assuming a non-performing ratio of 5% for single trusts in 2014, total loss of RMB 0.2 tn would trigger an increase by 0.2% of the total NPL ratio at the end of the year (NPL ratio of Chinese commercial banks was at 1.04% in 1Q14.). The shock is therefore largely absorbable by commercial banks.



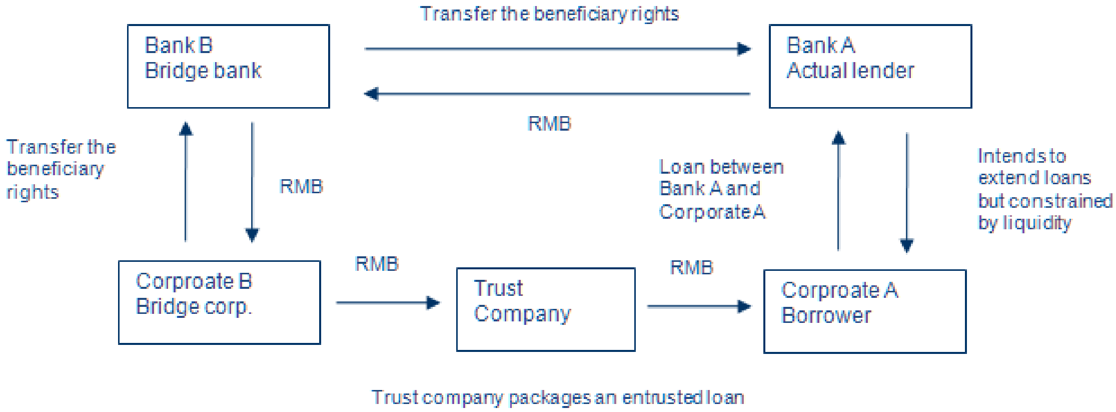
Therefore, the banking sector has enough capital buffers to absorb any losses in this sector. However, a wave of defaults would have significant consequences on several levels.

- Capital needs of banks will increase in order to absorb losses.
- The risk premium of banks would increase, further tightening their funding conditions and negatively impacting their profitability, which is already under pressure because of the deceleration of the economy and the correction currently at work in the real estate market.
- Small regional banks should face higher difficulties as their lower degree of diversification represents an additional risk compared to hazardous local projects.
- Difficulties of these regional banks could represent an obstacle to the continuation of investment projects and therefore play on the level of growth.
- Developers, largely dependent of funds coming from trusts, could be further penalized as investors will require increasing returns to compensate for the risk and instability inherent to trust products.

The risk of an interbank market freeze represents the main issue

Trust products are at the heart of the quick development of interbank activities and strong development of shadow banking. Via a complex chain using several bridge companies, banks can supply loans to risky companies via the issuance of trust products with the help of trust companies. The purchase of beneficiary rights backed on these trust products on the interbank market eventually allows banks to benefit from high returns linked to the original risky loans. In 2013, inter-bank activities linked to trust beneficiary rights under inter-bank activities were estimated at RMB 1.35 to 2 trillion, which accounted for 17.8% to 26.3% of single trust AUM in 2013. This process has largely underpinned the quick rise of interbank assets, which reached RMB 21.5 tn at the end of 2013 compared to RMB 6.5 tn at the end of 2008.

Trust products as interbanking assets



Sources: CIMB, HTI

The main risks related to complex financial products are related to the freezing of the money market when actors of the interbank system do not really know the exposure of their counterparties to potential losses linked to toxic products. In the absence of any certainty on the solidity of other banks, financial institutions could be incited to stop exchanging liquidities, triggering defaults not for investment or credit reasons but for liquidity reasons. In this case, the freezing of the interbank market impacts the whole economy via the blockage of the whole financing system via the stalling of credit. The different risks related to trust products in the interbank market are the following.

- **Liquidity risk.** Cash hoarding strategies could be adopted by Chinese banks in the case of a quicker accumulation of losses at the level of trust products. In a context of heightened uncertainty on the exact location of losses, banks could significantly tighten the conditions to which they distribute their surplus of liquidity. Banks in urgent need of liquidity could default due to the impossibility of assuming their short-term liabilities.
- **Maturity transformation risk.** Shadow banks traditionally borrow short (they have short-term liabilities) to lend or invest on long-term assets. In contrary with other financial institutions, shadow banks cannot access the liquidity facility of the central bank in emergency cases while they do not provide any insurance to depositors (hence the name of shadow bank). At the same time, these shadow banks are active members of the interbank market as they borrow and lend liquidities to banks. Trust companies and money market funds such as Yu'e Bao are part of the shadow banking system in China. The maturity transformation risk could occur in the case of increasing doubts on the value of the long-term assets in which shadow banks invest. Fire sales of these assets could endanger these institutions, which had previously become active participants of the interbank market.
- **Credit risk** is linked to the possibility of a default in the repayment of a loan effectuated in the interbank market. In this case, it is worth mentioning the case of special financing platforms of local governments, which can issue debt on China's interbank market. This specificity of China's interbank market, coupled with doubts on the viability of investments made by these vehicles, could represent another element contributing to freeze the interbank market and block the rest of the economy. In particular, credit risk is present at this level as no one knows if local governments will be able to infinitely roll-over their debt for hazardous projects.
- **Risk of deterioration in the value of collateral**. Any doubts on the value of trust products would have ripple effects on beneficiary rights, which were increasingly used as collateral in interbank transactions. The drying up of beneficiary rights as collateral could represent another factor triggering a freezing of the money market.
- **Leverage risk.** Leverage positions of trust companies could accentuate the level of losses and have significant impact on the interbank market. A high degree of leverage means a lower level of capital cushion to absorb potential losses. Trust companies could therefore be exposed to rapidly mounting difficulties. While on certain occasions, they would be protected by banks which implicitly guarantee their activity, the uncertainty surrounding the effectiveness of these guarantees could represent another element fostering distrust in the interbank market.
- **Bank run risk.** Banks or money market funds exposed to trust products could be exposed to a run by depositors or investors, which could jeopardize their liquidity and stability, as well as impact the rest of the interbank market via repercussion effects.

The new regulation will force banks to put off-balance assets back into their balance sheets. Costs for commercial banks engaged in such activities will increase. The prohibition of any explicit or implicit guarantees of inter-bank activities will intensify concerns from financial institutions (generally trust companies), which provide so-called "channeling services". As a result, "channeling services" provided by trust companies could significantly decline. Regulators have taken actions to curb shadow banking lending activities. On 16th May 2014, five regulators including the PBOC, CBRC, CSRC, CIRC and SAFE jointly issued the "File No.127" to regulate inter-bank business, which is a key component of shadow banking activities. This file includes the following key features.

- **Loans disguised as inter-bank business must be listed as on-balance-sheet items.** In the past, banks disguised lending activities via repo agreements under inter-bank activities. They now need to report these loans on their balance sheets, which will have a direct impact on the calculation of their loan-to-deposit ratio.
- **Repo agreements only apply to "Standard" financial assets with highest liquidity.** Repo activities involving the so-called "non-standard assets" like trust beneficiary rights would progressively be forbidden.
- **Higher capital and reserve requirement for "non-standard asset" investments.** Commercial banks can still directly invest in "non-standard assets" such as trust beneficiary rights, WMP and the asset management plans of security firms or mutual funds. Banks will be required to apply same risk weight and loss provision ratios to inter-bank loans as normal loans.
- Lending to any financial institution by one bank is **capped at 50% of its tier-1 capital** and the inter-banking borrowing is **capped at 33% of its total liabilities.**
- **Explicit or implicit guarantees for repo or investment of inter-bank activities are prohibited**. Under the single trust structure, banks generally provide explicit or implicit guarantees to the counterparties which provide "channeling services". This practice helps banks to translate corporate loans to less risky inter-bank lending, but will no longer be available following in implementation of "File No.127".

Conclusion. New regulation and alternative sources of funding are needed to better control shadow banking

Faced with increasing risks of defaults in the trust sector, the government has already adapted a regulatory framework with the so-called "File No. 99" and the "File No. 127" on inter-banking activities. However, this effort of supervision should be extended to the whole shadow banking sector including internet financing, trusts, leasing companies, credit-guarantee outfits and money market funds. An integrated supervision of the system is required to reduce risks and promote fair competition. A deposit insurance system is also urgently needed to reduce the risk of a run on a bank exposed to losses linked to trust products, but also to clarify the status of wealth management products as a form of deposit.

In 2013, inter-bank activities linked to trust beneficiary rights were estimated at RMB 1.35 to 2 trillion, which accounted for 17.8% to 26.3% of single trust AUM in 2013. The new regulation will force banks to put off balance assets back into their balance sheets. Costs for commercial banks engaged in such activities will increase. The prohibition of any explicit or implicit guarantees of inter-bank activities will intensify concerns from financial institutions (generally trust companies), which provide so-called "channeling services". As a result, "channeling services" provided by trust companies could significantly decline.

Stricter regulations on shadow banking should be accompanied with the promotion of more diversified financing channels, accelerating the development of the bond market, shortening the IPO listing process and easing access of private capital to infrastructure projects. The diversification of financing channels has been established as a priority by the 3rd plenary session of November 2013, the working conference of December 2013 and the NPC of March 2014.

Financing leases are one solution that could be explored to improve financing efficiency. Compared to other financing methods, this does not require large down payments and can help companies keep their equipment up to date. Because of its inherent advantages, financing leases may see a rapid boom in the coming years in sectors such as automobile, aeronautical and healthcare. The market size has been estimated at RMB 3 tn in 2014 with two-digit growth in following years. In the June 2013 regulatory meeting of the State Council, Premier Li highlighted the importance of developing financial leases as a key element of China's economic restructuring.