Orient Capital Research

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Trusts in China

When Will the Party End?

- **Fast Growth.** The Chinese Trust industry grew 46% in 2013 to 10.9 trillion RMB. To assess industry risks, we collected data on 6,491 individual Trust Products issued by 59 Chinese Trusts. We also conducted in-depth interviews with six Trusts.

- **Weak Sectors.** Trust loans to property and infrastructure have risen sharply as a percent of total trusts. We believe these are two of the most default prone sectors.

- **Interest Rates Falling.** The average rate of interest for products we surveyed fell 54 basis points in 2013 YoY as liquidity continued to rise. Risk is not being priced in by Trust distributors.

- **Land is Key.** We examined in detail thirty Trust prospectuses. Their reliance on land for equity, and collateral, and investment target, are systemic risks.

- **Nervous Industry.** Our interviews with Trust executives indicate increasing concerned concerns about the risks, both from stronger regulations and the systemic risk from the linkages between Trust products.

Trust by Investment Type (RMB Mln)	Amount	% Total
Loan	*4,858,081*	*47.1%*
Long Term Bonds	*1,908,914*	*18.5%*
Long Term Equity	*937,749*	*9.1%*
Short Term Investment	*937,625*	*9.1%*
Other	*764,653*	*7.4%*
Due from Banks	*702,488*	*6.8%*
Purchase and Sellback	*189,413*	*1.8%*
Lease	*9,600*	*0.1%*
Total	*10,308,523*	

Source: China Trustee Association

Summary

Rising Risks

Adequate Resources to Handle Defaults but Political Roadblocks Will Slow the Process

The trust sector has grown from 2.3 trillion RMB in 2010 to 10.9 trillion RMB at the end of 2013. Total outstanding issuance rose 46% in 2013 to 10.9 trillion RMB. That growth, along with the lack of transparency in the industry, inadequate risk assessment, and lack of due diligence among buyers, has raised alarms about the solvency of Trust products. Those concerns have been amplified by the near defaults of two trust products: A 3 billion RMB product from China Credit Trust called Credit Equals Gold No. 1, sold by the ICBC Bank; and a 973 million RMB product sold by Jilin Province Trust Co. and distributed by Haitong Securities. China Credit has agreed to refund investors, while no resolution has yet been reached with the Jilin Trust as of this writing.

In this report, we analyze data collected for **6,491 Trust products issued by 59 Trust companies** in 2010, 2011 and 2012, and 2013, many of them due to mature in 2014 and 2015. We also analyzed historical data to understand and forecast Trust trends, including default risks. In addition, we discuss our interviews with Trust officials, and conclusions from analysis of the prospectuses of 30 trust products.

On balance, ***the potential for default in the Trust market is rising***. Trusts continue to sell Trust products at an increasing rate, despite the widespread concerns about liquidity mismatch, the ability of borrowers to repay, and a slowing economy. In addition, there is more lending to two sectors that are arguably the most vulnerable to problems in the macro-economy: property and infrastructure. The property market may collapse due to excessive investment, and infrastructure investment is confronting a time mismatch between loans and investments.

Despite the growing problems in the industry, the average interest rate among the products we surveyed ***actually fell*** in 2013 to 9.81% from 10.35% in 2012. Lenders are failing to properly weigh the potential profitability the target investments. Tighter liquidity conditions as the impact of the stimulus declines should lead to higher rates.

We discuss in more detail the scope of the potential default risk from the Trust market. We

also speculate on the potential response from different arms of government, including regulators (CBRC and PBOC), the trusts (mostly government owned), and the state banks (who hold 80% of savings).

We also look at the pools of capital that may be available in case of a significant bailout of the Trust industry – and by extension, Shadow Banking in general. We agree with the argument often made within China that there are ample capital resources to handle large scale defaults. However, we believe ***the mechanism of transmission through the political system is likely to be a roadblock to rapid resolution of system risks from significant defaults.*** We first outline the conclusions from our data and interviews and then discuss the potential outcomes.

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Survey Data: Rising Risks

For our survey we collected data on 6,491 Trust products issued by 59 Trust companies. This totaled 1.362 trillion RMB of capital raised from 2010 to 2013. This is actually a small portion of the total market, which had 10.9 trillion of outstanding Trust products in 2013, according to the association representing the Trust industry. However believe our sample is a useful indicator of trends in the Trust industry because we collected data on individual trusts and did not rely on third party aggregates.

To further breakdown the analysis, we examined the prospectuses issued for thirty individual trusts. This is a more complicated than it sounds because the Trust companies seem determined to use confusing language to describe:

a) Target investment.

b) Nature of collateral.

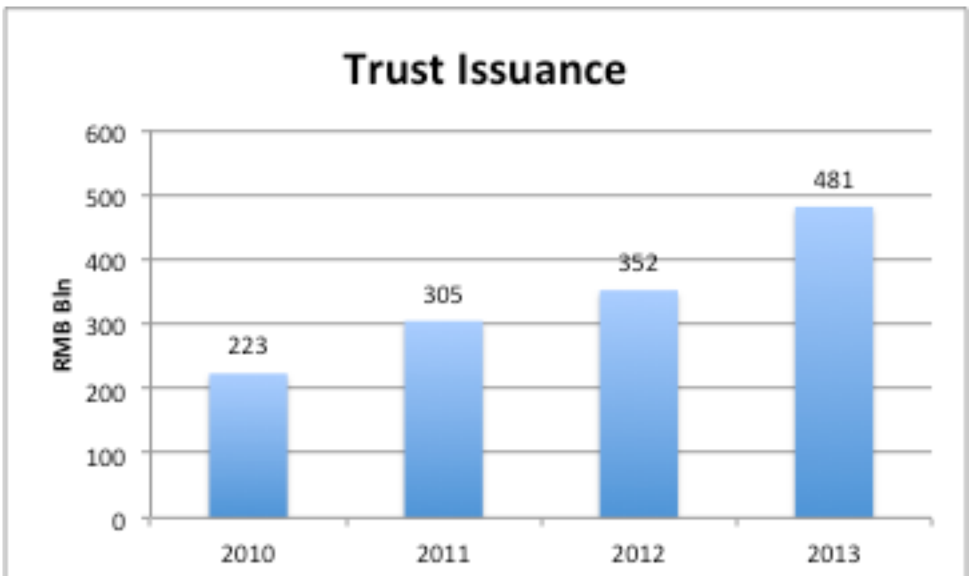
c) Connected parties issuing or participating in the Trusts.

We draw some conclusions based on this micro analysis that may be useful.

Conclusions from Our Survey

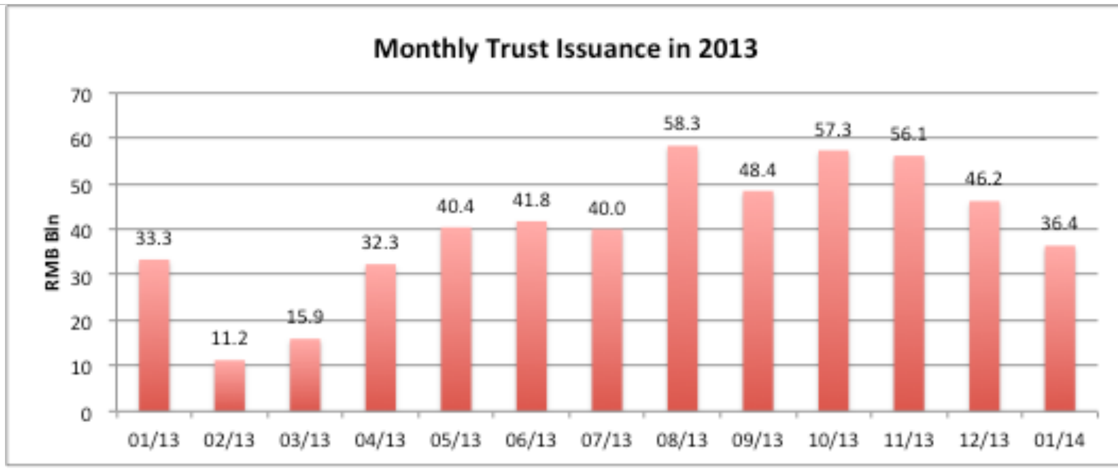
Total Assets are Rapidly Increasing

Trust issuance has been rapidly growing since 2010. Total issuance in our sample increased 36% in 2011, 16% in 2012, and 37% in 2013. Clearly, the industry's role as a non-bank lending channel has steadily increased with the tacit permission of the regulators in Beijing. The figures in the chart below are from our sample, which is approximately 45% of total Trust issuance.



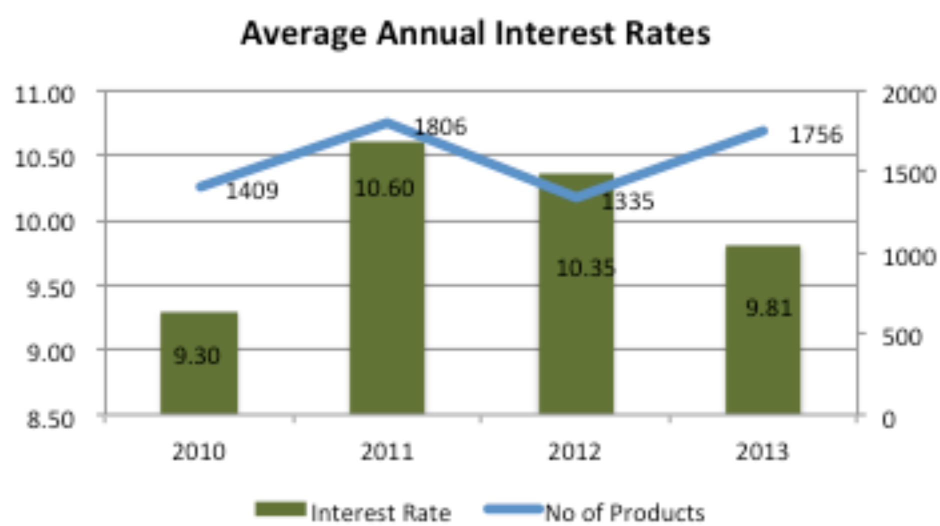
Monthly Volume in 2013 Showed Continued Growth

Trusts raised 75% more capital in the second half of 2013 than in the first half. Clearly the industry did not face a crisis of confidence in the latter half of 2013. However, there was a decline in monthly issuance from November 2013 through January 2014. This may be related to seasonal factors, including a brief slowdown in December due to banks' need to bring capital back on their books.



Interest Rates Decline As Issuance Increases

After rising in 2011, the average trust product interest rate fell in both 2012 and 2013. This reflects increasing liquidity due to the flood of trust and wealth management products in the market and the failure of issuers to take into account both increased default risk and the declining GDP growth in the economy.



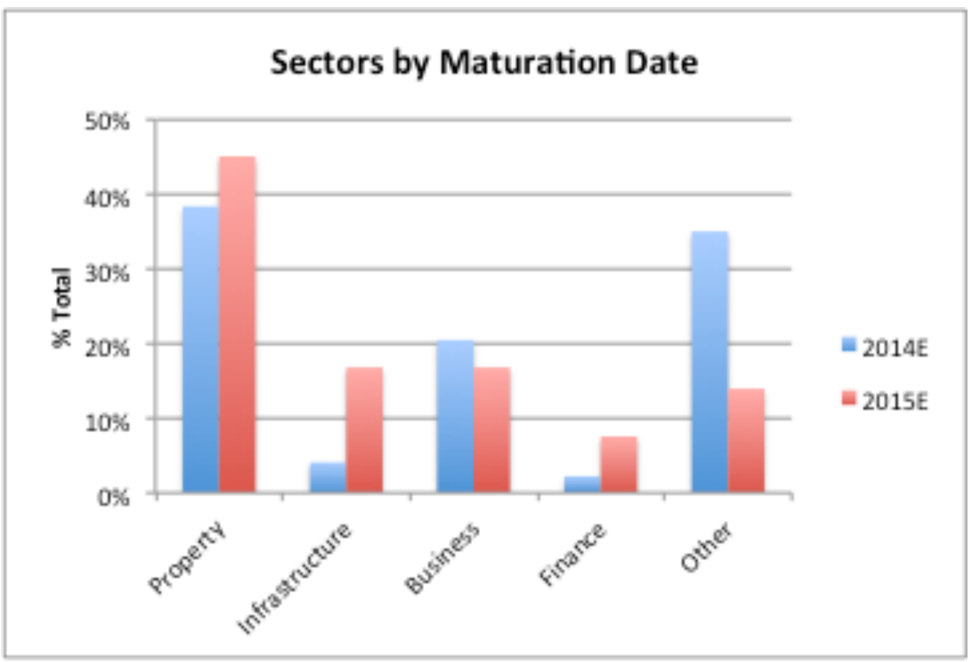
Sector Allocation Continues to Shift to Default Prone Industries

Issuance to the property and infrastructure industries will occupy a larger percentage of the products maturing in 2014 and 2015. In our sample, property will grow to 45% of the total in 2015 from 38% in 2014, while infrastructure will reach 17% in 2015 from just 4% in 2014. The other sectors, business, finance and other, are declining in importance. We believe that property and infrastructure are the most default prone sectors because:

a) There is the potential for a **bubble** that would cause a rapid deflation in asset prices, reducing the value of property as collateral for trust loans.

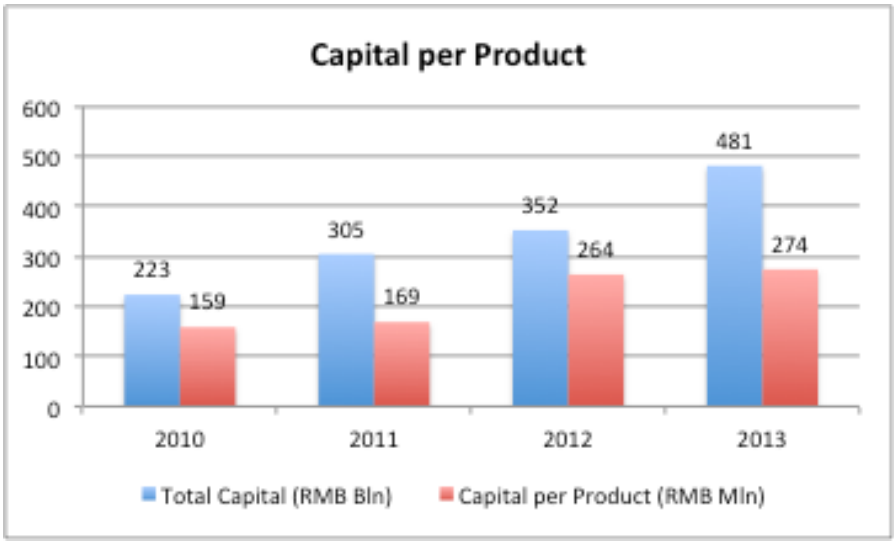
b) **Infrastructure** trusts are frequently invested in Local Government Investment Vehicles (LGFVs), whose cash flow potential may be limited and where there is also a significant maturity mismatch.

The **coal industry** is frequently mentioned as an area of trouble for Trusts. The data we obtained from the Trusts themselves did not provide a breakdown of coal Trusts. However, although coal is a heavily indebted and struggling industry, the consolidation of coal companies into larger firms is proceeding rapidly (judging from a trip we took through Shanxi Province last year). That suggests many smaller firms will be absorbed by larger companies and their debts will be consolidated. While this does not eliminate the default risk it reduces it.



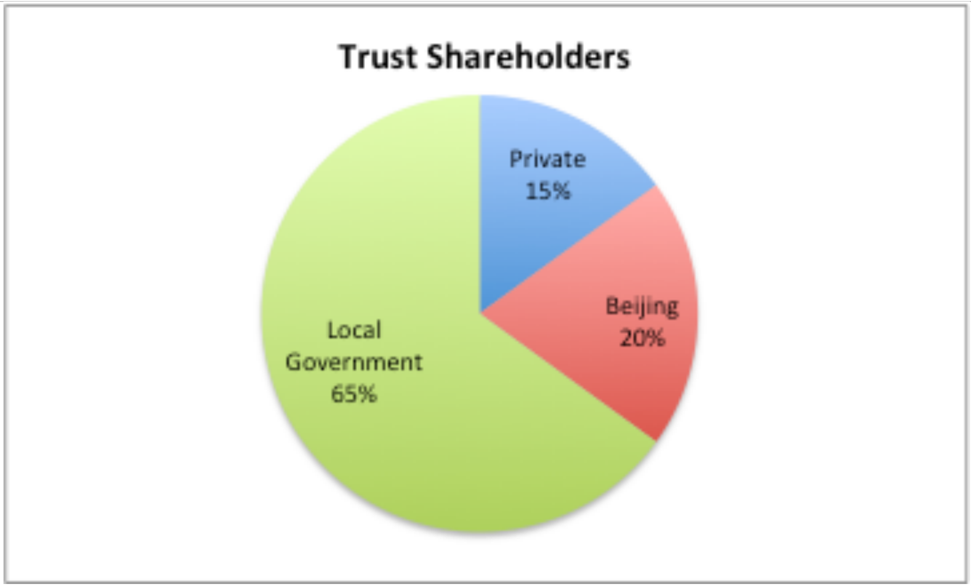
Fewer Products Raising More Funds

The industry is issuing fewer products but, with some annual variations, there is a significant trend of an increase in capital per product sold. We think distributors such as banks and investment banks have designed larger products to satisfy growing demand for high interest returns among investors. This “bulk packaging” of Trust products adds even more risk to the industry as oversight declines.



Trust Shareholders are State Entities

We estimate that 85% of Trusts in China are owned by some part of the State. We use the term estimate because many of the Trust firms have multiple stakeholders. This includes 65% owned by local government entities (including cities and provinces), and another 20% directly under the control of the Central Government in Beijing. Only 15% appear to be strictly private and even then they may have links to state entities. ***We believe this state control will have a significant affect on who bears responsibilities for defaulting products***, as we discuss below.



China's Hidden Leverage

Analysis of Trust Prospectuses

In this section, we analyze data on the collateral and obligations in thirty Trust products.

Chinese often argue that their country cannot undergo a financial crisis because mortgages are a small part of the economy and there is virtually no mortgage securitization market. The systemic problems that led to the U.S. financial crisis just don't exist in China, in their view. We recently heard this argument from a former PBOC official in Guangzhou. China's debt is not "systemic" in the way the U.S. debt was and China has more than adequate resources (including foreign exchange and bank savings) to handle a financial crisis. UBS economist Wang Tao agrees. China's Shadow Banking is manageable because of the "lack of leverage and securitization, and mark-to-market mechanism in China's shadow banking system."

On the face of it, this view is correct. Mortgages are about 15% of GDP in China compared with 80% in the U.S. Total household debt is around 10% of GDP compared with 120% for the U.S. Meanwhile, there is virtually no securitization of mortgages in China, so the vast linkages between traded financial products and the banking system itself that led to the crisis don't exist in China.

But if we step out of China's official financial markets and examine Shadow loans, we find a very different story. While China has a very shallow official financial system, and very little traded securitized products or leveraged debt, it has a complicated shadow banking apparatus with deep ties to many parts of the official economy. The lack of transparency about this apparatus hides financial relationships that could lead to systemic problems.

The focus thus far on Trusts has been on the size of the market and whether the underlying investment has any economic value, two legitimate concerns. However, we believe the network of linkages in Trusts is a time bomb. ***After examining in detail a number of Trust products, we think there is a potential systemic risk due to the weakness of the underlying collateral, primarily land, but also including cross guarantees between different corporate and government entities.***

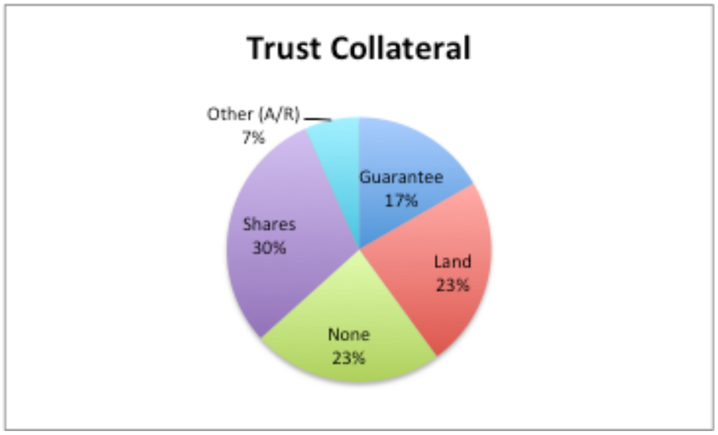
Trust Product	Collateral	Type of Collateral
Changhui Bohai Trust	Hua An Property Insurance, shares in Shanghai Shentuo Investmen	Shares
	Qingzhen, Guizhou Government Land	Land
Fuling Haozhi Project	Chongqing Fuling Government Land	Land
Chang Jing Sheng Real Estate	NA	NA
Mikawa Clean Energy Trust	250M Shares of Chuan Chuan Energy	NA
132 Industrial Park Devt Co Capital Trust	A/R Tenchong County Finance Bureau	A/R
	Jiangxi Government Land	Land
Suxin Money & Hanson B1321 (Phase II) Capital Trust scheme	Suzhou Trust and Suzhou City Joint Guarantee	Guarantee
Suxin Swiss Banking & Capital Trust Scheme city B1401	Suzhou Government and Suzhou Landscape Company Guarantee;	Shares, Guarantee
Foreign Trade Trust • dinghong the 6th Capital Trust scheme Sheet	Hainan Air Shares	Shares
	Certificates of Deposit in Grand China Airlines HNA Finance Co	Shares
	HNA Grand China Air Surety Bonds	Bonds
Department of Chengdu Bertone Chuanxin equity investments Capital Trust	Li Xu Chengdu Broadcom provides 10% of equity	Shares
	Land in Wuhu Yongfeng Township	Land
	Three Sichuan Property developers provide guarantees	Guarantee
Nantong Hui Tong Investment debt transfer and repurchase Capital Trust	NA	NA
Great Britain New Energy Property	Project Land and Construction in Progress; Other Land Assets	Land
Union Bank of Hangzhou, Xiamen trust equity transfer usufruct Capital Trust F	Shares in Biosensor Thermoelectric	Shares
	Shares in Zhejiang Thermoelectric Group as "equity Income Right"	Shares
Austrian Dollar Liquidity Loan Capital Trust Scheme	Shares in Fujian Corporation Holdings	Shares
Dragon Capital Trust	Guarantees from Science Dongguan New Century Development Co	Guarantee
Shanghai Guangfu Trust	None	None
Jintai Yi Chang Garden Trust affordable housing loan program	Shaanxi Jintai Hengye and Shaanxi Provincial Investment Group joi	Guarantee
Financial America 6th Art Capital Trust	None	None
Helen growing collection of real estate trust fund plan	Shares in Real Estate Development Co.	Shares
Eastern Pacific Group Capital Trust Loan Scheme	Land and construction in progress in Hohhot	Land, Construction
Hefei "Spring Lake" SME loan collection Feixi trust	None	NA
National Trust - Five foreign investment in dyeing operations usufruct Capital	Walmart Shopping Plaza; equity in five printing plants; Controlling sh	Property, Shares
Central Banking - [314] growth period - Capital Trust	Mortgage on Land	Mortgage
Hui Jin 679 unlisted companies Capital Trust product plans	Shares in Harbin Bank	Equity
Xu Hui Shanghai Cambridge project Stock Right Investment Trust collection p	Secondary debenture from 50% Owner, Radiant Group; Radiant's 5(	Debenture, Equity
Zhongyuan Trust 314 Capital Trust	Land	Land
Tianfu New City Construction Investment Liquidity Loans	Land; 3, Dujiangyan City, Jiangsu Investment Co., Ltd. to provide un	Land; guarantee
The East is Red No. 32 Capital Trust	None	None
Blue Ocean Capital Trust	Use rights to land in Hangzhou	Land
Hui Ying Money-Year (45) Capital Trust	None	None
Excellent debt 1388 debt investment Chenghua four projects Capital Trust	Chengdu government guarantee of repayment	None
Ginkgo 1311 Chengdu Golden Flower Project Capital Trust	Chengdu government guarantee of repayment	None

Trust Contracts Don't Reflect Risks

The hardest part of the analysis is understanding the language of prospectuses, which generally appears purposefully confusing. For example, the Zhongrong Trust 314 Capital Trust guarantor "guarantees strength and relatively good qualities." Others are so complicated it's not clear who's doing what to whom. The Hefei "Spring Lake SME loan collection Feixi Trust" states "Hefei Xingtai financing will be invited to provide a joint liability guarantee with the guarantee control rate less than 2%." Also, muddying the picture is the existence of several different entities – companies, governments, Trusts – providing guarantees, whose relationships are not clearly spelled out.

Shares are Most Common Form of Collateral

We devised a rough estimate from our sample of the underlying collateral. About one-third are company shares, 23% are based on land, 17% are guarantees, 23% don't appear to have any collateral whatsoever, and there is a small category for "other" which includes accounts receivables.



Conclusions about Trust Prospectuses

Too Much Reliance on Shares. First, the use of company shares as collateral is a lot more frequent than we had suspected. This included both traded and non-traded shares. Frequently, their value was not stated, nor were underlying financials provided.

Inadequate Land Valuation. Not surprisingly, land is a frequently used form of collateral but there doesn't seem to be any independent arbiter providing a valuation of the land.

Guarantees are Vague. There are frequent mentions of "guarantees," mainly by local governments and what look like their affiliated investment companies. But the obligations of these guarantees are not spelled out. For example, the Xu Hui Shanghai Cambridge project Stock Right Investment Trust Collection Plan Trust states that one investor, Radiant Group, is providing 50% of its shares in the targeted Trust investment project as collateral – a clearly unworkable arrangement.

A Plethora of Local Government Vehicles. Almost all of the products include some sort of off-balance sheet government investment vehicle. The whole system relies on the ability of these pseudo independent companies to raise capital, either from banks or unwitting investors.

Example of a Trust Product: The Helen Growing Collection

We have analyzed one Trust product, the Helen Growing Collection of Real Estate Trust Fund Plan, issued by Zhongrong Trust. The Trust is part of a 2.9 billion RMB Yanta City residential real estate development in the eastern suburbs of Xian.

Yanta City Reconstruction Project

The Guangdong Yi Investment Group (We assume this is an LGFV) has provided a joint liability guarantee; in addition, the Trust product has been pledged equity in three companies: the Fort Guangdong Helen Real Estate Group, the Guangzhou City Fan Sau Venture Capital, and the Xian De Maoxing Company. There's also an additional 650 million RMB in subordinated debt subscribed to by shareholders in the project.

In case of default, it's doubtful the developers could provide liquid assets given the current capital constraints on developers. The Trust itself, Zhongrong, is a likely candidate for a capital contribution during a default because it is a large and powerful Beijing based trust, with 2013 profits of 2.7 billion RMB. It also has a joint venture with State Street in Boston, which heightens the reputational risk of a default. But Zhongrong is likely to contribute only a portion of the capital as it would probably not have adequate cash on hand. Arguably, financial recourse will ultimately end up with the Guangdong Government. But why would Guangdong bail out a property development in Xian, hundreds of miles away in Shaanxi Province? We now have a case of inter-provincial politics. ***An Isolated failed residential***

development in Xian has now become the liability of the Guangdong Government.

Thus, the make-up of Trusts helps to transform them into a systemic risk:

1) **Property Underlies Many of the Trusts.** Even though the actual investment may not be a property project, the Trust itself often is inextricably linked to property or land. Land is frequently used as the equity contribution by the local government or government-funded entity. Or, it is underlying collateral for the loan being provided by the Trust. Clearly, any decline in the value of land in China is going to reduce the value of the collateral or equity in the Trust and hurt both the investment and the lenders.

2) **Shares Are Popular.** Another risk is the widespread use of shares -- traded or non-traded -- as collateral for Trust loans. The value of the tradable shares depends on the success of the investment project and also on the company that issued them. Lenders don't perform much due diligence so they often don't understand the risk. The value of non-tradable shares depends on who is doing the valuation with local accounting firms highly suspect.

3) **Complexity of Issuance.** The Trust Products are often the result of a complicated structure between local governments, local government financing vehicles (LGFV), collateral, and other investing partners. In the case of a default, or even a decline in collateral value, unwinding these structures would be difficult.

4) **Use of Trusts for Working Capital.** Even in the Trust products we examined in detail there are several examples of the use of Trust funds for corporate working capital. This suggests the corporate lacks adequate cash flow to fund operations and is a highly unstable use of capital. Trust investors are probably relying on guarantees by government or local groups that may prove weak in times of stress.

Interviews with Trust Executives

Nervous about Default Risks

We conducted in-depth interviews with officials at six Trusts. These interviews are becoming increasingly difficult because of heightened sensitivity among regulators to the threat of trust default following the high profile failures of two trust products sold by China Credit Trust and the Jilin Trust. Our conclusions:

- **Infrastructure is a Problematic Sector.** Trust officials believe that the rapid increase in investment in infrastructure poses a risk to the Trust market. As noted above, we estimate that Trust loans to infrastructure will grow to 17% of the total for loans maturing in 2015 from 4% for loans maturing in 2014. One Shanghai Trust official said the scale of Trust loans in infrastructure "could cause another scare similar to what we have seen in the property market."

- **Regulatory Crackdown on Bank Cooperation.** Although not unanimous, several Trust officials said the industry will slow down following new rules in December 2013 from the China Banking Regulatory Commission (CBRC) under the aegis of the State Council. Called Note 107, the rules allocate responsibility for Trusts among different regulators. The rules are perceived as vague by many in the financial markets but may have more weight than expected in reducing Trust investments. One Trust official said he is "looking to change jobs" because the CBRC's Note 107 will sharply curtail loans in the Trust industry.

- **Concern about a Domino Effect.** Issuers are concerned about the rising risks of the market. Trust capital is too small for the risks they are taking on. Payment to buyers often come out of Trust profits. A default of a single product could cause a collapse of the entire Trust. According to one company's database, the total revenue of 45 major trust companies in 2013 was 66.2 billion RMB with a 3.91% YoY growth rate. However, the assets managed by these companies have exceeded ten trillion, with a 60% YoY growth rate. "You see the cake (total assets) is expanding at a 20 times the speed of the edible part (revenue)."

- **Too Many Linkages—And Property is at the Bottom.** Trust officials are worried about the risk extended to the overall financial industry due to increasing connections with other financial sectors. There is also little oversight of the market. Many trust products are sold as a bundle, with investments in property, financial products (such as the interbank market) and in other sectors. These linkages mean a Trust failure could cross sector lines. The capital often is invested in several industries and frequently in non-standard assets such as credit assets, trusted loans, acceptance bills and various receivables. But "property is the only one behind these professional terms." The value of property going forward could be the largest systemic risk.

- **Banks are the Ultimate Holder.** The banks are seen as the behind-the-scenes controller of the Trust industry and may be held responsible for the majority of defaults. As one Trust official noted, "Every year, you can see plenty of close-to-default cases. Most of them are bundled with banks. In fact, banks charge more fees than trust companies in these cases. It's very clear that who the big boss is behind the curtain: banks!"

- **Recaps May be Difficult.** Trust officials say the scale of the problem is growing faster than the ability of the country to solve it. "I'm more worried about the Trusts in China than any of my colleagues. Currently, people focus on the scale and the number of defaults. However, no further attention is given after the default is solved. People concerned about the industry in China should understand that most trust defaults in China are solved by transferring the bad debts or non-performing assets. As the amount is accumulating, less and less people (refer to companies and local governments) will stand up to pay the bills."

What is the Likely Outcome of Excessive Investment in Trusts in China

How will the industry continue? Will it collapse in a "Lehman" liquidity crisis or act as a liberalizing force for interest rate reform? Are the Trusts just banks in disguise? Or ponzi schemes waiting to collapse?

We look at the "end game" for the Trust industry (and much of this analysis applies to Shadow Banking in general) and ask this question: What capital is available in China to recapitalize a systematic collapse of the Trust industry? What are the politics of such a recapitalization?

Pools of Capital and Recap Scenarios

There are several available sources of capital to recapitalize the Trust industry in case of significant collapse. These are:

- Bank Reserves
- Foreign Exchange
- State Firms

Bank Reserves

The most readily used source of bank capital is the required reserves held at the PBOC. The Required Reserve Ratio is 20%, much higher than global standards around 7%. Among the four state banks, reserves are around 8 trillion RMB. Total reserves from all banks in China was 27.4 trillion in January 2014. Cutting the RRR to international norms of around 7% would make available 17.8 trillion RMB ($2.9 trillion) for lending or other uses.

In March 2013, senior government officials hinted they were willing to do this in the face of a slowdown. According to an article by Reuters, "Cutting RRR is likely if economic growth slows further. But they may still need to wait and see the first-quarter economic data," said a senior economist with the State Information Center, a research institute affiliated with the National Development and Reform Commission, which advises the State Council. However, some have cautioned that this is a “last resort” and might raise concerns that the government was panicking. Still, it’s the easiest solution. However, there would be strong opposition among the state banks about using their capital to recapitalize failing local government investments.

Foreign Exchange

China has $3.7 trillion in foreign exchange, held mainly in the U.S. and in Europe. Some domestic Chinese economists point to this capital as available for domestic uses. However:

1) The sale of foreign exchange could cause a decline in the value of China’s overseas holdings.

2) China spends over $100 billion per year sterilizing the influx of foreign exchange.

Increasing these flows would increase this cost.

3) Injection of foreign exchange into the economy is potentially inflationary.

State Assets

China has more than 60 trillion RMB in state owned assets. These assets could be sold to provide additional capital for other purposes. This is another argument made by domestic Chinese commentators. The listing of the Asset Management Company Cinda is an example of a firm that converts state non-performing assets into useable capital. However:

1) The state also has 35 trillion in non-financial assets. However, this does not include local debt or contingent liabilities.

2) Many of these assets would be difficult to sell since they are either fixed assets, such as steel mills, or unpopular sectors, such as coal.

3) There is a significant timing mismatch between the sale of assets and the presumably short-term recapitalization needs of failed Trust products.

In sum, the easiest recapitalization scenario would be for the PBOC to lower the RRR and free up lending among the State Banks. There would be political reluctance to do so but they would have to do this under orders from the State Council.

The PBOC and CBRC: Regulators' Light Touch

Trusts are only loosely regulated by the CBRC. As a result, there is no standard Trust product. These loose regulations permit a great deal of freedom regarding interest rates, investment strategy, ownership structure, equity, and collateral. In many cases, they trust product is invested jointly with other entities, including local governments, LGFVs, and private corporates, further confusing the regulatory environment.

Regulators Try to Tighten the Strings

In 2007, concerned about the Trust industry, the CBRC limited most Trusts to a maximum of 50 people unless they had assets above 3 million RMB. Also, proprietary investments by a single Trust could not exceed 20% of its assets.

Note 107

In January 2014, the CBRC issued a document designed to further improve regulation of Trusts and the Shadow Banking market. Called Note 107, it targeted both unlicensed and lightly licensed credit intermediation companies, including online finance, micro credit, and wealth management businesses. The rules were designed to assign responsibility for regulation. Under the rules, banks fall into three categories:

1) **Unregulated.** Credit intermediaries that do not hold financial licenses and are completely unregulated, including new-type networked financial companies, third-party financial institutions, and related institutions.

2) **Loosely Regulated, Non-Licensed.** Credit intermediaries that do not hold financial license and are loosely regulated, including financing guarantee companies, small loan companies,

etc.

3) **Loosely Regulated, Licensed.** Institutions that hold financial licenses but are loosely regulated or circumvent regulations, including money market funds, asset securitization businesses, and some wealth management businesses.

These rules were perceived in the domestic financial markets as an attempt by the CBRC to control regulation of the Shadow Banking market. However, the proposal was widely viewed as ineffective. The rules effectively mean commercial bank WMPs, trust and interbank business basically do not belong to the category of shadow banking, even though their loose regulation, rapid growth, and off-balance sheet status would characterize them as Shadow Banking.

Document Number 9

Meanwhile, a draft has been circulated of a second, more strict, proposal to regulate the Shadow Banking market. Called Document Number 9, it appeared to be issued by the PBOC (although these initiatives are overseen directly by the State Council.) According to several reports, it states:

1) **100% Rule.**Lending to any single financial institution should not exceed 100% of a bank's net capital.

2) **25% Rule.** Lending to non-bank financial institutions should not exceed 25% of a bank's net capital.

3) **50% Rule.** Lending to all financial institutions should not exceed 50% of a bank's total deposits.

The proposal also would limit the duration of interbank loans to a maximum of one year and prevent banks from rolling them over at maturity. It stated that banks would have to set more capital aside against interbank assets, without quantifying the amount. However, according to market participants, the proposal has been sidelined. We can only guess at the politics behind the delays, but we note that the proposal would have forced the Trusts to abandon the lending business because of inadequate capital. At this stage in China's slowing economy, we hazard a guess that the State Council – and local governments – are concerned that closing the taps of unregulated capital flows would have too negative an impact on growth.

Ban on Fund Pools

In April 2014, the CBRC issued new rules aiming to reduce liquidity risks associated with off-balance-sheet WMPs by forbidding trusts from operating so-called "fund pools" that enable them to fund cash payouts on maturing products with the proceeds from new WMP sales. The guidelines also require trust companies to develop clear mechanisms for shareholders to provide emergency support to the trust firm during periods of liquidity stress. However, regulating whether capital comes from "fund pools" or Trust payouts will be difficult for the CBRC.

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