Orient Capital Research

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The Marriage of Insurance and Trusts

New Shadow Banking Risks

Summary

The growth of investments by China's insurance industry into Trusts started in October, 2012 after the China Insurance Regulatory Commission (CIRC) released Document 91. This was the first time regulators gave explicit permission for insurance firms to invest in domestic Trusts. By the end of 2014, insurance firm investment in Trusts and cross-shareholdings nearly doubled to Rmb 281 billion. Approximately two-thirds of insurance investment in Trust plans are in property and infrastructure, each accounting for one-third of total investment. Both of these pose industry and systemic risks. In our previous report, we looked at investments by the insurance industry in alternative assets. In this report, we drill down on the relationship between the insurance sector and the Trusts in particular.

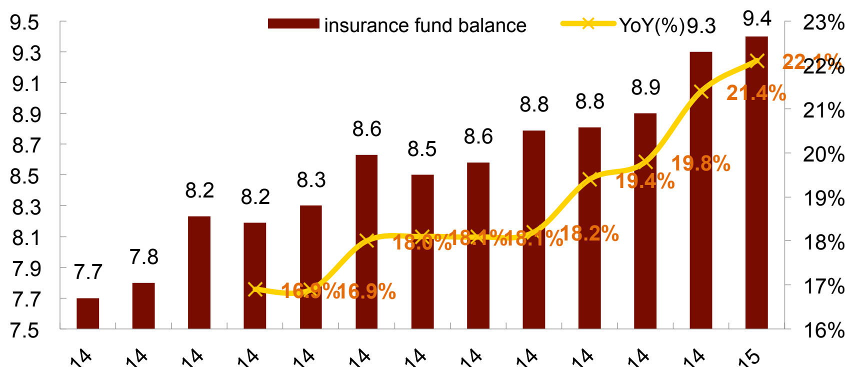
The rapid growth of these sectors through the Trusts poses financial risks for the insurance industry and China's economy due to:

1) Maturity mismatch.

2) Lack of transparency.

3) Debt that is not disclosed in the bank loan data.

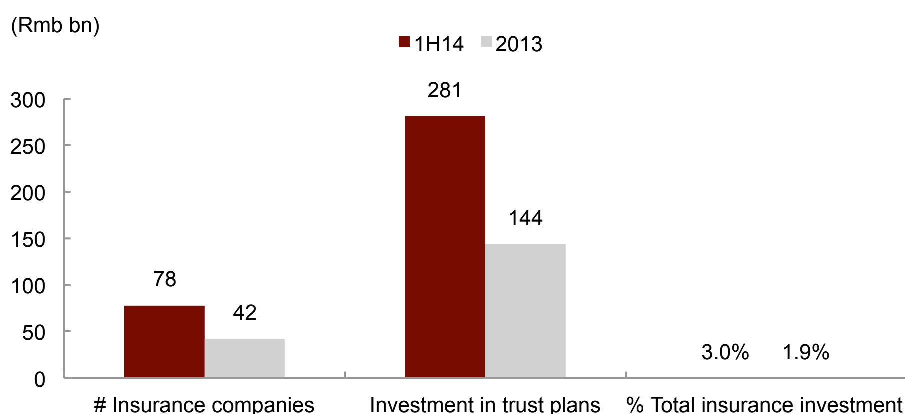
Growth of Insurance Funds



Rapid Growth of Trust Investments

By the second half of 2014, 78 insurance companies invested Rmb 281 billion in 739 Trust plans, a growth of 95%, according to data from Document 186[1] from the CIRC. This accounted for 3% of all-type insurance investment for the same period. The investments were made through 32 Trust companies. "It's a big leap for the industry as nearly Rmb136 billion was added in six months." Said a senior executive at a large insurance fund. "However, insurance investment in Trust plans only grew to Rmb144 billion by the end of 2013, using 14 months. Nevertheless, insurance funds accounted for 5% of total issued Trust plans at that point."

Figure 1: History of insurance investment in Trust plans



Source: CIRC, Orient Capital Research

Investment breakdown

The insurance investments in the Trusts are heavily concentrated in property and infrastructure, both prone to the pro-cyclical aspects of China's slowing GDP growth. They also generally are for terms of five years or less despite the need for long-term capital for infrastructure projects, which are better suited to bond financing. The breakdown by sector, credit rating, and maturity, is as follows:

By sector: Trust plans in the property sector are the most popular industry among insurance company investments, accounting for 33% of total investment[2], or,

[1] Released by CIRC at the end of 2014

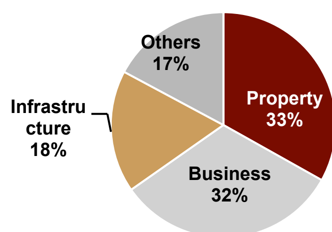
2 "Total investment" here means insurance investment in Trust plans only. It doesn't include other types of insurance investment such as direct investment in property and infrastructure, same for the rest of this section.

Rmb93 billion. General businesses[3] accounted for 32% of total investment, or Rmb 90 billion. Infrastructure was the third-largest group with an investment of Rmb49 billion, accounting for 17.5% of total investment.

By credit rating: Trust plans with AAA[4] ratings accounted for 63% of total investment, or Rmb177 billion. AA[5] accounted for 29% with a total amount of Rmb80 billion. The remaining 8% was invested in Trust plans with lower than-AA ratings.

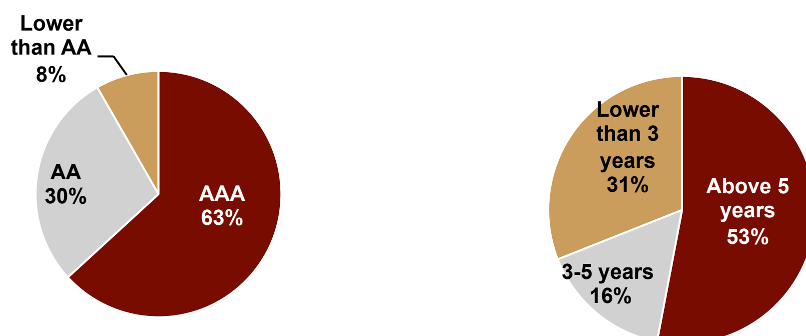
By maturity: Trust plans with maturity over five years accounted for 53% of total investment with an amount of Rmb148 billion. Plans from 3-5 years equalled Rmb45 billion and accounted for 16%. Plans with less-than three-year maturity were Rmb88 billion, accounting for 31%.

Figure 2: Insurance investment in Trust plans by sector



Source: CIRC, Orient Capital Research

Figure 3: Insurance investment in Trust plans by types



3 Include Trust plans invested in current loans
4 Include both AAA+ and AAA-
5 Include both AA+ and AA-

Source: CIRC, Orient Capital Research

Examples of Insurance Investments in Trusts

The following examples show the tremendous growth in the insurance industry's investment in Trusts and how unorthodox some of these investments are, heightening the risks for the insurance firms themselves.

- **China Life Insurance** Asset Management purchased the Changan Trust plan of assembled funds worth Rmb500mn on January 16th, 2015 with an estimated annualized interest rate of 5.85%. The Trust plans invested in China Minsheng Bank's transferable accounts receivables with less than one-year maturity. This investment raises questions as CMBC is a related party of China Life Insurance Asset Management.
- **Kunlun Health** Insurance balance sheet includes 13 investment projects listed under the item of "Loans & Accounts Receivables," of which 12 are debt investment plans. Although there's only one recently-added Trust plan, that single Rmb 400 million Trust accounts for 57% of Kunlun's investments.
- In 2012, **Hua Insurance** had no Trust investments on its balance sheet. In 2013, the investment in Trust plans rose to Rmb 2.4 billion. By the end of 2014, the number almost quadrupled to Rmb 9.0 billion.

The Risks of Cross-shareholding: Trusts Invest in Insurance Companies

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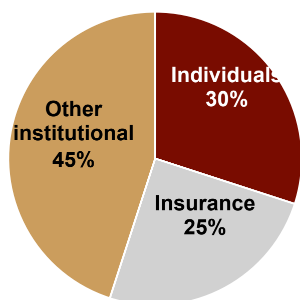
Cross-shareholding between insurance companies and Trust companies has risen in the past two years. Insurance companies are using Trusts to diversify their financial portfolios and gain more flexibility and versatility in their investments. Trust companies also need insurance funds to replenish their capital as required by regulators such as the CBRC (China Banking Regulatory Commission). According to a senior official at a state-owned Trust:

> "Most Trust companies are under pressure now to increase their net capital, which is required by the regulators as a way to reduce risks. Although funds from banks are still our major source of capital, insurance funds have become another attractive choice given their large size. We've heard that some Trust companies are even setting up independent departments to seek cooperation with insurance companies. Thus, my work focus has shifted from High Net Worth customers to institutional clients such as insurance companies. This started in 2013, the year competition for funds intensified."

Another interviewee, who is in charge of the wealth management department at a large Trust company in Beijing, told us that they have worked with more than 30 insurance companies in the past year. Currently, for this Trust, institutional funds account for 70% of the capital compared with 30% from individuals. Among them, insurance funds account for 25% of total, implying 36% of institutional funds.

Figure 4: Trusts' Source of Capital



Source: CIRC, Orient Capital Research

Expansion of the Trust – Insurance Nexus

Before 2014, only Ping An and PICC had stakes in Trust companies. However, the foreclosure of other Shadow Banking channels in 2014, along with the CIRC's more lax regulatory attitude toward the destination of insurance investments, led to an expansion of the market for these cross relationships.

In 2014, two large deals with a total value of Rmb2.3 billion drew people's attention to this new relationship between insurance companies and Trusts. One was the transfer in July 2014 of a 26.04% share of Chongqing International Trust to China Life Investment for a total value of Rmb 635 million. The other was the placement of 45% shares of SDIC Trust for Rmb2.2 billion to Taikang Life and Jiangsu Yueda.

According to the website licai.com[6], by July 2014, 15 Trust companies had become shareholders of insurance companies. These included National Trust's 50% stake in HSBC Insurance and 35% in Nova Insurance (formerly known as New World Insurance). Following National Trust, was CITIC Trust's 49% share in Allianz China Life Insurance. The largest shareholders of Tianan Life -- URTrust Insurance, Zhongrong Lie Insurance and Pearl Life -- are also Trust companies that combined own 20% of Tianan.

Joint Ventures are Also Common

Apart from cross-shareholding, in some cases insurance companies and Trust companies have set up joint ventures. For example, Aviva-Yili Asset Management Company was established by Aviva-COFCO, Sinatay Insurance and China Resource Trust, with shares of 41%, 34% and 20%, respectively. The registered capital of the company is Rmb100mn.

Figure 5: Summary of cross-holding between insurance companies & Trusts

Insurance company	Trust shareholder	% Share
HSBC Life	National Trust	50%
Allianz China Life	CITIC Trust	49%
Kurnia Insurance	Zhongjiang Trust	20%
URTrust Insurance	GFTC	20%
Zhongrong Life	Jilin Trust	20%
Bohai Property Insurance	Northern International Trust	20%
Pearl Life	GFTC	20%
Dubon Insurance	Zhongtai Trust	19.07%
Lian Life	Zhongjiang Trust	12%
ABC Life	Shandong International Trust	9.85%
Taishan Property & Casualt	Chongqing International Trus	9.80%
Taikang Life	CITIC Trust	8.80%
Aeon Life	Huaxin Trust	6.02%
Yong An Insurance	Shanxi International Trust	2.29%

Source: licai.com, Orient Capital Research

The Risks of The New Insurance-Trust Marriage

We believe there is increasing concentration of risk due to the overlapping of

6 http://www.licai.com/

underlying assets of insurance and Trust companies. These risks include:

1) **Excess Industry Growth.** For the first two quarters of 2015, insurance investment in Trusts grew 41.3% and 37.7% YoY, respectively.[7] "We think the growth is both unexpected and somewhat out of control. It's almost double last year's average," according to a senior officer at one of China's top five insurance companies.

2) **Some Companies Surpass the Mean.** Although an industry average of 40% YoY growth is high enough to alert the public of risk, certain companies actually experienced quadruple increase of the investment scale in Trusts such as Pacific Life, Taiping Pension, Dubon Insurance, Taiping Life, ICBC-AXA, and Huaxia Insurance. All are major players in the industry.

3) **High investment concentration.** We see a risk due to the high investment concentration in the underlying assets in which most insurance companies invest through Trusts. According to our discussions with industry officials, more than 50% of insurance funds flow to the property sector and infrastructure, all through Trusts. Based on an internal industry study, over 90% of the investments by Union Life, Guohua Life, Aeon Life, Sintay Insurance, Yongan Insurance, Foresea Life Insurance, ZKing Property & Casualty Insurance and Dragon Life are in Trusts that mainly focus on property. Around 80~90% of the investments of Taikang Life, Taiping Life, CCB Life, Sunshine Insurance and Greatwall Life is also in similar Trusts. Even for those with less exposure to the Trusts investing in property and infrastructure such as Sino-Life, China Insurance, ICBC-AXA, Ancheng Insurance and Lian Life, the percentage of investment in Trusts is as high as 60%~80%.

4) **High ratio of Trust investment to assets.** Inspired by a recent relaxation of investment policies, insurance companies such as ZKing Insurance, Kunlun Health, CNPC Captive Insurance, Tianan Insurance, and Aeon Life have invested 19.3%, 19.1%, 19% ,18.1% and 17.8% of their assets in Trusts. "The suggested guidance from the CIRC is between 5%~8%. However, we have noticed that there is an increasing number of insurance companies, especially small and mid-size ones, attracted by the higher returns that leads them to cross that line," a senior officer at a large

7 Source: CIRC

insurance company noted.

5) **Ambiguous underlying assets.** Even as they provide capital to Trusts, not all insurance companies clearly know where their funds are invested by the Trust companies. For example, the target asset is not mentioned in the Rmb 16 billion "No.2 Wealth Management Single Trust Plan," issued by China Credit Trust, in which PICC has invested. "This is only one of the many similar cases. The trick used here is to set up as many as limited joint enterprises as possible so that the fund flow is almost impossible to track. Although this is mainly applicable to Trust companies with a certain asset scale such as China Credit Trust, we think the use of 'ambiguous' underlying assets is becoming a general phenomenon," a risk controller at a medium-size insurance company said.

6) **High concentration of counter-party Trusts.** According to our research, over the past three years 60% of Trust plans which contain insurance company investments have been executed primarily by six Trusts: these are Shanghai Trust, CCB Trust, Ping An Trust, CITIC Trust, China Credit Trust and Huaneng Trust. We also found that most insurance companies tend to invest in a specific Trust company. For example, CCB Life (76% in CCB Trust), AllTrust Insurance (40% in Huaneng Trust), Lian Life (36% in Jiangsu Trust), Guohua Life (36% in Zhongjiang International Trust) and Ping An Insurance (31% in Ping An Trust). Although some insurance companies and their invested Trusts belong to one group, such as CCB Life and CCB Trust, along with Ping An Insurance and Ping An Trust, many have significant cross-ownerships.

7) **Incomplete credit rating scheme:** According to a recent investigation conducted by CIRC, a large portion of Trust plans invested by insurance companies actually lack a formal credit rating, and often only have preliminary opinions provided by related agencies. "We've heard that Guohua Life was criticized by name in the recent CIRC meeting as most of its invested Trust plans only have preliminary rating reports from Shanghai Brilliance Credit Rating & Investors Service Company. In our opinion, regulators are upset about insurance companies bearing the risks of Trust, an industry with chaos," said an official close to the regulators at CIRC.

What the Regulators Fear Most: Related-party Transactions

"Among all risks associated with insurance investment in Trusts, related-party transactions are what regulators are most concerned with," said an official close to the policy-makers at CIRC.

In general, there are two major risks of related-party transactions:

1) A high proportion of assets in a single entity.

2) Using Trust investments as a financing tool.

Related-party transactions account for a significant proportion of insurance investment in Trusts. For instance, Happy Life Insurance, CCB Life, Union Life and Lian Life have a high proportion of related party investments, with 94%/78%/64%/60% Trust investments considered as related-party transactions, respectively. There are many examples of this trend.

Example One: CCB Life

Most notable among these is CCB Life. According to the company's official website, CCB Life issued 10 announcements of related-party transaction in the second half of 2014 with a total amount of Rmb1.826 billion. All were invested in CCB Trust. Moreover, its aggressive strategy with the Trust assets significantly altered the original investment structure. In 2014, trading assets (funds), held-to-maturity investments (bonds), and available-for-sale financial assets including stocks, funds, and creditor's rights of CCB Life increased marginally. ***In contrast, loans and accounts receivables rose 245% YoY, with 56% coming from Trust investments.***

Example Two: Happy Life

Although Happy Life Insurance surpassed CCB Life with 94% of Trust investments as related-party transactions, the strategy adopted by the company is different from CCB Life. In general, instead of a simple one-way investment in a related company, in Happy Life's case either the financing side or the participating institution of the deal is the related party. This can be traced back to the origins of Happy Life's connection with Cinda Asset Management. Cinda holds a 50.955% share of Happy Life Insurance. For example, Happy Life Insurance invested a total amount of Rmb1.4 billion in two Trust plans launched by CCB Trust in 2014, which involved subsidiaries of Cinda Asset Management including Cinda Real

Estate and Cinda Fund Investment.

AMC Involvement in the Trust-Insurance Connection

According to our interviews, all of the other three central AMCs had substantive related-party transactions with their connected insurance companies through Trust plans in 2014. A rough estimate of the total capital involved is over Rmb3 billion. According to a banker familiar with the Trusts at one of the Big Four banks:

> "The Trusts are a great tool for cooperation between insurance companies and AMCs. On the one hand, insurance funds could easily flow to AMCs through Trust plans launched by the third parties separate from the AMCs themselves. On the other hand, AMCs in return have purchased a large amount of insurance products. An era of rising NPLs and default risks of WMPs will create new development opportunities for AMCs. Insurance funds are ideal for this need of AMCs. Nonetheless, the risk has to be treated seriously."

Holding Company Relationships

In addition to cross-investments with AMCs, insurance companies and the source of distributor often are owned by the same controlling shareholder. As such, insurance investment in Trust provides loans, funds investments in property, meets liquidity needs, and transfers creditor's rights held by the parent company. Examples are Union Life, Lian Life, and China Insurance.

Example of Parent Getting the Money: China Orient Asset. For instance, Chin Insurance has invested in a series of Trust plans launched by Yingda International Trust, Zhongrong International Trust and Huarun Trust. What is the problem?

1) First, all of these Trust plans are under AAA grade.

2) Secondly, none of them directly invests in specific underlying assets. Instead, most of them are nested Trust plans with more than two layers such as the plan issued by Yingda International Trust. This Trust invests in the 60% beneficiary's rights of the creditor's entrusted rights held by another asset management plan.

3) Furthermore, we found evidence of relationships among these investments with other subsidiaries under China Orient Asset Management, which is also the parent company of China Insurance. It's clear that the insurance fund finally

flowed back to the pockets of China Orient Asset Management's own property investments.

END

Appendix

- Document 1 (2006): Insurance companies are first allowed to invest in Trust plans targeted on infrastructure.

- Document 43 (2009): Insurance companies are first allowed to invest in creditor's rights through Trust plan but only limited to infrastructure.

- Document 91 (2012): Insurance companies are first allowed to invest in the Trust plans of assembled funds. This's the sign of relaxing regulations on insurance investment as the underlying assets eligible for invest are expanded to financing assets and unlisted equity assets with controllable risk.

- Document 38 (May, 2014): It's the first time since 2009 CIRC emphasized the risk control over insurance investment in Trust plans by adding two restriction. One is to prevent insurance companies from stand-alone Trust and specific industries required by the central government. The other is to put more requirements on Trust companies eligible to receive insurance fund. For example, net asset can't be lower than Rmb3 billion.

- Document 186 (October, 2014): Finally, CIRC has to face the risk directly by putting 25 insurance companies on the watch list.