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Comments On The Regulatory Philosophy Of The Trust Sector In China (2009-2012)

Xiling Jia

Associate Professor
East China University of Political Science and Law

jiaxling@foxmail.com

ASLI Visiting Fellow
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Asia Law Institute
c/o Faculty of Law,
National University of Singapore
Eu Tong Sen Building
469G Bukit Timah Road,
Singapore 259776
Tel: (65) 6516 7499
Fax: (65) 6779 0979
Website: http://law.nus.edu.sg/asli
Email: asli@nus.edu.sg

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COMMENTS ON REGULATORY PHILOSOPHY OF THE TRUST SECTOR IN CHINA (2009-2012)

XILING **JIA** *

Abstract:

The adoption of *Measures for the Administration of Trust Companies* and *Measures for the Administration of Collective Investment Scheme of Trust Companies* has successfully transformed China's trust sector. The asset management market in China has entered a new era of diversified competition, and has seen greater engagement by various financial institutions in investment trusts, with the result that the universal value of trusts to the asset management market has become increasingly apparent. This paper, which focuses on trust regulatory policies between 2009 and 2012, proposes that in the area of trust supervision competitive and coordinated regulation regimes should be developed simultaneously in order to promote the development of China's trust sector and asset management market.

I. INTRODUCTION

Since China's *Trust Law* was promulgated in 2001, the Chinese trust business as a whole has been constantly rising, in line with the explosive growth of the financial industry and the rapid accumulation of personal wealth. From 2001 onwards, China witnessed a golden decade, during which the trust system was established and the trust market flourished.[1] Trust companies, generally referred to in China as the trust industry[2], are heavily regulated by the China Banking Regulatory Commission (CBRC) as non-bank financial institutions.

In examining the trend of recent trust regulatory policies, this paper focuses on the regulatory philosophy and elaborates specific concerns.

* ASLI Fellow (Oct-Nov, 2012), Associate Professor of East China University of Political Science and Law.

[1] Lixin Jin, "Regulation and growth coexist: the essentials of golden ten years of trust industry—— interview with Jian Pu, the chairman of the board of ZhongXin Trust Co. Ltd. and the chairman of China Trustee Association", *Financial Times* (8 October 2012). In the article, the interviewee said that we may use the phrase "golden ten years" (or "golden decade") to describe the 10 year development of trust industry. To date, the trust industry has assets exceeding 5.5 trillion RMB, almost matching those of the insurance industry. It is for this reason that the trust industry has become one of the pillar industries in China's financial sector.

[2] Theoretically the expression 'trust industry' refers to all the trust businesses operated by trust companies, fund management companies and legal fiduciary institutions appointed by pension fund institutions. However, in common parlance it refers to trust sector in its narrowest sense, i.e. trust companies exclusively operating trust businesses chartered and regulated by the China Banking Regulatory Commission. This paper only examines those trust companies which are subject to CBRC policies.

II. THE HISTORICAL BACKGROUND TO RECENT TRUST REGULATIONS

In China, the trust industry has undergone unusual twists and turns, experiencing repeated ups and downs through five cleanups and ratifications.[3] The promulgation and implementation of the *Trust Law* in 2001 marked the rise of the trust. Shanghai Outer Ring Tunnel, sponsored by a trust loan issued by Shanghai Ai'jian Trust and Investment Co. Ltd, witnessed the first collective investment scheme in China, a new player in the field of financial products. However, due to its novelty, neither investors nor trust companies nor the invested ventures had any experience in dealing with collective investment schemes. Similarly, due to lack of precedent, the regulatory policies were fragmented and were developed using a reactive rather than proactive approach.

The trust regulatory policy dominated by CBRC recognizes the political and economic realities under the framework of trust laws. The trust regulatory policies introduced between 2009 and 2012 mainly supplement new regulations enacted in 2007. Under the regulatory scheme of "One Law and Three Measures for Administration"[4], trust policies have become increasingly fine-tuned.

An examination of the regulatory policies shows that the focus has been on three areas: bank-trust cooperation in the shadow banking system, new cooperation of land financing, and real estate financing. Other initiatives, including the series of policies relating to net capital management, can be described as 'constant patches' for mainstream trust products. Since the promulgation of the *Measures for the Administration of Net Capital of Trust Companies*, which introduced drastic changes, subsequent policies have tended to be mild and moderate. Few policies were enacted

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[3] China first launched trust businesses in October 1979, though without any laws or regulations. A notice provided by the State Council in 1982 subsequently banned all the trust investment businesses in all regions and departments except for Trust and Investment Companies approved by the State Council or departments authorized by the State Council. All other trust and investment companies were required to be 'cleaned up' within a limited period. In 1985, the State Council required the cessation of trust loans and trust businesses, and ordered that the businesses that had previously been operated be cleaned up to tackle the national credit situation and the problem of excessive money supply. Then in 1988, following the No.8 Decree of the State Council, the regulatory agency, the People's Bank of China, started the third rectification, focusing on the cleanup of businesses and industry rectification. In 1993, a further rectification focused on separating operations between the trust industry and the banking sector according to a notice issued by the People's Bank of China. In that notice, all the financial institutions, including Trust and Investment Company, were to be chartered by the People's Bank of China, together with a Financial Business Operation Licence, both in the period of pre-(arrangement) and establishment. The People's Bank of China launched the last rectification before the promulgation of the Trust Law in 1999. It enacted the principle of 'trust-based management, separated industry, scaled business and strict supervision' and clarified the business scope of the trust industry, separating it from the banking and securities businesses. It also imposed strict criteria for entry into the trust industry.

[4] This refers to *Trust Law of the People's Republic of China*, *Measures for the Administration of Trust Companies*, *Measures for the Administration of Collective Fund Trust Scheme for Trust Companies*, and *Measures for the Administration of Net Capital of Trust Companies*.

in 2012, reflecting the regulator's method of window guidance and its focus on risk-prompts. At the same time, competition between financial institutions and other institutions, and among trust companies, has intensified in the asset management market. As market constraints become tougher, the trust business has developed more steadily to serve the economy and iron out economic fluctuations.

The trust regulatory policies in China are significant in providing direct criteria for trust companies to develop specific trust products. The legal essence of financial products is the relationship between rights and obligations among financial institutions, financial consumers and financial investors as prescribed in laws, regulations and regulatory policies. The forces at work in the market have a reverse relationship with the demand for government intervention. Under the structure of regulatory laws, trust policies impact on issues such as risk control, leaving the specific rights and obligations of trust products to be determined by participants in the market. As a result, the market may in turn stimulate a more efficient internal control system to take effect. During the period being examined, trust companies accumulated key accounts and premium client groups, built up marketing centres, trained experienced trust professionals and developed increasingly plentiful product lines. And in the competitive asset market and wealth management market, trust companies reserved significant strategic resources.

With the accumulation of private wealth and the increasing influence of the financial economy on the substantial economy, the asset management market in China has stepped into a new era, in which competition is diversified and various financial institutions such as commercial banks, securities companies and their subsidiaries, insurance companies, fund management companies (and their subsidiaries) and futures companies, all engage in investment trust business. The basic regulatory philosophy of trusts is significant in the formulation of financial regulatory policy, and even the innovation of the financial regulatory system for functional supervision of asset management products.

III. THE PHILOSOPHY UNDERLYING RECENT REGULATORY POLICIES

A. *To Force Trust Companies to Improve Self-regulating Competence*

The '*bankerization*' of trusts has always been the nightmare of trust companies. The past five rectifications of the trust sector suggest that partly due to the lack of provisions of the *Trust Law* prior to 2001, trust companies did not operate as trustees, but rather they acted as a deposit-taking and loan business financial intermediaries. Taking into account the restraints on Chinese businesses in their financing methods, and in particular the fact that businesses cannot lend money to each other except through trust loans, trust companies still use the unique platform of the trust licences to expand their businesses.

Having carefully studied the various applications of the trust norm in the past several years, especially in the fields of asset management businesses, the CBRC has applied a so-called 'back to the original business of trust' regulatory philosophy since 2007. This philosophy has extensively influenced the trust industry, and a new conception of self-management was introduced into the trust sector in 2010, indicating that trust companies should act as a channel or platform for bank-trust cooperation and trust-government cooperation, etc.

After three decades of reform and development, Chinese social wealth has increased tremendously. The great demand for maintaining and increasing the value of assets has led to large-scale expansion of asset management businesses. Since 2011 in particular, an increasing number of financial institutions and non-financial institutions have been engaging in asset management. Examples include personal financial management products provided by banks, customers' property management services provided by securities companies, separated fund management accounts operated by fund management companies and insurance assets management business.[5] Almost all financial institutions are involved in businesses with trusteeship or quasi-trusteeship, or even products developed by other financial institutions, especially those overseen by CSRC or CIRC that cannot actually be called 'trusts' under the divided financial regulation system. The exclusive business of trust companies to act as trustees has been undermined due to competition in asset management from many quarters. The competition among various financial industries with a stake in the asset management business is becoming increasingly fierce, and the flow of capital between different sectors is becoming more and more frequent. Each trust company is inevitably affected both by competition within the trust sector and competition in the whole asset management market.[6] As obtaining a trust licence is no longer a guarantee for making a profit, it becomes imperative for trust companies to engage in product innovation and to improve their self-management practices.

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[5] Jia Xiling, "Legal report of China trust market" (2011) 2 Financial Law Review (edited by Hong Wu); Jia Xiling & He Yuewu, "Improvement required by compensation litigation system of financial service", *Securities Times* (12 November 2011). Financial services of commercial banks are mainly regulated by *Interim Measures for the Administration of Commercial Banks' Personal Financial Management Services*; financial services of securities and fund management companies are mainly regulated by *Securities Investment Fund Law*, *Measures for the Administration of Operation of Securities Investment Fund*, and *Trial Implementation Measures for the Customer Asset Management Business of Securities Companies*; financial services of trust companies are mainly regulated by *Measures for the Administration of Trust Companies' Trust Plans of Assembled Funds*; and Insurance Asset Management Businesses are mainly regulated by *Interim Measures for the Administration of Insurance Asset Management Companies*, and *Interim Measures for the Administration of Utilization of Insurance Funds*. On 26 September 2012, the China Securities Regulatory Commission issued the revised edition of *Pilot Measures for the Asset Management Services of Fund Management Companies for Specific Clients*. And on 19 October 2012, the CSRC issued the revised edition of *Measures for the Administration of the Customer Asset Management Business of Securities Companies* and its supporting rules, so as to loosen the restriction for asset management businesses. On 22 and 23 October 2012, the China Insurance Regulatory Commission issued six regulatory documents concerning Insurance Asset Management Business to expand the scope and ratio of insurance asset investment and to encourage innovation.

[6] "Transformation of trust company business needs the improvement of self-regulating competence", *Financial Times* (9 July 2012).

Compelling trust companies to improve their self-management practices has become a focus of regulatory philosophy in order to address common risks in the trust sector. This has been done to varying extents through almost all the regulations issued since 2009, whether by encouraging trust companies to develop self-management businesses, providing diversified and distinct services or achieving intensive and sustainable growth. Examples include restrictions imposed on trust companies in opening securities investment accounts, co-operation with banks, and the conduct of real estate investment trusts. The enactment of the *Measures for the Administration of Net Capital of Trust Companies*[7] (hereafter referred to as *MANCTC*) is a prime example and a milestone in the improvement of self-management of trust companies.

MANCTC imposes risk-based capital adequacy requirements on trust companies. It has two functions: firstly, it may restrict the unsustainably rapid expansion of trust companies by net capital management, which makes up for the deficiency of current regulatory instruments; secondly, it may promote the establishment of internal mechanisms of pre-warning and risk control in trust companies. The *MANCTC* encourages trust companies to switch their approach from one which is scale-driven to one which is driven by efficient profit-making, by using a full range of flexible investments and the active management of high-end wealth. Trust companies are urged to enhance their businesses according to their diversified and distinctive characteristics.[8]

B. *Clarifying the Misunderstanding Associated with "Rigid Repayment: Guarantee of Repayment to Beneficiaries"*

Public offering products are subject to the 'open, just and fair' principle under the *Securities Law* and *Securities Investment Fund Law of the PRC*. Yet trust plans, the collective investment scheme developed by trust companies, are privately placed under the supervision of CBRC. The CBRC does not explicitly set out strict criteria for IPOs, although it is worth noting that 'close supervision' is applied to public offering products. For each trust plan, trust companies have to make guaranteed repayment along with a timely report to the supervising authorities. More detailed approaches such as the 'window guidelines' are frequently applied. For real estate trust products, the CBRC has also employed the principle of 'substance over form' to avoid risks. The longtime existence of the principle of close supervision has led to the current situation where investment risks are almost wholly undertaken by trust companies and investors are excessively protected. As a result, no undue repayment of collective trust products ever occurred before 2012, and investors have even mistakenly come to believe that trust products bear fixed returns. On the one hand,

[7] No. 5 (2010) decree of CBRC, issued on Aug.20, 2010 by CBRC.

[8] *The answers to journalists concerning Measures for the Administration of Net Capital of Trust Companies by the person in charge of China Banking Regulatory Commission* (September 2010), online: China Banking Regulatory Commission <http://cbrc.gov.cn>.

trust companies stand to gain from the marketing effects that flow from this misunderstanding; on the other hand, they are also afraid of the possibility of a '99+1=0', situation in which specific risk events or the 'trust domino effect' could lead to a systemic crisis.[9]

The notion of 'rigid repayment' means a guarantee of repayment to beneficiaries, i.e. the invested principle and the expected return should be realized in spite of a possible loss of the subject-matter of the trust. For example, the trust company would guarantee repayment even if the financing entity did not repay the money.[10] There is, however, no legal support for this notion. As for financial products, the 'caveat emptor/buyer beware' principle is a mandatory legal principle that cannot be excluded by agreement.[11] According to Article 34 of the *Trust Law of the PRC*, "[t]he trustee shall be responsible for paying the beneficiaries within the limit of the trust property." The trust beneficiaries take all the interest of the subject-matter of the trust but they cannot get the expected benefits when the trust property suffers loss. In accordance with *Trust Law, Measures for the Administration of Trust Companies* and other regulations in the PRC, trust companies make profits from charging fees based on their management services instead of interest margin. They are liable only when they have violated the law or the purposes of the trust. They do not assume loss of the property or provide a guarantee for the principal or a fixed return. Therefore, from a legal perspective, the risks of the trust sector are mainly compliance risk, due diligence management risk and reputational risk when causing investors' loss, in addition to the redemption risk that is emerging in the banking industry.[12]

The notion of rigid repayment is not only misleading financial consumers, it is also destroying the essential non-debt attribute of trust products, thereby hampering the development of the trust sector. To overcome this, investors should be properly educated of the risks involved so that they will be more cautious in making trust investments.

The regulatory philosophy of the CBRC towards trust companies is gradually evolving, and trust companies are allowed to expose risks when their investments fail,

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[9] '99 + 1 = 0' has become a popular quotation in the trust sector, reflecting the view that trust companies are facing a helpless predicament. 99 + 1 = 0 is a philosophy of modern management studies, which means that a slight error or accident will contribute to the failure when 99 percent of the price has already been paid. See "'Rigid payment' deviates from the market rules, maintaining 'zero risk' would be hard", *Securities Times* (10 July 2012). The author believes that it can also be construed as either zero risk, or a systemic crisis.

[10] Yang Wenbin, *China is facing the risk of "Rigid Repayment"* (8 October 2012), online: Forbes China <www.forbeschina.com>.

[11] Zhou Xiaoming, *Does Trust Sector's "Domino" begin to fall? Review on China Trust Industry Development 2nd quarter, 2012*, online: China Trust Industry Association <http: //www.xtxh.net/xhdt/11189.html> (last accessed 25 July 2012).

[12] Cai Gaihuan, "Four proposals in Risk-Controlling for Trust Sector", *Financial Times* (20 August 2012).

which helps the market digest the crisis of repayment.[13] Regulatory authorities are expected to take action to correct the misunderstandings surrounding rigid repayment by adopting a 'caveat emptor' and 'responsible seller' regulatory philosophy. In the trust market, caveat emptor means that investors should be fully informed of relevant information regarding investments and the risks of trusts. When participating in any specific trust plan, investors should make an independent determination based on their own assessment of market information, and then bear the consequences of their transactions. This also promotes self-discipline for investors, epitomizing the principle of freedom of contract in the modern financial market. The regulators are recommended to issue specific guidelines on a caveat emptor basis to remind investors of investment risks. This is not only helpful to the sustainable development of the trust market and the innovation of trust products; it is also beneficial to establish a healthy environment for investors.

C. *Prudential Treatment to Shadow Banking*

There is no clear definition as yet of 'shadow banking' in China, which roughly refers to a collection of non-bank financial intermediaries that provide services similar to traditional commercial banks. In a 'bank-trust cooperation' arrangement, a bank invests funds from a personal wealth management scheme into a trust fund investment plan of a trust company. This type of cooperation enables banks to circumvent various investment rules, such as reserve requirements and capital restraints, by moving loans off their balance sheets. In another instance of shadow banking, trust companies make massive investments in government infrastructure projects, bringing about concentration risks and default risks in the governmental financing platform. Such financial instruments risk blurring the boundary between the market and the financial system, making the implementation of monetary policies and supervision by the authorities difficult, thereby exposing the financial system to systematic risks.

As the existence of shadow banking has influenced the implementation of monetary policies, and has to some extent transformed China's financial structure, regulators are paying increasing attention to it. Although the CBRC is still in the initial stages of establishing regulatory standards for shadow banking, there is already much controversy about how it should be supervised. However, given that a shadow banking business broadly circumvents supervision and involves the participation of formal financial institutions, it should be prudentially supervised and regulated.

The mode of operation of the trust is flexible and varied. This makes it an attractive tool to the banking system for regulatory arbitrage, short-term mismatch of capital,

[13] A source close to the regulators of the sector told a National Financial Weekly reporter that the attitude of the CBRC to trusts has changed from one which sought to avoid all risk to one which now allows some risks. Instead of speaking in terms of 'rigid repayment' (wether or not this is correct), it is now regarded as desirable that the market mechanism should digest the crisis of payment itself. See Qu Ruixue, "From Rigid Repayment to Caveat Emptor, the crisis of payment hit the trust sector", *National Financial Weekly*, No. 20 (2012).

mixed breakthrough and distribution. In this sense, the trust business appears to have certain similar characteristics to shadow banking. The bank-trust cooperation of banks and financial asset (loans) transfers also bears some characteristics of shadow banking. Shadow banking is now a key target for financial management departments.[14] As shadow banking gradually comes under prudent supervision, shadow banking products are likely to be re-regulated, with the consequence that the trust sector will come up with more innovations.

D. *Prudential Regulation*

To prevent and resolve banking risks, the supervision department has introduced a series of detailed and prudent operation rules with which banking and other financial institutions are required to comply. In addition, the department objectively evaluates risks associated with financial institutions through timely monitoring, warnings and controls. This mode of regulation is called prudential regulation.

When considering the specific characteristics of the trust system, it is important that the trust supervision department introduces appropriate supervision policies. Trust businesses have developed rapidly due to the flexibility and creativity of trusts. These characteristics have to be taken into account in implementing supervision of the trust industry, trust companies and trust products. At the same time, if supervision is too harsh, it will stifle the financial innovation of trust companies and financial institutions, reducing economic activity. Since the trust industry serves a major economic function but is still struggling to grow, we should be more tolerant towards it and leave more space for trust products, trust companies and the wider trust industry to develop.

Regulatory documents published by the relevant authorities should not be ignored in judicial practice. Even though they are not *laws* according to the *Legislative Law* in China, the courts do give them respect when dealing with cases. There are encouraging regulations, permissive regulations, prohibitive regulations and restrictive regulations. Prohibitive regulations and restrictive regulations set the legal obligations and standards for the operation of financial institutions. In judicial practice, violation of these two kinds of regulations is considered a violation of pre-contractual obligations, and can be used by the court as a direct basis for finding a trustee responsible. The risk control and compliance requirements of trust companies are of great significance—on the one hand, these documents help develop the trust industry by providing detailed rules, but on the other hand, they may affect judicial decisions. Thus the authorities should enact these regulatory documents with prudence and care.

[14] Lixin Jin, "Is Trust 'Shadow Banking'?", *The Financial Times* (23 May 2011).

IV. THE PROSPECTS FOR FUTURE TRUST INDUSTRY SUPERVISION AND COORDINATION

The trust industry in China is strictly governed by China's financial supervision policy. In line with China's social and economic transformation and reformation, the trust industry should continue to take more responsibility in the areas of supervision and product innovation. An underlying trend that has emerged is supervision coordination.

Competitive regulation involves various financial supervising authorities competing for their respective interests. The trust industry, which is a trans-industry system, serves as a good model for products in the banking, securities and insurance industries. Under the current financial regulatory and supervisory regime, PBOC, CBRC, CSRC and CIRC compete to regulate asset management businesses that make use of trusts. While there is as yet no hierarchy of the supervising powers to bar competitive regulation, it is expected that a cooperative and consolidated regime will prevail in the future.

There is a growing trend under which institutions which are regulated by one department or authority are encouraged to launch or issue new products regulated by another department, or to enlarge their range of businesses for more profit-oriented opportunities. On the one hand, the competition among financial supervising authorities provides an impetus for innovation in production, organization, supervision and regulation. On the other hand, it gives rise to potential problems. For example, collaborative ventures including cross-border sales or agency-cooperation (even cross-shareholdings or circle-shareholdings) between banking, securities, insurance, trusts, leasing and other financial industries may give rise to conflicts of interest and transfers of risk.

Another focus should be on the coordination of regulations to tackle the loopholes and overlaps of the current supervisory regime and to prevent monitoring risks and regulatory arbitrage. In the near future, we can expect a comprehensive financial supervisory regime to be established in order to address the growth of financial businesses in China.