
**China Issued New Rules to Regulate Shadow Banking – an interpretation of
CBRC’s Measures on Entrusted Loans**

Entrusted loan is a special term in Chinese financial market, which refers to a loan provided by a corporate lender to a corporate borrower through a commercial bank who acts as a trustee of the lender. Entrusted loans, together with trust products, P2P lending and other off-balance sheet business are considered as shadow banking in China. Since the global financial crisis, China’s shadow banking grew dramatically to provide loans to borrowers who cannot get credit from banks. According to People’s Bank of China (PBOC), the entrusted loans reached 13.97 trillion yuan by end of 2017, accounting for 8% of the aggregate financing in China. Though shadow banking has played a positive role for economic growth, there is growing concern on its risks, which is multi-faceted, hidden, complex, and contagious.

In January 2018, China Banking Regulatory Commission (CBRC) released the Measures for the Administration of Entrusted Loans by Commercial Banks (“the Measures”) to regulate entrusted loans and monitor risks thereof. The Measures sets up clear guidelines on the sources of funds, loan purposes and the risk management.

A. Restrictions on lenders of entrusted loans

The Measures prohibits a financial asset management company or a licensed lending institution to be an entrusted loan lender. Those institutions, such as banks, trust companies, finance companies of enterprise groups, small loan companies and etc. have licenses to lend directly. In practice, however, some of them used entrusted loan structure to avoid regulatory supervision, for example to finance restricted projects.

B. Source of funds for entrusted loans

The Measures forbids entrusted loans to be sourced from funds raised from others, credit funds extended from banks, special funds with specific purposes or funds raised as debt (unless otherwise prescribed by departments of the State Council), or funds from source that cannot be identified. Banks acting as trustee are required to verify funding source of entrusted loans by conducting due diligence on entrusted loan lenders, including for example, whether the entrusted loan amount exceeds lender’s normal revenue and capital strength.

By such prohibitions, funds from asset management products of securities firms, fund managers or private equity firms can no longer be lent through entrusted loans. As they do not have lending license, securities firms, fund managers or private equity

firms or their subsidiaries have to use entrusted loan structure to finance their clients who cannot get credit lines from banks. The Measures would direct non-banking financial institutions to focus on their own business instead of lending and therefore reduce the size of shadow banking system.

C. Purposes of entrusted loans

The Measures sets up bans for entrusted loans purposes. Entrusted loans cannot be applied for the following purposes:

- (a) Production, operation or investment prohibited by the State;
- (b) Investments in bonds, futures, financial derivatives and asset management products, etc.;
- (c) As registered capital or for capital verification purpose;
- (d) Equity investment in or capital increase of a company, unless otherwise provided by regulatory authorities; or
- (e) Other purposes in violation with regulatory requirements.

Before the Measures is released, there was no restrictions on utilization of entrusted loans so substantial part of entrusted loans flowed into restricted sectors like the stock market, the real estate, or industries with surplus capacity. Shadow banking system has acted a key source of funds for the stock market and was directly connected to the stock boom in the first half of 2015 and then market crash in second half of 2015. The real estate industry largely relies on shadow banking, which contributed to risks arising from continuously rise of housing price. Restrictions on entrusted loans purposes would help to prevent hot money from flowing in to restricted sectors to avoid hard landing of the economy.

D. Isolate banks from credit risks of entrusted loans

The Measures requires banks to treat entrusted loans as an intermediary business and to separate it from its credit businesses. In practice, some banks helped clients with abundant fund to provide entrusted loans to companies in need of fund, or suggested their clients to borrow from other companies instead of banks (in particular when the bank's credit lines is very tight). On some occasions, certain bank staff had been involved in the following activities:

- (a) choosing the borrower or making credit decisions on behalf of a lender;

- (b) providing funds to the lender to advance entrusted loans; or advancing funds to a borrower for the purpose of repaying entrusted loans or using proceeds of loans or wealth management products to replace entrusted loans;
- (c) selecting security providers for the borrower or providing security for the entrusted loans; or
- (d) signing documents that would change the nature of entrusted loans.

Banks will be involved in the credit risks of entrusted loans by any of the activity above and thus be inflected by risks of shadow banking. To reduce systematic risks, banks are banned by the Measures to take any of the above action or such other action that would cause banks to assume credit risks of entrusted loans.

E. Conclusions

The Measures is promulgated after three years consultation. In the past years, potential risks and dangers has been accumulating in the financial sector, as warned by Mr. Zhou Xiao chuan, PBOC governor. He pointed out that high leverage is the root of vulnerability of in China's macro financial system. At the end of 2016, China's overall debt was 247% of GDP with corporate debt at 165% of GDP, which exceeded international warning line. The Measures, along with other recent regulations, shows the effort of Chinese regulators to reduce leverage ratio and to avoid incurrence of systematic financial risks.