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The Coming Transformation of China's Trust Industry

—China Trust Industry Report 2013

November 2013

The Coming Transformation of China’s Trust Industry

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About China Ping An Trust Co., Ltd

China Ping An Trust Co., Ltd. (hereafter referred to as "Ping An Trust"),established on April 9, 1996, is a subsidiary of Ping An Insurance (Group) Company of China, Ltd. (hereafter referred to as "Ping An") and is the largest trust company in mainland China in terms of registered capital. In 2012, the Company continued to push forward its business transformation. Proactively building its brands on wealth management and non-capital market investment, the Company saw a significant boost in its active management capabilities, with consolidated net profit reachingRMB1.53 billion with a year-on-year growth rate of 43.87% and trust AuM climbed to RMB212.02 billion. The Company's strong fundraising ability is widely recognized by the market.

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Contents

Preface 2

Executive summary 4

The case for change: trust companies at a crossroads 4

Three distinct businesses: the future growth arenas for trust companies 7

Eight capabilities: a roadmap for trust companies' transformation 10

External accelerator: regulatory environment required 12

1. The unique nature of China's trust industry 15

Unique nature of China's trust industry 15

The rise of China's trust industry 16

Special discussion 1: how to decode the risks of China's trust industry? 19

2. Challenges facing Chinese trust companies 23

The diminishing conduit business 24

The volatility of the private placement investment banking business 24

Two new growth arenas for trust companies 24

3. Private placement investment banking: steady profit in the short to medium term 29

Trust loans: indispensable financing vehicle in the near future 29

Special discussion 2: China trust loan = US high yield bond? 31

Asset-backed securities: the next growth engine 33

Special discussion 3: Asset backed securities in developed markets 35

The volatile nature of private placement investment banking 37

4. Alternative asset management: mushrooming and mainstreaming 41

Mainstreaming of alternative investments globally 41

China's growing interest in alternative investment products 43

Special discussion 4: Domestic institutional investors 44

Underperformance of the traditional asset management sector 45

Asset management: "capital light" and a more profitable business 45

5. Private wealth management: prospering in the "golden decade" 49

Wealthy Chinese: nearly two million by 2015 49

Unprecedented demand for wealth management 51

Trust companies have a unique competitive advantage 52

The next RMB1 Trillion opportunity: overseas wealth management 52

Special discussion 5: overseas investment 54

The trust company angle: challenges of PWM business 55

6. Eight new capabilities: implications for individual trust companies 57

7. External accelerator: regulatory environment for change 61

Glossary 63

China's trust industry has had a phenomenal run...

Assets under management grew by

7 times from 2007 to 2012,

exceeding 10 trillion **RMB** by end of 2013 Q3

...but is facing unprecedented challenge at the moment

Approximately 88% **of current industry revenue** at risk and unsustainable in the long term

4 **risk factors** inherent in current business portfolio - operational risk, reputation risk, credit risk, liquidity risk

New battlegrounds, new opportunities

3 potential businesses in the future: **private placement investment banking, alternative asset management, private wealth management**

3-5 trillion **RMB** annual financing gap in China's economy, unmet by banks and capital markets

By 2015, China's high-net-worth individuals will exceed 1.9 million people, with total investable assets about 58 trillion **RMB**

Successful transformation of the trust industry requires building up 8 **core capabilities**

Perface

This report is the result of a combined research effort of Ping An Trust Co., Ltd., and McKinsey & Company over the past several months. The study draws extensively on McKinsey's experience working with leading investment banks, asset management and wealth management institutions, in China and globally. The research also incorporates insights from Ping An Trust and other domestic top-tier trust companies, and from in-depth interviews with more than 30 trust industry practitioners and experts on regulatory policies. We would like to thank the Ping An Trust's project team and the working team from McKinsey's financial institutions group in Greater China for their input into this report.

After China's first trust company was founded in 1979, the trust industry developed rapidly, changing the nature of its business model as the Chinese financial system developed as part of the overall economy. The current role of the trust industry in China is fundamentally different from how trusts operate in Western markets. As we will show, it is very much unique, and in many ways the result of the idiosyncrasies of the financial system in China today. In particular, with the release of the Trust Law in 2001 followed by two regulations issued by the CBRC in 2007, the trust industry has begun to take on a financing role in some segments of the economy that were otherwise cut off from financing through banks and the still underdeveloped debt capital markets in China. Trust companies were able to capitalize on the enormous liquidity in investment markets over the last five years, driven by high net worth individuals (HNWIs) and corporate investors searching for higher yielding assets – given low real deposit rates and underperforming equity market. A second anomaly in the Chinese financial system was the regulatory framework and licensing system that gave trust companies a unique role to be the single producer of particular wealth management products that invest across money market, capital market and unlisted assets market (such as loans, unlisted shares, etc.). This enabled a business model of "lending the license" to banks and other institutions who are not allowed to invest into certain asset classes by regulation. Both these factors have allowed for explosive growth in the trust industry in China. By the third quarter of 2013, asset under management (AuM) accumulated by the trust industry exceeded RMB10 trillion, second only to the banking sector in China and even exceeding the traditional insurance sector.

Much has been written about this unique development of the Chinese trust industry that has very little in common with what we see in Western markets. There is considerable concern especially by outside observers of China's economy and financial system about the amount of risk accumulated in this industry – although we believe that some or much of the concern is due to some misunderstanding about the nature of the trust business today (see Special discussion 1 in Chapter 1). While the regulatory framework of the Chinese financial system is evolving rapidly putting into question some aspects of the current business model of trust companies, the need for vehicles that bridge the financing needs of relatively higher risk businesses with the search for yield by HNWIs and institutions in China seems unlikely to be met by banks or debt capital

markets in the near future. Nevertheless, the current development does raise the question of sustainability of the trust industry's business model in the long run. On the other hand, there are some very significant opportunities for this industry in terms of future growth and development that we will point out in this paper. Alternative asset management and private bankding are two areas of the financial system that are not very well developed yet, and where trust companies have some significant competitive advantages.

Given all this, what are the strategic options for individual trust companies, and which core capabilities will they need to develop to capture these opportunities for the sector? If we fast-forward to 2018 and look back, will the trust industry still play the same role as today in China's financial system? What are the potential options for individual companies and how do they prepare for the future?

With these questions in mind, the authors of this report aim to raise awareness for the role of the trust industry in China's financial system today, and contribute to the discussion of the future of the trust industry as the Chinese financial system develops and matures further.

We will explain the development and trends of the different business models for trust companies in China today and going forward, and draw on experiences from international markets where we believe these can give some indication for the potential future trends of China's trust industry. Through this report, we hope different stakeholders, from investors to industry observers, can further understand the trust industry, the products and services it can provide, as well as its unique role in China's financial system today. Trust industry practitioners may leverage the findings to consider and plan their own business models and strategies. In our report, we are recognizing the unique features of the Chinese financial system at its current development stage. The approach we are taking is that we are analyzing the trust industry by type of activity, rather than looking at it as a whole – which we believe reflects better how these companies operate, and allows for more insights into what has been driving growth so far, and what will drive economic success in the future. This approach also allows for more meaningful comparison with developments in global markets where these are relevant to China's unique financial system.

The main contributors to this report include executives from China Ping An Trust Co., Ltd. including Chairman and CEO Hoi TUNG, President Chengli SONG and Senior Vice President Qun FENG, as well as contributors from McKinsey & Company, including Jun XU (Principal), and Xiyuan FANG (Associate Principal). We are also thankful to Chairman Peter MA and General Manager Alex REN of Ping An Group, as well as Stephan BINDER (Director and McKinsey Asia Insurance and Asset Management Practice Leader), and Joe NGAI (Director and McKinsey Greater China Financial Institutions Practice Leader) for their guidance.

November 2013, Shanghai

Executive summary

THE CASE FOR CHANGE: TRUST COMPANIES AT A CROSSROADS

The Chinese trust industry is unique by international comparison. Globally, trust is a legal form used in financial solutions for risk isolation and tax optimization purposes. For example, it is widely used for cross-generational wealth transfer and by philanthropic foundations. In China, however, it refers to a particular type of financial services license enabling it to engage in a number of quite distinct areas of financial services.

Trust companies in China today are primarily engaged in two businesses.

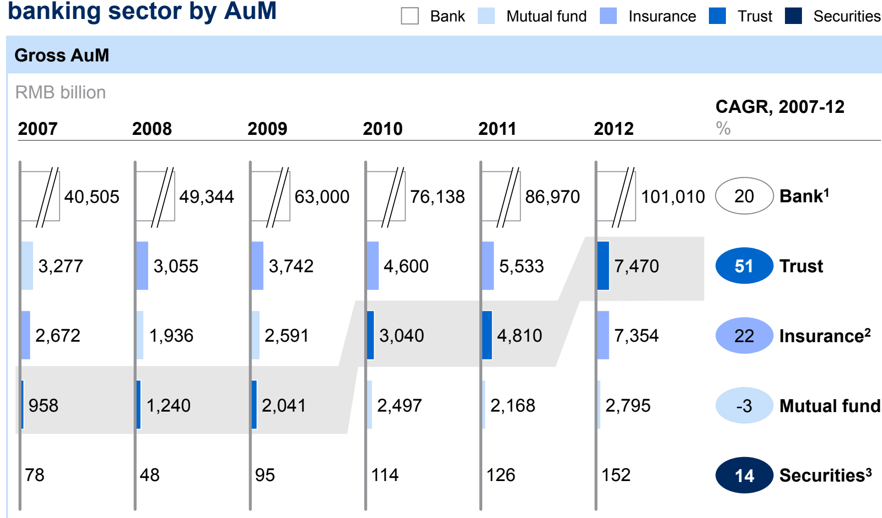
- **Private placement investment banking** – providing financing to relatively higher risk borrowers, funded by high-net-worth individuals (HNWIs) and corporations/institutions (investors)

- **Conduit business** – providing a conduit to banks and other financial institutions that are restricted from investing into certain asset classes or launching certain wealth management products. Trust is the only financial license that can invest in asset classes spanning across money market, capital markets and unlisted assets (such as loans, unlisted shares, etc.)

The trust industry has seen strong growth in AuM over the last 5 years. It had collected RMB7.5 trillion AuM by the end of 2012 (Exhibit 1), and this number rose to RMB10 trillion by Q3 2013 – more than the insurance and the mutual fund sectors. This rapid increase was due to the inability of the Chinese banking and capital market systems to provide sufficient financing for the fast growing and cash-hungry sectors like real estate and SMEs. Trusts were able to fill this gap in the financial system by bridging this financing need with the investment need in particular of the rapidly growing segment of wealthy investors looking for higher returns. The rise of HNWIs, (defined as individuals with personal investable assets worth over USD1 million or RMB6 million) looking for alternative investment opportunities to low interest rate deposits and long under-performing equities, have been key to generating funding for the industry.

EXHIBIT 1 GROSS AuM OF FINANCIAL SECTORS

By 2012, trust has become the second largest financial sector after the banking sector by AuM

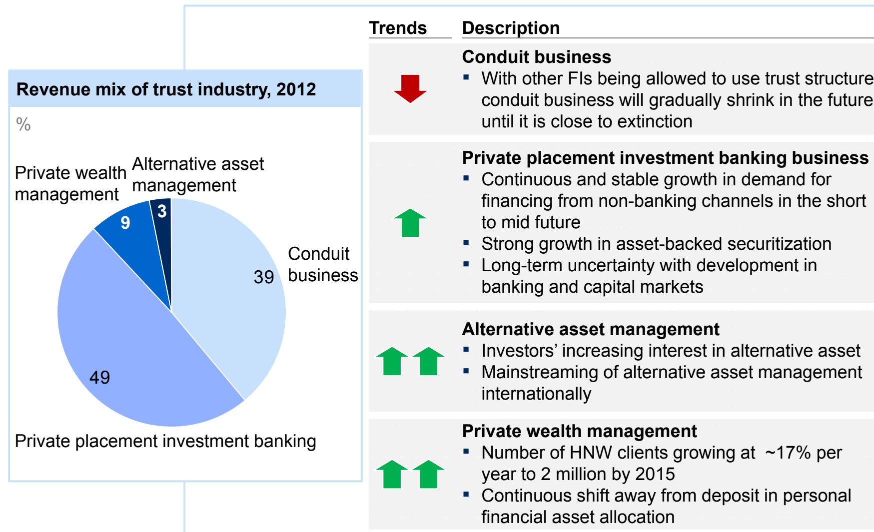


1 Bank gross AuM includes deposit and wealth management volume
2 Insurance gross AuM is the total asset of insurance companies, including investable assets and other assets
3 Securities gross AuM includes wealth management volume

SOURCE: PBOC; CBRC; CSRC; CIRC; McKinsey analysis

Despite this rapid growth of AuM, the industry faces significant challenges. We estimate that 88% of the revenues of Chinese trust companies' is at risk in the long-term. Today, 39% of revenue comes from the conduit business (Exhibit 2). We believe this is likely to vanish completely in five years as China continues its relaxation of the usage of the trust structure by non-trust companies – bringing the financial system more in line with what we see in international markets. Another 49% of the industry's revenue today stems from the private placement investment banking business. In developed countries, this financing function is typically performed by banks and capital markets. As Chinese banks extend their lending more and more to SMEs and other relatively higher risk borrowers, and capital markets become more developed, in particular the high yield or junk bond market, just how big a role will be left for trust companies and at what margins is unclear. However, the development of a well-functioning junk bond market and banks with the risk appetite and the underwriting skills to fully meet the financing needs of the vast and fast growing Chinese economy is most likely going to take many years. During this time, private placement investment banking will still be a viable business model for trust companies in China.

EXHIBIT 2 CURRENT REVENUE MIX OF TRUST INDUSTRY

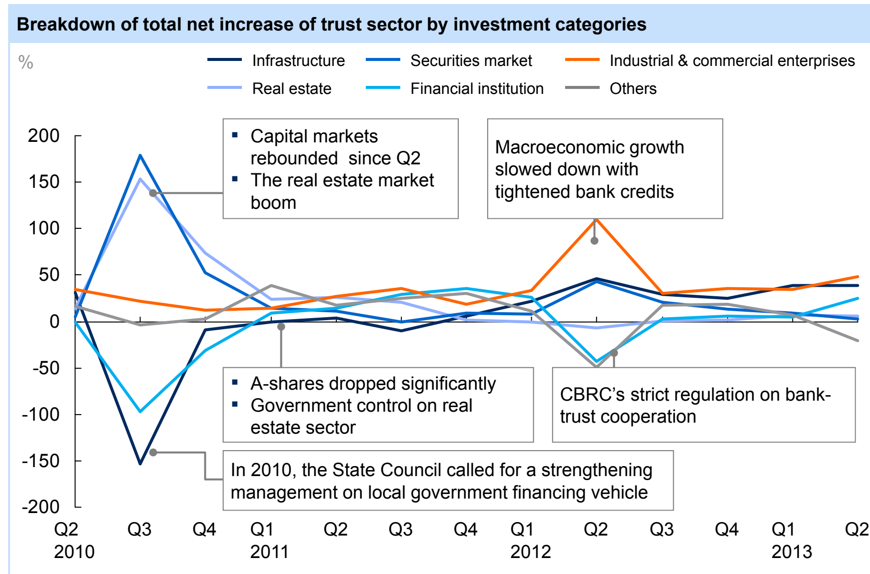


SOURCE: China Trustee Association; expert interview; McKinsey analysis

Moreover, AuM flows (and revenues) for trust companies from the private placement investment banking business have proven to be highly volatile, reacting sensitively to changes in the overall economy, changes in regulation and developments of other parts of the financial system (Exhibit 3). Today, the credit underwriting criteria for trust loans are often significantly lower than those applied by banks or debt capital markets. Given that trust loans are concentrated in a few high-risk areas, such as real estate and government lending vehicles, this part of the business could be hit hard in a downward economic cycle. Demand for trust loans is dependent on the economic and financial policies present in China, making it a highly volatile business, evidenced by the big swing in volume and sector focus over the last five years.

EXHIBIT 3 TRUST LOAN VOLUME AND SECTOR FOCUS

Trust loan volume and sector focus shifts rapidly with large volatility



SOURCE: China Trustee Association; McKinsey analysis

China's trust industry has, therefore, come to a crucial crossroads, where it is facing sustainability challenges to those parts of its business that have led to the fastest growth in the past. This poses the question of what will be the future growth model for the trust industry as the Chinese financial system keeps developing and maturing. On the other hand, the trust industry today is also engaged in areas that are bound to deliver attractive opportunities going forward, in particular alternative asset management and private wealth management. Shifting their business model to these less developed revenue sources, however, requires a fundamental business model transformation, rather than just incremental changes in selected areas. In the next five years, we expect the performance of trust companies to diverge at greater speed. Companies able to transform themselves sooner, have a better chance of building a more balanced and sustainable business model. They will be more likely to qualify for public listing as a standalone business, and be well-positioned to take advantage of the inevitable industry consolidation. Those trust companies that are unable to make the transition will face significant challenges to their business models. In the most extreme scenario, they will have to leave the market or be subject to consolidation.

THREE DISTINCT BUSINESSES: THE FUTURE GROWTH ARENAS FOR TRUST COMPANIES

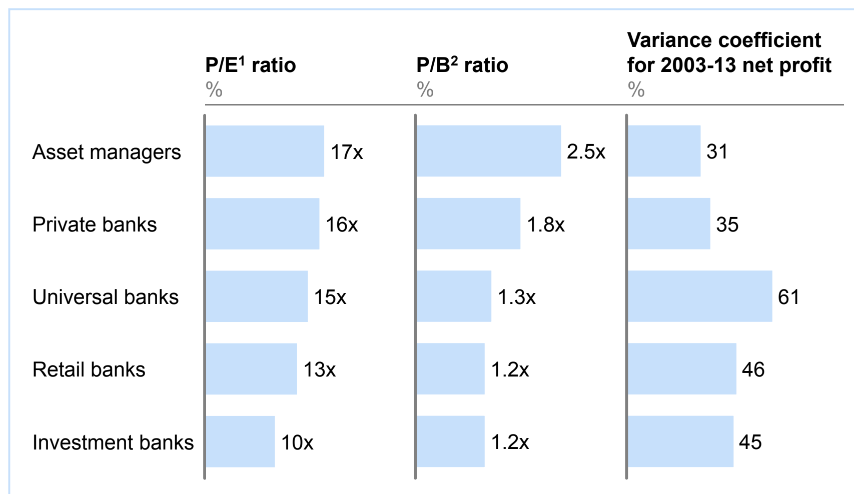
The crucial mission for Chinese trust companies is to find new and more sustainable revenue sources to compensate for the expected decline in the conduit business, and smooth out the volatility from the private placement investment banking business. We believe that the future Chinese trust industry has two high potential sources of revenue, namely alternative asset management (AAM) and private wealth management (PWM). First, these two revenue sources will be among the fastest growing financial sub-sectors over the next decade,

as private wealth accumulation continues its explosive growth path and seeks diversification away from bank deposits. Second, these are relatively new areas in China's financial landscape, with few mature and professional players. There is plenty of room for new entrants like trust companies. Third, trust companies do have some competitive advantages in these two businesses, such as the already extensive deal sourcing networks and sizable HNWI client bases. Fourth, AAM and PWM are relatively capital-light and more stable businesses, generating less volatile income streams. As such, they provide a good complement to the current capital-heavy, volatile lending business. Since the global financial crisis, the increased capital requirements towards volatility and risk and the global deleveraging have caused global capital markets to favor businesses that show consistent returns and lower risk, like asset management and private banking, as reflected in market valuations (Exhibit 4). We believe this trend is already affecting China's financial sector, too. Therefore, increasing the share of the asset management and private wealth businesses within their portfolio would enable trust companies to capture some of the most attractive growth areas in China's financial sector and stabilize revenues and earnings. A more sustainable and stable business model could also pave way for future IPOs of trust companies – which is a declared objective of some of the larger players.

EXHIBIT 4 VALUATION AND PROFIT VOLATILITY OF DIFFERENT TYPES OF FINANCIAL INSTITUTIONS

Asset managers and private banks have higher valuation and lower business volatility

EUROPEAN MARKET



1 As of 1st Oct, 2013 based on12 month forward EPS forecast
2 Median of monthly P/B ratios from 2003 to 2013

SOURCE: DataStream; McKinsey analysis

In summary, we believe there are three distinct areas in China's financial services market that will provide key growth opportunities for the trust industry over the next decade. Depending on their level of ambition and capabilities, individual trust companies will need to choose one or a combination of these opportunities (Exhibit 5).

EXHIBIT 5 BUSINESS MODELS OF TRUST INDUSTRY

The three business models differ significantly in business and profit model and core capabilities required

	Business description	Customer group	Revenue structure	Core capabilities
Private placement investment bank	▪ Identify financing needs and maintain relationship ▪ Design financing products ▪ Sell products via own or 3rd party channels	▪ SMEs ▪ Local government ▪ Real estate companies	▪ Underwriting fee	▪ Deal origination ▪ Clients coverage and sales ▪ Risk management
Alternative asset investment	▪ Raise funds from customers ▪ Develop investment strategy and make assets allocation based on customer requirements ▪ Perform portfolio management to increase ROI	▪ Institutional investors ▪ Ultra-HNWIs	▪ Management fee ▪ Carry	▪ Investment management ▪ Portfolio management
Private wealth management	▪ Mainly aim to satisfy customers' demands for financial management and select best products for maintain customer relationship	▪ HNWIs	▪ Sales commission	▪ Sales and service ▪ Product screening and selection ▪ Investment advisory capability

SOURCE: Expert interview; McKinsey analysis

Private placement investment banking, for most trust companies, will remain as a core business, but it will require a more professional and skills-based approach. Unlike the current private placement investment banking model, which relies heavily on "Guanxi", or relationships, at various levels of banks for client referrals, the new model requires direct and highly specialized coverage of underlying assets in target sectors. For most players, this will mean building up a professional coverage team with industry specialization that will nurture a more efficient "headquarters to headquarters" business development as banks increasingly centralize their decision-making. With dedicated teams, trust companies will also be better able to cultivate other sources of asset origination like local governments and non-bank financial institutions. At the same time, these private placement coverage teams need to have wider and deeper geographic footprints, to capture the attractive asset origination opportunities in tier-2 and tier-3 cities.

Alternative asset management is an area in which sophisticated trust companies could build an essential part of their business. The potential is especially great since established local players are few. In China today, institutional investors and high-net-worth individuals are increasingly looking for a wide array of alternative assets. This is not only a local trend – globally AAM is also becoming a more mainstream investment category in institutions' asset allocation strategy. This trend creates an attractive opportunity for trust companies to develop this business and make it a core revenue and profit source. In the not too distant future, China will have its own versions of such companies as "Blackstone" and "Carlyle", managing more than RMB1 trillion of assets – and some of these future asset management giants in China might originate from the trust industry.

Private wealth management is another strategic option for trust players with ambition to serve HNWI clients. The speed of personal wealth accumulation in China is astounding, and 2012 marked a tipping point for accelerated growth. McKinsey analysis suggests that, by 2015, the number of HNWIs in China will

reach approximately 2 million, with accumulated investable assets increasing to RMB60 trillion, compared to a mere 870 thousand HNWIs and RMB21 trillion HNW assets in 2010. By then, China will have become the second-largest onshore private wealth management market in Asia, second only to Japan. However, the capabilities required to be successful in PWM are very different to how trust companies operate today, and will take time to build. Leading trust companies with large business scale and proprietary distribution networks could strategically enter this area by building on their existing HNWI client base, in order to further enhance the stability of their overall business portfolios.

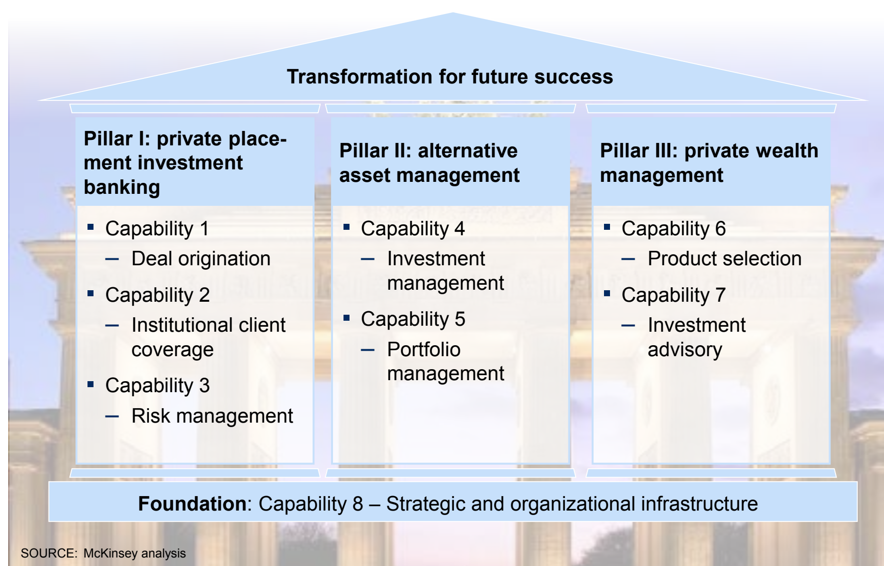
The transformation required for individual trust companies and the change at the industry level will not be easy. First, keeping the core business of private placement investment banking growing will be challenging amidst cut-throat competition from securities companies and fund managers. Second, AAM and PWM each requires very different capabilities than the traditional IB business, and these capabilities will take time and management attention to develop. Third, neither AAM nor PWM is in the exclusive domain of trust companies. Banks, securities companies, mutual fund firms, boutique AAM firms and Independent Financial Advisors (IFAs) are all eyeing these two opportunities and are in fact already competing in this space.

EIGHT CAPABILITIES: A ROADMAP FOR TRUST COMPANIES' TRANSFORMATION

New business models demand new capabilities. Given the distinct nature of the three potential pillars of trust companies, eight new capabilities are required to transform the trust industry for future (Exhibit 6).

EXHIBIT 6 EIGHT ESSENTIAL CAPABILITIES

Eight essential capabilities to transform trust companies for future success



SOURCE: McKinsey analysis

Pillar I: For private placement investment banking, companies need to develop:

- **Capability 1: Deal origination.** Trust companies need to professionalize their coverage team and increase the breadth and depth of asset coverage to originate high quality deals at scale

- **Capability 2: Institutional client coverage.** Trust companies urgently need to strengthen their institutional coverage team to build headquarter level relationships, upgrade their coverage for other asset sources such as local governments and non-bank FIs

- **Capability 3: Risk management.** Trust companies should prudently approach their trust loan portfolio with a solid bank-like risk management system, as well as a highly standardized and centralized credit decision process to improve the underwriting quality

Pillar II: For alternative asset management, trust companies need to build up:

- **Capability 4: Investment management.** Trust companies need to articulate their investment strategy, develop a rigorous investment management process, and be able to attract and retain high-caliber investment talents

- **Capability 5: Portfolio management.** A unique feature of and source of value creation for best practice alternative asset managers, is the ability to deliver substantial operational improvements at portfolio companies

Pillar III: For private wealth management, companies should aspire to establish:

- **Capability 6: Product selection.** Trust companies aspiring to build a full blown wealth management business should gradually establish an open product architecture to be able to offer non-proprietary products to become truly professional financial advisors and to satisfy clients' one-stop shopping needs

- **Capability 7: Investment advisory.** Trust companies should have a rigorous advisory process, carried out by a combination of an advisor team, supporting product specialists, and remote customers service channels

Organizational foundation: Lying beneath the "three pillars" is, we believe, a fundamental set of organizational capabilities required to enable the complex strategic transformation of China's trust companies.

- **Capability 8: Strategic and organizational infrastructure.** A clearly defined business strategy, a supporting organizational structure, a professional talent pool, and a rigorous performance culture, are critical to the success of trust companies' strategic transformation

EXTERNAL ACCELERATOR: REGULATORY ENVIRONMENT REQUIRED

On top of the internal capability building of trust companies, a market-oriented and open policy environment is crucial to the development of the industry. Based on our experience and research of the regulatory infrastructure in financial services in the developed markets, we propose four aspects of potential policy changes for the regulatory body's consideration.

- Private ownership should be further encouraged to invest in the trust industry, so as to diversify trust companies' shareholding structure and modernize their corporate governance practices. Currently, trust companies are still predominantly controlled by local governments or State-owned-enterprises. A more diversified shareholding structure could bring in more dynamic competition and stimulate innovation in the industry

- Open competition and healthy consolidation of the industry should be encouraged with an exit mechanism created for failed companies and, in the process, nurture a batch of flagship trust companies with the ability to go public

- Supervision on risk control and investor protection should be further strengthened. Although trust companies are theoretically not liable for the credit risks, a major hike in default rate will cause widespread losses for investors and industry-wide reputation crisis. Regulators should closely monitor the "leverage ratio" of the industry, steer the trust companies to reduce their concentration in real estate and local government lending vehicles, conduct rigorous stress tests to understand better the potential impact of risk factors, and actively strengthen risk management culture and capabilities of the trust companies

- Innovation of the business model and the product offering in the areas of asset management and private placement investment banking should be further encouraged, providing a "green light" for innovation and new idea generations from industry practitioners. Currently, although trust companies are only required to register their new products with regulators afterwards, in reality they often have to get approval in advance and different local CBRC offices exercise different level of prudence when approaching these approvals

China's trust industry is at a crossroads. Trust companies must transform themselves strategically to survive and prosper. For the companies that intend to embark on this transformation, they will need to set a clear strategic direction, articulate the path forward, invest significant amount of resources and management attention, and build up a series of core capabilities as soon as possible. Facilitated by a proper regulatory environment, the industry could eventually build on its unique legacy, and emerge with an even more distinctive value proposition for its customers and for the Chinese financial system as a whole.

Chapter 1

The unique nature of China's trust industry

1. The unique nature of China's trust industry

China's trust industry, which has seen enormous growth of asset inflows and revenues over the last five years, is a unique industry constituted of a group of quite distinct businesses under one single license. The industry is also unique in the way risks are perceived by the market and managed by institutions. Such a "trust industry" is totally nonexistent outside China.

UNIQUE NATURE OF CHINA'S TRUST INDUSTRY

The concept of a trust license is unique to the Chinese financial system, reflecting its current stage of development. Internationally trust is a financial and legal arrangement in which property is managed by one person or entity for the benefit of another. This arrangement can be used by various financial and non-financial institutions, but in itself, it is not a business line nor a financial institution. For example, international private banks usually leverage trusts as a legal arrangement to help their client with property inheritance and other tax-optimizing matters.

In China, trust is a unique form of financial institutions (FIs), to which there is nothing comparable in the developed markets. It is not a single form of financial business but rather a collection of businesses enabled by a single license in China. At its current stage of development, it mainly takes the form of two distinct business models, namely private placement investment banking (i.e., high yield loans funded by wealthy individuals or corporations/institutions), and conduit (effectively verifying the trust license to enable banks and other institutions to invest in certain asset classes they do not have a license to invest in on their own).

Private placement investment banking: intermediate financing between corporate or institutional borrowers and HNWIs and corporations/institutions (investors) in a non-public market context (i.e., private placement market). Given the separation of operations and supervision in China's financial sector, securities companies serve as the public market investment banks while trust companies play the role of private placement investment banks. This is unlike the practice globally where investment banks typically cover both the public and private market under a single license.

Conduit business: Trust is the only financial license that can invest in asset classes spanning across money market, capital markets and unlisted assets (such as loans, unlisted shares, etc.). Leveraging this unique regulatory and legal environment in China, trust companies serve as a conduit for financial and non-financial institutions that need to invest across asset classes or use the trust structure to launch investment products such as hedge funds. The most notable example is the bank-trust partnership where banks use trust companies as a conduit to create wealth management products that are invested across different asset categories. In China, banks are not allowed to invest into capital markets and some private asset markets on their own license.

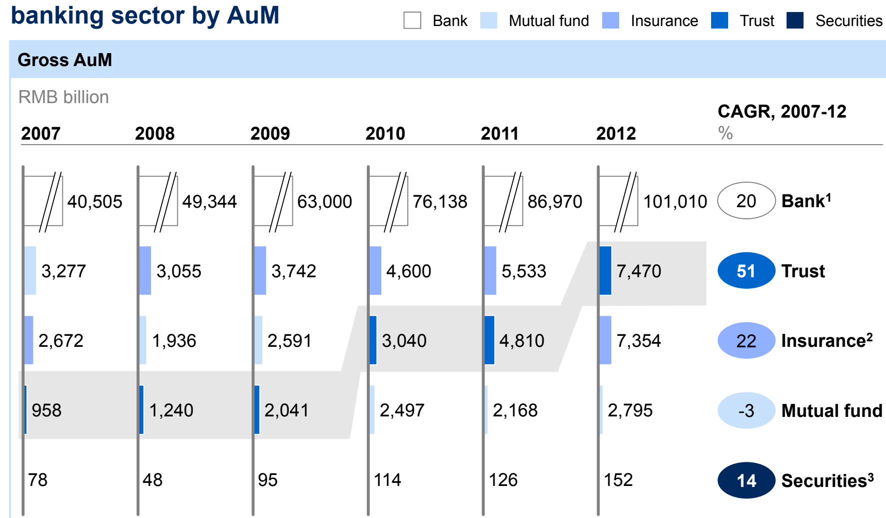
This combination of businesses for China's trust industry is quite unusual by international comparison. Private placement investment banking activities, in the global market, are primarily conducted by investment banks as an integral part of their underwriting business. They are also conducted by commercial banks, specialized lenders and direct-lending asset managers. The conduit business, again, is a distinctly Chinese concept. In term of legal form, it resembles the special purpose vehicle (SPV) created in securitization deals. Neither of these two businesses warrants a distinct business license except for China.

THE RISE OF CHINA'S TRUST INDUSTRY

Over the last five years, China's trust industry has seen a very rapid increase in AuM. With a compound annual growth rate (CAGR) of 51% between 2007 and 2012, the AuM of the Trust industry reached RMB7.5 trillion at the end of 2012 (Exhibit 7). By then it had surpassed AuM of the insurance industry and of the mutual fund sector. By Q3 2013, this number had already exceeded the hallmark RMB10 trillion. Trust loans, as a corporate financing channel, have become a major source of financing for the Chinese economy, in particular in higher risk segments like the real estate sector. Its share in total social financing in China, a broad measure of liquidity in the economy, has quadrupled from 3% in 2007 to 12% in June 2013.

EXHIBIT 7   GROSS AUM OF FINANCIAL SECTORS

By 2012, trust has become the second largest financial sector after the banking sector by AuM



1 Bank gross AuM includes deposit and wealth management volume
2 Insurance gross AuM is the total asset of insurance companies, including investable assets and other assets
3 Securities gross AuM includes wealth management volume

SOURCE: PBOC; CBRC; CSRC; CIRC; McKinsey analysis

The fundamental drivers behind the super-charged growth are three-fold:

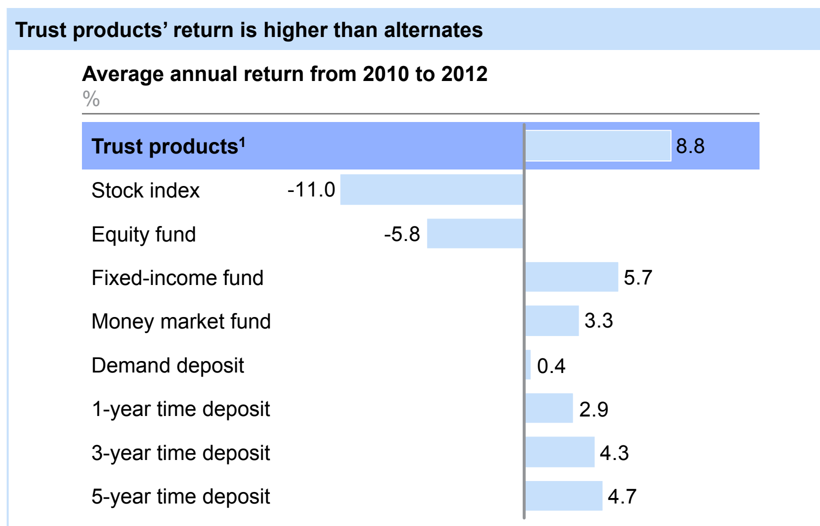
- The unique nature of the growth model of the Chinese macro economy: the fast and investment-led economic growth model led to a rising demand for financing, in particular in high growth and high risk sectors that are largely cutoff from bank lending

- The current structure of the banking sector and the lack of liquid high yield debt capital markets: the tightly regulated banking sector was unable to fulfill much of the financing demand in higher risk sectors, leaving ample room for alternative lending players like the trust companies to grow. Further, China currently does not have fully developed and liquid junk bond markets to finance lower-rating borrowers, so trust companies have effectively taken on this function

- The rapidly increasing wealth of China's HNWIs looking for investment opportunities: rapid wealth accumulation in China has resulted in increasing demand for higher return investments, compared to bank deposits with low or at times even negative real interest rates (with deposit return below inflation rate). The lackluster performance of the equity market in recent years, and a lack of alternative asset management products have made higher return fixed-income trust products a highly popular investment choice among China's wealthy. Indeed, the returns of trust products have been exceeding those of alternative investment options on average over the last three years (Exhibit 8) – however, this comparison does not take the differences in risk into account, and not all investors are fully aware of these underlying risks

EXHIBIT 8 NOMINAL RETURN OF VARIOUS INVESTMENT PRODUCTS

For HNWIs, trust products have claimed the highest investment yield in the past few years



1 Expected return. Actual realized return of all trust products is difficult to observe as payout information is not publicly disclosed

SOURCE: www.yanglee.com; China Trustee Association; WIND; Bloomberg; McKinsey analysis

China's trust industry is and will continue to be a combination of various business forms under one single license. Therefore, when we discuss the challenges and future of the industry, we would inevitably touch upon more than one established financial sub-sectors in the developed economies. It is also important to bear in mind that, with a unique manifestation of risk-return profile, trust loan as an asset class is yet to be fully comprehended by the investment community. These peculiarities of China's trust industry could never be overlooked when we consider its prospect going forward.

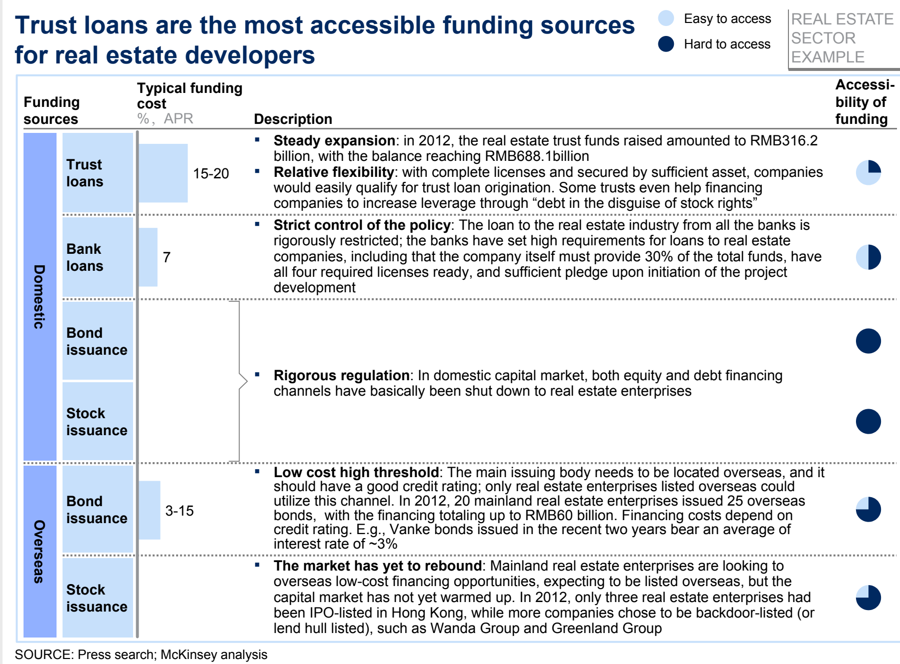
SPECIAL DISCUSSION 1:
How to decode the risks of China's trust industry?

The explosive growth of the trust industry has caused concerns over the risks facing the industry and the broader impact on the financial and economic situation at both home and abroad. While many associate the risks of the trust companies with those of the Western investment banks during the 2008 financial crisis, the reality is a bit more complicated. When a trust company issues a trust product, there is a trust plan where the issuers and the investors participate in. These trust plans are "off balance sheet", meaning that these assets do not sit on the balance sheet of the trust companies, and usually they do not have any exposure to the trust plans, except in the case when they also invest their own capital in these plans (relatively small scale – total equities of all trust companies amount to RMB260 billion, within which 12% are invested into trust loans). Therefore, the investors technically do not have any recourse to the trust companies – they can only go after the issuers or the guarantors of the trust plan.

However, trust companies are exposed to operational and reputational risks. As explained above, trust companies are theoretically not liable for any credit risk so long as they fulfill their obligation in the underwriting and selling process, nevertheless, a major hike in trust loan defaults will cause widespread losses for investors and jeopardize the reputation of the entire industry. Since many trust companies are quite primitive in terms of quality of management and there is no clear criteria to define whether a trust company fulfilled its obligation in conducting due diligence on the borrower and fully disclosed the risks to the investor, trust companies are perceived to provide an "implicit guarantee" of the investors' principal, especially when retail customers are involved. The fact that most trust companies are owned by large SOEs, financial conglomerates and local governments further reinforces this perception. Therefore, it is unclear how the regulator and the legal system in China would react if there were widespread losses for retail investors. But it is likely that investors in China today are taking on more risk than they are aware of, and this might have consequences for the trust industry and for distributors of trust products (like banks) in the event of large scale losses.

Given their focus on relatively higher interest-paying segments, trust loans are inherently exposed to higher levels of credit risks compared with traditional financing instruments such as bank loans and debt markets. (See Exhibit A) Historically, the default rate of trust loan has been very low at around 1%. As economic growth slows, however, the inherent risks of trust loans are likely to be exposed on a larger scale. Moreover, concentration of trust loans in the certain sectors, e.g. real estate, also means that specific industry volatility could bring about a shakeout in this market.

EXHIBIT A



Trust loans are the most accessible funding sources for real estate developers

Easy to access
Hard to access

REAL ESTATE SECTOR EXAMPLE

	Funding sources	Typical funding cost %, APR	Description	Accessibility of funding
Domestic	Trust loans	15-20	▪ **Steady expansion**: in 2012, the real estate trust funds raised amounted to RMB316.2 billion, with the balance reaching RMB688.1billion ▪ **Relative flexibility**: with complete licenses and secured by sufficient asset, companies would easily qualify for trust loan origination. Some trusts even help financing companies to increase leverage through "debt in the disguise of stock rights"	
	Bank loans	7	▪ **Strict control of the policy**: The loan to the real estate industry from all the banks is rigorously restricted; the banks have set high requirements for loans to real estate companies, including that the company itself must provide 30% of the total funds, have all four required licenses ready, and sufficient pledge upon initiation of the project development	
	Bond issuance		▪ **Rigorous regulation**: In domestic capital market, both equity and debt financing channels have basically been shut down to real estate enterprises	
	Stock issuance			
Overseas	Bond issuance	3-15	▪ **Low cost high threshold**: The main issuing body needs to be located overseas, and it should have a good credit rating; only real estate enterprises listed overseas could utilize this channel. In 2012, 20 mainland real estate enterprises issued 25 overseas bonds, with the financing totaling up to RMB60 billion. Financing costs depend on credit rating. E.g., Vanke bonds issued in the recent two years bear an average of interest rate of ~3%	
	Stock issuance		▪ **The market has yet to rebound**: Mainland real estate enterprises are looking to overseas low-cost financing opportunities, expecting to be listed overseas, but the capital market has not yet warmed up. In 2012, only three real estate enterprises had been IPO-listed in Hong Kong, while more companies chose to be backdoor-listed (or lend hull listed), such as Wanda Group and Greenland Group	

SOURCE: Press search; McKinsey analysis

In a worse case scenario, a systematic meltdown can happen if there is a major economic recession coupled with a corresponding plunge in asset prices. The vast majority of the trust loans are secured with real estate or company shares at less than 50% loan-to-value ratio. Short of a major collapse in asset prices particularly in the real estate sector, trust companies are exposed more to liquidity risk than credit risk as they can repossess and resell the collateral to cover the loss. Of course, those trust loans that have inflated collateral value or illiquid hard-to-value assets such as mining plants as collateral are more exposed. All in all, as with most risks in China, whether the trust industry will see a credit crisis almost entirely hinges on the ultimate question of whether China will face a major economic recession.

From a regulatory point of view, the regulator needs to continue to closely monitor the overall leverage of the industry, concentration in some high-risk segments and strengthen risk management capabilities and professionalize sales processes in the trust industry to avoid excessive risk taking and to make investors fully aware of the risk they take when buying these products.

Chapter 2

Challenges facing Chinese trust companies

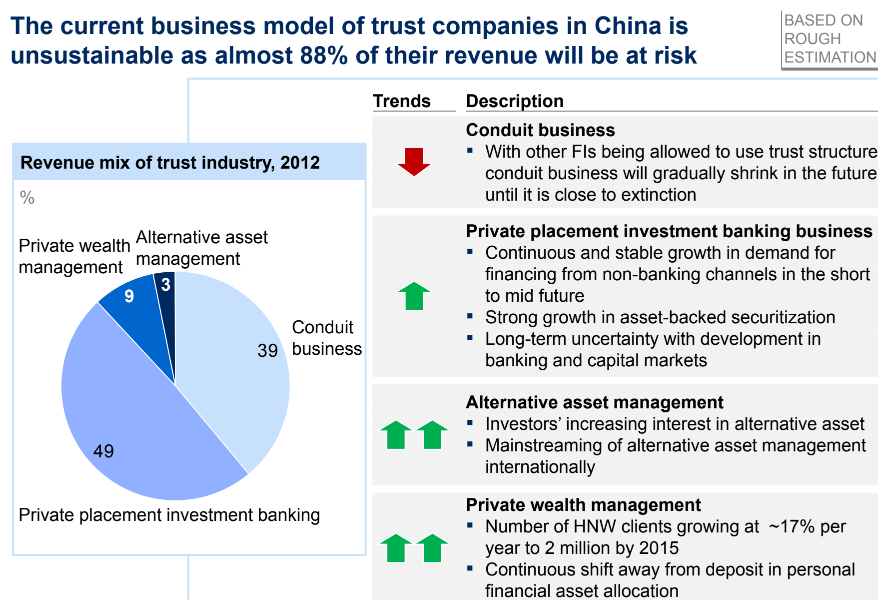
2. Challenges facing Chinese trust companies

We estimate that currently around 49% of the trust industry revenues can be attributed to private placement investment banking business, followed by approximately 39% from conduit business (Exhibit 9). This profit model that trust companies have relied upon is not sustainable in the future.

In the short-term, the conduit business will gradually shrink with declining profitability. In the mid- to long-term, the entire conduit business will likely diminish to conform to international market norms.

Private placement investment banking in its current form, while profitable and benefiting from continued unmet financing needs in the more risky parts of the economy, is inherently volatile, subject to regulatory changes and swings in the overall economy. It also faces increasing competition from banks, security companies and mutual fund managers. As the Chinese financial system matures, Chinese banks will become more flexible in their lending. Security companies and mutual fund managers are entering the lending space with a trust-like structure. High yield debt capital markets will become more developed and liquid. While the development will take many years, the role of trust companies in this particular area of finance is debatable in the long run. Without diversifying into other business areas, it is unlikely that the trust industry as a whole will be able to rely solely on private placement investment banking for long-term prosperity.

EXHIBIT 9 CURRENT REVENUE MIX OF TRUST INDUSTRY



SOURCE: China Trustee Association; expert interview; McKinsey analysis

THE DIMINISHING CONDUIT BUSINESS

In the short-term, the participation of securities companies and mutual fund companies will squeeze the market share of trust companies in the conduit business. This is a result of regulatory changes. In 2012, the CSRC allowed the asset management arm of securities companies and the subsidiaries of mutual fund firms to invest into more diverse asset classes and in effect enabled them to serve as a conduit, in direct competition with trust companies. Due to much lower capital requirements creating pricing advantage, these new players have been taking conduit business away from trust companies. The risk capital weighting for securities companies in conduit business is around 2%, in contrast to roughly 10% in trust companies. By June 2013, the asset under management of securities companies had reached RMB3.4 trillion, the majority of which came about as a conduit for the banks' wealth management products.

In the mid- to long-term, banks will likely be able to create wealth management products by directly leveraging trust as a legal form, thereby eliminating the market for conduit business completely. With the recent launch of the "bank-managed asset management plan", banks are able to launch wealth management products directly without going through any other intermediary. By November 2013, 11 banks had enrolled into the nation's pilot program and will launch asset management arms with a total AuM size up to of RMB10 billion. Despite the fact that the pilot program is on a small scale and therefore will have a limited impact on the conduit business for the time being, we believe it is a matter of time before this is rolled out universally. As a result close to 40% of trust companies' current AuM will disappear in the mid- to long-term.

THE VOLATILITY OF THE PRIVATE PLACEMENT INVESTMENT BANKING BUSINESS

Private placement investment banking is an inherently volatile business and thus would be quite challenging if it were the single primary business for trust companies. In today's market, the credit underwriting criteria used by trusts are significantly lower than those used by banks or debt capital markets. Given the high concentration levels in a few high-risk areas, such as real estate and government lending vehicles, this part of the trust business could be hit hard in a downward economic cycle. Demand for trust loans is dependent on the economic and financial policies in China, making it a highly volatile business, evidenced by the big swing in volume and sector focus over the last five years. We will describe this in more detail in Chapter 3.

TWO NEW GROWTH ARENAS FOR TRUST COMPANIES

To counter the long term sustainability challenges associated with private placement investment banking business, the trust industry needs to look for new sources of revenue. The two areas that trust companies are already participating and have some competitive advantages in are alternative asset management and wealth management.

The traditional asset management industry is already well established with many mutual funds and securities firms competing for market share. Trust companies have little experience and expertise in the capital markets business. In contrast, alternative asset management (AAM) and private wealth management (PWM) are relatively nascent businesses in China and are expected to see fast growth over the next decade. For the time being, the AAM and PWM markets remain small and fragmented, providing ample opportunities for trust companies to grow.

Furthermore, trust companies possess some unique advantages to compete in the emerging AAM and PWM businesses. In AAM, trust companies have built extensive coverage teams for deal sourcing and deep expertise in some sectors like real estate and infrastructure. In PWM, the overall market today is very "product-driven" – which plays to the strength of the trust companies as they are traditionally more knowledgeable on the product side compared to banks and independent wealth managers. In fact, many trust companies have already established proprietary sales teams selling their own trust products to HNW clients and have a substantial customer base to leverage.

Therefore, although there will be many competitors in the AAM and PWM space including the specialized asset managers, the private banking and wealth management units of commercial banks, and the securities firms, trust companies have their competitive advantage and would be able to provide a differentiated offering in these areas in the Chinese financial services landscape. From today's starting point where asset management and private wealth management only account for 3% and 9% of the revenue of trust companies, there is much room for growth.

Alternative asset management (AAM): traditionally the asset management industry in China is dominated by mutual fund companies. These traditional asset managers mainly invest in standardized products in capital markets, such as the money market, publicly traded stocks, bonds, etc. They charge a management fee typically set as a percentage of total assets under management without regard to the return on the assets. Alternative assets managers differ from traditional asset managers in two ways: firstly they invest in a broader range of asset classes, including private equity, infrastructure, and real estate. Secondly they operate with more aggressive pricing structures (e.g. typical hedge fund structures have a 15-20% incentive fee for returns above agreed-upon benchmarks). There is a wide variety of these alternative asset managers globally – the bigger ones such as Blackstone, Carlyle typically have multi-asset class offerings.

Private wealth management (PWM): this is an emerging area in the Chinese financial services industry, where financial institutions would provide HNW clients with comprehensive advisory services, such as asset allocation, product selection and investment consultation. PWM firms typically get paid by either commissions from product sales or as a percentage of the assets they advise on (most business models globally are still based on a sales commissions, although there are trends moving to a more AuM-based fee). (Exhibit 10)

EXHIBIT 10 THREE DISTINCT POTENTIAL BUSINESSES FOR TRUST COMPANIES

The three business models differ significantly in business and profit model and core capabilities required

	Business description	Customer group	Revenue structure	Core capabilities
Private placement investment bank	▪ Identify financing needs and maintain relationship ▪ Design financing products ▪ Sell products via own or 3rd party channels	▪ SMEs ▪ Local government ▪ Real estate companies	▪ Underwriting fee	▪ Deal origination ▪ Clients coverage and sales ▪ Risk management
Alternative asset investment	▪ Raise funds from customers ▪ Develop investment strategy and make assets allocation based on customer requirements ▪ Perform portfolio management to increase ROI	▪ Institutional investors ▪ Ultra-HNWIs	▪ Management fee ▪ Carry	▪ Investment management ▪ Portfolio management
Private wealth manage-ment	▪ Mainly aim to satisfy customers' demands for financial management and select best products for maintain customer relationship	▪ HNWIs	▪ Sales commission	▪ Sales and service ▪ Product screening and selection ▪ Investment advisory capability

SOURCE: Expert interview; McKinsey analysis

Given the nascent stage of these businesses in China, we believe that there is a lot of potential for trust companies to develop their businesses and reputation in these areas. And trust companies have a lot to offer to further develop this part of the financial system, given their unique skills in asset sourcing and their existing HNWI customer base and sales forces – to name just two. To do this, trust companies will need to define a clear strategy on where they would like to operate based on their ambition and competitive advantages. We believe smaller trust companies can evolve into specialized players within investment banking, AAM or PWM, while some larger companies with stronger capabilities will be able to simultaneously pursue most of these businesses.

Chapter 3

Private placement investment banking: Steady profit in the short to medium term

3. Private placement investment banking: Steady profit in the short to medium term

While the conduit business is likely to die out eventually, the trust companies' bread and butter business in private placement investment banking will likely continue to thrive in the near future. However, it is important to note that among all the financial sub-sectors, investment banking is perhaps the most volatile. Especially given the heavy regulatory changes that brought more competition from security companies and mutual fund companies, the profitability and growth of the investment banking business will face more challenges than before.

TRUST LOANS: INDISPENSABLE FINANCING VEHICLE IN THE NEAR FUTURE

Although the Chinese economy has entered a cycle of slower growth and structural adjustment, the economy's aggregated financing demand still outstrips credit supply by a large margin. In the foreseeable future, this gap cannot be met by the traditional banking system and capital markets. As a result, despite a slowdown from the previous five years, China's trust loan stock is expected to continue to grow at about 20% annually going forward, generating approximately RMB160 billion in industry revenue (USD26 billion) by the year 2018. Three factors are driving this growth:

First, total financing needs in China will continue to grow with the economy. In the past decade, the annual financing demand of the Chinese economy has risen eight-fold, from around RMB2 trillion in 2002 to RMB16 trillion in 2012. The amount of financing required for each incremental RMB in GDP growth also more than tripled, from 1.76 in 2002 to 5.95 in 2012. With a conservative estimate of 7% per annum GDP growth in the next five years, approximately RMB15 to 20 trillion financing will be required each year to fuel economic growth. Historically, banks could provide no more than about RMB10 trillion credit annually, with a peak level of RMB10.6 trillion lending during the stimulus in 2009. Under inflationary pressure and an imperative to optimize the structure of the economy, another credit stimulus similar in size to the one in 2009 is highly unlikely. On the other hand, even in the heydays of the last bull markets back in 2007 and 2010, the equity and debt market combined could only provide less than RMB3 trillion of financing in a single year. It is therefore anticipated that an annual credit shortage of at least RMB3-5 trillion will remain in the next few years. Non-bank, non-capital market channels, such as trust loans, will be absolutely essential to fill the gap.

Second, subject to many inherent restrictions, the banking system does not have the appropriate risk appetite to fully tap into private market financing opportunities. Given the banks' critical importance in China's economic, social and financial stability, banks are likely to remain being prohibited from engaging in high-risk businesses on a large scale. In the short to mid-term, banks are also constrained by regulatory requirements on capital adequacy, the loan-to-deposit ratio and annual credit quotas. Furthermore, even the most sophisticated

domestic banks have yet to acquire the skills or the appetite for a higher-risk lending business. The absolute level of the non-performing loan (NPL) ratio and the volume of write-offs are vital components of bank presidents' and branch managers' performance scorecard, and hence bank managers would always treat high-risk businesses with extreme caution, with many trying to avert them altogether.

Third, high-yield corporate bonds cannot fully replace trust loans in the short-term. Globally, the United States boasts the most sophisticated and liquid high-yield bond market. Since 2010, U.S. enterprises issued high-yield bonds with a total face value of more than USD200 billion annually, accounting for around 20% of total corporate bond issuance. They are primarily issued by companies with a lower credit rating, resulting in higher yields. Two factors contributed to the development of the U.S. high-yield bond market, namely a well-established credit rating infrastructure and a critical mass of institutional investors actively buying and trading these assets. Despite the fact that the U.S. credit rating agencies have been strongly criticized in the wake of the financial crisis, they have been a critical ingredient for the development of fixed income instruments. Investors make their trading decisions based largely on the credit rating of bonds and issuing entities. The existence of a large and sophisticated institutional investor community also stimulated the development of the high-yield bond market in the U.S. Due to their intrinsically high-risk nature, these bonds are mostly purchased by institutions rather than individual investors. Among the various market participants, pension funds, fixed income funds and insurance companies are typically the long-term-oriented bondholders, accounting for over 80% of bond holdings in total.

In contrast, China's economic and financial environment still lacks the conditions to support the expansion of the high-yield bond market. Local rating agencies are growing fast, but their tools and methodologies, as well as market credibility, still need to be strengthened. Domestic institutional investors are far from mature in terms of their size and sophistication. Pension funds and insurance companies are relatively conservative in their investment approach, while the total size of fixed income funds remains small. By 2012, China's fixed income funds had RMB285 billion assets under management, only about 10% of total mutual fund assets. The immaturity of the institutional investor community and absence of a well-established credit rating ecosystem is likely to hamper the development of a liquid high-yield bond market in the foreseeable future. Correspondingly, this market vacuum has been filled by trust loans, creating sustained momentum for trust companies' private placement investment banking business.

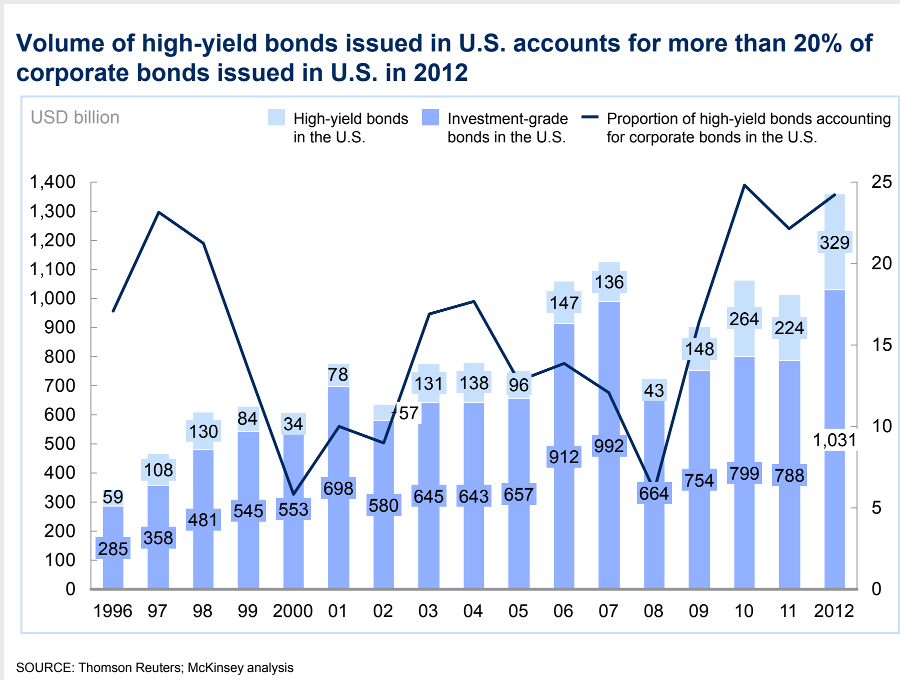
SPECIAL DISCUSSION 2:
China trust loan = US high yield bond?

What is a high-yield bond?

A bond that is rated below Baa/BBB, and serving corporations with financing needs and low credit ratings

Bonds can be classified into two major categories, namely, investment-grade bonds and high-yield bonds. Rating agencies, Moody and Standard & Poor's, define bonds with a rating below Baa and BBB respectively, as high-yield bonds or "junk bonds". High-yield bonds were initially issued in 1977. Having experienced several cyclical swings, the annual issuance volume of high-yield bonds exceeded USD200 billion since 2010, with a current total balance of roughly USD1.3 trillion (Exhibit B).

EXHIBIT B



The similarity: US high-yield bond is comparable to China's trust loan in underwriting and financing cost

- In terms of **underwriting**, high-yield bonds are primarily issued through private placement to increase fund-raising efficiency and lower the threshold at the expense of bond liquidity. Trust loans in China offers a similar value proposition

- The risk premium for issuing high yield bond is mostly in the range of 4-10% over risk-free market interest rate. Whereas financing costs of trust loans range mostly from 6% to 12% spread to the two-year treasury rate, similar to those of high-yield bond

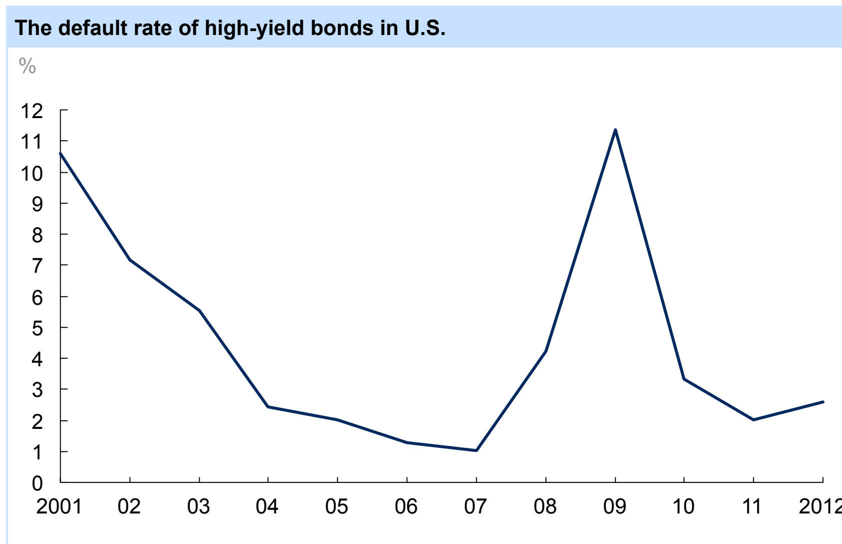
The difference: the default rate, the investor base and the duration

The **default rate** of US high-yield bond ranged from 1% to 12% in the past 10 years. It is particularly noteworthy that the default rate has been known to go

beyond 10% in the wake of an economic crisis (Exhibit C). For trust loans in China, the default rate has been lower than 1% so far given the fast growth in the Chinese economy. However, this is probably not sustainable. Once the economy experiences a slow-down, the default rate is expected to increase quickly. However, since this has not happened yet in the last few years, there is a risk that investors do not properly understand the true risks of these higher-yielding instruments. There is a twisted and inappropriate perception by many Chinese investors of an "implicit guarantee": in the event of a default, trust loan investors would expect the trust companies and distributors like banks to cover the loss and compensate them.

EXHIBIT C

The default rate of high-yield bonds fluctuates widely and is heavily influenced by the macro economy



SOURCE: Standard & Poor's Global Fixed Income Research and Standard & Poor's Credit Pro

Investors of global high-yield bonds in the US are mostly institutional investors, as this instrument is considered too risky and complex for individuals. However, in China, the majority of trust loans are issued to HNW clients, largely because of the search for higher-yielding investments and the perception of the lower risk (due to the implicit guarantee) – which again raises the question whether these investors fully understand the risk they are taking.

Regarding duration, US high-yield bonds usually have a maturity range of 6-10 years, whereas in China the maturity range of trust loans is often only 1-2 years. It is widely understood that in China, investors do not like investments with a long duration (especially individual investors) – so the duration does not mean that Chinese companies need short term financing but is rather an indication of investor's preference. However, in reality, in China many trust loans are continuously rolled over, making them effectively longer term lending instruments as well.

Trust loans in China and high yield bonds in the US share many similarities and serve the same financing needs to a large extent. Without the development and acceptance of a credit rating system, and the presence of large and mature institutional investors, trust loans will continue to be a popular vehicle for these types of financing of higher risk borrowers.

ASSET-BACKED SECURITIES: THE NEXT GROWTH ENGINE

Securitization of assets, especially through private placements, is likely to grow exponentially in coming years, posing attractive new opportunities for trust companies. In fact, the growth of asset-backed securities (ABS) is expected to significantly outpace that of trust loans, creating a potential new growth engine for trust companies.

Demand for securitization

Banks, local governments and non-bank financial institutions all have considerable demand for securitization. To fuel the 10-15% annual asset growth over the next five years Chinese banks need to significantly beef up their capital and deposit bases. To maintain the core capital adequacy ratio at its 2012 level of 10%, total equity of Chinese banks is required to almost double in 5 years, rising from RMB 8.7 trillion in 2012 to an estimated RMB 15 trillion in 2018. Additionally, the industry average loan-to-deposit ratio had risen to almost 72% by the end of 2012, edging toward the regulatory ceiling of 75%. There is therefore a natural impulse by the banks to securitize some of their assets, particularly those with a lower risk-adjusted return. Securitization could help banks streamline their balance sheets, off load less desirable assets, and significantly improve capital efficiency.

Other non-bank financial institutions are also eager participants in the securitization business. For example, leasing, auto finance, consumer finance and micro-lending companies, although highly fragmented and subscale at the moment, are expected to grow their assets to around RMB 4 trillion by 2015. Unlike the banks, these financial institutions are not allowed to take in deposits and therefore they are highly constrained by funding and the respective capital requirements prescribed by their licenses. Securitization could help to fulfill their growth ambitions.

The precarious financial conditions of many local municipal governments also calls for risk off-loading instruments such as securitization. With massive public sector expenditure in the development of infrastructure and public utilities, China's local governments have accumulated an estimated RMB 14-20 trillion in debt according to various sources in the market. With the central government's recent effort to bring transparency and stability to this part of the economy, securitization is one of the most attractive ways to de-leverage the local governments on a massive scale.

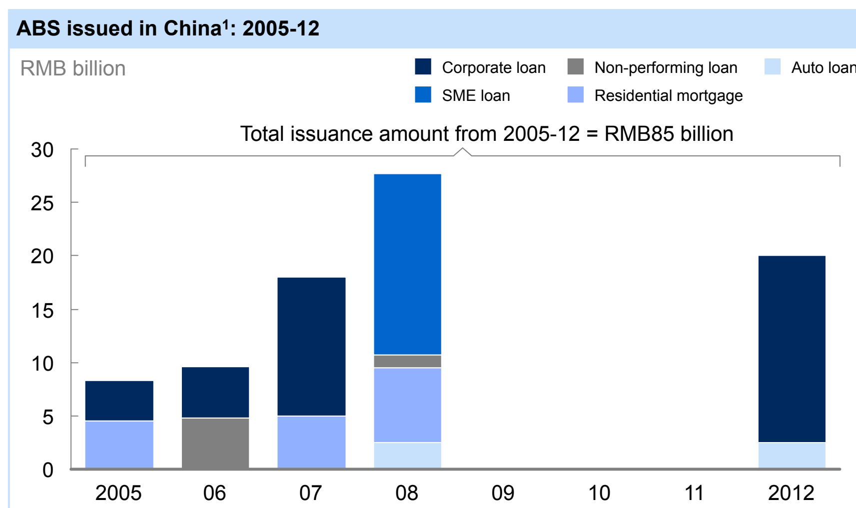
Rapid ABS development on the horizon

Next to trust loans, securitization and ABS looks likely to be another growth driver for the trust industry in China within their private placement investment banking business. The recent policy temperature points to a potential rapid development phase of ABS restarting soon. Securitization was piloted back in 2005-08, with ABS issuance volume peaking at over RMB 25 billion in 2008. However, hampered by the global financial crisis, the pilot was called off for three years, with the instrument only returning to market in 2012. In August 2013, a State Council mandate declared the government's ambition to develop a robust ABS market on the basis of prudent risk control. Ever since, regulators and

government officials have frequently expressed their support for the development of the ABS business. Some regulatory and legal roadblocks still need to be cleared, but the policy temperature and market momentum are clearly moving in this direction. China's ABS market is currently nascent with an extremely low market penetration, indicating large untapped growth potential – if Western financial markets are any indication of the future development of the Chinese financial system. By comparison, the total balance of ABS outstanding amounts to around 12 trillion USD in the US (approximately RMB 73 trillion), representing about 80% of nominal GDP in 2012, while, the accumulated issuance volume of China's asset-backed securities is around RMB 90 billion, a mere 0.18% of GDP in 2012 (Exhibit 11). However, a fast growing securitization market can also pose significant risks to the stability of the financial system if it is not accompanied by strict supervision and a stringent regulatory framework that ensures full transparency of the risks of these financial instruments to potential investors. The global financial crisis provides a valuable lesson for Chinese policy makers to avoid excessive and non-transparent risk taking in the financial system.

EXHIBIT 11 ABS ISSUANCE IN RECENT YEARS IN CHINA

The volume of ABS issued in China is relatively small, with no issuance between 2009 to 2011



1 Excluding origination under special asset management scheme

SOURCE: China Foreign Exchange Trade System

There will be three forms of asset securitization in China in the future, namely public offerings in the inter-bank market, public offerings on the exchange, and private placements primarily in the OTC market. In the US, private placement accounts for roughly 43% of new ABS issued in 2012. In China, there is reason to believe that the private placement market will take off first. Public offering of ABS at scale would require an objective and mature credit rating regime and a critical mass of institutional investors who are comfortable and competent with the asset class. Both will take significant time to develop. Therefore, private placements would likely be the avenue through which these higher risk-return assets would be marketed. Flexibility is the key here. Trust companies, with their experience in financial asset origination and a well-established investor base hungry for higher yielding returns, are natural players in the ABS private placement market. Players with the foresight to make an early investment in the relevant asset origination, product structuring and risk management capabilities, could well capture this high-growth opportunity over the next five years and beyond.

SPECIAL DISCUSSION 3:
Asset backed securities in developed markets

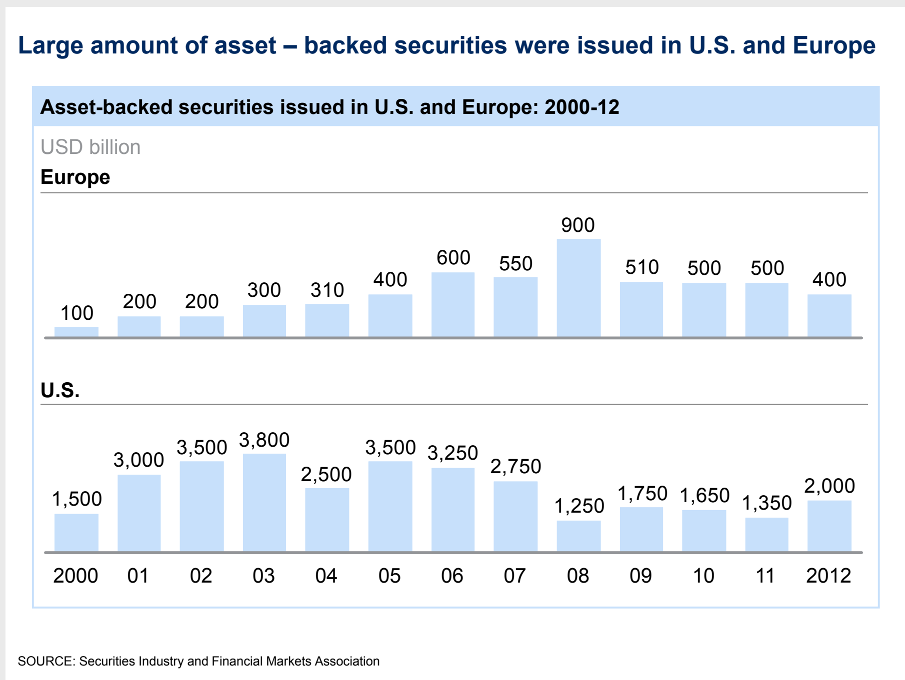
What are asset-backed securities (ABS)?

ABS is a significant asset class with large volumes in mature markets. At its peak, the annual issuance volume of ABS in the US amounted to USD3.8 trillion. Even after the financial crisis, the balance still exceeds USD12 trillion in the US, and more than USD2.5 trillion in Europe (Exhibit D).

There are five main types of securitized assets, of which residential and commercial mortgages are the principal source of assets in Europe and the US.

- RMBS (Residential mortgage backed securities): Securitization backed by mortgages from individuals and small business owners
- CMBS (Commercial mortgage backed securities): CMBS is backed by commercial mortgages for properties like office buildings, retail space, industrial properties, etc
- Credit card/ auto loan ABS: Includes a variety of consumer finance assets
- CLO (Collateralized loan obligation): CLO's assets comprise of corporate loans, which in turn can be further secured by properties and other assets
- WBS (Whole-business securitization): WBS is comprised of assets in continuous operation, such as public utilities, and toll roads
- Others: Other types of assets may include income from a lottery pool, receivables for medical services, royalty from patents, etc

EXHIBIT D ASSET BACKED SECURITIES IN US AND EUROPE



SOURCE: Securities Industry and Financial Markets Association

Learning from global experiences

ABS itself is a beneficial refinancing tool for the real economy. However, many investors have found that the multi-layer, complex nature of some of these securities and their related derivatives can make risk management difficult and amplify financial risks and volatility during time of crisis. Given the rather nascent risk culture and infrastructure today in the financial sector, China should avoid over-complicated financial tools and focus on primary securitizations that directly support the real economy. Some of these complicated instruments include multi-layer derivatives and structured assets that have already been securitized, usually termed CDOs (Collateral Debt Obligations). Throughout the 2008 financial crisis, such products have been criticized for serving as tools only for financial institutions to make enormous commission fees through inflated investment returns or under-stating the true risks.

EXHIBIT E SINGLE-LAYER ABS

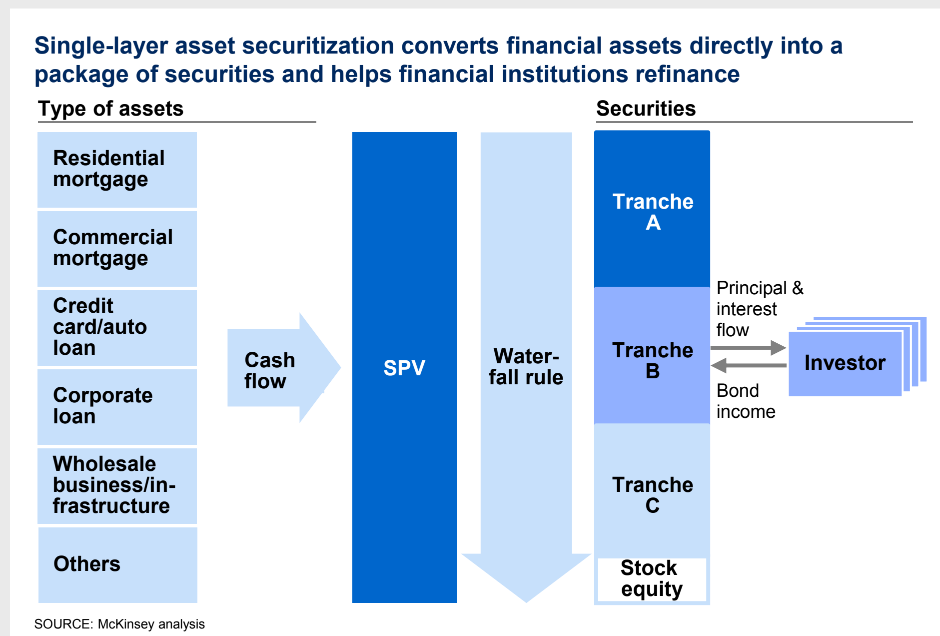
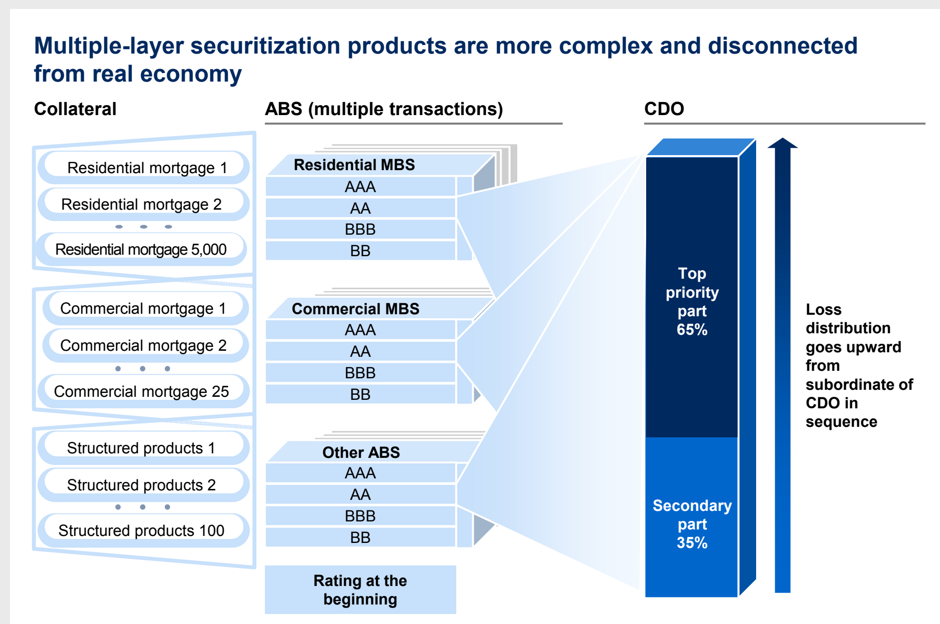


EXHIBIT F MULTIPLE-LAYER SECURITIZATION



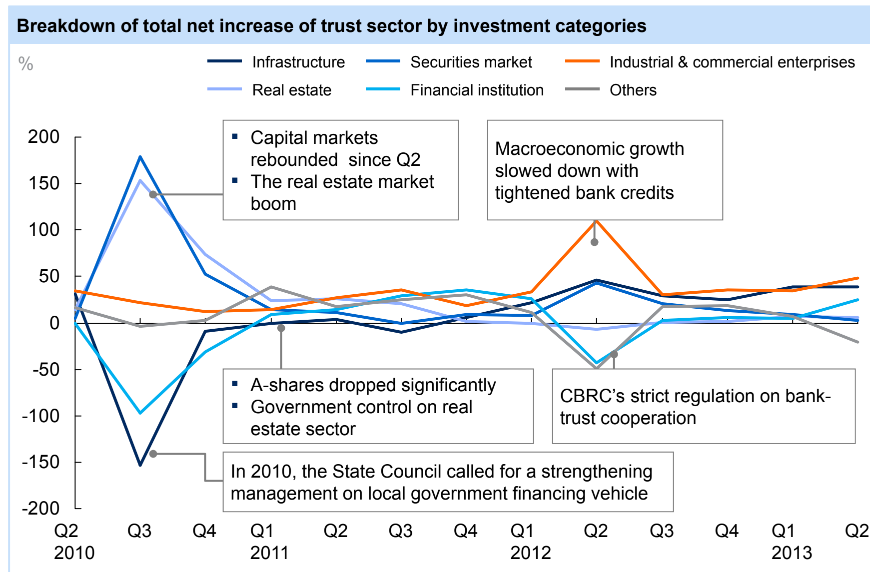
THE VOLATILE NATURE OF PRIVATE PLACEMENT INVESTMENT BANKING

The private placement investment banking business is risky, volatile and more competitive and uncertain in the long term since trust loans mainly goes to more risker segments. The trust loan business has inherent risks that cannot be overlooked. Since the business focus is largely policy sensitive and susceptible to changes in macroeconomic conditions, the entire industry is highly volatile in nature. And the competition is intensifying with security companies and mutual fund companies joining the battle for market share. Ultimately the development of more efficient and deeper capital markets could replace part of the role of trust loans today, edging closer to the more mature financing environment of developed markets. As a result, the private placement investment banking model could be severely challenged in the long-term.

Private placement investment banking is a policy driven business with high volatility. In China, unlike most global investment banks, trust companies have yet to develop sector specific know-how and underwriting expertise associated with industry verticals. The main reason for this is that investment themes and hotspots are constantly switching (Exhibit 13). For example, since 2010 the central government has imposed tighter controls over the local government financing vehicles. As a result vast amounts of trust loans shifted to the real estate sector and even into capital markets. This opportunistic nature of the trust loan business not only poses big uncertainties on trust companies' financials on a year-by-year basis, but also hampers their ability to build a more sustainable business platform and industry know-how.

EXHIBIT 13 IMPACT OF RAPIDLY CHANGING ENVIRONMENT ON TRUST LOAN VOLUME

Trust loan volume and sector focus shifts rapidly with large volatility



SOURCE: China Trustee Association; McKinsey analysis

To further complicate the situation, the competition in the private placement investment banking business is intensifying with security companies and mutual fund managers joining the battle for market share. Globally, securities companies do both private and public market transactions. They help finance a high-growth company during its growth phase, and then later bring them public. The ability to do both public and private market financing is actually a competitive edge for security firms. Therefore, although securities firms in China lack credit management skills in the short term, they pose a significant competitive threat to trust companies in the mid to long run. Particularly in the areas of securitization, if the public issuance market infrastructure is well in place, securities firms are likely to accrue the lion's share of the underwriting volume eventually, both in the public and private placement markets.

In the long-run, an investment banking business purely centered on trust loans will face significant challenges. Developed market experience indicates that as capital markets mature over time, publicly traded financial instruments will flourish, hence squeezing the margins and the volumes for banks and private market lenders. For instance, as of 2012, the U.S. stock market topped RMB119 trillion, whereas the corporate bond market amounted to RMB133 trillion, including around RMB10 trillion worth of high-yield bonds. These two markets combined is around twice the total size of outstanding bank loans (~RMB120 trillion). In contrast, only approximately RMB3 trillion assets originated as mezzanine debts, private distressed debts and private loans in the U.S. market. It is worth noting that most high-yield bonds cannot be traded on secondary markets, are issued in private placements and transacted over the counter. Therefore, the rough ratio between public market, bank loans and private market asset size in the U.S. is about 20:10:1.

In China, the scale of bank loans amounted to RMB68 trillion by 2012, while the stock market totaled RMB23 trillion, the corporate bond market is about RMB16 trillion, and the privately-raised fixed income market (represented by trust, securities' asset management and fund subsidiaries) represented RMB10 trillion. The ratio between public market, bank loans and private market asset size is roughly 4:7:1. If the Chinese capital markets successful transform themselves and grow in size and importance as the primary financing avenue for mid- and large-cap corporates, the trust companies' private placement investment banking activities will be severely challenged.

Private placement investment banking, and particularly the traditional trust loan business within it, is the dominant revenue generator of trust companies today. Going forward this trust loan business model will continue to exist as the burgeoning financing needs of society cannot be fully met by the banking system and capital markets in the short-term. Furthermore, securitization, particularly privately placed ABS, presents an additional growth opportunity for both public and private market underwriters. Both trust loans and ABS are likely to be major revenue generators for trust companies to tap into in the short to medium term.

However, the high volatility and high level of uncertainty associated with the investment banking business is likely to manifest itself over the long term. For those trust companies that have a long-term perspective, they may well start to diversify their business portfolio in order to avoid an over-concentration in investment banking activities.

Chapter 4

Alternative asset management: mushrooming and mainstreaming

4. Alternative asset management: mushrooming and mainstreaming

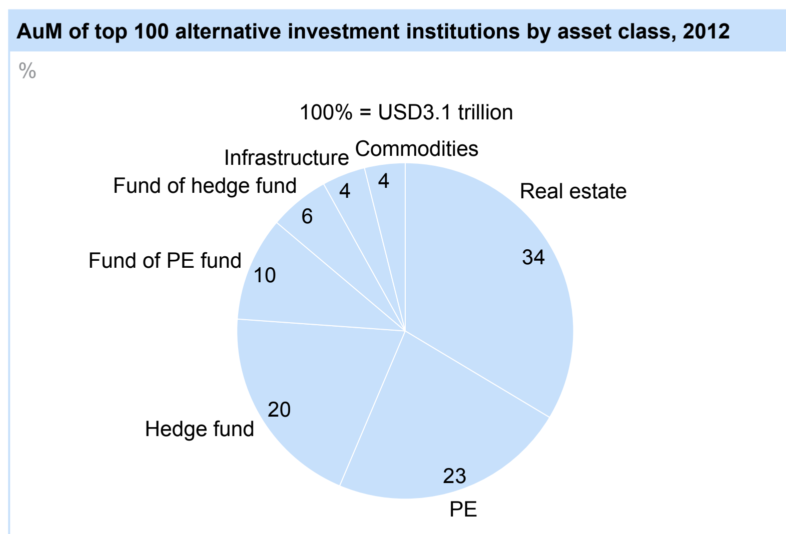
The recent global trend of "mainstreaming" alternative investments has reached China. The low interest rate environment and the sluggish performance of traditional asset management classes have heightened interest in alternative asset classes around the world, and China's alternative asset management industry is growing at unprecedented speed. There is good reason to believe that the strong growth momentum of this sector is set to continue throughout the next five years and beyond, presenting major value creation opportunities for trust companies.

MAINSTREAMING OF ALTERNATIVE INVESTMENTS GLOBALLY

In term of the size of the various alternative asset classes, a recent Financial Times and Towers Watson's survey on the top 100 global alternative investment institutions indicates that, the three biggest markets in terms of AuM are real estate, private equity and hedge funds, followed by fund of funds, infrastructure fund and commodities (Exhibit 14). These asset classes are traditionally deemed to be "alternative" to traditional asset classes, such as cash, equities and fixed income.

Exhibit 14 AuM OF TOP 100 ALTERNATIVE INVESTMENT INSTITUTIONS BY ASSET CLASS

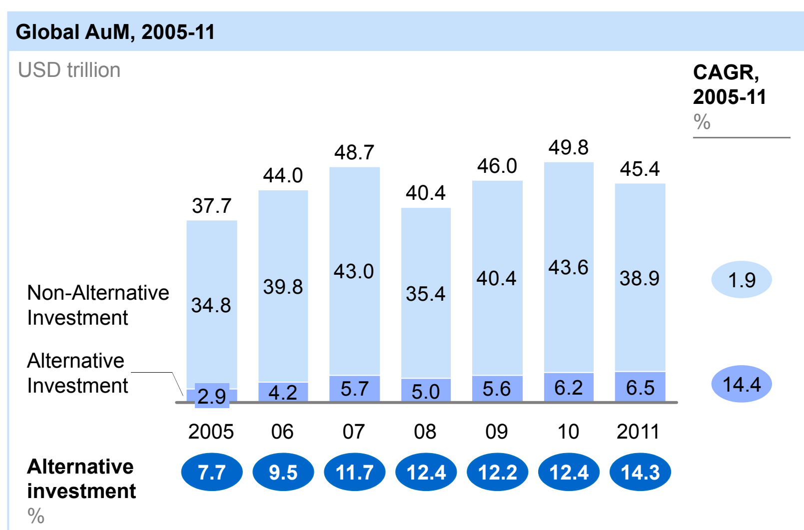
Among global top 100 alternative investment institutions, real estate, PE and hedge fund represent the greatest share of asset



SOURCE: Global Alternative Investment Survey, 2013

The global trend in alternative investments (including private equity, hedge fund, real estate, infrastructure and commodities) maps the way forward for China. McKinsey's annual global asset management survey shows that institutional investors have significantly increased their asset allocation in alternative asset classes since the global financial crisis. In 2009, U.S. and European institutional investors allocated an average of 14% of their assets to alternatives. This figure has risen to 23% in 2010/11 and is expected to exceed 25% by the end of 2013. As a result, the share of alternative investments in global assets under management (AuM) has risen from 7.7% in 2005 to 14.3% in 2011, a remarkable increase (Exhibit 15).

EXHIBIT 15 HISTORICAL GROWTH OF ALTERNATIVE AND NON-ALTERNATIVE INVESTMENT



SOURCE: McKinsey Asset Management survey; LipPEr; barclays; PEnsion and investment; preqin; HFR

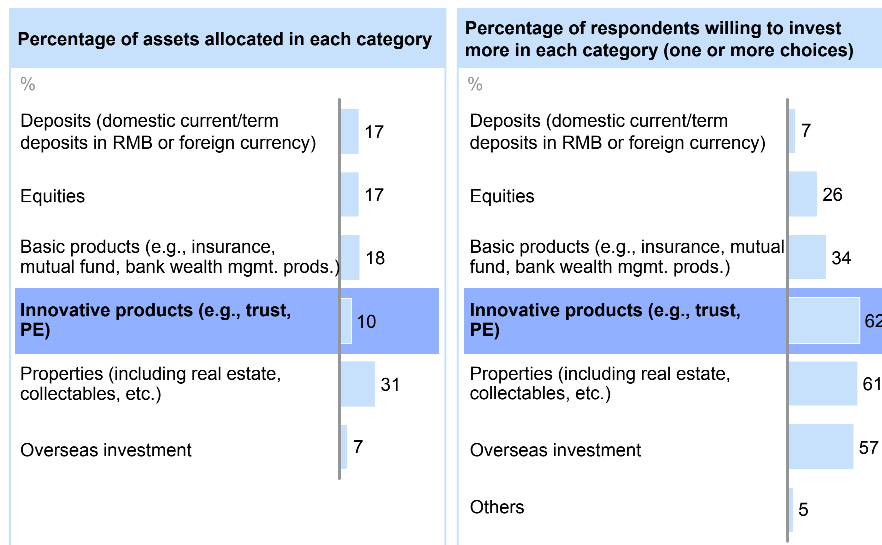
In addition to increasing adoption by institutional investors, the growth and mainstreaming of alternatives have also been fueled by retail investors, primarily high-net-worth individuals (HNWIs). Investment managers are facilitating this trend by making products more accessible, packaging alternative investment strategies into regulated mutual funds and Exchange-Traded Funds. Moreover, traditional and alternative investment managers have started to gradually converge over the last few years, with some traditional players now offering alternative products and strategies to the mainstream market.

CHINA'S GROWING INTEREST IN ALTERNATIVE INVESTMENT PRODUCTS

In China investors are becoming increasingly interested in alternative products, such as private equity funds, after several years of market cultivation. On the institutional side, the most sizable institutional investors, namely insurance companies, are gradually increasing their allocation in the alternatives space. More recently, CIRC has issued new regulations allowing for more allocation into these asset classes. Theoretically, insurers are now allowed to directly invest up to 40% in the alternatives. The objective is twofold: to capture excess returns superior to traditional asset classes in the short to medium term, and to alleviate the asset-liability duration mismatch. In particular, the duration mismatch in life insurance assets and liabilities is severe due to the limited availability of long-term fixed income products on the capital market. Long-term alternative investments in the areas of real estate and infrastructure would be part of the solution to this asset-liability mismatch.

On the retail investor side, the 2012 McKinsey survey on Chinese HNWIs shows that more than 60% are very interested in buying more "innovative products" such as trust products and private equity funds. At the moment China's HNWIs have only invested about 10% of their assets in these products, mainly in plain vanilla trust products. An increasing number of investors are, however, interested in more sophisticated private equity and real estate funds (Exhibit 16).

EXHIBIT 16 CURRENT ASSET ALLOCATION AND LIKELY FUTURE TRENDS FOR CHINESE HNWIs



SOURCE: Survey on High Net Worth Individuals in Mainland China 2012

SPECIAL DISCUSSION 4: Domestic institutional investors

Banks, insurance companies, wealth management institutions and large corporations are potential key institutional investors for trust products (Exhibit G). They are relatively concentrated in scale and region, especially banks and insurance companies. Decision-making on the selection of trust products within these organizations is being centralized to headquarter level.

Banks are the major funding source for the trust industry today. Banks invest in trust through inter-bank funds and treasury pool offering wealth management products, holding RMB4 trillion trust products by 2012. There are two key trends. First, banks are centralizing their decisions regarding whether or not to cooperate with trust companies. Second, regulators are watching closely and regulating the cooperation between banks and trust companies by (1) setting limits on non-standardized products held by the wealth management funds of banks, and (2) enhancing regulations with regards to interbank funds' purchase of trust products.

Insurance companies are now allowed to purchase non-standardized trust assets. According to the regulatory limits and the scale of the insurance industry, the estimated volume could reach as much as RMB2 trillion. With their vast asset base and the need to find higher yielding assets, insurance companies will likely be an important source of funds for alternative investment business.

The private banking departments of banks and various wealth management institutions serve a large number of high net-worth individuals. It is estimated that the investable financial assets of high net-worth clients in China is about RMB30 trillion, of which about RMB1.4 trillion has been used to purchase trust products.

Large Chinese enterprises hold huge amount of deposits, with a deposits to GDP ratio of 102%, much higher than that of any other country (for example, in the U.S. it is 53%). In mature economies, it is inconceivable that corporates are major buyers of asset management products or non-standardized products. However, in the short-term large Chinese enterprises still have a significant amount of cash sitting on their balance sheets. Many of them are trying to improve their yields or capital efficiency through different investment products and cash management solutions. As such, large enterprises have become an important funding source for trust products and even the alternative investment business, with the scale of trust products purchased exceeding RMB1 trillion. Even with this volume, it accounts for an insignificant portion of their total deposits.

EXHIBIT G BUYERS OF TRUST PRODUCTS

Banks, insurance companies, wealth management institutions and large corporations are the key buyers for trust product

	Funding source	Amount invested in trust products in 2012
Banks	▪ Bank treasury and product department (Can go off balance sheet through wealth management products)	▪ ~4 trillion RMB
Insurance company	▪ Insurance's investable asset	▪ NA(regulation just opened up, 2 trillion RMB potentially could be tapped based on regulatory ceiling)
Wealth mgmt. institutions	▪ Distributers, such IFAs, BUs of commercial banks	▪ ~1.4 trillion RMB
Large corporations	▪ Corporate cash	▪ ~1 trillion RMB

SOURCE: PBOC; CBRC; CIRC; press search; McKinsey analysis

UNDERPERFORMANCE OF THE TRADITIONAL ASSET MANAGEMENT SECTOR

As a result of the sluggish performance of China's stock market and structural deficiencies in the fixed income market, traditional asset managers like mutual fund companies have suffered huge AuM and revenue losses over the past few years. While China's economy has sustained an average annual growth of 9.4% in the period of 2002-12, the Shanghai Composite Index grew by a mere 2.4% per year, or a total of 27% over the time period – albeit with very significant volatility. In the meantime, the stock market indices of other emerging economies – most notably Brazil's Bovespa Index and India's Sensex-30 Index, have quadrupled. Even the Standard & Poor's 500 Index in the U.S. rose by 85%, and Germany's DAX rose by 125% over these ten years. The overall mutual fund industry in China was badly hit by the stock market crash. The total AuM of mutual funds in China has declined by more than 15% over the last five years, from RMB3.3 trillion in 2007 to RMB2.8 trillion in 2012.

The biggest beneficiary of the capital market underperformance has been the alternative asset managers, such as private equity, infrastructure and real estate funds. All these investment forms are nascent and rapidly growing in China. All present huge growth opportunities going forward. In the short-term, as bank credit becomes increasingly scarce and local governments strive to de-leverage their investment portfolio, there are substantial investment opportunities for buyout funds and mezzanine financing specialists. Our estimate is that the private equity industry could grow by over 25% annually in the next 5 years.

Of course, there are some short-term uncertainties associated with these new areas of asset management. For example, real estate sector is under severe regulatory squeeze, both in term of property prices and market liquidity. Private equity funds are nowadays desperate in exit options, as the re-initiation of A-share IPO activities got suspended by the authorities. Infrastructure funds would also suffer, if local government-driven investment activities come to a halt in the economic structure adjustment and government de-leveraging process. However, given the nascent nature of all these investment areas, a sizable Chinese alternative asset management industry is clearly in sight when we look from a mid- to long-term perspective.

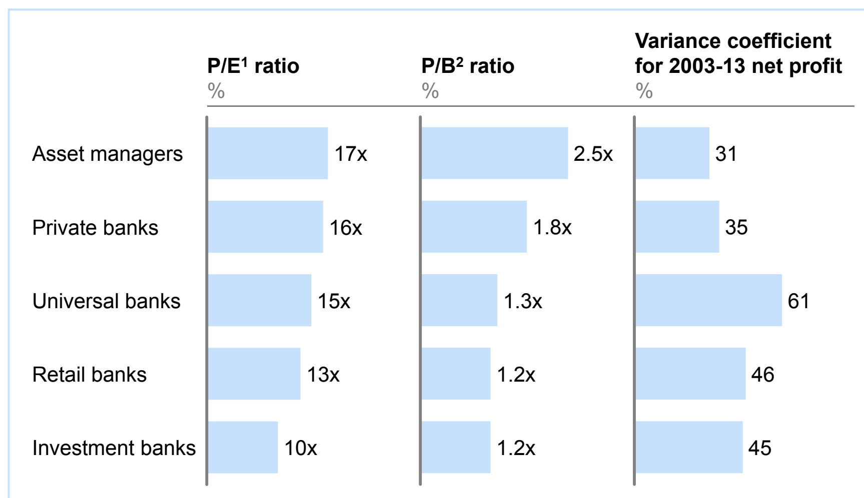
ASSET MANAGEMENT: "CAPITAL LIGHT" AND A MORE PROFITABLE BUSINESS

Globally speaking, over the last ten years, fee businesses like asset management and private wealth management enjoyed less volatility, higher return on equity, and higher stock market valuation, compared to other sub-sectors of financial services that have to manage large balance sheets. In Europe, asset managers and private banks had the highest price-to-earnings and price-to-book ratios, and much lower earnings volatility over the past 10 years. In contrast, investment banks proved to have the most volatile earnings stream and currently trade at very low valuation levels. Universal banks and retail banks lie in the middle (Exhibit 17).

EXHIBIT 17 VALUATION AND PROFITABILITY VOLATILITY OF DIFFERENT TYPES OF EUROPEAN FINANCIAL INSTITUTIONS

Asset managers and private banks have higher valuation and lower business volatility

EUROPEAN MARKET



1 As of 1st Oct, 2013 based on12 month forward EPS forecast
2 Median of monthly P/B ratios from 2003 to 2013

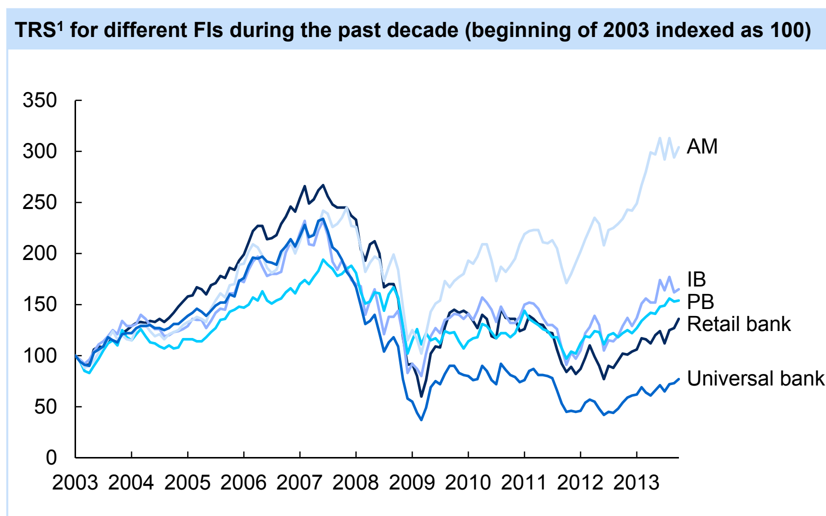
SOURCE: DataStream; McKinsey analysis

In term of total return to shareholders (TRS), the 10-year performance of these five sub-sectors also differ significantly. In Europe, the average shareholder of asset management companies would have almost tripled his or her investment in the period of 2003-13. Meanwhile, total return on investments in various banking sub-sectors would have yielded players a 10-year cumulative return of no more than 50% (Exhibit 18).

EXHIBIT 18 TRS OF DIFFERENT TYPES OF EUROPEAN FINANCIAL INSTITUTIONS

Asset managers and private banks generated higher return for shareholders than many others

EUROPEAN MARKET



1 Total return to shareholders

SOURCE: DataStream; McKinsey analysis

Alternative asset management is booming both in China and globally. Alternative assets are also "mainstreaming" into institutional and individual investors' portfolios. Moreover, asset management as a fee business has proved to be a more stable and higher valued sub-sector of the financial services industry in the past 10 years – compared to banks and other institutions that are managing large balance sheets. Considering the remarkable growth potential of the asset class, strategic moves into this space could be a lucrative strategic option for trust companies in China.

Thus far China's alternative asset management landscape remains extremely fragmented. However, with time, leaders with scale will certainly emerge.

There is a saying in China that "the early bird gets the worm". In China's nascent alternatives market, many competitors have already entered, eyeing a piece of this market. In fact, there has been a rapid increase of local private equity funds in the past few years. However, established trust companies are just as well positioned to grasp this opportunity, as long as a series of new capabilities can be acquired quickly.

Chapter 5

Private wealth management: prospering in the “golden decade”

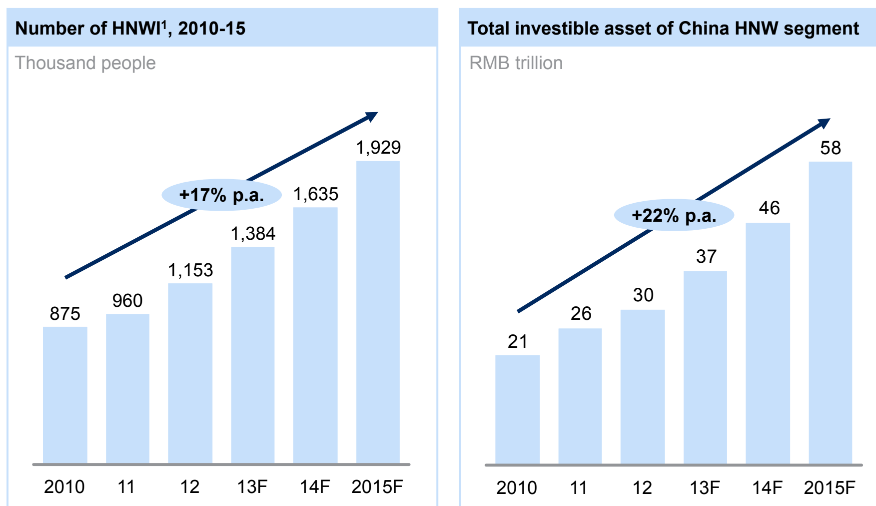
5. Private wealth management: prospering in the "golden decade"

With the continuing economic growth in China, enormous amounts of personal wealth are being created and accumulated at an unprecedented speed. Undoubtedly, the next ten years will be the "golden decade" for China's private wealth management industry. But the industry is still in its infancy. The market remains largely product-driven, clients' investment universe is still highly limited in scope, and none of the institutions have established a truly profitable business model. With attractive proprietary products and an increasingly mature investor clientele, trust companies are well positioned to compete and capture the next wave of growth opportunity in this area.

WEALTHY CHINESE: NEARLY TWO MILLION BY 2015

McKinsey estimates that, by the end of 2015, the number of China's high-net-worth individuals – defined as individuals with personal investable assets worth over 6 million RMB – will be close to 2 million. In aggregate, their investable assets will reach around 58 trillion RMB. This indicates a strong growth of 17% per annum and asset growth of 22% per annum in the period of 2010 to 2015 (Exhibit 19).

EXHIBIT 19 GROWTH OF CHINA HNW SEGMENT IN NEXT 3 YEARS



1 HNWI is defined as an individual with RMB 6 mn (USD 1 mn) or more worth of investible asset

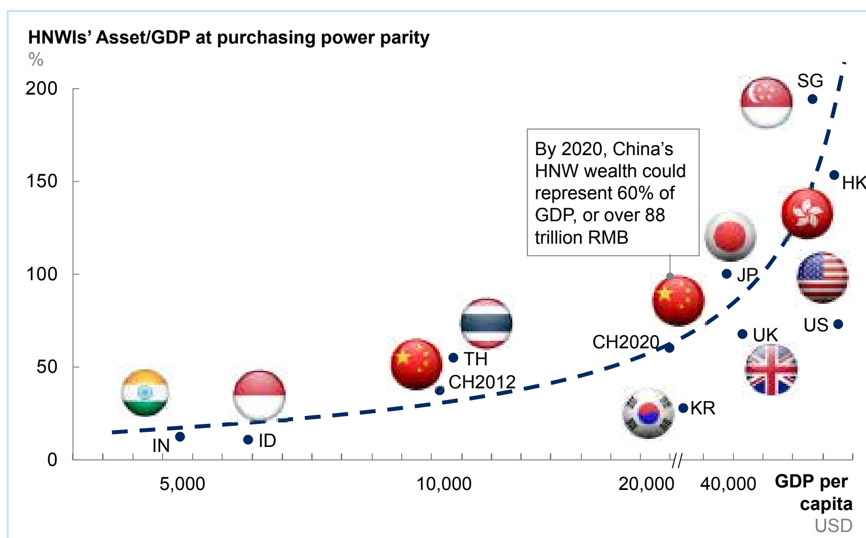
SOURCE: McKinsey Global Wealth Database

Looking at longer-term industry trends, China's HNWI segment is still nascent compared to developed markets in Asia, indicating its growth potential in the next decade. We observe that, as an economy grows bigger and wealthier, the level of wealth concentration also rise over time. In major developed markets such

as Japan and United States, the total assets of HNWIs account for 70-100% of annual GDP in the past five years. In contrast, China's HNW segment contributed 37% of the GDP in 2012. Following the trajectory of other markets, the total assets of China's HNW segment could well exceed RMB 88 trillion by 2020, more than doubling the 2012 level (Exhibit 20).

EXHIBIT 20 WEALTH CONCENTRATION TRENDS

China will observe further concentration of wealth in the next decade



SOURCE: World Wealth Report 2013; McKinsey analysis

The rise of the wealthy class is supported by three economic mega-trends and recent policy moves. First, urbanization was the most powerful force to transform China in the past 30 years, and is still a fundamental driver for the economy going forward. About 53% of Chinese population dwells in cities at the moment, far from developed country average of 70-80%. Until 2025, China will continue to urbanize almost another 250-300 million of its population, resulting in huge opportunities in the urban development-related sectors. In the process, about 20 city clusters are likely to evolve in China, creating room for the rise of a sizable middle class, the backbone of HNWI segment.

Secondly, the service industries are likely to prosper under the central government's drive to shift Chinese economy to a more consumption-led structure. As the service industry is dominated by small and medium-sized enterprises (SME), a new class of HNW SME owners is likely to grow rapidly. In particular, during the period of the 12th Five-Year Plan, the growth of the modern service sector is likely to accelerate. Financial and business services, domestic services, travel and logistics, technology, e-commerce, as well as sports and recreation, are the focal points for development. Prosperity in these sub-sectors could also trigger the emergence of a group of high-income professionals in finance, law and other fields, further expanding the HNWI segment.

Lastly, a blueprint for economic reforms was announced by the leadership at the Third Plenum of the Central Committee of the 18th Congress of the Chinese Communist Party, held in November 2013. These reforms include as a goal an open market system with "orderly competition", with the market playing a "decisive" role in the allocation of economic resources. Few details have been

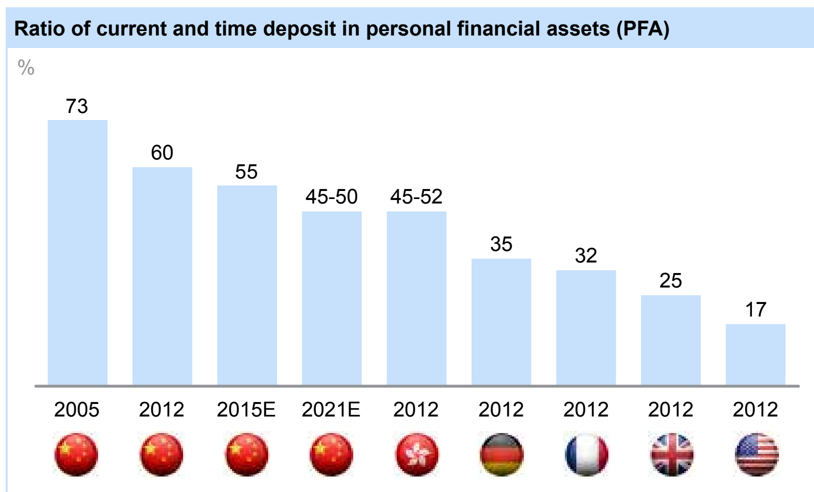
released but the signal emanating from the meeting is clear. Private entrepreneurs already constitute the majority in China's HNWI segment today. They are likely to proliferate if a more robust and healthy private sector takes hold in China over the next five years, and become new clients in the growing private wealth management market.

UNPRECEDENTED DEMAND FOR WEALTH MANAGEMENT

As expressed in the shift from deposits to investments, an unprecedented demand for wealth management has emerged in China. China's personal deposit rate is by far higher than that of developed countries. In 2012, current and time deposits accounted for about 60% of total personal financial assets, as compared to 45-50% in Hong Kong, 25-35% in Europe, and only 17% in the United States. (Exhibit 21). However, the deposit rate has witnessed a marked decline during recent years, from 73% in 2005 down to 60% in 2012. Our estimate is that the share of deposits in personal financial assets will further decline in the next decade, reaching about 45-50% by 2020.

EXHIBIT 21 PERSONAL SAVING RATIO COMPARISON

There is still a gap in deposit ratio between China with developed nations, the ratio is expected to dip further to release more investment capital



SOURCE: China Statistical Yearbook; the People's Bank of China; McKinsey analysis

In particular, China's HNWIs have already aggressively diversified their assets over the past five years. In 2012, deposits made up an average of 17% of their financial assets, significantly lower than other income segments. This is largely due to the fact that HNWIs have more sophisticated investment needs and more diversified investment channels – and with increasing wealth the need for liquid assets does not increase as fast. McKinsey's 2012 opinion poll of China's HNW segment shows that most of them would like to increase their holding of other types of assets at the expense of traditional bank deposits.

TRUST COMPANIES HAVE A UNIQUE COMPETITIVE ADVANTAGE

Since 2008, commercial banks and trust companies have been most active in developing new service models for the HNW segment. However, after five years of experimentation, the market is still at a very early stage of development, and many players are still struggling with profitability of their business model.

Major banks adopt an “affluent-plus” model, tapping into the vast affluent banking customer base of their retail banks. However, these “private banking units” are highly restricted in the product range they could offer to HNW clients. On the other hand, a wave of “product specialists” such as trust companies and securities firms have also emerged, fighting for their share in the private wealth management arena. With alternative products offering substantially higher return than bank deposits and similar products, these specialists have successfully captured a portion of customer assets. Both types of players are yet to become truly profitable at scale though. Adviser-sales force productivity is very low compared to international benchmarks, and product commission levels are constantly challenged by increasing competition. Besides, most Chinese private banks tend to over-invest in the physical branch network and value added services, adding pressure to their cost base.

Given the lackluster performance of capital markets and the lack of investment products, Chinese HNWIs have welcomed trust products as a core part of their portfolio. As a result, compared to the commercial banks and securities companies, trust companies have their unique value proposition to this set of customers. The 2012 McKinsey survey also showed that that more than 60% of the HNW segment will likely invest more in alternatives such as trusts and private equity funds in the future.

THE NEXT RMB1 TRILLION OPPORTUNITY: OVERSEAS WEALTH MANAGEMENT

Beyond the onshore business, overseas asset allocation and offshore private banking services have great growth potential for institutions servicing the HNW market in China. With increasingly globalized business operations and gradual emigration of high net worth individuals and their off-springs, the demand for attractive international assets and offshore services is on the rise. Nearly 60% of the HNW segment surveyed last year planned to allocate part of their assets.

At present, offshore wealth management needs are primarily focused on three areas: The first is a convenient cross-border transactional platform, allowing clients to move their funds around for overseas consumptions and investments. The second is investment advice and transaction execution support, particularly in the areas of equities and real estate. Lastly, non-financial advisory services, such as emigration counseling and application support to overseas educational institutions, are demanded by the wealthy individuals in China.

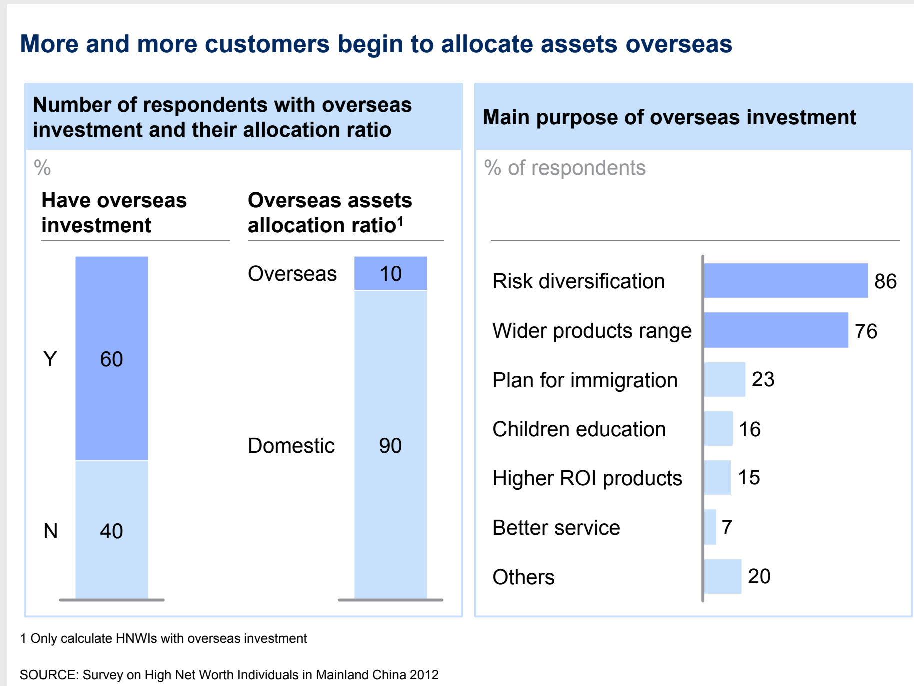
To harness the opportunities provided by overseas/offshore market, banks and other wealth management institutions have begun to set up offshore wealth

management centers. However, as they are competing head to head with global financial institutions in this area, a full set of new capabilities required to serve clients well in a foreign market environment need to be built up from scratch. To fully capture this opportunity, Chinese private wealth managers still have a long way to go.

SPECIAL DISCUSSION 5: Overseas investment

With the fast accumulation of personal wealth, as well as increasing sophistication in investment philosophy, HNWIs are looking for diversified investment channels, including allocating asset overseas. In the 2012 HNW survey in mainland China, 60% of HNW segment has already made overseas investments, which represent 10% of their total investable assets, and many show intention to increase the portion in the future. Purposes for doing so are primarily to diversify risks and enrich product lines. (Exhibit H)

EXHIBIT H



1 Only calculate HNWIs with overseas investment

SOURCE: Survey on High Net Worth Individuals in Mainland China 2012

However, few investing channels are available for HNWIs to make overseas investments today. Currently, QDII and foreign private banking are the predominant channels, and in-depth discussion with customers has revealed three main concerns:

- As these HNWIs are not educated and unfamiliar in the concept of overseas banking, they require a lot of advice and hand-holding. But in their current environment, they are unable to identify trusted persons or institutions to help them
- Some have indicated that their family members' disappointing experience has highlighted to them about the risks of offshore private banking. This segment shared concerns about the reputation of offshore banking
- Logistical difficulties in managing accounts due to long distance or time difference

This unbalanced demand and supply will create a potential sweet spot for private wealth management institutions, if they prepare themselves with a clear value proposition, and corresponding capabilities to understand and satisfy the overseas investment needs of the HNW segment.

THE TRUST COMPANY ANGLE: CHALLENGES OF PWM BUSINESS

Although wealth management and alternative asset management businesses have some overlap, in terms o-f product range and the quality of investment advice required, they are fundamentally different. The Chinese private wealth management market is also unique in the challenges it represents. Consequently, trust companies should selectively enter the business only if they are aware of the challenges involved and the capabilities required.

First of all, the product range and superior risk-return profile of individual products will continue to play a vital role in the investment decisions of HNW clients. Unlike mature market investors, Chinese HNWIs are much more product-driven and are less likely to value the advisory and valued-added services. As a result, trust companies will remain competitive only if the returns of trust products can be maintained at a superior level. Meanwhile, trust companies are traditional product specialists – their ability to quickly establish an open third-party product platform is underdeveloped.

Second, private wealth management is a business with a longer investment period and time to breakeven, as compared to the investment banking business. In China, after 3 to 4 years of market development, there is no evidence that many private wealth managers are independently profitable yet. Some commercial banks claim their private banking arm began to be profitable, but their cost base is always blurred with the overall bank. Some leading independent players began to show profitability for the last two years, but deal origination and quasi-investment banking business still accounts for a large share of their profit pool. In a word, due to the intensifying competition on product commissions and high cost structure of current branch-heavy model, there is no evidence that private wealth managers can survive on their own yet.

Third, the shortage of qualified private banking talents in China is so severe, that the scalability of any private wealth management operation is questionable. Private banker is a new profession in China with less than 5 years of history. Most existing bankers are much younger and less experienced than their developed market counterparts. It is also extremely costly and time consuming to rigorously train new private bankers from scratch, with a high annual attrition rate of 30 to 40%. Private wealth advisors in trust companies, unlike those in banks with job safety and in securities firms with lucrative package, are commission based, and often severely underpaid with little job security. It is a major challenge for trust companies to attract, develop and retain a stable advisor force.

With all these internal and external challenges, private wealth management is not a must-have business for every trust company. Only strongly committed players equipped with fundamentally new skills and capabilities, can fully leverage their unique value propositions to master this game.

In China, private wealth management is a young industry just about to enter its "golden decade," both onshore and offshore. While trust companies are uniquely positioned as product specialists and have built a significant customer base, the challenge in building a full blown wealth management business is significant. Only those players with strong strategic and financial commitment in the long-run, will likely be able to build these capabilities and succeed in developing a sustainable business.

Chapter 6

Eight new capabilities: implications for individual trust companies

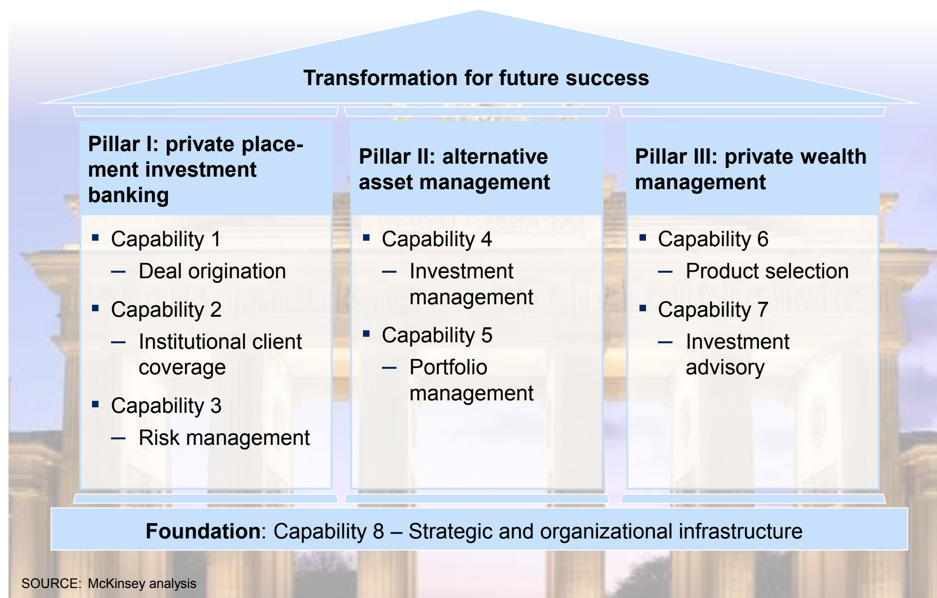
6. Eight new capabilities: implications for individual trust companies

As we have outlined above, some of the key growth drivers of the trust industry in the past will not be sustainable – some already in the short to medium term, like the conduit business, some more in the medium to long term, like the trust loans in its current form. But there are also new growth arenas opening up, including private wealth management and alternative asset management. This will most likely completely change the nature of the industry and its basis for competition.

From an individual company perspective, this means a real transformation is required to allow trust companies in China to capture opportunities in what we see as the core growth arenas for this industry going forward. New business models demand new capabilities. To accomplish the transformation and to succeed in all three growth arenas, trust companies will need to build eight core capabilities (Exhibit 22).

EXHIBIT 22 EIGHT ESSENTIAL CAPABILITIES

Eight essential capabilities to transform trust companies for future success



SOURCE: McKinsey analysis

Three capabilities are required for the **private placement investment banking** business. **(1) Deal origination.** Trust companies need to increase the breadth and depth of the origination team to source high quality deals at scale. This means, to most companies, an expansion of geographical network to some Tier 2 and 3 cities, as well as an increasingly specialized deal origination team organized around industry verticals. For many of them, this expansion outside their own geographic area will be a major challenge, with implications on talent and organization. **(2) Institutional investor coverage.** As institutional investors become more sizable and more sophisticated over time, trust companies need to

strengthen their institutional coverage by building a dedicated and professional institutional coverage team, in order to foster partnership with institutions at the "headquarters to headquarters" level. This requires a rethink in how they think about compensation as well as key performance indicators for their bankers. **(3) Risk management.** Trust companies need to significantly improve their investments and skills and systems in measuring and managing risks. In addition, cultivating a strong risk culture based on a balanced incentive system across the organization is of paramount importance to the long-term health of trust companies.

Two new capabilities are required for the **alternative asset management business**. **(4) Investment management.** Trust companies need to articulate their investment strategy in terms of which asset class they want to cover and what should be their strategy with regard to each asset class, develop a rigorous investment management process, and be able to attract and retain highly specialized investment professionals. The "flavor of the day" business model to-date is not sustainable. **(5) Portfolio management.** With the shift from "project-based" products to more long-term "fund-based" products, trust companies will hold some assets such as private shares and infrastructure for much longer period of time. As an important source of value creation in alternative asset management, trust companies need to build an in-house portfolio management team, staffed with operational managers with deep industry experience.

Two new capabilities are required for the **private wealth management business**. **(6) Product selection.** Trust companies aspiring to build a full service wealth management business should gradually establish an open product architecture and be able to offer non-proprietary products to meet clients' one-stop shopping needs. **(7) Investment advisory.** As advisory services become an increasingly important buying factors for Chinese HNWIs, trust companies should have a rigorous advisory process, carried out by a combination of an offline advisor team, supporting product specialists, and remote customers service channels. This requires a significant upgrade from today's product push model.

Last but not least, the **(8) organizational foundation** A clearly defined business strategy, a supporting organizational structure, a robust and professional talent pool, and a rigorous performance culture, are critical to the success of trust companies' strategic transformation. Trust companies should make a decision on their business portfolio based on one, two or three of the aforementioned business pillars based on their competitive advantages. They need to revamp their organization structure to encourage collaboration between front, mid and back office to drive for business growth. They also need to professionalize their talent pool beyond purely relationship or "Guanxi" hiring, and establish an incentive system aligned with the characteristics of each business and a strong performance culture.

These eight capabilities, as straightforward as they might seem to be, are part of a journey that will take time. Only the trust companies with clear strategic vision, strong leadership and financial commitment, and an equal dose of patience and perseverance, could navigate the transformation well in the next five years. There really is no short cut in this high-stakes game. But for the players who get it right, this is the opportunity of a lifetime to create a special kind of financial firm in China.

Chapter 7

External accelerator: regulatory environment for change

7. External accelerator: regulatory environment for change

To enable a successful industry-wide transformation and better serve the customers' needs, further development of the regulatory environment is crucial to the sustainable development of China's trust industry. We observe four areas where regulatory reform could make a major contribution to develop a strong asset management, investment banking and private wealth management sector in China's financial system. Furthermore, we believe further regulatory reform will be required to better contain the intrinsic risks involved in the trust industry.

Ownership of trust companies should further diversify. Currently, most trust companies are founded or owned by local governments, major financial institutions and state-owned enterprises. Only less than 10% of the over 60 trust companies are formed by the private sector. While there are government-owned trust companies that could transform themselves, the inflow of private sector capital could accelerate the adoption of better corporate governance of the trust companies, and help improve their market orientation. In addition, a more diversified shareholding structure in the industry could bring in more dynamic competition and stimulate innovation in the industry.

Healthy competition and industry consolidation should be encouraged. Globally asset management and private banking industries have gone through various waves of horizontal integration. For China's trust industry, open competition and healthy consolidation could help upgrade management and operational efficiency. Meanwhile, a market-oriented exit mechanism could help eliminate companies with poor performance and risk management capabilities. With time, consolidation could also nurture a group of leading trust companies with the capacity to expand into international markets and publicly list on capital markets.

Strengthen supervision on risk control and investor protection. Although trust companies are theoretically not liable for the credit risks, a major hike in default rate will cause widespread losses for investors and potentially trigger another round of clean-ups of the trust industry threatening the very existence of many trust companies. First, the regulator needs to closely watch the "leverage ratio" of the industry and each individual company – the ratio between total volume of outstanding trust loans issued and the capital level, to avoid the industry taking on too much risk. Secondly, the regulator should also steer the trust companies to reduce their concentration in real estate and local government lending vehicles and further diversify into other emerging sectors as pronounced in China's latest reform blueprint. Third, trust companies should be asked to perform rigorous stress tests to understand better the potential impact of different scenarios of economic slowdown and asset price drop on the trust industry and the consumer. Finally, in their regulatory rating assessment process, the CBRC should allocate much more weighting to the risk management culture and capabilities of each trust company over and above business growth rate.

Product innovation should be actively supported by a streamlined regulatory review process. Currently, although trust companies are only

required to register their new products with regulators afterwards, in reality they often have to get approval in advance and different local CBRC offices exercise different level of prudence when approaching these approvals. At the forefront of financial product innovation, trust companies should be encouraged to test new products in the market with an efficient approval process. Globally, asset management companies typically can freely develop and launch new financial products, as long as the structure and risk profile of these products are accurately documented and filed with the regulator, and the relevant risk factors are properly disclosed to potential investors. In China, to foster an environment of innovation, a similar new product registration mechanism could be maintained by the regulatory body. The current de facto product-by-product approval process could then be streamlined or even abandoned, to reduce the time-to-market of new trust products.

China's trust industry has arrived at a crossroads. The industry is likely to go through a complete overhaul with heavy impact on company strategies and business models. A further development of the regulatory environment is crucial for the successful transformation of the industry over the next several years. Any change in policy and regulatory framework must of course be prudently taken and implemented gradually, consistent with global practice, and executed in the best interests of the end customers, and the Chinese financial sector as a whole.

Glossary

Abbreviation	Definition
AAM	Alternative asset management
ABS	Asset-backed security
AuM	Asset under management
BU	Business unit
CAGR	Compound annual growth rate
CBRC	China banking regulatory commission
CDO	Collateral debt obligations
CIRC	China Insurance Regulatory Commission
CLO	Collateralized loan obligation
CMBS	Commercial mortgage-backed security
CSRC	China securities regulatory commission
ETF	Exchange-traded fund
FI	Financial institution
HNWI	High-net-worth individuals
IB	Investment banking
IFA	Independent financial advisor
KPI	Key performance indicator
KSF	Key success factor
M&A	Mergers and acquisitions
NPL	Nonperforming loan
PWM	Private wealth management
QDII	Qualified domestic institutional investor
RM	Customer relationship manager
RMBS	Residential mortgage-backed security
RWA	Risk-weighted asset
SOE	State-owned enterprise
TSR	Total shareholder return
UCITs	Undertakings for collective investment in transferable securities
WBS	Whole-business securitization

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