China Ready to Make Real Estate Trusts Official

——— *David Yu*

China has witnessed a rapid development of its real estate sector during recent years. However, commercial banks which used to take a dominant role in financing real estate development and sales are seeking to diversify their loan business away from property exposure for risk management purposes. Coupled with the central government announcing credit-tightening measures, this means it is becoming more and more difficult for property developers to seek funding from commercial banks and many real estate development projects are running short of capital. At the same time, because of the expected appreciation of Renminbi and the continuing growth of PRC real estate market, international property funds are seeking to launch their first investments in China. Real estate Investment Trusts ("**Reits**") may become an effective instrument for foreign investors to increase their exposure to the Chinese property market.

In October 2004, the China Banking Regulatory Commission ("**CBRC**") circulated the Draft Provisional Rules on Real Estate Trust Business of Trust and Investment Companies to solicit comments from the public. This was widely seen as a positive signal that the regulator intended to encourage the formation and development of China's real estate investment trusts. Although so called quasi-Reits have been taking shape in PRC market under the existing legal framework, true Reits, which has been popular in more developed capital markets □like the US, Australia and Singapore are a new product for PRC market.

The existing framework

It is understood that a Reit may take, depending on the different investment requirements, different legal forms as open-ended funds vs. close-ended funds, contractual trust funds vs. corporate funds, as well as publicly offered funds vs. privately placed funds. The investment scope and financial instruments available to a Reit shall also be flexible, including investing directly in real property, equity investment in developers, extending loans to developers. However, generally speaking, a typical Reit with those characteristics and advantages those available as in developed market may not be able to be launched to domestic investors due to the various limitations and prohibitions under the current PRC legal framework. For example, in the US and Australia, Reits are given a tax transparency status and are traded separately on a different board to accord the investment class sufficient liquidity. Given the diversity and flexibility Reits is supposed to have, PRC laws have not provided a mature framework for Reits yet, although the market demand may have formed and developed.

The Fund Law

The PRC Securities Investment Fund Law ("**Fund Law**") was promulgated on October 28, 2003 and came into effect from June 1, 2004. The legal structure of a fund, either open-ended fund or close-ended fund, provided under Fund Law is very similar to that of a Reit both based on settlor-trustee relationship. Notwithstanding the above, the Fund Law only applies to publicly offered funds whose investment scope concentrate in securities. Such funds only take the form of contractual trust fund rather than an independent corporation. Therefore the legal framework for funds under the Fund Law may currently not be applicable to Reits. Due to the limitations on the investment scope of funds established according to the Fund Law, these funds cannot be involved in real estate business directly except that their portfolio may include shares of public companies which engage in real estate business.

It is also mentioned in the supplementary provisions of Fund Law that the PRC State Council may separately formulate specific procedures governing private placement of funds and funds taking the form of a limited liability company. Such procedures have not been formulated yet. In the lack of such procedures, theoretically speaking, it is doubtful whether privately placed fund or fund in the form of a limited liability company can be legally launched in the PRC market.

Collective Trust Investment Plans

However, trust and investment companies may offer a type of product called collective trust investment plans ("CTIPs") to both institutional and individual investors. CTIPs were officially recognized in a regulation issued by CBRC in July 2002. The investment scope of a CTIP may be significantly broader than that of securities investment funds under Fund Law. In particular, trust and investment companies already can offer a CTIP which targets in real estate projects under the current l□egal framework.

Investment scope

Generally, a CTIP may make investments in various manners according to the provisions of the trust agreement which shall be subject to certain compulsory requirements such as no creation of security interest in trust assets. Funds raised in a CTIP may be used to directly buy real property or extend loans to real estate developer or make equity investment if so permitted under the trust agreement.

However, in practice, possibly due to regulatory preference and lack of professional expertise of investment management, trust agreements of most CTIPs specify the particular target investment project rather than a general description of the investment policy. In that case, trust and investment companies will have comparatively little discretion in the management of funds so raised. Such arrangement, although aiming to minimize moral risks, may result in lack of flexibility, which may be very important for the success of a real property investment in a rapidly changing market.

Market practice

There have been precedents in PRC market whereby trust and investment companies launched CTIPs to invest in real estate properties. For example, Beijing International Trust and Investment Corp Ltd ("BITIC") has launched a CTIP for a shopping mall project in Tianjin sponsored by Auchen, a France–based supermarket corporation. BITIC, as trustee under the CTIP, will use the money so raised to purchase the property title over the commercial center and then rent the property to Auchen. Investors of such CTIP, as beneficiary are expected to receive stable profits derived from the rental. This project is viewed as the first innovative product similar to Reits in PRC. However, although CTIPs are offered on a collective basis, it has certain shortcomings that prevent them from developing into typical Reits.

Investor limitations

Under the current CBRC regulations, a CTIP may have up to 200 investors and each shall subscribe in an amount of not less than RMB50,000. The underlying rationale for such limitations may be to control the risks of a new type of product and to protect small investors who are supposed to be more financially vulnerable by setting a threshold amount. Another reason may be the general understanding that the publicly offered financial products shall be subject to the administration and approval of China Securities Regulatory Commission ("CSRC"), and it may be beyond the authority of CBRC which is in charge of administration of the business of trust and investment companies to grant them the capacity to launch publicly offered products.

The investor limitation makes it impossible to raise sufficient funds through a CTIP to meet the demand of large amount of financing in many real estate projects. In practice various methods have been developed and adopted by some trust and investment companies to circumvent the quantity limitation on investors of a CTIP, but such methods may be deemed as violation of mandatory laws and may incur legal liabilities. In response to the practice, CBRC has circulated notices to investments and trust companies to reiterate the limitation. The investment amount threshold deprives many small investors of the opportunity in investing a CTIP.

Marketing

Due to the private nature of CTIPs, trust and investment companies cannot conduct marketing or promotion activities via newspapers, television, broadcasting and other public media during offering a CTIP.

Information disclosure

Due to lack of regulatory experience on private placement, the regulatory body has not established a sound and systematic framework regarding information disclosure requirements for offering CTIP products. The regulations only provided general principals regarding risks disclosure for CTIP products which are too general to be enforced in practice. Although a CTIP is viewed as a privately placed product, it seems unrealistic for investors to bargain with the issuer on information disclosure.

CBRC has recently issued Provisional Measures on Information Disclosure of Trust and Investment Companies as well as a notice on information disclosure for CTIPs. It is expected that stricter information disclosure requirements and practice may enhance confidence of the regulatory body and the public in this product and may help to develop the product in a healthy ad sustainable fashion. It is also provided in the Provisional Measures that the accounting record of trust asset shall be audited if so required in the relevant trust agreement and be disclosed in the annual report of the trust and investment company.

Tax

The PRC lacks of systematic and practicable tax regime regarding trust arrangements, which may incur great uncertainty (e.g. double taxation) of investors' actual earnings from their CTIP investment. Recently the Ministry of Finance promulgated Measures on Accounting of Trust Business. It is viewed as a positive signal that the tax authority has noted the complexity of tax issues regarding trust business.

Transferability and liquidity

The investment attractiveness of a financial instrument will be greatly affected by its transferability and liquidity. A lack of liquidity and transferability imply that an investor may find it difficult to exit the investment. Also investors need information on valuation. CTIPs are not securities that can be traded in stock exchange like closed-ended fund or redeemed via distribution network like open-ended fund, hence, the transferability and liquidity of CTIPs are very limited. The interests and rights of a beneficiary to a CTIP may be transferred according to the provisions of the trust agreement. However, because a CTIP product cannot be traded on an exchange, it is difficult for an investor to sell in a secured and convenient manner with reliable reference market price. It is also difficult for them to value their investment.

Furthermore, as the trust managers tend to ensure a steady scale of the trust assets, they may be reluctant to accept redemption of the CTIP interests held by the investors. As a market practice, most trust agreements provide that such interests may only be transferred up to certain times, say two or three times each year.

The limitation on the number of investors also contribute result to a lack of liquidity in a Reit set up under the CTIP rulings. Such a situation usually results in an undervaluation of the units – which will directly result in a negative impact in the development of the PRC Reits market.

Registration of real property

To protect the interests of the Reits investors' interests and ownership, a sound and clear registration system of real property under Reits is of great importance. According to the PRC Trust Law and relevant regulations, a trustee shall act in its own name and in the interests of beneficiaries in handling trust management activities and shall keep the trust assets in separate account from its own assets. The PRC Trust Law also has registration requirements for trust assets. However, the current registration rules regarding real property keep silent on registration regarding real property as trust assets. The practice varies in different regions. In most circumstances the registration will not reflect the fact that a trustee is holding the title in trust.

New Rules

As mentioned in the very beginning of this article, the Draft Reits Rules is regarded as a fundamental measure of CBRC to reduce financial risks while promoting Reits business. It may worth observing more closely on some provisions of the Draft Reits Rules.

Lift of Quantity Restriction

In the Draft Reits Rules, the aggregated number of subscribers under a single Reits plan may exceed 200. However, there is a very high threshold for issuance of Reits product not subject to quantity limitation of subscribers. For example, the net asset value of issuer shall be not less than RMB 500 million, the trust business revenue shall account for 60% or more in the total revenue in the past two profitable years, and the issuer must have issued 3 or more Reits which have ended in realizing expected earning. In addition, each such Reit is subject to CBRC approval, in contrast with filing requirements for Reits subject to 200 subscribers ceiling, on a case by case basis.

Custodian of Funds

The definition of custodian is introduced to China's trust business for the first time. Only commercial banks which have met certain criteria are qualified to be custodians. Before investment, trust funds must be deposited in a special account opened by a custodian. Custodians will be responsible for the supervision of use and safety of the trust funds.

Commissions

Trust and investment companies and custodians are entitled to collect 15% and 5% respectively from the investment profit as commissions and the commissions should not be collected before the profit is realized. Before the promulgation of the Draft Reits Rules, the commissions on CTIPs have always been determined by agreement between the trust and investment company and the settlor. Moreover, in practice the commissions for CITPs are not based on profit realized.

Qualifications of Investment Targets

The qualification of Reits investment targets is subject to very strict requirements in the Draft Reits Rules. In principle, trust and investment companies are not permitted to lend any money to real property projects if any of the land use certificate, the construction land use planning certificate, the construction project planning certificate and the construction certificate has not been obtained. The only exception is Reits involving qualified investors and capped by 200 subscribers limitation.

Investment Scope

The usage of trust funds is much broadened in the Draft Reits Rules. The Draft Reits Rules makes it clear that the trust funds can be used in land purchase, land initial stage development, real property enterprises' development and construction of commercial or residential building, purchasing and leasing land, commercial or residential real property. Furthermore, trust funds can also be used as residential mortgage loan.

Portfolio Investment

Under the Draft Reits Rules, it is required that funds raised without limitation of number of subscribers shall be invested in portfolio projects rather than single real property or real property developer. For Reits having not more than 200 subscribers, however, there is no particular requirement that there should be a specific investment project at the time of soliciting subscriptions, although this requirement seemingly can be inferred from the procedure set out in the Draft Reits Rules.

Prospects of Reits

Even though there are deficiencies in the PRC legal framework for Reits, the government is proactive in developing the Reits market as a necessary foundation to a healthy real estate market. It may take several years for Reits in the PRC to mature due to the time needed to develop of professional Reits managers, sophisticated investors and an integrated legal framework. However, given the benefits that such a developed Reit market can bring, the popularity of Reits is set to grow.

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