Risk Management in China: A Case Study on Equity Pledges

By Dr. Yongqiang Bu

Executive Summary

As China moves to further open its financial system, much global focus is on the entry of large players, such as Goldman Sachs, into the Chinese market. However, smaller, home-grown enterprises are already transforming the landscape in China, making up 60% of GDP and 90% of new jobs created since 2018.

These private enterprises still face considerable challenges operating in China's "double-mechanism system." One particular difficulty is getting credit at affordable rates.

The Chinese government has introduced a series of policies in support of the private economy in recent years. One method of raising financing – equity pledges for listed companies – can be a helpful source of financing for private companies. It allows companies with excess capital to get loans secured by equity in the borrower. However, while it would seem to be an easy solution to the capital dilemma, it presents considerable risks for all parties and, if widely used, can make the financial system less stable. If the value of the pledged shares falls close to the amount of the loan, pledged shares can be sold by the lender and the proceeds used to repay the loan. Those who pledged the shares no longer own them and may lose control of the firm. Moreover, sales of pledged shares can amplify equity price fluctuations, especially price declines, making financial markets less stable.

This whitepaper summarizes the case of Orient Landscape, once widely known as the "No. 1 Chinese garden enterprise in the stock market" and now subsumed by a public entity. The winding path Orient Landscape took to arrive at its current position highlights the risks private enterprises face if they do not take a disciplined risk management approach to equity pledges.

The details of the Orient Landscape case should help risk managers operating in China, or entering the market anew, to understand the challenges

associated with equity pledges. It also should provide food for thought for organizations lending the capital, and for government regulators.

Introduction

Since 2018, the Shanghai Securities Composite Index has fallen from its peak by 30 percent. In the technically bearish context created by deleveraging policies and the trade war, the A-share market has been on a roller coaster, causing suffering among investors.

However, the private sector has indeed been a growth engine in China during that time. In 2018, there were more than 25 million private enterprises across the nation, accounting for over 50% in national taxes, and over 60% in GDP, fixed asset investment, and outbound direct investment. High-tech entities run by private enterprises make up over 70% of the national total. Among all nationwide urban employees, more than 80% work in private enterprises. In addition, 90% of new jobs are created by private enterprises.

One difference in the stock market tumbles since 2018, compared with the stock market crash in 2015 and the circuit breaker crisis in 2016, is the frequent changes of the position of leaders in listed private companies (“chairman”).

One of the main reasons for this is the loss of pledged shares due to sharp falls of stock prices in repurchase transactions based on equity pledges, which naturally results in change of actual controllers (generally, the chairman).

Such changes can be further explained by several major factors: market risks arising from fluctuating equity value, moral hazard risks related to lack of credit of pledgers, and disposal risks due to incomplete equity trading market mechanisms. However, the case of equity pledges is the focus of this whitepaper, due to lessons it presents for risk managers.

One of the private companies in the stock market was Orient Landscape, at the time widely known as “No. 1 Chinese garden enterprise in the stock market.”

Background

The residential and commercial real estate markets boomed in China in the first ten years of the 2000s and companies that supplied that booming market grew rapidly. For He Qiaonyu, who had founded Beijing Orient Landscape Co., Ltd. in 1993 by opening flower shops and peddling green plants in office buildings, it was a time of massive expansion. In the booming capital city, Orient found much room for growth as whole new neighborhoods of offices and residences needed landscaping. As their businesses grew mature, the company was listed at Shenzhen Stock Exchange in 2009, and soon became the "No. 1 Chinese garden enterprise in the stock market." At its peak in 2010, its share price stood at RMB 229 (Figure 1). Orient expanded its main scope of business to include Engineering Procurement Construction (ERC) and disposal of waste and dangerous materials.

Figure 1: Share Price of Orient Landscape

Note: In the Chinese financial market, red means rising and green means falling, as opposed to the US.

He acted as chairman of the company from the very beginning. In 2015, she began attempts to pilot and promote various financial innovation strategies. In addition to the private offering of additional shares, M&A, and restructuring, He added public-private partnership (PPP) to the list. With such lucrative partners, Orient Landscape could open new markets serving government agencies and helping them supply their customers. Orient quickly amassed work. By 2016, the company was responsible for water system management and whole-basin tourism for government agencies. Orient was awarded projects totaling RMB 38.01 billion, 71.571 billion, and 40.805 billion in 2016-

2018 respectively, adding up to RMB 150.386 billion.

The radical expansion in PPP projects, however, led to both drastic increases in contractual income and constantly high liabilities. In the five years from 2014 to 2018, Orient Landscape's liabilities greatly outweighed its assets. The asset/liability ratio of Orient Landscape was 56.22%, 63.83%, 60.68%, 67.62%, and 69.33%, respectively, over those years. Moreover, although PPP projects were launched in the name of the government, the majority of upfront funds were paid by Orient. In 2016-2018, nearly RMB 10 billion of cash was invested, but the operating income cash flow was as low as RMB 3.7 billion (see Figure 2), implying a difference in market and book value of about RMB 6 billion.

To deal with the serious imbalance between investment and return, Orient Landscape engaged in a series of borrowings. In May 2018, the company issued RMB 1 billion worth of bonds, but only sold RMB 50 million. At the end of the third quarter of 2018, the cumulative liabilities reached RMB 29.24 billion, the highest level since its IPO. The amount of unrestricted monetary funds on the company's account was disproportionately low – merely RMB 925 million. This raised doubts about its solvency. As a result of the unsuccessful bond issue, the share price of Orient Landscape plummeted. The drop from early May 2018, when the bond issue failed, to December 10 was more than 50%, driving down its market value from more than RMB 50 billion to RMB 21.8 billion.

Figure 2: Composition of Orient Landscape's Income

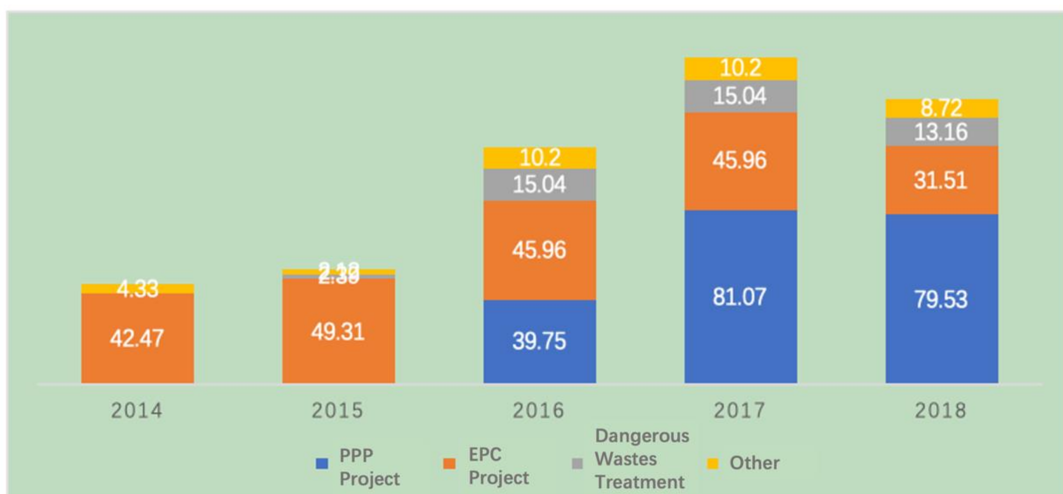


Table 1: PPP Investment Data

Project (unit: RMB 100 million)	2016	2017	2018	2019H1
Equity investment funds of PPP project companies	19.15	55.37	79.94	80.19
Constructions in process of PPP operation projects	1.25	1.57	7.07	14.65
Constructions in process of BOT projects	4.16	5.72	5.05	3.99
Total	24.56	62.66	92.06	98.83

Table 2: Financial Data of Orient Landscape in 2016-2019, H1

	2016	2017	2018	2019H1	Total
Income	85.64	152.26	132.93	21.91	392.74
Water system management & whole-basin tourism	39.75	81.07	79.53	12.39	212.74
Net profit attributable to parent company	12.96	21.78	15.96	-8.94	41.76
Net cash flow from operating activities	15.68	29.24	0.51	-8.01	37.42
Net cash flow from investment activities	(26.44)	(45.11)	(35.89)	2.64	(104.80)

To ease operational and budget pressure, He and her family and friends borrowed money and used it to increase their equity in the company. From the failed bond issue in early May 2018 to October 17 of that year, He, her husband, and other persons acting in concert with them had their equity pledge rate boosted from 56.01% to 82.88%. Meanwhile, with the slump of the stock price, the couple was in a very high equity pledge risk. Forced liquidation could be

triggered at any time for Orient Landscape.

Amid broad concerns, the Beijing Regulatory Bureau of the China Securities Regulatory Commission issued a letter to the controlling shareholders of the company, giving them a grace period to mitigate risks and put off a forced liquidation. Thereafter, Orient Landscape started a succession of survival actions and tried to solve the crisis.

On October 9, 2019, the company announced it had completed registration procedures to transfer equity and majority ownership from majority shareholders (actual controllers) He and Tang Kai to Beijing Chaohuixin Enterprise Management Co., Ltd. (Chaohuixin), a wholly-owned subsidiary of Beijing Chaoyang District State-owned Capital Operation and Management Center. The transfer was equal to 134 million shares and 5% of total equity capital of the company. Chaohuixin became the majority shareholder of Orient Landscape, and Beijing Chaoyang District State-owned Assets Supervision and Administration Commission became the actual controller.

On October 28, 2019, Orient Landscape declared a change in ownership, naming Liu Weijing as board president and legal representative and Mu Yingjie was as chairman.

After becoming the actual controller of Orient Landscape, Beijing Chaoyang District State-owned Assets Supervision and Administration Commission granted financial and operation support to the company, helping it significantly improve its external financing environment. Furthermore, Beijing Chaoyang District State-owned Assets Supervision and Administration Commission assumed joint guarantee responsibilities for the new bonds of the company. Accordingly, Shanghai Brilliance Credit Rating & Investors Service Co., Ltd. upgraded the rating of the company’s main business and its bond credit rating. With increasing liquidity, as of October 30, 2019, the third-quarter report of the company predicted a net profit range from RMB -350 million to RMB 100 million, and remarkably improved operational and financial conditions in the fourth quarter.

On November 7, 2018, ABC Financial Assets Management Co., Ltd. increased its capital in the environment protection group under Orient Landscape with an initial capital increase of RMB 1 billion. In November, Orient Landscape sold its waste and dangerous materials disposal projects with

sustained fixed income to Shanghai Electric Group at a price of RMB 342 million.

On December 9, 2018, Orient Landscape issued a public statement that its actual controllers, including He, Tang, and their spouses, planned to transfer 5% of their shares in Orient to the Beijing Yingrun Huimin Fund Management Center (L.P.) (YRHM), a strategic investor. According to the statement, the equity transfer price, once received by the actual controllers, would be used for operating capital and other purposes at Orient.

Evolution of the Stock Pledge Regulation System in China

The dual structure in the Chinese credit system and subtle prejudice against private enterprises resulted in long-standing financing difficulties for them. Traditionally, large state-owned banks funded central state-owned enterprises and construction of major infrastructures. Local banks supported local state-owned and private enterprises financially.

Large state-owned enterprises are far more capable of raising funds at much lower costs than their private peers. The characteristics of the so-called "double-mechanism system" are most prominently reflected by the bank credit system, as witnessed by the higher financing cost of private enterprises.

Despite such difficulties, these private players play an irreplaceable role in national economy, in terms of employment, GDP, and innovation. As a result, the government introduced a series of policies to support private companies, aiming to help them grow stronger and stronger. Among these policies, the equity pledge for listed companies was introduced to address difficult financing faced by private enterprises.

In the type of equity pledge discussed in this paper, the borrower is a shareholder of a company and uses the equity it owns as collateral for a loan. The equity must be transferrable and pledgeable according to the law. The borrower pays interest regularly. If the market value of the equity collateral falls, the borrower may be required to quickly repay the loan or contribute more collateral. If the borrower cannot do so, the collateral is sold and the loan is paid off with the proceeds. A borrower that had enough equity to give it control

of a firm would lose control of the firm because the borrower no longer owns the equity.

An equity pledge transaction for a listed company may take two forms: on-exchange transaction and off-market transaction.

- On-exchange transaction, also known as a stock pledge repurchase, represents a standard securities trading process, in which a financing party pledges its shares as security for funds provided by a qualified investor (a securities company or a fund management program managed by such a company) registered at a securities exchange. The pledge will be relieved upon repayment of the fund. The transaction is declared by the securities company through the exchange transaction system based on authorization by the financing party and the investor, and then confirmed by the transaction system according to applicable rules. The transaction result (the collateral) will be delivered to the China Securities Depository and Clearing Co., Ltd. (CSDC).
- Off-market transactions include all stock pledge transactions registered and handled at the CSDC except for pledge repurchases. In other words, off-market transactions are not processed by the transaction system of a securities exchange. Instead, the pledge registration procedures are completed directly by the CSDC, or electronically via the remote declaration system of securities companies.

On May 24, 2013, the Shanghai Stock Exchange and CSDC jointly issued *Measures for Stock Pledge Repurchase Transaction, Registration, and Settlement (Trial)*, providing a system for official launch of equity pledges.

Thereafter, the practice of pledging stock gradually evolved. From 2014 to 2018, stock pledging began to gain popularity, leading to an increasing balance of pledges. M&A, restructuring, and private offering of additional shares were

among the most common transactions related to stock pledge. In 2014, M&A and restructuring activities by listed companies were greatly encouraged. In order to protect the interests of individual stock investors, CSDC limited the P/E of asset objects acquired by listed companies to 20 in the course of window guidance. In 2015, the bullish market resulting from the umbrella financing structure dramatically boosted secondary market valuation of listed companies, causing huge differences between valuations in primary and secondary markets. Some major shareholders acquired assets from the primary market at a low valuation (with a P/E of 10-15), and then injected them into listed companies by means of M&A, restructuring, and private offering of additional shares. In this way, the valuation level of these assets was quickly driven up to that of existing assets of these listed companies (typically with a P/E of more than 30).

In the stock market, these changes corresponded to an increase in consecutive daily limits following the release of bulletins about asset restructuring plans. Seeing that these major shareholders made a fortune by pushing up the price of acquired shares, many listed companies scrambled to acquire assets through private offering of additional shares, M&A, and restructuring.

Statistics about such transactions in 2014-2018 show that they reached a peak in 2015, and then gradually fell back due to the revision of major asset restructuring management measures in 2016 and increasing difficulty in private offering of additional shares after issue of new refinancing management measures in 2017. The craze for M&A and restructuring led a lot of listed companies into disorganized transactions. The performance commitments made for acquired assets proved unrealizable in the ensuring years in most cases. A direct result was that goodwill became a significant part of profit for listed companies, leading in turn to lower profitability (see Figure 3.)

Figure 3: Capital Raised by Listed Companies via Private Offerings

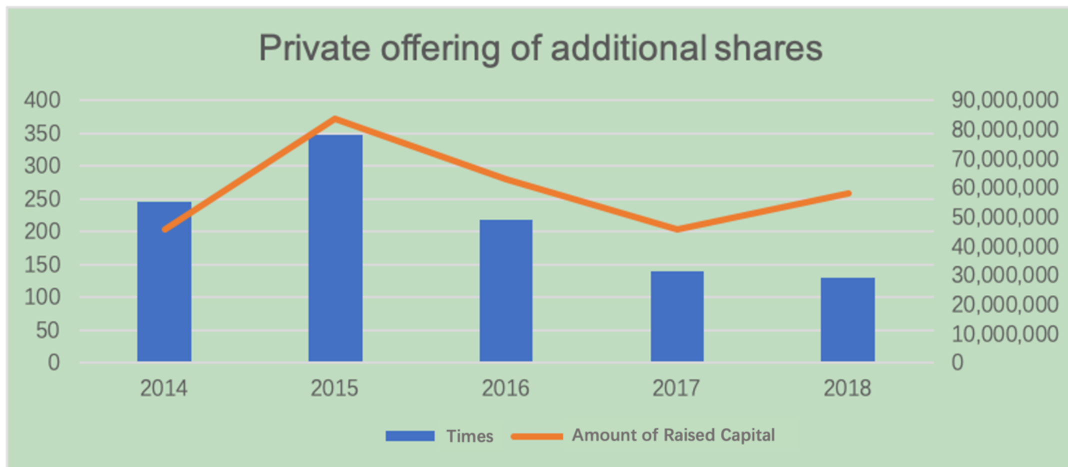
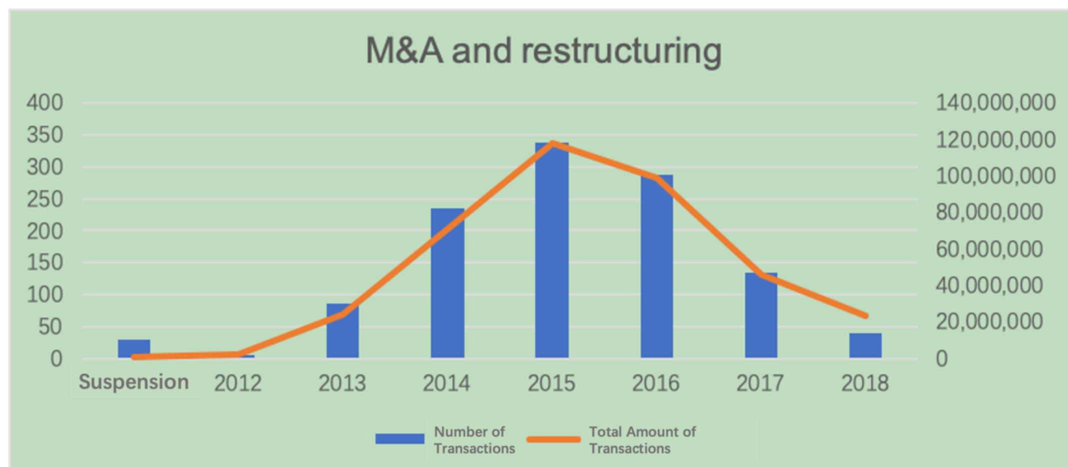


Figure 4: M&A and Restructurings in China, 2014-18



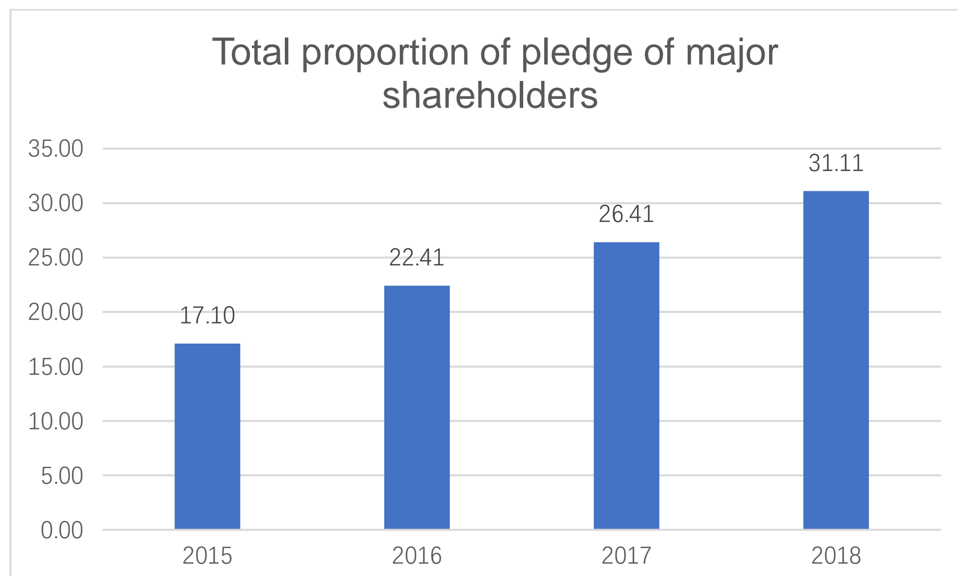
In the period when M&A and restructuring transactions intensified, timely fund payment became a much more important subject of negotiation. As a result, stock pledges became the most preferred financing form among major shareholders due to rapid fund withdrawal and unrestricted fund purposes (prior to issue of new rules concerning on-exchange transactions). For private enterprises, facing disadvantages in the credit market, stock pledge transactions, particularly on-exchange ones, quickly became a major means for listed private companies to improve financial liquidity due to their low threshold, high financing efficiency, and high amounts of available funds.

Regulatory Consequences of the Buying Spree

The extensive asset acquisitions in 2014-2016 increased the refinancing scale of listed companies drastically. A great number of financial institutions in the market engaged in the private offering of additional shares. In 2016 and 2017, however, the financial institutions faced the fact that bans on sales of more than RMB one trillion worth of shares were lifted in succession.

After the crash in 2015, new policies were launched to gain stricter control of the market. First, *Several Provisions regarding Management of Reduction of Shares Held by Shareholders, Directors, Supervisors, and Executives of Listed Companies* (*"the Provisions")* were promulgated to weaken liquidity of equity pledge collateral.

Figure 5: Equity Pledges of Significant Shareholders



The Provisions introduced in May 2017 contained explicit provisions concerning transfer of shares held by certain shareholders. Since liquidity of stock pledge collateral had become restricted, investors might not be able to recover principal and interest by disposing of collateral when the ratio of collateral value to secured liabilities dropped below a predefined position-closing level. This could build additional pressure on businesses.

Second, *Guidelines for Regulating Asset Management Business of Financial Institutions* ("*the Guidelines*") imposed restrictions on business fund renewal sources. Officially launched in April 2018, *the Guidelines* included clear

provisions concerning non-standard asset management product investment, maturity mismatch, and multi-level nesting of investment. Because stock pledge income rights are non-standard assets with a long maturity period, it was difficult to link them with new products under the maturity matching principle defined in *the Guidelines*. Besides, before enactment of *the Guidelines*, it was a common practice to put bank financial management funds into on-exchange stock pledge transactions of securities traders by means of multi-level nesting. As *the Guidelines* allowed only one level of nesting, such involvement became rigorously regulated.

Third, with release of *New Stock Pledge Rules* ("*the Rules*") at the beginning of 2018, relevant activities were now regulated in a more standard way. More restrictions were put on fund purpose, pledge rate, pledge concentration, financing parties, and investors.

Fourth, securities traders were no longer permitted to engage in off-market stock pledge transactions. In June 2018, the Securities Association of China distributed to securities traders *Notice about Issues concerning Off-market Equity Pledge Transactions by Securities Companies*, putting an end to their off-market stock pledge transactions. Specifically, the securities traders were not allowed to "provide banks, trusts, or other institutions or individuals with third-party agent services such as deposit security adjustment and position closing for stock pledge financing of listed companies through off-market transactions." Besides extending the market exit period of institutional investors, *the Provisions* greatly affected liquidity of major shareholders starting M&A and restructuring at an early stage. In the year preceding *the Provisions*, the changes of shares held by management corresponded to about RMB 95.2 billion. In the year following *the Provisions*, such changes were RMB 52.4 billion in total, representing a 45% decrease approximately. As a result of *the Provisions*, major shareholders may find it impossible to decrease their liability rate through reduction of shares and liquidation when dealing with the high liabilities arising from early-stage M&A activities based on high-proportion pledge. The pressure of interest payment may build up every year, and the stock price may drop, thus causing buy-in behaviors and weaker and weaker risk resistance.

Market Impact

Since 2018, the assets acquired during the rush in 2015 and 2016 began to reveal their true features, with large quantities of assets showing decline in performance, a direct result of which is the deteriorating fundamentals.

The general environment is also challenging. As a consequence of evolving macro economy, policy adjustments, and the trade war, the A-share market has experienced sharp falls since the second half of 2018, and caused additional pledges by major shareholders. In cases where buy-in option is deprived, breaches occur gradually, and loss of refinancing capability ensues. The resulting systematic risks eventually lead to change of actual controllers and passive share reductions. Taking the second half of 2018 as an example, the 651 companies listed in the A-share market that experienced share reductions saw their share price go down by 19% on average.

In order to address potential systematic risks and help enterprises avoid predicaments that may trigger ownership transfer, the People's Bank of China, China Banking and Insurance Regulatory Commission, and China Securities Regulatory Commission issued policies from October 20-26, 2018,, aimed at extricating private enterprises from financing difficulties and equity pledge risks through a series of financial relief moves. Concrete steps have been taken in Beijing, Shenzhen, Shanghai, Zhejiang, Sichuan, Guangdong, and other provinces to grant necessary financial aid to private enterprises whose operations are promising and in line with national economic structure optimization and upgrading policies.

Based on Wind data, a comparison of actual controllers between December 31, 2017 and November 10, 2019, shows that after a succession of financial relief moves made by the government, 48 private companies listed in the A-share market have become state-owned in nature (see Table 3).

Table 3: Change of the Nature of Actual Controllers

the Nature After Changing / the Nature Before Changing	State-owned Assets Supervision and Administration Commission of the State Council (SASAC)	Local Government and State-Owned Enterprise	Central Enterprise	Sole-Proprietorship Enterprise	Other	University	Total
State-owned Assets Supervision and Administration Commission of the State Council (SASAC)	6	2	6	28	13	1	56
Local Government and State-Owned Enterprise	5	0	0	17	4	0	26
Central Enterprise	7	1	3	3	6	0	20
Collective Enterprise	0	0	0	2	1		3
Sole-Proprietorship Enterprise	8	2	0	20	152	0	182
Other	2	0	1	36	1	1	41
Total Change of the Nature of Actual Controllers	28	5	10	106	176	2	327

Such change from private to public operations happened to 29 companies in 2018, and 19 in 2019. There is still a long list of listed private companies looking for similar changes, pending completion of ownership transfer procedures. In most cases, sales of shares by these private enterprises to state-owned asset operators can be traced to a high proportion of equity pledges initiated by major shareholders that later resulted in performance decline, high liabilities, and a desperate need for external capital.

Given the current downward pressure in the Chinese economy and the increasing demand for deleveraging, some private listed companies that expanded drastically in their early stages are now facing tremendous survival stress. In this context, the intervention by state-owned asset operators helps ease the liquidity pressure of these companies on one hand, and, on the other, paves the way for potential reforms regarding mixed ownership in the future.

Reasons for Actual Controller Changes

There is much to learn from the case of Orient Landscape – and much that risk managers for all parties must consider when it comes to equity pledges or controller changes.

The reasons for actual controller changes can be categorized into two groups: internal and external factors.

Internal factors:

1. **Too high equity pledge proportion.** Wind statistics show that private enterprises were the main parties seeking funding in stock pledge deals. Compared with state-owned enterprises with

favorable resources, private enterprises are generally smaller in scale and less stable in operations, which in turn leads to higher direct and indirect financing costs. Because on-exchange stock pledge business features a low-threshold, high-financing efficiency, and large accessible fund amounts, it has grown to be one of the main tools for private enterprises to improve financial liquidity. In particular, starting in 2017, as the government put great efforts into financial deleveraging and the financing measures for non-standard products were tightened, the financing channels available to private enterprises became narrower. Major shareholders in private enterprises turned to on-exchange stock pledges in hopes of gaining access to circulating capital and leverage for business expansion.

2. **Disclosure of the Use of Funds.** Possibly due to reasons such as more radical operation or low cash flow, the chairman of a listed company engaged in an equity pledge may opt not to disclose the specific purposes of funds raised through equity pledge. Typically, a chairman choosing a high proportion of equity pledge tends to be radical in operation concepts (e.g. with preference for high debt ratio or pledge ratio), or has to deal with stressed capital flow. These features and internal factors are more sensitive to external influences such as regulatory policies and industrial environment. By contrast, listed companies not involved in an equity pledge usually have adequate cash flow and stable operation, and are therefore more resistant to external impacts.
3. **Other reasons.** Non-performance factors other than an equity pledge, such as "resignation for evading restricted stock trade period" and "scheduling by central government" are beyond the scope of the present analysis, and are therefore not discussed in detail. "Resignation for evading restricted stock trade period" is a tactic that may be adopted by original shareholders of listed companies. Since they often obtain the shares prior to IPO at a very low or even negligible cost, they can earn a big profit by selling their shares even at a low price. Hence upon expiry of restricted

stock trade period, they may have a strong tendency to sell. The desire for rapid cash-out grows more intense in a falling market. Due to restrictions on share reduction ratio, a chairman often has to wait long before selling his/her shares for cash. In addition to time cost, the value of shares may diminish over time given that many listed companies are experiencing downward fluctuations of stock price. Besides, a statement made by a listed company about its chairman's share reduction is likely to impact its stock price negatively, and consequently reduces overall income of the chairman. Therefore, for some chairmen of listed companies, resignation seems a good way to evade restrictions. In some listed companies, the management personnel may be changed during declines of performance and confrontation with major operation risks. In this case, a departing chairman can be considered the scapegoat for poor performance.

External factors:

1. **Limited financing channels.** Bank loans are often granted to private enterprises after long approval procedures and subject to more limitations. By comparison, an equity pledge deal can be approved within a shorter period, and there are no restrictions on fund purpose imposed by counterparties. Hence in the eyes of directors, supervisors, and executives of listed companies, equity pledge is a more convenient financing channel. Private offering of additional shares used to be another main financing tool for listed companies. With changing policies, however, the price of additional shares for private offering is now linked with stock market price, thus eliminating the price difference previously obtainable by investors. Accordingly, in such private offering activities in the past two years, the investors usually requested that the major shareholders of the listed companies indemnify them against all losses if stock prices drop below a threshold, or insisted that the major shareholders act as the main investors. Obviously, the role of main investors necessitates substantial financial input. This is another factor that drives listed companies towards equity pledge as a way of raising fund for main investment.

2. **A preference for equity.** The preference for a high equity pledge

proportion among major shareholders of many listed companies in the A-share market in recent years has been spurred to a certain extent by a tide of opinion that “great wealth is created out of equity.” These shareholders feel an urge to cash out by way of equity pledge and to race into equity investment. In financial terms, the cost of equity pledge deals for listed companies is merely about 7% in most cases, slightly higher than benchmark interest rates of bank loans but fairly justifiable considering expected returns from investments in other projects made with the money thus raised. Since bank loans are not as easily accessible, such equity pledges seem a reasonable move for shareholders of listed companies if the stock price remains in a stable range and the control of major shareholders won’t be affected.

3. **The Impact of Macroeconomics and Trade.** The A-share market has experienced continued downturn pressure and increased volatility since 2018. On March 8, 2018, U.S. President Donald Trump officially signed a memorandum on trade with China to charge 25% and 10% custom duty respectively on all steel and aluminum products imported from China. The 25% custom duty imposed by the U.S. government on Chinese commodities impacted Chinese private manufacturing enterprises directly and caused Chinese stock market to tumble. From March to December 2018, CSI 300 Index dropped by nearly 30%, driving the value of collateral in some equity pledge transactions to their position-closing threshold. Major shareholders holding a high proportion of equity pledges began to face intense risks. As the stock market followed a downward trajectory in fluctuations, there has been an exponential increase in the number of listed private enterprises that have changed their chairman since March 2018. In December 2018 alone, 33 listed private enterprises declared replacement of chairman. Such chairman turnover risks mounted following sharp fluctuations of the stock index in October 2018.

4. **Government policies.** After the stock market crash in 2015, the central government put forward plans for reducing excess production capacity, inventory and leverage, improving weak links, and lowering cost for prevention of systematic financial risks. These policies shaped the priorities of economic and financial work of the government in the ensuring years. Since 2017, due to efforts made in deleveraging and tightening non-standard financing, market liquidity and financing channels for enterprises have been put under stricter

control. Consequently, major shareholders turned to on-exchange stock pledge to achieve liquidity, and in doing this they pushed stock pledge repurchases to the fast lane. The total volume of equity pledge deals in 2017 reached a historical high. From May 2017 to the beginning of 2018, in order to control and mitigate market risks and corporate governance risks arising from high-proportion equity pledge, relevant regulator authorities issued a large number of policies. Clear restrictions were put on new equity pledge transactions, though the existing transactions and their potential risks were not accounted for. Before 2018, with the A-share market steadily going up, the risks from high pledge proportions, perceivable as they were, did not result in transfer of equity ownership in general. From March 2018 onward, the downward fluctuations of A-share market caused some pledged equity assets to hit their position-closing line. Some major shareholders had to face closing of position and change of corporate ownership.

Figure 6: Variations of CSI 300 Index in 2017 and 2018 and Data About Monthly Chairman Replacements in Private Companies Listed in the A-Share Market

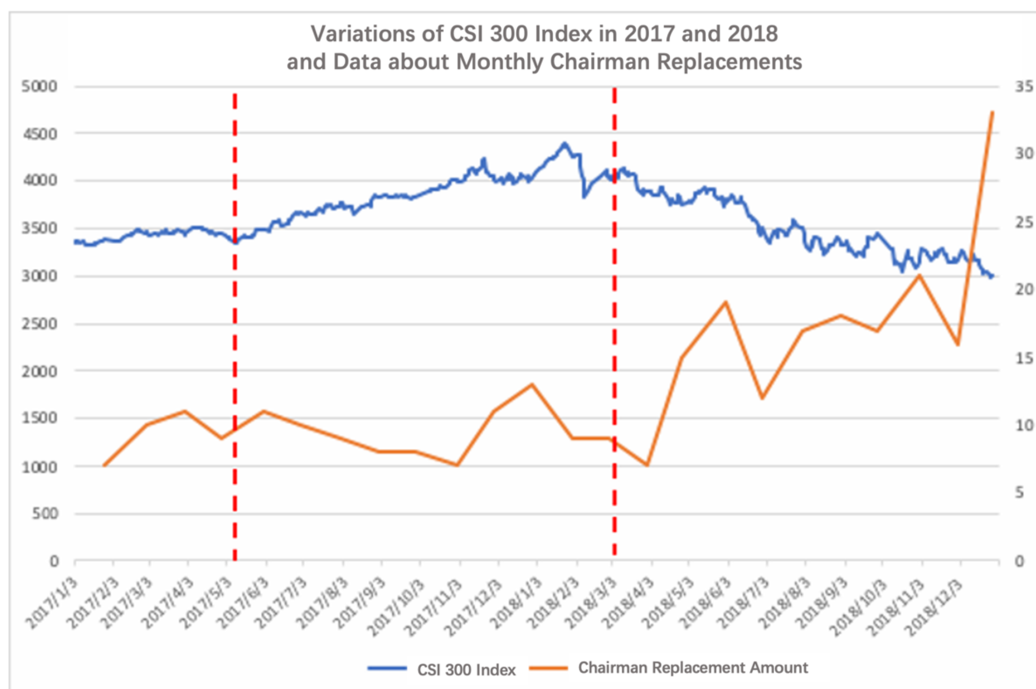
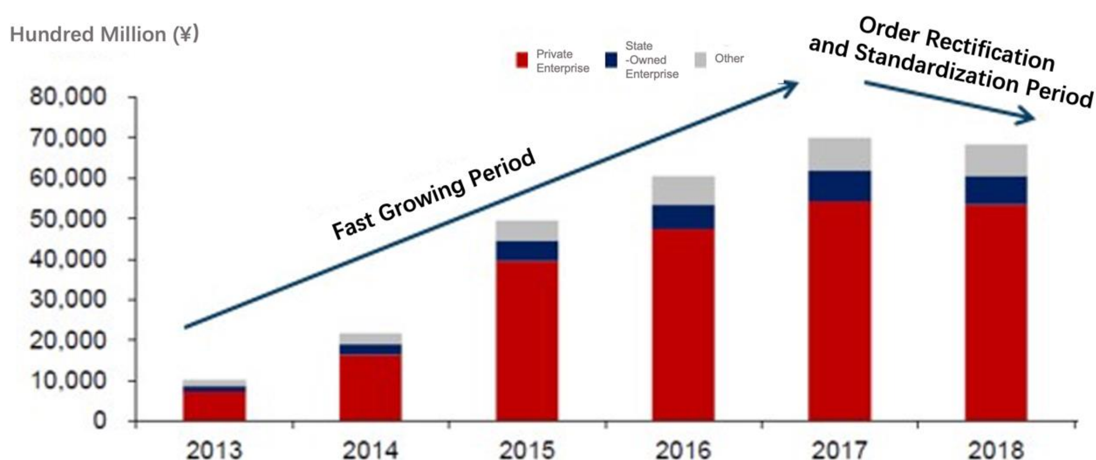


Figure 7: Proportion of Private Enterprises, State-Owned Enterprises, and Other Enterprises in Total Market Value of Stock Pledges (2013-19)



According to initial statistics of Wind, as of March 2019, the financial relief funds provided by the government in different areas add up to more than RMB 350 billion, including RMB 200 billion for securities traders, 72.5 billion for funds, and 106 billion for insurance products. Thanks to supportive policies and financial relief funds, the stock pledge risks are declining. The combined output of multiple positive factors, including rising market, *the Rules*, financial relief funds, and business structural optimization, is a remarkable decrease in overall stock pledge volume and relevant risks.

Conclusion

To mitigate equity pledge financing risks and potential systematic risks, all parties to equity pledge transactions and regulatory authorities have to reinforce risk management.

First, pledgees need to examine pledge rights concerned carefully. In a financing process based on an equity pledge, both the borrowing enterprise and the company in possession of the pledged equity should be subject to close scrutiny to ascertain their management conditions, financial strength, financing purpose, and future debt repayment ability. Throughout the term of a pledge, the pledgee should supervise the pledger company by conducting regular tracking and investigation. A counterparty credit risk system should be

established if possible.

Second, pledgers should void radical investments. Taking Orient Landscape as an example, in 2015 and 2016, the total price of PPP projects awarded to it reached over RMB 60 billion. As deleveraging already became a prevailing practice in the market, the huge amounts of money required for PPP operations placed the financing system of the company at risk. It eventually resorted to radical equity pledges that led to change of actual controller.

Lastly, government functional departments need to provide relevant support systems. Regulatory authorities should fulfill their registration, supervision, and management functions properly.

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