

## Trust Business in China: The Challenges of Moving Towards Family Trust Service

Trust business in China is arguably the most misunderstood area of the financial services sector. Yes, China has a trust law which dated back to 2001 and its trust industry is the second largest financial services sector in China, after banking only, boasting a total asset of RMB10.9 trillion (US\$ 1.8 trillion) under management as at the end of 2013<sup>1</sup>. However, until fairly recently, trust business in China, as represented by the sixty or so trust companies, has had little to do with family wealth management; rather it has been known as part of China's shadow banking sector.

It appears that the situation is about to change. In 2013, for the first time in the short history of China's trust business, family trust services were launched purportedly to cater for the wealth planning needs of the burgeoning HNW clients. Since then, more trust companies have expressed interest in moving in the direction, perhaps encouraged by the Guidance Note issued on 10 April 2014 by the China Banking Regulatory Commission (CBRC) on Risk Management of Trust Companies, known as the CBRC No. 99 Guidance Note (银监99号文)<sup>2</sup>.

This paper assesses the significance of this development, asking how likely it is that China's trust business can make the transformation from a capital market player to a family wealth manager.

### 1. Legal and Regulatory Framework of China's Trust Business

Unlike trust laws which evolved under the common law tradition, China's trust law is a product of China's effort to modernise its financial market. As Professor Linge notes, the law was passed as a catalyst for the rise of institutional investment funds, seen to be a stable and efficient source of capital for China's rapidly growing economy<sup>3</sup>.

Consequently, the regulation of the trust business centres on establishing the rules for the marketing of trust products. Issued by the CBRC, these rules typically concern the conduct of trust companies and the administration of "collective" investment trusts.

### 2. Trust Business as "Shadow Banking"

Given the nature of its historical origin and the matching legal and regulatory impetus, trust companies in China have emerged as an important source of alternative capital financing. Their growth is further stimulated by the gaps in the financial market left open by the banks which tend to lend to state enterprises. Consequently, their reputation as the shadow banking institutions refers not only to the enormous assets under their management, but also the key role they play in managing alternative assets such as private equity, infrastructure, real estates, and commodities. Trust products, known as "wealth management products", typically generate a return between 9% and 11%, much higher than bank deposits<sup>4</sup>.

### 3. Trust Products for the Wealthy

China's HNW clients are typically sold three types of trust products, known respectively as collective investment trust (CIT) (集合资金信托), single capital trust (SCT) (单一资金信托), and property management trust (PMT) (管理财产信托). Whilst a CIT is a standardised product developed by the trust company that is sold to multiple investors, the SCT is a bespoke product for a single client. The PMT involves the management of non-monetary assets.

According to the China Trustee Association, as at 31 December 2013, SCTs accounted for nearly 70% of the trust assets under management, while the data for CITs and PMTs were just under 25% and 5.49% respectively.

In terms of investment sectors, 25.25% of the funds went to infrastructure, 28.14% “industrial and commercial enterprises”, 10.03% real estate, and 14.23% “Other”. The remainder were invested into different categories of financial instruments such as securities, bonds and investment funds.

It is clear that the trust companies have been the key provider of high-yield alternative investment products to China’s wealthy class.

#### 4. The Crisis of Shadow Banking

Until fairly recently, a number of factors conspired to push the trust industry into new heights. These include China’s low interest rate environment after the 2008 global financial crisis, and various government policies and measures of curbing inflation by restricting bank lending. With formal bank lending slowing, shadow financing rose to account for more than a third of new credit in China in 2013.

However, since 2012, there have been a number of high profile defaults and near defaults by trust companies, the latest involving China Trust Co, which had to default on interest payment due in January 2014 on its issued credit loan tied to a coal mine that went bankrupt. The default on the principal was narrowly averted due to a last minute bail out by a “white knight” whose identity remains a mystery today<sup>5</sup>.

With more potential defaults expected by industry watchers, and the opaque circumstances surrounding the few bailout cases, the role of the shadow banking sector in China’s financial market is causing increasing concerns.

A few months after the latest threatened default, the No. 99 Guidance Note was issued by the CBRC, calling significantly, among other things, for the trust industry to make a transformation into a true wealth management industry able to provide bespoke family trust services to China’s HNW clients.

#### 5. The Launch of the Family Trust Service

Even before the issuance of the Guidance Note

in April 2014, at least three trust companies had started pioneering the family trust service in 2013; they were Ping An Trust Co, in partnership with Ping An Bank, Beijing International Trust Co in partnership with Beijing Bank, and China Foreign Economy and Trade Trust Co. in partnership with China Merchants Bank. Since then, more trust companies have indicated their plan to provide family trust service, including Citic Trust, Zijin Trust, Shanghai International Trust, Zhongrong International Trust, Anxin Trust, and CCB Trust. Meanwhile, the three trail blazers have also publicised their plans to expand their business in this area<sup>6</sup>.

#### 6. Key Features of the Services

It is far too soon to assess the significance of this new development. However, at this early stage, key features common to the embryonic business can be noted as follows:

- Target market: HNWI’s with assets exceeding RMB500 million (circa USD83 million) and financial assets exceeding RMB100 million. As can be expected, most of the clients are business owners.
- Type of trust: Typically irrevocable, for a fixed period ranging from 5 to 50 years.
- Trust asset: As these are onshore trusts, trust asset is all in RMB, typical threshold being RMB30 million. However, due to the uncertainties and complications relating to real properties and other tangible assets, trust property can only comprise financial assets. There is talk of widening trust asset to include shares in pre-IPO companies on China’s stock exchanges as the next step of development.
- Terms of trust: Full discretionary investment powers are vested in the Trust company acting as the Trustee, and the Settlor can express their preferences on investment strategies and target at the trust establishment stage. Further, the Settlor can dictate the terms of beneficiaries’ entitlement.

In practice however, the trust’s Custodian bank, which is invariably the investment advisor of the trust, often plays the leading role in making investment decisions. Indeed, it is rather

revealing that the claims for being the first to launch family trust service were made not from the trust companies, but the banks they worked with.

Clearly China's family trust business is limited in scale and scope.

Further, its nature is uncertain. The leading role played by both the bank and the Settlor, for example, in managing the trust property, would raise questions about both the core fiduciary duties of the Trustee and the potential conflict of interest where the trust property is invested only in the bank's products.

## 7. Constraints of Future Development

Short history may account for the current limitations of the family trust business; this should change over time. However, unless the legal infrastructure is significantly strengthened, the business will remain constrained.

The first major such constraint is the trust law itself. As already mentioned, the law was designed to facilitate commercial trust business in the capital market. Under this framework, trust is envisaged solely as an investment product, usually with a short-term time horizon.

Under the family trust business model, however, trust is an omnibus tool catering for the comprehensive wealth management needs of the HNWI. These needs go beyond investment to include wealth preservation and wealth and business succession. Unlike the investment product known as trust, family trust is essentially a blueprint for the long-term, with the key focus on future generations. Trustees must perform an irreducible core of fiduciary duties to ensure the integrity of the trust and beneficiaries have enforceable rights against the Trustee in the event of any breach of fiduciary duties.

In its current version, China's trust law is woefully inadequate as a framework for such a business model. A case in point here concerns the role of the court. China's trust industry has had its share of scandals of mismanagement over the years. What has transpired from these is that the Chinese courts have little authority over trusts and limited expertise in trust matters.

Therefore, current experimentations with the family trust business model are fraught with legal uncertainties.

Another legal ambiguity lies in China's tax law, which offers no guidance on the treatment of trusts. As Peter Ni and Hao Jiang of Zhong Lun Law Firm point out, in the absence of such guidance, local tax authorities are most likely to "take matters into their own hands" by treating the transfer of real estates into a trust as a taxable event when the trust is publically registered as required by the trust law<sup>7</sup>. This will work as a powerful disincentive for settling real estates into the family trust.

Finally, Professor Lucina Ho identifies the lack of clarity in China's family law, especially with regard to the concept of community property, as another constraint in the development of China's family trust business<sup>8</sup>. In short, the legal architecture required to support the family trust business would consist of at least three modern pillars: an updated trust law and other laws that would have an impact on the trust business, crucially the tax and family laws.

## 8. Conclusion

Since its inception in 2001, China's trust business seems to have reached an interesting stage where it is both pushed and pulled to make a dramatic change in direction. The trust companies, instead of providing alternative asset management service to China's HNWIs, are now encouraged to transform themselves from shadow bankers into family trust service providers.

The timing seems opportune: On the one hand, the demand for this service is palpable in the form of the increasing number of HNWIs. On the other hand, government intention to see this transformation is undoubtable, as reflected in the No. 99 Guidance Note. Further more, a number of trail blazers have bravely made the plunge by launching their family trust service albeit on a limited scale and scope.

Whilst all these are encouraging, the key challenge facing the desired transformation is the inadequate legal infrastructure underpinning this development. Unless and until the trust law is rewritten to facilitate comprehensive and long-term family wealth management as opposed to capital flow, and clarities are injected into the related tax and family laws, China's family trust business will unfortunately feel like walking on sands, unable to venture far.

1. See the data provided by the China Trustee Association,  
[http://www.xtxh.net/Trust\\_Statistics/19124.html](http://www.xtxh.net/Trust_Statistics/19124.html)
2. Twenty-First Century Economic Report,  
[www.21so.com](http://www.21so.com).
3. Eric Linge, "Trust as Institutions in China's Financial Markets" *Tsinghua China Law Review*, Vol3, 2011-9-2
4. Jason Bedford quoted by *The Economist*,  
<http://www.economist.com/node/18118975>
5. Forbes Asia, 1/27/2014
6. 凤凰财经 2014-05-05  
[http://www.21so.com/HTML/ifeng/2014/05-05-74291\\_3.html](http://www.21so.com/HTML/ifeng/2014/05-05-74291_3.html)
7. Yongjun Peter Ni and Hao Jiang, "Assessing the Family Trust in China", *Offshore Investments*, April 2011
8. Lucina Ho, "Family Trusts for Chinese Clients", *Trusts & Trustees*, Vol 20, No 1&2, Feb/Mar 2014

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