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The Failure of Trusts in China

The First Wave of Trust Defaults

Summary: Chinese Trusts currently have 11.7 trillion yuan ($1.9 trillion) in funds outstanding for investment. These Trust assets make up approximately one-quarter of all Shadow Banking funds in China. As China's economy slows, there is concern that Trusts – and by extension Shadow Banking in general – will undergo a wave of defaults. Using a list provided by the Central University of Finance and Economics in Beijing, we have analyzed a list of 31 failed Trusts to see what common themes they provide and what they suggest for the future of the industry. The principal conclusion is there is a surprisingly lack of government support for these failed Trust investments. In only four cases did the Trusts, most of which are government owned, provide capital. The majority of the failed trusts were simply liquidated. This suggests the implicit obligation by the Trusts to support their products may not be in force. Some of our main conclusions:

- **Weak Property Sector.** More than half of the Trusts that have failed are invested in the property sector. Over one-third uses land as collateral for the investment. And even though coal accounts for 30 percent of the investments, we think that number will decline over time as coal accounts for just 14 percent of total Trust assets. This will make the property sector the most important area to watch when it comes to the Trust industry.

- **Systemic Risk in Guarantees:** Almost three-quarters of the failed Trusts used guarantees to back them in case of default. Among these guarantees, 85 percent were personal and 60 percent were provided by companies. These guarantees no doubt vary tremendously in terms of quality of assets and willingness to provide capital in case of a default. When Trust defaults become widespread – as we expect they will – the amount of litigation and negotiations will strain the regulatory and political system.

- **Little Government Support.** There widespread assumption of state backing for many Shadow Banking loans may not be accurate. We found that investors were paid back by the Trusts that sold these products in only four

cases. That suggests local Trusts, and their Provincial owners, are reluctant to put up cash to make investors whole.

	AUM	Paid in Capital	Loss Provision	Retained Profit	Total Equity	Leverage Ratio
2013	10,907.1	111.7	9.1	84.9	255.5	42.7
2012	7,470.6	98.0	6.2	61.2	203.0	36.8
2011	4,811.4	87.1	4.3	42.4	163.0	29.5
2010	3,040.5	73.8	2.9	27.2	132.0	23.0

Moral Hazard in the Trust Industry

Summary: Trusts have become the backbone of China's Shadow Economy. Trust lending has ballooned to 11.7 trillion yuan in the first quarter of 2014, up 34% from a year ago. With declining profits and inefficient investments, these Trust loans eventually may be unable to pay lenders interest or even principal and could default on a massive scale. The rising number of Trust defaults could potentially create a breakdown of the financial system because Trusts have been in the center of such a large portion of financial flows in the Shadow Banking market.

Beijing is becoming concerned. In August 2014, the China Banking Regulatory Commission required three big trust companies to watch for "severe risk" in their projects and said another 11 should also be alert to potential problems. These "risk assets" include bad assets where the borrower has failed to make repayments on time. The three firms the regulator named are Citic Trust, Huarong International Trust and New China Trust. All recorded an amount for risk assets that exceeded net assets at times during the past several months. However, this assessment in all likelihood only scratches the surface of problem loans.

Our report report examines this "First Wave" of Trust defaults. Using a list of known

Trust defaults (or near defaults in some cases) compiled by the Central University of Finance and Economics, we analyzed each one to understand their financial make-up and what caused them to break down. The purpose is to see if this initial wave provides any clues to how this industry may fare under the pressure of lower GDP growth.

First, we provide the data that we collected on the Trusts. Then, we attempt to draw summary conclusions about what this first wave of defaults means for the future of the Trust industry.

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Section One

What Caused These 31 Trusts to Fail?

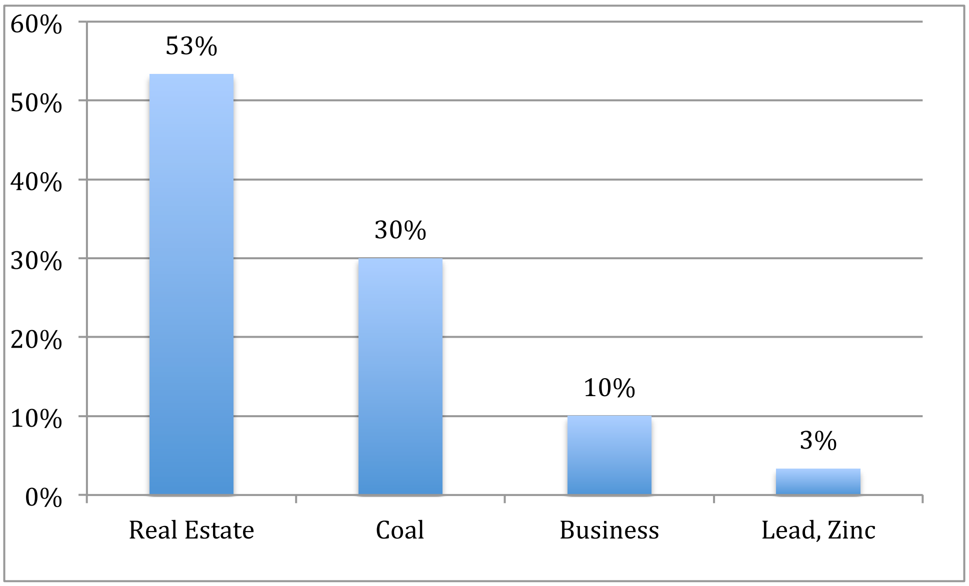
1) **Trusts are Reluctant to Step In.** Close to 65 percent of the 68 Trusts are partially owned by Provincial Governments. Another 15 percent are owned by central government entities. However, in only four cases thus far did the Trusts provide capital to pay back investors. This suggests the moral hazard – at least in the early stages of what could be a larger workout – is not in force. Investors who buy these products may incorrectly believe the government is behind them. This may be true in the case of the Trusts distributed by state banks, which is approximately, 25 percent of the total. But this backing may vanish if the Trusts begin defaulting on a large scale.

2) **Quick Funds Through Liquidation.** The largest method for handling these defaulted products has been through liquidating the assets. Given that the majority of the investments are in inefficient property and infrastructure projects, it's doubtful that the investors are getting much of their capital back. It also shows a measure of desperation in that the managers are seeking to exit quickly.

3) **Real Estate is the Biggest Source of Defaults.** Given that over 90% of Trusts are invested in local real estate and infrastructure projects (according to

our earlier examination of Trust Prospectuses), it is to be expected that the dominant source of defaults in the first wave of Trusts would be in the property sector. This sector accounts for 16 or 53% of our group. The next largest group is coal, with 9 or 30% of the defaults.

Trust Failures by Sector



4) **Reason for Defaults.** We were able to collect data on the reason for the defaults on only 13 of the 31 Trusts. The issuers of the Trust products generally are reluctant to discuss the collapse of their projects or the negotiations that may have occurred after toward dispensation of collateral. The majority of our group suffered from a category we call "weak sales." This is a catch-all term to describe a poor project that was unprofitable. Coal prices, bad management, and misuse of funds each were cited in six other cases.

Reason for Trust Defaults

Four Trust Failures with Information on Collateral

Trust	Issuer	financing company	Collateral	Details of Guarantee
Shanghai Lurun Industry Equity Investment Collective Trust Plan	New China Trust	Shanghai Lurun Industry Co. Ltd	Guarantee from Shanghai Gaoyuan Industry Co. Ltd. Person guarantee.	Zou Yunyu, president of Shanghai Gaoyuan Industry Co.,Ltd,provided personal irrecovable guarantee with unlimited liability. Shanghai Gaoyuan Industry Co.,Ltd provided irrecovable guarantee with unlimited liability.
Changbai Mountain No.11 Nanjing Lianqiang Collective Trust	Jilin Province Trust	Nanjing Peony Garden Real Estate Co Ltd.	Land (valued at 580 mln RMB); guaranteen from wholly-owned subsidiaries;	Wholly owned subsidiary and actual controller provided guarantee with unlimited liability
Shanxi Liansheng Energy Equity Investment Collective Trust Plan (the third phase)	Huarong International Trust	Liansheng Group	Mining right. Guarantee from Shanxi Zhongyang Steel Co. Ltd. Personal guarantee	Shanxi Zhongyang Steel Co. Ltd provided guarantee with unlimited liability. Xing Libing and Li Fengxiao,the actual controller of Shanxi Liansheng Group,provided guarantee with unlimited liability.
Yangcheng Jindu Real Estate Specific Asset Collective Trust Plan	Sichuan Trust	Zhejiang Zhoushan Yangcheng Jindu Real Estate Co., Ltd.	Land valued at 317 mln. Guarantee from Zhejiang Qiangda Construction Co;, Ltd. Personal guarantee	Zhejiang Qiangda Construction Co;, Ltd, and its actual controller, Ma Xiaoping,provided guarantee with unlimited liability.
Yuantou No. 7 trust plan	Shandong International Trust	Yichang Hongjian New Material Co. Ltd.	Land(valued at 136.99 mln RMB). Personal guarantee	Yu Hongzhi, the actual controller of the trust, provided guarantee with unlimited liability.

5) **Liquidation is a Popular Method of Disposing of Defaulting Trusts.** We were surprised to note that liquidation is the most popular exit vehicle. Almost 90 percent of the 67 Trusts are owned by Provincial or Central governments. We had assumed they would step in to recapitalize any failing products they sold.

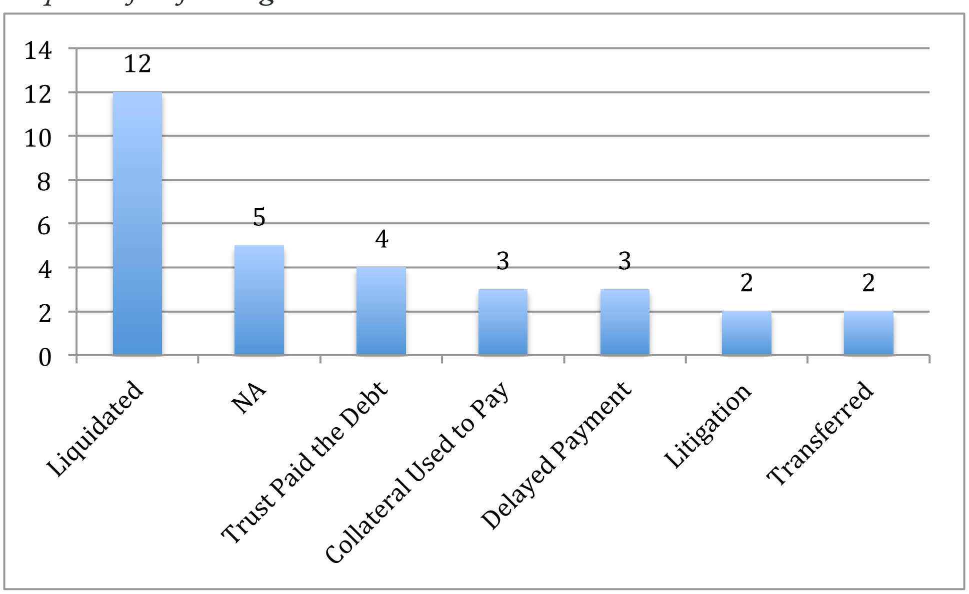
- However, 12 or 39% of the Trusts were liquidated outright. We assume in most cases this included the sale of existing assets, but as most investments were likely in uneconomic property projects, it is doubtful much capital was recovered.

- In four of the 31, as noted earlier, the Trusts did step in to pay off investors, probably concerned about the reputational risk of a failed Trust on their hands.

- In three cases, collateral was sold to pay off investors – which is how the Trusts are supposed to function in case of a default given their covenants. In another three cases, payment has been delayed, so the actual workout is still in question.

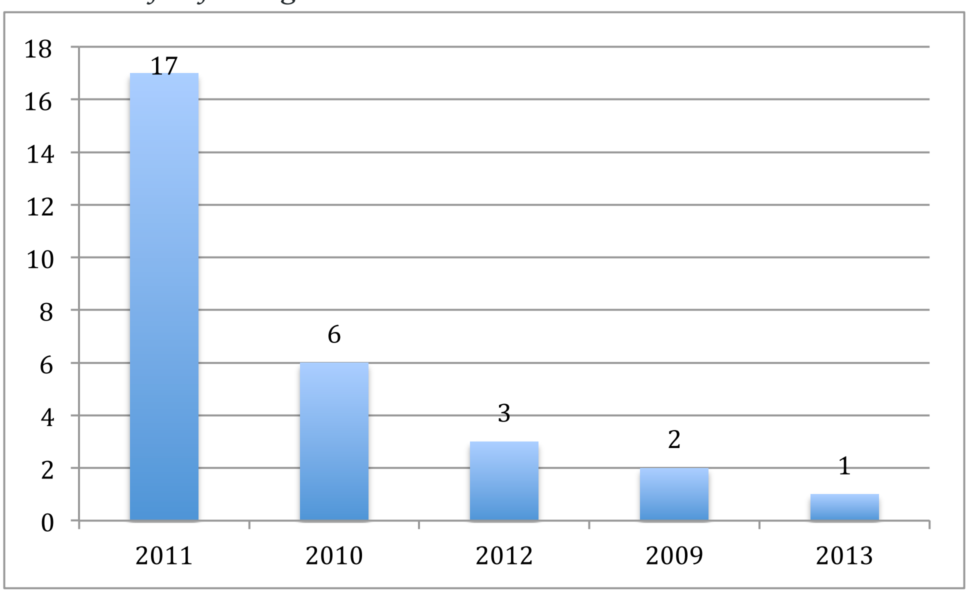
- Two are in litigation and two were transferred to other financial entities, another form of juggling debt between financial groups, which in some cases may be related.

Disposal of Defaulting Trusts



6) Most Defaulting Trusts are Over Two Years in Duration. We next looked at the timing of this first group of defaulting Trusts. When were they issued? More than half of our pool of 29 (we couldn't get data for two), or 17, were issued in 2011. This makes sense given the average duration of Chinese Trusts. In a previous report, (The Risks of Trusts in China, May 30, 2014), we collected data on 6500 Trusts. The average duration was 26 months. That means that the majority of problematic Trusts issued in 2011 would have begun defaulting in mid to late 2013. Another 6 or 21% Trusts were issued in 2010, and the remaining eight in subsequent years. Not surprisingly, only four trusts issued in 2012 and 2013 have defaulted; in some cases, the interest in many of these recent Trusts either were prepaid or have been covered ponzi-like by new Trust issues.

Issue Date of Defaulting Trusts

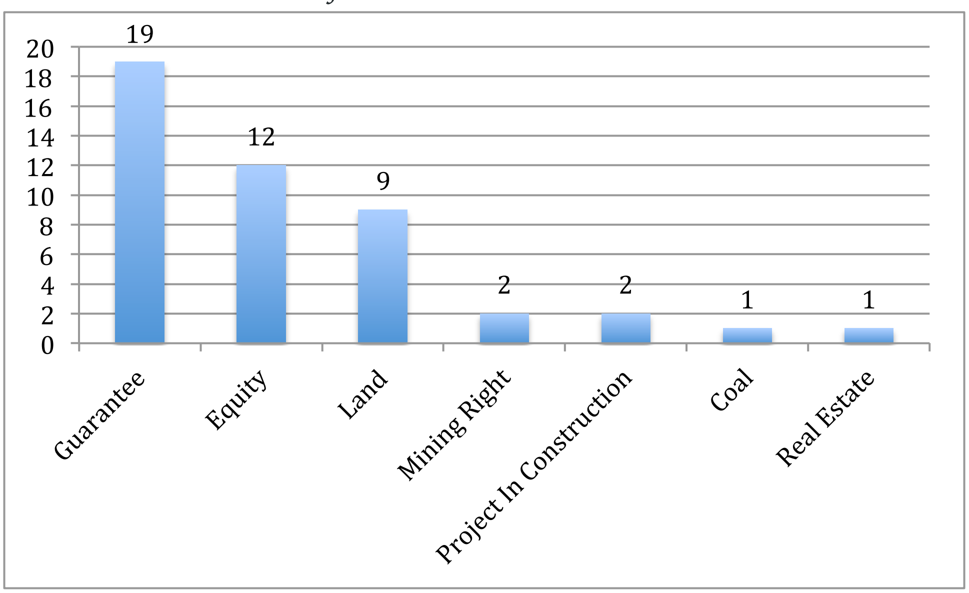


Trusts Due in 2014 and 2015 (RMB Tln)

	Principal	Interest	Total
2014	4.9	0.34	**5.24**
Q1	0.54	0.04	**0.58**
Q2	1.42	0.09	**1.51**
Q3	1.99	0.13	**2.12**
Q4	0.95	0.08	**1.03**
2015	5.8	0.51	**6.31**

7) **Weak Guarantees and Collateral Are Behind the Trusts.** When sold to investors, the Trust products include legal agreements that provide collateral or financial guarantees in case of default. One of the interesting issues in the Trust industry – and in Shadow Banking in general – is who is providing the collateral and the guarantee in case of default. It is often assumed that the government will step in to provide capital for almost all defaulting debt in China. We think this view is mistaken. Unlike the recapitalization of the four State Owned Banks a decade ago, most of the debt issued by Shadow Banks is the responsibility of local entities, and the bulk of this resides in Townships and other governments. How committed Beijing is to these local governments is unclear. Therefore, the guarantees and collateral may be important. In our group, 19 or 68% of them included some form of financial guarantee. As for actual collateral, 12, or 43% included equity in a variety of local companies. Land as collateral, surprisingly, came in third with 9 or 32% of the Trusts.

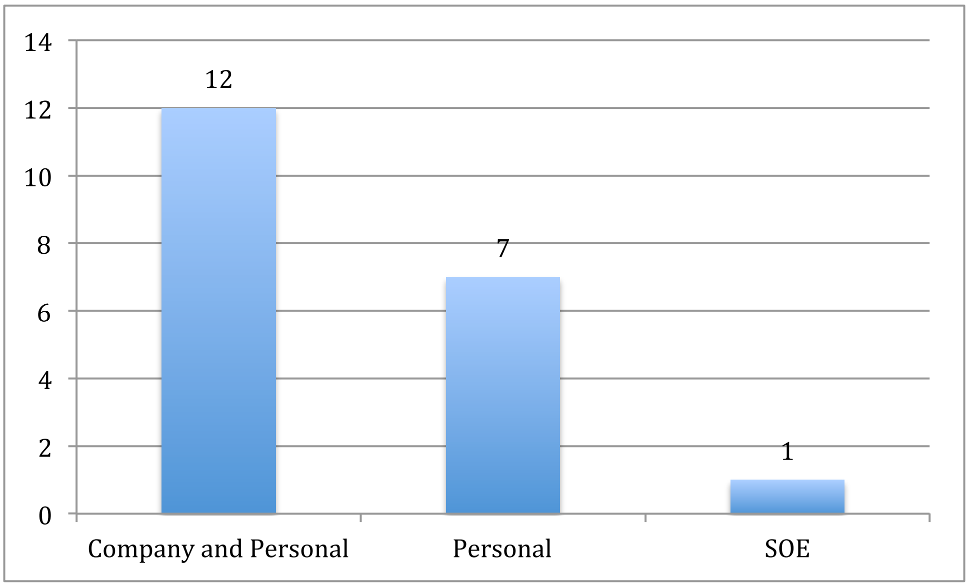
Guarantees and Collateral for Failed Trusts



8) **Personal Guarantees are Used in Many Trusts.** In the 20 Failed Trusts for which we could obtain data on guarantees, 12 or 60% of them contain clauses with a combination of company and personal guarantees. This is particularly alarming as it is not clear of the financial status, legal responsibility or

background of the individuals and companies providing the guarantee. An additional 7, or 35% of the group of 20 for which we have data, provide personal guarantees only. It is unlikely that the buyers of these Trust products are given precise details on the financial resources of these private individuals, whose ability to repay is probably relying on reputation alone.

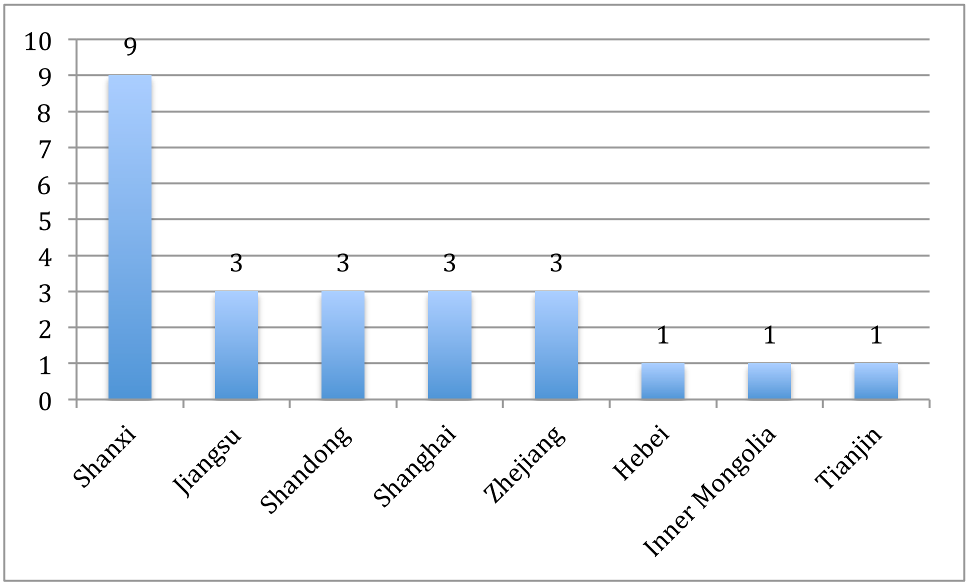
Type of Guarantees Provided for Failing Trusts



9) Geographical Breakdown – East Coast

All except for one Trust was issued on the wealthy eastern corridor. More than one-third came from one Province, Shanxi, which is where the country's coal industry is concentrated.

Geographic Breakdown of Trusts



Map of Geographic Origination of Trust Defaults

Section Two

What Do These Trust Failures Mean for China's Economy?

The examples we have so far of failed Trusts provide an indication of what may happen if a slowing economy causes an increased in failed loans.

1) **Two Scenarios: 10 percent and 20 percent Default Ratios.** We can't predict the extent of the potential failures of Trusts in China because our sample size is too small. However, we can use the data we have to make an educated guess about the dispersion of failure under certain scenarios. We chose two metrics, default rates of 10 percent and 20 percent.

A 10 percent default rate would equate to 1.2 trillion yuan in trust defaults. Under this case, we could expect almost 500 billion yuan of Trusts to be liquidated; 159 billion yuan of defaulted trusts would be paid by the Trusts themselves (although it's not clear where they would obtain the capital as their equity is relatively small compared to total loans); and the remainder would fall under other categories, including transferal and litigation.

Under a 20 percent default rate, the numbers would double with 2.5 trillion yuan in total defaults, of which close to 1 trillion yuan would be liquidated.

Breakdown of Categories of Trust Defaults under Two Scenarios

10% Failed Trusts	**RMB Bln**	**% Total**
Liquidated	476	39%
NA	198	16%
Trust Paid the Debt	159	13%
Collateral Used to Pay Investors	119	10%
Delayed Payment	119	10%
Litigation	79	6%
Transferred	79	6%
	1,230	

20% Failed Trusts	**RMB Bln**	**% Total**
Liquidated	952	39%
NA	397	16%
Trust Paid the Debt	317	13%

Collateral Used to Pay Investors	238	10%
Delayed Payment	238	10%
Litigation	159	6%
Transferred	159	6%
	2,460	

2) **The Property Sector is Biggest Weakness in the Trust Market.** More than half of the Trusts that have failed are invested in the property sector. Over one-third use land as collateral for the investment. And even though coal accounts for 30 percent of these failed investments, we think that number will decline over time as coal accounts for just 14 percent of total Trust assets. This will make the property sector the most important area to watch when it comes to the Trust industry.

3) **Guarantees will be a Problem in the Future.** Almost three-quarters of the failed Trusts used guarantees to back them in case of default. Among these guarantees, 85 percent were personal and 60 percent were provided by companies. These guarantees no doubt vary tremendously in terms of quality of assets and willingness to provide capital in case of a default. When Trust defaults become widespread – as we expect they will – the amount of litigation and negotiations will strain the regulatory and political system.

4) **Banks will Absorb Losses**. Single Trusts account for three-quarters of all Trust assets. For much of this capital the banks were the ultimate lenders, almost 8 trillion yuan in total. Assets of the commercial banking sector totaled 125 trillion yuan in 1Q14. Meanwhile, current amount of single trust products due in 2014 amounts to 4.1 trillion yuan, according to Haitong Securities. Assuming a non-performing ratio of 5% for single trusts in 2014, total loss of 0.2 trillion yuan would trigger an increase by 0.2% of the total NPL ratio at the end of the year. The shock is therefore largely absorbable by the commercial banks. However, widespread failures of Trusts will likely curtail bank loans as they raise capital to absorb the losses.

5) **Concerns about the Interbank Market as Trust Failures Increase**. In 2013, inter-bank activities linked to trust beneficiary rights under inter-bank activities were estimated at 1.35 to 2 trillion yuan, which accounted for 17.8% to 26.3% of single trust AUM in 2013. Trust Beneficiary Rights are

loans under which one bank makes the loan but a second bank will have the rights to the interest payments. This keeps the actual loan off-balance sheet and allows banks to increase their loans to risky sectors. This has helped increase interbank assets, which reached 21.5 trillion yuan at the end of 2013 compared to 6.5 trillion yuan at the end of 2008.

6) **Banks May Increase Trust Ownership.** Pudong development bank announced in March 2014 that it would acquire Shanghai Trust, becoming the fourth trust firm under commercial banks following the Bank of Communications international trust, CCB trust and China industrial international trust. Taikang insurance also bought in SDIC trust via private placement in January, doubling its capital from1.8 billion yuan to 4 billion yuan.

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