To default, or not to default: an update on China's shadow banking industry

- **China may narrowly escaped the first default in its shadow banking industry**
- **Absence of default has become a major market distortion**
- **The challenge is to contain the contagion risk if a default happens**

To default or not to default: that is the question. Over the past several weeks, market has been watching out closely whether a first default will happen in China's RMB 10-trillion trust industry. A 3-billion trust product (named "Credit Equals Gold No 1") issued by the China Credit Trust and sold by the Industrial and Commercial Bank of China (ICBC), is facing the risk of default. The borrower of the trust product, a privately owned coal miner (named Zheng Fu Energy Corp), has declared bankruptcy, leaving a total debt of RMB 5.9 billion and a total asset of less than RMB 500 million.

A local media reported that the China Credit Trust has reached a last-minute agreement with investors, with all principal and most accrued interest to be repaid. That means China will again narrowly escaped the first default in its shadow banking. However, the worries remain. The absence of default has become a major distortion in China's shadow banking, and we believe that default will happen in 2014 amid economic slowing. The concern is that, if a default occurs, whether investors will walk away and put the whole shadow banking market into a liquidity-driven credit crisis.

The stake on the table

The concern about the contagion risk is not groundless. In the past several years, non-bank financing (or the so-called shadow banking) has grown rapidly. In an earlier report (Research Note: "Shadow Banking in China", May 3, 2013), we estimate that the gross amount (i.e. with possible overlapping among sub-components) of non-bank financing in China reached RMB 36 trillion by the end of 2012 (or nearly 70% of GDP), compared to RMB 18.3 trillion in 2010 (or 46% of GDP).

Non-bank financing continued to grow fast in 2013. An update of our estimate suggests that non-bank financing has further increased to RMB 46.7 trillion by September 2013 (or 84% of GDP). The increase was most dramatic for trust assets (an increase of RMB 2.66 trillion in the first nine months of 2013), wealth management products (an increase of RMB 2.82 trillion), entrust loans (an increase of RMB 1.8 trillion) and bank-security channel business (i.e. banks use security firms as a channel to extend loans, which more than doubled in the first three quarters in 2013 and reached RMB 2.79 trillion).

The rapid growth in non-bank financing activities, especially for trust loans, WMPs and bank-security channel business, has been driven by the perception of implicit guarantee from product issuers and distributors. The absence of default confirmed such perception. Indeed, prior to the China Credit Trust story, there were several reported cases of investment failure of trust products or WMPs, but eventually investors all got repaid under various arrangements.

Note that our estimate does not include interbank assets, which more than doubled between end-2010 (RMB 15.4 trillion) and September 2013 (RMB 32.0 trillion), during which period its share in total bank assets rose from 16.0% to 21.8%. Lack of breakdown information is one reason for the exclusion: while some interbank transactions are related to shadow banking activities (i.e. credit extension), other interbank transactions are for short-term liquidity management purpose. In addition, there is substantial overlap between interbank assets and other components, for instance WMPs investing on interbank assets or claims on trust assets being traded in interbank markets. Nonetheless, banks are closely connected to shadow banking activities, hence possible turbulence in shadow banking will also affect the banking system.

Possible contagion risks

We believe that default will happen in 2014 as the growth momentum slows down, and it will help restore market discipline and mitigate the moral hazard problem in the long run. However, the challenge is how to contain the near-term negative impact, as there could be three possible outcomes (in the order of increasing severity) if a default occurs.

The first possibility is that it is perceived as an idiosyncratic event, i.e. no spillover at all. This is the least likely outcome.

The second possibility is that the contagion risk is contained within a manageable level, i.e. only to similar products or sectors. For instance, if "Credit equals Gold No 1" defaults, investors will move away from collectively trust products that are only sold to wealthy individuals (but not affecting WMPs that are sold to retails investors); investors will worry about the credit quality of similar loans (non-SOE borrowers in mining industry), but not spillover to other products (e.g. local government debt, real estate companies and SOEs); investors question about the safety of trust companies but not banks. We can call it "limited spillover".

The third possibility is a “systemic spillover”. In a mild scenario, it will affect the vulnerable components such as trust loans (48% of trust AUM), WMP investment on non-standard credit products (estimated to be 35-50% of total WMPs) and bank-security channel business. In a worse scenario, it will affect the whole trust industry, WMPs and channel business (with a total gross size of RMB 23 trillion). Rollover of trust products (we estimate 30-35% trust products will mature in 2014) and WMP (64% WMPs has maturity less than 3 months) becomes extremely difficult. The liquidity stress could evolve into a full-blown credit crisis.

What can the government do? In our view, avoiding defaults is not the right answer, as it will only delay or even amplify the problem in the future. Meantime, there are measures the government can take to contain the contagion risk.

First, let defaults happen but establish a transparent legal process (rather than under-table arrangements) to resolve the dispute between different parties.

Second, regulators should tighten supervisory and regulatory framework to contain regulatory arbitrage activities, and clarify the responsibilities in various shadow banking products. The uncertainty in regulatory and legal responsibility behind each product is an important caveat in the market, and could amplify the contagion risk.

Third, impose hard budget constraints on local governments and SOEs, so as to avoid crowding out of credit to other business borrowers and establish risk-based pricing practices.

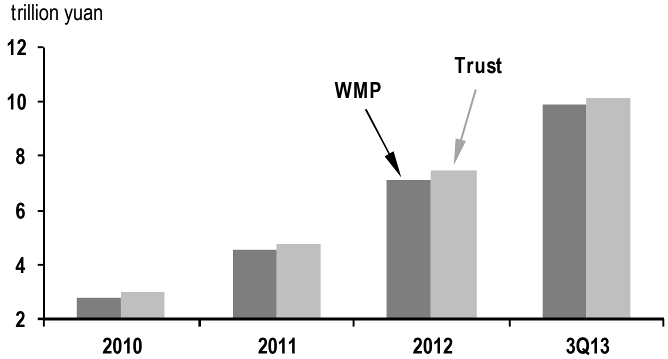
Finally, avoid defaults that could be easily linked to systemic concerns, such as the default of banks (rather than non-bank financial institutions as the perception of government protection on banks is stronger) or local government financial vehicles or SOEs. Similarly, the default of a WMP could have a bigger impact than a trust product, as the latter does not have maturity mismatch problem and are sold to wealthy individuals rather than retail investors. In that sense, China may miss an "ideal" first default if "Credit Equals Gold No 1" gets bailed out.

Shadow banking in China
September 2013

	Size (bn yuan)	% of GDP	Memo: size at end-2012	*% of GDP (end-2012)*
1. Trust	10,130	18.3	7,471	14.4
2. WMP	9,920	17.9	7,100	13.7
Narrrow definition (1+2)	*20,050*	36.3	*14,571*	28.0
3. Entrust loans	7,571	13.7	5,750	11.1
4. Bank acceptance	6,540	11.8	5,904	11.4
5. Security firms	2,779	5.0	1,350	2.6
6. Pawn shop	72	0.1	71	0.1
7. Guarantor	1,252	2.3	1,200	2.3
8. Small lender	754	1.4	592	1.1
9. Finance company	4,140	7.5	3,442	6.6
10. Financial leasing	1,000	1.8	770	1.5
11.Underground lending	2,500	4.5	2,500	4.8
Broad definition (1 to 11)	*46,658*	*84.4*	*36,150*	*69.6*

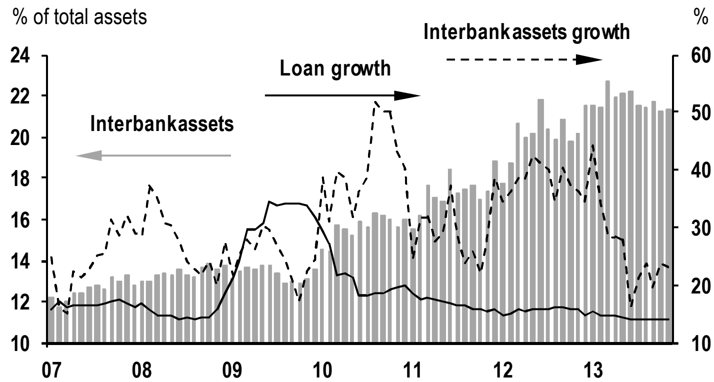
Source: PBOC; CBRC; China Trust Associaton; media reports; J.P. Morgan.

China: trust AUM and WMP
trillion yuan



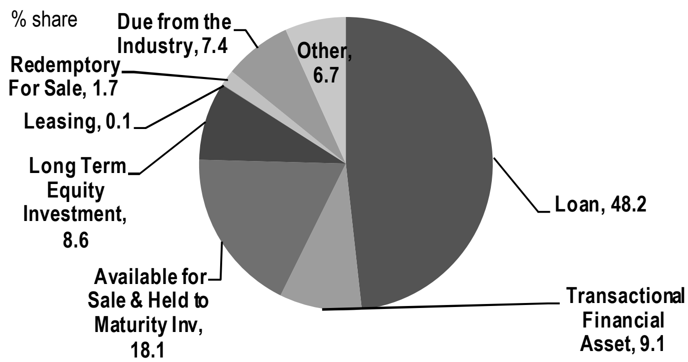
Source: WIND

Interbank assets and percentage of total assets



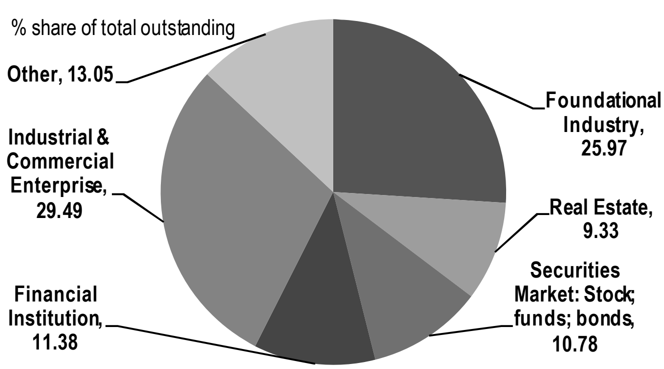
Source: CEIC

China: trust fund use (end of 3Q13)



Source: CEIC

Trust fund by investment type (end of 3Q13)



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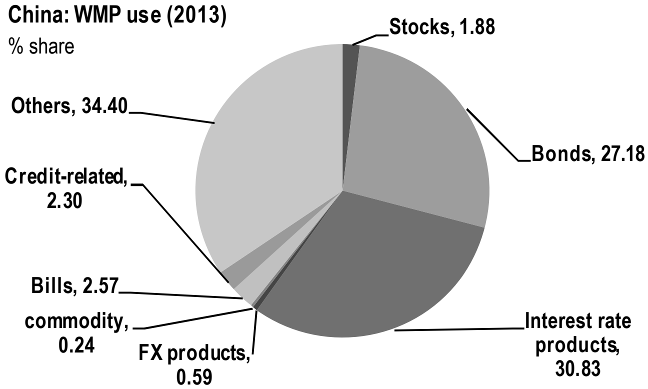

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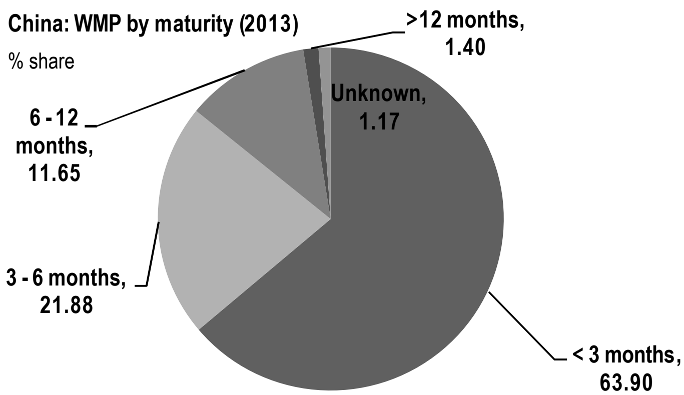

Source: WIND

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