A photograph of the Great Wall of China winding across a lush green hillside under a clear blue sky. A large crowd of people is visible walking along the wall.

Chi on China

China's Systemic Risk I: Shadow Banking



SUMMARY

- The size of China's shadow banking market may not be a problem, but the combination of its rampant growth rate and opaque nature is. This market also suffers from adverse selection, as it mainly caters to credit demand of non-state small and mid-sized firms.
- Financial stress in both the trust sector and wealth management products is rising quickly in a structural reform environment, but worries about a systemic risk blowout are exaggerated.
- Regional exposure to shadow banking is unevenly distributed. For the top 10 provinces, 40% or more of the funding comes from shadow banking. All these regions have persistent fiscal deficits impairing their repayment ability and making them the focal points of financial stress.

We define shadow banking in China as non-bank financial activity, including trust loans, wealth management products (WMPs), company-to-company entrusted loans, money market funds (MMFs), banker acceptance bills and curb market (or underground) financing. It is a double-edged sword. On one hand, shadow banking is interest rate liberalisation by stealth, facilitating China to exit financial repression. On the other hand, it increases systemic risk as it is not yet properly regulated and suffers from adverse selection.

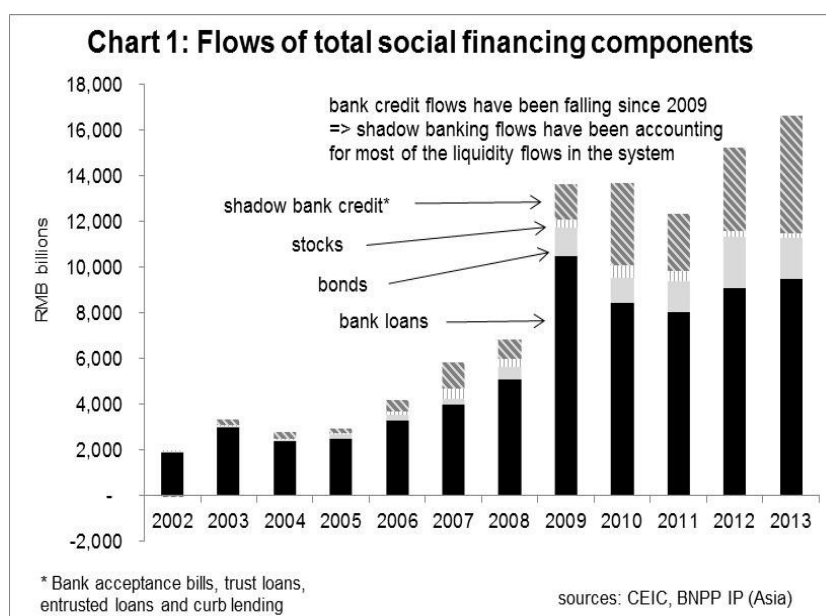
Rising systemic risk

The local banks' cosy relationship with, and presumably large exposure to, shadow banking has aggravated systemic risk, despite increasing regulatory control since 2011 on banks' cooperation with and exposure to the trust sector and WMPs. Typically, banks package their loans into WMPs and sell them to retail clients, thus taking these loans off their balance sheets and relaxing their regulatory loan constraint. The proceeds are channelled to trust companies which, in turn, invest the funds either back in the banks' loan assets or other assets, including local government debt instruments. Trust companies also issue WMPs themselves.



If defaults were to occur in the shadow banking market, banks would not be able to expand their balance sheets at will to offset the contraction of shadow bank credit. This is because banks are restricted by regulations, including their loan-to-deposit ratio, loan quotas, reserve requirements and administrative lending restrictions. Due to the close bank-shadow-bank relationship, banks' asset quality would deteriorate and they would suffer losses as they put the off-balance sheet assets back onto their balance sheets.

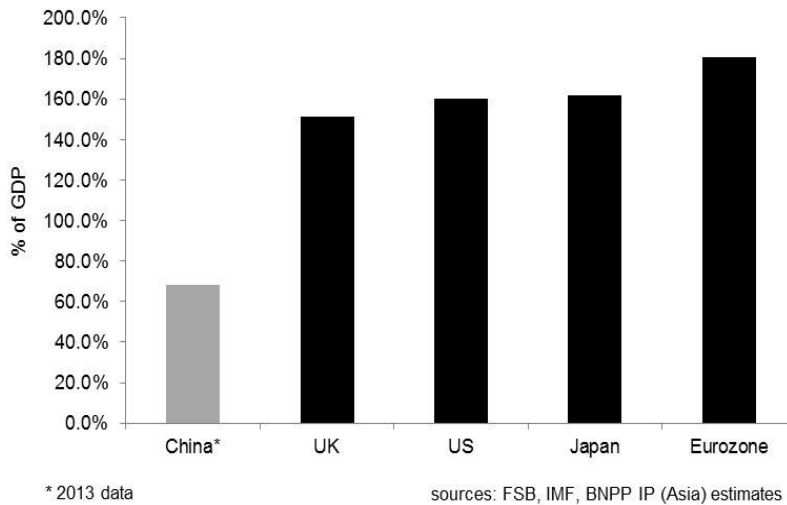
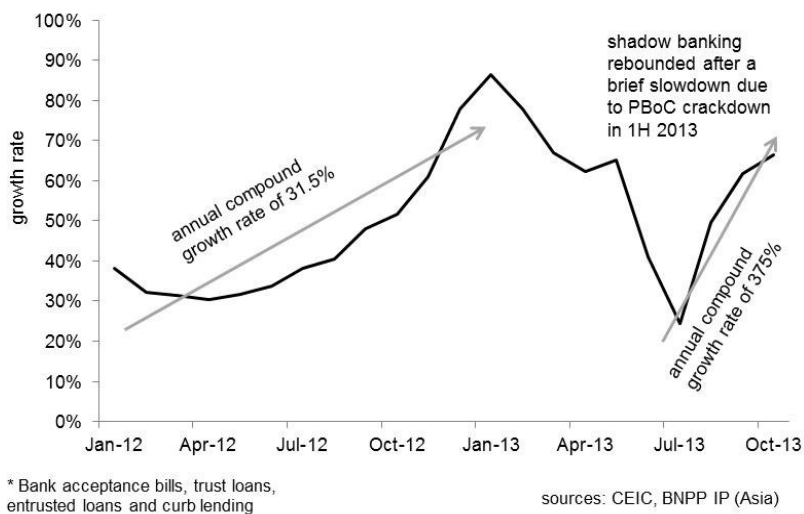
Shadow banking flows have accounted for the bulk of new liquidity flows into the system since 2009 (Chart 1). This adds to systemic risk because of both insufficient regulatory oversight of the shadow banks and rising financial stress. The latter has been aggravated by structural reforms which are pushing up interest rates and crimping economic growth.



Size is not a problem

Nevertheless, China's shadow banking market is still much smaller than those in developed markets (Chart 2), with its size estimated at RMB30-40 trillion. Our estimate is RMB36.8 trillion (US\$6.09 billion) or 68% of 2013 GDP. The sizes of the trust sector and the WMPs were estimated at about RMB10 trillion each, implying that together they accounted for 54% of the total shadow banking market in China in 2013, or 36.7% of GDP. Such a size is not necessarily a problem, but the combination of rapid growth (Chart 3) and its opaque nature is.

There is no official data on the breakdown of the shadow banking segments, products and investments because the market is not properly regulated. There is overlap between the estimated sizes of the trust sector and the WMPs because the trust companies issue WMPs to fund local government debt and lend directly to local governments.


Chart 2: Shadow banking market size (2012)

Chart 3: Share of shadow banking* in TSF flows


Misinformed views

The opaque nature of shadow banking has generated misinformed views about its bad-risk profile and systemic risk implications. The shadow banking risks are not uniformly bad, as many have assumed, and they will not blow up anytime soon. As we have argued recently, the bulk of China's shadow banking assets have normal risks just like any official banking system¹. We estimate that high-risk shadow banking assets (including those WMPs that are invested in dodgy assets, the amount of WMPs that are subject to high roll-over risk and the amount of trust loans to local governments) amounted to about 16.3% of 2013 GDP (Table 1).

¹ See "Chi on China: China's Shadow Banking Risk, the Good, the Bad and the Ugly", 10 May 2013.



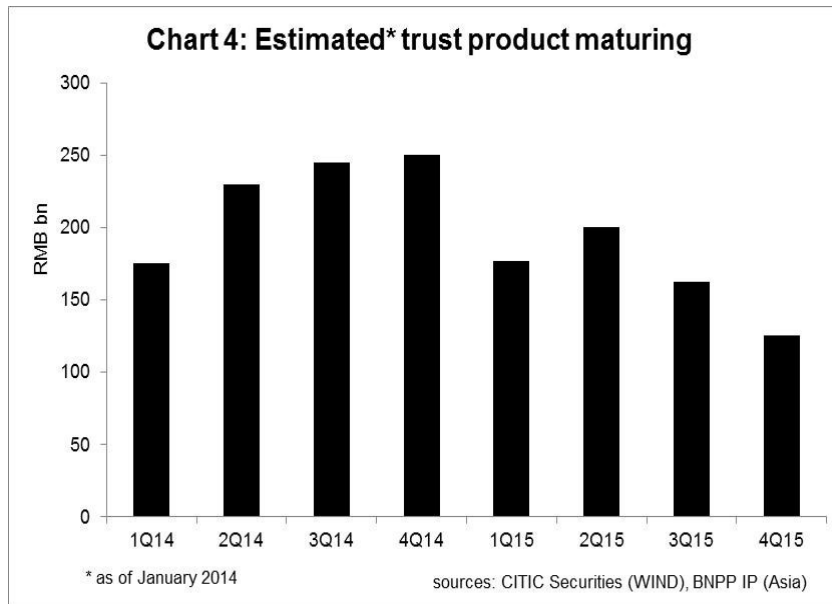
Table 1: Estimated breakdown of China's shadow banking risk profiles (2013)				
		RMB trn	% of total shadow banking assets	% of GDP
1	The good risk assets: entrusted loans, micro/private lending, bank acceptance bills	21.6	58.7%	39.9%
	The bad risk assets: trust loans to local governments and WMP with rollover risk (40% of total WMPs)	6.1	16.6%	11.3%
	The ugly risk assets: WMPs with dodgy assets	2.7	7.3%	5.0%
2	High risk shadow bank assets = bad risk + ugly risk	8.8	23.9%	16.3%
3	WMPs in safe assets (60% of total WMPs)	6.4	17.4%	11.8%
	Estimated total shadow banking assets = 1+2+3	36.8	100.0%	68.0%
sources: DB, BoAML, Nomura, BNPP IP (Asia) estimates				

This amount of risk should be manageable under China's closed capital account, "implicit guarantee" policy and ample financial resources that Beijing can mobilise (such as the US\$3.9 trillion FX reserves, 44% of GDP). However, due to the rapid rise of shadow banking risk, Beijing can only proceed with opening up the capital account and exiting "implicit guarantee" slowly.

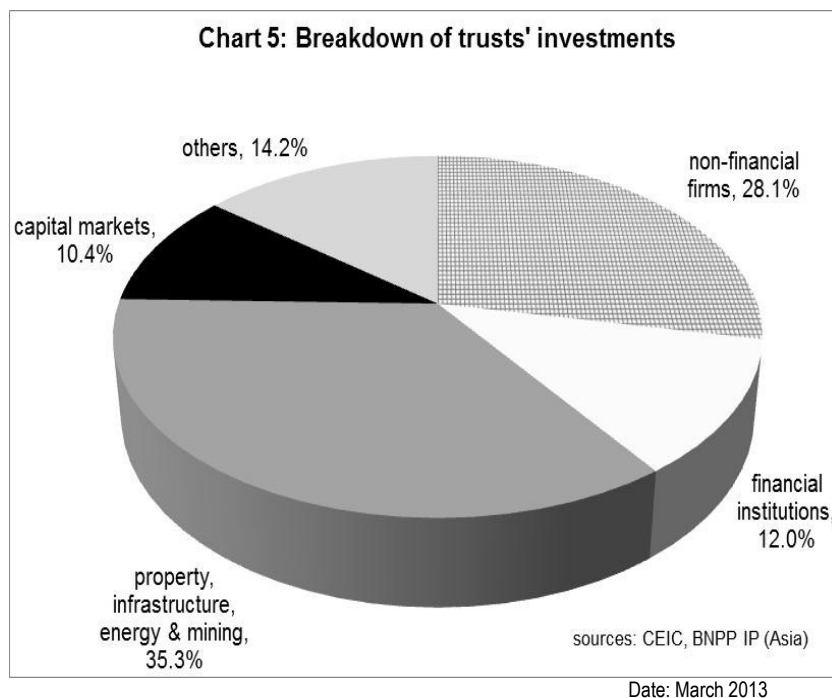
Trusts and WMPs under stress

Both trust and WMP products are ways of skirting the official interest rate cap on deposits and, hence, are means of interest rate liberalisation by stealth. However, they suffer from the adverse selection problem under China's distorted system that starves non-state companies (typically small and mid-sized companies) of credit. They typically borrow short (less than three years) and lend long (over 10 years), thus aggravating the balance-sheet mismatch pressure in the official banking system.

Trust and WMP products are under increasing stress as rising interest rates, slowing economic growth and lower energy prices have lowered investment returns and have eroded their ability to pay investors. They face a heavy calendar of maturing products in 2014 (Chart 4). According to some market estimates, about RMB3.5 trillion of trust products will mature in 2014 and of that 57% (RMB2 trillion) in 2H14.

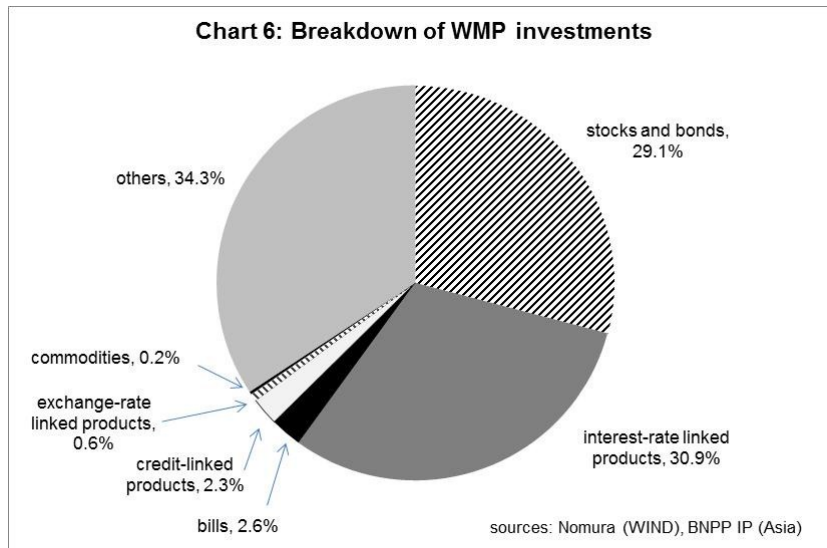


The trouble is the illiquidity of these assets. China Trust Association's data shows that in 2013, 35.3% of the trust products were invested in long-term illiquid assets, such as property and infrastructure, and in sectors suffering from excess capacity, such as energy and mining (Chart 5). Another significant portion of trusts' investment went to non-financial firms and the 'others' category (42.3% = 28.1% + 14.2% in Chart 5). Though official data is not available, it is likely that the bulk of these non-financial and 'others' investments went to fund projects in property, energy, mining and infrastructure companies and local governments, many of which do not generate enough cash flows for the trusts to pay investors.

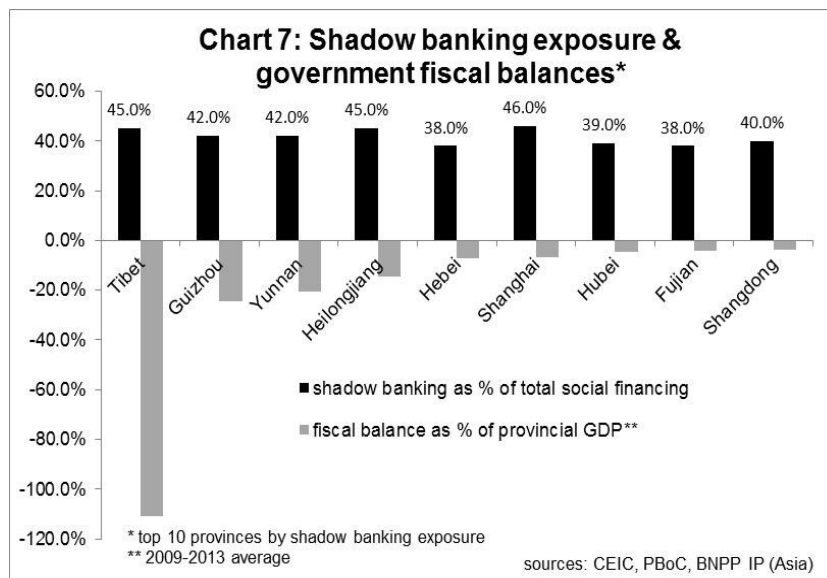




There is no accurate data on the amount of WMPs maturing each year, since they are short-term products of between one and three months with 60% investing in safe and liquid assets, such as money market funds, short-term notes and bonds. Numerous WMPs mature and are issued throughout the year. The murky part of the WMPs is their 34.3% investment in 'others' (Chart 6), which may likely include risky local government projects and dodgy assets.



Date: March 2013



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Uneven regional exposure

From a macroeconomic perspective, geographical exposure to shadow banking activity is unevenly distributed with shadow banking accounting for a much higher share of total financing in some provinces



than in others. Recent PBoC data² shows that in the top ten provinces by exposure to shadow banking, 40% or more of their funding comes from this market (Chart 7).

All 10 provinces have persistent fiscal deficits, with the poor inner and northern provinces (including Tibet, Guizhou, Yunnan and Heilongjiang) running fiscal deficits averaging more than 14% of GDP for the past five years. This data provides a guide to understand regional shadow banking risk. In a nutshell, the provinces with higher levels of shadow banking exposure and larger fiscal deficits are more vulnerable to defaults and financial stress as these off-balance sheet products mature.

Implications

From a policy perspective, the authorities should scrutinise these regions more intensively for systemic risk, imposing more restrictions on regional fiscal and debt management in the coming years. From a market perspective, if, as and when these provinces come to the capital market for funding, they should pay higher risk premiums.

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² "Aggregate Financing to the Real Economy by Province (2013), the People's Bank of China
http://www.pbc.gov.cn/publish/goutongjiaoliu/524/2014/20140220083142756827424/20140220083142756827424_.html



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