Economic danger lurks in China's shadow banks

By Simon Rabinovitch

Of all the economic dangers to flare up over the past week, the most unsettling was at first glance also the most esoteric: the near default of a high-yield loan product held by a few hundred small-time Chinese investors.

Set against the turmoil in other emerging markets – steep currency falls in Turkey and South Africa that prompted their central banks to raise interest rates, stubbornly high inflation in India and a collapsing currency in Argentina – China appears to be a bastion of economic strength. Even analysts with a bearish bent still expect its growth to come in at about 7 per cent this year.

The renminbi is steady against the dollar and inflation is under control. And unlike developing countries faced with cash outflows as the US Federal Reserve winds down its monetary stimulus, China is protected by robust capital controls.

Why then has the saga of Credit Equals Gold No. 1, the Chinese investment product that was rescued from the brink of failure, so captivated global attention?

There are both direct and indirect reasons; the latter are especially worrying. First, the direct risks. Credit Equals Gold No. 1 is just one of a wave of Chinese shadow banking products that will fail to live up to their outlandishly confident names when they mature this year. The drama over repayment will be played out again and again.

Over the past decade, China's economy has grown ever more reliant on financing outside the formal banking system. Bank loans, which used to account for more than 90 per cent of total credit, fell to little more than half of new financing last year. Lending by shadow banks now totals Rmb47tn, or 84 per cent of gross domestic product, according to JPMorgan.

Reducing the dominance of banks is part of the plan for unleashing more market forces in China – a positive development. But some of the loosely regulated institutions that have plugged the lending gap are simply reckless. It is the most buccaneering of these that are now sowing doubts about China's financial stability.

This week's story began in 2011 when China Credit Trust loaned Rmb3bn to Wang Pingyan, a coal mine operator in the northern province of Shanxi. Mr Wang made the ill-fated decision to scale up investment dramatically just as coal prices peaked. His company collapsed soon after receiving the loan.

If the pain had been confined to China Credit it would have been bad enough.

But making matters worse, the case has shown that there is only a thin dividing wall between shadow banks and the better-regulated parts of the financial sector. China Credit had pitched the loan as an investment product, promising an annual return of 10 per cent. Rather than sell it directly, the product was marketed by Industrial and Commercial Bank of China, the country's largest lender, to wealthy private banking clients.

The controversy in recent weeks about which party, if any, is responsible for the dud loan has drawn in all involved: the local government in Shanxi, which gave its blessing to Mr Wang's plan; China Credit, which structured the investment product; and ICBC, which distributed it. In the end an unidentified entity bailed out investors by covering their principal, though not the full interest.
danger lurks in China's shadow banks/

Those wondering where the next big troubled shadow bank loan might lurk need only look down the road from Mr Wang's failed mine to another in Liulin, the same county in Shanxi province. Xing Libin, a coal tycoon who threw a Rmb70m wedding party for his daughter in 2012, is restructuring his mining company because it could not repay its loans. Among those debts is an Rmb1bn ($164m) investment product – structured by Jilin Trust and distributed by China Construction Bank – that falls due in a few weeks.

In all, there are about $660bn of trust products up for repayment or refinancing this year, according to Bank of America Merrill Lynch. Chinese shadow banks, by definition, have been focused on customers – miners, property developers and local governments – that regulators have deemed too risky for banks, so more problem loans are a certainty.

Shadow banks have not all been pedalling junk. Many trust companies are well run and have demanded ample collateral from borrowers. And where they have been poorly managed, China's state-owned banks have enough assets to cover much of the damage. Most investors in trust products will walk away unscathed. It is the indirect consequences of this week's bailout that are more worrying. As rating agency Fitch put it, the rescue of the trust product was a "missed opportunity" to create more risk awareness in the financial sector. This could cast a shadow over Chinese markets for years to come.

Chinese investors who lend money to heavily indebted miners or property developers are not crazy. They are making a calculated gamble – one that has proved mostly correct until now – that the government or state-owned banks will bail them out if they get into trouble. Yet an accumulation of bad investment decisions explains the excess capacity that plagues manufacturers from sportswear companies to steel mills. The perception of ironclad, if implicit, government guarantees is also why overall Chinese debt levels have soared from

130 per cent of GDP in 2008 to more than 200 per cent today. Similarly fast increases have been precursors to financial crises in countries from South Korea to the US.

Hence China's uncomfortable predicament. Because the government was unwilling to see Credit Equals Gold No. 1 collapse, fears of an imminent economic meltdown are overblown. But for precisely the same reason China's debt powder keg is only getting more tightly packed.