

Shadow banking in China

Battling the darkness

Every time regulators curb one form of non-bank lending, another begins to grow

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IN THE town of Jingjiang, a few hours' drive from Shanghai, Yangzijiang Shipbuilding is making 21 huge container ships for Seaspan, a Canadian shipping firm. An enormous sign declares, "We want to be the best shipyard in China." It is certainly among the most profitable, earning 3 billion yuan (\$481m) last year. But only two-thirds or so of that came from building ships. The rest came from lending money to other companies using a local financial instrument called an entrusted loan. This puts Yangzijiang at the forefront of another industry: shadow banking.

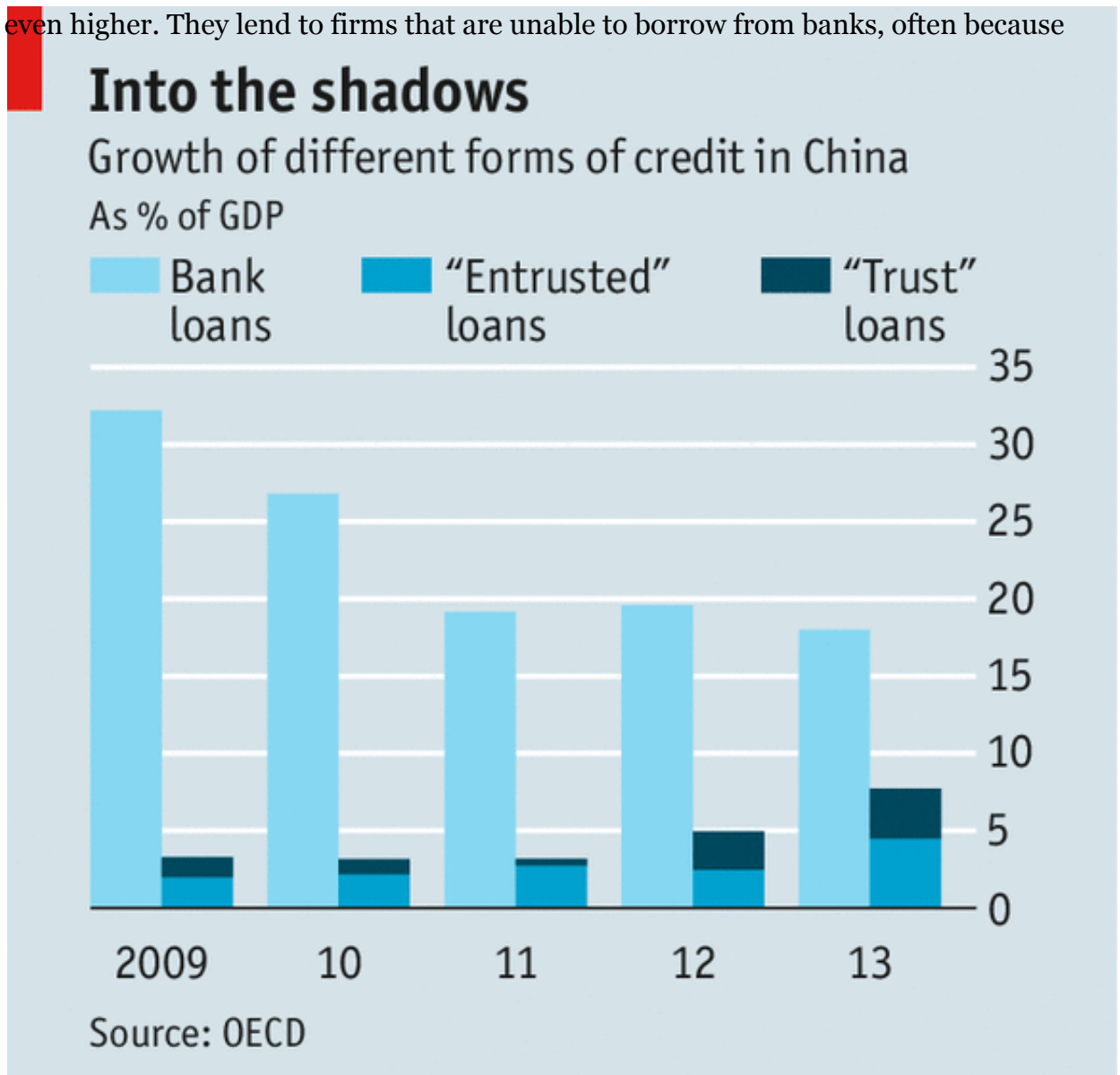


A decade ago, conventional banks, which are almost all state-owned and tightly regulated, accounted for virtually all lending in China. Now, credit is available from a range of alternative financiers, such as trusts, leasing companies, credit-guarantee outfits and money-market funds, which are known collectively as shadow banks. Although many of these lenders are perfectly respectable, others constitute blatant attempts to get around the many rules about how much banks can lend to which companies at what rates.

Although bank lending remains far bigger than the shadowy sort and is still expanding at an astonishing pace, its rate of growth has recently stabilised. The growth of some of the more worrying forms of shadow lending, in contrast, is accelerating (see chart). Shadow banks accounted for almost a third of the rise in lending last year, swelling by over 50% in the process.

Thus far, most of the concerns about shadow banking in China have centred on trusts. By offering returns as high as 10%, they raise money from businesses and individuals frustrated by the low cap the government imposes for interest rates on bank deposits. The interest they charge to borrowers,

naturally, is even higher. They lend to firms that are unable to borrow from banks, often because they are in frothy



industries, such as property or steel, where regulators see signs of overinvestment and so have instructed banks to curb lending. Over two-fifths of Yangzijiāng's loans go to property developers in smaller Chinese cities; land makes up nearly two-thirds of its collateral.

China's economy is slowing. It has grown by 7.6% for the past two years, the slowest rate since 1990. Several trust products have defaulted, although investors in most of them have got their money back one way or another. Over \$400 billion-worth of trust products are due to mature this year—and borrowers will want to roll over many of those loans. Many observers worry that investors will lose faith in trusts, prompting a run, which may, in turn, blight certain industries and other parts of the financial system. No country, pessimists point out, has seen credit in all its forms grow as quickly as China has of late without suffering a financial crisis.

One reason for optimism is that trusts are regulated by the same agency that supervises banks, the China Banking Regulatory Commission (CBRC). This, argues Jason Bedford, an independent expert who used to audit trust companies, means the CBRC can tell not only whether the trusts themselves are wobbly, but also how any wobbles would affect banks. As our special report this week explains, it and other regulators have recently strengthened oversight of trusts, requiring clearer accounting and limiting dealings with banks.

Now that regulators are tightening the screws on trusts, money is flowing to other, less closely watched intermediaries. “Shadow banking in China looks like a cat-and-mouse game,” declares Liu Yuhui, chief economist of GF Securities, a brokerage house.

For instance, the CBRC’s limits on the ways that banks and trusts could co-operate do not apply to securities houses. That has fuelled a boom in the assets these firms manage: they rose to 5.2 trillion yuan by the end of last year, up from 1.9 trillion yuan a year earlier. In some instances, the brokers are using loans originated by banks to back “wealth-management products” they sell to investors themselves; in others, they are acting as intermediaries to allow trusts to do the same, in spite of the new rules. These manoeuvres, in effect, allow banks to sidestep various restrictions on their lending.

Trust beneficiary rights products (TBRs) are another way around the restrictions on dealings between banks and trusts. A bank sets up a firm to buy loans from a trust; it then sells the rights to the income from those loans to the bank—a TBR is born. The bank can then sell the TBR to another bank. The intention, Mr Bedford says, is often to make risky corporate loans look like safer lending between banks, thereby evading capital requirements and minimum loan-to-deposit ratios, among other rules.

Entrusted loans are yet another fast-growing form of shadow banking. These involve cash-rich companies, often well-connected state-owned enterprises (SOEs), lending to less well-connected firms. There are so many SOEs now competing with Yangzijiang to offer loans, reports Liu Hua, the shipbuilder’s chief financial officer, that her firm has been forced to reduce the interest rates it charges from around 15% a year to closer to 10% a year.

Such loans, often made using banks as intermediaries to get around regulations forbidding such lending, expose the financial sector to yet more risk. The value of new entrusted loans in March was 239 billion yuan, up 64 billion from a year earlier. Companies borrowed 716 billion yuan via entrusted loans in the first three months of the year; corporate bond issuance over the same period amounted to only 385 billion yuan.

Entrusted loans are not the only way companies are lending to one another. Hangzhou, home to

Alibaba and many other entrepreneurial outfits, is one of China's richest cities, but it is now undergoing a quiet financial crisis. Its many small steel and textile entrepreneurs found it hard to get loans from official banks, so they banded together. Reports suggest that firms guaranteed one another's debts, forming a web of entanglements that helped everyone get credit during good times. But now, with the economy slowing, the weaker firms are beginning to default, dragging healthy ones down too.

Steel traders in Guangdong, chemicals firms in Zhejiang and coal miners and energy firms in Shanxi appear to have developed similar networks. Xinhua, China's official news agency, has reported that in some of these industries the guarantees invoked have spread from the "first circle" of firms vouching for the original defaulters to the "second" and "third" circles, meaning guarantors of the guarantors.

Just as a crisis in shadow banking could spread to the real economy, a sharp downturn in some sectors could cause trouble for shadow banks, leading to a broader financial mess. Many trust loans are secured with property, and many developers are reliant on shadow finance, but China's raging property market is showing signs of cooling, especially in smaller cities. The fear is of a downward spiral in which the pricking of the property bubble leads to a panic in shadow finance, which reduces access to credit, pushing property prices and economic growth down further.

How bad could things get? IHS, a consultancy, recently predicted that such a property crash could reduce China's GDP from a forecast 7.5% this year to 6.6%, and to 4.8% next year. That may not sound like the end of the world, but by China's standards, it would be an alarming slowdown.

All this poses a genuine dilemma for China's regulators. They have long desired to develop deep and versatile capital markets, and shadow banking is a natural part of that. Indeed, there is an argument that China would benefit from the expansion of certain forms of shadow banking, such as the securitisation of loans.

Although some kinds of lending are clearly getting out of hand, the losses should be manageable. For all the subterfuge Chinese shadow banks indulge in, their loans usually come with decent collateral. The biggest threat to the system is that by moving too forcefully to rein in shadow lending, regulators accidentally precipitate a run on shadow banks. Instead, they are moving warily, slowly ratcheting up regulation and allowing the occasional minor default.

Calibrating this curtailment, however, will be tricky. Standard & Poor's, a ratings agency, argues that reforms could lead to "a turbulent period in which funding could dry up as the domestic market struggles to re-price risk". That is a polite way of saying that there is no easy way out of China's

shadow-banking mess.

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