CHINA

Is shadow banking another subprime debt?

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- Trust lending, or "shadow banking" [1], and its associated risks of potential deleveraging, are dominating concerns about the Chinese economy lately, as housing prices decline and economic growth moderates. The rapid growth of shadow banking has occurred in response to China's repressive financial system and tightening monetary policy conditions.
- Two types of off-balance-sheet lending present greater risks: a) trust schemes created by trust companies selling wealth management products to the public; b) entrusted loans intermediated by financial institutions. A recent KPMG survey found that infrastructure is the largest recipient of trust financing (32%), followed by industrial and commercial projects (18%), and real estate (16%).
- Whilst shadow banking has improved the efficiency of capital allocation, attention is increasingly focusing on its significant risks. Memories of China's trust industry, which suffered massive losses and widespread bankruptcy in the late 1990s, still weigh on investors' minds: when the high profile GITIC went bankrupt ten years ago, institutional investors recovered only 12.5% of their original investment.
- Like subprime debt, trust financing has not been adequately regulated. It lacks transparency, is dependent on underlying asset prices which are subject to potential correction, and sometimes involves overly risky pricing behavior to attract investment. However, unlike subprime debt, its investors are not financial institutions, but private individuals.
- We expect regulators to further tighten restrictions on trust financing, affecting high-risk companies' ability to borrow trust or entrusted loans.
- Potential defaults should not directly add to NPLs in commercial banks, although the second-round effects of borrowers' deteriorating financial positions could bring more serious risks to the financial system. Moreover, financial losses by individual investors may cause growing social and political tension.
- Isolated cases of defaults could also trigger widespread redemptions. However, we do not expect the vicious cycle of falling asset prices, deteriorating balance sheets and forced selling-off of assets that defined the downward spiral of the US subprime crisis to ensue.
- We conclude that for now, shadow banking does not amount to systemic financial risk, unless both the economy and asset markets experience a sharp collapse.

[1] In this report, "shadow banking" refers to activities mainly intermediated by non-banks, particularly trust financing. Our analysis does not cover private lending activities, often being categorised as another major form of shadow banking in China.

The new deleveraging concern

"Shadow banking" and its associated risks are dominating concerns lately

Trust lending, or "shadow banking", and its associated deleveraging risk appear to be dominating concerns about the Chinese economy lately. Data from the People's Bank of China (PBoC) suggest that off-balance sheet lending accounted for 22% of new total social financing of CNY9.8trn, with the latter also including new bank loans and capital market financing, as of Q3 2011 (Figures 1). This type of financing was relatively small six years ago. Rapid growth of the volume and risks of deleveraging caused widespread worries about outlook of the Chinese economy, especially given recent painful memories of unwinding of the subprime debt in the US.

Our discussion focuses on trust financing and entrusted loans

We focus on two types of off-balance sheet lending where involvement of non-bank financial institutions and potential risks are high[2 3]: a) trust schemes created by trust companies selling wealth management products to the public; b) entrusted loans intermediated by financial institutions. Year-to-Q3, entrusted loans increased to CNY1trn (50% of new off-balance sheet lending). Meanwhile, following increased regulations, trust loans fell to 85bn (4% of new off-balance sheet lending), compared with CNY390bn and a share of 10% of new off-balance sheet lending in 2010 (Figure 2).

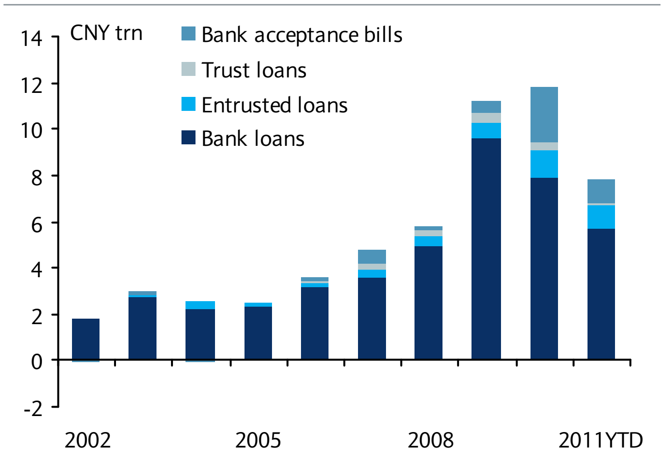
Financial innovation improves efficiencies but also poses higher risks

Shadow banking is a form of financial innovation that has grown in response to China's repressive financial system and tightening monetary policy conditions. With few exceptions, we believe these transactions improve the efficiency of capital allocation as they finance activities with higher returns, and possibly higher risks, but with limited access to bank credit. They are also a form of "bottom-up" interest rate liberalization. Clearly, however, these transactions also pose significant risks to the economy, as to date they have not been adequately regulated. Their minimal transparency also means that individual defaults could lead to widespread redemption.

Worries that China could become a source of instability are rising

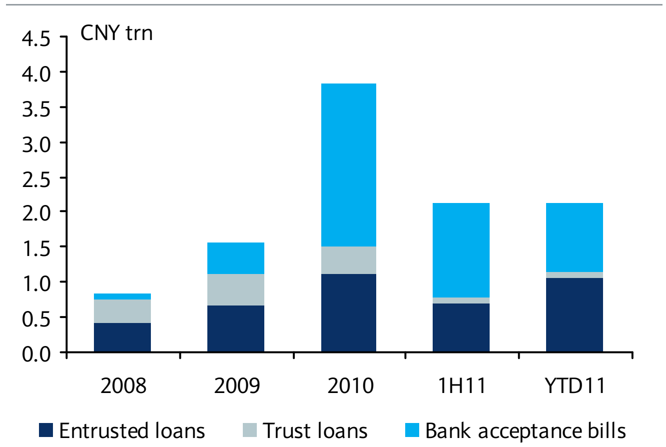
During the past few months, investor sentiment toward the Chinese economy has been quite volatile, shifting from one extreme to the other. Not long ago, when the European debt situation started to deteriorate sharply, investors wondered if China could save the world, as some viewed it as having done during the global financial crisis. Today, however, market participants worry that China itself might become a source of global economic instability.

Figure 1: Off-balance sheeting activities expanded rapidly



Source: CEIC, Barclays Capital

Figure 2: The pace slowed somewhat on improved regulation



Source: CEIC, Barclays Capital

[2] For discussions on private lending, which is a key funding source for SMEs, please see *China Banks: SMEs (Part II)…Sharing the pain?* May Yan, Shujin Chen, Tom Quarmby, 3 October, 2011.

[3] Bank acceptance accounts for a sizeable share of new off-balance sheet financing (46% as of Q3 2011), but we do not believe growth in such short-dated lending through banks creates systemic concerns.

"Shadow banking" is a new kind of risk that is taking center stage

Rising investor concerns about the Chinese economy are probably the result of recent developments in a number of areas, including bankruptcy of a large number of small and medium-sized enterprises (SMEs), decline of housing prices in a growing number of cities across the country and financial difficulties of the highly leveraged local government funding platforms (LGFPs). But most investors concur that the Chinese government still have sufficient resources and policy flexibility, as evidenced by high reserve requirement ratios (RRR), low public debt/GDP ratios and gigantic foreign exchange reserves. We believe the authorities should be able to prevent a collapse of real economic activities.

But "shadow banking" is a new kind of risk that is taking center stage in the debate over the outlook for the Chinese economy. Until recently, the topic did not even appear in macroeconomic discussions. The authorities, however, have gradually brought the world's attention to this new development through a number of steps, including:

- In December 2010, the People's Bank of China (PBoC) introduced the concept of "total social financing" in order to cover funding outside the banking sector;
- In August 2011, the PBoC decided to bring off-balance sheet transactions under reserve requirement regulations; and
- In October 2011, the CBRC required all financial institutions to report on the detailed activities of off-balance-sheet transactions.

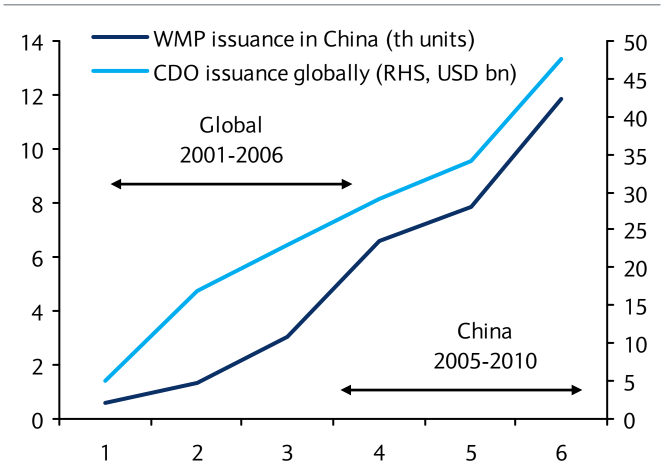
Regulators are concerned about the rapid growth of under-supervised activities…

Clearly, policymakers had become worried about the risks of these transactions since they were not properly supervised and grew very rapidly over the past five years. The total number of issuance of wealth management products (WMPs), for instance, increased from around 600 in 2005 to around 12,000 at the end of 2010 (Figures 3 and 4).

…whilst investors are afraid of a repeat of the US subprime debt crisis

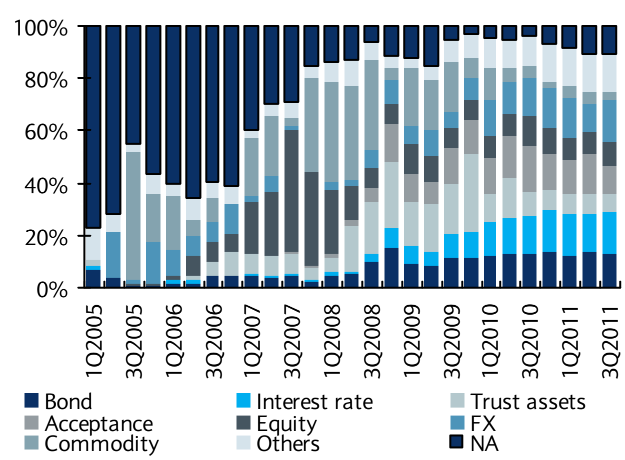
When such information was made public, the world immediately became concerned. Perhaps this was, at least in part, because of recent memories of the subprime debt market in the US. During the first several years of the new century, US subprime market expanded rapidly. For quite a while, this market performed quite well, generously rewarding investors. However, as housing prices started to moderate from early 2007, the subprime market started to unravel, eventually leading to the biggest financial crisis in decades, reinforced by a vicious cycle among asset prices, balance sheets and deleveraging.

Figure 3: Issuance of WMPs increased dramatically



Note: WMP stands for "wealth management products" and most CDO issued during the 2001-2006 period are in United States. Source: Barclays Capital

Figure 4: Wealth management products by asset class



Source: Wind, Barclays Capital

Why "shadow banking"?

Shadow banking emerged amid "overbanking"…

It might appear somewhat puzzling that shadow banking emerged in the Middle Kingdom where there is an "overbanking" problem. After all, China's broad money supply, M2, is already the largest in the world. More importantly, bank credit was about 120% of GDP at end-2010, which is probably among the highest in the world. These figures at least suggest that there is lots of liquidity or bank credit floating around the country. And the common perception is that capital is too cheap in China. So, why has trust financing or shadow banking flourished in recent years?

… because some borrowers are cut off from formal lending

The short answer is that some potential borrowers probably were not able to borrow enough through formal channels of financial intermediation. The long story contains several elements, the core of which is really the repressive financial system. As we discussed in our previous report[4], despite more than thirty years' financial liberalization, the financial system is still far from a free market mechanism: most financial institutions still act more like policy entities; key interest rates remain tightly regulated by the PBoC; and the government still exerts some influence on fund allocation. At the same time, capital markets are still relatively underdeveloped.

Suppressed interest rates led to excess demand for credit and supply of funds outside the banking system…

These dynamics generated demand for and supply of funds outside the banking system. The central issue is suppressed interest rates in the formal banking system. Since real lending rates are probably too low, there is an excess demand for credit. This creates room for the state to influence allocation of bank credit: it normally favors state-owed enterprises (SOEs), government-affiliated entities such as the railway ministry and local government funding platforms, and other large corporations. To be sure, even without explicit government influence, the financial institutions would probably show similar preferences in their loan extension because the SOEs are more stable, have longer profit histories and own better assets, which can be used as collateral for the loans.

… non-state enterprises are often cut off from traditional sources of funding

The flip side of the story is that other enterprises are likely excluded from the lending decision process. One such group is SMEs. According to one survey in the Zhejiang province, only about 15% of the surveyed SMEs obtained bank loans and about 20% never borrowed money. The remaining 60-65% of the SMEs had to meet their funding needs through other channels of financial intermediation. There are other groups of enterprises which need funding from outside the banking sector. One example is technological start-ups, which offer potential for high returns but are also very high risk, and thus are not a natural client for commercial banks. Another important example is property developers.

Negative real rates and subdued asset prices fuel hunger for yield

Real deposit rates are even lower. In fact, they returned to negative territory again in recent years. This basically means that depositors lose money if they keep their money with the banks. Perhaps it was not accidental that increases in off-balance-sheet transactions during the past years coincided with the collapse of stock markets in 2007 and the softening of the property sector in parts of China in 2007-08. There was a period of housing price rally in 2009, but the government quickly started to take action to cool the housing market. In 2010, there was continuous speculation on garlic, beans, cotton, apples and other agricultural products, but the government tried to crack down on these speculative activities.

Informal lending and WMPs became favoured options

What this suggests is that the public is doing what it can to beat inflation and bypass interest rate regulation. Every year, household savings are equivalent to 20% of GDP. If households cannot invest such savings in the stock market or the housing market, but the real deposit rate

[4] *China: Beyond the miracle Part 2: the coming financial revolution,* Yiping Huang, May Yan, Jian Chang, Lingxiu Yang, Shujin Chen, 6 October, 2011.

is significantly negative, they have to find other alternatives to preserve value. Informal lending and wealth management products naturally become favored options.

A brief history of trust financing and the case of GITIC

Trust financing started in 1979 when economic reforms began

Strictly speaking, trust financing is not entirely new in the Chinese financial industry. In 1979, when economic reforms had just begun, the State Council issued a directive to encourage development of the trust business. The China International Trust and Investment Corporation (CITIC) was established in October 1979. In the following years, many central government departments and local governments set up a large number of trust and investment companies (TICs). Most of the TICs, however, were engaged in actual deposit and lending activities. They not only competed for funds with commercial banks but often also utilized short-term funding to finance long-term investment projects.

Six rounds of cleaning and consolidation of the TIC industry

During the following thirty years, the government implemented six rounds of cleaning and consolidation of the TIC industry (Figure 5). The first round occurred in 1982. Central government departments and local governments, other than those authorized by the State Council, were prohibited to establish TICs and were ordered to close down their TICs within given periods. However, the policy changed in 1983, when the government again encouraged TICs as long as they were beneficial to the introduction of foreign capital, the advancement of technology and the development of the economy. This policy once again triggered a period of rapid growth of TICs and extraordinary expansion of fixed asset investment, causing overheating of the economy and loss of control of the money supply.

Figure 5: Trust industry development in China

Time	Events	Details
1979	Start-up of trust industry in China	The State Council issued a directive to encourage development of trust business, and China International Trust and Investment Corporation (CITIC) was established in October that year as the first TIC in China.
1982	1st round cleaning and consolidation	The State Council issued a directive, prohibiting the establishment of TICs by agencies other than those authorized by the State Council. The existing TICs were ordered to be closed down within given periods
1983	Support to trust industry again	The government again encouraged TICs as long as they were beneficial for introducing foreign capital and advanced technology and for developing the economy in "The national conference to support trust industry and promote trust industry reform"
1985	2nd round cleaning and consolidation	PBoC called for the banks to stop trust lending and other trust businesses, and clean up the existing businesses.
1988	3rd round cleaning and consolidation	PBoC again cleaned up trust businesses when the economy showed signs of overheating
1993	4th round cleaning and consolidation	PBoC started cleaning up TICs, and focused on separating the bank and trust businesses, and required TICs to get permit from PBoC before conducting business
1998	5th round cleaning and consolidation	PBoC closes many illegal TICs and set strict requirements for TICs' establishments and their business areas.
2001	Establishment of Trust Law	"Trust Law" was established and approved by People's Congress.
2007	6th round cleaning and consolidation	The CBRC issues several directives to establish a new and comprehensive regulatory framework for trust business and required TICs to apply for new licenses.

Source: State Council, PBoC, CBRC, Hexun.com, Barclays Capital

In 1985, the government had to start the second round of consolidation, calling for the banks to stop trust lending and other trust businesses. In 1988 and, again, in 1993, when the economy showed signs of overheating, the government executed the third and the fourth rounds of consolidation. The fifth round of consolidation, in 1998, was primarily a response to the sharply weakening financial positions of the TICs, calling for separation of bank and trust businesses and tighter regulation and supervision. The last round of consolidation occurred in 2007, when the government introduced a separate regulatory framework for trust businesses and required TICs to apply for new licenses.

The development experiences of the TICs have been volatile

Overall, the development experiences of the TICs have been quite volatile. They complemented the banks in providing funding for investment projects and supporting economic growth. But often they also fueled overheating problems, contributed to extraordinary monetary expansion and increased financial risks. During the second half of the 1990s, when economic growth slowed significantly and asset markets, especially the property market, collapsed, many TICs ran into significant financial difficulties or became insolvent. A large number of high profile TICs were bankrupted during those years (Figure 6).

Figure 6: Bankruptcy of trust companies in the 1990s

Time	Events
1995	State Council approved separation of trust business under four banks (ABC, ICBC, BOC and CCB (then the "People's Bank of Construction") from the bank.
1995	PBoC took over BoC Trust Investment Corp, and the latter was acquired by Guangdong Development Bank one year later
1997	PBoC closed China Rural Development Trust Investment Corp
1998	PBoC closed China New Technology and Entrepreneur Trust Investment Corp
1998	PBoC closed Guangdong International Trust Investment Corp
2000	PBoC closed China Education and technology Trust Investment Corp

Source: Post-crisis trust industry regulatory regime trend, Tingfang Li, Nan Lu, 2010, Barclays Capital

The rise and fall of GITIC provided a good case study

The rise and fall of the Guangdong International Trust and Investment Corporation (GITIC) provided a good case study. The predecessor of GITIC was one of the first TICs in China, established by the Guangdong provincial government in 1980. In 1983, it was approved by PBoC as a non-bank financial institution, with rights to conduct foreign exchange businesses. In 1984, it adopted the new company name of GITIC, with registration capital of Rmb1.2 billion.

During 1992-97, GITIC aggressively expanded its business involvement, including in real estate, finance, trade, transportation, energy, telecom, textiles, electronics, etc. At the same time, it developed substantial problems such as high interest rate deposits, off-balance-sheet transactions and irrational investment decisions. These problems quickly led to insolvency and, in 1998, the PBoC decided to close down GITIC. During the bankruptcy clearance period, the regulators discovered that GITIC had total assets of Rmb21.5 billion, total liabilities of Rmb36.3 billion and a liability/asset ratio of 168%.

During the bankruptcy period, 320 creditors claimed a total debt of Rmb38.8 billion. Of these, 167 foreign creditors claimed a total debt of Rmb32.0 billion. In the early stage, individuals who lent money to GITIC were paid back the principal without interest. During the final bankruptcy period of 2000–2003, the total payout after deduction of payable employee wages, social security benefits and taxes was Rmb2.5 billion, or 12.5% of the recognized debt (Figure 7). In other words, institutional creditors, mostly foreign creditors, lost about 87.5% of their lending.

Figure 7: Unwinding of GITIC

Unwinding and settlement	
Jan-1999	Guangdong Higher People's Court announced GITIC to file bankruptcy application, requiring creditors to claim debts within 3 months. Within this period, 320 creditors claimed total debt of Rmb38.8 billion. Of these, 167 foreign creditors claimed total debt of Rmb32.0 billion.
Apr-1999	Guangdong Higher People's Court held the first meeting for GITIC creditors, and designated 9 banks including Swiss Bank, Citibank, and Bank of China to be the creditor committee, based on their credit amounts claimed. The Court recognized a total of 200 creditors with Rmb20bn debt. The meeting also approved the bankruptcy liquidation principles.
2000-2003	After repaying individuals who lent money to GITIC their principal without interest and deducting payable employee wages, social security benefits and taxes, the total payout to creditors was CNY2.5 billion, or 12.5% of the recognized debt during the final bankruptcy period (2000–2003).
2003	In accordance with the "Enterprise Bankruptcy Law", article 38, and "A number of rules regarding enterprise insolvency cases" article 97 by the Supreme People's court, the Guangdong Higher People's Court announced 1) an end to GITIC bankruptcy proceedings 2) the deregistration of GITIC, and 3) that the bankruptcy liquidation group retained the rights to additional allocation of any aftermath.

Source: Southcn.com, Barclays Capital

Three types of business activities contributed to GITIC's downfall

In retrospect, at least three types of business activities contributed to the downfall of GITIC :

- The first was uncollateralized lending and guarantees to externally oriented enterprises. When the Asian financial crisis (AFC) hit the external sector, these enterprises were not able to pay back their debts. For instance, GITIC provided an illegal guarantee to "Meizhou Lisi Textile Co." and lost Rmb180 million when the latter went bankrupt in 1997[5].
- The second was investments in domestic and Hong Kong property markets, both of which declined. For instance, when Hong Kong's property bubble burst, GITIC lost HKD200 million in its investment in the "Yuexin Building" project.
- Finally, GITIC's overseas branches also provided illegal guarantees for and investment in overseas companies, without due diligence. GITIC's 20% equity investment in "New York-Guangdong Finance Co.", about USD27 billion, also suffered from massive losses due to the malfunction of the latter company.

[5] *http://www.southcn.com/news/dishi/guangzhou/shizheng/200312250186.htm*, December, 2003

Comparison with subprime debt

The flourishing of shadow banking highlights the pressing need for financial reform

It was somewhat surprising that, despite the six rounds of nationwide consolidations, shadow banking has grown exponentially in recent years, reaching an absolute scale and relative importance it had never achieved before. This probably means that reform of repressive financial policies has indeed become a pressing task. In the near term, however, the question is: will current trust financing experience unwinding similar to that which befell GITIC or US subprime debt, both of which caused substantial losses to investors?

Banks act as intermediaries under the entrusted loans scheme

We look at two types of shadow banking businesses: entrusted loans and trust financing. Under the usual entrusted loan scheme, a corporation deposits funds in a bank to provide a loan to a designated company or project company. The depositing corporation and the borrowing company may or may not be related. Here financial institutions, such as commercial banks, act as intermediary between depositor and borrower, but do not provide their own funds. In essence, one company is lending to another company. The interest rates are often negotiated based on market conditions (Figure 8). So the main function of financial institutions is to administer the loans, collecting interest and principal repayments from the project company and then repaying the depositing corporation.

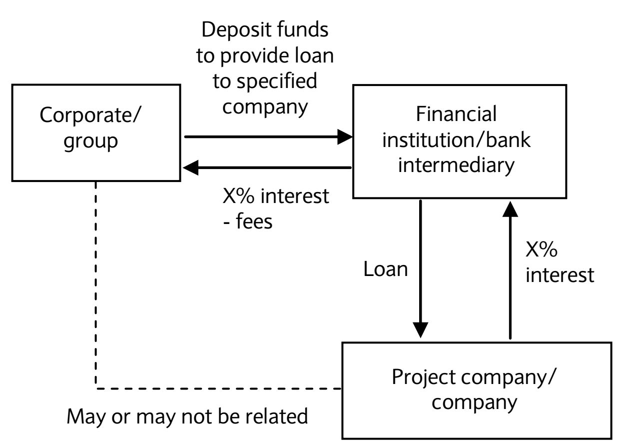
Trust loans often intermediated through a trust company

Trust financing is mainly intermediated through a trust company, which provides funding to a project company by selling wealth management products to the public. In this case, the involvement of commercial banks is lower – sometimes by way of being the channel for distribution for these wealth management products.[6] There are varying forms of detailed organization of such trust financing. One form is a trust company creating a trust scheme, raising funds from the public and lending to a project company at market interest rates (Figure 9).

Another form involves a trust with different tranche levels…

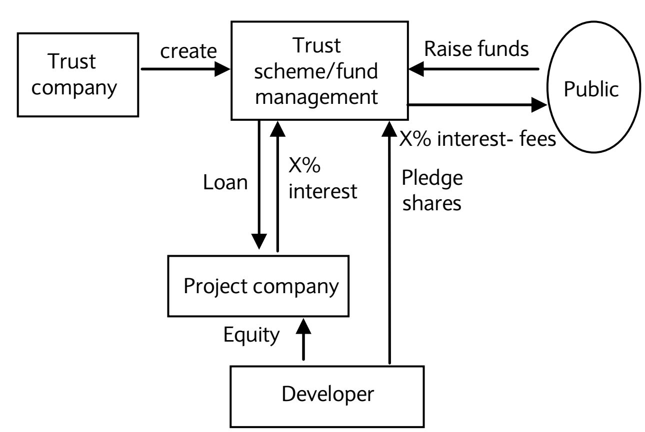
Another form is a trust company creating a trust with different tranche levels – higher-tranche debt and lower-tranche equity. A company setting up the project company would often take the equity tranche and at the same time guarantee a minimum return to higher-tranche debt should there be a shortfall from the project company. Investors in the wealth management products, often the public, are normally guaranteed a minimum return plus some profit sharing (Figure 10).

Figure 8: Stylized structure of an entrusted loan



Source: Barclays Capital

Figure 9: Stylized structure of trust financing for a property developer arranged as a loan (trust loan)



Source: Barclays Capital

[6] In cases involving the development of "Bank-trust cooperation products", the underlying assets sometimes are primarily loans originated by the banks. Default will add to NPLs of the banks. This is the area of shadow banking that has been subject to strict regulations (see Figure 12).

… reminding us of US subprime debt structure

These funding activities, especially the second form of trust financing, would probably remind many of the experiences with US subprime debt. In the case of US subprime debt, a financial institution would set up a special purpose vehicle (SPV) to purchase blocks of subprime mortgages and repackage them for selling of financial products in different tranches (from high grade debt to equity). This scheme worked for several years, channelling large amount of funds to the housing market. However, when housing prices started to decline, repayment of subprime mortgages also declined, which caused defaults of subprime debt. This was the beginning of the subprime crisis in 2007.

During the first three quarters of 2011, total off-balance-sheet lending was CNY2.14trn, or 22% of total social financing. The share of entrusted loans rose to 10.9% of total social financing, from 7.9% in 2010, while that for trust loans fell to 0.9% from 2.7% in 2010. KPMG's *Mainland China Trust Survey 2011* found that infrastructure (32%) is the largest recipient of trust financing, followed by industrial and commercial projects (18%), and real estate (16%). [7]

Similarities exist between trust financing and subprime debt

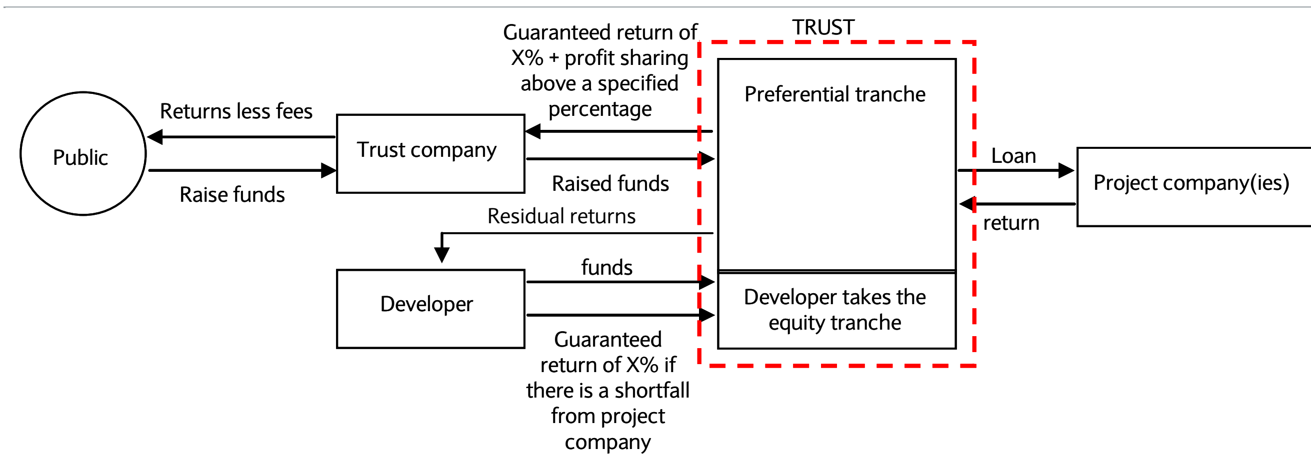
There are indeed some similarities and differences between trust financing in China and subprime debt in the US. In both cases, investors were attracted to potential high return/ high risk investment opportunities. However, investors had limited knowledge about the actual situation of the underlying assets. This was probably even more so in the case of trust financing, as it was almost impossible for the individuals to conduct due diligence. Rating agencies received some blame for not providing sufficiently accurate information about the risks of subprime debt. This was probably also the case in China.

But there are three important differences

The deleveraging story is different when investors are households using their own savings

But it is also useful to point out three important differences between the two products. First, with some exceptions, investors in the subprime market were mainly financial institutions. By contrast, investors in wealth management products are mainly Chinese individuals. If the value of investment products declines, both groups of investors will incur serious losses and widespread redemption would likely follow. But the second round deleveraging stories should be quite different. During the subprime crisis, when financial institutions were hurt financially, they were forced to sell off assets to repair their balance sheets. This, however, forced asset prices to decline further, setting off a vicious cycle among asset prices, balance sheets and asset sales. By contrast, Chinese households are not highly leveraged and are for the most part invested in wealth management products using their own savings. Therefore, second-round selling-off or deleveraging is probably unlikely.

Figure 10: Stylized structure of trust financing to a property developer arranged as equity



Source: Barclays Capital

[7] Mainland China Trust Survey, KPMG, July, 2011

The risks of the trust financing are market- or policy-driven

Second, the inherent risks of subprime debt were probably much greater than trust financing. Many subprime mortgages were taken out by households that normally would not qualify for this level of borrowing. Therefore, by definition, the subprime debts were likely to be nonperforming, as long as housing prices stopped rising rapidly. The default of such assets, therefore, was only a matter of time. By comparison, risks of trust financing are also high, but the risk lies mainly in prices of the assets (property or others) declining significantly. These risks are mainly market-driven, such as a collapse of exports, or policy-driven, such as the continuation of housing purchases by the government.

Financial institutions would not be directly affected if trust financing collapsed

Third, the collapse of the subprime market in the US caused a malfunction in the financial system, reflecting the deterioration of balance sheets and the rise of counterparty risks. If China's trust financing collapsed, households would likely suffer from great losses. This would be a serious concern for social and political instability. In the case of GITIC, individual investors reclaimed their principal investments but institutional investors were harder hit. But Chinese financial institutions are unlikely to be directly affected by any collapse of trust financing. Of course, indirect impacts could be significant because many of the companies receiving trust financing also borrowed from the banks and the WMPs were sold to banks' clients (hence banks also face reputational risk).

Figure 11: Comparing trust financing with Subprime debt

	Trust financing in China	Subprime debt in the US
Main investors	Individuals	Financial institutions
Investor leverage	Low	High
Financial product	Wealth management products	Subprime debt/equity
Underlying assets	Projects/housing projects	Subprime mortgages
Risks to underlying assets	Policy-/market-driven	Unemployment rate/Borrower creditworthiness
Financing vehicle	Trust scheme	Special purpose vehicle
Intermediary	Trust company	Mortgage finance divisions/Investment banks
Due diligence	Almost none	Limited
Rating quality	None/poor	Poor
Risk of redemption	High	High
Deleveraging to repair balance sheets	Not likely	Very likely

Source: Barclays Capital

What to expect now?

We suggest several important factors to monitor

It is difficult to predict what exactly will happen to the shadow banking business given the various uncertainties which can affect its trajectory. But given current developments, the likely evolution of policy, and past experiences with similar financial products and markets, we suggest several important factors to monitor and keep in mind.

First, while shadow banking is probably efficiency-enhancing and growth-promoting, it is, by nature, a high-risk business. Now that it has become a significant phenomenon in the macroeconomic picture, we are likely to see important policy changes:

- In the near term, the regulators might introduce more regulations/restrictions on certain types of businesses and companies involved in trust financing (Figure 12). For instance, companies with limited capital which guarantee investment returns are arguably involved in fraudulent behavior that is likely to be prohibited. Property developers may also be singled out in new regulations.

More policy restrictions, a clear regulatory framework, and a transformation of the financial system are expected

- A more fundamental policy approach would be to outline a clear regulatory framework governing this particular business. This would be useful because it is normally impossible for individuals to conduct proper due diligence. It would be helpful for the regulators to set clear criteria for qualified institutions regarding fund raising, financial conditions, and resolution terms.

- A more significant transformation of the financial system, including interest rate liberalization, is also required, in our view. Such changes would allow companies with restricted access to finance to borrow from either banks or the capital markets.

Figure12: Policies introduced by CBRC to regulate bank-trust cooperation

Time	Policy/Regulation announced	Detail
2008	A guidance for bank-trust cooperation	CBRC issued a guidance to support and set regulation rules for cooperation between banks and trust companies while requiring better risk management for those businesses as well
2010	A directive to regulate bank-trust cooperation	CBRC requires: 1) the trust loans extended in the bank-trust cooperation should be less than 30% of the total bank-trust businesses; 2) banks should move back off balance-sheet assets related to trust-bank cooperation by end of next year; 3) large banks should set aside risk-weighted capital as 11.5% for trust loans extended in the bank-trust cooperation that not included in banks' balance sheet, and small banks should set aside 10% capital as for trust loans extended in the bank-trust cooperation
2011	A directive to further regulate bank-trust cooperation	CBRC requires: 1) bank should move back off-balance-sheet assets related to bank-trust cooperation by end of year; 2) trust companies should set aside risk-weighted capital as 10.5% for trust loans extended in the bank-trust cooperation that not included in banks' balance sheet; 3) trust companies are not allowed to distribute dividend if the trust compensation reserve is less than 150% of its non-performing loan or 2.5% of the trust loans extended in the bank-trust cooperation

Source: CBRC, Barclays Capital

Some trust financing is likely to default, eg, a certain segment of the real estate sector

Second, some trust lending is likely to default in the coming year (Figure 13). Of the three key industry areas of trust financing, the most vulnerable appears to be the real estate sector. In Figure 13, we identify some Chinese developers' exposure to trust financing. All these are developers that have tapped the offshore bond markets and hence have accessed other sources of financing. On the other hand, smaller sized developers are unlikely to have the scale to enable them to access offshore markets. Given their dependence on trust financing and softening in home prices/volumes, that segment is more at risk. The industrial and commercial sector could also be at risk should the economy experience a hard landing or should exports suffer a collapse. By contrast, infrastructure projects should be relatively more stable, as most of these projects are, directly or indirectly, supported by the government.

Figure 13: Property developers' exposure to trust financing (CNY mn)

	Trust financing	Total debt	% of total debt
Agile Property	3,130*	21,835	14%
Central China Real Estate	1,668**	6,495	26%
Country Garden Holdings	2,730*	27,473	10%
China Overseas Land & Investment	0	37,592	0%
China Resources Land	0	45,248	0%
Evergrande Real Estate	5,000	50,753	10%
Franshion Development	0	20,939	0%
Glorious Property	1,250***	16,737	7%
Guangzhou R&F	2,630*	30,743	9%
Hopson Development Holdings	Not disclosed	27,343	--
Kaisa Group Holdings	750	12,890	6%
KWG Property Holding	1,500	13,904	11%
Longfor Properties	0	22,830	0%
Road King	0	8,170	0%
Shimao Property Holdings	1,630*	37,445	4%
Yanlord Land Group	0	14,234	0%
Average (excluding those without trust loans)			11%

Note: * Includes Asian Games City joint venture. **Includes CNY1.3bn of equity trusts. ***As at 3 Oct 11. Source: Company reports, Barclays Capital

Falling property prices a key to watch for potential risks

The expected housing price decline, however, is largely a policy result. Until now there has been no sign that the central government is ready to relax purchase restrictions, although prices have begun to fall in an increasing number of cities and some local governments have become anxious to adjust the policy. Some central government officials signalled recently that they are prepared to see some property developers to go under water. If that is the case, we are likely to see much of the property-related trust financing run into serious difficulties. But it is also possible that the government might quickly turn around the policy once it sees signs of systemic risk arising from falling property prices.

We may see a wave of redemptions

We believe the bottom line is that we might see a wave of redemptions in the coming year. Although many of the shadow banking-funded projects might remain financially sound, even isolated cases of default could lead to widespread redemption, since individual investors have little clear information about the financial positions of the projects in which they invested. This also means that in the short term, the amount of trust lending is likely to decline, while more money may flow back to the banking system in the form of deposits.

But we do not expect systemic economic and financial risks…

Finally, will such developments lead to systemic economic and financial risks? At this stage, it looks very unlikely to us. Both trust and entrusted loans have limited direct-risk exposure to the commercial banks. Banks' direct involvement in trust lending is low (except for the development of "Bank-trust cooperation products" which is now under strict regulations), as individuals as a rule do not borrow to invest in wealth management products. Banks do act as intermediaries for entrusted loans. But the funds are from designated deposits by corporations, not from the banks' own deposits. If such lending defaulted, then individuals and corporations would incur significant financial losses, but this would not add directly to the nonperforming loans (NPLs) of the commercial banks. Losses by individual investors could cause significant social and political tensions, however, which could eventually require intervention by the regulators or even the government.

…though commercial banks cannot be entirely insulated

But, of course, the commercial banks and other financial institutions cannot be entirely insulated from these developments. For instance, while defaults of trust loans borrowed by property developers would not cause an increase in NPLs, property developers already borrow quite massively from the banks, accounting for about 8% of total bank credit. If property developers face redemption from investors, then their ability to repay bank loans would be seriously affected. Similarly, SMEs still borrow a large volume of loans with the banks, accounting for about 22% of total outstanding loans. So the second-round effect could increase NPLs at the banks.

Risks amid falling house prices and slowing growth are high

Therefore, the risks inherent in shadow banking are high at the moment, as housing prices decline and economic growth moderates. Defaults of some projects could lead to widespread redemption. It is possible that the size of trust financing might actually fall in relative terms. Investors, including both individuals and corporations, will likely suffer significant financial losses. Risks for financial institutions may also rise, as an indirect result of deterioration of trust financing conditions. In the short term, however, these are unlikely to represent systemic financial risks, at least in the immediate future, as we will probably not see the vicious cycle among falling asset prices, deteriorating balance sheets and forced selling-off in China. By contrast, social and political tensions might be a bigger worry. Of course, if deterioration of trust financing persists, especially if it is accompanied by a steep hard landing of the economy and a deep correction of housing prices, then the financial risks are bound to turn systemic.

Analyst Certification(s)

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