Trust bailout highlights massive growth of China’s “shadow banking”

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The bailout of a trust operation that was teetering on the brink of default has underscored the huge growth of debt in the Chinese economy, largely centred on the operations of the unregulated “shadow banking” industry.

The financial product that precipitated the crisis was issued by China Credit Trust, a major Chinese shadow bank, in February, 2011. It was marketed by the state-owned Industrial and Commercial Bank of China, one of the world’s largest banks based on asset values, to some 700 of its private customers, raising around $500 million. Dubbed Credit Equals Gold No. 1, it was forecast to draw annual returns of between 9.5 and 11 percent.

There were widespread fears that the trust would default on the product before its scheduled maturation on January 31, as a result of the collapse of a coal mining operation in which the trust had heavily invested. Had the default proceeded, it likely would have been the largest to date involving a shadow bank.

Instead, the trust was bailed out just four days prior to maturation by an unnamed third party. It is widely believed that Chinese authorities were involved in the bailout. Investors will reportedly receive their principal, and a 2.8 percent return for the third year, well below the forecast amount.

International ratings agencies criticised the bailout, having called for authorities to allow the prospective default to occur in an attempt to rein in the shadow banking sector. Days before the bailout was organised, Standard and Poor’s called the crisis an opportunity for Chinese authorities to “instill market discipline” by allowing the default to go ahead.

Jonathan Cornish, an analyst at Fitch, warned that by carrying out the bailout “authorities are perpetuating moral hazard within the Chinese financial system—and this risk may in fact have become a whole lot bigger.”

Moody’s noted that the bailout was prompted by the fear that a default could trigger a wider financial crisis. However, the agency continued, it “reinforces the perception that investors will be bailed out one way or another when the products go sour, which is contrary to the establishment of sound market discipline and a healthy credit market.”

An article in the Australian online publication *Business Spectator* raised what it described as the “eerie similarities” between the Chinese bailout and the operation mounted by the US Treasury and Federal Reserve to rescue the US investment bank, Bear Stearns, in March 2008. That bailout was a prelude to a deepening of the financial crisis triggered by the unravelling of the US sub-prime mortgage market. The *Business Spectator* article floated the prospect of a similar role being played in the Chinese economy by local government debt and a crisis of the shadow banks.

The massive growth of unregulated shadow banks poses Chinese authorities with an intractable economic dilemma. Had they allowed the trust to go bust, they would have faced the prospect of a string of defaults, under conditions in which the actual value of the various debt-laden operations of the shadow banks is unknown. That would also have created the conditions for a deepening of the credit crunch that has been developing over the past year, and a sharp drop in investment.

Having bailed out the trust, however, Chinese authorities have effectively given the shadow banks carte blanche to continue their highly speculative operations, without any substantial government oversight.

The growth of the shadow banking sector assumed almost gargantuan proportions last year. According to

China Trustee Association statistics, the value of assets managed by China's 67 major trust companies grew to $1.67 trillion as of September 2013, a rise of 60 percent on the previous year. The sector is now estimated to be equivalent to around 40 percent of the country's gross domestic product.

The shadow banking sector largely developed following the onset of the global financial crisis in 2008, which resulted in a major drop in levels of productive investment, and left around 20 million workers unemployed. In response, the government initiated a huge stimulus package, with state banks pumping cheap credit into the economy.

The shadow banks effectively functioned as intermediaries, borrowing from state-owned banks at low rates, and lending to property developers and highly leveraged business that were being denied state credit. Charging high interest rates, they also financed local government projects.

Various financial products were developed, for the purpose of evading government restrictions on financial speculation. The bulk of them are not priced according to the risk of the underlying asset.

This process has led to a situation in which an estimated $15 trillion of credit is circulating in the Chinese economy, much of it financing highly speculative property investment.

According to media reports, more than 20 trusts have missed interest repayments in the past, while at least one of them has failed to pay out the entire principal to investors.

There are growing fears over the trajectory of the shadow banking sector, in the context of a broader slowing of the economy. China's official growth rate for 2013 was 7.7 percent, the same as the previous year, but well below rates approaching 10 percent that were recorded just a few years ago. Growth is expected to fall to 7.4 percent this year, which would mark a 20-year low. Purchasing managers' indices showed a decline in manufacturing last month, for the first time since last April.

A drop in coal mining profitability has placed additional pressures on trust funds. Growth in both infrastructure construction and real estate, two of the prime investment centres of the shadow banks, is also expected to slow this year.

Local authorities are vulnerable to any shadow banking crisis. According to the National Audit Office, some 53 percent of local debts, many of them financed through trust products, are due this year.

The Industrial and Commercial Bank of China's involvement in China Credit Trust's operations indicates that state banks are also potentially exposed to the toxic assets of the shadow banks. The full extent of the relationship, however, is murky and unclear.

Concerns have also been raised about the vulnerability of the Chinese financial sector to international currency fluctuations, and the exposure of foreign banks to any significant crisis. According to Bank for International Settlements figures, quoted in the *Sydney Morning Herald*, foreign currency loans booked in China had risen from $270 billion in 2009 to $880 billion by March 2013. Some estimates now place the figure at more than one trillion dollars.

In addition to destabilising the global financial system, the eruption of a new financial crisis in China would have a major impact on many countries that depend heavily on China as an export market.