Orient Capital Research

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The ICBC Trust Crisis

Why A Trust Default Wouldn't Cause a Financial Crisis in China

ICBC Gold Product – Bank Collapse or Isolated Case?

China's largest bank, ICBC, formally declared it would not support a 3 billion yuan bankrupt trust investment product the bank sold through its branches. The Wealth Management Product (WMP), called the "Credit Equals Gold No. 1," raised funds for a coal mine and is due for repayment January 31. The announcement brought a mild panic to China's financial community and among overseas investors. Already worried about China's large local government debt, repeated liquidity crises, and growing shadow banking market, the concern is the default would trigger a massive flight from investments and result in a banking crisis. The frenzy was fueled in the west by an article in Forbes by noted contrarian Gordon Chang.

The outcome of the ICBC case was confusing even in China. The head of Treasury Operations for a Chinese Commercial Bank in Beijing last week texted me, "This may be the first trust default." In contrast, a policy analyst for the PBOC told me: "I don't think the central government could let it default." However, he added, "If the default can be controlled and orderly, the result would be better."

It now looks like there will be a joint rescue between ICBC, the Shanxi government, where the coal mine was located, and the trust itself. We think in a high profile case like this there was pressure from the PBOC for a quiet resolution – most likely behind closed doors. The PBOC would like to scare off the more risky lenders but not close down the shadow banking market entirely.

Whether the Gold Trust defaults or not, here are five reasons why a financial crisis caused by a trust default is unlikely:

1) Trusts Have Reduced Risk Since They Are Off Balance Sheet

While there is a significant risk to the financial system due to excessive debt, the failure of a Trust Product would not lead to a viral contagion of financial defaults for policy, political, and structural reasons.

First, a trust in China is not a bank. In fact, it is a financial institution with a license from the China Banking Regulatory Commission to package financial products. Thus, it does not itself hold the bulk of the assets, but merely acts as a conduit. The trusts perform two functions: private placements (similar to investment banks) and investing in a broad variety of asset classes including money markets, capital markets, and unlisted assets. They are essentially performing a "regulatory arbitrage" by bridging the financing needs of relatively higher risk businesses with the search for yield by wealthy individuals and institutions. This arbitrage is a function of the lending restrictions placed on the formal banks by the CBRC. As a result of this structure, they have little on-balance sheet exposure to their investments.

2) Banks – not Trusts – Control Most Assets.

In 2012, China's trust business totaled 7.5 trillion yuan in 2012, rising to around 10 trillion in 2013. Its share in total social financing in China, a broad measure of liquidity in the economy, has quadrupled from 3% in 2007 to 12% in June 2013.But trust assets in 2012 were only 6.3% of total assets under management. The bulk of the assets, 101 trillion yuan or 85%, are held by the state banks. They have captive lenders due to lending restrictions and thus their assets are relatively safe. In addition, the vast majority of trust loans are collateralized with real estate or shares at less than 50% loan-to-value, although these assets may very well be over-valued.

This contrasts with the U.S., where the shadow banking market is much larger than in China. Zoltan Pozsar, of Soros' Institute for New Economic Thinking, argues that there is a $2 trillion "cash pool" managed by institutional funds, securities lenders and pension funds, that seeks insured deposit alternatives whose size exceeds outstanding government debt by at least $1.5 trillion. They are forced to invest this cash pool in derivative instruments that he calls shadow banking instruments. However, their tight connections with the banking system means that defaults and "flight to safety" can quickly transform a short-term liquidity problem into a banking crisis.

And the cash pool is even larger if other investors apart from the funds are added in. Zoltan notes that the figure of around $2 trillion does not include wealthy individuals, endowments, hedge funds and other financial actors. All told, the estimated total for these cash pools looking for investment products is closer to $3.4 trillion in 2010 (his latest data at the time of writing.) "With a shortage of short-term government-guaranteed instruments, institutional cash pools next gravitated—almost by default—toward the other alternative of privately guaranteed instruments, fueling the secular rise of the non-bank-to-bank subset of wholesale funding markets and the "shadow" banking system in general," he notes. In other words, the money games by the big financial players in the U.S. dwarfs China's shadow banking contribution to the credit pool, which is dominated by bank loans.

3) Could A Liquidity Shortfall Cause a Massive Trust Default?

One of the arguments for a trust bust is the potential for a liquidity crisis caused by a "run on the trusts." This is both a political and technical question. In short, the PBOC uses the short-term rates to signal its intentions. They would like to see a few high profile shadow lenders fail. However, the bigger source of credit is controlled administratively.

Technically, the widely used measure for liquidity in China is the 7-day interbank repo rate. In fact, it's not a very good measure. The PBOC relies primarily on administrative actions to guide access to credit, including the reserve rate requirement (RRR), deposit rates and lending targets distributed through the Beijing headquarters of the state banks and through local PBOC offices. The widely watched Shanghai Interbank Rate (Shibor), has a very bad track record of indicating monetary policy. "Interbank money market lending rates, such as Repo and Shibor, are insufficient and potentially misleading indicators of the central bank's monetary policy intentions," notes a recent paper by the Hong Kong Institute for Monetary Research (HKIMR). This is partly because in a situation in which the benchmark deposit rate ceiling is persistently below the equilibrium level, the PBOC must also rely on quantity-based instruments to achieve its policy objectives because of the resulting price distortions in the banking system.

The interbank interest rate does have a modest impact on lending rates. According to an HKIMR study, a 100 basis points increase in the market interest rate causes the loan rate to rise by 4.7 percentage points. But even more important is the deposit rate – an administrative tool: a 100 basis point rise in the deposit rate causes the loan rate to increase by 26.2 basis points. "The regulated benchmark deposit rate is still the most powerful factor in determining loan pricing," according to Dong He and Honglin Wang of the HKIMR.

The significance of this for the Trust business is this: a spike in the Shibor does not necessarily mean a shortage of liquidity in the market. In fact, changes to many policy variables, including open market operations and the RRR, do not have a significant impact on the interbank interest rates. The biggest impetus to interbank rate changes are purely time sensitive – Chinese New Year and the end of the month have the largest impact on interest rates.

So the PBOC monetary injections are more to *signal* policy intentions toward liquidity and bank lending – which are primarily administrative measures -- than to manipulate interest rates. So when investors fear a crisis presaged by a spike in the Shibor rate they are most likely looking at a wildly inconsistent measure; sometimes it suggests policy, and other times it is a short-term blip.

4) **The Politics of Too Big to Fail.** Politically, the trusts are supported by the state. In fact, many of the trusts – as many as 90% -- are controlled by state owned or large Chinese corporates. These corporates borrow from state banks, because they are perceived as a good credit risk, and then lend at much higher rates. PetroChina has various shadow banking units: an asset management company, a trust bank, a commercial bank and an internal finance unit. Baosteel has a 98 percent stake in a trust company, Fortune Trust. Yangzijiang Shipbuilding, a Singapore listed Chinese corporate, has an 11 billion yuan trust business that produces more profits than its core shipbuilding business. Given that many trusts are state owned or connected to state banks, the backing by state entities is high and the risks of default are lower.

5) The Real Problem is Local Debt.

If you talk to PBOC officials they are far less concerned with short-term market liquidity, and a crisis from the Trusts, than they are with local government debt and the property bubble. It's easy to see why. In 2012, China created US$2.04 trillion in new credit. An estimated 27% of this new credit was shadow loans – a combination of bond sales, wealth management products and interbank borrowing, according to data from Goldman Sachs' Chinese joint venture, Gaohua Securities. How much of this shadow basket are WMPs? According to Gaohua, somewhere around $260 to $400 billion. No small sum, but that's only 10% to 20% of new credit.

So where did the bulk of new credit go? Bank loans –US$1.4 trillion or 67% of new credit. The real problem is the majority of these bank loans generally are issued to large state owned firms, along with government investments in infrastructure, funded through the so-called "Local Government Financing Platforms," private/government hybrid companies. Local government debt now stands at US$3 trillion and growing. Some trust credit ends up in speculative property and LGFVs. But a much larger portion is issued by banks. The trusts can't be blamed for a credit bubble fueled by the banks.

Conclusions: The Problem of Asset Deflation.

The PBOC is trying to use signaling to shrink the number of speculative investments by shadow lenders, including trusts, particularly those that use short-term loans from the interbank market to fund ill-conceived investments. They would like to reduce the moral hazard of speculative lending that has implicit government backing. Unfortunately, instead of imposing new rules, a lack of political will at the top forces them to use the interbank market, which as noted, is a rather blunt instrument. The PBOC is in a much weaker position to tackle the bigger problem of excessive local government debt and the property bubble.

The real risk to the economy is asset deflation. A collapse or decline in property prices, which function as collateral for many parts of the economy, including local governments, would have a severe impact on lending and growth in general. However, the Trusts are only a small piece of a larger puzzle.

To resolve these problems, the government must enact new policies. The regulators have to free up deposit and lending rates to reduce the regulatory arbitrage that corporates and non-bank institutions like trusts are taking advantage of. In addition, the PBOC and CBRC must enact new regulations that clarify the WMP market. Measures to do this include asking the banks to move their wealth manage operations to a separate mutual fund business; develop the money market industry; force lenders to pair their WMPs with specific assets instead of putting them into a pool; and imitate the U.S. system, where only high net worth individuals are allowed to purchase "risky" assets.

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