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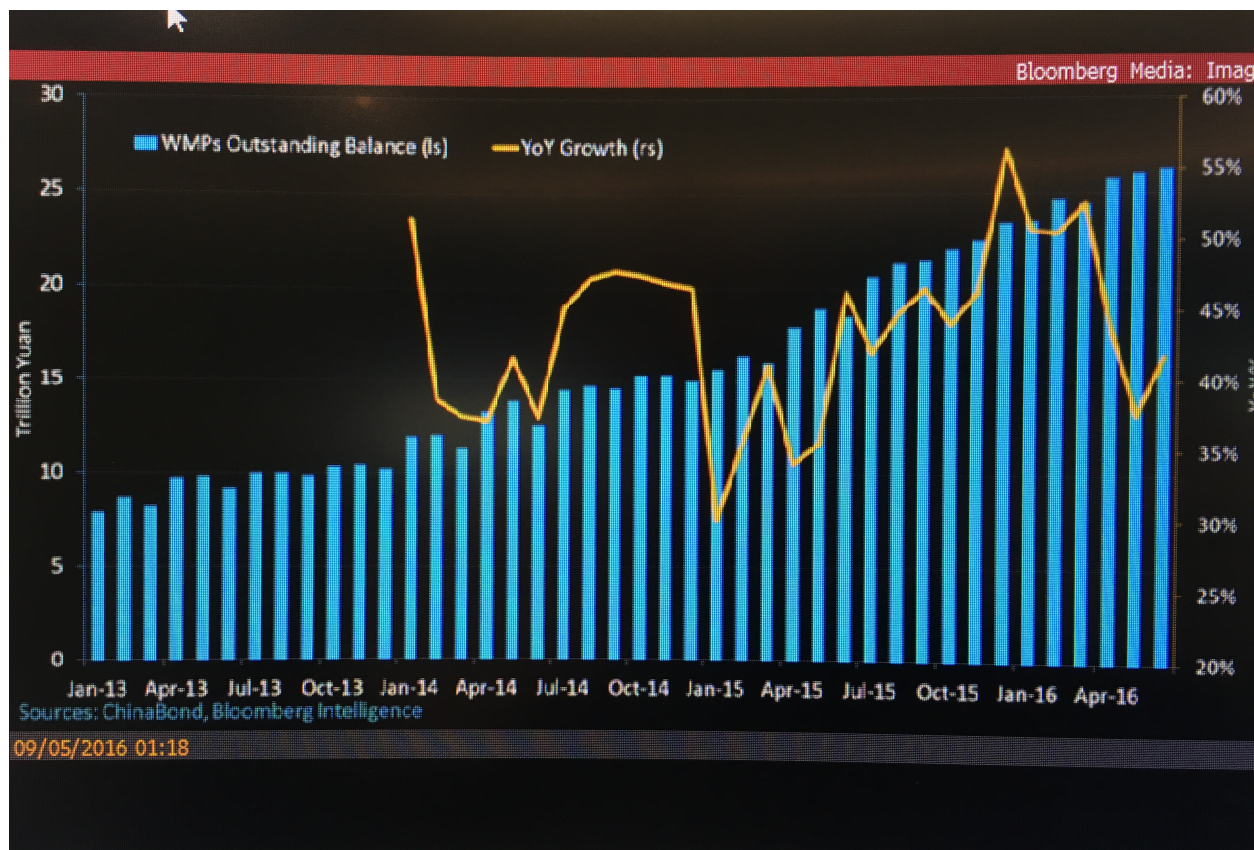
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Shadow Banking Defaults

Demographics Show Strong Ownership of Shadow Banking Products by Wealthy

Summary

The weak link in China's financialized economy is the country's Wealth Management Products. They are short in duration, widely sold by formal and informal institutions, and are invested in important institutions including corporate bonds and smaller banks. We think a run on WMPs is quite likely as banks face a rising inability to pay interest on these WMPs, which exceed Rmb26 trillion. *Demographic analysis of their ownership structure suggests these will become the explicit responsibility of state banks. We estimate Rmb 19 trillion of Rmb 26 trillion of WMPs will end up on bank balance sheets.*



Source: Bloomberg

State Backing is Questionable

Investors widely assume the state will support almost any credit in the system – including WMPs. During a talk at the University of London last month on Shadow Banking, a Chinese student said her and her parents' WMPs had defaulted. “What is Beijing going to do,” she asked?

One of the issues that have been ignored in analyzing the State's likely response to a widespread default of WMPs is the question of *who owns them*. Are they rural residents in remote towns or city dwellers? Middle class or elites? And what does this mean in a run on Shadow Banking?

Wealthy Elites Control WMPs

To that end, we assembled data on the demographics of High Net Worth individuals from a useful source – the IPO of one of China's largest brokerages, Guotai Junan. Admittedly, these represent Guotai Junan's a variety of services including securities and futures brokerage, margin financing and securities lending, wealth management and financial planning services. But it is a good proxy for Guotai's overall business – including the sale of WMPs.

The chart below shows the data. In 2016, ordinary accounts, with a balance of less than Rmb500,000, were Rmb 189.2 billion, or 9.9% of Guotai Junan's total personal finance. Affluent accounts of less than Rmb5 million, were Rmb277.4 billion, or 14.9%. Affluent accounts with more than Rmb5 million, were Rmb1.4 trillion, or three-quarters of the total.

<i>Guotai Junan's Personal Finance Business</i>						
Assets (Rmb Bln)	2014		2015		2016	
RMB Bln	Number	% Total	Number	% Total	Number	% Total
Ordinary Accounts	139.2	9.9%	173.2	10.6%	184.1	9.9%
Affluent Accounts	207.8	14.7%	249.2	15.2%	277.4	14.9%
HNW	1,062.8	75.4%	1,212.6	74.2%	1,406.0	75.3%
Total	1,409.8		1,635.0		1,867.5	

How many people are we talking about in this wealthy cohort? According to Guotai Junan, the wealthy accounts are 0.2% of the total, or 22,000 accounts.

<i>Number of Accounts per Demographic</i>						
	2014		2015		2016	
000s	Number	%	Number	%	Number	%
Ordinary Accounts	4,564	96.0%	6,496	96.50%	8,838	97%
Affluent Accounts	162	3.4%	193	2.90%	255	2.8%
HNW	30	0.6%	40	0.60%	22	0.2%

Total	4,756	6,729	9,114
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Each of the accounts is quite large – an average of Rmb 65 million.

<i>Average Account Size (Rmb 1000s)</i>			
	2014	2015	2016
Ordinary Accounts	30	27	21
Affluent Accounts	1,281	1,291	1,089
HNW	35,784	30,315	65,091

The Dominant Owners of WMPs are the High Net Worth Individuals

These numbers apply to one brokerage’s accounts that manage the assets wealth of their customers’ personal financial products. But we think it is representative of the breakdown of assets in China because Guotai is the country’s second-largest broker, which tends to be a distributor of products to a wide swath of Chinese society. If our cross-analysis is correct, across the country as a whole, 8.6 million wealthy individuals control Rmb19.5 trillion in WMPs.

<i>Estimate of Demographic Breakdown of China’s WMPs</i>	
Total WMPs (Rmb Bln)	26,000
HNW Investors %	75%
% Total WMP Outstanding (Rmb Bln)	19,500
Total number of HNW Accounts	8,637,600
% China Population	6.3%

The Political Power of the HNW Increases the Risk to the Financial System

We assume the WMPs are the weakest link in China’s financial chain because”

1. They are short-term, generally three months or less;
2. They are sensitive to confidence in the economy because they are the closest to market economy financial product that China has;
3. They are often use to invest in China’s bubble-like property industry;
4. They increasingly are used to invest in the country’s smaller -- and weaker – financial institutions.

My operating thesis has been that Beijing – the State Council, the PBOC and the CBRC – will let some financial products and institutions fail, because a) they don’t want moral hazard to become standard; and b) they will be disinclined to assist private individuals. ***But what if the wealthy own most of these WMPs – can they control the outcome?***

We think this depends on what we call *the hierarchy of money* in China. The corruption cases that have come to light suggest most of the serious wealth has been gained through the listed subsidiaries or spinoff companies relating to state firms. A collapse of these firms is unlikely; they are protected both by state ownership and political connections. Defaults of WMPs from funds obtained through these channels would be recapitalized by the state banks they are linked to.

There may be a category of wealthy individuals whose wealth was derived from firms connected to *local* state entities. These would have fewer protections given their distance from Beijing. In addition, their WMPs may have been sold by an entity that is politically and financially weaker than a state banks; e.g., a city or rural commercial bank. These *peripheral institutions and peripheral wealthy individuals* would have a harder time getting money out of Beijing. But out of the 8.6 million people these most likely constitute a minority.

Conclusion: The SOE Banks Will Pay

In case of widespread defaults of WMPs, the political connections of the elites that own the majority of them are likely to force the state banks to recapitalize the defaulting WMPs. That means, the majority (my data puts that at Rmb 19 trillion) will be the responsibility of the banks and are thus implicitly a liability of the state banks.

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