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Into the shadows: risky business, global threat

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The first of an FT series investigates China's precarious shadow banking system

From the window of his office, Qiao Jingshan can look out across downtown Yuncheng and see signs of new construction everywhere. Half-built or empty apartment complexes are scattered across the cityscape bearing names like "Eastar Upward", "Golden Riverside" or "Stars and River Mansion".

As chief accountant for Yuncheng City Investment, a financing vehicle for the local government, Mr Qiao has played a crucial role in the development of this gritty steelmaking city in central China. His latest job is to sell his company's "trust product" – a high-interest, deposit-like investment – with the proceeds going to a big public heating project for Yuncheng.

Despite paying a tempting 9.7 per cent annual interest rate, his product, marketed as "Eternal Trust Number 37", is not catching on with investors. Mr Qiao is worried.

The problem could be that Yuncheng's property market has hit a rough patch or that a local steel plant has closed. But he blames events outside Yuncheng for his predicament. The near-default of other Chinese financial products recently has set off alarms – inside China and in global markets – that the country is in the midst of a dangerous credit bubble.

Mr Qiao admits the Yuncheng heating project will not provide any returns for his company, an unsettling fact for any investor. But he is dismissive that this is the problem.

"All of our investments are public works that should actually be paid for by the local government so when the trust product matures the government should take this project off our hands and give us the money to repay investors," he says. "Don't worry, it is impossible for there to be any sort of financial crisis here in Yuncheng."

Trust products, such as the one offered by Yuncheng City Investment, lie at the heart of China's shadow banking sector, which has provided more than Rmb30tn ($4.8tn) worth of loans to the country's riskier enterprises since 2007. It has helped create the biggest credit boom in history. But in Yuncheng and scores of similar nondescript cities across the country, China's enormous and poorly regulated shadow banking sector is starting to run into trouble, with profound implications for the world's second-largest economy – and potentially the global economy.

Today the Financial Times begins a series on how "shadow banking" – a term that covers a wide range of "non-bank" institutions that perform many of the functions of traditional banks, but do so outside the traditional system of regulated banks – is reshaping finance around the world. The last shadow banking bubble, in the US in the run-up to 2008, compounded the global crisis that followed. Now markets and regulators are concerned that the rapid build-up of risk in China's shadow banking sector could inflict similar damage.

Worries about China's shadow banking system rattled global stock markets this winter, after a wealth management product called "Credit Equals Gold" was reported to be on the verge of default. It was quickly restructured, only to be followed by concerns about a similar product known as "Opulent

Blessing".

Although these were small products in relation to the Chinese economy, the financial markets – and regulators – paid attention.

Noting how large the sector has grown, many in China warn that the country could face its own "Lehman moment" if it were to see a serious run on shadow banks.

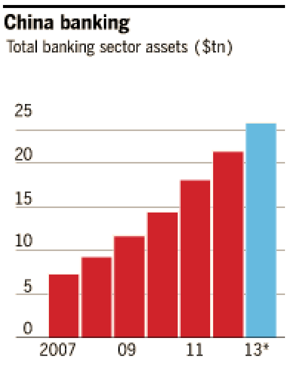
The concern is that financing could disappear for the most leveraged and riskiest parts of the economy, from real estate developers to steel mills. China's investment-reliant growth could come to an abrupt end.

"The [traditional] banks have been very strategic about pushing their weakest assets into these channels," says Charlene Chu, the former Fitch analyst who was one of the first to raise serious questions about the rise of China's shadow banking sector and who now works for Autonomous, the research group. "The weakest institutions and creditors are the ones engaged in shadow banking, where bad decisions and bad risk management are the norm."

A necessary evil

Yuncheng City Investment is one of more than 10,000 "local government financing vehicles" (LGFVs) set up by Communist party officials as a way to circumvent laws that forbid local governments from running deficits.

Their job is to raise money any way they can and spend it on behalf of local authorities, often on public works projects such as roads, public heating or sewage systems. The latest official estimate puts the total amount of debt held by LGFVs at Rmb17.9tn by the middle of last year, equivalent to more than 31 per cent of China's gross domestic product in 2013. Most LGFVs were created in the wake of the global financial crisis in late 2008, when Chinese exports fell off a cliff and the government launched an enormous stimulus plan to stave off economic disaster. The LGFVs were seen by Beijing as a necessary evil and were initially allowed to borrow directly from the country's state-owned banks.



With Beijing exhorting companies and local governments to borrow and spend as much as they could, total debt to GDP in China's economy rose from 130 per cent in 2008 to more than 220 per cent in 2013. Assets in the formal and shadow banking sector increased from around $10tn to as much as $25tn. That means China created new credit roughly equivalent to the entire US banking system in the space of five years.

The massive stimulus quickly led to a rebound in growth rates, but the new credit soon began weighing on lenders' balance sheets and capital requirements. So, with tacit approval from policy makers in Beijing, alternative forms of credit began to sprout in the shadows.

The banks repackaged their riskiest loans to their least creditworthy borrowers, including many LGFVs, and sold them as "wealth management products" to ordinary depositors.

Lightly regulated trust companies joined the action, making high-interest loans to risky borrowers, repackaging them and selling them through banks as "trust products".

On paper, trust products are only supposed to be sold to investors with Rmb1m to spend but this rule is often broken. And the trusts were designed to be alluring. Deposit rates in China are capped by the government but these innovative trusts were classified as investment products, allowing banks to tempt depositors with the promise of much higher returns.

"The non-bank side of the financial system is primed for disaster and nowhere more so than in the trust sector," says Jonathan Anderson, founder of Emerging Advisors Group. "Trust products are genetically engineered to go bad when the credit taps turn off."

Growing fast

After the Chinese economy rebounded in 2009 and 2010, policy makers began worrying about wasteful investment and asset inflation.

Banks were told to cut back on lending to real estate projects, local government borrowers like Yuncheng City Investment and industries suffering from serious overcapacity, such as steel, glass and cement. That created enormous demand for the high-interest loans on offer through the fledgling shadow banking sector.

Economists at Barclays estimate the size of China's shadow banking system at around Rmb38.8tn at the end of last year, or around a quarter of the size of total assets in the banking sector. Analysts say roughly half of all credit extended in 2013 came from outside the formal banking system.

FT Series: Into the shadows

Part of this includes activity such as corporate bond sales that would not be considered shadow banking in other economies. But much of it is made up by the wealth management and trust products that Chinese regulators are worried about.

Total outstanding trust product assets in China rose 8 per cent in the first quarter from the previous quarter to reach Rmb11.7tn, a fourfold increase from the total at the end of 2010. As much as Rmb5.3tn of those products will come due this year, according to estimates from Haitong Securities, a Chinese brokerage.

Next in the series: how shadow banking is restructuring the financial landscape and Paul McCulley on challenges for the US Federal Reserve

Biting the bullet

Yuncheng City Investment was established in 2003, earlier than most of its peers, as a way for the local government to access bank loans to pay for public works. But the company was mostly dormant until 2009, when the local government gave it a staff of several dozen people and launched it into a frenzy of borrowing and investing in roads, museums and government-subsidised housing.

When policy makers in Beijing turned off the credit flowing from state banks to LGFVs, City Investment turned to the corporate bond market, raising Rmb800m from a 2012 bond sale to investors for which it had to pay 7.5 per cent annual interest.

But last year Mr Qiao and his colleagues were told they would not be allowed to tap the bond market again thanks to new rules linking government officials' performance to local debt levels. So, despite the almost 10 per cent interest rate they would have to pay, they decided to launch a trust product and turned to Sino-Australian International Trust, a Shanghai-based venture between two state owned companies and Australia's Macquarie Bank, which owns 20 per cent.

The two-year trust product Mr Qiao is trying to sell – he had planned to raise Rmb350m by the end of March – was collateralised by a piece of land near the Yuncheng airport.

The fortunes of the property developments he can see out his window are of great importance to Mr Qiao since government land sales to commercial real estate developers provided almost two-thirds of Yuncheng's Rmb22.4bn in fiscal revenue in 2012. City Investment's outstanding debt before it launched its trust product was already Rmb4.2bn, or almost half of the Rmb9.1bn in revenue Yuncheng City took in last year from sources other than land sales.

Unfortunately for Mr Qiao, Yuncheng's real estate market has hit a rough patch.

"Prices are falling and sales are really terrible because too many apartments have been built and so many of them are empty," said a sales manager at a property development on the outskirts of Yuncheng who would only give his surname, Guo.

Mr Guo says in the district where he works the government approved 800,000 square metres of new property construction last year alone, even though the total population of the district is just 300,000 and most people cannot afford the apartments.

The term sheet for City Investment's trust product is not very long or detailed. But it points out that Yuncheng has several large industrial companies that the local government can rely on for tax revenues.

The first company on that list is Highsee Iron and Steel Group, which recently collapsed under the weight of more than Rmb20bn in debt.

Too many apartments have been built and so many of them are empty

- Property development sales manager

A large aluminium smelter that is another important source of the city's tax revenues is facing such dire market conditions that it loses as much as Rmb30,000 on every ton of metal it produces, according to local officials. They say the company has responded by shutting down production.

The bailouts begin

Even as China's economy is slowing and revenues from land sales dry up, local governments such as Yuncheng's are being called on to prop up their financing vehicles and bail out the high-interest trust products they have sold to investors.

At best, this could push growth lower, since government revenues will be diverted from new investment into paying off old debts. At worst, collapsing government revenue will lead to financial crises as defaults in the shadow banking sector soar and investment-reliant growth collapses.

Yuncheng is not a particularly extreme example, since Mr Qiao and his colleagues have been relatively conservative in their borrowing. Many Chinese cities have dozens of LGFVs that have issued scores of trust products between them.

"Yuncheng represents a case of a city in real need of financial restructuring and there are many cities like this across China," says Li

Daokui, of the Center for China in the World Economy at Tsinghua University and a former member of the central bank's monetary policy committee. "The central government will have to step in to facilitate this restructuring but the holders of these kinds of high-interest trust products across the country will definitely lose money."

As far as the banks and trust companies such as Sino-Australian are concerned, any risks of default by borrowers like City Investment are borne by investors alone.

Most ordinary investors bought the wealth management and trust products assuming they were guaranteed by the government, since they were usually sold by state banks. But many investors are starting to question this assumption. Some are even taking to the streets to protest and demand the government bails them out.

That is bad news for Mr Qiao and his trust product. But it is also a concern for financial regulators in Beijing, who would like to limit the growth of shadow banking but who realise the sector has become so big that it now has the potential to destabilise the entire system.

"Right now there is a lot of concern over the fiscal condition of the system," a senior financial regulator said. "If we see a very sudden withdrawal of funds from the shadow banking system then it will definitely be a macroeconomic problem."