Elston

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Elston Insights

China's shaky shadow-banking sector

- Shadow-banking sector accounts for 40% of China's loans
- Trusts offer better rates than national banks
- Government trying to stave off a crisis of confidence

What is a Trust company?

Trust companies essentially provide the same services as banks but are not legally denoted as such. Similar to a building society in the UK or a savings and loan business in the US, trust companies can take deposits. The trusts can then use these pooled assets to issue loans and mortgages and other products. In some countries, the volume of assets controlled by trust companies means that they essentially comprise a shadow-banking sector, and there are few places where this is more pronounced than in China. The World Economic Forum estimated in 2019 that approximately 40% of the country's loans were accounted for by the shadow banking sector.

Why do trust companies have such a large share of the market in China?

Constraints on credit lending in China are onerous and there are considerable barriers to access for both businesses and individuals. The government discourages banks from making loans to certain industries and also caps interest payable at artificially low levels. The banking sector in China is also almost entirely domestic, thus lacking the robustness, competitiveness and mitigation of risk that would come with allowing established foreign players into the market.

What kind of activities do China's trust companies engage in?

One of the most common transactions carried out by China's trust companies is the sale of a wealth management product. These carry a higher rate of interest than a standard bank deposit but crucially are for the most part not covered by standard deposit regulation. Trust loans or trust products are also widely used, involving the transfer of unlisted equity, tradeable assets and other forms of capital. Significantly, both wealth management products and trust products frequently involve loaning to or investing in the property market, which accounts for approximately 10% of all trust assets[1].

[1] Bloomberg

What prompted the current problems we are seeing in China's shadow banking sector?

For the large part, the crunch in the shadow banking sector has its roots in a faltering property market. What began as a private-sector slowdown two or three years ago has spread to state-owned enterprise (SOEs), ie. businesses with government backing. Two years ago, of the 38 SOE property firms listed in Hong Kong, 4 posted losses. Today that number is 18 and rising.[2] Sales slumped in the pandemic and at the same time the government decreed a crackdown on property lending. Trusts' investments into the property market have soured accordingly, in turn leading to a default on product payments. Approximately 106 trust products with a value of approximately RMB44bn defaulted in the first seven months of the year, 74% of which are tied to the property market.

How are those problems playing out?

Zhongzhi Enterprise Group, a privately-owned manager of more than US$137bn, is one of the biggest of the trust companies to falter. It has had to call in KPMG to carry out what is likely to be a protracted restructuring. Significantly, small-scale protests outside its headquarters in Beijing were immediately quelled by the government. The main fear now is of contagion: if wealthy investors and corporate clients lose faith and pull their deposits, the entire shadow banking sector is threatened. While China's big national banks are not likely to be affected, the country's top financial regulator – the National Financial Regulatory Administration – has moved to establish a working group to examine the risks at Zhongzhi and other trusts caught up in defaults. Renminbi has been pushed to a 16-year low and the central bank has implemented a rate cut in an attempt to bring some stability. For now, for China's imperilled US$2.9 trillion trust sector, it is a matter of wait and see.

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[2] Bloomberg

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