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China's recent funding crunch and responses thereto

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Executive Summary

Financial risk has surfaced in China amid a corporate liquidity crunch. Chinese authorities are taking action to avert systemic risk. Meanwhile, new approaches to financing SMEs are also emerging.

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Emergence of bond and trust product default risk

Chinese companies are in the midst of a liquidity crunch. This year's bond and trust product default crisis in China has been reported in the media even in Japan[1].

In January, a collective trust plan whose end-borrower is a private coal mining company in Shanxi Province nearly defaulted on repayment of principal at maturity[2]. Although the plan was sold to investors by a bank acting as a sales agent, it appears to be a circumventive lending (i.e., shadow banking) scheme routed through a trust company. The plan's investors ended up being repaid on time with funding from strategic investors recruited by the local government and banks.

In February, the maturity date of a collective trust plan with a different coal company as its end-borrower was extended. The borrower has since entered debt restructuring. In March, a solar panel maker in Shanghai defaulted on a bond interest payment[3]. The default was the first ever in China's corporate bond market.

The emergence of default risk in China is attributable to two major factors. First, China's economic growth rate has slowed since 2012 to the vicinity of 7.5% from 9-10% previously. Second, since the latter half of 2013, Chinese regulatory authorities have kept a tight rein on financial markets amid a clampdown on shadow banking. Against such a backdrop, pre-existing default risk manifested in economically sensitive industries and industries that reportedly have overcapacity problems (e.g., solar panel manufacturing).

Chinese authorities' response

Some 900 billion yuan of collective trust plans like those mentioned above are scheduled to mature in 2014[4]. In a macro environment where the government is

NOTE

1) Although media coverage in Japan has increased in 2014, trust products have previously had principal repayment problems.

2) The trust plan was originated by China Credit Trust Co. and sold through the Industrial and Commercial Bank of China. Collective (fund) trust plans have multiple investors (trustors). Single (fund) trusts have one trustor. Single (fund) trusts structured with a bank as trustor are also used in shadow banking.

3) The collective trust plan's sponsor was Jilin Trust. The defaulting bond issuer was Shanghai Chaori Solar Energy. Shanghai Chaori Solar Energy is a publicly traded company, but on the Shenzhen Stock Exchange its name is prefixed with an ST* designation indicating an extremely high risk of delisting. Its dire financial condition was presumably widely known.

4) According to an estimate by CITIC Securities (as reported in the February 19, 2014, edition of China Securities Daily). Broken down by end-borrower, this total includes 247.9 billion yuan lent to the real estate industry and 225.1 billion yuan lent to local government financing vehicles.

targeting a 2014 economic growth rate of around 7.5%, maturity default risk may pop up again.

When maturity default risk arose in the past, local governments and financial regulatory authorities' response was to avert systemic risk that could adversely affect the financial system as a whole. In the aforementioned case of the collective trust plan that nearly defaulted in January, the maturing principal was a hefty 3 billion yuan. If that plan had defaulted, shadow banking liquidity dependent on similar schemes could have dried up. Such a scenario could have put the entire Chinese economy at risk of adverse repercussions.

The China Banking Regulatory Commission (CBRC) has long been warning about the risk of trust products (including those related to shadow banking) that provide funding to local government financing vehicles, real estate developers, or industries with excess production capacity. Since mid-2013, the CBRC has started checking trust products' cash flows. It currently aims to control the situation once it has gauged the risk to some extent. Such an approach poses a risk of mismanagement (e.g., late response) even when the problem could ultimately be temporarily resolved (or, more accurately, postponed) with bailout funding from a local government or other such source.

Some argue that because bailouts promote moral hazard, it is better to administer shock treatment by allowing insolvent financial products to default. This argument has merit from the standpoint of normalization and maturation of the Chinese bond market, which has been called abnormal because it had never experienced a default until very recently.

On the other hand, such drastic measures may not be feasible because banks have been selling financial products amid a public perception, originating from a tacit understanding that bank deposits are guaranteed in their entirety, that financial products sold by banks are also fully guaranteed.

As a first step, China needs to inculcate risk consciousness in the public. Specifically, the public must be made aware that high returns entail high risk. Such investor and depositor education has in fact recently been evident in China's domestic media. Such education is also a prerequisite for interest rate liberalization and introduction of deposit insurance and a bankruptcy resolution scheme for financial institutions as precursors to interest rate liberalization.

Need for SME financing

From a long-term structural standpoint, another key issue is how to improve a structural distortion that is particularly pronounced in China. Specifically, when monetary tightening occurs, the first companies to experience funding difficulties are those with the most acute need for funding, namely SMEs.

Although China has been taking various steps to promote SME financing since around 2003[5], SMEs' funding difficulties have not improved much.

5) Development of the non-state-owned sector of the economy was a key theme of the third plenary session of the 16th Central Committee of the Communist Party China in 2003. A law to promote SMEs' growth also took effect in 2003.

The root problem is that the Chinese economy is dependent on indirect finance, particularly major state-owned banks. Banks have little incentive to lend to SMEs because they have hitherto been able to earn respectable net interest margins on loans to state-owned enterprises and local governments and such loans pose little risk of nonperformance.

With banks' net interest margins expected to shrink in the wake of ongoing interest rate liberalization, progress in diversifying capital markets and outwardly opening them (raising capital from overseas) is also important on a macro level. In this respect, China is in a situation similar to Japan from the 1980s. Like in Japan, Chinese banks may gradually shift their focus toward lending to SMEs if some large corporations, banks' prime customers, start borrowing directly from capital markets.

On a micro level, China must devise solutions to SMEs' financing difficulties. One recent policy development is establishment of private banks, chiefly to promote lending to microenterprises and the agricultural sector. In March, the CBRC announced the establishment of five private banks on a pilot basis[6]. The new banks are owned by ten companies in total, including Alibaba, China's biggest e-commerce company. The banks plan to operate on a pilot basis in Tianjin, Shanghai, Zhejiang and Guangdong.

6) On March 11, the CBRC published a list of the pilot private banks' ten initial shareholders. They are Alibaba, Wanxiang China Holdings, Tencent Holdings, JuneYao Group, Fosun International, Shenzhen Baiyetuan Investment, Tianjin Shanghui Investment, Huabei Group, Chint Group, and Huafeng Group. The CBRC will grant licenses to five private banks after reviewing these ten companies suitability as shareholders.

Meanwhile, market-driven innovation is also afoot. One example is Internet finance. Alibaba lends to its e-commerce sites' merchants based on their transaction histories[7] (it lends up to 1 million yuan for up to 12 months). Suning Commerce Group (formerly Suning Appliance) likewise provides financing to its suppliers, which are mostly microenterprises.

7) See "Alibaba Microfinance's asset securitizations" (October 2013): http://www.nri.com/~/media/PDF/global/opinion/lakyara/2013/lkr2013179.pdf

Supply-chain finance also has started to gain prevalence in recent years. Based on the creditworthiness of the core company in a supply chain, some banks have for the past several years been lending to other companies in the supply chain through such means as factoring or inventory financing.

China is now laying the regulatory groundwork for such modes of financing. For example, the Ministry of Commerce issued a directive authorizing commercial factoring on a pilot basis[8)] in June 2012. In December 2013, the CBRC published a draft Commercial Bank Factoring Business Control Law. With financial conditions tight, such new developments bear watching in addition to the authorities' crisis responses.

8) The directive authorizes commercial factoring on a pilot basis in Tianjin's Binhai New Area and Shanghai's Pudong New Area.

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