



Information Release: Shadow Banking and China's Apparent Credit Crunch? – 25th June 2013

- **Government is well aware of the Situation and Risks**
- **The key is the misallocation of credit which needs adjustment**
- **PBoC's prudent approach to create a more balanced system**
- **China's Largest Banks to continue running strong**

In recent weeks, there has been a lot of news released into the market regarding the shadow banking system in China, and subsequently its consequences. We want to clear up a few issues here, and explain how each part of the system is interlinked.

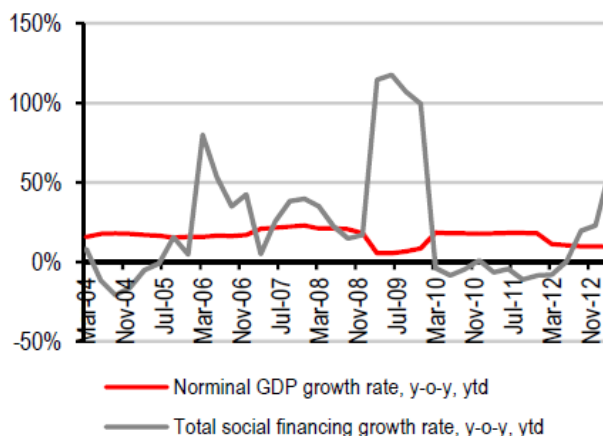
What is Shadow Banking?

Shadow banking is essentially credit that is obtained through unusual channels. This does not necessarily mean they are untrustworthy channels, but generally does not involve the bank directly. In Australia, we have our own shadow banking system in the form of private equity funds and venture capitalists. In China, it has mainly been through a range of trust structures. We will look into this further later on in this paper. Shadow banking usually appears when liquidity in the traditional banking system is tight and funding is needed.

How has the system created a misallocation of credit?

Historically, if you look at Chinese M2 growth, which is currently growing at 13-16%, it shows that there is an abundance of liquidity, which should in turn flow into the real economy through the creation of infrastructure and, expansion of businesses and related entities. Unfortunately, what has occurred recently was the creation of trusts (in some cases private equity funds) which create wealth management products (WMPs) to which banks then lend money to. Subsequently the trust then lends the money out at an even higher rate but it never makes it to the real economy (and ends up in non real economy projects such as social financing), hence causing somewhat of an illusion that there is credit growth, but no associated economic growth. Therefore a mismatch occurs whereby the growth of social financing outpaces GDP (i.e. not showing much correlation). Looking at the chart on the right, it can be seen that over history, there have been these cases of misallocation of credit and hence capital has not been reaching the real economy. Effectively, misallocation has occurred through the use of short term funding to fund long term projects (which causes issues when you try to extend that short term funding into the long term) - i.e. a credit system mismatch

Figure 2. Growth of total social financing vs. GDP



Source: CEIC, HSBC

Does the government understand the situation?

One thing that investors and professional fund managers alike can be rest assured of is that the Chinese Central Government is well aware of the situation. Since March 2013, the government has been taking action to rectify the situation. However, one must remember that the government is adjusting at the ends to balance out the allocation of credit and not cause any serious shocks to the system. It is simply not in the interest of the leaders to shut down its banking system. The CSRC (Chinese Securities Regulatory Commission, China's ASIC) has forced WMPs to readjust their asset allocations to publicly listed assets, and away from small-time property developers and local government financing vehicles. As well as this, China's Ministry of Finance has banned local governments from placing public assets, such as schools or hospitals, into trusts or WMPs. There are also increased levels of deposit requirements for provincial governments on property purchases and in some cities, outright bans on multiple property purchases.



Further to new policy, the CSRC has started investigations into misconduct on intermediaries that have launched questionable WMPs. Prime Minister Li Keqiang has been on the public record a number of times in support of a more efficient use of funding into the real economy rather than just growing the countries loan book.

In June, the government has been tightening the availability of credit in the system, and effectively forcing the banks to deleverage in advance of any catastrophic situation that may occur down the track if the government were to leave market forces in place with continuous credit growth and misallocation of credit.

What ammunition does the government have to combat any potential crises?

First and foremost is the Chinese government's sheer size of reserves which sits at circa \$3.2trillion USD. These have been accumulated over the decades as China has run strong current account surpluses. In any case of a crisis, the government can utilise these to bolster the banking system.

A long-term criticism of the Chinese system has been the issue of state ownership and control. In this case, China has a distinct advantage over Western economies like the US when facing a credit crunch head on. Reflecting on the US situation, when one bank (e.g. Merrill Lynch) was struggling to obtain any new interbank funding to keep itself afloat, the other banks tightened at the same time, unwilling to help its peer. In the case of China, the government can effectively order stronger banks to help its peer by "opening the pipes" to save them; a luxury the American's will never have.

Debt at the government level is also quite low in the context of the world, with the central government debt totaling 20% of output. If this is then coupled with regional and local government debt, this only total 50% of output. Therefore, the government has more room to raise additional debt to bail-out financial institutions if necessary. Additionally, as China maintains a medium term growth rate of circa 7%, its debt-to-GDP ratios will also fall over time.

Impact on Fund Strategy

For the Premium China/Asia Funds, there are clearly still pockets of growth, but not in the traditional sense. Through this ongoing "fiasco" the funds have been adjusting their way out of cyclicals that do not work in this current market environment and into sectors such as independent power producers (IPP) due to lower input costs, or SUV Manufacturers such as Changan Automotive Group. As opposed to popular thinking, the funds have also started building up exposures in tier 1 banks. This is due to the current issues plaguing the banking system; banks have fallen more than 15% off their previous highs and hence further value is on offer. These tier 1 banks are net lenders as opposed to net borrowers, putting them in a strong position during the reform period. As well as this, the developers we have exposures to in our funds (including the Premium Asia Property Fund) are the largest in the country and use traditional ways of borrowing that are not affected by the shadow banking system, such as from banks or the issuance of bonds. Overall, the investment team is reviewing the companies which are held in the portfolios that are highly leveraged and will adjust accordingly from a risk management perspective.

Final Comments

Yes, the shadow banking system is a problem for the economy, but it is a problem that the government is well aware of and is addressing in a controlled manner to ensure that imbalances and misallocation of credit is restored to the real economy without sending any unnecessary shocks into the financial system of China. In the short term, it will inevitably cause further market volatility due to tight liquidity, but in the long term it will strengthen the Chinese banking and credit system, which in turn will ultimately benefit the economy's ability to reallocate credit to the real economy and generate sustainable economic growth. At the end of the day, having a bank run, or credit crunch in China serves no benefit to anyone across the globe because if it were to happen, it would plunge the globe into an extended period of uncertainty. Therefore, we certainly do not believe that a bank run or credit crunch is likely to occur.

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