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Trivium China

Markets Note

What we do in the shadows: Our best guess as to why Zhongzhi's in distress

August 24, 2023 / No. 177

On August 14, Bloomberg reported that the National Financial Regulatory Administration (NFRA) – China's newly created financial regulator – set up a task force to deal with problems at Zhongzhi Enterprise Group, a private wealth manager.

Zhongzhi is hardly known outside of China, but reportedly has as much as RMB 1 trillion under management.

- Despite its size, Zhongzhi isn't systemically important, meaning the risk of widespread financial contagion is low.

The immediate risk is that Zhongzhi cannot repay investors the funds entrusted to it, resulting in large defaults.

- The broader risk is that investors with other private wealth managers are spooked and decide to reallocate their savings to safer institutions, like banks.
- That shouldn't be overly destabilizing unless other wealth managers are involved in practices similar to those we suspect Zhongzhi has engaged in – in which case they could also be subject to defaults.

The opacity surrounding Zhongzhi and its operations means few investors or analysts have been able to discern the extent of the challenges that Zhongzhi faces.

Based on our reading of Chinese and English press reports and our understanding of shadow banking, we suspect at the heart of Zhongzhi's problems is a mismatch between assets and liabilities.

We believe:

- The firm funded long-term corporate loans with funds raised from short-term investment products.
- By constantly issuing new investment products, Zhongzhi could meet interest payment obligations and use the newly raised funds to pay back the principal on maturing funds.
- It ran into difficulties because it could no longer raise new funds in sufficient volume, likely due to regulatory tightening.

This is how banks used to manage their wealth management products (WMPs) until the China Banking and Insurance Regulatory Commission (CBIRC) cracked down in 2018.

- Media reports suggest that such practices have persisted at Zhongzhi.

An overview

Zhongzhi manages a range of financial services companies. It has:

- A mutual fund
- Two insurance companies
- Five asset management companies
- A wealth management company
- A minority stake in Zhongrong International Trust

Most English language coverage of Zhongzhi's problems has focused on a recent spate of defaults on trust products issued by Zhongrong – one of China's 68 trust companies – in which Zhongzhi has a 33% stake.

However, local media has additionally reported that at least three of Zhongzhi's four wealth management units have suspended payment on WMPs since June, which tells us far more about Zhongzhi's operations and the challenges it faces.

WMPs are typically short-term (1–12 month) fixed interest investment products.

- Funds raised by WMPs are typically invested in assets like bonds or equities, or used to make loans.
- **If the assets fail to generate a return, the investors – not the issuer – bear the loss.**

It's highly unlikely that all Zhongzhi's WMPs simultaneously defaulted.

- Instead, for Zhongzhi to suspend payments on all its products suggests they are linked to each other.

That's how banks used to manage their WMPs prior to a 2018 regulatory overhaul.

The old model

Banks used to structure WMPs to include exposure to high-return corporate loans alongside lower yielding assets like bonds and money market funds.

- However, corporate loans typically have a longer maturity than most WMPs and trust products.
- As WMPs matured and the principal was repaid to investors, banks needed to issue another investment product to replace the maturing funds.

To ensure banks could always replace maturing capital, they started pooling the funds raised from multiple WMPs.

- WMP prospectuses became incredibly vague, providing little detail on how money would be deployed.
- That gave banks the latitude to pool together funds raised from many different WMPs.

Maintaining a pool of funds simplified the process of replacing maturing funds with new funding. But it also meant banks didn't need to recognize losses on assets the pool invested in.

- Banks could use funds from the pool to pay the interest and principal on maturing WMPs, regardless of whether the asset pool had generated a return.
- As long as the pool continued to grow, banks could keep rolling over delinquent loans, in effect using new investment products to provide funds for loans that would never be repaid.

However, this arrangement worked only as long as the pool of funds continued to expand.

- If it shrank, banks couldn't continue paying interest to investors, forcing them to recognize losses on bad assets.
- And if the pool shrank too much, banks would no longer be able to pay out maturing WMPs, as doing so depended on replacing old WMPs with new.

Regulators intervened to clean up banks' WMP operations before a major blowup occurred.

- However, we believe regulators haven't been as vigilant in dealing with WMPs issued by non-banks. In recent years, WMPs issued by developers – such as Evergrande and Kaisa – and conglomerates – such as HNA Group – have experienced significant losses.

Local reports of Zhongzhi's operations suggest it manages WMP funds in a similar way.

- Zhongzhi has a reputation for offering returns on its WMPs far above what banks now offer.
- Moreover, Caixin reports that Zhongzhi was pooling funds.
- According to media reports, both Zhongzhi's WMP and Zhongrong's trust prospectuses don't specify exactly how funds are used.

We suspect that three of Zhongzhi's wealth management units have stopped making payments because newly raised funds were no longer enough to paper over their losses.

- Caixin reports that regulators have recently tightened channels through which Zhongzhi has traditionally raised funds.
- If that's the case, it could explain the recent defaults.

So, what happens next?

Our best guess is that regulators take over Zhongzhi, restructure it, and sell it off, much like Anbang Insurance and Tomorrow Group, two heavily indebted financial services firms.

Things could also get worse for Zhongrong International Trust.

- If a large proportion of its products depend on Zhongzhi raising fresh funds to ensure repayment, then we should expect further defaults from Zhongrong.

We're confident that Zhongzhi doesn't pose a systemic threat to China's financial system.

- However, the fallout could have spillover effects.

Investors in other private wealth managers might be spooked and opt to put their money somewhere safer.

- If those wealth managers are engaged in the same practices as Zhongzhi, defaults could cascade throughout the wealth management industry, wiping out household savings on a large scale.

- Moreover, if other trust companies have similar relationships with wealth managers, defaults could spread through the trust sector as investors move their wealth into safer investments.

This is the worst-case scenario, and as painful as it would be, it wouldn't lead to a catastrophic meltdown of China's financial system.

- Regardless, it's fair to assume Zhongzhi's woes could weaken confidence at a time when property sector developers and overstretched local governments already represent a mounting stress in the financial system.
- And that might contribute to the default of the next large – but fringe – financial company.

Need anything more?

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