The Tricky Thing About Moral Hazard in China - China Real Time Report - WSJ

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Zhou Xiaochuan, governor of the People's Bank of China, pictured during a news conference in Beijing on Thursday, March 12, 2015.- Bloomberg News

China has unveiled a bank insurance deposit plan, but can it convince people that Big Daddy won't swoop in and save everyone?

China announced its bank deposit insurance plan this week after 21 years of discussion. The plan aims to strengthen the nation's creaky financial architecture and encourage banks and depositors to better evaluate risk by erasing the idea that Beijing will always step in to rescue financial institutions on the brink of failure.

But economists say getting banks to stop believing in that implicit guarantee could be tough.

"It's very, very tricky," said Mizuho economist Shen Jianguang. "It's very difficult to transmit this idea of risk."

As outlined by China's cabinet Tuesday, company and individual deposits of up to 500,000 yuan ($80,550) per bank will be insured by a fund run by the People's Bank of China that will cover over 99% of depositors.

One reason many Chinese believe their government will bail out struggling institutions is that it has repeatedly done so in the past in order to safeguard stability in the one-party state.

In the early 2000s, China used its foreign exchange reserves to bail out the four big state banks after they extended too many loans to state-owned companies that subsequently soured. A number of trust and wealth management products have since encountered repayment problems. But there have been no high-profile defaults to date and little transparency into how investors were eventually made whole.

In early 2014, a 3-billion yuan trust product named "Credit Equals Gold No. 1" — built on loans to a coal miner and sold by the Industrial and Commercial Bank of China — faced default risk only to be bailed out at the last minute by an unidentified third party.

"In fact, the word 'implicit guarantee' has been widely used in almost all investment products in China, including the risky shadow banking trust products," OCBC Bank wrote in a research report. This has undermined market discipline and "created the wrong impression that Chinese banks will never go bankrupt," it added.

While Tuesday's insurance plan chips away at moral hazard — the belief that you're fully protected at someone else's expense – the idea of an implicit guarantee is endemic to a system in which most banks and many of their customers are state-owned, analysts say.

There's a persistent belief that Beijing won't let one of its own go under, said Gan Jie, a finance professor at the Cheung Kong Graduate School of Business. And their employees' promotions and pay aren't necessarily linked to performance, she added, blunting the focus on market results.

"All top executives are pretty much state officials, so they have an incentive to play politics," Ms. Gan said. "It's very difficult to get rid of the implicit guarantee without changing the whole incentive system."

Removing implicit guarantees may be a secondary objective as Beijing focuses on managing risk and strengthening its financial structure. With deposit insurance in place, analysts say, China can move on introducing a bank bankruptcy law, granting charters to more private banks, freeing up interest rates and liberalizing capital markets. "This year, they're laying the framework," said Oliver Barron, head of investment bank North Square Blue Oak. "Clearly they have not removed the moral hazard."

Even assuming these other building blocks are put in place, there's still the knotty problem of how to let a financial institution fail – the best way to encourage people to start factoring risk into their decisions — without sparking fear, contagion and bank runs.

"Even the U.S. hasn't figured out how to avoid systemic risk," said Ms. Gan. "And in China, things are 10 times more complicated."

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