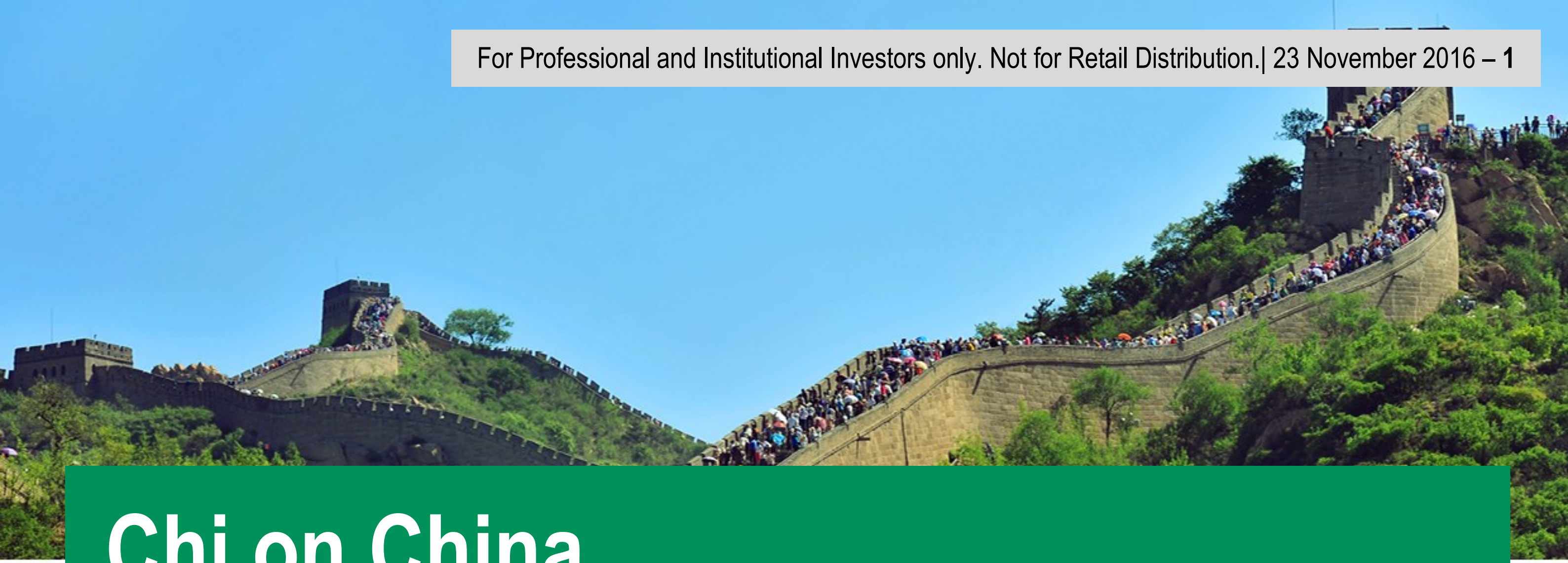

Chi on China

WHERE DOES CHINA'S FINANCIAL RISK LIE?

You can fool all the people some of the time, and some of the people all the time, but you cannot fool all the people all the time.

Abraham Lincoln

Summary

- The focus on China's rising debt level and worsening asset quality is exaggerating the fear about a banking crisis. China's financial risk is still localised in nature because the current system distorts rational domestic creditor's behaviour and, ironically, reduces systemic risk.
- We cannot ignore the risk of local financial accidents which could turn viral if not tackled properly when the system changes over time. The local risk stems from the rapid expansion of small and regional banks that rely on wholesale funding and abuse financial innovation for regulatory arbitrage.
- However, comparison of China's situation with the US pre-subprime-crisis conditions is inappropriate because of the differences in funding structures and creditor behaviour. In China, no one can easily pull the plug on the banking system and send it into a tailspin yet.

International credit-rating agencies have been warning about the danger of a Chinese banking crisis for quite some time. Recently, Fitch Ratings warned that China's bad loans in the banking system might be 10 times the official estimates of 1.8% of total assets[1]. S&P also warned that the growing piles of local government debt and corporate debt would add to China's fiscal vulnerability and cost the banks dearly[2].

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[1] See "*China's toxic debt pile may be 10 times official estimates: Fitch*", CNBC, 23 September 2016 http://www.cnbc.com/2016/09/23/chinas-toxic-debt-pile-may-be-10x-official-estimates-fitch.html

[2] See "China faces delicate balance between debt and growth: S&P", CNBC, 13 October 2016 http://www.cnbc.com/2016/10/13/china-debt-gdp-growth-a-delicate-balance-for-beijing.html

That China's banking system has a non-performing loan (NPL) problem is nothing new. The predictions of a Chinese banking crisis have been proven wrong for more than three decades because pessimists treat China as an open-market driven system with a liberalised capital market and an open capital account, which is clearly not the case. This is not to deny China's financial risk. But the concerns should lie somewhere else in the system rather than in a systemic blow-up.

A systemic financial "bomb" that won't detonate

Despite its high debt level, China's financial risk is still localised in nature rather than systemic[3], though this will change as China continues to liberalise its financial sector and capital account. However, as long as the current system set-up remains, or changes very slowly, an increase in bad assets *per se* is probably not enough to trigger a financial crisis. This is because the government still owns the major banks which are funded by stable retail deposits. Its implicit guarantee policy is the linchpin that holds the system together by, ironically, distorting creditors' behaviour.

If China were an open and mature market and given its NPL problem, the creditors would lose faith in the debtors and cut funding, leading to a systemic collapse in the form of a debt-currency crisis. However, the majority of the creditors in China are the households, who are ultimately backed by the government's implicit guarantee policy.

So long as there is no loss of public confidence, the creditors in China will not cut off funding to the banking system which, in turn, will not cut off funding to the corporate sector. This "irrational" behaviour suggests that no one could pull plug on China's financial system easily, so there would not be a financial crisis or capital flight or a collapse in the renminbi exchange rate. Meanwhile, China's closed capital account helps lock up domestic liquidity and keep the banking system whole.

What about China's surging debt-service burden, which is now the highest among the major economies (Chart1)? The Bank for International Settlements (BIS) argues that when a country's private-sector debt-service ratio rose to above 25% of GDP a year, a financial crisis would follow later[4], citing the experience of the high-profile financial crises in Finland in 1991-92, South Korea in 1997-98, the US and the UK in the early 1990s and more recently in 2007-08. Some market estimates have put China's non-public sector debt-service ratio at over 30% in 2015, higher than the BIS's estimate of 20%. However, the crisis triggers, namely a deregulated financial system, a heavy foreign debt burden and an open capital account which pushed these countries over the cliff, are not present in China.

Thus, focusing on China's high debt level and poor asset quality is exaggerating the fear about a systemic blow-up. Generally, banks do not fail because they have bad assets. They fail when they cannot fund themselves either through deposits (as in a classic bank-run case) or the wholesale market. The trigger for a banking crisis lies on the liability side of the bank balance sheet; a rise in bad assets *per se* does not necessarily bring down a financial system.

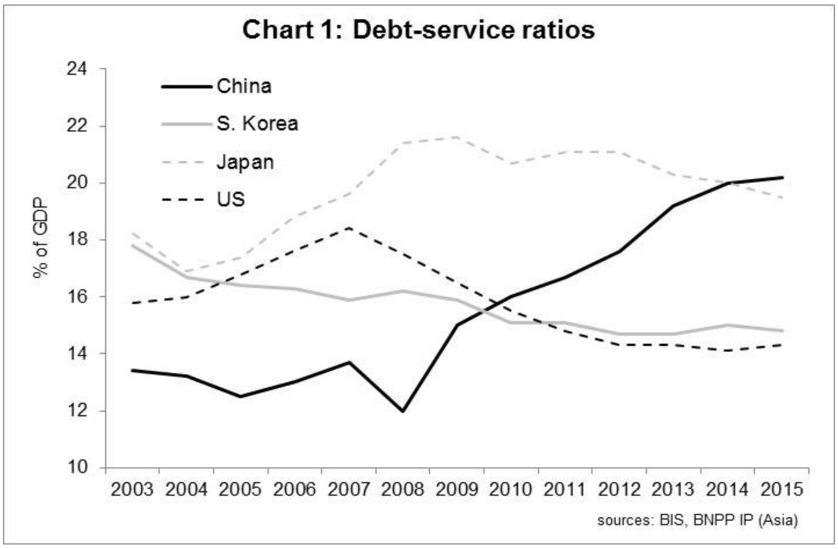
Chinese banks may have bad assets, but they have stable funding from domestic deposits. Despite years of gradual increase, the system's credit-to-deposit ratio[5] is only 100% (Chart 2). This is less than half of the ratios

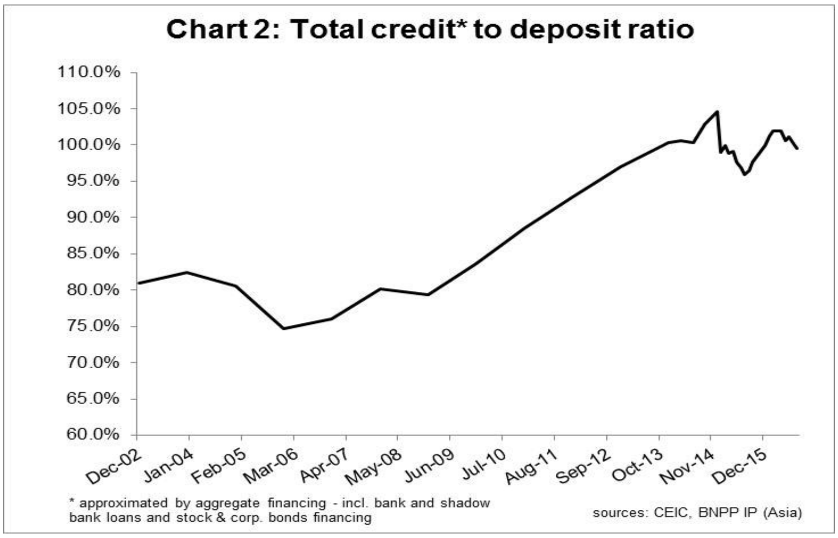
[3] See "*Chi on China: China's Debt Problem May be Different From What You Think*", 11 May 2016.

[4] See "*Do Debt Service Costs Affect Macroeconomic and Financial Stability?*" M. Drehman and M. Juselius, BIS Quarterly Review, September 2012.

[5] China scrapped the 75% loan-to-deposit ratio regulatory cap (which was put in place in 1975) in October 2015.

seen in many other countries. Foreign creditors play no role in funding Chinese banks, so the system is not susceptible to withdrawal of foreign funds.





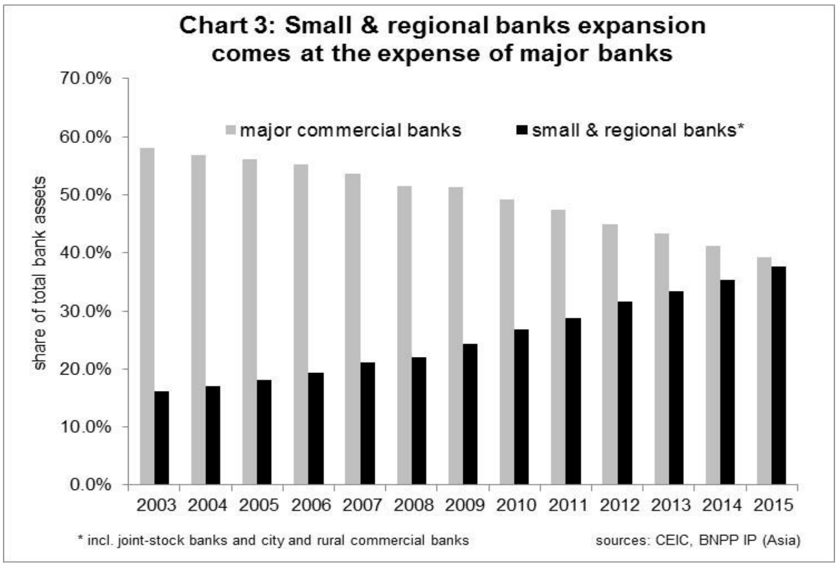
The risk lies somewhere else

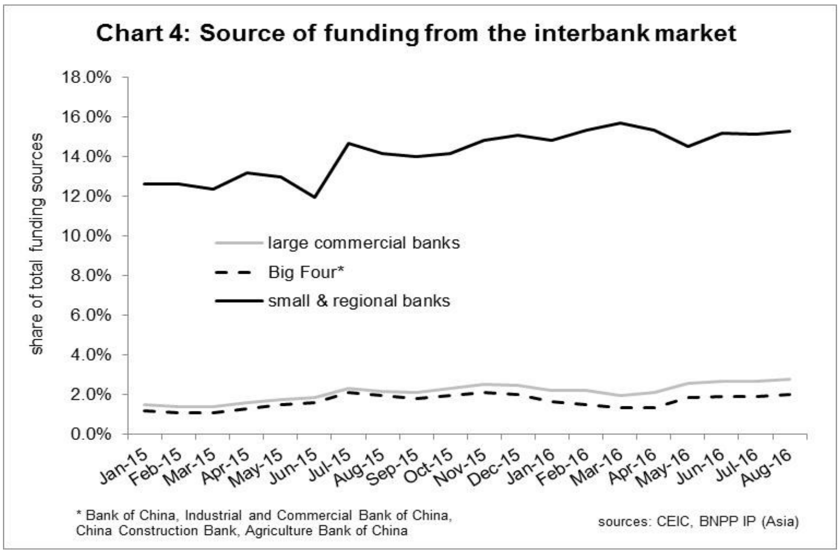
All this is not to deny any financial risk in China. There is indeed a rising risk of some localised financial failures, thanks to the rapid expansion of small and regional banks[6] (Chart 3) many of which have engaged in regulatory arbitrage through opaque and complex financial activities funded by wholesale funding. To see this, note that interbank borrowing by small and regional banks has risen from 12% of their total funding sources in 2015 to 15% in 2016, compared to about 2% by the large commercial banks and the Big Four (Chart 4). Bottom-up data from 26 listed Chinese banks shows that almost every small and regional bank had increased their reliance on interbank funding between 2013 and 2015, with the share of interbank borrowing ranging between a quarter to half of their funding sources[7]. The big Chinese banks are well funded through their deposit networks and their

[6] These banks include joint-stock banks, city commercial banks and rural commercial banks. Joint-stock banks have mixed public-private ownership with the majority stake still held by the (central or local) government. The city and rural commercial banks also have mixed ownership but with only a minority stake held by the local government (the central government is not involved).

[7] Data from three mid-sized listed banks, namely Bank of Junzhou in Liaoning, Zheshang Bank in Zhejiang and Industrial Bank in Fujian shows that nearly half of their funding sources came from the interbank market.

relationship with the government and SOEs. However, small banks lack this advantage and have, thus, become more reliant on wholesale funding.

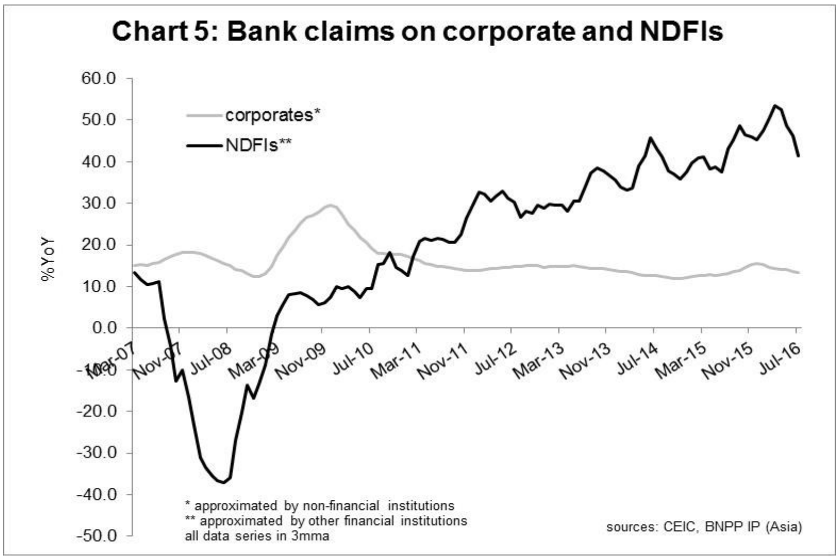




Normally, an increase in reliance on wholesale funding raises systemic risk because when the interbank market seizes up, as it typically does during times of financial stress, these small banks would be vulnerable to funding squeeze which could, in turn, create a domino effect on the system. In the developed markets, this could lead to a systemic collapse. But the situation in China is different. The People's Bank of China (PBoC) would most likely step in either to keep funds flowing or force the major banks to take over the small troubled ones, as it did in 1998 when it asked the Industrial and Commercial Bank of China to absorb all the liabilities of Hainan Development Bank.

How do they cheat?

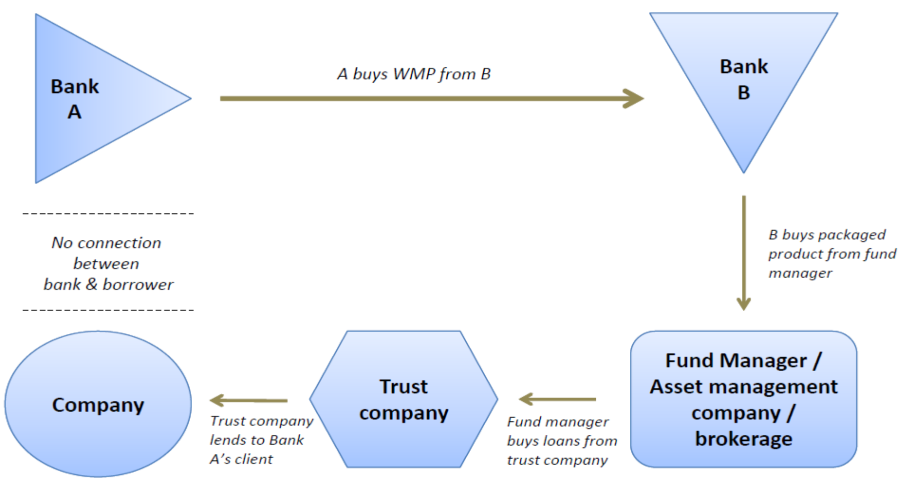
The weakest link in China's banking system is the increasing complexity of credit creation, which involves multiple layers of transactions between banks and non-deposit-taking financial institutions (NDFIs) aiming at eschewing regulatory constraints on lending. Bank lending to NDFIs has grown at an annual average rate of 35% since 2011, even when other types of bank loan growth has remained relatively stable at around 14% (Chart 5).



Trust companies play a central role in this bank-NDFI nexus, which emerged in 2009. Being NDFIs, trust companies cannot take deposits but are allowed to make loans and invest in real estate and securities. They package their investments or loans into wealth management products (WMPs) and sell to banks, which may re-sell them to their clients or keep them as investment. Since 2014, other NDFI players, including fund managers, asset management companies and brokerage firms, joined the game, adding many layers to the credit creation process.

In a stylised example (Chart 6), a company approaches Bank A for a loan. But the Bank's lending ability is restricted by some regulatory constraints (see below). So it makes the following arrangement for its client: It buys a WMP from Bank B, which uses the proceeds to buy some packaged assets from an asset manager. The asset manager uses the funds to buy loans from a trust company, which then uses the proceeds to lend to Bank A's client. In the end, the company gets a loan via this complicated credit creation process without having any connection with Bank A who is the *de facto* lender by eschewing the regulatory lending constraints. All the other players are, arguably, rent-seekers in facilitating this regulatory arbitrage process.

Chart 6: Stylized example of regulatory arbitrage involving banks & NDFIs



Source: BNPP IP (Asia)

The credit risk of the final borrower does not change regardless of how many layers of credit creation are added. But complicating the credit creation process increases systemic risk: if any one of the players defaults, it will set off a domino effect by triggering counter-party risk. According to industry estimates, two-thirds of the credit created by this complicated process ends up as loans to the real economy.

Why do they cheat?

The innovative credit creation process is indeed regulatory arbitrage. Under Chinese regulations, a corporate loan carries 100% risk-weighting for capital adequacy purposes. An indirect loan routed through a NDFI counts as an interbank claim and carries only a 20% risk-weighting. So the process lowers the banks' capital charge and allows them to expand their loan books by breaking the regulatory constraints but not breaching the regulations. But it also encourages rent-seeking and financial excess to build up[8].

Banks also exploit this multi-layer process to dress up their sickly balance sheets. For example, Bank A might sell a bad loan to an asset management company, which then sells the cash-flow rights of the loan to a brokerage, which packages them in a WMP and sells it to Bank B. Bank B then repackages the WMP into a new investment product and sells it to Bank A.

In this transformation, Bank A "magically" turns a bad loan into a "safe" interbank claim on Bank B, which is recorded as investment in A's balance sheet. The "paper" risk of Bank A disappears, but the underlying risk from the bad loan is still there. Most importantly, the process has increased systemic risk.

Not yet a dire problem

Such regulatory arbitrage activity funded by the wholesale market looks similar to the situation in the US before the subprime crisis in September 2007, leading many observers to fret about a financial meltdown in China sooner or later. However, the comparison with the US situation is not appropriate at this stage. This is because the majority of the Chinese banks do not rely on wholesale funding, which is a major determinant of bank vulnerability during the US subprime crisis. In China, wholesale funding accounts for only 14.5% of total funding, according to the PBoC, compared to 75% at the peak in the US system.

Furthermore, virtually all banks in China are owned (directly or indirectly) by the government. There are only five private (small) banks, and foreign banks account for less than 1% the banking market share in China. All the major NDFIs are also majority-owned by the government. The point is that the state is behind the Chinese financial system. The US crisis was triggered by private creditor decision to cut off funding for over-extended firm such as Bear Sterns and Lehman Brothers. In China, the state ownership and implicit guarantee policy distort rational creditor behaviour which, in turn, helps preserve the system. In the event of defaults by small institutions, the government can also order the big state-owned banks to keep the credit lines open.

There is certainly risk in the Chines financial system, but it is not systemic yet.

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[8] Interested readers can further read "*China's Impossible Trinity: The Structural Challenges to the Chinese Dream*", pp.115-120, Chi Lo, Palgrave Macmillan 2015.

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