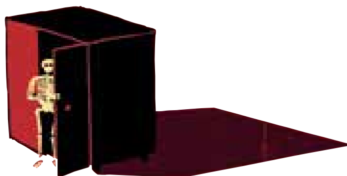

SKELETON IN THE CLOSET

Is China's shadow banking industry really a threat to its entire financial system? Paul Golden reports

The impact of shadow banking activity on China's economic development is a sensitive subject in domestic government and finance circles. The International Monetary Fund, and even the People's Bank of China (PBOC), have warned of the danger of unchecked shadow bank lending pushing up levels of bad loans as the growth of the economy slows.

Yet, as recently as June, the chairman of Industrial and Commercial Bank of China launched a defence of such lending, saying it supported commercial growth in the manufacturing and construction sectors. Jiang Jianqing said loans from informal lenders were "invested in the real economy" whether they came from trusts, wealth management products or other channels.

Also in June, the banking industry regulator China Banking Regulatory Commission (CBRC) referred to relatively significant downward pressures on the economy as a reflection of "imperfect financing structures, inefficiencies in finance allocation and use, and difficulties with small- and medium-enterprise financing".

But research by private-sector polling organisation China Beige Book suggests that the economic slowdown is working in the regulator's favour by reducing demand for shadow bank lending. In the second quarter of this year, interest rates charged on these types of loans fell below the rates charged on conventional bank loans for the first time, indicating that firms are reducing their borrowings.

The factor that has made the largest contribution to the growth of shadow banking in China is the cap on lending and savings rates, which are controlled by the central bank. The state-owned banks will not lend to small businesses because they cannot charge them higher rates than large corporations that have a lower risk profile. Therefore, small businesses have to rely on informal lending for financing, for which they pay higher interest rates.

Yingying Xu, an economist at the Manufacturers Alliance for Productivity and Innovation, explains that shadow banking initially boosted Chinese export activity because most exporters are small- and medium-sized private businesses. It is only since the start of this decade that the exponential growth of this type of lending to local government (for infrastructure construction in particular) has started to cause concern.

Appeal of shadow banking

Despite its dubious moniker, the shadow banking industry attracts funding from both formal financial institutions and savers, who see it as an alternative to investing in a stock market that has been depressed for several years or seeing the value of their cash deposits eroded by interest-rate caps.

According to Chris Devonshire-Ellis, founding partner of Dezan Shira & Associates (which provides tax advice to foreign direct investors across Asia), the interest rates charged by informal lenders are so high that it is questionable whether such lending creates significant long-term benefit for the businesses that borrow the money. He says: "It seems that the Chinese government has tried a number of different tactics to limit

the growth in loans created outside formal channels without success. This suggests that either the government has lost control of its economy or that the shadow banking industry is unofficially supported by the state."

Advocates of shadow banking claim that putting a restriction on lending would negatively impact the economy. But Devonshire-Ellis is sceptical about how much of this money actually goes to worthwhile projects or businesses in any case. "I would suggest very little is actually long-term investment capital, so I don't think restrictions would have much impact on *bona fide* businesses' potential," he notes.

In January, the CBRC said it would implement a limited licence regime and set up three to five private banks on a trial basis in an effort to deepen reform in the domestic banking sector. It also said that it would explore lowering the threshold for foreign banks to enter the industry.

Devonshire-Ellis describes this proposal as 'window dressing' and is equally dismissive of the CBRC's commitment to lower the entry threshold for foreign banks.

"Foreign banks generally have much stronger balance sheets than Chinese institutions, which would not be able to compete," he says. "There is so much unserviceable debt out there that if the full extent of this debt emerged, it would seriously damage China's credit rating. I think China will try and keep foreign banks out, and look at other ways to spread its debt across the global economy to lessen damage to China when the crunch happens. The Communist Party won't care too much about the impact on other markets; it just wants to keep its own country intact."

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> "Right now, we judge that financial risk lies mostly with entrepreneurs rather than shadow banking institutions; and shadow banking probably does not pose a big threat to Chinese public finances"

Credit risk issues

It has been suggested that interest-rate liberalisation and China's deleveraging strategy would lead to improved credit risk management, but such an outcome is far from inevitable, according to Peter Wong, founding chairman, International Association of CFOs and Corporate Treasurers (China), and executive board member of the Hong Kong-based Treasury Markets Association.

He suggests that, as Chinese banks face the pressure of reduced margin, some may choose to lower their credit standard to expand their loan book. "During the 1980s, the US experienced a setback in implementing interest-rate liberalisation when around 1,000 savings and loan associations or regional mortgage banks bankrupted in an attempt to lower underwriting standards to compete for loan volume to compensate for reduced margin."

As the CBRC is implementing Basel II standards, and credit risk (along with operational risk and market risk) is one of the three enhanced risk control measures for banks, it is reasonable to assume that credit risk management in general should be strengthened in Chinese banks.

Some financial institutions may diversify to develop non-interest income, Wong continues. "Hong Kong implemented interest-rate deregulation in stages between 1994 and 2001. While the net interest margin dropped from an average of 2.6% for domestic banks in 2001 to 1.39% in 2013, their capital adequacy ratios have remained relatively stable at 16-17% during that period."

Privately financed banks would probably have more control over the interest rates they charge, but they would not address the problem of interest-rate caps within the state banks, adds Xu. "Without meaningful reform on liberalisation of interest rates, private banks wouldn't be able to charge higher rates to riskier borrowers and they wouldn't be able to compete on a level playing field with state-owned banks to attract savings either. The Chinese banking system does not currently allow for proper risk assessment and it is unclear what regulations the privately financed banks would have to comply with. There is risk assessment in state-owned banks, but it is still at an early stage of development."

Wong is more optimistic, suggesting that privately financed banks should further increase bank competition and encourage product innovation. Since they need to grow their balance sheets, businesses should benefit from an alternate source of funding.

Furthermore, Wong expects the CBRC to lower the entry threshold for foreign banks. "Since its formation in 2003, the CBRC has implemented banking reform very successfully. On the structural aspects, most major banks have been listed, with the first one being China Construction Bank in 2005. Improved

The Financial Stability Board's *Global Shadow Banking Monitoring Report 2013* refers to an increase of 42% in assets of 'other financial intermediaries' in China in 2012. According to analysis from Credit Suisse, core Chinese shadow banking products were worth RMB 22.8 trillion ($3.72 trillion) at the end of 2012, accounting for 44% of GDP and half of all new credit issued.

corporate governance and alignment with international standards have been greatly facilitated by the participation of global banks as strategic investors. Further opening up the entry threshold for foreign banks is consistent with the latest central government policy to continue reform towards a market-based economy."

Alternative measures

David Blair, an independent treasury consultant based in Singapore, reckons the Chinese government will struggle to limit the growth in loans created outside formal channels without significantly affecting the flow of credit to businesses. He says alternative macro measures would be more appropriate for deflating bubbles and observes that even credit going to *bona fide* commercial business gets recycled in multiple ways into real estate and other 'bubbly' sectors.

"The failure of state-owned banks to lend to customers other than state-owned enterprises and large companies – as well as the fixing of interest rates by the PBOC – have been the key drivers for shadow banking expansion. It is unlikely that state-owned banks can effect the required culture changes fast enough to replace shadow banking," he notes.

He agrees that there will be some bumps in the road towards improved credit risk management, even if interest-rate liberalisation and deleveraging are achieved, while adding that deleveraging will reduce credit risk in the long term almost by definition, and that long-term interest-rate liberalisation will lead to more efficient capital allocation and thus lower credit risk in the system.

Blair expects the CBRC to lower the entry threshold for foreign banks, but only to an extent that will enable it to maintain control of the banking system. "It is important to note that shadow banking is not some kind of people's rebellion against a rigged finance system," he says. "The PBOC found that the old system has created massive distortions and terrible capital allocation, but the state-owned banks are too big to change, so the central bank 'let a thousand flowers bloom' to see how it pans out. It is not old-style micro managing, but the PBOC could still shut shadow banking down very fast if it felt the need to. It has observed that there is huge, pent-up retail demand for yield and will observe what works and try to encourage that."

The main risks resulting from shadow banking are liquidity risk due to maturity mismatch, credit default risk from loans to weaker companies or projects, and the exacerbation of already high corporate overstretch as shadow banking helps to plug cash holes, concludes Tim Summers, principal at Hong Kong-based XTEChina Consulting.

"There are few tools available to identify clearly or quantify these risks," he says. "Right now, we judge that financial risk lies mostly with entrepreneurs rather than shadow banking institutions; and shadow banking probably does not pose a big threat to Chinese public finances. This situation may change, however, if rapid growth in the sector continues."

In terms of global financial markets, the biggest victims of a Chinese shadow banking crash would be foreign companies that have invested in China. Owing to the restrictions on capital outflow from China, these companies cannot liquidate their assets and take back their invested capital easily.

WHAT IS SHADOW BANKING?

The shadow banking system consists of financial intermediaries involved in facilitating the creation of credit across the global financial system and which are not subject to regulatory oversight. The term is also used to refer to unregulated activities by regulated institutions, such as credit default swaps.

Paul Golden is a freelance journalist who specialises in writing about finance