THE EAST IS RED

CHINA'S MOUNTING DEBT PROBLEM

BREAKINGVIEWS

REUTERS

THE EAST IS RED

CHINA'S MOUNTING DEBT PROBLEM

BREAKINGVIEWS
REUTERS

CONTENTS

REUTERS

INTRODUCTION
CHINA’S FINANCIAL PARADOX: RESCUE OR REFORM?

China's financial system is a paradox. Reform demands that the authorities relax their grip on banks and capital flows. But if they do, it could trigger the debt crisis the country has so far avoided.

On a broad measure, Chinese credit is now almost 200 percent of GDP, according to the International Monetary Fund. Such a level of borrowing is unprecedented among countries that are still developing. The rate of increase is alarming too: at the end of 2008, total credit was just 129 percent of GDP.

Much of the lending has been wasteful. Industries from steel to shipping to solar panels are being kept alive because state-backed lenders are reluctant to call in loans. Meanwhile, local governments have borrowed through opaque financing vehicles, accumulating a debt pile that the central government struggles to measure.

In most countries, such a rapid boom would have already become a painful bust. Yet China has so far avoided a crisis, and may continue to do so. Capital controls are part of the explanation. China is less vulnerable to the self-fulfilling runs that threatened Western financial institutions five years ago.

The state also directly controls large parts of the financial system. Deposit rates are capped, guaranteeing banks cheap funding and borrowers low-priced loans. Meanwhile, big state-owned banks are tools of state policy. The government can tell them when to open their wallets - and when to put them away.

Much of what counts as debt in China is actually a claim from one branch of the government on another. State-owned banks lend mostly to state-owned companies. Local government borrowing can be seen as a disguised form of fiscal policy. Though the numbers are large, the government could afford to take these obligations onto its books.

China has been here before. In the late 1990s as many as 30 percent of the loans on banks' balance sheets had gone bad. The government stuffed the dud loans into bad banks, and partially floated the cleaned-up lenders on the stock market. Beijing would be ill advised to repeat the exercise.

That is why China is preparing reforms. At the World Economic Forum in Dalian on Sept. 11, Prime Minister Li Keqiang spelled out a list of actions: liberalising interest rates, loosening capital controls, relaxing state ownership of the banking system, expanding capital markets, and introducing insurance on bank deposits.

If China really became a market-based financial system, interest rates would be set by supply and demand rather than government dictat. Loans would flow to the most profitable investments, rather than industries favoured by bureaucrats. Companies and local governments would suffer the consequences of reckless borrowing, while banks would be forced to recognise and write off bad debts.

The cleanup need not become a cataclysm: if China's largest eleven banks wrote off 10 percent of their loans, they would need $500 billion in fresh capital, according to Reuters Breakingviews calculations. While large, this figure represents a little more than two times the pre-provision operating profit the same banks earned last year.

The bigger question is whether the state can give up control without sparking broader panic. Today, the government's implicit backing helps maintain faith in bank deposits, state-owned enterprises, wealth management products, and debt issued by local government-backed vehicles. That faith remains untested: no domestic bond has yet been allowed to default.

Removing that guarantee is essential to reforming the financial system. But doing so, even gradually, could have all sorts of unforeseen consequences. Solving that paradox could be the challenge that defines China’s next decade.

Peter Thal Larsen
Asia Editor, Reuters Breakingviews
September 2013

WARNING SIGNALS

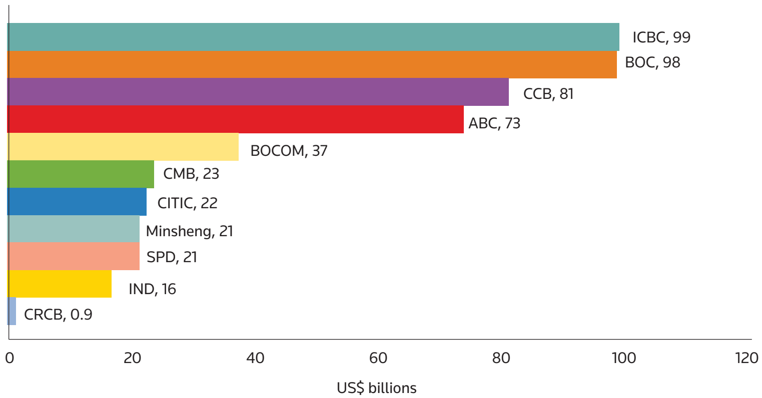
CHINA'S BAD DEBT COULD LEAVE $500 BLN EQUITY HOLE

BY JOHN FOLEY

China's bad debts could blow a $500 billion hole in bank balance sheets. That's roughly how much extra equity the eleven biggest lenders might need if 10 percent of their loans went sour, according to a Breakingviews calculator. Though the chairman of ICBC, China's biggest lender, thinks dismal bank valuations are "unfair", the malaise is well deserved.

China's banks: how much equity do they need?

How 11 lenders will fare if bad debts rise to 10 percent, and risk-weighted assets grow 20 percent



Banks featured: Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), Bank of China (BOC), Agricultural Bank of China (ABC), Bank of Communications (BOC), China Minsheng Bank (Minsheng), China Merchants Bank (CMB), China CITIC Bank (CITIC), Industrial Bank (IND), Chongqing Rural Commercial Bank (CRCB), and Shanghai Pudong Development Bank (SPD).

Source: Bank interim earnings statements; Thomson Reuters. J. Foely, K. Hamlin, R. Mak 18/09/2013

To interact with this chart click on the chart area.

On the face of it, the industry is in great shape. Non-performing loans were below one percent of total loans at the end of June. But that number is meaningless. Many bad loans are simply rolled over while overdue loans, a herald of problems to come, are multiplying at some banks. Of particular concern is the $1.5 trillion of credit channelled to local governments through financing vehicles.

Assume the real bad loan ratio is a plausible ten percent, and that banks have to clean up their own mess. That would leave big lenders with $511 billion (3.2 trillion yuan) of bad debts they haven't already set aside provisions for. Though capital ratios are currently above the minimum required by regulators, banks would need almost $350 billion of new equity to recover from the shock.

They also need capital to make new loans. If risk-weighted assets expand by 20 percent, the total equity required is $491 billion. In this scenario, ICBC would need to raise the equivalent of 53 percent of its current equity, Bank of China 73 percent. It could be more if regulators force lenders to take off–balance sheet loans back onto the books.

Fortunately, fees from selling wealth products and credit cards – not to mention cheap funding from capped deposit rates – mean earnings are healthy. Even $500 billion is just twice the eleven lenders' combined pre-provision operating profit for 2012. They could also conserve capital by selling loans to China's asset management companies, as Bank of Communications did recently, or cutting back the $50 billion they pay in annual dividends, most of which goes back to the government.

China may choose to defer the reckoning rather than face up to its bad debt problem. But valuations are already languishing: big banks trade at just 90 percent of their estimated book value a year from now, according to Bernstein Research. The hit, when it comes, will be large.

4 September 2013

CHINA'S DEBT MOLEHILLS COULD TURN INTO MOUNTAINS

BY JOHN FOLEY

Tourists visit the Badaling section of the Great Wall on the outskirts of Beijing on the second day of the Chinese Lunar New Year February 4, 2011. REUTERS/Petar Kujundzi

The mountains are high, and the shareholders are far away. China's banks are reporting results that suggest their bad debts are under control and earnings healthy. But where investors don't easily see them, risks are growing. It's at the local level that the problems with China's debt build-up could escalate most rapidly.

The six large and mid-sized lenders that had released half-year figures by Aug. 27 reported an average 15 percent increase in earnings. Non-performing loans were, on average, a mere 0.9 percent of the total. Look closer, however, and things are more precarious. Take the export-dependent east coast. China Construction Bank increased its charges against future bad debt in the Yangtze River Delta by 52 percent year on year. China Merchants Bank's reported bad loans in the area increased by 37 percent, while Shanghai Pudong Development Bank increased its provisions in the three delta provinces by 76 percent.

Some industries are also a greater cause for concern than the headline numbers suggest. In the over-expanding retail sector, bad debts are rising. Shanghai Pudong Development Bank reported retail and wholesale bad loans increased by 22 percent from the year end, CCB by 19 percent. At China Merchants Bank, the number rose by 48 percent, and at Industrial Bank by 50 percent. With so many privately owned companies in retail, there is less chance of local or central government stepping in as it might in, say, shipping or steel.

Diversification protects the big lenders. But even at China's megabanks, a small problem could still escalate. China's shadow banking system has spread credit risk to institutions whose finances aren't visible, like credit guarantee companies. Banks also play pass-the-parcel with debt, repackaging loans into investments such as "trust beneficiary rights". These instruments, which channel loans through off-balance sheet vehicles but leave banks with the underlying credit exposure, accounted for almost half of new assets accrued by Industrial Bank and Shanghai Pudong Development Bank in the first half.

Lenders and regulators are aware of the risks. CCB chairman Wang Hongzhang warned of the potential for a "hidden crisis", even as his own institution showed no change in its bad debt ratio. That contrast shows how unhelpful reported bad debt numbers have become. Bank investors need to watch for the molehills before they turn into mountains.

27 August 2013

EXPOSED BONDHOLDERS SUFFER SOLAR BURNS IN CHINA

BY JOHN FOLEY

Pedestrians are seen in front of the setting sun in Beijing May 2, 2013. REUTERS/Kim Kyung-Hoon

Who wants equity-like risk for a debt-like return? Investors in bust Chinese solar panel maker Suntech got something close when they bought $575 million of convertible bonds back in 2008. Even though the bonds remain unconverted, the company's bankruptcy could leave them with pennies – little better off than regular shareholders. Yet the lessons appear to be going unheeded.

Suntech's bonds were issued through a Cayman Islands holding company, with no guarantee from the panel maker's onshore operations. Though it sounds risky, such structures are common in China. Getting regulatory approval to issue or guarantee an offshore bond takes time. As a workaround, most companies raise funds through a foreign holding company or subsidiary, and then channel proceeds onshore as foreign direct investment. Keen for yield, investors have mostly decided that's good enough.

Companies have made some improvements in recent years. Some bonds now come with a "keepwell agreement", where the issuer promises to avoid insolvency. A related innovation is that if there is a default – and the regulator approves – the onshore company automatically buys out a subsidiary, with the cash going to bondholders. Such innovations can enable companies to lower the coupon on a new issue by 0.25 percentage points, say people who have worked on such deals. Still, such promises have yet to be tested.

Investors are undeterred. Chinese real estate developers issued $5 billion of offshore bonds in January and February alone. Some used keepwell agreements. Others were guaranteed by offshore subsidiaries, though still lacking a direct link to what sits onshore. Chinese real estate is risky and in many cases, carving up onshore assets in a bankruptcy would see investors at the back of the queue.

Issuers, meanwhile, are making the most of a good thing. Shimao, a highly indebted developer, issued bonds at 6.6 percent in January, little over half what it paid for similar bonds a year earlier. Gemdale, one of the first to use a keepwell agreement in China, recently sold five-year bonds for roughly half the yield it paid on shorter-term money in July. In the hunt for yield, Suntech's bondholders won't be the last to get burned.

22 March 2013

THE LOWDOWN ON CHINA'S SLOWDOWN

BY JOHN FOLEY

For China, 2013 is becoming the year of the credible shrinking GDP growth target. Earlier in the year, the old 8 percent norm was shaved down to an official estimate of 7.5 percent. On July 11, Finance Minister Lou Jiwei moved that to 7 percent – and said an even lower number was possible. What's going on? Here's the lowdown on the China slowdown.

China's slowdown is real – but relative

While President Xi Jinping has told China's officials to worry less about GDP and more about quality of life, investors still focus on the crude indication. The official target of a 7.5 percent increase would already have created China's slowest growth since 1990. The official acceptance of a lower number shows that the old received wisdom – anything below 8 percent puts China at risk of rising unemployment and social unrest – has been discarded.

For China-watchers, 6 percent growth sounds bizarre. It was not that long ago that double digits were normal. But by the standards of other middle-income countries, China is still doing exceptionally well. The International Monetary Fund expects 3 percent GDP growth this year in both Latin America and the Middle East.

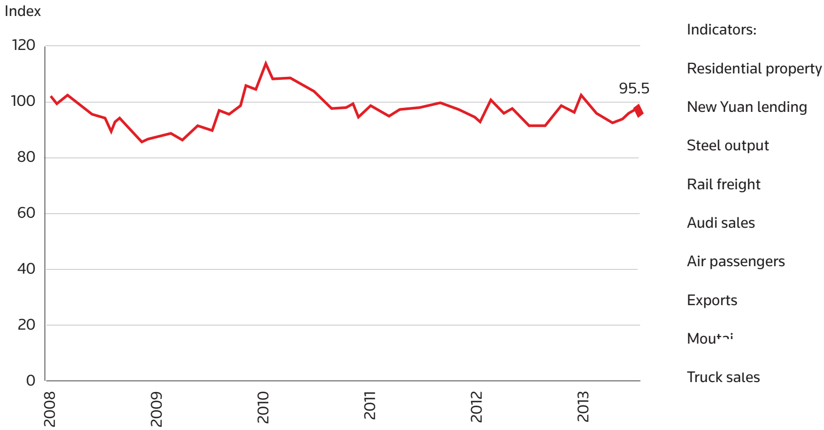
It has three causes

First, demand for exports from China is slowing. June's 3 percent decline is especially weak, but the average increase over the last twelve months is the slowest rate since the beginning of 2010. A strong currency hurts, as does weak demand. But as China gets richer, it's natural that the currency rises and that exports based on cheap labour fade away.

Second, economic gravity is catching up. The Chinese workforce is no longer increasing and the pace of urbanisation is slowing because so many people have already left the farms. Of more concern is the decreasing efficiency of investment. A few years ago, only one yuan of investment was needed to add a yuan to GDP. Now it takes almost four yuan.

Breakingviews China Tea Leaf index

Tracking China's growth through ten alternative indicators



Source: Datastream, Company reports, Foggybeijing.com; J. Foley, K. Hamlin, R. Mak 18/09/2013

To interact with this chart click on the chart area.

Finally, the authorities are not trying to fight gravity. The government knows about stimulus; it did a huge one in 2009. With a fiscal deficit of just 2 percent of GDP and total control of the big banks, it has the means. It also controls the statistics, so can basically report whatever number suits. Clearly, the authorities are comfortable with lower GDP growth numbers.

It's not about credit

China's growth has been fuelled by borrowing. But there's no sign that the slowdown has been created by a credit crunch. The official effort to rein in "shadow banking", loans that do not appear on banks' books, may hurt; and total social financing, the government's favoured measure of new money pumped into the economy, has come down recently. But the six-month average of social financing, a good measure of what's affecting GDP today, is rising.

Still, there's a monetary problem. Because profitability is falling and leverage has risen, companies have to put more of their profits into servicing debt and less into investment. The government does not seem too bothered. Officials seem to have learned the lesson of the last stimulus: mandated mega-lending leads to wastage and recklessness.

This might be a fairly good slowdown

The key issue is not the pace of growth, but the effect on society. There is a good argument that by that standard China's recent growth has been too fast. The all-out pursuit of more production led to grave environmental degradation and probably encouraged a lax attitude towards corruption.

A slower-growing economy could allow for more investment in things that make China a happier, healthier place over the long run. Those would include cleaner production, genuine innovation and human capital. But some recently announced projects – the world's largest free-standing building, the longest under-sea tunnel, a flamboyant space programme – suggest old habits die hard.

It's not a hard landing

Investors' talk of a hard landing in China is unhelpful. Even GDP growth of 2 percent a year would be quite acceptable, as long as employment remained adequate and social unrest low. Conversely, 7 percent growth with a spike in labour-related protests and bankruptcies would be tough.

Perhaps the best test of a hard landing is whether the authorities appear to remain in control. Deducing that is largely a question of parsing political rhetoric. It's encouraging that Premier Li Keqiang says growth hasn't fallen below the minimum acceptable rate, whatever that is.

What seems most likely is that policymakers are biding their time. The tools they have – forced lending, currency depreciation, vast infrastructure mandates – are powerful but they are also rough, and come with uncertain consequences. For now, the mentality of "best left alone" looks about right.

12 July 2013

OUT OF THE SHADOWS

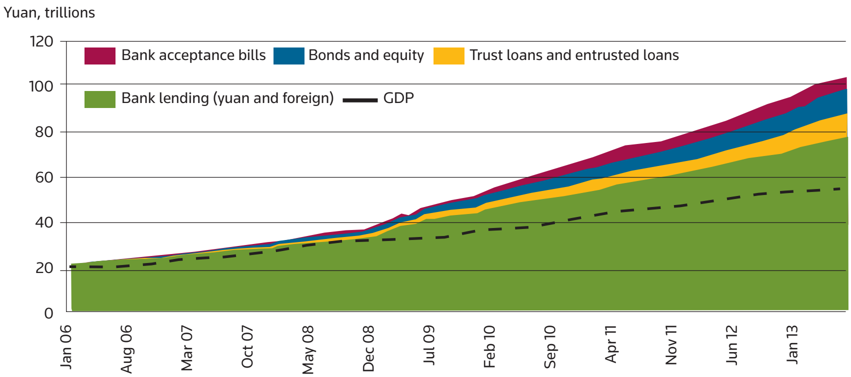
CHINA SHADOW BANK SHAKEOUT WOULD BE WELCOME

BY JOHN FOLEY

A wealth product goes wrong; a bank blames a rogue employee. It sounds trivial. But in China, the crisis at lender Hua Xia could be the beginning of a shadow–bank shakeout. The country's $2 trillion off–balance sheet financing channel may not stay off the balance sheet for much longer.

Bank customers have more than doubled their holdings of wealth management products since 2010, according to Fitch Ratings. These short-dated investments typically offer annualized returns of 3 to 4.5 percent, beating the 3 percent return on bank deposits, which is capped by regulators. Defaults are unheard of, and buyers range from pensioners to state-owned enterprises.

Who funds China?
Total social financing by type vs GDP



Note: Discrepancies between total social financing figure and component figures have been added back into "Bank lending."
Source: Thomson Reuters. J. Foley, R. Mak 10/09/2013

Hua Xia is a test of what happens when a product goes wrong. The bank says an employee in its Shanghai branch illegally sold a wealth management product, which Chinese media reported had then failed to repay investors. It's not yet clear which path regulators will take. One option is to force Hua Xia to pay investors back in full, setting a precedent that banks are liable for the products they sell. The alternative is to leave buyers dangling.

The first option would effectively force $2 trillion of outstanding products – and the associated loans – onto the balance sheets of China's lenders, increasing their assets by around a fifth. That would eat up capital, and push some banks far beyond the maximum loan-to-deposit ratios enforced by regulators.

But leaving buyers to bear losses isn't much better. If they decline to roll over their investments – or demand higher yields – borrowers whose loans have been funded with wealth management products may hit the wall. This could turn into a disorderly run on the shadow banking system.

Ultimately, the best solution is to lift China's deposit cap. If banks could compete for deposits, they would suck cash out of wealth management products and back into bank accounts. Lenders would lose fee income and see margins squeezed, and some shadow borrowers would get into trouble, but the sector would quickly shrink.

Wealth management products aren't evil. But mispricing, and widespread selling to customers who don't really understand the risks, make them dangerous. If Hua Xia proves a turning point, its long-term legacy could be a healthier financial system.

12 June 2012

HOW TO CUT THE CORD ON CHINA'S SHADOW BANKS

BY JOHN FOLEY

Scissors are left at the Yiwu Lianfa clothing factory in Yiwu, Zhejiang province June 8, 2011. REUTERS/Carlos Barria

It's time for some delicate surgery on China's financial system. The growth of non-bank lending channels – collectively known as "shadow banking" – is basically helpful for the economy. But regular banks are in too deep. China's financial regulators need to separate the siamese twins.

Shadow bank activity in China mostly refers to what doesn't appear on banks' balance sheets, such as lending by trust companies and wealth management pools. It accounted for $3.7 trillion of credit at the end of 2012, according to Standard & Poors, equivalent to a third of China's bank loans. These loans are repackaged as short-term products and sold to savers. In theory, rates are set by the market, unlike bank deposits, where low rates are capped by the government.

The problem is that, in China, shadow banking has leached into the mainstream. Regular banks have used their access to cheap deposit and interbank funding, and the assumption that they are "too big to fail", to sponsor huge quantities of products that are not on their books. In the first ten days of June, banks lent a record one trillion yuan – 70 percent of it in the form of short-term notes that are mostly off banks' balance sheets, the Wall Street Journal reported on July 2.

That has allowed banks to get around lending quotas, offer savers products with higher interest rates, and earn sales commissions. But it has brought shadow bank risk into the deposit-taking safety net – too close for comfort to regular savings, the lifeblood of the economy.

Two shades of grey

There are two ways shadow bank activities could ping back onto mainstream lenders. The first is through liquidity risk. Short-term products – some lasting just a month – must be refinanced regularly. That's a problem if the products are being used to finance longer-term loans. If a bank can't attract enough new savers it might have to use its own cash to plug the hole.

Last month's spike in inter-bank lending rates was a warning. Some lenders were effectively frozen out of the market, even as some $240 billion of wealth products came due, according to Fitch. In a nightmare scenario, a bank could be so strapped that its ATMs ran dry. The central bank would have to step in, but confidence would be dented.

The solution is simply to prevent banks from being seen as the backstop for wealth products. Investors are already told that if a product fails, they are on their own. But the message will only sink in when a product is allowed to default. Provided regular bank savings were clearly labelled as safe, a wealth product slip-up need not create total chaos. The only alternative is to stop banks from selling wealth products completely.

Hidden dragons

The second channel is credit risk. It's linked to liquidity: if the ultimate borrower from an off balance sheet vehicle can't pay back, a bank may be forced to take the loan onto its own books and repay investors, even if technically it was only the middleman. The bank regulator has already told lenders to limit how many credit-linked wealth management products they distribute.

But there's another fear, namely that lenders may also be hiding direct exposure to shadow credit. One way they do it is through trust products. Banks can arrange for one company to lend to another through a trust structure, with the bank then taking on the credit risk through complex trades with other banks. This can then be classed as an interbank loan.

Such "innovative" interbank activity may have made up 2.7 percent of total loans by the end of 2012, according to CIMB. Rising inter-bank lending rates makes these trades less attractive, but won't kill them off entirely.

Improved financial stability may come at the expense of economic growth. If banks stop pushing shadow credit, growth would slow, and borrowers who are relying on shadow lending to service real bank debts might go to the wall, causing bad debts to rise. However, that correction is inevitable. The longer the wait, the more painful it will be.

Eventually, China should be able to harness shadow banks for good. They already give a useful signal of what kind of savings rates depositors really expect. A non-bank lending sector where investors understand there's no free lunch would help channel funds where they're needed. It may even help pave the way for China to abandon its tightly regulated bank interest rates. That's a worthy target – but it won't happen unless the authorities can make that crucial cut.

7 March 2013

REVIEW: TALES FROM CHINA'S WILD LENDING FRONTIER

BY PETER THAL LARSEN

A woman walks past a wall bearing an image of Beijing's skyscrapers outside a construction site for a new residential complex in Beijing June 18, 2013. REUTERS/Kim Kyung-Hoon

Joe Zhang has impeccable timing. The former investment banker's book about running a small Chinese microcredit firm, "Inside China's Shadow Banking", has hit shelves just as concerns about the country's runaway credit boom are capturing global headlines. Yet despite the title, it's China's state-owned banking system that emerges as the tale's dysfunctional villain.

Zhang's story is part memoir, part diagnosis. It begins with his brief tenure as chief executive of Wansui Microcredit, a small lender in southern China making business loans with interest rates as high as 23 percent a year. In extensive and sometimes unnecessary detail, he describes the controlled chaos of an institution struggling to grow despite restrictive rules and unsympathetic regulators. In an attempt to build a more sustainable firm, Zhang deploys all the tools of Chinese business: personal connections, mutual backscratching, and endless dinners.

China's pervasive corruption is never far from the surface. Shortly after arriving at Wansui, Zhang discovers that two senior managers have accepted stock options from a borrower in return for a cheap long-term loan. Later, a private equity investor tries to interest him in a business that will raise money by selling investment products to bank customers. Success is assured because the bank president's cousin has been granted a secret stake in the business. Zhang professes himself shocked, and steers clear.

Along the way, Zhang provides a helpful taxonomy of China's shadow banking industry – a phrase that is as widely used as it is little understood. It is a world full of misleading labels. Beyond its name, Wansui Microcredit has little in common with the lending schemes for Bangladeshi peasants made famous by Nobel laureate Muhammad Yunus. "Trust companies" sound reassuring, but actually resemble Wall Street investment firms, arranging high–risk loans for borrowers shut off from conventional bank credit. Perhaps the best euphemism of all is "wealth management products", actually parcels of risky loans sold to bank customers on the unspoken assumption that the institution will pick up the tab if things go wrong.

Critics often point to China's shadow banking boom as evidence of the shaky foundations of economic growth. Zhang, however, makes a compelling argument that real problem lies with China's regulated banking industry. Official interest rates, which are tightly controlled, have fixed the cost of borrowing below the pace of inflation for decades. Loan volumes are controlled by crude quotas imposed by the central bank. As a result, access to credit is determined not by market forces, but by official decree or personal connections.

Those able to borrow, mostly big state-owned firms, have ample opportunity to make extensive and sometimes wasteful investments. Smaller companies are forced to seek out alternative sources of credit at much higher rates. Consumers who are tired of watching the real value of their savings dwindle in their bank accounts speculate on property or other risky investments. This system is not just inefficient; it's also responsible for China's rampant inequality.

When China's interbank interest rates spiked in June, the central bank held back from a rapid, public intervention. That decision has been praised as a sign that the authorities are finally willing to rein in uncontrolled credit growth. Yet it can also be interpreted as a retrograde step that will reduce the flow of credit to those that do not enjoy official favour. Zhang concludes the only solution is to loosen restrictions on bank interest rates and let the market decide.

But he admits that doing so will be dangerous: "The major challenge for the economy and the banking industry in the next decade is how to abandon financial repression without causing havoc."

Zhang claims to have written this book on his Blackberry in ten days, and it shows. Its structure is as chaotic as the world he describes. The text flits between personal anecdote, biographical detail and analytical observation. Terms that might confuse the uninformed reader are not always explained. Nevertheless, these dispatches from the wild lending frontier add colour to a topic that is often lacking details.

That, and Zhang's excellent timing, makes it a valuable reference for anyone attempting to understand the causes, consequences and conclusion of China's credit boom.

28 June 2013

GUEST COLUMN: CHINA'S SHADOW BANKS DESERVE CREDIT

BY JOE ZHANG

An employee counts money at the last workday of a week at a bank in Taiyuan, Shanxi province, June 28, 2013. REUTERS/Jon Woo

Few people sing the praises of China's shadow banking sector. Yet for all the misgivings of officials and economists, this enigmatic industry has doubled in size over the past three years – to an estimated $6 trillion. I would argue this has done China a world of good.

The loosely defined term "shadow banking" means two things in China. One is wealth management products (WMPs), short-term investments offered by banks to their customers, often including repackaged credit. The other is the diverse credit creation that takes place outside the banking system, involving trust companies, pawn shops, microcredit firms and kerbside lenders.

Important signals

Such activities may conjure up images of fly-by-night financiers. But there are several reasons to give shadow banking more respect. The first is that the industry is performing a valuable service for China's savers.

Millions of savers (including me) have bought WMPs because they offer 4–6 percent returns, compared with the 2 percent or so on regular deposits. It's taken for granted that banks would step in if these underlying investments fail. So as far as the buyers are concerned, WMPs are just deposits in disguise, pure and simple.

Why would banks shoot themselves in the foot by paying higher rates than they need to? It's simple: to stop depositors leaving for better deals. The banks are effectively acknowledging that the officially regulated rates they offer are too low. WMPs reveal the true market price of deposits.

They also reveal the truth about China's real rate of inflation. Let's assume the real, inflation-adjusted return on deposits should be close to zero. The going 4 percent rate for wealth products suggests savers think prices are rising twice as fast as the latest official inflation figure of 2.1 percent.

This may all bring about the end to China's financial repression. The government has kept the real interest rates negative for most of the past four decades. The consequences are severe: industrial overcapacity, persistent inflation, a real estate bubble, and worsening inequality. Since the 1980s, the government has promised but not delivered rate liberalisation. Now shadow banking may force its hand.

Bank regulators, meanwhile, can no longer claim the "conservative" regulatory loans-to-deposits cap of 75 percent keeps banks safe, since banks have already used WMPs to get around this restriction. The spike in interbank market rates in June shows that regulators need to take notice of assets both on and off the balance sheets.

The regulators may also need to be clearer about who is on the hook for what. That includes who must pay out if a WMP fails, but also what would happen to savings if a bank got into trouble. A long-debated deposit insurance plan is now back on the drawing board.

A division of labour

Despite these contributions, shadow banking still leaves a bad taste. Officials have never publicly welcomed pawn shops, microcredit firms or kerbside lenders. "High interest rates are immoral", some warn. "They could destabilise the banks", others protest.

The reality is that China needs these unloved stepchildren. They create millions of jobs by providing small- and medium-sized enterprises with much-needed financing. Not only are they often the only place for SMEs and underprivileged consumers to go, but in many cases they are more nimble and efficient than the banks.

Take the products issued by China's 67 trust companies, which had $1.4 trillion of assets under management at the end of the first quarter, according to the China Trustee Association. Like banks, trust companies may find themselves on the hook for products they sold. But trust companies are largely state-owned, and their loans are mostly backed by hard assets.

Moreover, trust companies, despite being one of the least well understood parts of the shadow banking industry, serve the purpose of matching borrowers and lenders who don't get what they need from the banking sector. I would argue that they serve a similar function to junk bond originators like Michael Milken's Drexel Burnham Lambert in the 1980s and 1990s.

Chinese banks remain little more than cashiers to state-owned businesses and well connected private-sector companies. Thanks to shadow banks, they now have formidable rivals – and SMEs have a source of finance that lets them compete with bloated state-owned companies. The end result is higher productivity and better services for all. That contribution shouldn't be dismissed lightly.

7 August 2013

WHAT KIND OF CRISIS?

LESSONS FOR CHINA FROM JAPAN'S LOST DECADE

BY ANDY MUKHERJEE

Is China condemned to suffer a Japanese "lost decade"? Its economy today has three big similarities with Japan in the late 1980s: high and rising debt, diminishing export competitiveness and an ageing society. China can avoid slipping into Japan's deflationary hole, but only if it learns from Tokyo's failure to cleanse its banking system.

The most striking similarity between Japan in the late 1980s and China today is the level of debt. In 1989, total private credit in Japan was about 200 percent of GDP. It is around the same proportion of the economy in China now.

Another important parallel that doesn't get as much attention is a rising currency – and diminishing export competitiveness. This is as big an issue for China today as it was for Japan a quarter century ago.

Following the 1985 Plaza Accord, the yen appreciated by 30 percent against its trading partners' currencies in 15 months, after adjusting for inflation. Japan responded to the loss of foreign demand by running loose fiscal and monetary policies. Eventually, it lost control of credit growth.

China's exchange rate has risen more gradually. Yet, after taking into account galloping wage costs, the yuan has strengthened by 47 percent against other major currencies since 2005. Japan's current account surplus – the excess of domestic saving over investment – shrank by just 2 percentage points of GDP between 1985 and 1989. By comparison, the drop in China's current account surplus since the financial crisis has been massive: from 10 percent of GDP in 2007 to just 2.5 percent in the past four quarters.

China's response to the crisis and recession in the developed world has been increased borrowing, particularly by local governments and by companies. Last year, interest costs ate up a quarter of the operating profit of the median Chinese company with a market value of more than 1 billion yuan, according to a Breakingviews analysis of Starmine data. A decade earlier, the bill was only 14 percent.

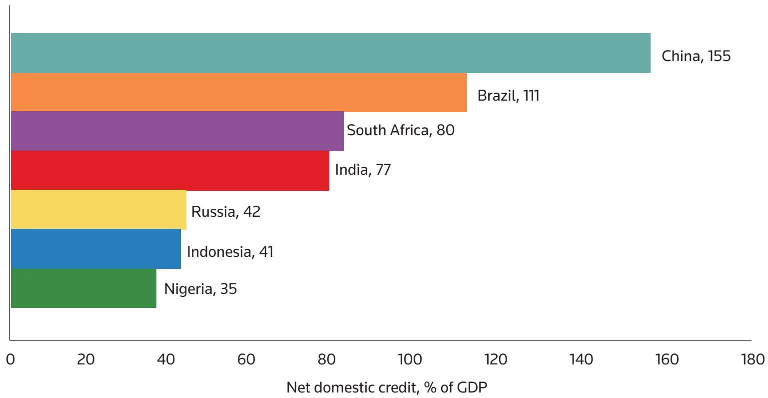
Ageing workers also put a limit on growth. Japan's old-age dependency, or the ratio of the elderly to those of working age, was 17 percent in 1989, and the figure doubled over the next two decades. In China, the ratio is currently lower at 12 percent. But Beijing's one-child policy means the country will age at a faster rate.

What overwhelmed the Japanese economy, though, was property mania. Residential land prices in Tokyo tripled between 1985 and 1988 before collapsing. As much of the speculation had been financed by credit, the financial system froze. However, Japan allowed its banks to hide their problems until 2004, when Prime Minister Junichiro Koizumi finally cleaned them up.

China's authorities are in a similar bind: the country's local governments have borrowed anywhere between $2.4 trillion and $2.9 trillion, according to an estimate by the deputy head of the National Audit Office, largely by pledging increasingly valuable land as collateral. On the one hand,

Addicted to debt

Emerging markets net domestic credit as percent of GDP, 2012



Source: Datastream, World Bank. J. Foley, R. Mak 17/09/2013 regulators are keen to rein in further speculation. On the other, deflating the bubble could have unpleasant consequences for the economy. The temptation will be to hide the debt, either in the banking system or in government-owned bad banks. But failing to write down dud loans could clog up the system and impede new investment and growth.

China has some advantages. For one, it is still developing, while Japan's urbanization was largely complete by the 1980s. City-dwellers in modern jobs may be able to support more household debt than rural workers. Similarly, increasing labour productivity will boost growth and gradually make China's debt less burdensome. China's controls on domestic deposit rates and on international capital flows also reduce the chances of a short-term debt crisis. That gives the leadership some breathing room to sort out its problems.

Yet China's relative lack of economic development can also be a handicap. The real purchasing power of average Chinese incomes is still only a third of what it was in Japan in 1990. After almost two lost decades, Japan is still prosperous. By contrast, a lost decade in China would be more agonizing – both for its citizens, and for the rest of the world.

3 September 2013

CHINA AND THE CHAOS THEORY OF FINANCE

BY JOHN FOLEY

Dancers perform a fire dragon dance Chinese Spring Festival at an amusement park in Beijing February 10, 2013. REUTERS/Kim Kyung-Hoon

Will China have a financial crisis? And if so, would Chinese people be any worse off? The answers are not found in the country's rapidly rising levels of debt, but in the potential for chaos when things go wrong. China is sliding further along the scale of chaotic financial systems, but is not yet in the danger zone.

Financial chaos might be described as the potential for one event to cause other unforeseeable ones. That might happen because of unexpected linkages. Or it might be because people respond to developments in unpredictable or irrational ways. It's close to what investor George Soros has called "reflexivity". In Soros' eyes, thinking actors are fallible, and that makes them prone to inappropriate and destructive actions.

A bit of unpredictability in the financial system is a good thing. Freewheeling promotes innovation, and helps capital to go to where it's needed, rather than where a centralized authority thinks it belongs. Chinese leaders are deeply troubled by the idea of chaos, or "luan", but have tolerated the financial kind occasionally, say by letting in foreign investors, setting up stock markets and occasionally laying off state-sector employees.

Imagine a Financial Chaos index. It starts at zero – total state control in a country where the government is entirely trusted. The authorities can print money to make problems go away, and there are no foreign creditors or trade partners to complain. Now picture a system with a score of 100. It has no trust at all, and its denizens are driven by fear and ignorance. Only gold has financial value. At the height of its own financial crisis in 2007, the United States was probably around 70.

China used to be close to zero. Until 1978, there was really only one bank, the People's Bank of China, which dispensed investment funds following government orders. Later, new banks were created, but the state retained its virtual monopoly on credit. In that world, it didn't really matter whether borrowers paid back loans or not. The mandarins, as owners of the whole banking system, could rewrite accounts and make losses disappear.

Twenty years later, things had got more chaotic. Private lenders and foreign investors proliferated. Claims on China's borrowers were spread more widely, but the system remained pretty simple – probably a 10 on the Financial Chaos index. Even when a financial institution failed and bad debts spiked, trust in the government to make things whole – at least for Chinese lenders and depositors – was absolute.

Then came the big bang. In 2010, banks stepped up a clever trick of repackaging credit into trusts and wealth management products that don't appear on their balance sheets. This so-called shadow banking has thrived since. Banks are still at the centre of the spider's web, but the number of people with claims on Chinese companies has widened to include literally millions of depositors.

That means more room for chaos. Say a small business, whose debts were repackaged as a wealth management product, defaults. Tracking down its thousands of creditors would be a nightmare. Moreover, individuals are unpredictable. They might protest angrily if they don't get their money back. Or stop buying such products, creating a credit crunch. Or pull their savings from banks that sold failed investments, leading to dreaded bank runs.

Despite that, China is probably only a 30–40 on the Financial Chaos index – more uncertain than in 1978, but less than the United States in 2007. That's because as long as the state can credibly bury bad debts with new money, the financial system can remain more or less whole. At a push, the government could buy all outstanding "shadow bank" lending, estimated at $3.7 trillion. Trade partners and foreign investors would worry; moral hazard would result. But there wouldn't be a social collapse.

China isn't totally immune to self-destructive fear and ignorance. Environmental degradation could provoke chaos; so could corruption. Unproductive lending and too much control could harm the real economy, by giving people too much of what they don't want, and too little of what they do. But provided the level of financial chaos stays low, a credit crisis, even if it does happen, needn't be an economic one.

8 April 2013

WHY CHINA'S "MINSKY MOMENT" MAY BE A LONG WAY OFF

BY PETER THAL LARSEN

China may be a long way from its "Minsky moment". Rising leverage has prompted many to predict the kind of financial meltdown theorized by the economist Hyman Minsky. But China's closed, state-controlled system is well placed to postpone such market panics. The bigger challenge is managing social tensions arising from slowing growth.

Minsky's "financial instability hypothesis" described what the academic considered a structural feature of capitalist financial systems. The "speculative finance" of an economic boom, loans refinanced before they are repaid, yields to the "Ponzi finance" of a bubble, where borrowers take on new debt just to pay the interest on existing loans. A crash follows.

Many investors believe speculative finance is rampant in China. The total amount of new credit expanded by roughly 60 percent in the first quarter, but GDP growth was a mildly disappointing 7.7 percent. Corporate balance sheets are deteriorating: according to the International Monetary Fund, the earnings of Chinese companies were just 2.4 times interest payments in mid-2012, down from 4.4 times in 2003.

Bank of China Chairman Tian Guoli attends a news conference on interim results in Hong Kong August 29, 2013. REUTERS/Bobby Yip

Then there are local governments, which have used financing vehicles to finance property development and infrastructure. Nobody seems sure quite how much they owe: a former Chinese finance minister recently put the figure at 20 trillion yuan ($3.25 trillion), double the officially estimated amount of loans.

To top it all off, debt is increasingly backed by short-term instruments, such as wealth management products which are distributed by banks but tend to be held off their balance sheets. As these investments mature every few months, the risk that savers will lose confidence is ever present. Ponzi-finance may have already arrived, and fears of a Minsky-meltdown would appear well-founded.

However, the Minsky-ites seem to have forgotten that their teacher thought a strong government could counter the destructive dynamics of unchecked financial capitalism. The Chinese state is probably still sufficiently powerful and financially active to prevent a meltdown.

For a start, it is the controlling shareholder of all the largest banks. The government can mandate that loans be rolled over or new credit extended. This is exactly what it did to counteract the 2008 economic slump. The state can also direct banks, insurers and other investment companies to keep buying corporate and local government bonds.

And if investors' confidence did crack, the government could bail out the banks or the local governments directly. It did exactly that in 2003, by removing bad debts from banks' balance sheets.

A repeat would undoubtedly be messy, and would send the level of government debt soaring. According to George Magnus of UBS, adding up local government debt, banks' bad loans as well as bonds issued by state institutions and the now-defunct Ministry of Railways would lift the state's total borrowings to 80 percent of GDP – more than four times the official figure.

Still, a rescue would be largely a domestic concern. Unlike most big countries, China does not depend on international investors. With tightly controlled capital flows, no foreign debt to speak of and more than $3 trillion in foreign currency reserves, the country is largely insulated from any Minsky-style run by international investors. A large-scale bailout would essentially involve reallocating resources from Chinese people to the Chinese state.

However, avoiding a panic could ultimately cause as many problems as it solves. Rescuing lenders and borrowers from their mistakes would reinforce the belief that, in China, normal market rules do not apply. That would further delay the point at which the country starts allocating capital on the basis of economic efficiency, rather than state direction.

Moreover, even if China avoids a meltdown, it can no longer continue to rely on credit to boost the economy. If less new lending slowed down job creation and the property market, an important store of wealth for China's new middle class, the social consequences would be a huge test for the government's political legitimacy. China's "Minsky moment" may turn out to be not financial, but social.

1 May 2013

CHINA'S SPIKING RATES CREATE WINNERS AND WORRIERS

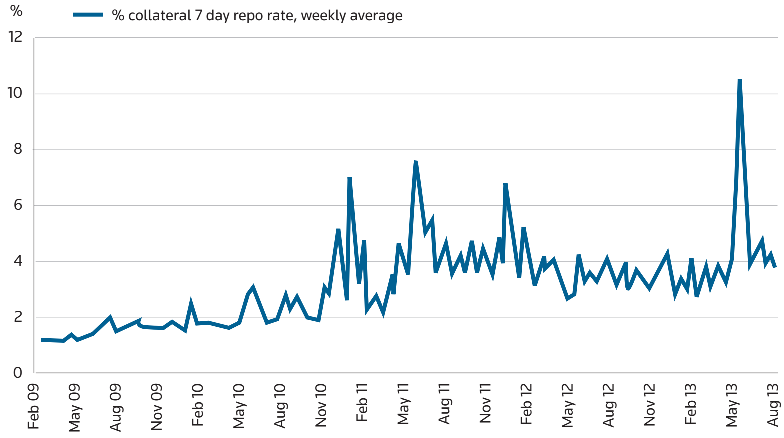
BY JOHN FOLEY

China's biggest banks have thumbed their noses at the government. The Ministry of Finance sold just two-thirds of the 15 billion yuan ($2.5 billion) of bills it offered on June 14, according to Bloomberg. The failed auction is not a vote of no confidence, or a sign that interest rates are too low, but a reflection of reality: banks can get better returns lending to each other.

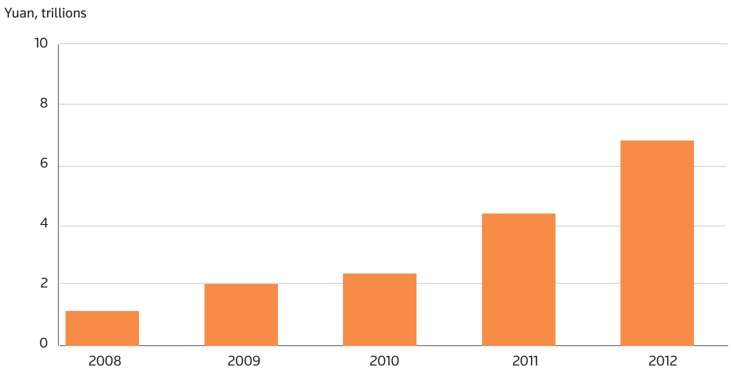
Tight liquidity has pushed up rates in China's turbulent interbank market, creating winners, losers and worriers. The winners are banks with money to spare. The likes of China Construction Bank and Agricultural Bank of China can make a profit through interbank lending or bond repurchases. Together, those two activities made for a $31 trillion market in 2012. Rates for short-term transactions have almost doubled in recent days.

The losers are those who have to pay up or go without. For now, that includes the Ministry of Finance itself. The 3.8 percent yield on the 273-day bills it hoped to sell is unappealing when banks can charge each other almost 7 percent for overnight loans. Many smaller local banks are strapped for funds and have no choice but to borrow.

Chinese interbank lending rate



Interbank money-go-round
Chinese banks' claims on other financial institutions



Banks featured: Industrial and Commercial Bank of China, China Construction Bank, Bank of China, Agricultural Bank of China, Bank of Communications, China Minsheng Bank, China Merchants Bank, China CITIC Bank, Industrial Bank, Chongqing Rural Commercial Bank, and Shanghai Pudong Development Bank.

Source: Thomson Reuters. J. Foley, R. Mak 17/09/2013

REUTERS

Why have interbank rates risen so high? One reason is that there's less money flowing in from exports – the central bank soaked up just $10 billion of foreign exchange in May, a quarter of the amount in April . As the end of the quarter nears, banks also scramble to dress up their balance sheets. Many have issued short-term wealth management products that mature close to key dates. Banks need liquidity to repay those products: it's no coincidence that the 21-day bond repo rate began to spike in early June.

This is a short-term spike, not a systemic freeze. Nevertheless, the failed auction is a reminder that, even in a closed, state-controlled system, the unexpected can happen. That's a worry for central bankers, who would have to step in if a bank got into trouble. It should also concern regulators, whose job it is to know where the counterparty risks sit in China's increasingly complex financial system. As bank-to-bank rates rise, so must their disquiet.

14 June 2012

LENDING SQUEEZE TESTS FAITH IN CHINA'S AUTHORITIES

BY PETER THAL LARSEN

Forget U.S. talk of monetary "tapering": to see what it really looks like when liquidity is sucked out of the market, look to China. A standoff between the People's Bank of China (PBOC) and the country's overextended lenders has pushed short-term interbank rates to record highs. China's closed and state-controlled financial system has a better chance of averting the kind of meltdown that took place in the United States and Europe during the financial crisis. But everything hinges on the authorities' ability to react quickly and decisively.

For anyone who watched the events of 2008 unfold in Western financial markets, the sight of Chinese banks charging each other 25 percent for overnight money – as some apparently did on June 20 – looks like a sign of impending disaster. The reality is less severe, though still serious. Some banks – probably smaller and mid-sized lenders – are short of liquidity ahead of the end of the quarter. One explanation is that they have been funding loans by issuing off balance sheet wealth management products. Now that regulators are cracking down, banks are being forced to fund these loans themselves.

So far the PBOC, led by governor Zhou Xiaochuan, has refused to intervene publicly, maybe to teach overextended banks a lesson. But it's unthinkable that the central bank would allow any Chinese lender to fail. Indeed, the PBOC could well be supporting individual institutions behind the scenes. The state-controlled banking system gives the PBOC more power over individual banks than its counterparts in the West. Moreover, China's mostly closed capital account means it doesn't have to worry so much about cash fleeing the country.

A trainee walks pass a communist party logo as he attends a training course at the communist party school called China Executive Leadership Academy of Pudong in Shanghai, September 24, 2012. REUTERS/Carlos Barr

Even so, it's still possible that something could go wrong. With nerves on edge, a missed payment from a bank to its own lenders could set off a chain of reactions that would prove hard to contain. If depositors fear they won't be able to access their savings, or if a wealth management product fails to pay out, unrest could ensue.

The opaqueness of China's financial system may be helpful at times. Problems can be smoothed over without investors or depositors knowing anything is amiss. But if trust were knocked, a lack of transparency could quickly become a weakness, and the authorities' ability to prevent a worse crisis would be severely tested.

20 June 2013

HOW WE GOT HERE

CORPORATE CHINA BEATING BANKS AT THEIR OWN GAME

BY WAYNE ARNOLD

Office workers walk past an advertisement for a credit card in the centre of Shanghai August 10, 2009. REUTERS/Nir Elias

Corporate China appears to be beating the country's lenders at their own game. Even as banks heap credit into China's economy to keep its credit-fuelled growth from crashing, companies are handing out credit to their own customers. That may help keep the economy revving, but the risk is that past-due bills make it harder for companies to service mounting debt.

Loans from China's banks have been growing at roughly 16 percent a year. Expanding credit helps to mitigate slowing growth. But extending credit when business opportunities are declining can be like throwing good money after bad, as lenders let indebted companies pay off old loans with new ones rather than allow them to fail. The result is the kind of deflationary downturn Japan has experienced, where refinancing crowds out new investment.

China's companies are extending credit to their customers at an even quicker rate. Receivables at companies listed on Shanghai's stock exchange now amount to roughly $190 billion, equivalent to 30 percent of all bank lending, with over half of those outstanding bills owed to just 60 state-controlled companies. Receivables at these firms have been climbing at roughly 30 percent a year for the past four quarters, while the length of time companies are lending to customers has climbed from about 33 days a year ago to 41 days. China Shipbuilding's receivables have climbed 50 percent in the past year. China Merchants Property's receivables have doubled.

A receivable represents a zero-interest loan, and the amount of credit a company extends to customers usually rises when times are good and falls when the outlook is uncertain. If companies fail to rein in customer credit, the risk is that unpaid bills force otherwise healthy companies to default on their own loans. This so-called triangular debt deepened Asia's financial crisis in 1997 and 1998.

It's a troubling sign, therefore, when companies extend credit terms in tough times. It suggests that they believe money earned tomorrow will be worth more than money earned today, or in other words, deflation. That helps explain why the average listed Japanese company waits 96 days for repayment. Increasingly generous corporate credit may be another ill omen for China's economy.

17 October 2012

HOW CHINA MADE $300 BLN (ALMOST) DISAPPEAR

BY JOHN FOLEY

Zhang Yun (C), president of Agricultural Bank of China, is shown on a screen as he speaks in Beijing during a video conference to journalists in Hong Kong August 28, 2013. REUTERS/Bobby Yip

Economic crisis or not, China's lenders are in good shape. The country's big listed banks Industrial Commercial Bank of China (ICBC), Bank of China and China Construction Bank (CCB), all unveiled mid-year balance sheets enviously light on bad debts. Thank China's rapid growth and an astonishing $300 billion vanishing act.

That figure is the amount of bad debt the top three banks offloaded in the early 2000s. Back then, the People's Bank created four asset management companies to scrub away the dirt from two decades of policy-driven lending. But the resulting losses still lurk, out of sight, and are getting harder to ignore.

The plan was that the AMCs would suck out poisoned loans from the big banks, and recover what they could over the following ten years. In return, the AMCs issued bonds, whose interest would be paid from what the AMCs could salvage. Hey presto: the banks were free to lend again.

There was a big catch. The AMCs bought the loans for up to 100 percent of face value, while recoveries were in the 20-30 percent range. That means the top three lenders' 1.2 trillion yuan of AMC bonds, which start to mature this year, are likely to be almost worthless. In theory, the Ministry of Finance is ultimately on the hook, but it is unlikely to make good for the banks. The amount due to all three is roughly one-sixth of China's fiscal revenues for 2008.

Fortunately, two very Chinese alternatives present themselves. One is to reinvent the AMCs as securities firms, giving them an extra income stream, a process that's already underway. ICBC and CCB have even talked about taking stakes in the AMCs, suggesting some kind of debt-for-equity swap, though it's hard to see how the equity value of these entities could approach the amount owed.

The other is simply to roll over the bonds indefinitely. The amounts at stake aren't small, though. Besides, the banks are once again lending rapidly at the state's behest. If new loans too are eventually evergreened, banks' balance sheets could become truly sclerotic – and require further surgery.

Still, China's rapid development might ease the pain. The country's GDP has, at current prices, almost tripled since the turn of the century. So long as China keeps growing, and deferring repayment, the off-balance sheet problem will get relatively smaller and smaller. The peculiar $300 billion magic trick might just work after all.

28 August 2009

ICBC SHOWS HOW TO MAKE A MONSTER

BY JOHN FOLEY

People stand near a Chinese flag as the Oriental Pearl TV tower is seen in the financial area of Pudong in Shanghai. REUTERS/Carlos Barria

China has created a beast, in banking terms. Industrial and Commercial Bank of China reported a 27 percent increase in earnings over the first nine months of the year on Oct. 28, to $19 billion. Its market capitalisation of $233 billion is almost twice that of Citi, and its annualised 26 percent return on equity for the third quarter was five times that of the U.S. banking giant.

How did ICBC get so big? The answer lies in some monster-sized distortions in China's banking system.

First, banks in China have an incentive to grow quickly. That's partly down to the fact that there are guaranteed margins between deposit rates and loan rates. Even though the margin (slightly more than two percentage points) isn't terribly fat, it's still a lot better than sticking surplus liquidity in government paper.

A cap on deposit rates has helped mega-banks swell to greatness too. Since lenders cannot compete on price for savings, those with more branches tend to win customers more easily. Meanwhile, the lack of a government deposit guarantee scheme means that ICBC, undoubtedly too big to fail, looks the safest lender in town.

Not that savers have much choice. True, deposits as a share of household wealth have almost halved in the last decade, according to Credit Suisse estimates, as property and stocks gained favour. But deposits are still 180 percent of GDP and growing. Bond markets remain shallow and borders largely closed – explaining why ICBC's deposits are growing faster than its loans.

Finally, no monster can thrive without an injection of moral hazard. State investment fund Huijin and the Ministry of Finance own a majority of ICBC's shares, and are likely to invest in its upcoming $6.7 billion capital-raising. That may increase managers' sense of scrutiny – but could also encourage risk over prudence.

Creating an ICBC may look like an impressive feat. But China's financial Frankensteins should worry. First, because while ICBC has the pick of loans, depositors and investors, smaller banks are left with slimmer pickings. And the bigger ICBC gets, the more regulators must worry about keeping their progeny under control.

28 October 2010

TAKE CHINESE BANK EARNINGS WITH A PINCH OF SALT

BY JOHN FOLEY

China's five biggest banks grew combined earnings by 37 percent during the first half of 2011. Lending margins and fees rose, while bad debts fell. In a sign of high times, some big banks are now even offering their best customers private jet services. Yet there is still plenty to worry about, and that explains why their shares have fallen roughly a quarter from this year's peak.

There are three concerns. The first is that after two years of rapid lending, bad debts are a problem. There are already early signs a slowing economy is taking its toll. Despite falling bad debts overall, loans overdue by less than three months spiked 36 percent at Bank of China. At ICBC, loans three to six months overdue grew by 35 percent. At Minsheng they more than doubled.

A man eats noodle at a restaurant in Shanghai March 2, 2009. REUTERS/Aly Song

The second concern lurks off the balance sheet. Banks have stuffed loans and securities into wealth management products that are sold to clients desperate to beat the 3.5 percent one-year deposit rate. If the underlying assets go bad and the products can't be repaid, the banks are usually not technically liable, but the risk is that they will be forced to take the losses nonetheless.

Agricultural Bank of China, Bank of Communications, CCB and Minsheng sold an astonishing 7 trillion yuan ($1.1 trillion) of wealth management products in the first half. AgBank revealed, in a footnote, that products guaranteeing investors their money back are 4 percent in the red. Meanwhile, the off balance-sheet commitments disclosed, like undrawn loans and letters of credit, shot up. Minsheng's grew 42 percent over the period, ICBC and AgBank half as much.

For all that, the big banks are liquid and soundly capitalised. But smaller banks are a different story. The minnows can't win customers on price because their deposit rates are fixed. This has pushed up rates in the interbank market as they clamour for funding from their rivals. AgBank is one that took advantage, doubling its "placements to other banks" during the period. Yet if small banks really get into trouble, some big state-owned banks may be forced to take them over rather than profit from their difficulties.

Bad debts, risks lurking off the balance sheet, and a wave of potential takeovers of weak banks all sound distant. But it isn't hard to see why investors aren't taking China's super-strong financials at face value.

26 August 2011

REFORM OR REPENT

RATE REFORM WILL TEST CHINA'S MODERNISING METTLE

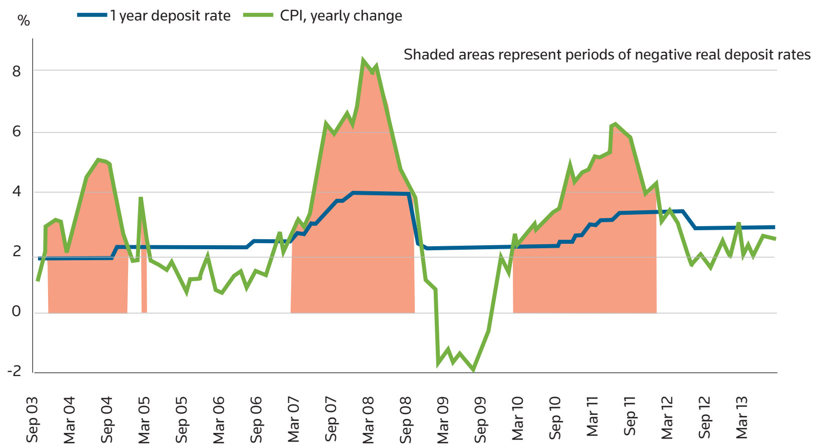
BY PETER THAL LARSEN

Freeing interest rates is more than a financial test for China. Lifting strict controls on the official cost of money is necessary for the development for the world's second-largest economy. The question is whether China can avoid the financial problems that other liberalising countries suffered, and relax its grip on banks, companies, and citizens.

China's central bank caps the amount that banks can pay for deposits, and sets a minimum charge for loans. This leads to three kinds of economic distortions. First, it guarantees banks a positive spread on every loan of around three percent, according to the World Bank, giving them little incentive to distinguish between good and bad risks, or compete for business.

Banking on reform

China's deposit rates and consumer price inflation



Source: Thomson Reuters. J. Foley, R. Mak 10/09/2013

Second, the state has for decades held deposit rates at or below the level of inflation. This has allowed borrowers to engage in wasteful spending, while forcing consumers to seek riskier investments like property to protect the real value of their savings. Crude lending quotas distort the system still further. Large state-owned enterprises and officially sanctioned projects gobble up available credit, leaving smaller private businesses to seek other, more expensive sources of finance.

It goes without saying that China would be better off without these oddities. The central bank would be able to make greater use of interest rates to control the overall economy. And cross-border capital controls could be eased with less risk of sudden outflows.

China's rulers appear to agree: in May, the country's ruling State Council identified interest rate reform as one of its key economic priorities for 2013. The recent spike in Chinese interbank rates may be a sign officials are testing how banks cope when markets are allowed to set the price of money.

History advises caution. In the last 40 years, Argentina, Sweden, Korea and the United States all granted some banks the liberty to set their own deposit and lending rates, only to suffer damaging booms and busts.

Imagine what would happen if China loosened interest rate controls today. Banks would quickly raise savings rates in an attempt to attract new deposits. All else being equal, if deposit rates rose by just one percentage point, banks' interest income would fall by as much as a third. To make things worse, large companies would probably demand cheaper loans, since the lending floor had been eliminated.

Banks rely on strong earnings to absorb future bad debts. So they might slash costs just when they should be beefing up their risk management. Even now, few have the equivalent of a chief operating officer.

And to protect margins, they might offer loans to riskier borrowers at higher rates, leading to an expansion in overall credit. China already faces the consequences of a large and poorly controlled lending splurge. If liberalisation left some borrowers paying higher interest rates, many would face a severe cash crunch.

Assume that China manages these challenges, and joins the small group of countries – including Canada and Australia – that liberalised interest rates without unleashing turmoil. Even then, true reform could be undone if state retains its grip on the economy. Most countries liberalised interest rates as part of an embrace of free markets. If money is to be priced by supply and demand, overextended borrowers must be allowed to default, and reckless lenders must suffer the consequences of their mistakes.

China's unique brand of capitalism is far from this ideal: the state controls most of the banking system, and many of the country's largest corporations. Any institution at risk of bankruptcy would expect the government to bail it out. China's domestic bond market has yet to experience a single default.

This may explain why, even though China has been talking about liberalising interest rates since the mid-1980s, it has made little progress. Unlike other changes, rate reform can't be embraced gradually, or tested in a few remote provinces. China has tended to "cross the river by feeling the stones"; in this case, it would simply have to take the plunge.

The country's new leaders may deliver on their promise. But if they successfully embrace genuine interest rate reform it will signal a more profound shift for China than for any other country that has trodden this path before.

10 July 2013

CHINA'S BAIL–IN BONDS LEAVE ROOM FOR CONFLICT

BY JOHN FOLEY

Shaolin monks perform at the Mediterranean Conference Centre in Valletta November 6, 2009. REUTERS/Darrin Zammit Lupi

When China's banks make a mess, the government usually pays the clean-up bill. But Industrial and Commercial Bank of China's plan to issue $9.6 billion of so-called "bail-in bonds" suggests the costs of the next crisis will be spread more widely. For investors, there's room for confusion and conflict.

China's biggest lender looks set to be the first mainland bank to issue securities that meet new Basel III requirements. The big difference from older bonds is a "non-viability" clause, which means that if the regulator decides the bank is in deep trouble, the bonds can be written down. That has the same effect on a bank's capital ratios as raising new equity.

Bail-in bonds could be big in China. The country's top five banks have 15 percent of their capital in subordinated debt, which is being gradually phased out from capital calculations. If the banks merely replace what's already outstanding with bail-in debt, they would issue bonds worth $96 billion. Private banks and funds are likely to be enthusiastic buyers.

Pricing is likely to be keen too. Other Basel III-compliant bonds have tended to trade with yields 1.5 to 2 percentage points above similar bonds without a bail-in clause. For mainland lenders, traders expect a narrower spread – say 25 basis points – to reflect Chinese banks' strong capital ratios, and Asian investors' aggressive search for yield.

But investors are in danger of ignoring two risks. First, Chinese capital ratios may not be as healthy as they look, if bad debts aren't being properly recognised. Second, Basel gives regulators discretion about when to impose losses on bondholders. Even the decision that a bank needs an injection of public funds can be a trigger. In China, where the banking system is majority owned by the state, that could describe almost any kind of equity issue.

By their nature, bail-in bonds create a potential conflict between shareholders, who don't want to be diluted by an equity issue, and bondholders, who don't want to be wiped out. In China, that conflict is intensified because the regulator and majority shareholder are both part of the state. If outside investors aren't careful, China's bail-in bonds could leave the cost of the next clean-up squarely on their shoulders.

23 January 2013

CHINA’S CENTRAL BANK WILL FIND VALUE IN CONTINUITY

BY JOHN FOLEY

China’s rapid economic growth has broken so many rules that one more can’t hurt. Zhou Xiaochuan, the governor of the central bank, may have his tenure extended despite reaching the mandatory retirement age of 65, sources told Reuters on Feb. 20. The PBOC is a rather weak institution, but Zhou, ten years into his governorship, remains the best man to run it.

Unlike the Federal Reserve or Bank of England, the PBOC lacks independence in setting monetary policy. Major decisions must be approved by China’s cabinet: the country’s leaders deem interest rates and the value of the currency far too important to be left to bankers. Such political meddling makes it hard to judge China’s top decision makers objectively. Zhou’s non-appearance at the International Monetary Fund meeting in Tokyo last year amid a territorial dispute with Japan – a low point in China’s financial diplomacy – showed how political his job is.

If ideas count, though, Zhou is unmatched in China. He masterminded the rescue of China’s banks a decade ago, when bad debts made up a quarter of their loan books. He has overseen the 9.5 percent appreciation of the currency since it was unpegged from the U.S. dollar in June 2010. And while

A television camera screen shows China's central bank governor Zhou Xiaochuan answering a question at a news conference during China's annual session of parliament, in Beijing March 13, 2013. REUTERS/Jason Lee his plans to make the yuan into an international tender have underwhelmed, the idea of China's currency becoming convertible is no longer unthinkable.

Ten years of stability have brought risks. China's last decade has been characterized by financial repression, including too-low deposit rates, and a too-cheap currency. Loans and foreign exchange reserves have exploded, while China's broad money supply has increased by 19 percent a year over the past five years. Officially, bad debts remain low, but probably not for long.

The PBOC will eventually have to deal with the effects of that repression, including the runaway growth in "shadow bank" lending outside of the banking system. China may also need to relax its paternalistic policies and allow market forces to rule, even if that means more failure. Politics may put that beyond Zhou's ability, but given his experience, the PBOC is better with him than without.

21 February 2013

CHINA MUST LEARN TO LIVE WITH CORPORATE DEFAULT

BY JOHN FOLEY

China has a troublesome case of default-o-phobia. No domestic corporate bond has ever failed. It's not because companies don't get into trouble, or are immune to economic shifts. Rather, distressed issuers like Chaori Solar, a Shanghai-based solar panel maker, get bailed out in private and bondholders are spared. Without treatment, the condition can be debilitating.

Chaori's banks agreed last week to defer their own claims over the company so it could pay the $15 million of interest due on its bonds in March. That goes against finance convention, where bank loans usually get paid back before bonds. In China, it's not unheard of. Shandong Helon, a textile company, was saved from defaulting on its bonds by a local government in April 2012.

China's first corporate bond default would be more than just an embarrassment. Local governments themselves have issued at least $2 trillion worth via so-called financing platforms, and need new willing buyers to fund infrastructure projects. A private company that failed to pay back investors, and whose local government failed to step in, might lead buyers to shun similar issues. A high-profile default would also increase the cost of borrowing for riskier companies, causing further blow-ups.

Banks are keen to postpone default, because they hold more corporate bonds on their balance sheets than anyone else. Commercial lenders hold a third of corporate bonds, and half of all medium-term notes, according to ChinaBond. Losses apart, a correction would affect the market value of their remaining assets. Put simply, if a bond that yields 5 percent were suddenly deemed to merit a yield of 6 percent instead, its market value would fall by almost 20 percent.

Investors are beginning to get the message, but selectively. The yield of a five-year double-A rated domestic corporate bond has risen from 4.3 percent to 5 percent in the past six months. But in a sample of 300 bonds issued by Chinese city investment vehicles and listed on Thomson Reuters Eikon, two-thirds were still trading above their issue price on Jan. 28. If China wants the bond market to channel credit efficiently, it must eventually remove such distortions, and allow issuers to fail.

29 January 2013

China's Central Bank Governor Zhou Xiaochuan listens to a question at a news conference during the on-going National People's Congress, China's parliament, in Beijing March 12, 2012. REUTERS/Jason Lee

CHINESE FOR INVESTORS

A GLOSSARY OF TERMS FOR STUDENTS OF CHINA'S FINANCIAL SYSTEM

BY JOHN FOLEY

Asset Management Company – 基金管理公司

Companies set up in 1999 with public funds to suck over $300 billion of bad loans from the Chinese banking system. Now they are moving towards initial public offerings, having been repurposed to suck capital from foreign institutional investors instead.

A book cover is pictured at a communist party school called China's Executive Leadership Academy of Jinggangshan, in Jiangxi province, September 20, 2012. REUTERS/Carlos Barria

REUTERS

Bad bank – 坏银行
In the West, the portfolio of loans excised from a bank that has lent too recklessly. In the eyes of China's economic planners, the name for a bank that hasn't lent recklessly enough.

Chinese Communist Party – 中国共产党
China's ruling party. The effective regulator, borrower, investor, credit officer, human resources department and lender of last resort for the entire banking system.

Discounted bill – 票据贴现
An IOU issued by a bank to a company on behalf of its customer, and cashed in by the recipient at another bank. Traditionally a means of facilitating trade, more recently used as off balance-sheet credit to facilitate speculation and keep troubled companies alive.

Entrusted loan – 委托贷款
A loan made from one company to another, with a traditional lender acting as middleman and taking a fee. An innovation that has effectively enabled any cashed-up company to act as a bank.

Fees – 手续费
The best alternative source of income for banks as regulators gradually remove the caps on deposit rates and minimum rates on loans that guaranteed banks a healthy interest margin. Fees at smaller banks are growing by as much as 60 percent year on year.

Guarantee company – 担保公司
One of over 20,000 companies which receive a fee for guaranteeing loans and bonds from companies who may otherwise be unable to borrow. China's answer to the Western bond insurer.

Housing – 房子
A convenient store of value and – for many years – a source of tremendous capital gain in China. To remain so, in the popular imagination, it must under no circumstances be lived in.

Interbank market – 银行间市场
A market for banks and other financial institutions to offer and obtain short-term liquidity, but used by some to boost earnings or lending capacity. Rates in June reached 25 percent – four times what many state-owned companies pay for loans.

Japan – 日本
A cautionary tale.

Karl Marx – 卡尔马克思
Noted Western economist whose name is often cited by Chinese leaders and is written into the country's constitution. Despite this, China has spent thirty years ignoring his warning that capitalism leads to social calamity.

Local government financing vehicle – 地方政府融资平台
A vehicle that allows governments to get around rules that prevent them from borrowing or issuing bonds. LGFVs are the recipients of 9.3 trillion yuan ($1.5 trillion) of lending, according to official estimates. Who pays if one goes bad is unclear – which for now suits all parties.

Micro-finance –小额信贷.
Loosely regulated lending for small, private companies ignored by large banks. Often decried by regulators and officials. Like bacteria on which a host depends for survival, but about which that host would rather not think too deeply.

Non-performing loans – 不良贷款
Debts that have gone bad – currently about 1 percent of banks' total loan assets. The number may be inversely proportional to China's systemic credit risk.

Off balance-sheet lending –表外融资
Leverage that does not appear on the books of a regulated lender. An intricate pass-the-parcel of credit risk in which the central government, and thus Chinese depositors, are both the likely winner and certain loser.

Ponzi scheme – 庞氏骗局
A scam whereby funds raised from new investors are used to pay out old participants. A term used by regulator Xiao Gang to describe the shadow banking system. Also see wealth management product, interbank market, trust company, housing, etc.

Quota –配额
In earlier days, China's preferred way of allocating credit. Now quotas have officially been dispensed with, but their spirit lives on in the form of sky–high interest rates charged to private companies, and the rise of shadow banks.

Regulator – 监督管理委员会
A financial policeman with the ear of the Party, but none of its power. In China, regulators are split into banking, securities, monetary policy and insurance, to ensure weakness in numbers.

Shadow banking –影子银行
Defined in most markets as credit allocation outside the remit of bank regulators, and without public guarantees. In China, used broadly to mean anything off the balance sheets of licensed banks.

Trust company – 信托公司
A company that will match investors and borrowers for a fee. Their assets grew over 50 percent in 2012. While many are benign, nefarious uses include moving loans off bank balance sheets, and raising money for real estate developers.

Useful idiots – 有用的白痴
Mythically attributed to Vladimir Lenin, the term for someone who enthusiastically supports a cause they do not understand. Today, could be applied to many foreign financial institutions.

VIE – 可变利益实体
A common structure used by offshore investors to buy into sectors the regulators have deemed off limits, giving them all the risks of equity, and none of the ownership rights.

Wealth management product – 理财产品
Short-term products issued by banks and securities companies to retail depositors, who see them as a risk–free alternative to the low rates offered on bank savings. May hide $2 trillion of credit, according to Fitch Ratings. Some see WMPs as financial liberalisation; others see a ticking time bomb.

Xi Jinping – 习近平
China's president since March 2013 who, in financial terms, must foot the bill for a meal his predecessors cooked and ate.

Yuan – 元
China's currency. While it is not yet fully convertible and its value is set each day by the central bank, the yuan is already being proclaimed by some as a credible replacement for the U.S. dollar. See "Useful idiots", above.

Zero – 零
The number of bank failures or bond defaults that have occurred in China's domestic markets over the past decade. Also, the chance of that situation continuing over the next one.

10 September 2013

ABOUT US

Reuters Breakingviews is the world's leading source of agenda-setting financial insight. Breakingviews was acquired by Thomson Reuters in December 2009 and is now Reuters' brand for financial commentary. Everyday, we comment on the big financial stories as they break. Breakingviews has around 30 columnists based in London, New York, Hong Kong, Washington, Singapore and Beijing. We also syndicate selected columns on Reuters.com and in more than a dozen influential newspapers around the world including the International Herald Tribune.

www.breakingviews.com

www.reuters.com

Reuters photojournalists have witnessed and documented the events that define the modern era. The Reuters Pictures website offers access to the entire output of a global network of 600 photographers. View the day's top stories in visuals and search an archive of 4 million images at reuters.com/pictures.

ACKNOWLEDGEMENTS

Research by Robyn Mak.
Design by Nicola O'Hara, Nita Webb and Gavin White.
Production by Katrina Hamlin.

ON THE COVER
A worker checks the light on a symbol of the Red Dragon Chinese market in the outskirts of Bucharest December 2, 2009. REUTERS/Bogdan Cristel

BREAKINGVIEWS

THOMSON REUTERS
ACCELUS™

OVERCOME THE OBSTACLES OF OPERATIONAL RISK MANAGEMENT

CONNECT | SIMPLIFY | PERFORM

ACCELUS RISK MANAGER

Operational risk managers need to be aware of the potential impact that the rapid growth of the Chinese Shadow Banking System could have on their organizations, and prepare to manage those risks. Thomson Reuters Accelus Risk Manager can help with your organization's need to deliver deeper, richer understanding of its operational risks, while simultaneously exceeding regulatory expectations.

- Connect framework elements to view risks holistically
- Effectively embed your op risk framework and culture
- Provide scenario analysis, stress testing, and AMA capital calculations
- Analyze and manage operational risk challenges
- Drive operational risk perspectives into strategic planning

For more information on Accelus Risk Manager please visit:
http://accelus.thomsonreuters.com

THOMSON REUTERS™