China’s shadow

Will the debt overhang in China result in systemic risk to the financial system?

by Jack Rodman

For more than a decade, I have been concerned about the potential for a real estate– and debt-driven crisis in China and its potential impact on global financial markets. To date, my concerns have not been realised, but the fundamental economic principles causing my concern have grown exponentially.

In the past, analysts and pundits, such as myself, have periodically compared the Chinese economy to the US savings and loan crisis, Japan’s bubble economy, the Asian financial crisis and, most recently, the global financial crisis. All of these events were fostered by the same underlying fundamental economic problems — massive growth in debt markets (government, corporate and household debt); real estate appreciation and speculation; weak and/or lax bank and securities regulations; poor transparency; and an unfounded belief the government would prevent a systemic failure within the banking system.

The search for systemic risk

Chinese government officials and regulators in the China Banking Regulatory Commission, China Insurance Regulatory Commission, the National Development and Reform Commission, as well as the State Administration of Foreign Exchange, are attempting to circle the wagons to prevent a Lehman Bros–like moment, most recently due to irrational exuberance regarding outbound acquisitions and an overheated housing market at home.

For the first time in memory, Chinese government leadership and highly-regarded think tanks, such as the Chinese Academy of Social Sciences, have echoed rating agencies Moody’s Investors Service and Fitch Ratings, as well as the Bank for International Settlements, which have voiced concern over the potential of systemic risk in China’s financial system.

Industry watchdogs have ordered regulators to check for systemic risk across all sectors of the economy — from banking and insurance to commercial enterprises (conglomerates) — that have all recently binged on debt to fuel real estate, overseas mergers and acquisitions (across all sectors), and faulty/risky insurance products. The maturity gap between short-term investment trusts, wealth management products (WMPs) and long-term lending sets the stage for a liquidity crisis that could trigger the biggest financial crisis in history.

While China has taken steps in recent years to address these problems in its banking system, at least for the largest state-owned banks, off–balance sheet trust and wealth-management products have grown from near nothing 10 years ago to an eye-popping 65 trillion yuan (US$9.8 trillion), equal to 87 percent of China's GDP as at year-end 2016, according to Moody's.

"Shadow banking" complexities

China has become the master of the universe in circumventing the regulatory system in banking, insurance and real estate through complex and opaque ownership structures and creative unregulated financial products, generally referred to as the "shadow banking" system.

These products, often with mismatched maturities, have grown rapidly and in many forms. The repurchase agreement — or repo — market became of high concern to regulators due to a rigid interest-rate regime imposed in late 2013; overnight, repo rates spiked to 25 percent as the government moved to restrict the market. Banks replaced repos with negotiable certificates of deposit (NCDs) and entrusted loans (corporate through intermediary lending). Small- to medium-size banks issued three-month NCDs to raise capital, increasing the interest rate offered from 2.90 percent to 4.72 percent and using the proceeds to invest in higher-yielding, longer-term assets, such as corporate bonds or investment products (trust and WMPs) issued by fellow banks. The interconnectedness between small- to medium-size banks and shadow banking continues to grow, increasing the risk that funding structures — which invest through non-bank intermediaries in trust and asset management schemes — could become fragile if banks are unable to continue to roll over short-term NCDs to meet longer-term obligations, according to Moody's. Borrowers have turned to high-cost shadow banking as an alternate funding source, to delay default through a Ponzi-like scheme to "extend and pretend". Unfortunately, these programmes have gone on for so long they have become a part of the "institutionalised" financial system that China seems unable to wean itself off, despite regulatory and governmental concerns. Withdrawal of these short-term "wholesale" funding sources could trigger a massive liquidity crisis.

BTCC, China's Bitcoin exchange, stopped accepting deposits and shut down its business as at 30 September 2017, with all digital withdrawals to have occurred by 30 October.

The following is a high-level summary of the most prominent issues by industry:

(1) Corporate indebtedness accounts for approximately 167 percent of the near 280 percent debt-to-GDP in China. Less than half of China's corporate sector can service its debt and is dependent on rolling over loans. Most notable are Anbang Insurance Group Co, Dalian Wanda Group, Fosun International, and HNA Group Co, all of whose overseas buying binges have resulted in a crackdown on overseas mergers and acquisitions, and sparked concerns of systemic risk. A host of regulatory agencies are reviewing the risk posed by many of these enterprises.

(2) In the banking sector, loans to mortgages and real estate developers (and general contractors) now account for as much as 50 percent of all new bank lending. The government has continually failed to bring down residential real estate speculation, despite a decades-long, multipronged effort. Housing affordability in China's largest and fastest-growing cities is 30 to 40 times median incomes, compared with only 12 times median incomes in New York City. Despite being unsustainable, the

high cost of housing fuels social unrest. As a prelude to October's 19th National Congress of the Chinese Communist Party, President Xi Jinping laid a heavy hand on municipal governments in Tier 1 cities to put a hold on runaway housing prices.

(3) In the insurance sector, unchecked speculators — such as Anbang, which bought the Waldorf Astoria New York and attempted to buy Starwood Hotels & Resorts Worldwide, before regulators stepped-in — issued unorthodox and controversial universal life products that offered life/death benefits and a guaranteed current return greater than the regulated bank savings rates. Anbang, Evergrande Life Insurance Co and Foresea Life Insurance Co have also participated in the sales of these instruments. From February 2015 to 31 December 2016, the premium

income raised from the sale of universal life products for the 81 life insurers in China grew from 133 billion yuan (US$20.0 billion) to 1.18 trillion yuan (US$177.44 billion), a nine-fold increase. An insurer's ability to meet its actuarial needs raises concerns of a liquidity crisis, as investors demand a return of their investments in these products. Xiang Junbo, chairman of the China Insurance Regulatory Commission, was arrested for alleged graft. Xiang oversaw the deregulation of the insurance market, whose assets nearly tripled from 6 trillion yuan (US$902.2 billion) to 16 trillion yuan (US$2.4 trillion) from 2011 to 2016. He was the highest-ranking financial regulator ever arrested on charges of corruption.

(4) Joint stock banks have recently made headlines, as they binged on NCDs as an alternative to restrictions imposed on the repo market. There have also been recent scandals, most notably at China Minsheng Banking Corp, which issued NCDs and used proceeds to channel money through entrusted investments to asset managers to invest in bonds, stocks and commodities. The bank reported the products sold in its Hongtianqiao branch were forged and are under investigation. Investors were demanding a return of more than US$400 million, as reported in *The New York Times*. The bank cited a breakdown in its internal controls that allowed the defalcation to occur, and it is cooperating with police.

Today, global investors, companies and stakeholders have to assess and evaluate China's ability to continue to successfully circumnavigate the potential for systemic risk and its impact on world economies.

As at first quarter 2017, Moody's *Quarterly Shadow Banking Monitor* reports the world's largest money-market fund, Yu'e Bao — managed by an affiliate of Chinese firm Alibaba Group Holding — had assets totalling US$165 billion, fuelled by the fund's investment in interbank NCDs.

(5) Adding to the issues of transparency, opaque ownership and reporting structures is a lack of audit quality in China. The China Securities Regulatory Commission reviewed the annual reports and internal evaluations of 612 companies, which were randomly selected from among 3,050 listed on the Shanghai and Shenzhen stock exchanges, for compliance with audits and financial disclosures. Their findings pinpointed five audit defects affecting the veracity of the companies' financial results. Most notable were a lack of adherence to standard accounting principles and disclosure requirements in reporting revenues; inadequate information and disclosure for asset impairment, continuing operations and accounting policies; and discrepancy with internal evaluations and audits, and differences between internal reports and published annual reports.

Key takeaways

Despite having lived with these issues for most of the past decade, China has successfully avoided any of the calamities that triggered previously-mentioned financial crises.

A decade ago, global investors and companies were required by stakeholders to have a China strategy and plan for how to integrate and work with a rapidly-emerging China. A number subsequently ventured into the Chinese market, and a great deal has been written about their experiences (both good and bad).

Today, global investors, companies and stakeholders have to assess and evaluate China's ability to continue to successfully circumnavigate the potential for systemic risk and its impact on world economies. During the global financial crisis and its aftermath, we were witness to the global impact of third-tier economies, such as Greece and Portugal, in dealing with liquidity events.

How effectively have global investors factored in the potential and probability China could have its own "Lehman moment"? Despite the government's overwhelming motivation to avoid a systemic shock to the system or loss of confidence in the banking system — including property markets, wealth and trust products, the insurance sector, etc — the Chinese government will do anything and everything in its power to maintain stability and confidence in the financial system, and thus protect the interests of the party. The financially-minded Chinese are extremely smart and have been effective in avoiding a liquidity crisis. This has protected the banking system and large state-owned enterprises by channelling liquidity to troubled industries and moving impaired and nonperforming assets from bank balance sheets into state-owned asset management companies. The sheer size of these asset management companies — at both the national and local levels — is anyone's guess, but if comparable to the prior crises in Japan or Asia as a whole, they could be sitting on several trillion dollars of nonperforming loans/assets, or as much as 25 percent of China's GDP. The asset management companies bought these impaired assets with loans provided by the government in one form or another, contributing to China's enormous debt-to-GDP, which is approaching 280 percent.

One thing is for certain: Having lived and worked in China for more than a decade, I believe the overwhelming objective of China's considerable economic and political power will be to ensure the continuation and survival of the party, no matter what the costs. Come October 2017, we can expect the Xi government to lock in five more years of leadership, a reasonable period of time to accomplish the long-awaited financial reforms. Let's all wish him well. ❖

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