



# Financial Services Special Report: Risks in China's Financial System

## SUMMARY:

China's financial system has rapidly grown to the largest in the world. The risks however have grown in parallel. Non-performing loans (NPLs) could be as high as 20%, as much as a third of assets are hidden in the shadow sector, and smaller banks are heavily reliant on short and emergency liquidity. Tackling NPLs has been a key priority for authorities but bankruptcies, debt-for-equity swaps and asset disposals have a patchy record and have not resolved structural risks. The government is now stepping up its response. The central bank is tightening liquidity, anti-corruption has ratcheted up, the banking regulator has unleashed a 'regulatory storm' of enforcement action, and President Xi summoned the Politburo to increase political focus on financial security. Efforts to tackle financial risk will gain momentum, but short-term stability is the main priority.

## China Economics Network

### Ting Su

Financial Policy Advisor, British Embassy Beijing

### Jiaxin Zhang

Economic Officer, British Consulate General Guangzhou

### Kunal Khatri

First Secretary, Financial Policy, British Embassy Beijing

## Introduction to China's Financial System

China's financial system is the largest in the world. Total assets in the Chinese banking sector hit CNY232 trillion (USD33 trillion) as of end of 2016, 2.8 times national gross domestic product, surpassing the euro area to become the largest banking system globally. The banking system dominates, accounting for 70% of social financing in China. As of 2015, there are 3 policy banks, 5 big state-owned commercial banks, 12 shareholding commercial banks, 133 city commercial banks, 71 rural commercial banks, 68 trust companies in China.

The huge fiscal and credit stimulus in the aftermath of the 2008 financial crisis has been the catalyst for extraordinary growth in China's financial system. Between 2009 and 2015, total assets in China's banking industry doubled. The five state-owned commercial banks (Industrial and Commercial Bank of China, ICBC; Bank of China, BOC; China Construction Bank, CCB; Agricultural Bank of China, ABC; and Bank of Communications, BankComm) make up 39% of the sector's total assets. The shareholding commercial banks (for example, Industrial Bank, Everbright Bank, Ping An Bank) accounting for 18% of total assets, with mid-small size rural financial institutions (including rural commercial bank, rural credit cooperation, village and township banks) accounting for 12.9% and urban commercial banks, 11.4%. Foreign banks account for only 1.8% of total assets.

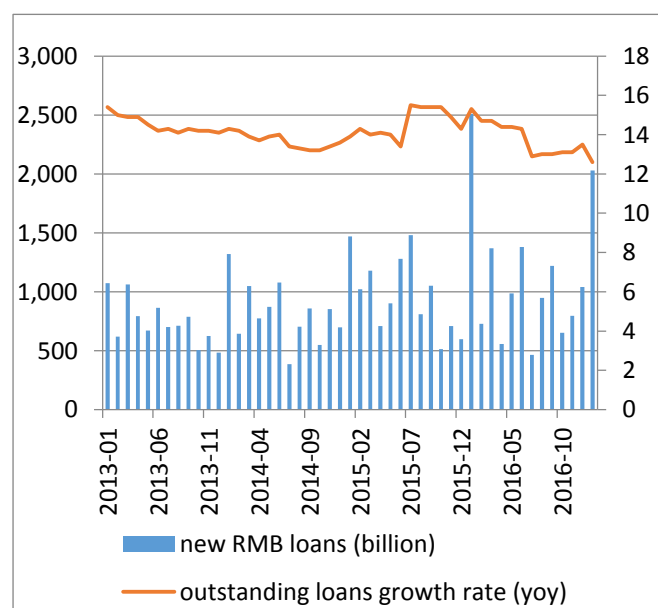


Figure 1: Loan growth in China; Source: Wind

China's credit and loan growth continues to outstrip GDP growth. Lending has grown more than 12% per year over the last few years even as growth fell to 6.5% in 2016. In January 2017, Chinese banks extended RMB2tn in net new loans, the second highest monthly tally on record. The composition of lending is slowly changing nonetheless with banks shrinking their exposure to heavy industry, especially over-capacity industries, while rapidly expanding

mortgages lending. The share of mortgage in the overall outstanding loan increased from 22.6% in 2012 to 31.9% in 2016, while heavy industry dropped from 17.4% to 11.4%.

### Risks in China's Financial System

#### China's economic slowdown has resulted in rising non-performing loans (NPLs) in the banking sector.

Following years of inefficient allocation capital, Morgan Stanley estimates that each additional RMB1 of nominal GDP growth now requires almost RMB6 of new credit. According to the China Banking Regulatory Commission (CBRC), outstanding NPLs increased to 1.81% (RMB1.4tn) in 2016, almost double the total in 2014. UBS Bank estimates these NPLs are primarily concentrated in the manufacturing, wholesale and retail, and micro-small sized enterprise sector. NPLs are also more heavily concentrated in the smaller banks. (Figure 2)

	Amount (RMB billion)	% of total loans	% of all reported NPLs
State owned commercial banks	776.1	1.68	51.34
shareholding commercial banks	340.7	1.74	22.54
city commercial banks	149.8	1.48	9.91
rural commercial banks	234.9	2.49	15.54
foreign banks	10.3	0.93	0.68

Figure 2 CBRC data on NPLs by type of bank; Source: CBRC

There are significant market doubts however as to the accuracy of China's NPL ratio with concerns that they are being under-reported across the system. It is likely that the Big Five are more reliably reporting their NPLs than the smaller and medium sized banks. Furthermore, whilst across the board the economic slowdown is impacting on loans to the manufacturing and private SME sector, the rebalancing of the economy away from investment and heavy industry and cutting of overcapacity should also be giving rise to NPLs in those sectors dominated by SOEs, but this is not yet the case in CBRC's NPL estimates.

Other indicators of balance sheet risk have also risen in recent years. Special mention loans (where a borrower has been loss making for two quarters, or the borrower is in a sector in wider distress) stood at RMB3tn, of which a third were overdue. Not all special mention loans are necessarily non-performing, but a proportion likely will be.

Most importantly, it is likely that NPLs are not being recognized because they are instead being rolled over through the shadow sector (Figure 3). Whilst CBRC capital and liquidity requirements limit the scope for on-balance sheet expansion, smaller and medium sized banks have rapidly expanded credit provision through complex shadow finance products that effectively mask loans through investment like products. These products typically require lower capital held against them, nor require provisioning/impairments in the same manner as loans. Estimates for the scale of shadow sector loans vary significantly according to definition from RMB 12 billion to RMB 60 billion, but at the very least, for some smaller and medium sized banks, the shadow book dwarfs the commercial loan book.

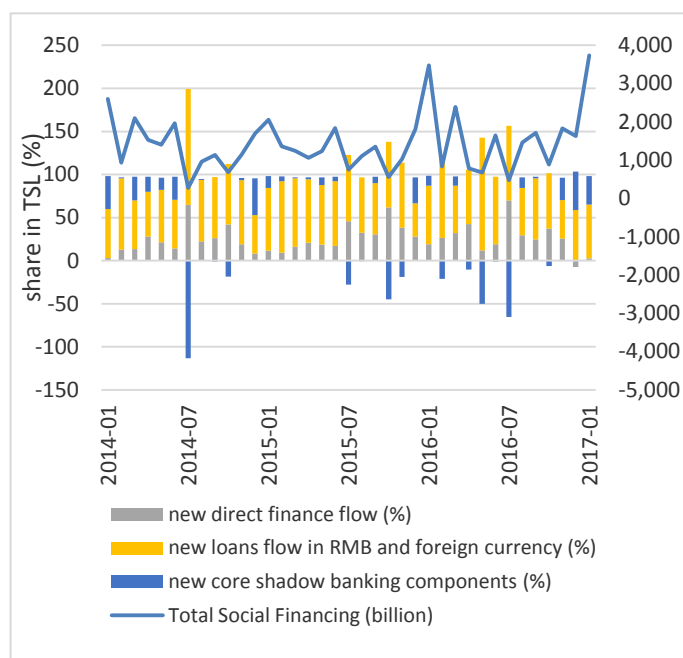


Figure 3: Total social financing by type; Source: Wind

**Compounding the risks, these products are also being increasingly packaged in to Wealth Management Products (WMPs).** WMPs are typically high yielding and short-term investment products that are sold directly to retail investors primarily as a way for banks to increase their stable deposit base. Moody's estimates that assets funded by WMPs were RMB25.9tn 1H 2016, which accounts for 12.2% of total banking assets. Real estate forms a substantial and growing part of the underlying assets of these products but there are indications that shadow trust loans and investments are growing as proportion of the underlying assets, directly exposing retail savers to the risks in this market.

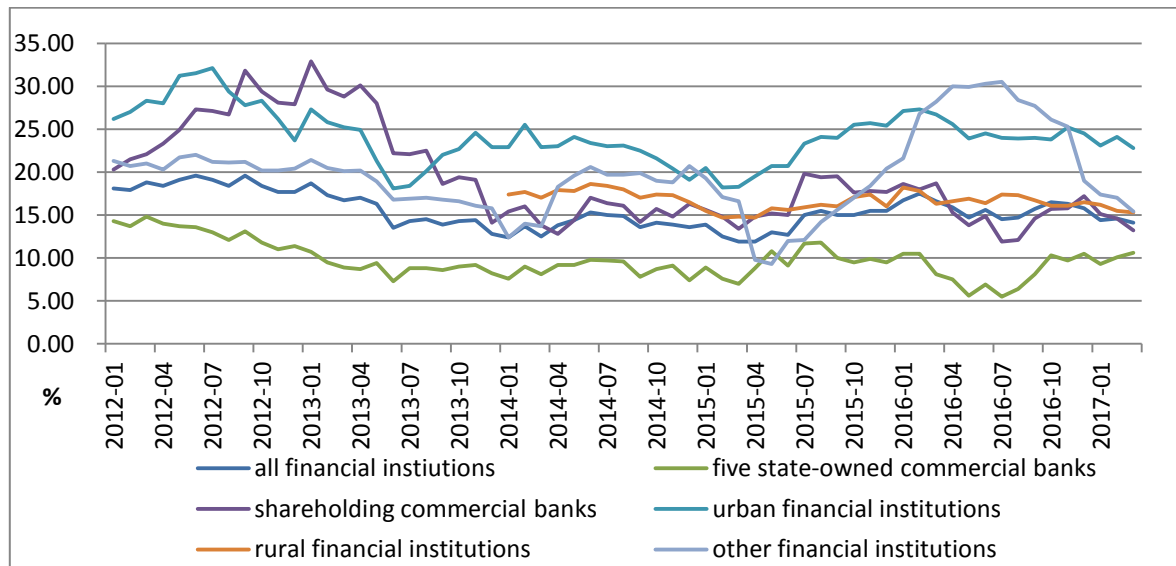


Figure 4: Bank asset monthly growth year on year by type of bank; Source: Wind

Given the above, private analyst estimates of the actual ratio of NPLs are much higher than those estimated by the CBRC. Fitch estimate that the NPL ratio could be between a range from 15 percent to as much as 21 percent, equivalent to around 11-20 percent of China's economy. The IMF estimates that total 'debt at risk', which is not the same as NPLs but is based on individual firm level data on interest coverage ratio and liability/asset ratios, at 15%. As discussed above it is likely that NPLs are heavily concentrated amongst regional and smaller/medium sized banks which have driven new loan creation and most aggressively expanded in to the shadow banking sector (Figure 4)

There are also growing liquidity risks in the banking system with smaller and medium sized banks increasingly relying on short term funding. This is compounded by continued efforts by the PBOC to tighten liquidity in the system in an attempt to shift banks to more stable longer term funding and reign in credit growth. Tightening carries risks however: against a backdrop of a slowing economy and a US federal reserve rate rise, PBOC tightening led to a spike in money markets precipitating the largest ever correction in China's bond market. Even then, as discussed above, tightening liquidity has not yet had a significant impact on credit growth.

### Tackling non performing loans

**Bankruptcies and bond defaults continue to play a small, albeit growing role, in tackling NPLs.** Bond defaults in 2016 ticked up to 80 cases, almost 4 times the year before. Bankruptcies also increased in 2016, with the bankruptcy of the state owned Guangxi Nonferrous Metals Group, the first time a state owned enterprise defaulted on creditors in the interbank bond market (not just bank loans or corporate debt). This rate of defaults and bankruptcies nonetheless remains small compared to the size of the financial system and wider economy.

**Asset disposals driven through China's Asset Management Companies (AMCs) have been the most significant vehicle for tackling NPLs.** The CBRC estimates that around RMB2tn of non-performing assets have been written off between 2013-2015, approximately equal to 2% of total loans. AMCs have a long history in China and played a critical role in tackling NPLs in the aftermath of the 1997 Asian Financial Crisis with the government establishing four

AMCs in 1999 to tackle distressed assets from China's largest banks (Cinda for China Construction Bank and China Development Bank; Huarong for ICBC; Orient for Bank of China; and Great Wall for Agricultural Bank of China). Building on this, recent reforms now allow every Province to establish two AMCs to take on bad debt with 35 currently in operation. Equally significant, new regulations permit these AMCs to sell on bad debts to third-party investors rather than simply acting as warehouses for NPLs.

However the original four AMCs have themselves morphed into vast financial institutions with rapidly growing balance sheets and there are risks that the new AMCs are following a similar path. Whilst also expanding their range of business lines, there are signs they are also relying heavily on bank loans to finance their purchases. Given the circular relationship with the banks, in some cases the local AMCs are simply perpetuating loans to zombie firms.

In 2016 the State Council also initiated a "debt-for-equity" swap scheme with banks replacing their loans for an equity stake in companies. Stressing the 'market based, commercial approach' of the initiative, the scheme intends to ease the debt burden on companies suffering from short term difficulty whilst avoiding bailout for zombie companies. As of early March 2017, more than RMB 430 billion (\$62.5 billion) of swaps deals have been signed since the launch of the new scheme with RMB 40 billion debt turned into equity. GF securities and Sina have identified 18 swaps to date, all SOEs, and mostly from heavy industries such as coal, steel, metal, and construction. However, distinguishing zombie firms from those in temporary difficulty and pricing deals at a market value is difficult to do with many transactions in fact conducted at face value. There are also concerns that whilst the scheme supposes an equity injection from the banks, it in fact remains debt-like (in nature with the banks assuming preferential treatment over other equity holders).

At the same time, whilst bank capital ratios are above regulatory requirements, this is measured against on-balance sheet assets. CBRC *Capital Rules for Commercial Banks* incorporates the core elements of the Basel III capital standards and requires all banks to comply by 2018, including additional capital requirements for those banks deemed domestically systemically important banks. Banks have actively raised capital in recent years through new share capital, consolidation, and central government bailout. However, falling profitability (profit growth was 2.4% in 2015 compared to 9.7% in 2014) due to liberalised interest and deposit rates and increased competition (including from FinTech firms) has meant that no Chinese banks organically raised capital in 2016.

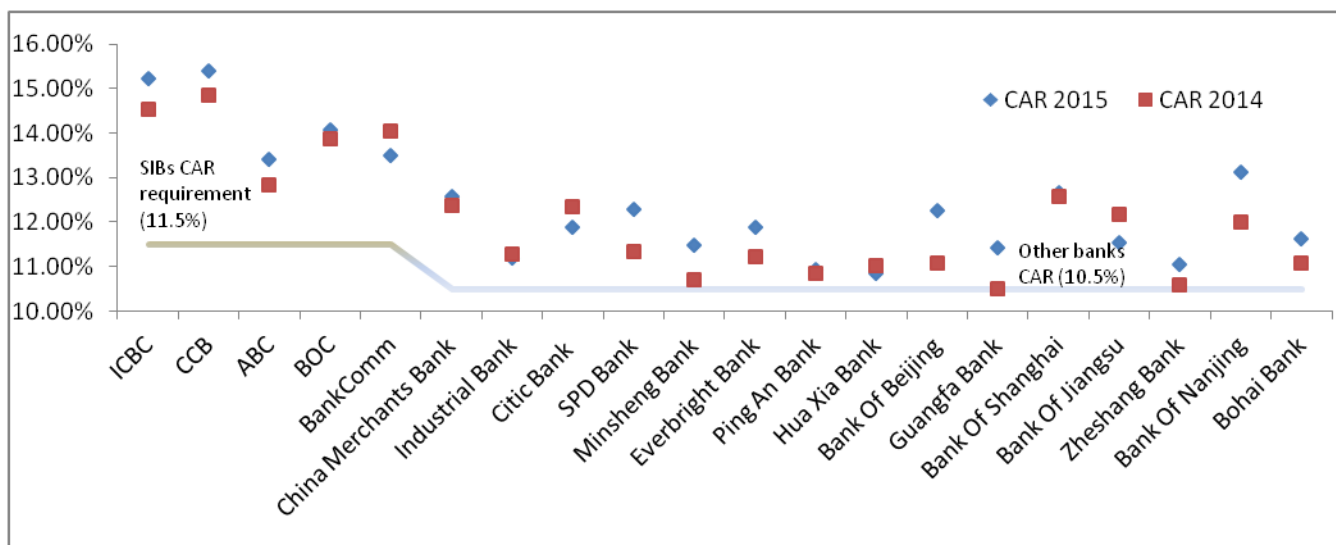


Figure 5: Bank Capital Adequacy Ratio (CAR) compared to CBRC's requirement' Source: KPMG Mainland China Banking Survey, 2016

## **Rising up the political agenda**

**Financial instability has risen up the political agenda in the last six months with President Xi even convening a special meeting of the Politburo to call for greater efforts to safeguard financial security.** The government's Central Economic Working Conference in December year signalled that stability would be the priority for 2017, and at a party meeting of the Central Economic Leading Group, both Xi and Premier Li stressed the need to accelerate regulatory coordination to tackle bad assets and risks in shadow banking and FinTech.

**The PBOC has led the way to drive forward new regulatory cooperation.** Noticeably, Governor Zhou has led the way to establish a "more effective and upgraded" coordinative mechanism to consolidate asset management regulation, suggesting this could be a more viable route to regulatory reform compared to previous rumours of merging the Bank and the three regulators into one "super regulator." A new mechanism to coordinate regulation of FinTech, currently split between all four regulators, is also being led by the PBOC.

**The PBOC is also strengthening its ability to produce a comprehensive and thorough view of risks in the financial system.** Divided responsibilities between China's four regulators has long stifled attempts to develop a comprehensive and consensus view of risks in the system, but the PBOC is addressing the challenge by extending the reach and power of its Macro Prudential Assessment (MPA) system. Introduced in 2016, the MPA provides the most complete picture of risks in the financial system, including banks' capital adequacy and leverage ratios, assets and liabilities, liquidity, pricing of interest rates, asset quality, foreign debt risks and implementation of credit policy. Importantly, the PBOC has been expanding its coverage to include off-balance sheet items and more accurately capture credit growth in the shadow finance sector.

**Regulatory enforcement action is also on the rise, coupled with a newly arrived Chairman of the CBRC, Guo Shuqing's, unleashing what media are reporting as a 'regulatory storm'.** Guo only arrived in post in February but has already issued eight policy documents to more strictly enforce implementation of existing requirements and force banks to bring loans and exposures on balance-sheet rather than hidden in the shadow sector. Fraud and corruption are also under the spotlight, with Yang Jiakai, Assistant Chairman of the CBRC, and Xiang Junbo, Chairman of the CIRC, brought under investigation in April.

**The increased attention and action on regulatory reform and tackling financial risks is welcome, but the challenges remain enormous.** Reform may itself trigger periods of instability as demonstrated by last year's bond correction, and stability will remain paramount in the run up to this year's Party Congress. China still retains sufficient resources to tackle instances of volatility but the pressure for fundamental and structural reform is growing.