PERSPECTIVE

China and Shadow Financing

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For the first time ever, the president of China was in attendance at the World Economic Forum Annual Meeting in Davos this month. President Xi Jinping joined a roster of presidents, prime ministers, central bankers, executives and other officials from around the world at this prestigious event, which carried the theme this year of “responsive and responsible leadership.” With China at center stage, I thought it might be appropriate to talk about an aspect of China’s economy that I think many people misunderstand: so-called “shadow financing” or “shadow banking,” which is said to be a significant contributor to China’s growth rate. In simple terms, shadow financing refers to activities outside the formal banking system that perform similar functions. Shadow banks can make financial services (namely loans) more widely available to the public, but since they are not subject to the same regulations, there is concern about the risk they pose to the financial system. The growth of shadow financing is reflective of an overall boom in consumer-oriented products and services in China. The consumer sector in China is one we are excited about in general.

Some people believe that shadow financing in China is banking reform gone wrong, and is a sign that banks have been circumventing regulations in order to increase or even protect their profit margins. Critics say that this has resulted in the possibility of much higher amounts of bad debt on the books of the banks. Since the Chinese government considers banking to be a strategic industry, it is a big issue.

Shadow banking has been associated with China but is practiced in many parts of the world. There is really nothing “shadow” about the term, since it is actually quite transparent. And, it is not “banking” in the true sense of the word since it involves all kinds of investment products, including mutual funds and private equity. Shadow financing is often called “bank loans in disguise,” because a bank is often at the core of the transaction, for example, offering an implicit guarantee for the various wealth products it sells to the non-banks it engages with. This is similar to the major US banks that have affiliated brokerage-end fund sales organizations to sell various wealth-management products.

Shadow banking has been growing in China. Some estimates indicate shadow financing currently amounts to roughly Rmb58trillion (as of 2015), representing 80% of China’s gross domestic product (GDP).[1] It started in 2007, when banks were allowed to invest in trust plans, then by 2010 wealth-management products became popular. In 2012, securities, insurance and mutual fund companies entered the market.

Are Banking Fears Founded?

The fears regarding shadow financing activity are similar to other fears or misconceptions we have found about China, including the fear that the country’s total debt is much greater than officially reported. Some say there is not enough disclosure for retail investors in terms of the risk they are taking, and that they are being misled. Of course, concerns about debt and the financial system are not unique to China. In Italy, for example, many banks found themselves saddled with non-performing loans (bad debt), and some small banks faced restructuring. New European Union rules now require stock and bond holders to absorb losses before a government bailout can be implemented. The fate of Italy’s third-largest bank still currently hangs in the balance.

Many consider shadow financing in China to be operating outside the regulated banking system, but the People's Bank of China, which carries out monetary policy and regulates financial institutions in mainland China, is aware of these activities. Securities regulators are also aware of them. In China, there is generally a lag in financial reform because of the conflicting interests of wanting to have a modern market economy, while at the same time wanting to keep control of it. This is a challenge for China in many areas of the economy, not only in banking.

Chinese banks are now among the most profitable in the world, and the government certainly wants to keep it that way in light of the banks' position as the home of the country's financial structure. If we look closely at shadow financing that includes various types of wealth-management products such as trusts, mutual funds and other instruments, some critics say these are in fact bank loans in disguise where the banks take the greatest part of the implied risk but use insurance companies, brokers and trust companies as the middlemen. So in effect, the banks are intermediating the shadow-bank products. For example, a wealth-management product may be based on a pool of underlying assets that could be a group of loans, including in risky industries such as mining, property and even local government infrastructure projects. The potential problem with these is that they are not standard to credit assets that might be traded on the interbank or stock exchange markets. They can include bankers' acceptance bills, letters of credit and accounts receivable.

It's important to note that the G20's Financial Stability Board 2015 Global Shadow Banking Monitor estimated that China's shadow financing was about 26% of GDP in 2014, which was much lower than the 59% average for 26 other major countries.[2] Therefore, we might say that China is somewhat behind the other major countries in terms of developing a non-bank financial system. Of course its definition of shadow financing may be different for China, but in any case, it doesn't seem as if this activity in China is way off the norm.

Probably the most interesting and major financial development in China has been the growth of trusts. Banks were allowed to have their wealth-management products invest in trust plans, and these trusts have funded government infrastructure and real estate projects. Although there is no legal guarantee for the trust investors, there is a perception that the bank in fact guarantees it. This thinking is augmented by the fact that most of these trust companies are owned not only by banks but also by large state-owned enterprises and local governments. These trusts have become a major method for banks to invest in equities, listed assets such as loans and the money market. Therefore, they provide a method for banks to offer finance to higher-risk sectors that normally would be restricted in some way by regulators.

At the end of the day, we believe the risks in China's financial sector are actually quite similar to what we find in other parts of the world. There is no question that many of the wealth-management products were exceedingly successful and provided excellent returns to investors. When that happens, there is often a tendency for the market to ignore the risks, and people pile into the products at even a greater rate. International organizations such as the International Monetary Fund have warned about the risk of corporate debt in China and its rapid growth. However, although the corporate sector may be sitting on high debt levels, the leverage in the government and household sectors is still rather low compared with some other developed countries. For example, China's household debt-to-GDP ratio was just over 40% last year, while the same reading in the United States was at about 80%, down from nearly 100% in 2008.[3]

Given the popularity of non-traditional lending vehicles with the public, it seems unlikely China's government would allow major defaults. Remember, while China continues to open its economy, it's still a controlled one. One might say the burden of risk sits with the government and the government is quite aware of this. That said, shadow financing sits in contrast to a system which overwhelmingly consists of bank loans funded by stable deposits; shadow financing in general involves more complex intermediation and funding structure, and generally requires the government to do more work to monitor the situation. In the event of a liquidity problem in the system, it may be more difficult for the government to stabilize the funding condition so as to prevent such to develop into systemic crisis. There are signs regulators are carefully examining the more egregious instances of financial product sales and abuses. At the end of 2016, the China Insurance Regulatory Commission announced measures against life insurers' aggressive and inappropriate market practices; insurance companies were restricted from filing for new products and selling universal insurance products for three months. Many insurers were warned about their sales of high-cash-value universal products, while others were prohibited from further sales of online insurance business because of misleading sales pitches.

China's Consumer Boom

I wouldn't necessarily say the record of banking regulation and banking behavior in other parts the world is something to be praised. However, the bottom line is that due diligence is required no matter where you invest. While the year ahead is certain to bring challenges, we remain optimistic about investing in China and the many opportunities we see in various sectors of the economy. The growth in financial services is just one area representing the boom in consumer-oriented products and services we expect to continue in China. For example, we view the automobile market favorably as penetration rates remain quite low versus developed markets. In addition, there has been a lot of technological change in the industry, with greater focus on efficiency, lower emissions and a shift towards electric vehicles. Another area we are focusing on is entertainment. We think gaming has good potential; Macau's casinos, for example, have attracted Chinese tourists. Similarly, we see a rapid growth of multiplexes and movie theaters in China and emerging markets in general, along with other types of entertainment venues.

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1. Source: Moody's Investors Service, Global Credit Research, October 2016.

2. Source: Financial Stability Board, Global Shadow Banking Monitor Report 2015.

3. Sources: Bloomberg, Federal Reserve Bank of St. Louis.