# The Global China Worry

*But are we worrying about the wrong risk?*

**By Chi Lo**

The U.S. Congressional Research Service published a detailed report on "China's Banking System: Issues for Congress" in February 2012, showing the importance of China's banking risk to the global economy. A lot has changed in the Chinese banking system since the publication of that report, but the world's concern about China's systemic risk has not faded, especially when its accumulated debt has accelerated while its asset quality has deteriorated.

Nevertheless, the focus on China's rising debt level and worsening asset quality exaggerates fears about a debt crisis. China's financial risk is still localized in nature because the current system set-up distorts rational domestic creditors' behavior and, ironically, reduces systemic risk. But we cannot ignore the risk of local financial accidents which could turn viral and systemic when the system set-up changes over time. This risk stems from the rapid expansion of small and regional banks that rely on wholesale funding and abuse financial innovation for regulatory arbitrage.

International credit-rating agencies have been warning about the danger of a Chinese banking crisis for quite some time. Fitch Ratings even boldly warned that China's bad loans in the banking system might be ten times the official estimates of 1.8 percent of total assets. That China's

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*Chi Lo is a Senior Economist at BNP Paribas Investment Partners and author of* China's Impossible Trinity: The Structural Challenges to the "Chinese Dream" *(Palgrave Macmillan, 2015). Opinions here are those of the author and do not necessarily reflect those of his employer.*

THE INTERNATIONAL ECONOMY
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220 I Street, N.E., Suite 200
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Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

banking system has a non-performing loan problem is nothing new. The predictions of a Chinese banking crisis have been proven wrong for more than three decades because pessimists treat China as an open-market system with a liberalized capital market and an open capital account, which is clearly not the case. This is not to deny any financial risk in China. But concern should focus on other areas the system, rather than in a systemic blow-up.

### A SYSTEMIC FINANCIAL "BOMB" THAT WON'T DETONATE

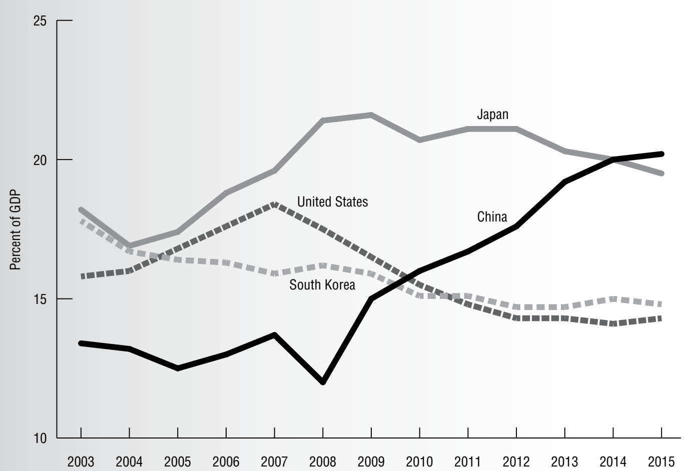
Financial risk in China is still localized in nature rather than systemic, though this will change as China continues to liberalize its financial sector and capital account. As long as the current system set-up remains, or changes very slowly, an increase in bad assets *per se* is probably not enough to trigger a financial crisis. This is because the government still owns the major banks, which are funded by stable retail deposits. Its implicit guarantee policy is the linchpin that holds the system together by, ironically, distorting creditor behavior.

If China were an open and mature market, which is how most western analysts see China, and given its non-performing loan problem, the creditors would lose faith in the debtors and cut funding, leading to a systemic collapse in the form of a debt-currency crisis. However, the majority of the creditors in China are the households, who are ultimately backed by the government's implicit guarantee policy.

As long as there is no loss of public confidence, the creditors in China will not cut off funding to the banking system which, in turn, will not cut off funding to the corporate sector. This "irrational" behavior suggests that no one could pull plug on China's financial system easily, so there would not be a financial crisis or capital flight or a collapse in the renminbi exchange rate. Meanwhile, China's closed capital account helps lock up domestic liquidity, providing support for keeping the banking system whole.

*The focus on China's rising debt level and worsening asset quality exaggerates fears about a debt crisis. China's risk stems from the rapid expansion of small and regional banks that rely on wholesale funding and abuse financial innovation for regulatory arbitrage.*

**Figure 1 China's surging debt-service burden**




Sources: Bank for International Settlements, BNPP IP (Asia)

What about China's surging debt-service burden, which is now the highest among the major economies (Figure 1)? The Bank for International Settlements has argued that when a country's private sector debt service ratio rose to above 25 percent of GDP a year, a financial crisis would follow, citing the experience of the high-profile financial crises in Finland in 1991–1992, South Korea in 1997–1998, and the United States and the United Kingdom in the early 1990s and more recently in 2007–2008. Some market estimates have put China's non-public sector debt service ratio at over 30 percent in 2015, higher than the Bank for International Settlements' estimate of 20 percent. However, the crisis triggers, namely financial deregulation, a heavy foreign debt burden, and an open capital account which pushed these countries over the cliff, are not present in China.

Thus, focusing on China's rising debt level and deteriorating asset quality exaggerates fears about a systemic blow-up. Generally, banks do not fail because they have bad assets, but when they cannot fund themselves either through deposits (as in a classic bank run case) or the wholesale market. The trigger for a banking crisis lies in the liability side of the bank balance sheet; a rise in bad assets per se does not necessarily bring down a financial system.

Chinese banks may have bad assets, but they have stable funding from domestic deposits. Despite years of gradual increase, the system's credit-to-deposit ratio is only 100 percent, which is less than half of the ratios seen in many other countries. Foreign creditors play no role in funding Chinese banks, so the system is not susceptible to withdrawal of foreign funds.

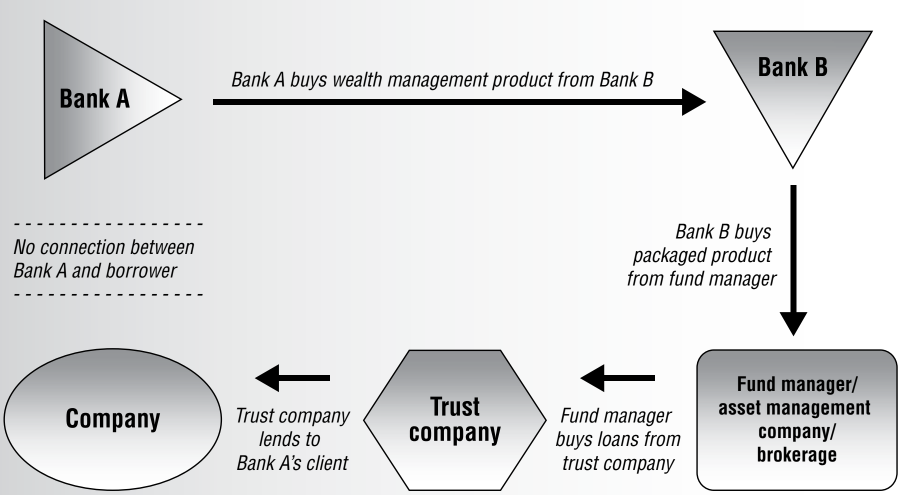
## THE RISKS REST SOMEWHERE ELSE

All this is not to deny any financial risk in China. There is indeed a rising risk of some localized financial failures, thanks to the rapid expansion of small and regional banks which have engaged in regulatory arbitrage through opaque and complex financial activities funded by wholesale funding. To see this, note that interbank borrowing by small and regional banks has risen from 12 percent of their total funding sources to 15 percent in 2016, compared to about 2 percent by the large commercial banks and the Big Four. Bottom-up data from twenty-six listed Chinese banks shows that almost every small and regional bank saw an increase in their reliance on interbank funding between 2013 and 2015, with the share of interbank borrowing ranging between a quarter to half of their funding sources. The big Chinese banks are well funded through their deposit networks and their relationship with the government and state-owned enterprises. However, small banks lack this advantage and have thus become more reliant on wholesale funding.

*The weakest link in China's banking system is the increasing complexity of credit creation.*

Normally, an increase in reliance on wholesale funding raises systemic risk because when the interbank market seizes up, as it typically happens during times of financial stress, these small banks would be vulnerable to a funding squeeze which could, in turn, create a domino effect. In the developed markets, this could lead to a systemic collapse. But the situation in China is different. The People's Bank of China would most likely step in either to keep funds flowing or force the major banks to take over the small troubled ones, like in 1998 when it asked the Industrial and Commercial Bank of China to absorb all the liabilities of Hainan Development Bank.

**Figure 2 Example of regulatory arbitrage involving banks and NDFIs**




Source: BNPP IP (Asia)

## HOW DO THEY CHEAT THE SYSTEM?

The weakest link in China's banking system is the increasing complexity of credit creation, which involves multiple layers of transactions between banks and non-deposit-taking financial institutions (NDFIs) aiming at eschewing regulatory constraints on lending. Bank lending to NDFIs has grown at an average annual rate of 35 percent since 2011, even when other types of bank loan growth has remained relatively stable at around 14 percent.

Trust companies play a central role in this bank-NDFI nexus, which emerged in 2009. NDFIs cannot take deposits but are allowed to make loans and invest in real estate and securities. They package their investments or loans into wealth management products which they sell to banks, who may then sell the products to their clients or keep them as their own investment. Since 2014, other NDFI players, including fund managers, asset management companies, and brokerage firms, joined the game, adding many layers to the credit creation process.

In a stylized example (Figure 2), a company approaches Bank A for a loan. But Bank A's lending ability is restricted by some regulatory constraints (see below). So it makes the following arrangement for its client: It buys a wealth management product from Bank B, which uses the proceeds to buy some packaged assets from an asset manager. The manager then uses the funds to buy loans from a trust company, which turns around and uses the proceeds to lend to Bank A's client. In the end, the company gets a loan via this complicated credit creation process without having any connection with Bank A, and Bank A eschews the regulatory constraint on its lending. All the other players are, arguably, rent-seekers in facilitating this regulatory arbitrage process.

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The credit risk of the final borrower does not change regardless of how many layers of credit creation are added. But complicating the credit creation process increases systemic risk: if any one of the players defaults, it will set off a domino effect by triggering counter-party risk. According to industry estimates, two-thirds of the credit created by this complicated process ends up as loans to the real economy.

## WHY DO THEY CHEAT?

The innovative credit creation process is indeed regulatory arbitrage. Under Chinese regulations, a corporate loan carries 100 percent risk-weighting for capital adequacy purposes. An indirect loan routed through a NDFI counts as an interbank claim and carries only a 20 percent risk-weighting. So the process lowers the banks' capital charge and allows them to expand their loan books by breaking the regulatory constraints but not the regulations. But it also encourages rent-seeking and allows financial excess to build up.

Banks also exploit this multi-layer process to gussy up their sickly balance sheets. For example, Bank A might sell a bad loan to an asset management company, which then sells the cash-flow rights of the loan to a brokerage, which packages them in a wealth management product and sells it to Bank B. Bank B then repackages the wealth management product into a new investment product and sells it to Bank A.

In this transformation, Bank A "magically" turns a bad loan into a "safe" interbank claim on Bank B, which is recorded as investment in A's balance sheet. The "paper" risk of Bank A disappears, but the underlying risk from the bad loan is still there. Most importantly, the process has increased systemic risk.

## NOT YET A DIRE PROBLEM

Such regulatory arbitrage activity relying on wholesale funding looks similar to the situation in the United States before the subprime crisis broke in September 2007, leading many observers to fret about a financial meltdown in China sooner or later. However, the comparison with the U.S. situation is not appropriate at this stage. This is because the majority of the Chinese banks do not rely on wholesale funding, which is a major determinant of bank vulnerability during the U.S. subprime crisis. In China, wholesale funding accounts for only 14.5 percent of total funding, according to the People's Bank of China, compared to 75 percent at the peak in the U.S. system.

Furthermore, virtually all banks in China are owned (directly or indirectly) by the government. There are only five private (small) banks, and foreign banks account for less than 1 percent of the banking market share in China. All the major NDFIs are also majority-owned by the government. The point is that the state is behind the Chinese financial system. The U.S. crisis was triggered by private creditor decisions to cut off funding for over-extended firms such as Bear Stearns and Lehman Brothers. In China, the state ownership and implicit guarantee policy distort rational creditor behavior which, in turn, helps preserve the system. In the event of defaults by small institutions, the government can also order the big state-owned banks to keep the credit lines open.

There is certainly risk in the Chines financial system, but it is not systemic yet. ◆