What Ponzi Scheme?

BY CHI LO

The risks of China's shadow banking system are manageable.

China's shadow banking system (or underground finance) has been a key funding source for the debt-ridden local government sector in recent years. This has the potential to set off a systemic problem because the official banking sector has a large exposure to shadow banking activity. Due to these concerns and the fact that China's total credit has approached 200 percent of GDP, Fitch Ratings downgraded China's long-term local currency debt rating by one notch to A-plus (from AA-minus) in April 2013. Shortly after the downgrade, a top Chinese auditor (Zhang Ke of ShineWing Certified Public Accountants) joined the chorus in warning about a potential debt crisis in China.

Rapid debt build-up and shadow banks are indeed potential problems. However, some of the pessimistic arguments are misplaced, and evidence shows that the scale is not yet alarming in China. Most analysts focus on the total size of China's shadow banking system. They assume that all the underlying assets are equally high risk and conclude that China has an impending financial crisis. This is an exaggeration. A clarification is needed.

COMPARING APPLES TO ORANGES

It is important to note that the widely cited estimation of China's 200 percent credit-to-GDP ratio (and hence the argument that this would lead to financial implosion soon) is not comparing apples to apples. This is credit-to-GDP that the market is talking about, even in Fitch's own language, not debt-to-GDP. This 200

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percent credit-to-GDP ratio of China's includes everything from bank credit, capital market activity (that is, bond issuance), and shadow banking activities.

When broken down, China's public debt (including local governments) is about 60 percent of GDP, and China has very little household debt (personal loans, including mortgage debt, account for less than 20 percent of total banking assets in the Chinese system). By contrast, U.S. public debt is 107 percent of GDP; its household debt is 85 percent of GDP. Famously, Japan's public debt is 245 percent of GDP, and household debt 65 percent of GDP. The point is that lumping China's credit altogether into 200 percent of GDP and comparing it to the debt-to-GDP ratios of other economies is comparing apples to oranges.

Further, the claim that "China's credit is now twice as large as its GDP" misses the point. China has an underdeveloped capital market. Its corporate bond market is still non-existent; its equity market is not a mature funding channel. At this development stage, the main channel through which Chinese savings can be converted into funding for investment is bank credit. Other mature economies have diversified funding sources through the capital market, so their credit-to-GDP ratio is lower than China's.

THE SCALE OF THE SHADOW BANKING SYSTEM

Chinese banks participate in underground financing in order to eschew financial repression. The activity amounts to regulatory arbitrage to circumvent government controls on interest rates, lending quotas, loan-to-deposit ratios, and reserve requirements. Market competition has prompted the banks to find loopholes to make loans and attract deposits via unconventional channels, such as shadow banking or circumventive financing activities, including wealth management products, trust loans, entrusted loans, bank acceptance bills, and micro (or private) loans.

Market estimates of the size of China's shadow banking market range from ¥11 trillion to ¥30 trillion (or 21 percent to 57 percent of GDP). Our estimate is ¥25.8 trillion (or 49 percent of GDP). In a global comparison, the Financial Stability Board analysis shows that Europe and the United States have far larger shadow banking markets than China. This should not be surprising because, in essence, shadow banking is non-bank financing activities, including money market funds, hedge funds, lending by non-bank entities, structured investment vehicles, and so forth. With mature financial systems and diversified funding avenues, Europe and the United States are deemed to have larger shadow banking sectors that China.

THE GOOD RISK

It is wrong to assume that all Chinese shadow banking assets are of the same bad risk quality that will cause a negative systemic shock sooner or later. The good, or manageable, risk assets amounted to ¥15.1 trillion in 2012, or two-thirds of the shadow banking assets, according to People's Bank of China data. They included:

- Entrusted loans (¥5.5 trillion). These are corporate loans specifically arranged and extended by one firm to another via banks.
- Micro and private lending (¥4.0 trillion). This involves loans by registered micro lenders to small businesses and loans between individuals and small businesses.
- Bank acceptance bills (¥5.6 trillion). These are short-term financing means for companies with legitimate business and proper credit status.

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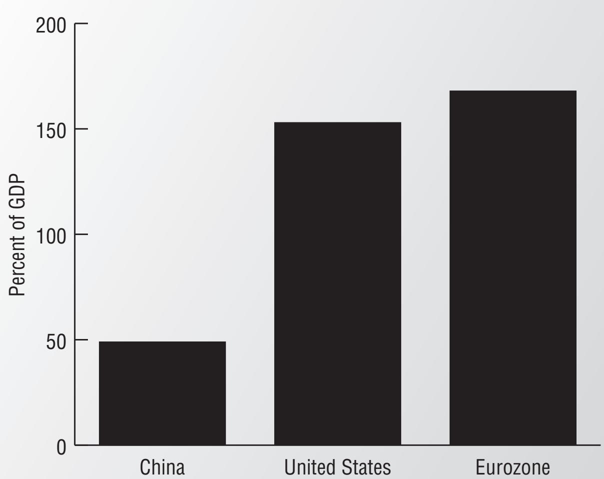
Size of shadow banking markets



Sources: FSB, S&P, BNPP IP Asia

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The risk involved in these activities is typical bank balance-sheet risk and is thus not unusual. These shadow banking activities are a result of both financial repression and financial liberalization, with the latter helping to relieve the budget constraints of the small- and medium-sized companies suffering from financial repression.

THE BAD RISK

The first type of bad risk that comes to mind is the wealth management products, which are financial products that borrow short (typically less than six months) and lend long (by investing in bonds and loan products longer than three years). They amounted to an estimated ¥7.5 trillion in early 2013, up from an official ¥7.1 trillion at the end of 2012 (according to the China Banking Regulatory Commission, the Chinese bank watchdog). These products are not properly regulated.

Sixty percent of the wealth management products are invested in money market funds and/or bonds, which are subject to the same credit, market, and balance-sheet-mismatch risks that the official banking sector faces. The real bad risk is the rest of the 40 percent, or ¥3 trillion, that are invested in medium- and long-term loans. This portion of the wealth management products may face rollover risk if investors do not want to buy the next products upon maturity to finance the underlying projects. The wealth management products' maturity mismatch is no different from the typical bank balance-sheet risk. But they do add to the size of the balance-sheet-mismatch risk in the financial system.

The next bad risk comes from the trust company loans to the local government projects, many of which are not fully covered by cash flows. These loans are estimated at ¥1.3 trillion, or 10 percent of all local government debts in 2012. Due to the opaque nature of these

Breakdown of China's shadow banking risk profiles

The good risk	Renminbi (trillion)	Percent of total shadow banking assets	Percent of GDP
Entrusted loans	5.5		
Micro/private lending	4.0		
Bank acceptance bills	5.6		
Sub-total	15.1	58.5%	28.9%
The bad risk			
Wealth management products (40 percent of total, with rollover risk)	3.0		
Trust loans to local governments	1.3		
Sub-total	4.3	16.7%	8.2%
The ugly risk			
Wealth management products with dodgy assets	1.9		
Sub-total	1.9	7.4%	3.6%
High risk (the bad plus the ugly)	6.2	24.0%	11.9%
1) The good+the bad+the ugly	21.3		
2) Wealth management products (60 percent of total, in safe assets)	4.5		
Estimated total shadow banking size (1+2)	**25.8**		**49.3%**

Sources: DB, BoAML, BNPP IP (Asia)

loans and the implicit guarantee by the government, the pricing of these trust loans does not reflect the true underlying risk. So the size of the bad-risk shadow banking assets is ¥4.3 trillion (¥3 trillion in wealth management products plus ¥1.3 trillion in trust loans to the local governments), or about 8.2 percent of GDP.

THE UGLY RISK

Some banks have also issued wealth management products for unspecified investments. The market estimate for this portion is ¥1.9 trillion. These investments include dodgy assets such as wines, oil paints, curb market loans, and even graveyards, which have generated the negative news headlines. The fundamental problem is not so much about the size and the nature of underlying assets but about the lack of transparency and disclosure of the underlying risks.

This is the most risky part of the shadow banking system, since these assets do not enjoy the implicit government guarantee that the trust loans do. There is also insufficient regulatory supervision of the shadow bank investments. However, their scale is limited, at least for now, amounting to 3.6 percent of GDP.

IMPLICATIONS

The high-risk shadow banking assets amount to ¥6.2 trillion, or 12 percent of GDP (with the most risky part amounting to only one-third of this). So the scale of China's shadow banking risk is manageable, especially when it is put in the context of China's ¥20.5 trillion (US$3.3 trillion) foreign exchange reserves, which are 40 percent of GDP. When push comes to shove, the Chinese government does have the means and resources to bail out the system (though this is not the way it should be going forward).

Chinese banks participate in underground financing in order to eschew financial repression.

Financial liberalization will inevitably create unforeseen risks along the way. It is imperative that China continues to reduce financial repression, as it is the root cause for the circumventive financing activities. Regulators may try to be preemptive, but usually they can only respond with new regulations and guidelines after risks have emerged. Rapid expansion of underground finance has prompted Beijing to regulate the banks' wealth management products recently by capping their non-standard investments (notably trust company loans, receivables, and non-traded products) to 35 percent of assets under management, and to bar local governments from using trust loans to raise funds for projects that are not fully covered by cash flows.

The risk of China's shadow banking market rests not with its size but with its opaque nature and insufficient regulatory control.

The central bank has also started to purge trading irregularities in the interbank bond market, which is part of the circumventive financing activity involving non-bank financial institutions, corporations, and individuals. China should upgrade its systemic risk management by reforming the regulatory framework, which currently is chaotic and fragmented. There are four regulators (the People's Bank of China, the China Banking Regulatory Commission, the National Development and Reform Commission, and the China Securities Regulatory Commission) regulating the bond market, with overlapping duties and bureaucracies.

In a nutshell, China's shadow banking risks are still manageable. The risk of China's shadow banking market rests not with its size but with its opaque nature and insufficient regulatory control. It is an exaggeration to say that the system has degenerated into a Ponzi scheme or subprime state. From a macro perspective, China's closed capital account, implicit government guarantee, and small foreign debt will help contain the problem of underground finance from blowing up anytime soon, because under these circumstances, capital flows cannot wreak havoc on the system and public confidence can be upheld. In other words, China's capital account opening can only proceed slowly due to domestic systemic considerations. ◆