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Shadow Banking in China and Expanding debts of Local Governments

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＜Summary＞

➢ The shadow banking system is expanding in China, and concerns are rising for the risks from high-yielding wealth management products (WMPs) that shadow banks have sold. Most of the money raised through these products has been channeled to what is called "local government financing vehicles (LGFVs)" that the local governments have established to finance their infrastructure projects. Because of poor profitability of those projects, however, the credibility of the WMPs has been largely lost, threatening bottlenecks in the flow of money in the Chinese economy which will invite a great uncertainty that may shake the whole financial system in China.

➢ Currently, banks in China have a stable management base with their bad asset ratio coming down to less than 1%. With significant amount of loans being made to LGFVs, however, they are facing a potential risk that these loans become non-performing loans. The Chinese government has recognized the seriousness of the problems and taken some measures to tackle them. Since the central government has sufficient money and ability to deal with the problems, the possible risk of overall financial collapse will be ultimately

avoided, yet there remains a question on how promptly the government can come up with pre-emptive actions.

- The shadow banking system in China shows that unlike in the case of the former International Trust and Investment Corporation (ITIC) Affairs and the US subprime loan problems in 2008, its final providers of the funds are mostly the Chinese individuals with less involvement of foreign investors. In this regard, it may be said that the systemic risk, even if it comes up to the surface, will be limited to be a domestic problem and there will be no or low possibility that it will directly spread to the rest of the world.
- However, even if China can avoid the emergence of a systemic risk and following financial crisis this time, there remains a possibility that the similar crisis will be repeated in the future unless the problem is solved fundamentally. Further, in the medium- and long-term, the government will be required to take financial liberalization measures and fiscal reforms, and, last but not least, to promote urbanization programs in the way that will contribute to the improvement of economic efficiency.

＜Full Text＞

1. Present situation of shadow banking in China

(1) What is shadow banking in China?

In recent years the shadow banking system has seen a rapid growth in China. There is no simple and clear definition on the shadow banking in China. The Financial Institute of the Chinese Academy of Social Sciences (CASS) describes it in its recent report as the “off-balance businesses of banks and activities of financial institutions other than banks”. Based on this description, it can be summarized as the following table. (Table 1)

Table 1：Shadow Banking in China (estimate as of the end of 2012）[1]

<table>
<tr><td>Route</td><td>Type</td><td>Outstanding; RMB tn</td><td>Ratio to GDP(%)</td><td>Reference</td></tr>
<tr><td rowspan="3">Bank route</td><td>Bank WMPs</td><td>7.1</td><td>13.7</td><td>Chart4-1</td></tr>
<tr><td>Of which, joint products of banks and trust companies</td><td>2.0</td><td>3.9</td><td></td></tr>
<tr><td>Bank acceptance</td><td>5.9</td><td>11.4</td><td></td></tr>
<tr><td rowspan="9">Financial Institutions other than banks</td><td>Trusted properties</td><td>7.5</td><td>14.5</td><td>Chart4-2</td></tr>
<tr><td>Of which, Trust loans</td><td>2.8</td><td>5.4</td><td></td></tr>
<tr><td>Entrusted loans</td><td>5.7</td><td>11.0</td><td></td></tr>
<tr><td>Asset management of securities companies</td><td>1.9</td><td>3.7</td><td>Chart4-3</td></tr>
<tr><td>Pawn shops</td><td>0.3</td><td>0.6</td><td></td></tr>
<tr><td>Financing of guarantee companies</td><td>1.2</td><td>2.3</td><td></td></tr>
<tr><td>Microfinance companies</td><td>0.6</td><td>1.2</td><td></td></tr>
<tr><td>Finance companies</td><td>3.4</td><td>6.6</td><td></td></tr>
<tr><td>Lease</td><td>0.8</td><td>1.5</td><td></td></tr>
<tr><td>Nonbank-institutions</td><td>Private lending (Underground lending)</td><td>2.0</td><td>3.9</td><td></td></tr>
<tr><td>Total</td><td></td><td>34.4</td><td>66.3</td><td>Charts2,3</td></tr>
</table>

Source :Compiled by the authors based on data from People’s Bank of China (PBoC), Securities Association of China, China Trustee Association, China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC), media reports

[1] Some of the types of shadow banking provided here may partly duplicate each other. Total figure does not include the joint products of banks and trust companies to make an allowance for possible duplications.

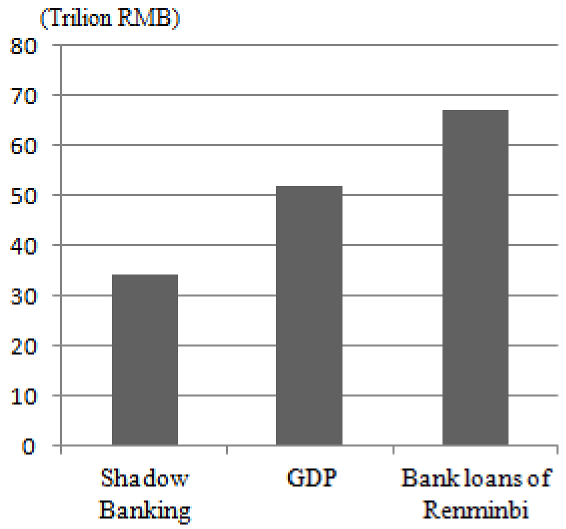
Glossary	
Bank WMPs	Financial products like investment trusts that banks sell mainly to individual investors.
Joint products of banks and trust companies	Businesses jointly conducted by banks and trust companies. The banks sell to their customers WMPs structured by the trust companies and lend the raised money to companies.
Bank acceptance bills	Bills that the banks guarantee the payments of the customers. Acceptance itself doesn't constitute the amount of credits.
Loans by trust companies	Trust companies sell to the individual investors their asset management products by which they raise money to make loans to project companies.
Asset management business of securities companies	Securities companies administer and manage the funds of customers under the contract with them. Unlike in Japan, the business areas of securities companies in China include not only brokerage, consigned sale and issuing of securities, proprietary trading, but also such businesses of investment advisory, financial advisory, asset management and security loans.
Entrusted loans	Method of financing funds from affluent companies to the needed companies by bank intermediation.
Microfinance companies	Specialized in micro financing, they accommodate the short-term funds to private small businesses and self employed business operators
Finance companies	They conduct for a group of affiliated companies such businesses as finance, payment, guarantee, and lending.
Private lending （underground lending）	Individual lending based on the credit from a family, acquaintances, etc.

Source : Compiled by the authors based on the information of Nomura Foundation, Economic Research Division of the Bank of Tokyo- Mitsubishi UFJ, J. P. Morgan, and others.

There is no official statistics on the shadow banking in China and there are differing opinions on its definition. Its estimated outstanding volume generally ranges from RMB20tn to RMB30tn (40-60% of GDP)[2]. The Chinese government has been trying to grasp the entire picture of the shadow banking, with the People's Bank of China (PBoC) starting to publish the statistics on "Aggregate Financing of the Economy" from 2011. However, it seems very hard to have a true figure of its scale. Take up the size of the bank WMPs, for instance, and their outstanding volume as of the end of 2012 is estimated at RMB6.7tn by the PBoC, RMB7.6tn by the China Securities Regulatory Commission, and RMB7.1tn by the China Banking Regulatory Commission (CBRC).

[2] Credit Suisse estimates the volume of the shadow banking as of the end 2012 at RMB22.8tn, JP Morgan at RMB36tn, and S&P at US$3.7tn (app. RMB23tn).

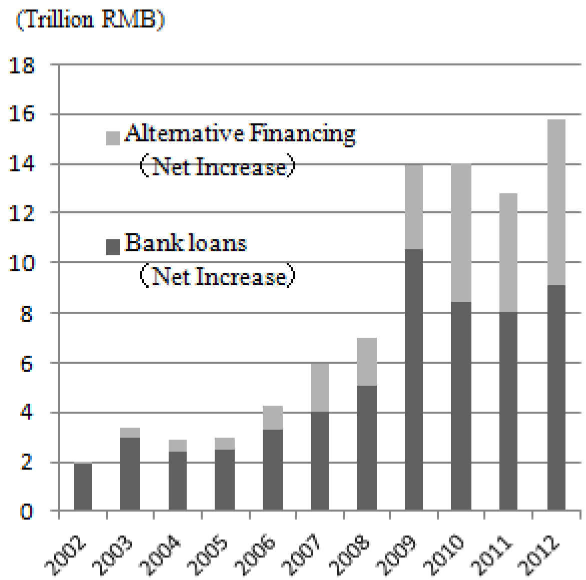
Chart 2 : Scale of the Shadow Banking in (as of the end 2012)



Source : National Bureau of Statistics of China, PBoC

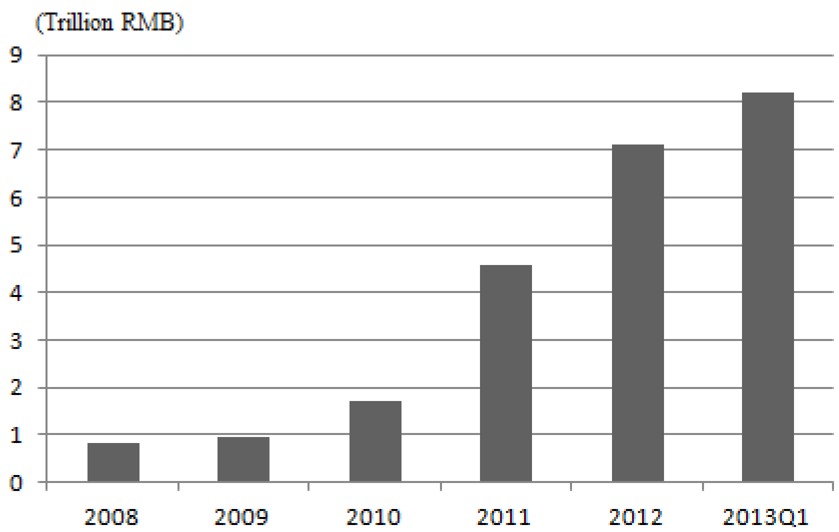
Shadow banking figure of RMB34.4tn is taken from Chart 1

Chart 3 : Bank Loans and Alternative Finance[3] in the Aggregate Financing in the Economy



Source: PBoC

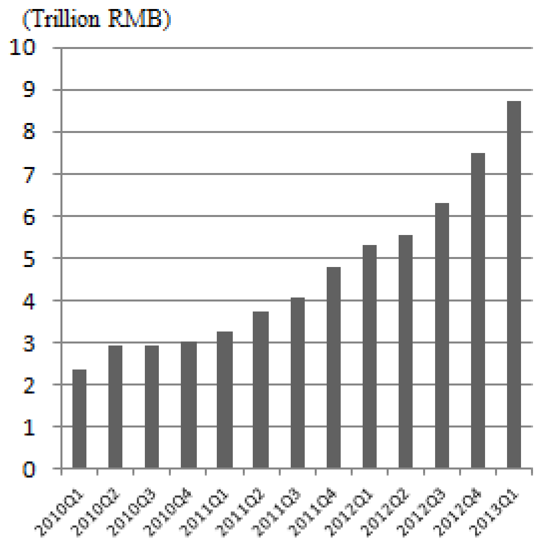
Chart 4-1 : Outstanding of Bank WMPs



Source : CBRC

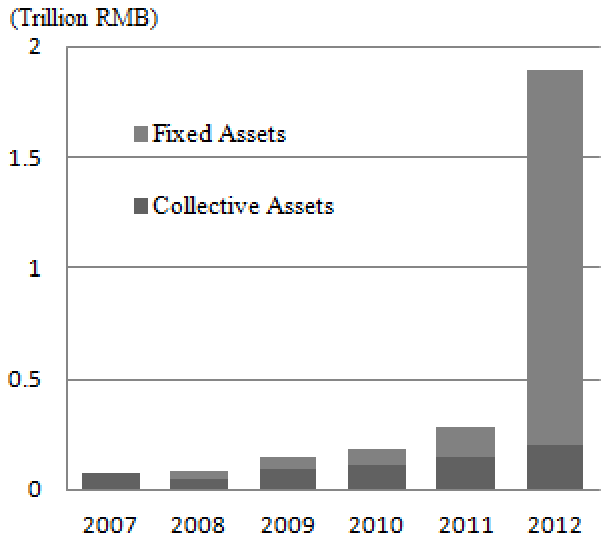
[3] Alternative finance refers to the total of entrusted loans, trust loans, bank acceptance, corporate bonds, and equities issued by non-banking institutions that are shown in the Aggregate Financing in the Economy Statistics, published by the PBoC. This equals to the aggregate social financing less bank loans.

Chart4-2： Outstanding of Trusted Properties



Source：China Trustee Association

Chart4-3：Outstanding of Assets Managed by Securities Companies[4]



Source：Securities Association of China

As is in the other countries, the problem with the shadow banking in China is the incapability of the authorities to adequately regulate and supervise those non-banking institutions. Most problematic of their products are the bank WMPs (explained in more details below). In fact, in November 2012, the WMPs sold by Shanghai Jiading Branch of the Huaxia Bank with an expected interest rate of more than 10 % defaulted on the repayment of interest and principle. In December 2012 investors had a loss of more than 50% on the WMPs sold by Shanghai branch of China Construction Bank which served as an agent. These incidents are becoming a social problem since the investors started to file a class action suit against the banks for their losses.

(2) Background of the expanding shadow banking

The main reason why the shadow banking is expanding in China, despite the fluid liquidity with money supply of RMB97tn and lending of RMB67tn against China's GDP of RMB52tn at the end of 2012 lies in the financial regulation of the authorities.

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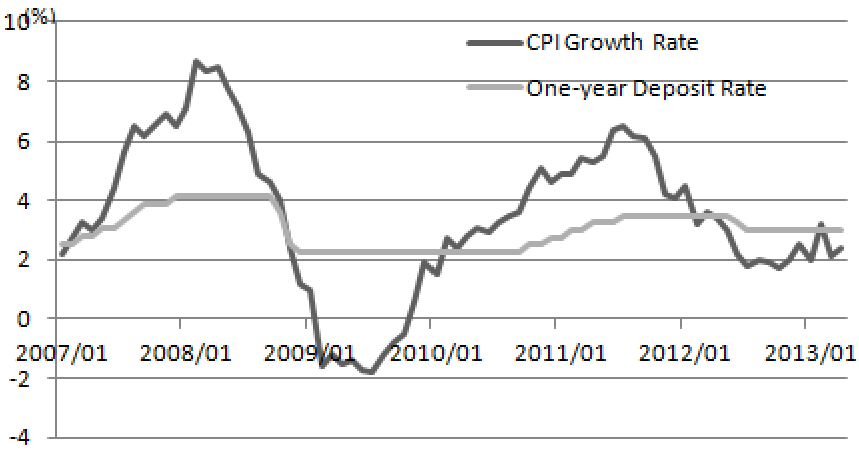
[4] The asset management business of securities companies include three types of management for fixed assets, collective assets, and limited assets. (Limited assets are excluded in the graph as they amount to only RMB3.5bn at the end of 2012.) Fixed assets management refers to the management of those assets by contract between a company and its customer. Collective assets management refers to the management of the funds collected from investors on a private offering by a securities company under a certain contract with the investors. Limited assets management is a kind of collective assets management, but it mainly invests in the products of higher credibility with high liquidity such as government bonds and securities, and there is a limit on the ratio of equities and equity funds to be incorporated in the investment.

Well before the shadow banking got an increasing attention, there was an unregulated finance (so-called underground lending) called “private (individual) lending” which is outside of the regulation networks of the authority. It is general that small and medium-sized enterprises (SMEs) rely on the private lending between individuals to raise their needed funds. According to the survey conducted in 2012 by the National School of Development at Peking University and Alibaba, an IT group in China, relatives and friends accounted for 69.3% among the lenders (multiple answers allowed) to the SMEs in Central West region including Sichuan Province and Hubei Province, followed by 37.7% of bank loans. In the Yangtze River Delta that includes Zhejiang Province and Jiangsu Province, SMEs’ reliance on the bank loans accounted for only 48.1%. This is because there was a cap on the bank lending rate until 2004 and banks were unwilling to lend the money to the SMEs with low credibility. Even after the abolishment of the bank lending rate cap, there still remained a cap on the deposit rate (currently 1.1 times or 110% of the basic rate of 3%) and a floor on the lending rate (currently 70%[5] of the basic rate of 6%) and therefore the banks did not dare to take risks to increase the lending to the SMEs since they could secure comfortable margins by lending to large companies when they faced restrictions on increase in lending within the framework of total volume control. In this sense, there was a significance of existence (raison d’etre) for this type of informal financing forms called the shadow banking in that they helped the fund raising of the SMEs that were unable to access the bank loans.

Currently, however, there often have been distortions in the interest rate regulation both for the investors and depositors. One year deposit rate is now fixed at 3% but it often happens that the rate goes under the rise of the CPI, making it a negative interest in the real term. (Chart 5) For this reason, the WMPs that advocate high yields have attracted investors as a favorable asset management product. According to the CBRC, the WMPs sold in China by banks amounted to RMB8.2tn (app. ¥130tn) at the end of March, 2013, accounting for 8.4% of the total bank deposits (RMB97.9tn).

[5] The PBoC announced to abolish its floor regulation on the lending rate as of July 20, 2013.

Chart 5：Basic rate on One year deposit and CPI



Source：Data stream

(3) What are the Bank WMPs?

The bank WMPs are the asset management products like an investment trust which are sold by banks mainly to individual investors. When a depositor buys a WMP, his deposit is transferred to a liability account of the bank called “Sales Agent Liability” and removed from the bank balance sheet. Usually minimum purchase amount is set at RMB50,000 (app. ¥800,000). Data of National Bureau of Statistics of China shows that the average annual income of urban employees of private enterprises amounted to RMB26,252 (app. ¥420,000) in 2012 and that of non private employees to RMB46,769 (app. ¥750,000). This means that the buyers of the WMPs belong to the middle class or upper with money to invest. According to the report of the CASS, most of the WMPs are of short-term products with maturity of less than 6 months, and those with 1-3 months accounted for 60%. Expected rate of return is currently 4-5%, with more than half of the WMPs invested in bonds.

What makes a big problem in these bank WMPs is those called “Funding Pool WMPs” which account for 50% of the total WMPs of the banks. They are the packaged products with which the banks aim to effectively pursue high profitability by investing in various products. The problems with these products include the sloppy management of the pooled funds by administering in a rough estimate what should be separately managed, inadequate disclosure to the investors of the products at the time of sale, mismatched maturity of the short-term products invested in the long-term assets. In addition, their sales are on the rise under the advertisement of “relatively low risk nature” because they are invested mainly in government and corporate bonds rather than in equities and commodities. However, it is highly possible that in reality they are largely invested in the low rated bonds such as LGFV Bonds (explained below) to secure higher yields.

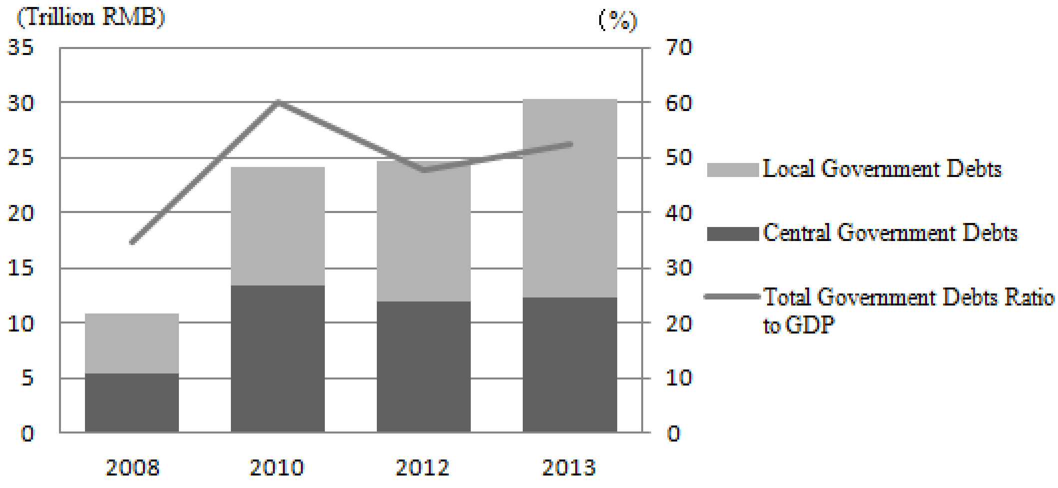
2. Local Governments and the Shadow Banking

(1) Local Governments and LGFVs

In present China, local governments bear the burden of providing various public services while their financing faces perpetual shortage mainly because of the tax sharing system[6]and prohibition in principle of issuing bonds. What made it possible for the local governments to raise funds under such constraints was the so-called "local government financing vehicles (LGFVs)", which local governments established to finance real estate development and other infrastructural projects such as road and railway construction. The National Audit Office (NAO, equivalent to the Government Accounting Office in the US or the Board of Audit in Japan) revealed in June 2011 that the debt outstanding of the local governments amounted to RMB10.7tn (app. ¥170tn), or 26.9% of GDP at the end of 2010, of which 46.4% was owned by the LGFVs. Also the NAO forecasts that the debts of the local governments will increase to RMB15tn -18tn (app. ¥225tn) in 2013 (Chart 6).

Chinese authorities, worrying about the risk of their debts becoming non-performing, started in the latter half of 2010 to put a control on the total volume of the bank loans made to the LGFVs. However, the amount of LGFV bonds are still on the increase driven by strong willingness of the local governments to invest, which is partly supported by their sense of competition with other local governments for higher growth (Chart 7).

Chart 6：Government Debts Outstanding

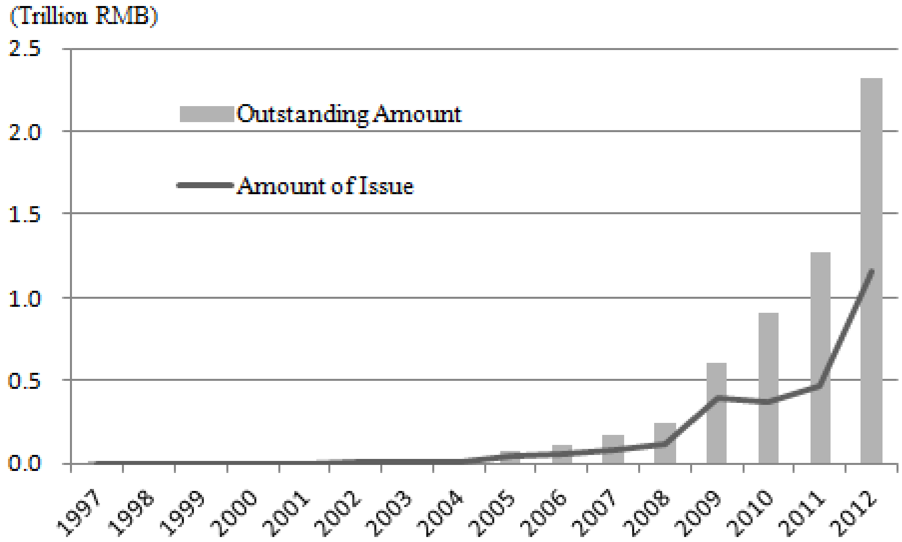


Source：Compiled by the author from data of IMF,CEIC and media reports

(The figure of 2013 is the prediction)

[6] Tax sharing system divides tax revenues into central tax, local tax and shared tax between central and local governments, depending on the tax items and tax payers. It was introduced to secure the revenues for the central government.

Chart 7：Issues of LGFV Bonds



Source：WIND

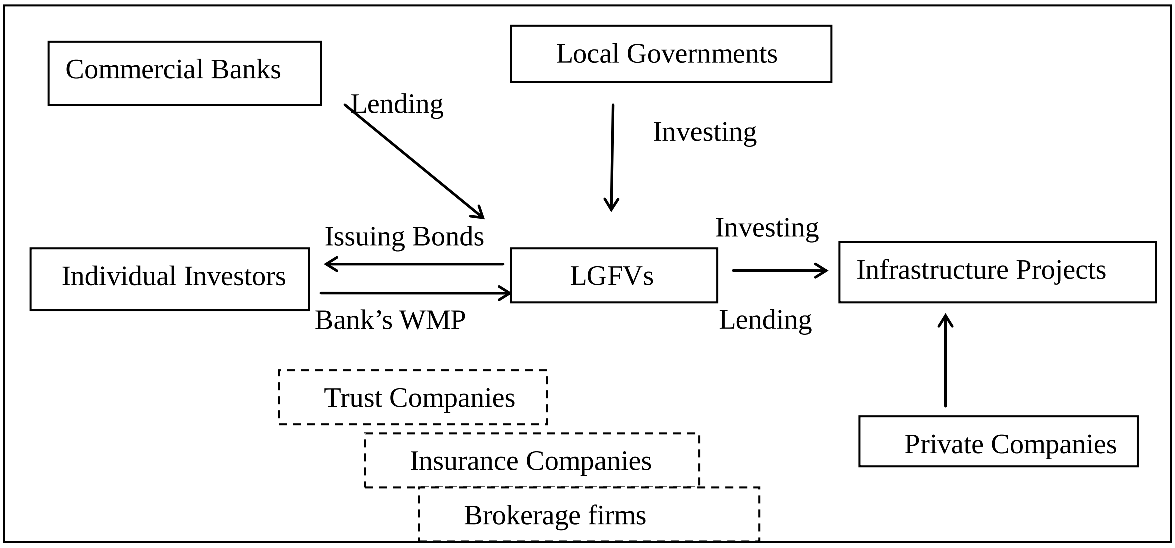
N.B.: Newly issued bonds in Q1 2013 amounts to RMB 364.12bn, or RMB 1.5tn on an annualized base.

According to a report by the CASS, LGFV bonds accounted for 80% of the total corporate bonds issued in China and had an average maturity of 5.7 years. The share of non-collateralized corporate bonds increased to 78.5% in 2012 from 0% in 2006 and those issued by the issuers rated at AA or under accounted for 24.4%. Further, according to a news report, these bonds usually carry a yield of less than 7%, giving the issuers more attractive means compared to bank loans to curb the fund procurement cost.

A great deal of bank WMPs are invested in these LGFV bonds. Reportedly banks are investing their lion's share of money in the lower rated LGFV bonds to secure higher profits, revealing the structure where the money of individual investors supports the LGFVs. (Chart 8)

Chart 8：General Scheme of a LGFV

(→indicates the flow of money)



Source：Author's Composition

(2) Growing Concerns for Systemic Risks

While the shadow banking is generally appreciated as a new way of financial innovation in China, its risks have also been recognized. Mr. Xiao Gang, Chairman of the CSRC, criticized WMPs in a newspaper interview held in October 2012 that those WMPs which are rolled over by issuing new WMPs are basically a kind of "Ponzi scheme" and therefore there is a great risk that they default once the credibility of issuers starts to falter if only a little[7].

Some of the LGFVs which were established blindly taking an advantage of an investment boom show a poor profitability in their projects. There are cases where they could raise the fund by the implicit guarantee of the government. According to another news report, Mr. Shang Fulin, Chairman of the CBRC, expressed his concern in April 2013 that the loans made by Chinese banks to the LGFVs amounted to RMB9.3tn (app. ¥150tn) at the end of 2012 and they may pose a big challenge to the banking system because 37.5% of these loans are expected to reach their maturity dates within 3 years[8]. Thus, there are concerns that if they were to cause a credit crunch in the flow of money, there will be a possibility that the whole financial system of China will be rocked.

3. Future Prospects

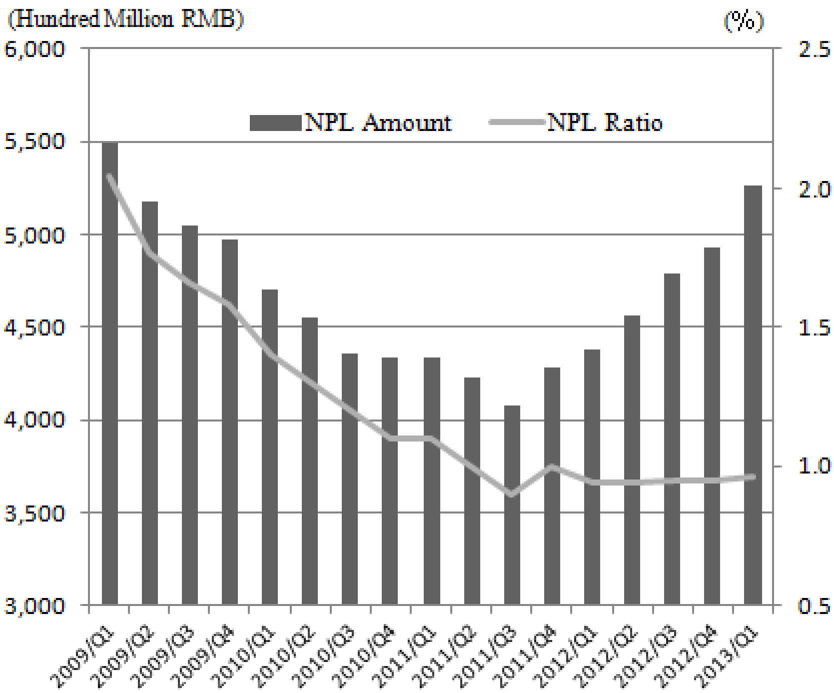
Attentions are mounting on the financial risks hanging over the rapidly expanding shadow banking in China which led the Fitch Rating to downgrade in April 2013 the sovereign rating of

7 Reported by "China Daily" of October 12, 2012.
8 Japanese edition of "WALL STREET JOURNAL" of April 24, 2013.

China from “AA-” to “A+”, and the Moody’s Investors Service to lower its outlook on the Chinese economy from “positive” to “stable” while affirming its previous bond rating of Aa3.

While Chinese banks currently have a stable management base with the Non-performing Loans (NPL) ratio declining to below 1%, the amounts of their bad loans are on the increase since the fourth quarter of 2011 (Chart 9). As stated above, their loans made to the LGFVs amounted to RMB9.3tn, about 14% of the total bank lending at the end of 2012 and there are concerns that their NPL ratio will jump up if and once these loans default as some of the LGFVs have a poor or doubtful profitability on their projects.

Chart 9 : Non-performing Loans(NPLs) of Chinese Banks



Source：CBRC

To address the situation, the Chinese authorities started to take necessary measures. In March 2013, the CBRC issued a notice to strengthen the regulation on the banks’ WMPs, requiring the banks to separately administer the assets corresponding to the WMPs and make adequate explanation on the nature of the products to the purchasers and others. Further in May, it demanded the banks to restrict their lending to the local governments and conduct a complete risk management.

Looking into the capacity of the Chinese government to deal with the problem, the national revenues are increasing although less rapidly than before but on a stable pace, recording

RMB11.8tn in 2012, whereas the debt of the central government is restricted at a low level (Chart 6). In addition, the central government virtually owns lands and state owned enterprises whose asset values far exceed the debt outstanding of the local governments. Therefore, the central government has a sufficient capacity to ultimately deal with the debt problems of the local governments and the problems will be controlled up to some extent. There remains, however, an uncertainty of how quickly the central government can take preemptive measures since their assets are not always of high liquidity.

Some people point out the similarity of the expanding Chinese shadow banking to the ITIC affairs and the US subprime problems of 2008. Similarity includes their involvement of real estate where the funds are ultimately invested. On the other hand, the shadow banking differs from the latter ones in that the ultimate investors are individual households and therefore the leverage is not always high as they invest their money within their savings in the household, and that foreign investors are not directly involved in the transactions. From this perspective, it is considered that the problems will be domestically contained without direct repercussions of its impact to overseas even if its systemic risks come up to the surface.

Chart 10：Comparison of financial crises in Japan, China and the US

	Japanese Housing Loan Companies	ITIC in China (International Trust and Investment Corporation)	US Subprime Loans	Chinese Shadow Banking
Time of crisis	Around 1995	Around 1998	Around 2008	?
Features	Banks established Housing Loan Companies to promote their housing loans and HLCs failed on their heavy investment in properties for commercial use.	Local governments established the ITIC for raising money. It failed after expanding its business, circumventing regulations, to not only fund raising but also to investment in securities and real estates.	Securitized products based on the original housing loan assets for low income earners flourished, they became non performing triggered by the deterioration of asset quality and depletion of liquidity	The authorities strengthened the regulations as the loans and fund raisings of unregulated institutions rapidly increased.
Main lenders/ investors	Domestic banks	Financial institutions (including foreign)	Financial institutions (including foreign)	Domestic individuals
Areas of ultimate investment	Housing, Real estate	Real estate, finance, trade, transportation, energy, communication and other infrastructure related business	Housing, Real estate	Housing, Real estate
Foreign repercussions	Small	Medium	Large	Small
Magnitude of loss	App. $8.4bn (app. ¥7.9tn) (app. 1.7% of GDP)	App. $1.2bn (app. RMB99.6bn) (app. 20.6% of GDP)	App. $1.4tn (app. 10.6% of GDP)	Not known. The outstanding reaches app. $5.4tn (app. RMB34tn) (app. 66.3% of GDP)

Source：Complied by the Authors based on the data from The Resolution and Collection Cooperation, Japan Center for Economic Research, Fujitsu Research Institute ,IMF, Others

4. Conclusion

In the global concern over the expansion of Chinese shadow banking, the Chinese authorities are trying to avert a possible financial risk that will be triggered by the systemic risks by putting a brake on its further expansion. While optimism will not be allowed, the new leaders of the Chinese government are showing their willingness to promote domestic financial reforms, even if they succeed in the aversion of financial crisis this time, so that they will not be required to repeat the same upset. In this regard, we would like to stress the following points.

The shadow banking spilled over to trust banks and securities companies under the radar of banking supervision. It will be difficult to completely restrict the shadow banking but in order to make an appropriate regulation, it is important to give the financially weak people better bank access by promoting further liberalization of financial transactions. At the same time, it is desirable to promote the development of direct finance in the bond and equity markets, thus helping shift the funds in the shadow banking to the more controllable regime of regulated world.

The greatest problem lies in the point that the local governments were forced to rely on the shadow banking because they could not obtain sufficient financial resources needed to perform their important roles of serve the people in such areas of general public services and social securities. It will be necessary to shift more tax revenues from the central government to the local governments by reviewing the tax sharing system, and change its model so that the lowest level of local governments such as townships and villages can secure the tax revenues they need.

The funds in the shadow banking have been invested through the LGFVs in the infrastructures in many urban areas. The incumbent leaders of the government strongly advocate to promote the urbanization, but there is a risk that the investments without economic rationality will continue to be made in the unnecessary real estates, if they press forward only with "urbanization projects of land space" while shelving such problems of household registration (Hukou) system and land system. The urbanization policy of the central government should be accompanied by the fundamental and radical reforms of household registration (Hukou) system and land systems. It will be a sheer nonsense if they are satisfied only with the construction of big buildings.

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