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China's Financial Risk: Towering Inferno Or Slow Burn?

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Understanding China's financial system risks

- Much alarmist analysis and media commentary has hyped financial system risk in China. The main reasons for concern:
  - Gross credit / GDP rose from <150% before the GFC to 262% in 2016.
  - Much of the increase in credit has come from "shadow lending" by non-banks, which is poorly understood and believe to be poorly regulated.
- As in any fast-growing financial system, the risks are real. But fears of systemic crisis or collapse are overblown:
  - Much of the rise in debt reflects necessary financial deepening.
  - Rise of shadow lending reflects a growing ability to price different types of risk, allowing different types of borrowers to access credit.
  - Credit cycles are more tightly managed than is generally understood, and regulators are vigilant.
  - Systemic reliance on wholesale funding is low, although smaller city commercial banks do face significant funding risk.

Changes in financial system structure (2007-16): Institutions

Table 1
Financial system assets by institution, 2007

Institution type	**Assets Rmb trn**	**Pct of total**
Banks	51.80	85.7%
Policy banks	*4.39*	*7.3%*
*State-owned commercial**	*29.08*	*48.1%*
Joint-stock	*9.68*	*16.0%*
City commercial	*3.35*	*5.5%*
Rural	*5.30*	*8.8%*
Asset managers	-	0.0%
Trusts	0.96	1.6%
insurance	2.90	4.8%
Mutual funds	3.03	5.0%
Hedge funds	-	0.0%
Securities	1.73	2.9%
Total	**60.42**	**100.0%**

*Includes Postal Saving Bank

Table 2
Financial system assets by institution, 2016

Institution type	**Assets Rmb trn**	**Pct of total**	**Market share change**
Banks	223.47	71.3%	-14.4
Policy banks	*22.94*	*7.3%*	*0.1*
*State-owned commercial**	*99.49*	*31.7%*	*-16.4*
Joint-stock	*42.89*	*13.7%*	*-2.3*
City commercial	*28.24*	*9.0%*	*3.5*
Rural	*29.90*	*9.5%*	*0.8*
Asset managers	34.48	11.0%	11.0
Trusts	17.46	5.6%	4.0
Insurance	15.12	4.8%	0.0
Mutual funds	9.16	2.9%	-2.1
Hedge funds	7.89	2.5%	2.5
Securities	5.79	1.8%	-1.0
Total	**313.36**	**100.0%**	

In 2016, 86% of financial system assets were in the banks, and two-thirds of these were in the big state-owned commercial and policy banks.

Non-bank financial institutions were small, and the main players were insurance companies and mutual funds.

By 2017, the bank share of system assets had fallen to 71%, almost entirely because of a loss of market share by the state-owned commercial banks.

Among NBFIs, asset managers, trusts and hedge funds—non-existent a decade earlier—now accounted for almost 18% of system assets.

Institutional change: the banks

Table 3

Banking system assets, 2007

Bank type	Number	Rmb trn	Pct of total
Policy banks	3	4.39	8.5%
State-owned commercial bank:	6	29.08	56.1%
Joint-stock	12	9.68	18.7%
City commercial	169	3.35	6.5%
Rural	3,873	5.30	10.2%
Total		**51.80**	

Table 4

Banking system assets, 2016

Bank type	Number	listed	Rmb trn	Pct of total	change
Policy banks	3	0	22.94	10.3%	1.8
State-owned commercial banks	6	6	99.49	44.5%	-11.6
Joint-stock	12	9	42.89	19.2%	0.5
City commercial	169	15	28.24	12.6%	6.2
Rural	3,873	5	29.90	13.4%	3.1
Total			**223.47**		

Banks remain the core of the financial system, but the composition of the banking industry has changed substantially.

In 2007, the six state-owned commercial banks (ICBC, Bank of China, Construction Bank, Agricultural Bank, Bank of Communications and the Postal Bank) accounted for 56% of bank assets. City and rural commercial banks accounted for just 16% of the system.

By 2016, city and rural commercial banks controlled 26% of bank assets, their growth coming at the expense of the SOCBs. Visibility is poor because few of these smaller banks are listed.

Changes in financial system structure (2007-16): Assets

Table 5
Financial assets by type, 2007

Asset type	Rmb trn	Pct of total
Bank loans	27.77	62.9%
Shadow loans	-	
Bonds	12.70	28.8%
China government (CGBs)	*4.94*	*11.2%*
Local government	*-*	
Policy bank	*2.88*	*6.5%*
Other financial institutions	*0.34*	*0.8%*
Corporate	*4.54*	*10.3%*
PBOC bills	3.66	8.3%
Total	**44.13**	**100.0%**
Total non-equity financial assets, % of GDP	163%	
Equities	*32.72*	
Equities pct of GDP	*121%*	

Table 6
Financial assets by type, 2016

Asset type	Rmb trn	Pct of total	Market share change 2016/2007, pp
Bank loans	112.06	57.5%	-5.5
Shadow loans	17.20	8.8%	8.8
Bonds	58.77	30.1%	1.4
China government (CGBs)	*12.10*	*6.2%*	*-5.0*
Local government	*10.85*	*5.6%*	*5.6*
Policy bank	*12.40*	*6.4%*	*-0.2*
Other financial institutions	*1.86*	*1.0%*	*0.2*
Corporate	*21.56*	*11.1%*	*0.8*
PBOC bills	0.01	0.0%	-8.3
Negotiable certificates of deposit	6.28	3.2%	3.2
Asset backed securities	0.65	0.3%	0.3
Total	**194.95**	**100.0%**	
Total non-equity financial assets, % of GDP	262%		
Equities	*50.84*		
Equities pct of GDP	*68%*		

In 2007, nearly two-thirds of financial assets were bank loans; most of the rest consisted of plain-vanilla government, policy bank and SOE bonds, and PBOC sterilization bills.

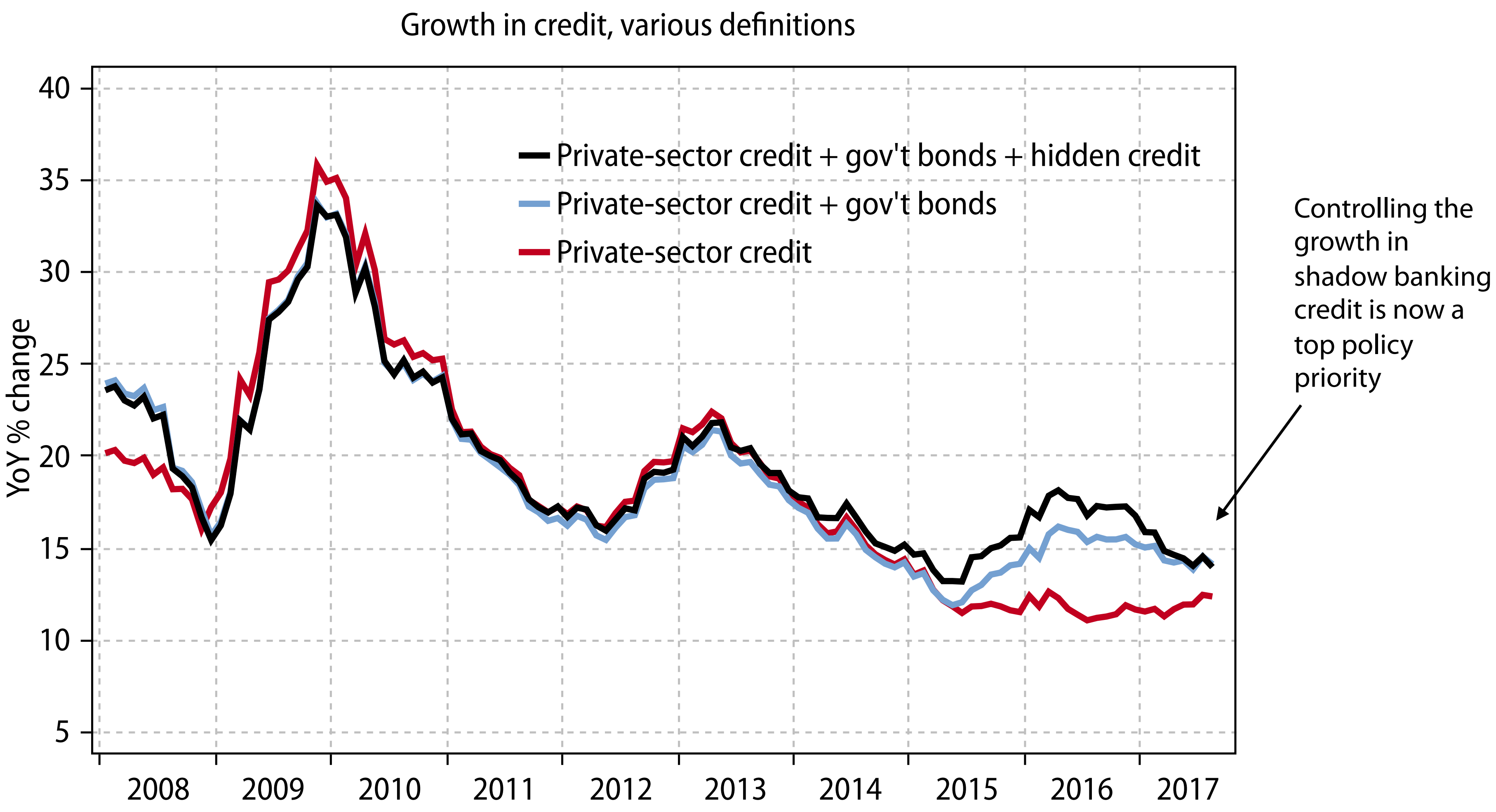
Equity market capitalization was about three-quarters the size of total credit assets.

By 2016, the share of bank loans, central government bonds and PBOC bills in system assets had shrunk by 19pp.

In their place arose a panoply of shadow lending, local government debt, and most recently, negotiable CDs.

The credit cycle is more tightly managed than many realize

Credit growth driven by government borrowing and shadow finance

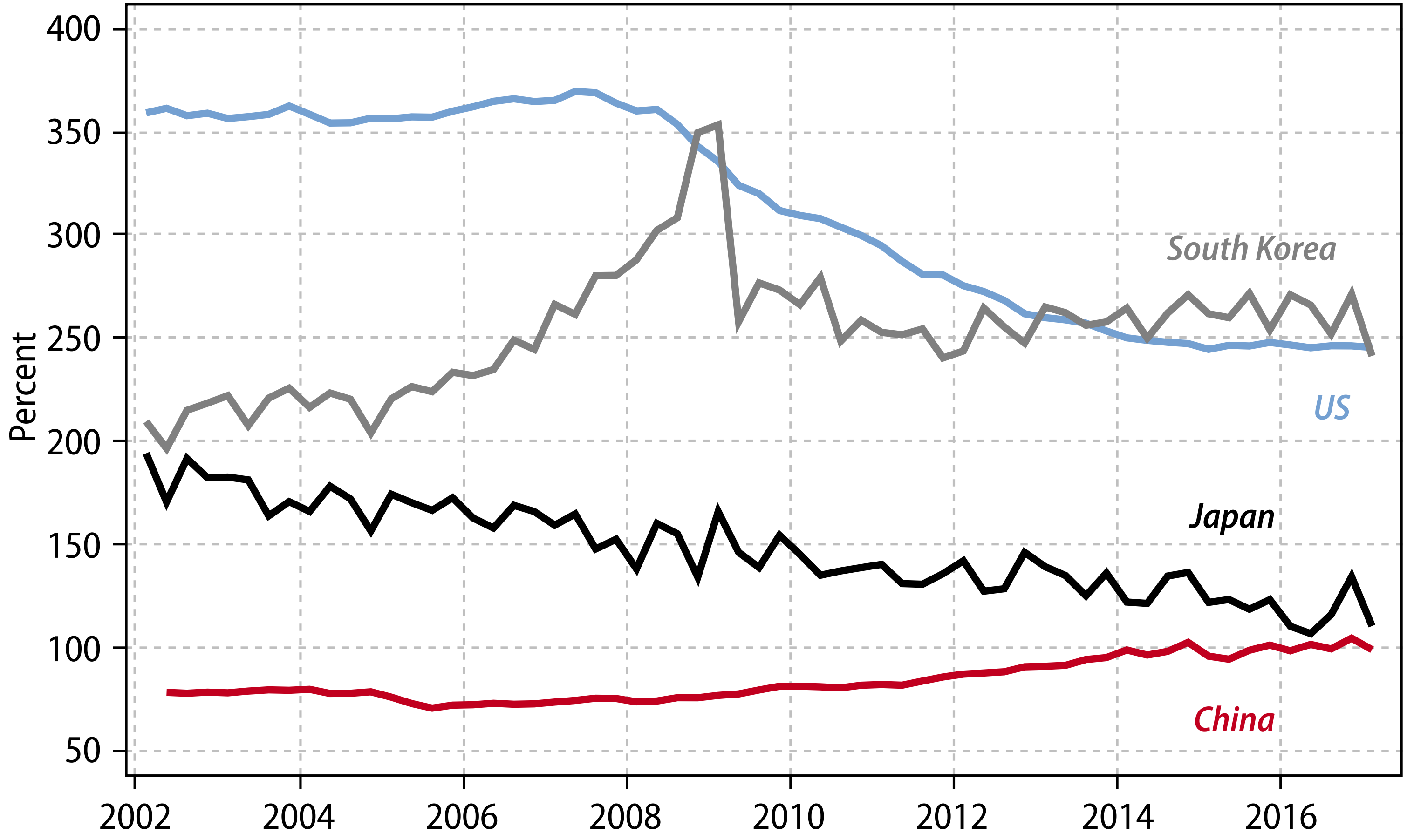


CEIC, Gavekal Data/Macrobond

An often overlooked point: systemic funding risk is low

China still has a strong deposit base by global standards

Ratio of credit to the private sector (BIS estimate) to bank deposits, by country



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Banks' three credit books

1. Ordinary lending

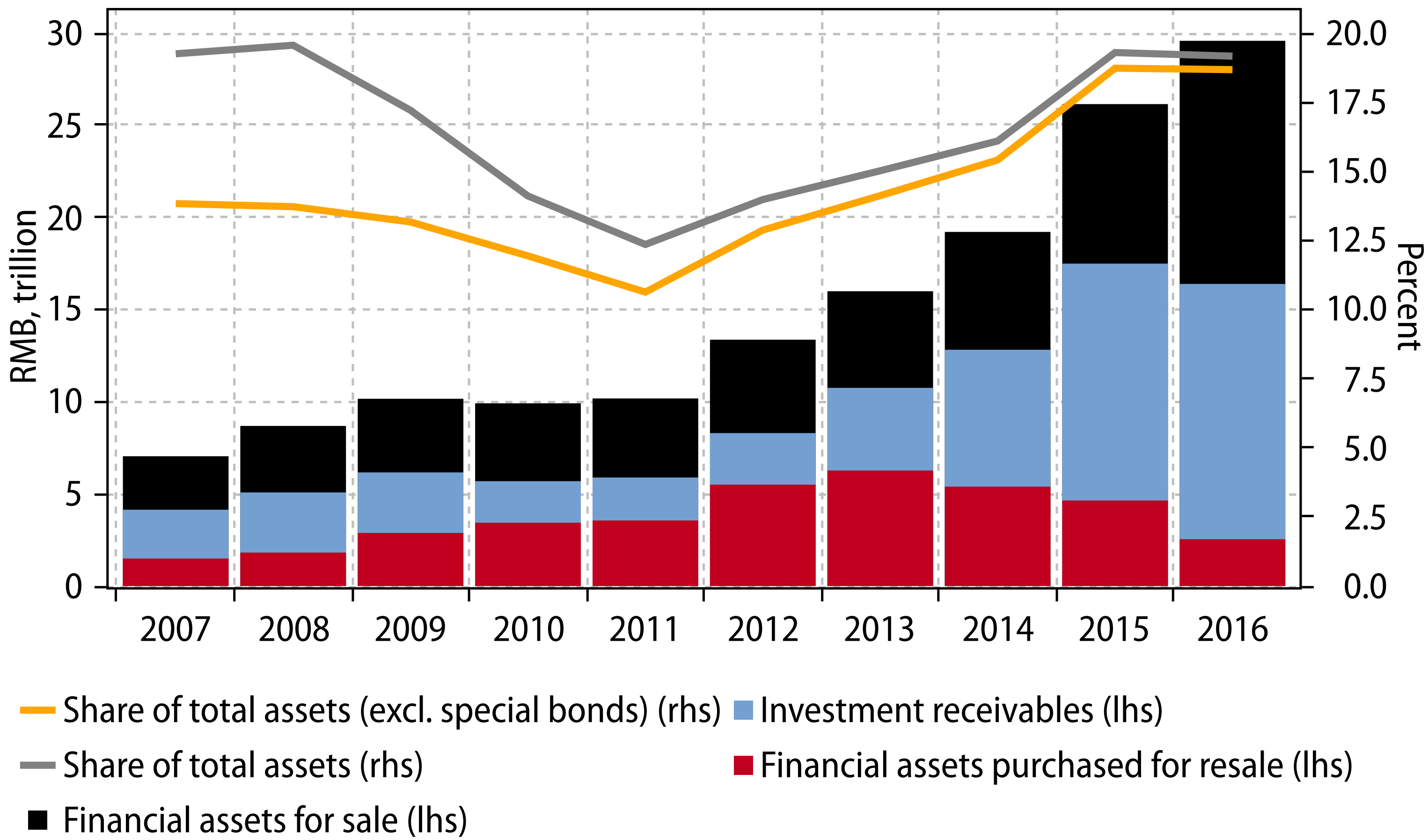
2. "Investment" portfolios
   - SOCBs: 13% of assets
   - Joint stock banks: 25% of assets
   - City commercial banks: 38% of assets (bigger than the loan book)
   - Rural commercial banks: 25% of assets

3. Off-balance-sheet exposures
   - Mainly non-guaranteed wealth-management products
   - Joint-stock banks are the most enthusiastic users: their off-balance sheet exposures are about one-quarter the size of their on-balance sheet exposures.

The rise of bank "investment portfolios"

Shadow lending tripled between 2011 and 2016

Bank investment portfolios, by type



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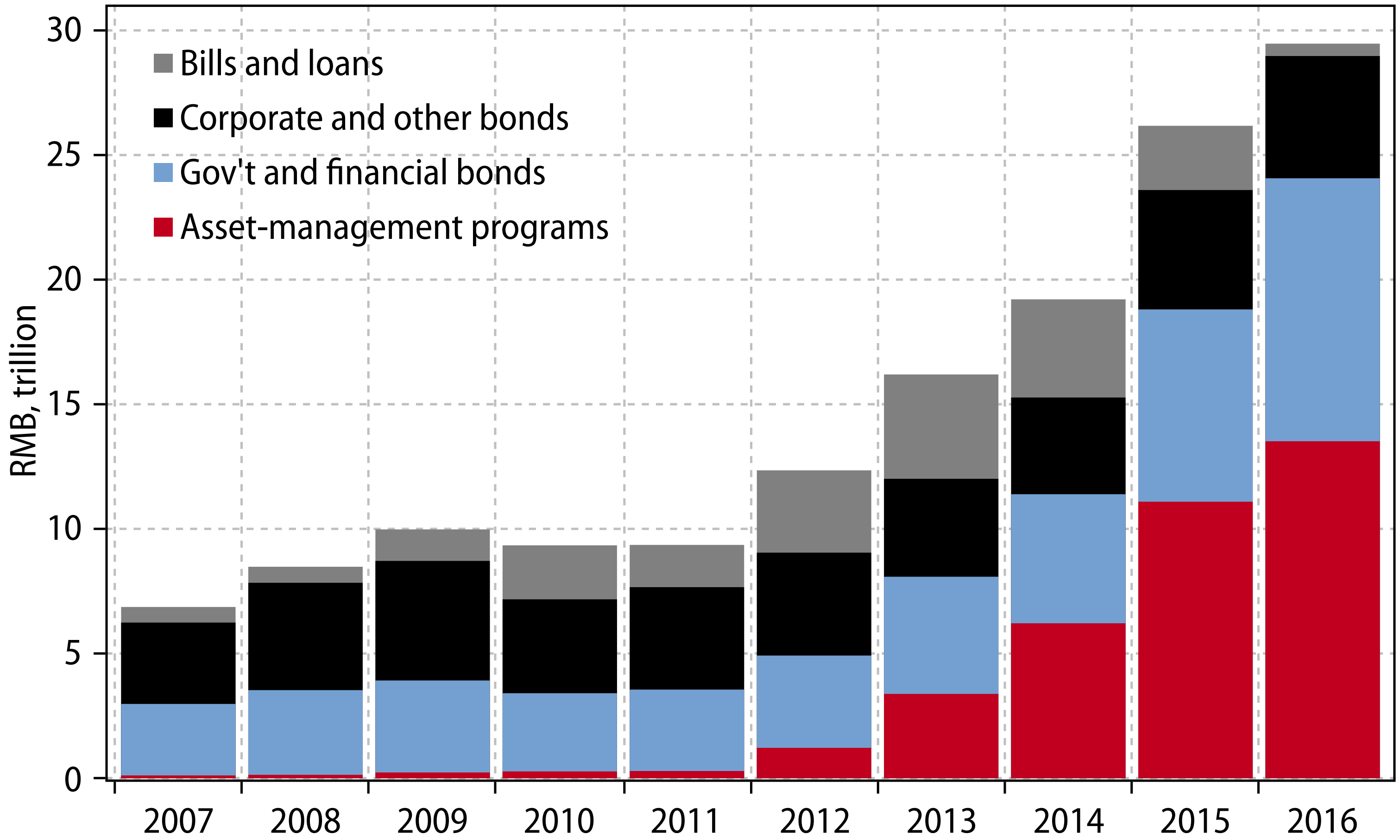
The rise of "asset management programs"

Asset-management programs make up nearly half of total investments

Investment assets, by type



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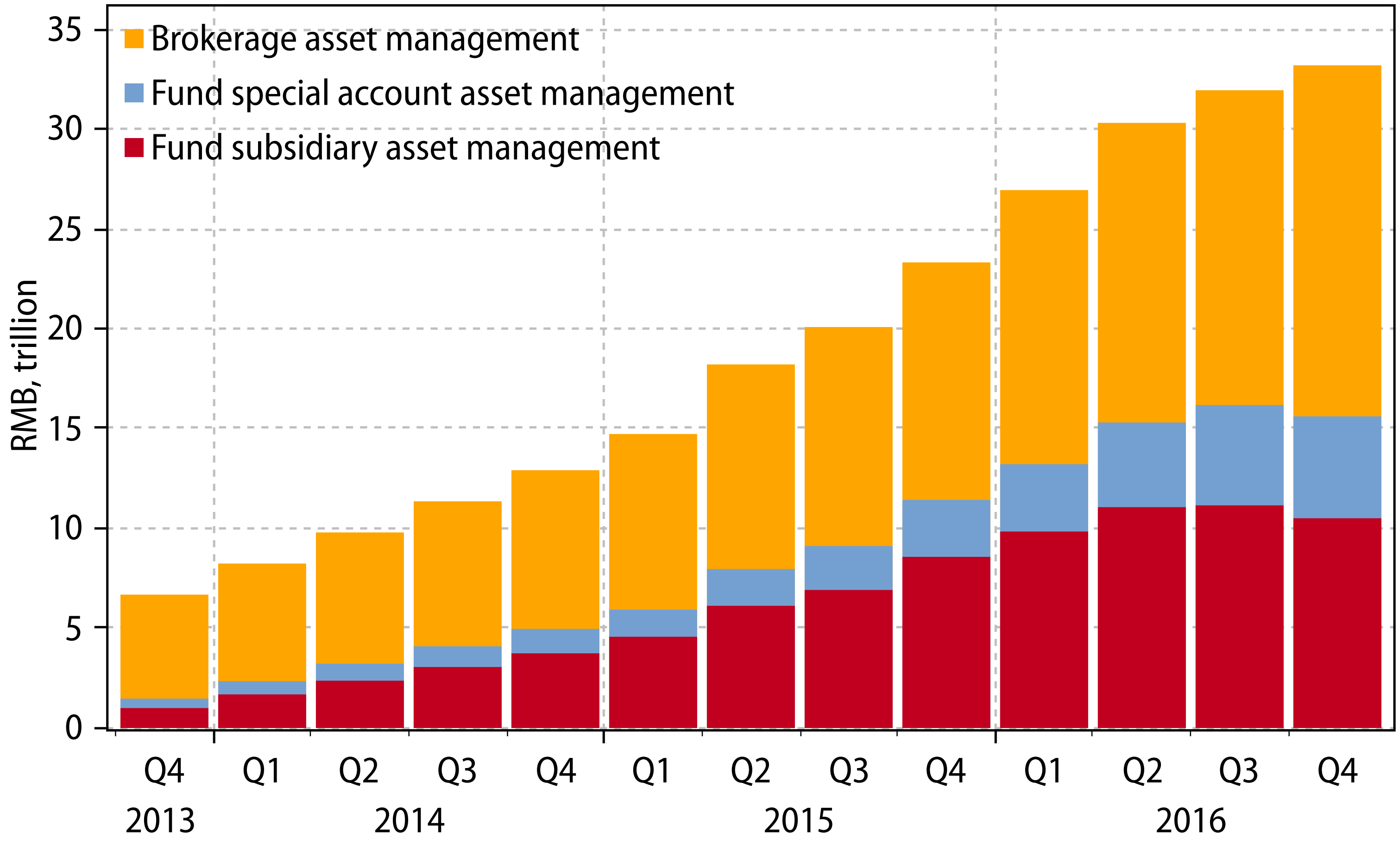
Regulators have started to tighten up

Asset managers are facing pressure to shrink

Assets under management, by type



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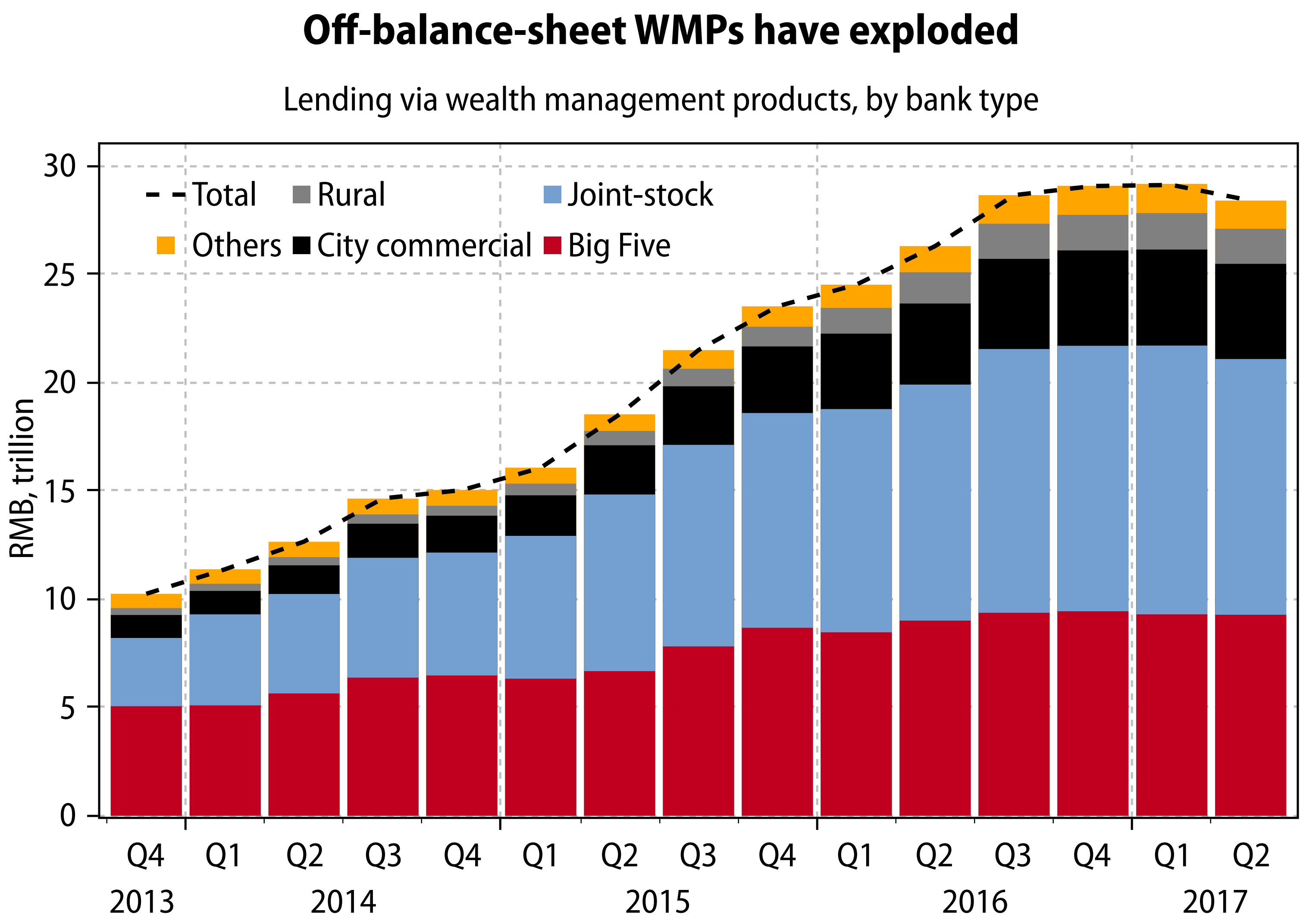
Growth in off-balance sheet exposures has also tapered



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Final thoughts

- Financial crises come in two basic flavors
- "Towering Inferno"
  - ➢ Triggered by balance of payments or domestic liquidity shortfall
  - ➢ 1997-98 Asian Financial Crisis
  - ➢ 2008 US financial crisis
- "Slow Burn"
  - ➢ Dramatic impact contained by regulatory action; effects spread out over years and government bailouts required
  - ➢ Benign scenario: 1986-94 S&L crisis in the US
  - ➢ Malign scenario: 1990s "lost decade" of Japan
- If China hits a financial crisis within the next 5 years, the most likely form is an S&L-type "slow burn" among city commercial banks

Contact and disclaimer

Thank you!

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