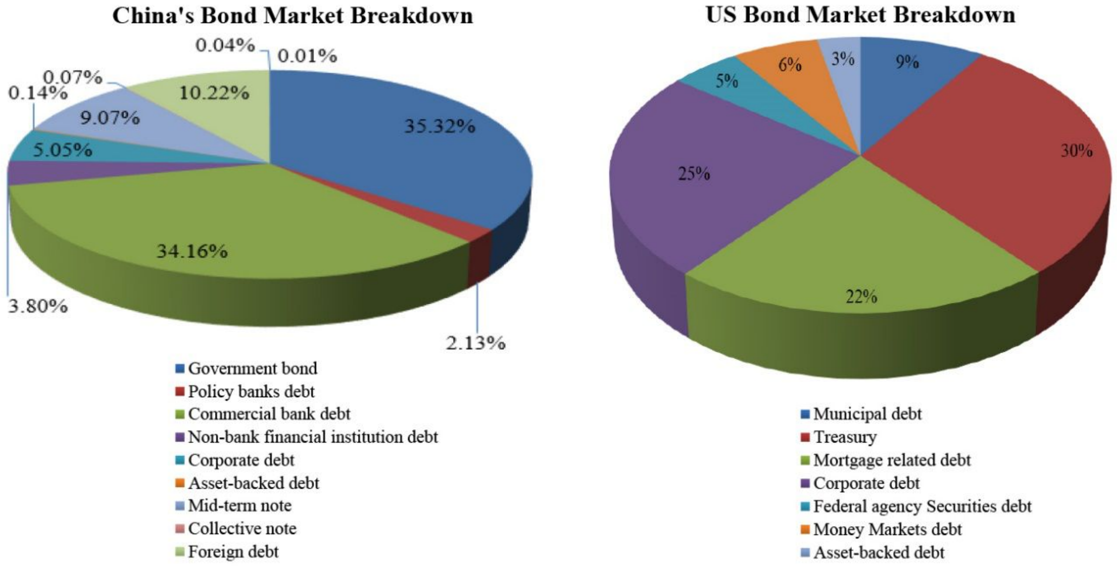
Risks for Banks and Financial Reforms in China

Beijing, January 28, 2014 – In the latest of their joint breakfast seminars, CKGSB and KPMG hosted a discussion about why China needs to reform its financial market, the role the banks might play, and the risks involved. Dr. Ou-yang Hui, Professor of Finance at CKGSB, gave a keynote presentation on the risks for banks regarding financial reforms in China. He was followed by Wilson Pang, head of KPMG China's Special Situations team, who offered insights from an industry perspective on the recent trend of non-performing loans in China. For the first time ever, the seminar was held simultaneously in two cities – Beijing and Hong Kong – connected via video conference. Those in attendance included senior executives from Japanese trade and financial institutions, including the Japanese Chamber of Commerce, Risona Bank and Norinchukin Bank.

Over the past 30 years, China's GDP has grown exceedingly fast, from USD 0.19 trillion in 1980 to USD 9.4 trillion in 2013. In 2013, China accounted for around 10% of global GDP and exceeded the average growth rate by posting its own figure of 7.7%. Yet both speakers agreed that a country's economic performance should not be judged by the size of its economy, but by the quality of its economic activities. China's high GDP does not reflect the status of the country's bond and financial markets.

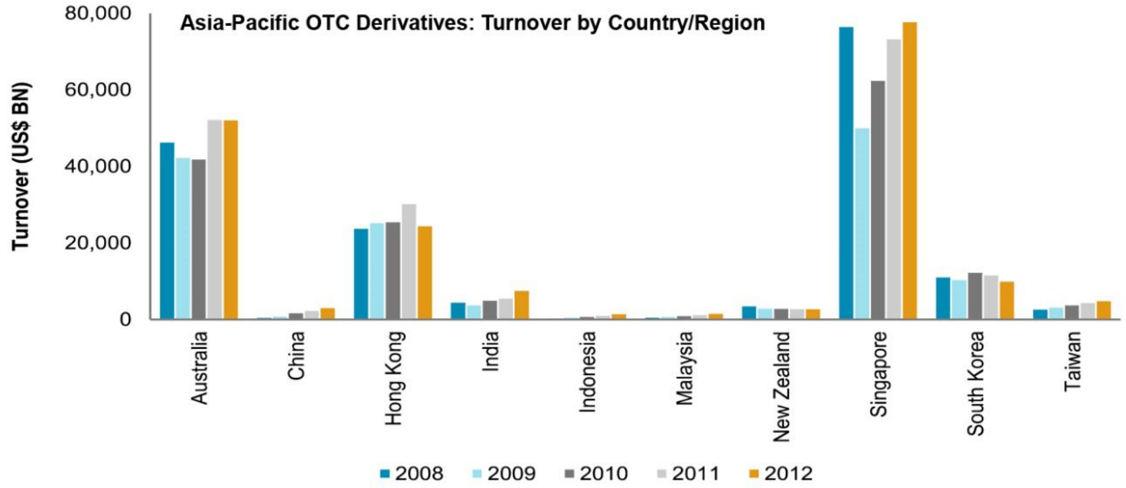
Dr. Hui stressed that the size of the Chinese bond market is highly negligible. While the US bond market is far from perfect, it is more diversified, spread mainly across treasuries (30%), mortgage-related debt (22%) and corporate debt (25%). Conversely, China's bond market is dominated by government bonds and commercial bank debt, which, added together, makes up nearly 70% of the total market. This lack of diversity affects the stability of the Chinese bond market and the financial market as a whole.

Bond Markets: China and the US



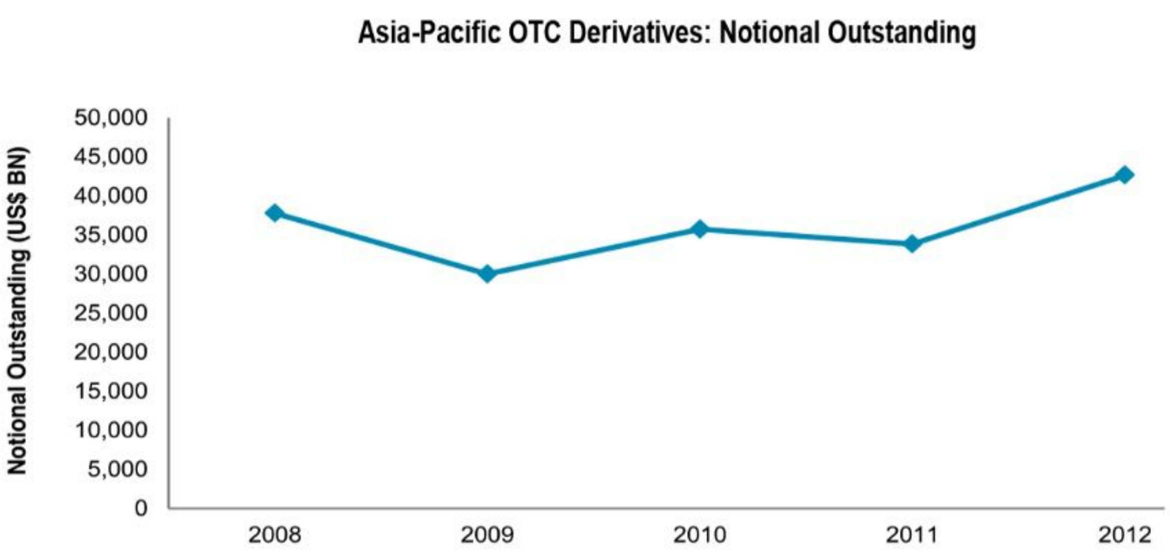
The derivatives market is composed of futures, options, mortgage-backed securities (MBS), credit default swaps (CDS) and collateralized debt obligations (CDO). Leading markets in Asia-Pacific OTC derivatives are those in Singapore, Australia and Hong Kong. In China, the derivatives market, like the bonds market, is also close to non-existent.

Asia-Pacific OTC Derivatives Market



Misconceptions about derivatives are prevalent – even in the finance industry – and may be a factor in China's non-participation in the market. One is that derivatives are risky. An official from the China Banking Regulatory Commission has described derivative products as "akin to financial opium" because they are sold to China by international banks, but not used by the providers themselves. Another misconception is that derivatives were the cause of the global financial crisis, but the financial crisis was not caused by (simple) derivatives. The graph below shows that after the financial crisis, the derivatives market dipped slightly in 2009, but has since grown and rose 25% year-on-year in 2012.

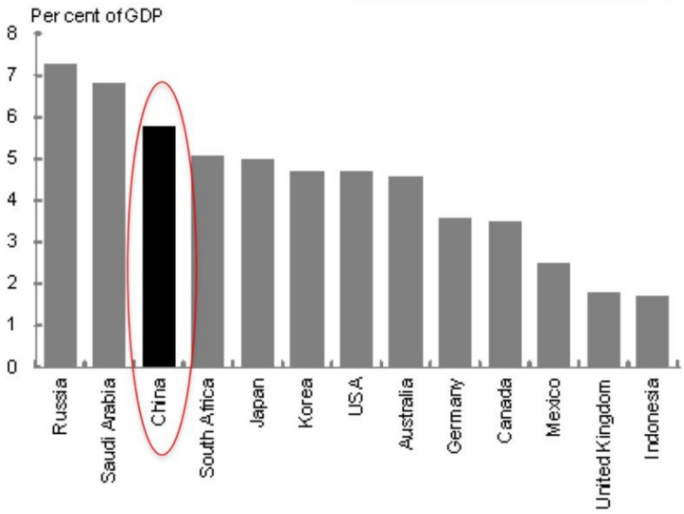
Asia-Pacific OTC Derivatives Market



Source: Celent analysis based on central banks, BIS, IMF, World Bank, news sources

With an inadequate financial market, the big question is how did China's economy grow? In China's centrally-planned, investment-oriented economy, investment is seen as the most direct and effective way of stimulating economic activity. For example, in November 2008, China announced a RMB 4 trillion stimulus package to mitigate the effects of the financial crisis. Unsurprisingly, the majority (72%) of the stimulus package went towards infrastructure investment.

Combined 2009 and 2010 stimulus, by country



Source: IMF 2010

Breakdown of the RMB 4 trillion stimulus package (RMB)

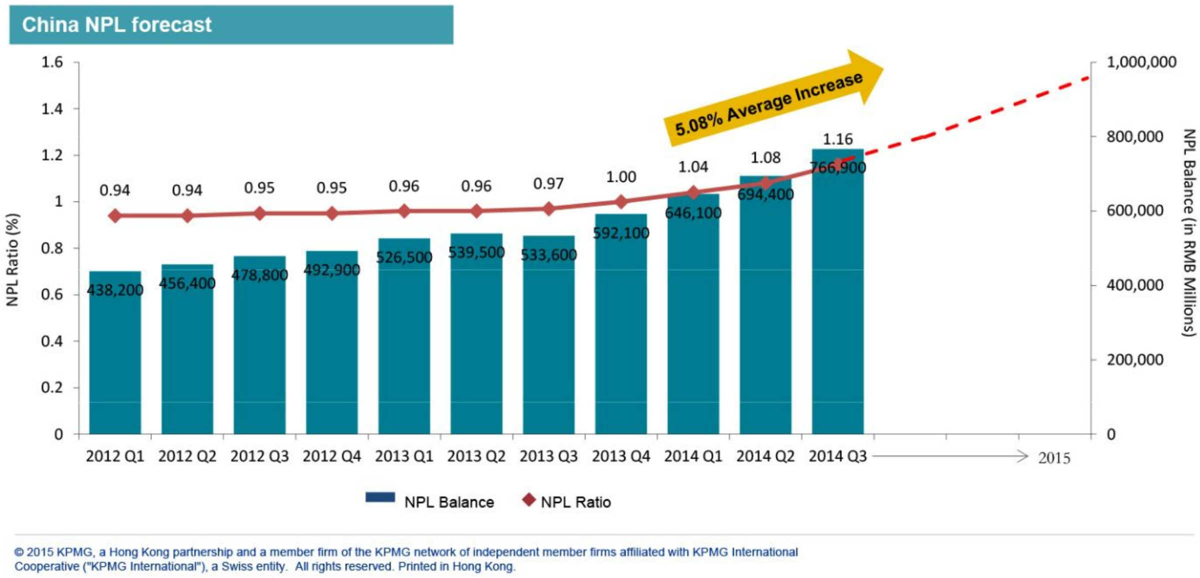
Infrastructure	2.87
General Infrastructure	1.50
Reconstruction of Sichuan earthquake area	1.00
Rural area infrastructure	0.37
Technology & Environment	0.58
Technology & structural adjustment	0.37
Energy savings & emission reductions	0.21
Social Measures	0.55
Construction & renovation cheap houses	0.40
Social security & health	0.15

Source: NDRC 2009.

A majority of the funding for the stimulus package came from banks, meaning that investment was mostly driven by bank loans and shadow banking activities as opposed to by the bond market, as would have happened in the US. Since around two-thirds of the stimulus package was funded through borrowing, expansion of credit was a critical element of the stimulus package. The most important means of expanding credit was increasing new lending targets from RMB 4.7 trillion in 2008 to RMB 10 trillion in 2009. The actual amount of loans totaled RMB 9.6 trillion in 2009. During this period, the required rate of return was significantly lowered from 17.5% to 13.5% for smaller banks and 15.5% for larger banks. Meanwhile, the deposit rate was reduced from 4.14% to 2.25%. In addition, the lending interest rate was reduced from 7.47% to 5.31%. With a lower lending interest rate, more people were incentivized to get bank loans, and banks were more liberal with their lending. Shadow banking allowed people to easily borrow money from unregulated sources, mostly investing the funds in real assets.

Excessive investment all into one basket from investment-oriented borrowers led to industrial overcapacity – an overwhelming supply coupled with the inability to generate enough demand to absorb production as people did not invest in other channels or markets like bonds. Domestic consumption and export markets were also too low. The result was an eruption of non-performing loans throughout China. Default cases first emerged in eastern China in late 2012, and over the next two years, the non-performing loans of major Chinese commercial banks increased dramatically. In the map below, the green dots represent locations where non-performing loans emerged in the first half of 2014 and the red dots represent the spread of non-performing loans to northern and southern China by the second half of the year. By geographical location, Zhejiang in the east had a non-performing loan portfolio of RMB 15.2 billion in 2014, the largest among all regions. The industries most hit with non-performing loans were wholesale and retail; transportation, storage and postal services; the manufacturing industry; and the real estate industry, of which commercial and residential properties carry the highest exposure of risk in terms of non-performing loans.

Without a proper plan for reform in China's financial industry, the trend of non-performing loans in China will increase. In the Chinese markets, the ratio of non-performing loans reached 1% in 2013, which is predicted to climb to 1.5% by the end of 2015. There are also signs that the economy is slowing down. In the third and fourth quarters of 2014, the GDP increased by 7.3%, which was the lowest growth rate for China in over two decades.



At the moment, Chinese banks are stable, but this will not last long. Reforms on the national level are necessary. They include, but are not limited to, a further liberalization of interest rates and the internationalization of the renminbi. However, these two measures need to be implemented slowly in order to allow the economy to gradually readjust. In order to mitigate the risks coming from the banking sector, Dr. Ou-Yang recommends that the government place more emphasis on the quality of economic development as opposed to quantity. In the last five years, China has been the fastest growing economy in the world. However, China's economy may not be the strongest in the world, or even in Asia. China needs to reduce its focus on GDP forecasts and take the figures less seriously, as it may lead to more stimulus packages (which could then lead to greater oversupply and loan defaults) if the figure is not met.

Wilson Pang added that the government should reform state-owned enterprises to be more market-driven (i.e. invest in more profitable companies, get rid of less profitable state-owned enterprises, or look to mergers and acquisitions). There needs to be further development of bond markets, of a more stable financial market by diversifying risks that are highly-concentrated on the banking system, and of simple derivatives products like futures, options, and swaps, credit default swaps and asset-backed securities. Perhaps then the real economy's reliance on banks will decrease, and the trend of non-performing loans will also decrease to bring stability to China's financial system.