

Chinese finance: A shadowy presence

By Henny Sender

Published: March 31 2011 20:27 | Last updated: March 31 2011 20:27



A high-rise residential building in Nanjing, eastern China. Since developers cannot borrow money from banks until they own the land, many raise funds in the shadow banking sector

John Kuhns was in Hong Kong at the end of January, visiting local branches of his mainland banks in search of money. That was because “my banks told me they might only be able to provide 60 per cent of what they lent last year, given restrictive new quotas”, says the head of China Hydroelectric, a Beijing-based investor in hydropower.

But there was no need for alarm, these bankers added, according to Mr Kuhns, an American who has been active in Chinese power generation since the 1990s. “They said: ‘If you need more, we can help you arrange a bond issue in Hong Kong. Or we can help you set up a trust company to obtain more money.’”

Welcome to the unofficial financial realm that has sprung up outside China’s heavily regulated banking system. At the same time as banks in China – under orders from a government [anxious to rein in a lending boom](#) – act to cut their credit to China Hydroelectric and other borrowers, their Hong Kong arms are offering alternative arrangements. Mr Kuhns says he was told he could raise as much as HK\$3bn (US\$385m) in bonds tied to the value of the renminbi, an amount far greater than he needed.

The message he had received in Beijing was the same as that conveyed to countless other borrowers across China as the authorities try to control credit growth. This year, with inflation running at almost 5 per cent and expected to rise, the government has signalled that it is serious about adopting a more restrictive policy.

But can it? In response to the heavy hand of the regulators, a host of grey-market institutions and arrangements has sprung up precisely to get around formal restrictions in China’s heavily controlled financial markets. Analysts say annual flows could involve Rmb2,000bn (\$305bn) – equivalent to about one-third of gross domestic product.

“The People’s Bank of China has difficulty in controlling liquidity and getting the banks to meet the loan quotas,” says Francis Cheng at CLSA in Hong Kong. He reckons the banks account for only half of total financing. The rest comes from a variety of trust companies, finance companies, leasing companies and underground banks. All of them are less regulated than the banks, subject to conflicting regulators or not regulated at all.

Yet Beijing operates as if the banks account for all of the financing. That is one reason [credit growth](#) has continued to exceed official targets, fuelling the inflation that worries Beijing.



Some senior banking officials deny the very existence of the informal sector. “The term ‘shadow banking’ doesn’t really apply to China,” says [Jiang Jianqing](#), chairman of Industrial and Commercial Bank of China, one of the country’s biggest banks. “There are no financial institutions outside the supervisory and regulatory system here.”

Whether Beijing succeeds or not in reining in informal fund flows is important, since the fate of these restrictions provides clues to the future direction of China’s economy. If credit growth became too great, China would face more inflation in the short term and possible excess capacity in the longer term. That could lead to a resumption of the profitless growth that China is trying to leave behind. If inflation remained high, social unrest would become increasingly likely.

If, conversely, China slammed the monetary brakes on too hard, it would have a big contractionary impact both at home and abroad, given that Chinese imports have become an important source of global growth.

Monetary policy matters more in China than it does in most developed markets, because the ability to allocate capital remains largely the preserve of the state. It is where financial power and political power intersect.

One main spur to the shadow financial world has been the strict rules in place on the price of money. The shadow system has developed because interest rates in the formal financial sector are tightly controlled – and kept within a narrow band. So banks prefer to lend to large state enterprises that can be relied on to repay.

They will never be blamed for lending to these giant enterprises; indeed, that is what they are supposed to do. Dealing with the state sector buys the lenders political goodwill and puts the individual bankers making the loans in a good light. By contrast, the banks have virtually no incentive to lend to private enterprises, since they cannot charge higher rates to compensate for the greater risk of lending to entities that often have less collateral.

Yet China boasts an ever-growing number of entrepreneurs and other wealthy individuals with excess savings. They have no desire to put their money in a bank when real interest rates on deposits are negative. They are therefore happy to put money into informal channels that lend to cash-strapped young private companies that will pay 20-30 per cent a year to obtain it.

“Without interest rate deregulation, you will drive more money underground,” says Christina Chung at RCM Asia Pacific in Hong Kong, a fund manager. “It is difficult to reduce the importance of the black market until financial reforms take place and banks have the incentive to lend to small and medium enterprises and diversify their loan books.”

“Credit quotas are ineffective,” adds Qiang Liao, a director of Standard & Poor’s in Beijing and a former official at the Chinese Banking Regulatory Commission. “Non-banks such as trust companies are a response to a regulated interest rate regime.”

The trust companies are often at the heart of these new kinds of money flows, operating in a murky domain where the official banking system meets the shadow banking system. The trust companies cater largely to two groups of clients: private companies that need capital and cash-rich families in search of higher returns.

The trust companies and other shadow institutions are particularly active in the politically sensitive real estate market. Informal money flows are a big reason why property prices continue to rise. Across China, money continues to flow into apartment blocks, gleaming office towers and shopping malls. Since developers cannot borrow money from banks until they own the land, many need to raise funds elsewhere. As they are willing to pay upwards of 10 per cent for the privilege, that sort of return attracts lots of interest from those with a surplus to invest.

So when Banyan Tree, a Singapore-based resort company, was looking to raise a Rmb1.1bn fund for China, it turned to established entrepreneurs and high net worth individuals whom it tapped through wealth management consultants. “Institutional investors in China are not mature enough to understand the concept and give us their money,” says a Banyan Tree executive. “Wealthy entrepreneurs can make decisions very quickly.”

Virtually everyone has a stake in keeping the game going and turning a blind eye to edicts from Beijing. Since the trust companies are supposed to be simply intermediaries and cannot collect deposits from retail customers, Beijing is not all that bothered about them, bankers say. Banks themselves take advantage of less regulated institutions, shifting loans off their balance sheets by selling them to the trust companies, which slice them up and distribute them to their clients. That enables the banks to make more loans. “Innovative tools can make credit simply not appear,” says Helen Qiao, an economist with Goldman Sachs in Beijing.

Meanwhile, local governments rely on land sales to fund their own operations. So they are happy to ensure developers have the capital to bid extravagantly at land auctions. Local governments in many cases own the trust companies that help developers finance their purchase of the land, taking fees in the process. Finally, senior municipal bureaucrats are often among those who have the money and are seeking high returns.

Private lending in this form started in Zhejiang province near Shanghai, the heart of entrepreneurship in China, as clubs to which entrepreneurs and other wealthy people contributed and borrowed, depending on their circumstances. These informal underground banks rely on personal networks, and work as long as their scale remains personal. But as they expand, the personal knowledge and constraints invariably break down. Many of the cases clogging up courts in Hong Kong, where a lot of the investment companies that have been used in the process are based, concern disputes between underground banks and borrowers in China.

Beijing is aware that it needs to do more to ensure that capital reaches private companies, which these days account for more economic activity than state-owned enterprises. Yet they receive only 30-40 per cent of the official financing and have to pay more for money in the underground market. "Your cost of capital depends on who you are," says the founder of one advisory boutique in Beijing.

One thing the government has attempted to do is to encourage the establishment of credit guarantee companies that backstop loans to private groups and pay off the loans in the event of default. Today there are thousands of guarantee outfits. But many of them are themselves far from creditworthy. "The amount of the guarantee compared to the capital is very large," says May Yan, an analyst with Barclays Capital in Hong Kong but formerly a rating agency employee who rated some of these companies. "They are very levered and there are no rules on leverage. Both the industry and the regulators are very fragmented."

Still, thanks to these informal channels, analysts estimate that lending in 2010 was at least as much as the Rmb9,000bn quota set centrally for 2009, the year China turned up the lending tap in the wake of the global crisis. In 2010, the banks were meant to slow their loan growth sharply.

The head of markets at the Shanghai branch of one big international bank describes the formal financial system and monetary policy as a policy for a socialist economy. But that is a framework that China has long left behind. "At some stage, China could control what was going on," adds China Hydro's Mr Kuhns. "It's a much more complex economy today. They are a lot less able to do that now."

Additional reporting by Jamil Anderlini

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A more nuanced regime delivers mixed results

For years, one of the January rituals in Beijing was for regulators to issue explicit quotas to banks, telling them how much they were expected to lend – no more, no less. This year that changed as regulators stopped issuing such guidance. The shift was seen as an admission by the authorities that quotas were routinely ignored and therefore ineffective.

Instead, the Chinese Banking Regulatory Commission has adopted a regime that, says Helen Qiao of Goldman Sachs, is "more nuanced, discrete and intransparent".

Beijing has also tried to signal recently that it is serious about enforcing a less generous monetary policy. It has tightened reserve requirement ratios – so-called RRRs, or money that banks have to keep on reserve with the central bank – three times this year, most recently in mid-March.

Compared with restrictions on loans, the RRR has the advantage of “limiting the fundamental ability of banks to lend”, writes Ms Qiao in a recent report co-authored with a colleague, Yu Song. Under the guidance system, banks with ample liquidity found “innovative ways to lend which are not officially called lending”. The result was “a difficult cat and mouse game for authorities”.

Both monetary growth and loan growth have apparently slowed in the first two months of 2011. Yet analysts agree with HSBC’s Qu Hongin that “liquidity in China remains more than ample”. Indeed, the rate at which banks lend to each other is dropping.

The Goldman economists reckon that a rise in the RRR rate does not necessarily mean a tighter monetary policy stance. Stiffer requirements only partly offset other central bank actions and foreign exchange inflows as companies bring home the proceeds of overseas business. “The magnitude of tightening is not as large as [the monetary] data suggest,” they note.

One big distortionary factor is that a lot of financial products do not show up as normal deposits. These include wealth management products created by taking bank loans and chopping them up and then selling the slices to their customers, who can earn more from such investments than from deposits.

As long as real interest rates remain negative in China – and become more negative as inflation ratchets up – retail bank deposits become ever more unattractive. That may explain why deposit growth at the banks is slowing dramatically. New deposits totalled only Rmb1,300bn for the first two months of the year, compared with Rmb2,500bn over the same period in 2010.

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