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China's Banking System and Access to Credit

This testimony seeks to address the facts, risks, and concerns regarding China's official banking system as well as those of the shadow-banking system operating in parallel and performing financial services in China not currently fulfilled by banks or formal financial institutions.

How stable are China's financial institutions, especially the major state banks?

The stability of China's banks has been significantly enhanced over the past decade after they received government bailouts, offloaded non-performing loans, brought in foreign investors for minority stakes, sold stock to the public, upgraded transparency, and improved their earnings ability and internal controls.

The size of China's banks, with 128 trillion yuan ($21 trillion) in assets as of end-September, is second only to the U.S. This figure has increased from 28 trillion yuan ($3 trillion) in 2003. The Big Five state-owned banks -- Industrial & Commercial Bank of China, China Construction Bank, Agricultural Bank of China, Bank of China, and Bank of Communications -- account for almost half, or 47 percent, of total banking assets.

The banks have significantly lessened their risks from non-performing loans. The ratio of bad loans to all loans was 0.95 percent as of Sept. 31, a significant decrease from the 19.6 percent of 2003. [In the U.S., the number was 3.9 percent as of Dec. 31; Spain had 10.7 percent.] While the numbers may be slightly understated, and the true figures could be a few percentage points higher in some cases at some banks, this still would generally be considered low by the standards of developing countries. Therefore, it is not an area of great concern at this time, nor is it expected to be when trillions of yuan in loans to local-government-financing vehicles (LGFVs - see details below) come due over the next two years.

The Big Five banks have been enormously profitable, benefiting from the government-mandated spread between fixed interest rates for what they pay out on deposits compared with what they earn from loans. Their combined profit rose to 674 billion yuan ($108 billion) in 2011, compared with 121 billion yuan ($19.4 billion) in 2005.

China's foreign exchange reserves valued at $3.3 trillion as of the end of last year will help state banks withstand unexpected internal and external shocks, including any potential crisis from a rise in non-performing loans.

Policy makers are aware of the need for interest-rate reform and are starting a process of allowing banks greater flexibility in setting their own interest rates for loans and deposits. This will introduce more competition into the market, narrow banks' net interest margins, and thus erode their earnings ability over the long term.

Disintermediation -- meaning a reduction in use of the banking system to perform basic functions of finance, including holding the savings of the populace and lending to businesses and consumers -- is taking place faster in China than policy makers would like. Banks are no longer the main sources of long-term financing, as they provided only 25 percent of medium- and long-term loans to corporations in China in 2012, down from an average 70 percent in 2008-2010. Bond-issuance, stock listings, and loans from trust investment funds, which can be categorized as shadow-financing, are making up the difference.

Currently, 97 percent of China's 42 million small-and-medium sized companies are unable to or don't seek loans from banks. Many of them turn to shadow-financing (see statistics below), including private loans from family, acquaintences and the pooled investments of unknown lenders. Due to its unregulated nature, this practice and its recent rapid growth increases the risks to China's financial stability as a whole, but not to the stability of the banking system itself, which maintains its stability through its insulation from the riskier loans and financial operations that would otherwise be incurred if the banking system were enhanced to include all financial services needed to grow China's economy, including lending to small businesses.

China's slowly unfolding efforts at banking reform are aimed at calibrating the balance between this distermediation process -- and consequent reliance on shadow banking to provide otherwise-unobtainable financial services -- and maintaining the stability of the banking system including its continued profitability.

What role do these banks play in the nation's economic development and how are their lending practices driven and defined? Whom do they lend to? What is their portfolio of loans, both good and bad? What are the interest rates, repayment procedures, etc.?

State banks are key drivers of China's economic development, as they are the biggest providers of financing to state-owned enterprises (SOEs) and local governments. While their share of China's total social financing, which includes bank loans, non-financial bond and equity sales, trust loans, entrusted loans and bankers' acceptance bills, fell to record low in 2012, bank loans still provided 52 percent of the nation's total financing.

While SOEs are still the most coveted clients for banks, Big Five banks are increasingly lending to small and medium-sized firms, in part because of government directives, but also because loans to smaller borrowers can now offer higher yields, and many SOEs now opt to go to the bond market for financing instead of taking out bank loans.

Interest rates charged by the Big Five banks now based on the creditworthiness of borrowers. China now has a formal credit-scoring system similar to the one in the U.S., with 800 million people and 18 million companies in the data base. Chinese banks have also developed their own sophisticated internal screening systems to gauge customers' ability to repay. In most cases, corporate loans need to be approved by the regional branch headquarters instead of a local outlet, reducing risk and political influence. Official policy currently allows banks to offer a discount of up to 30 percent on benchmark lending rates to its most creditworthy customers; however, no state banks are willing to do that, as loans are still in short supply and the central bank sets a lending quota every month. Instead, big banks normally offer a maximum 10 percent discount to their best corporate customers, mostly SOEs, while for others they charge a premium over the benchmark lending rates.

In order to keep non-performing loan rates low, China's big banks will speed up the loan-collection process if they see signs of a weakening in the borrower's repayment ability. Bank managers are hyper aware of non-performing loan levels, and each branch closely monitors loans in danger of turning bad.

What are the roles of local governments in China's economic development and the avenues of credit available at the local level? What are Rural Credit Cooperatives (RCCs), to whom are RCC loans most readily available, and what are the forces influencing availability of these loans? Are RCCs too big to fail?

Local governments are the key forces that led China's economic recovery after the financial crisis in 2009, as they borrowed heavily from banks to fund local infrastructure projects. As China's law prohibits local governments to borrow directly from banks, they set up so-called local-government-financing vehicles (LGFVs) to borrow on their behalf. Such loans are sometimes guaranteed by local government's land and fiscal revenue.

China's banking regulator since 2011 has strictly limited borrowing by LGFVs, as many projects initiated by LGFVs are unable to generate enough cash flow to make interest payments. Bank loans to LGFVs totaled 10.7 trillion yuan ($1.72 trillion) by the end of 2010, with 62 percent to which the government has responsibility to make repayment, according to the National Audit Office. About 3 trillion yuan ($480 billion) of LGFVs loans will mature between 2013 and 2015, and another 3.2 trillion yuan ($515 billion) is to mature after 2016.

This may seem to pose a looming upcoming risk; however, based on China's experiences of 2012, when 1.8 trillion yuan ($288 billion) worth of LGFV loans already came due, banks didn't experience an increase in bad loans. Therefore, the risks are still considered to be under control, especially with the current pickup in economic growth and return to growth of the property sector, increasing the projects' ability to generate revenue.

Rural Credit Cooperatives were established starting in 1951 in rural counties and towns to serve farmers and agricultural development. By the end of 2011, there were 77,000 rural cooperatives with 760,000 employees. These institutions are the major credit and banking service providers in China's countryside, financing 77 percent of borrowing by Chinese farmers. China started reforming rural credit cooperatives in 2003 by transforming some into commercial banks and applying to them the same capital-adequacy and non-performing loan ratio requirements as banks. Capital strength and healthiness of balance sheets at such rural banks have improved considerably since then.

The term "shadow banking" encompasses a variety of unofficial avenues of credit. Can you elaborate on the kinds of practices that define the Chinese shadow-banking industry, the drivers behind the growth of this industry, and any associated risks? How does China's shadow banking system figure into the Chinese economy's overall financial health and developmental trajectory? What regulatory concerns does it raise?

China's shadow banking universe includes underground banking, trust products (investment funds with a fixed interest rate and fixed date of maturity), wealth management products (WMPs), and other off-balance-sheet loan-like claims held by commercial banks. According to UBS chief China economist Tao Wang, the total is an estimated $3.35 trillion -- about 45 percent of GDP.

China's underground lending, mainly private lending and borrowing activities among individuals and small companies, are not subject to regulation. Only lending rates in excess of four times the benchmark interest rate (currently that would be more than 24 percent annually), is illegal. A survey by the central bank estimated the size of underground lending at about 3.4 trillion yuan ($545 billion) as of May 2011. Such activities have declined since then as a spate of bankruptcies and borrowers evading their debts have made people more cautious in lending money.

China's shadow-banking began growing tremendously after China adopted a tighter monetary policy in 2011 making credit even scarcer for small- and medium-sized firms, which have to resort to non-bank sources for financing. Also low and negative real deposit interest rates -- meaning that the rate banks had paid in interest on savings deposits had been lower than inflation until inflation rates fell in 2012 -- pushed households to move their savings out of banks to seek high returns, thus spurring off-balance-sheet activities of banks and surge of WMPs as banks needed to come up with higher-yielding products to retain depositors.

A lack of regulatory oversight and transparency of the shadowing banking activities poses serious risk to China's financial and social stability. In cities such as Wenzhou, in the coastal province of Zhejiang south of Shanghai, more than 90 percent of families and 60 percent of small firms took part in underground lending. One default often leads to a wave of failures as companies often provide loan guarantees for each other.

Growing shadow banking activities have also eroded the stability of formal banking system by siphoning away deposits, the most important source of funds for banks to support their lending. Many shadow-banking funds, such as WMPs and trusts loans, went to property sector and local government financing vehicles, areas that are being cracked down upon by policy makers.

China has been increasing regulations for WMPs and trust investments after a few defaults have occurred. But the size has continued to grow partly because Chinese people want higher-yielding products and have few other investment options.

China's trusts sector is the fastest-growing shadow banking sector over the past few years with 7.47 trillion yuan ($1.2 trillion) of assets under management, second only to banks. They make up a quarter of the estimated size of the shadow-banking sector. The sector's repayment ability will be tested this year as an estimated 310 billion yuan ($50 billion) of property-linked investments will come due and there have already been some cases of delayed repayments. Again, like China's LGFV loans, the chances of a debt crisis such as what China experienced in the late 1990s is unlikely, as the nation's banks or trust issuers can roll over the debt and sell off collateral, and local governments can also seek and would likely obtain bailouts from the central government.

How much of China's GDP is accounted for by the public sector vs. the private sector? To what extent is the private sector able to access official lines of credit? What are the social stability implications of issues surrounding access to credit?

China's 42 million small and medium-sized private businesses contribute 60 percent of the nation's GDP and 80 percent of urban employment. They are increasingly unable to access loans from banks. In 2008, bank loans accounted for 13 percent of Chinese small enterprises' funding needs; 36 percent came from underground or private lenders, and 41 percent came from their own savings, according to Citic Securities. Last year, only 3 percent of China's SMEs were able or willing to take out bank loans, a number demonstrating the decrease in private enterprise's dependence on banks and increase in dependence on shadow financing.

The primary risk to the government lies in its potential inability to intervene if a large number of underground loans suddenly go bad in a crisis; there's no centralized place to put the money, as in a bank bailout. In Wenzhou, more than 80 suicides or bankruptcies by indebted businessmen in a four-month period in late 2011 prompted Premier Wen Jiabao to visit the city last year and pledge to increase lending to small businesses. The State Council subsequently, in March 2012, announced this pilot financial reform program in Wenzhou to bring the city's rampant shadow-banking activities under control. Key measures include launching private lending services and a monitoring center by introducing authorized agencies for lending and contract notarization; allowing private funds to start and participate in rural banks; and exploring setting up small-loan companies to issue bonds designated for SMEs. So far the reforms are in early stages. [We will be checking on the progress of this project in mid-March.] Various reports of unrest were reported in late 2011 and early 2012 over people losing their investments in the shadow-banking system. Through such efforts at reform, the government hopes to keep investors, who might then turn to unrest to air grievances and seek redress, from further losses.

Another risk to the government is its inability to implement effective monetary policy -- when so much lending through shadow financing takes place outside of government control at interest rates the government does not set, the levers of the economy, including fiscal stimulus and controlling inflation, are more difficult for the government to maneuver. This poses potential risks should there be a fiscal or economic crisis.

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