EVENT REPORT

EUROPEAN CAPITAL MARKETS INSTITUTE

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The last 15 years have been something of a rollercoaster for China´s banking system. From systemic insolvency in the early 2000s, China made a comprehensive restructuring effort and moved to a larger and seemingly sounder banking system. More recently, a huge fiscal stimulus and massive borrowing by corporates have again increased Chinese banks' vulnerabilities and delayed the liberalisation process. China's State Council released a new policy document in May on capital markets development, which reaffirmed the goal of increasing the country's share of direct financing of the economy. Several issues need to be considered, namely: access to capital markets for private firms, the composition of investors (retail/institutional, domestic/foreign), and regulatory barriers.

Chair: Karel Lannoo, CEO, CEPS

Speakers

- **Alicia García-Herrero**, Chief Economist for Emerging Markets, Banco Bilbao Vizcaya Argentaria (BBVA).
- **James Hopegood**, Policy Analyst, Asset management unit (G4), DG MARKT, European Commission.
- **Norbert Wunner,** Deputy Head of Unit, Countries of the G-20 - IMF - G-Groups (Unit D3), DG ECFIN, European Commission.

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In her introductory remarks, **Alicia García-Herrero (BBVA)** indicated that China is probably taking financial liberalisation too seriously. The mantra 'the sooner the better' should be treated with some degree of caution.

China's banking sector has more than doubled (its total assets) over the past decade. SOBs (state-owned banks) still dominate, although the share of the largest ones decreased in recent years. China's banking sector has not become more private, however. For many banks, the amount of shares that are actually traded on the market is rather small, with a majority of banks being either locally or state-owned. There is more competition but not necessarily fully private ownership. There are very few fully private banks. Also, there is very little foreign ownership.

If we look at regulatory concepts such as capital adequacy and loan-to-deposit ratios, China's banking sector looks rather healthy. There is no immediate solvency problem but other problems are looming. In terms of asset quality ratio, NPL (non-performing loans) ratio has fallen to 1% but there are some mechanics in it that should be taken into account. For example, the denominator increased due the fast credit growth while the numerator decreased due to transfer of NPLs to asset management companies (AMC). In addition, the impact of the 'credit binge' has not been yet evaluated as all the loans granted to local governments during the global financial crisis have been rolled over to 2016. Profitability measured by ROE, ROA was very low in the early 2000s. After the balance sheets were cleaned up by recapitalisation, transfer of assets to AMC, provisioning, both ratios have improved considerably. Net interest rate margins benefited from a cushion created by financial repression as the deposit rate (not the lending rate) is still capped.

Total profit growth reached a record high in 2011, close to 40%. Much of it came from asset growth, credit grew at a rate of 13-14%, and the stimulus package introduced in 2009 by the Chinese Government that was intermediated by the banking system. It was a very special package, not fiscal expenditure as such. Banks were asked to lend through the window guidance to the local government for infrastructure projects. As a result, the balance sheets grew enormously during the global financial crisis as a means of creating the necessary liquidity and the borrowing capacity to execute that huge fiscal stimulus package. That benefited banks in terms of profitability because of the larger volumes of loan together with the cushion which did not allow for full competition when attracting deposits.

With regard to financial openness, a very important benchmark for reform was the entry into WTO. China committed to opening up its banking sector to foreign competition but in a limited way; a 20% limit on foreign ownership for one investor and a 25% limit for joint ownership. At the moment, there is no way to go beyond 25%. It is also very difficult to operate on a massive scale in China due to regulatory constraints. Opening a branch in China is a very cumbersome, lengthy and costly process. You also need to wait for at least 3 years to operate in RMB and only then after having shown 2 years' profit. Consequently, the participation of foreign banks in China is very small. Foreign banks invested in China through strategic IPOs, but many left over time. Some banks cashed in profits during the financial crisis because they needed the money at home; the so-called 'pull effect'. Others found it difficult to operate without entering into the management of the bank. The fully-owned foreign banks, meaning those that open a branch and after many other branch, they can incorporate in China as a subsidiary, only account for 1.5-2% of the banking system. Their share has not increased since 2004 and they did not manage to gain more market access. It was almost impossible to lend to local governments and compete with local banks. As for Chinese banks going abroad, the model is opening up branches, rather than acquisitions.

There are three key aspects to China's financial reform process: bank restructuring, financial liberalisation and bank regulation. In the late 90s and early 2000s, banks were saddled with NPLs of around 10% of the total amount of loans. During the banking reform, the authorities injected around 7% of GDP in terms of capital (mainly foreign exchange reserves) into major commercial banks. Foreign capital was attracted through strategic investments and IPOs in Hong Kong and at a later stage in Shenzhen. Banks' balance sheets were cleaned up, with NPLs transferred to AMC. The cost was around 25% of GDP after recoveries. Restructuring was done in a growth period and the process was reinforced through regulation. With regard to financial liberalisation, the lending rate was completely liberalised in October 2013. The deposit rate is not yet not fully liberalised, there is a ceiling and banks cannot compete to attract deposits. This is one of the main reasons why shadow banking started in China and is likely to continue until the deposit cap is lifted. As a wealthy individual, the only option in the formal banking system was a negative real interest rate. Wealth management products started to be created. Parts of the banking conglomerates, mainly trust companies within the group, were allowed to offer products for wealthy individuals in order to obtain a higher interest rate outside the system. Those money were invested through a financial vehicle in real estate and infrastructure projects. In practice, these sectors were basically thrown out from the formal banking sector due to the excessive exposure of the banks, tighter regulation and instructions from CBRC (China Banking Regulatory Commission). The profitability and solvency of the developers in these sectors impinges on these financial developments and might explain the fragilities within the shadow-banking sector. Capital account is not yet liberalised, by any means. In March 2014, the floating of the RMB was limited to a daily trading band of +-2%. Banking regulation during the reform was accelerated in several areas but is not yet fully enforced.

Ms. García-Herrero was of the opinion that it is unwise to start implementing Basel III requirements, liberalise the deposit rate, cut the roll-overs of NPLs, i.e. have all these measures becoming effective at the same time, because the banks are not yet in shape. The outlook for medium-term profitability of the Chinese banking sector is gloomy.[1] Another major restructuring effort of the banking system is unlikely to be announced by the public authorities. The additional steps on restructuring the banking sector, namely encouraging IPOs, asset securitisation, transfer of bad assets to national AMCs and newly created local AMCs, seem fragmented but rather on purpose in order to dilute concern over the quality of assets, liquidity squeezes and capital pressure.

[1] For the scenario-based analysis, see the presentation at:
http://www.eurocapitalmarkets.org/system/files/BBVA_presentation.pdf

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James Hopegood (European Commission) offered insight into the discussions on market access for UCITS that the technical delegation of the European Commission had with the China Securities Regulatory Commission (CSRC), the People's Bank of China and the Chinese asset management community, following on from initial contact made by Commissioner Michel Barnier. UCITS brand is a gold standard in terms of regulation and consumer confidence. It has become popular in places like Hong Kong, Singapore, and Chile.
The European Commission is very interested in making the brand successful outside the EU. In terms of competing brands, there are initiatives to develop a UCITS-style Asia Region Funds Passport. In Hong Kong, a direct competitor to the UCITS model is being developed and the HK authorities are going to seek an exclusive marketing agreement with the Chinese authorities so that these HK funds could be marketed in the mainland China market and vice versa. Hence, the HK authorities are very keen to lock out EU UCITS.

Chinese authorities invited the European Commission to deliver further training on how UCITS work in practice and the potential interaction with China's financial and currency liberalisation processes. In terms of the types of products Chinese investors look for, Mr. Hopegood reported a lot of interest in the use of UCITS to liberalise and increase convertibility of the RMB. Chinese investors don't want European money market funds and it is unwise to try to compete with the domestic ones. They want smaller, specialised, niche investments in their UCITS. Chinese funds are already available within the EU. The European Commission is actually playing catch up, it is not about allowing something new to the EU but rather trying to gain market access for EU funds in China.

The work to be done by European Commission will be incremental because everything is based on quota systems and pilot programmes still to be tested. Mr. Hopegood expects the HK authorities to be successful in their exclusive marketing arrangements initially and then a couple of years later EU UCITs to be given a quota. In practice, Chinese investors will obtain a domestic investor quota to convert part of their RMB holdings into the investment currency of a UCITS – the opposite of the QFII arrangements, which involve foreign investors obtaining a quota for investment in China.

Norbert Wunner (European Commission) made the point that China is facing formidable challenges with regard to the timing, speed and sequencing of the reforms. After 30 years of spectacular growth rates, largely driven by exports and associated with the build-up of huge external imbalances, this type of development cycle came to an end during the global financial crisis. After 2007-2008, China shifted towards a debt-fuelled, investment-driven growth model associated with the accumulation of domestic imbalances, namely a huge increase in domestic debt levels (200% GDP), both government and corporate debt, and in investment activity (almost 50% of GDP). This model has also run out of steam, as evidenced by decreasing marginal returns to investments and real GDP growth rates. In his view, China would have to move its economy towards more stable sources of growth, be it consumption or service sector activities, higher quality investment and maybe some return to more export-driven activities. In past 2 years, economic activity has slowed down and the Chinese authorities implemented stimulus measures in various shapes and forms. The authorities are now facing a policy conundrum, meaning that by trying to stabilise economic growth in the near term they could actually move away from the rebalancing necessary to achieve results in the medium to long term. The reform of the financial sector alone would not be enough. This will have to be embedded in a wider reform process that will address distortions in other areas of the Chinese economy, such as local government finances and state-owned enterprises. A whole liberalisation chain has to be worked out and this was fully acknowledged by the Chinese authorities, which laid out a comprehensive reform plan last year at the 3rd Party Plenum.

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