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China's Banking Sector Risks and Implications for the United States

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Table of Contents

Executive Summary	3
Introduction.....	4
Structural Overview	4
Composition of China’s Banking System.....	4
Policy and Regulatory Oversight.....	5
Underdevelopment of Direct Financing	7
The Role of Shadow Banking.....	8
Trends and Policy Developments	9
The Evolution of Balance Sheet Risks	9
2019: Year of the Bailouts	11
Nonperforming Loans and Capital Replenishment	13
Pandemic Banking.....	15
Spotlight: Retail Banking.....	16
The Rise of Fintech and Its Disruption of Banking.....	18
Impact on Consumption.....	18
Conclusion and Considerations for Congress.....	19

Executive Summary

Banks are the dominant players in China's financial system, but they are also a source of systemic risk as China's growing debt burden is concentrated on their balance sheets. While Chinese banks appear similar to their U.S. counterparts, there is a key difference: they remain beholden to and supported by the state. This makes them operate in fundamentally different ways than U.S. banks. Despite four decades of promised liberalization, the Communist Party-state retains the ability to intervene decisively in the banking system to achieve desired outcomes. However, the government's efforts to control and direct the financial system have also limited the growth of direct financing channels such as stock and bond markets, leaving banks as the main providers of credit in China's economy and, thus, indispensable. Beijing has consequently been forced to bail them out on several occasions.

Beijing's focus on maintaining stability and control warps market incentives by encouraging investors, creditors, and depositors to evaluate a bank based on its likelihood of receiving government support if there is a risk of insolvency rather than on its individual fundamentals. Banks themselves follow the same logic and prefer to lend to companies that enjoy explicit or implicit government support. Thus, the subordination of banks' commercial objectives to political priorities distorts credit allocation and undermines the development of a professionalized financial system based on market fundamentals.

The giant stimulus Beijing deployed during the 2008–2009 global financial crisis prompted banks to engage in a decade of risky expansion. This has left them without sufficient capital to cover foreseeable risks and saddled them with large volumes of nonperforming loans (NPLs). Regional banks, restricted to serving a specific province or metropolitan area, were the most aggressive and borrowed heavily from larger nationally licensed banks to fund their expansion. In late 2016, financial regulators belatedly recognized the severity of these risks and initiated a cleanup campaign. Nevertheless, liquidity risks erupted in dramatic fashion in 2019, first with the Baoshang Bank bailout in May and followed by problems at other regional banks. The scale of the problem will require an extended period of unwinding characterized by slower growth. The probability of additional isolated bank crises remains high. Meanwhile, the outbreak of the novel coronavirus (COVID-19) has complicated this effort by straining companies' financials and damaging their ability to repay loans. Banks now face renewed pressure from the government to extend extra support to struggling companies even as they face a possible spike in new NPLs, compounding existing capital shortages and liquidity problems.

To cope with a changing economic and policy environment, many banks have turned to consumers to drive continued growth. Here, too, significant headwinds are emerging. As tracked by the Bank for International Settlements, households in China borrowed faster than in any other country over the last decade, and they are beginning to reduce consumption to pay down their debt. Moreover, not all banks are equally equipped to take advantage of the rise in consumer borrowing. Financial technology (fintech) companies, which collect large volumes of consumer data and offer attractive alternatives to standard bank deposits, present a further challenge to bank profitability. Regional banks, the weakest link in China's banking system, are especially poorly positioned to attract new retail customers.

Despite the challenges facing Chinese banks, observers should be cautious about predicting an imminent financial crisis. Beijing has demonstrated capacity and willingness to intervene as necessary to prevent bank collapse. Yet its capacity to do so more broadly, especially amid the unprecedented global shock of COVID-19, remains untested. Further, such individual bank interventions are intrinsically market distorting and may exacerbate problems in the future. In some cases, government bailouts hurt the value of assets held by U.S. investors, whose interests are secondary to the Chinese government's need for stability. The fate of Chinese banks is also of growing relevance to the United States because Beijing has slowly expanded market access for foreign financial companies and portfolio investors. Through their investment or retirement accounts, individual U.S. savers are increasingly likely to have exposure to China's financial markets, own equity in Chinese banks, and acquire Chinese NPLs. U.S. investors thus have a growing stake in China's financial system and all its unattenuated economic and political risks. This is an important issue for policymakers to assess.

Introduction

Over the past decade, China’s banking sector has grown fourfold from \$10.2 trillion in 2009 to \$41.6 trillion at the end of 2019 and is now the world’s largest.*¹ However, this expansion was not matched by commensurate economic growth during the same period. China’s gross domestic product (GDP) increased by only \$9.2 trillion between 2009 and 2019, and the pace of growth slowed significantly, already hitting a 29-year low before the COVID-19 pandemic.² This mismatch between bank-sector expansion and decelerating growth reflects decreased efficiency in the allocation of financial resources as new credit generates diminishing economic returns. Behind China’s significant corporate debt burden is a mountain of bank loans, a significant portion of which are backed by opaque, high-risk assets. Beijing’s current regulatory approach to the financial system can largely be understood as an attempt to reduce the threat these risky assets present to overall financial stability while keeping borrowing sufficiently high to stimulate growth. This report reviews the structure of China’s banking sector and the causes of its current challenges. It then assesses recent regulatory efforts to curb risky lending, offload bad assets, and recapitalize banks. It concludes by examining China’s booming retail banking market and analyzing the implications of China’s banking policies for the United States.

Structural Overview

Composition of China’s Banking System

On the surface, China possesses a well-developed and diverse financial system. As of January 2020, the Shanghai and Shenzhen stock exchanges had a combined market capitalization of \$8.5 trillion, making China the second-largest equities market in the world after the United States.³ In addition to banks, a wide range of financial institutions—including brokerages, financial leasing companies, trust companies, fintech companies, etc.—are active in China’s financial market. Despite this apparent diversity, commercial banks[†] overwhelmingly dominate China’s financial sector, accounting for more than 80 percent of all assets held by Chinese financial institutions and provided 67.8 percent of all credit to the economy in 2019.[‡]⁴ Moreover, although there are over 4,000 commercial banks,[§] the six largest state-owned banks—Industrial and Commercial Bank of China (ICBC), China Construction Bank, Bank of China, Agricultural Bank of China, Postal Savings Bank of China, and the Bank of Communications—hold 47 percent or \$15.9 trillion of all commercial bank assets (see Figure 1).⁵ These are followed by 12 national joint-stock banks,^{**} which hold an additional 21 percent of total commercial bank assets.⁶ There are also a multitude of regional banking institutions with various ownership structures, including 134 city commercial banks, around 1,400 rural commercial banks, and thousands of rural credit cooperatives.

* Other countries’ banking systems also expanded during this period. For example, between January 2009 and December 2019, total U.S. commercial bank assets grew from \$12.3 trillion to 17.8 trillion, while those of Japan grew from \$8.9 trillion (804.6 trillion yen) to \$10.4 trillion (1129.5 trillion yen) over the same period. However, the speed and scale of China’s credit expansion was far greater than that of other countries and was unprecedented in modern history. See Dinny McMahon, *China’s Great Wall of Debt: Shadow Banks, Ghost Cities, Massive Loans, and the End of the Chinese Miracle*, Houghton Mifflin Harcourt, 2019, 31; FRED, Federal Reserve Bank of St. Louis, “Total Assets All Commercial Banks.” <https://fred.stlouisfed.org/series/TLAACBW027SBOG>; Bank of Japan, “Assets and Liabilities of Domestically Licensed Banks.” https://www.boj.or.jp/en/statistics/asli_fi/index.htm/.

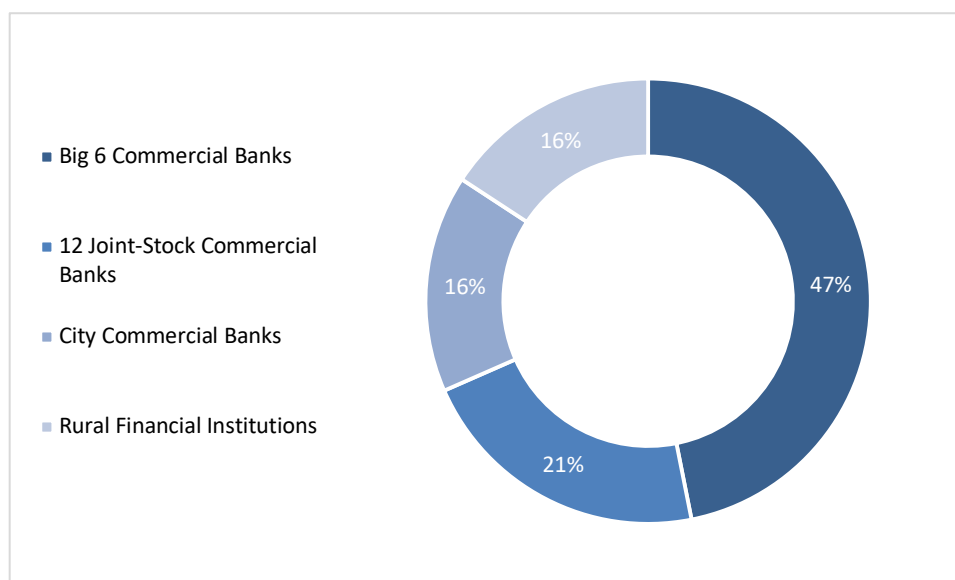
† The use of the term “commercial banks” in this report does not imply that such banks operate according to free-market principles. Commercial banks—as opposed to investment banks and policy banks—here refers simply to banks that accept deposits from individuals or corporations; make business, consumer, and mortgage loans; and provide checking account services. Commercial banks primarily earn a profit from the spread between the interest rates they pay to depositors and those they receive on loans they have extended. They also collect fees for certain services they provide, such as credit card transactions and currency exchange. The consumer-oriented portion of a commercial bank’s business is called retail banking.

‡ This figure includes only formal bank loans. If off-balance-sheet shadow loans are included, then the percentage would be higher.

§ This number includes rural credit cooperatives: financial institutions that provide the same services as commercial banks to rural communities, where the larger commercial banks do not have a physical presence.

** The shareholders of these joint stock—or shareholding—banks are corporations. Unlike the big six banks, these are not necessarily wholly state owned, but the government often has a strategic or controlling interest through state-owned investment or holding companies. The 12 national joint-stock banks are China Merchants Bank, Shanghai Pudong Development Bank, China Citic Bank, Hua Xia Bank, China Everbright Bank, China Minsheng Bank, Industrial Bank (distinct from ICBC), China Guangdong Development Bank, Ping An Bank, China Zheshang Bank, China Bohai Bank, and Hengfeng Bank. See Sun Guofeng, “Banking Institutions and Banking Regulations” (draft) in Marlene Amstad, Guofeng Sun, and Wei Xiong, eds., *The Handbook of China’s Financial System* (forthcoming in Princeton University Press), 12. <https://www.chinafinancialsystem.com/chapters/>.

Figure 1: Chinese Commercial Bank Assets by Bank Type, December 2019



Note: This figure includes the assets of rural credit cooperatives, which largely perform the same function as commercial banks but are not counted in the aggregate commercial bank asset figure published by the China Banking and Insurance Regulatory Commission's (CBIRC).
Source: China Banking and Insurance Regulatory Commission via CEIC database.

In addition to commercial banks, China also has three national state-owned policy banks: China Development Bank, Export-Import Bank of China (Exim Bank), and Agricultural Development Bank of China. The Chinese government does not publish disaggregated figures for the policy banks' assets, but the three banks' most recent annual reports reveal that their combined assets equaled about \$4 trillion at the end of 2018.⁷ The three policy banks were established as part of a restructuring effort in 1994 to separate commercial and policy financing functions, with each bank charged with specific policy domains. For example, China Development Bank was formed specifically to finance domestic and international development projects, while the Exim Bank provides financial services for importers and exporters.⁸ The existence of separate policy banks does not mean China's commercial banks are nonpolitical enterprises. The central government, as well as regional and local governments, regularly influence the lending decisions of commercial banks by issuing policy directives or through informal dialogue known as "window guidance."⁹ This subordination of banks' commercial objectives to political priorities distorts credit allocation and undermines the development of a professionalized financial system.

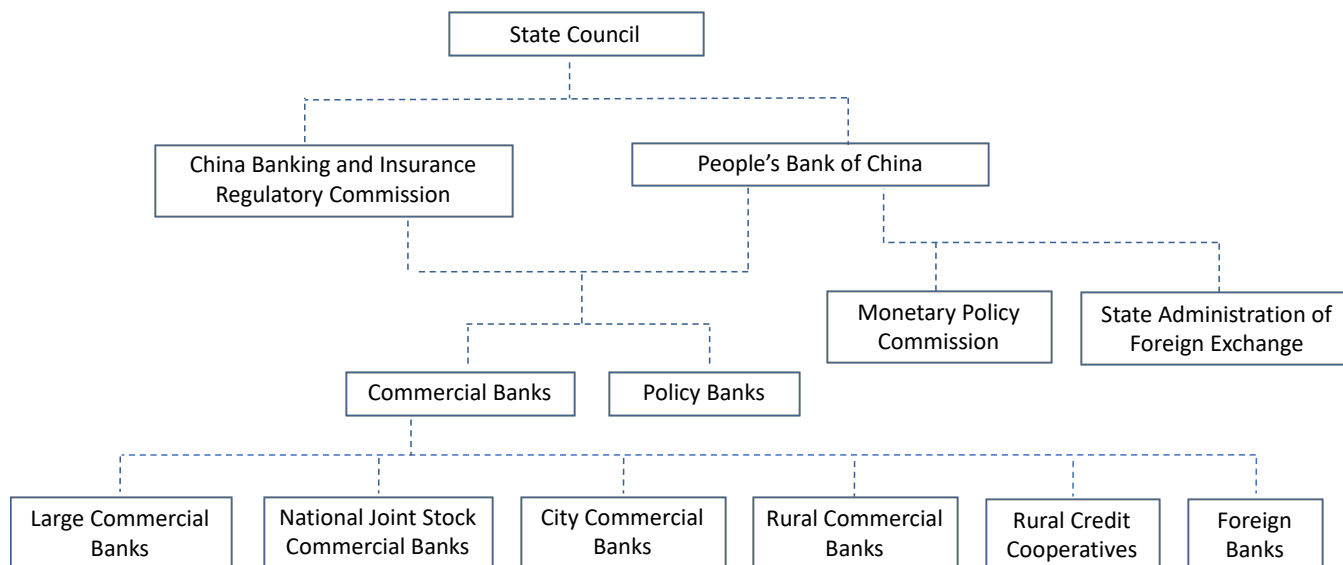
Policy and Regulatory Oversight

The two main regulatory authorities responsible for overseeing China's banking system are the People's Bank of China (PBOC) and the China Banking and Insurance Regulatory Commission (CBIRC). The PBOC is China's central bank and, similar to the Federal Reserve System in the United States, is tasked with setting monetary policy and maintaining stability in the financial system.¹⁰ Although the 1995 Law of the People's Bank of China mandates currency stability as its key monetary policy objective, in practice the PBOC pursues several high-level goals simultaneously. These include maintaining price stability, supporting economic growth, ensuring employment, maintaining stability in China's balance of payments, and promoting financial reform and financial market development.¹¹

* Window guidance is an unconventional method of conducting monetary policy in which authorities seek to influence banks' lending volumes through dialogue and "moral suasion" rather than through legislation or formal regulations. See Georgina Lee, "China's Biggest Banks Well Prepped on Nonperforming Loans, Ready for Stricter Reporting Standard," *South China Morning Post*, May 15, 2019. <https://www.scmp.com/business/article/3010372/chinas-biggest-banks-well-prepped-non-performing-loans-ready-stricter>; Stefan Angrick and Naoyuki Yoshino, "From Window Guidance to Interbank Rates: Tracking the Transition of Monetary Policy in Japan and China," *Bank of Finland Institute for Economies in Transition*, 2018, 1. <https://helda.helsinki.fi/bof/bitstream/handle/123456789/15212/dp0418.pdf;jsessionid=E48CC5018DB01891C2A27F2BD740B5CF?sequence=1>.

A critical difference between the PBOC and the U.S. Federal Reserve System is that it does not have the same degree of institutional independence. The PBOC is subordinate to the State Council (see Figure 2)—China’s highest administrative authority—and must submit “decisions about money supply, interest rates, exchange rates and other specified important matters” to the State Council for approval before implementing them.¹² The PBOC must therefore formulate monetary policy in coordination with other government agencies and is ultimately answerable to the political will of the Chinese Communist Party (CCP).

Figure 2: Oversight Structure of China’s Financial System



Source: Created by Commission staff.

The CBIRC is the successor institution to the China Banking Regulatory Commission (CBRC), which existed from 2003 to 2018 and then merged with China’s insurance regulator during a government-wide bureaucratic overhaul at the 13th National People’s Congress in March 2018. The CBRC was originally created to take over supervisory and regulatory functions of the PBOC for banks and some nonbank financial institutions (NBFIs)* in China.¹³ The CBIRC retains many of these powers, such as drafting and promulgating rules and approving the creation of financial institutions. However, following the March 2018 reorganization, the PBOC largely regained control of regulatory policy development as the CBIRC’s role was narrowed to that of a supervisory institution to oversee banks and insurance companies.¹⁴

Under the leadership of General Secretary of the CCP Xi Jinping, financial policymaking has become increasingly integrated and directly subordinate to the Party. In 2017, the State Council established a Financial Stability and Development Committee (FSDC) to coordinate across different agencies and ensure that monetary, fiscal, and financial policy are better aligned.¹⁵ The committee includes representatives from the PBOC, CBIRC, China Securities Exchange Commission, National Development and Reform Commission, and National Council for Social Security Fund. It is chaired by Vice Premier Liu He, General Secretary Xi’s top advisor on economic issues.¹⁶ Vice Premier Liu has a close personal relationship with General Secretary Xi and also heads the general office of the Central Leading Small Group on Financial and Economic Affairs, a Party coordinating body.¹⁷ Thus, the FSDC represents a parallel structure concentrating power in the hands of General Secretary Xi’s trusted lieutenant and bypassing Premier Li Keqiang, who retains formal authority over financial policymaking as head of the State Council.

* The CBIRC’s Non-Bank Inspection Bureau performs onsite inspections and evaluations of insurance companies, trust companies, and other financial companies. The Non-Bank Department handles market entry and offsite stress testing for financial asset management companies, corporate group finance companies, financial leasing companies, auto leasing companies, consumer finance companies, currency brokerages, and other financial institutions. China Banking and Insurance Regulatory Commission, *Non-Bank Inspection Bureau* (非银检查局). <http://www.cbirc.gov.cn/cn/view/pages/jigougaikuang/nsjg-xiangqing.html#87>; China Banking and Insurance Regulatory Commission, *Non-Bank Department* (非银部). <http://www.cbirc.gov.cn/cn/view/pages/jigougaikuang/nsjg-xiangqing.html#102>.

How the PBOC Manages Interest Rates

The PBOC uses a variety of tools to achieve its monetary policy objectives. Unlike in the United States, where there is a single benchmark interest rate—the federal funds rate—China’s central bank maintains several different interest rates that can be reasonably seen as having benchmark status.¹⁸ Until the second half of 2019, the most watched of these were the so-called benchmark lending and deposit rates, which have remained unchanged at 4.35 percent and 1.5 percent, respectively, since 2015.¹⁹ Although interest rates were nominally liberalized in 2015, commercial banks still based their own interest rates on the benchmarks (and continue to do so for deposit rates).²⁰

In August 2019, the PBOC changed the way it calculates the Loan Prime Rate (LPR)—the average rate a collection of 18 banks charge their best customers. Participating banks now must submit their LPR quotations in terms of a spread over the Medium-Term Lending Facility (MLF).^{*} Although this reform was trumpeted as making the LPR more market based, linking it to the MLF actually gives the PBOC greater influence over the LPR since it can cut or raise the MLF rate at any time, and thereby also prevents banks from colluding to keep lending rates high.²¹ In December 2019, the PBOC ordered banks to reprice all outstanding floating interest rate loans[†] according to the LPR instead of the old benchmark lending rate by August 2020—effectively replacing the benchmark rate.²²

The MLF in turn tends to track the PBOC’s interest rate on seven-day reverse repurchase agreements or “reverse repos.”²³ In a reverse repo, the PBOC buys securities (usually with maturities of seven days) from major banks, which agree to repurchase them at a higher price on the maturity date—effectively a short-term loan from the PBOC to major banks.²⁴ The PBOC regularly conducts reverse repos through its open market operations, and uses them as its primary tool for short-term liquidity management. The seven-day reverse repo rate also serves as the benchmark for money market rates.²⁵

Through the LPR, MLF, reverse repo, and benchmark deposit rates, the PBOC is firmly in control of the actual interest rates banks offer depositors and charge their customers. However, prior to the COVID-19 pandemic, the PBOC was extremely reluctant to cut interest rates despite a significant slowdown in economic growth. This was partly because it was afraid to stimulate the property market (which is widely believed to be overheated) as mortgage loans are also linked to the LPR.²⁶ However, it was also because lowering interest rates too much would squeeze banks’ guaranteed profit margin that results from the spread between lending rates and the artificially suppressed deposit rates.²⁷ Although the economic impact of COVID-19 has forced the PBOC to trim interest rates slightly, this second factor continues to keep China’s interest rates higher than in most of the developed world and helps explain why the LPR was 3.85 percent as of April 2020 compared to 0.5 percent for the federal funds rate.²⁸

Underdevelopment of Direct Financing

The banking sector’s dominance of the financial system has limited development and growth of China’s domestic stock and bond markets. Despite its headline-grabbing volatility, China’s stock market accounted for only 2.9 percent of China’s total outstanding credit stock at the end of 2019.²⁹ This contrasts with the United States, where stock holdings account for 51.8 percent of outstanding corporate liabilities.³⁰ Corporate bonds do account for a significant share of financing in China—13 percent in 2019.³¹ However, the bond market is dominated by banks, which held 56.2 percent of corporate bonds and 86.1 percent of local government bonds traded on the interbank bond market at the end of 2019, according to official statistics.³² The actual numbers are likely higher as this data does not account for off-balance-sheet bond purchases funded through wealth management products.[‡]³³ Combined

^{*} Alongside reverse repurchase agreements and its Standard Lending Facility, the Medium-Term Lending Facility (MLF) is a monetary policy tool the PBOC uses to increase liquidity in the banking system. As the name suggests, the MLF consists of PBOC loans to the banking sector of a medium-term maturity (i.e., between three months and one year). *Bloomberg*, “China’s Evolving Toolkit to Manage Monetary Policy,” June 7, 2019. <https://www.bloomberg.com/news/articles/2018-06-14/china-s-evolving-toolkit-to-manage-monetary-policy-quicktake>.

[†] A floating interest rate—as opposed to a fixed interest rate—is one that fluctuates according to the market as represented by an index. Previously, floating interest rate loans were indexed against the benchmark lending rate. Kevin Yao, “China to Switch Benchmark for Floating-Rate Loans to Lower Funding Costs,” *Reuters*, December 27, 2019. <https://www.reuters.com/article/us-china-economy/china-to-switch-benchmark-for-floating-rate-loans-to-lower-funding-costs-idUSKBN1YW00N>; Financial Industry Regulation Authority, “Can You ‘Float’ with Rate Hikes? 6 Things to Know about Floating-Rate Loan Funds.” <https://www.finra.org/investors/insights/can-you-float-rate-hikes-6-things-know-about-floating-rate-loan-funds>.

[‡] In China, WMPs are essentially uninsured, high-yield certificates of deposit. Issuers of WMPs typically invest the funds in property development or other risky ventures. For further discussion of WMPs, see U.S.-China Economic and Security Review Commission, Chapter 1, Section 1, “Year in Review: Economics and Trade,” in *2018 Annual Report to Congress*, November 2019, 53.

with the fact that commercial banks tend to pursue buy and hold strategies (which reduce market liquidity), this strongly suggests the majority of China’s bond market activity is little more than disguised bank lending.^{*34} This chronic underdevelopment of China’s financial markets forces small entrepreneurial firms to seek unofficial sources of funding, primarily from shadow banking intermediaries.

In the Chinese government’s own assessment, this reliance on bank loans and underdevelopment of capital markets tends to distort credit allocation in favor of large companies and has contributed to China’s high corporate debt levels.³⁵ It disadvantages smaller, less politically connected firms because banks are less willing to lend to them. Yet government policy is itself a key obstacle to the development of a mature and diversified financial system. Although China’s economic policymakers have called repeatedly for the expansion of so-called “direct financing”[†] channels, they remain fearful that liberalizing stock markets would threaten stability and therefore have taken only limited steps to address the issue.³⁶ China’s 2015 stock market meltdown delayed improvements to China’s initial public offering (IPO) approval system for nearly five years, resulting in a backlog of 400 applications.³⁷ Only recently, amid the urgency of a slowing economy and the COVID-19 pandemic, have regulators accelerated efforts to encourage domestic stock listings.³⁸

The Role of Shadow Banking

China’s financial institutions perform a variety of credit intermediation functions outside of formal banking channels—also known as shadow banking.³⁹ A distinctive feature of China’s shadow banking system is that traditional banks themselves are also key participants.[‡]⁴⁰ After the global financial crisis, traditional banks began partnering with NBFIs to extend shadow loans. This enabled them to lend more to meet local funding needs and circumvent a regulation capping on-book loans at 75 percent of deposits (this cap was removed in 2015 to stimulate lending).⁴¹ They accomplished this primarily by channeling loans through NBFIs—establishing contractual arrangements that convert the loans into investments in NBFI financial products backed by loans—in order to move the loans and risk off the bank’s own balance sheet.⁴²

Shadow banking is intentionally opaque, and it is impossible to calculate the precise distribution of shadow assets within the banking sector. Broadly, though, exposure to risky shadow assets is concentrated among regional banks, particularly city commercial banks, while the balance sheets of the big six banks are comparatively strong.⁴³ In terms of overall size, analysts have offered a wide variety of estimates. Data published by Moody’s and the Bank for International Settlements suggests shadow banking accounted for 24 percent of total nonfinancial sector debt in China as of the third quarter of 2019 and was roughly equivalent to 60 percent of China’s GDP, or around U.S. \$8.3 trillion.⁴⁴ Before the 2008–2009 global financial crisis, the Reserve Bank of Australia calculates it was about 5 percent of nonfinancial credit.⁴⁵

Beginning in late 2016, the central government started to curb risky shadow lending as part of a broader financial cleanup. Guo Shuqing, head of the CBIRC, has spearheaded the effort by unleashing a barrage of new banking regulations aimed at controlling the riskiest forms of speculation. This has led to a contraction in shadow banking activity and a reduction in the most destabilizing behavior. However, the thrust of Guo’s regulatory effort is aimed at preventing systemic risks in the banking system rather than reducing China’s overall debt stock. This is especially clear from the way regulators selectively eased pressure on certain subsets of shadow banking in 2019 to stimulate lending while maintaining curbs on those elements that present the greatest systemic risk—namely banks’ channel business with NBFIs.⁴⁶

* The commercial banks that dominate China’s bond market tend to pursue buy and hold strategies. If a bank buys a corporate bond and holds the bond on its balance sheet until maturity, then this is functionally equivalent to a bank loan. See Tian Chen, “Why China’s Bond Market Is About to Get Less Exotic,” *Bloomberg*, March 28, 2019. <https://www.bloomberg.com/professional/blog/chinas-bond-market-get-less-exotic/>.

† Direct financing refers to fundraising channels that do not require an intermediary. Bank lending is considered “indirect” because the bank intermediates between lenders and borrowers.

‡ Shadow banking typically describes lightly regulated NBFIs engaging in bank-like borrowing and lending. In China, there is an additional component: banks themselves partner with NBFIs to extend high-risk loans that would otherwise require them to increase their capital reserves. This is often termed banks’ “channel business” because the banks act as an intermediary or “channel” between depositors and NBFIs.

Trends and Policy Developments

The bailout of Baoshang Bank (discussed later) in May 2019 exposed a number of latent risks in China’s banking system. However, government intervention to support or recapitalize failing banks is not a new phenomenon in China. In the late 1990s and early 2000s, the government bailed out China’s four largest banks at a cost of \$385 billion.⁴⁷ This time around, however, Beijing is contending with the slowest economic growth in 29 years and an unprecedented global pandemic, making it difficult to replicate past rescue efforts.⁴⁸ Although policymakers are employing a variety of strategies to reduce risks, help banks recapitalize, and deal with high NPL levels, it remains unclear whether they can correct the underlying structural challenges and avert either economic stagnation or a significant downward adjustment to the value of bank assets.

The Evolution of Balance Sheet Risks

Over the past decade, Chinese commercial banks undertook an unprecedented expansion of their balance sheets, extending massive quantities of new loans to companies and local governments. Between 2009 and 2019, China’s total banking assets grew from \$10.2 trillion to \$41.6 trillion.⁴⁹ This expansion was initially kicked off by stimulus policies rolled out by the Chinese government at the onset of the global financial crisis, but quickly took on a momentum of its own. In November 2008, Beijing announced a fiscal stimulus package of \$586 billion (renminbi [RMB] 4 trillion), but because the plan required local governments to share project costs with Beijing it had to be augmented with an expansion of bank lending. Local governments exploited the loosened credit conditions to fund infrastructure projects, and banks sought to scale up their operations by swelling their balance sheets.⁵⁰ Within a month of the announcement of the stimulus package, investment projects proposed by local governments totaled \$2.6 trillion (RMB 18 trillion).⁵¹ Not all of these projects were ultimately funded, but conservative estimates still place the final stimulus bill at around \$1.4 trillion (RMB 9.5 trillion)—more than double the value of the original package.⁵² Bank lending also remained inflated for years afterward and did not return to pre-stimulus levels until May 2013.⁵³

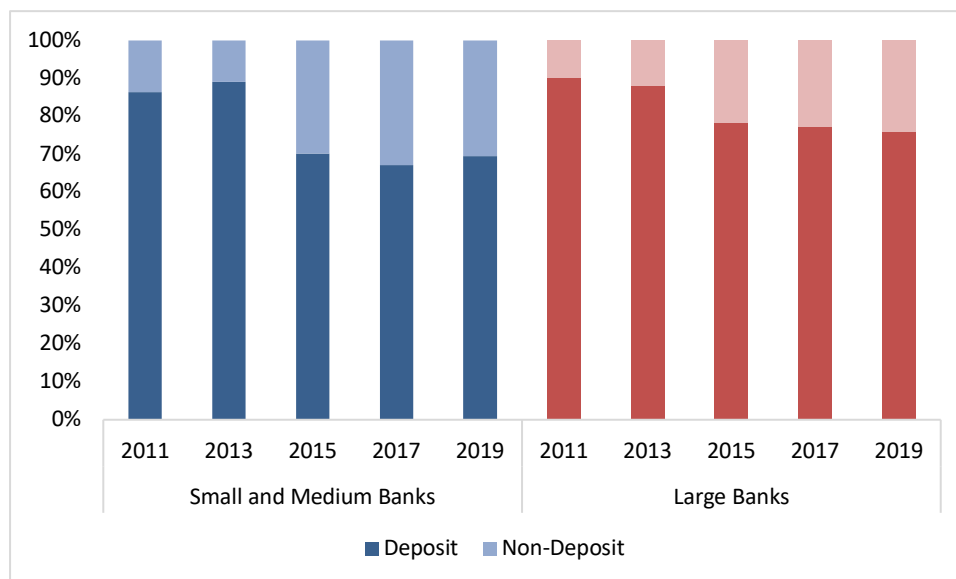
Local governments’ insatiable demand for credit stems from a structural imbalance in the fiscal relationship between local governments and Beijing. While they shoulder the majority of expenditure obligations, local governments receive less than half of all tax revenue and are legally prohibited from running a budget deficit.* Theoretically, this gap should be closed with fiscal transfers from the central government, but in practice these transfers do not always cover local government expenses, resulting in a de facto unfunded mandate.⁵⁴ Moreover, the Party’s emphasis on economic growth targets as a key performance indicator for local cadres prevents them from imposing fiscal discipline on their jurisdictions.⁵⁵

The scale of the credit boom that followed the government’s stimulus efforts in 2008–2009 eventually outgrew banks’ ability to fund new loans through standard deposits, forcing them to search for alternative funding channels. A variety of external factors—among them declining household savings rates after 2010 and the launch of Alibaba’s first money market fund, Yu’e Bao, in 2013—also suppressed growth of deposits as people invested money elsewhere or spent it on consumption.⁵⁶ However, 2014 marked a watershed as large-scale capital outflows from China† permanently reversed its large capital account surplus, prompting a structural change in the composition of bank balance sheets.⁵⁷ The funding crunch was particularly severe for small and medium-sized commercial banks as they relied more on corporate deposits, which tend to fluctuate with the business cycle.⁵⁸ Between 2013 and 2016, total deposits declined from 89.1 percent to 67.1 percent of total funding at small and medium banks (see Figure 3).⁵⁹

* Article 35 of China’s revised Budget Law, adopted in 2014, explicitly prohibits local governments from running a deficit. However, in an effort to eliminate the practice of borrowing through local government financing vehicles, the article also allows local governments to issue bonds within limits set by—and with the approval of—the State Council. China’s National People’s Congress, *Budget Law of the People’s Republic of China* (中华人民共和国预算法), November 2, 2014. Translation. http://www.npc.gov.cn/wxzl/gongbao/2014-11/02/content_1892137.htm.

† China has experienced persistent capital outflows since 2014. These were caused by waning confidence in China’s economy and a reversal of the RMB’s appreciation. From 2005 to 2014, the RMB consistently appreciated against the dollar; since 2014, its movements have been much more volatile, but it has generally depreciated against the dollar. See *Bloomberg*, “What’s Causing Those Capital Outflows from China: Quicktake Q&A,” January 13, 2017. <https://www.bloomberg.com/news/articles/2017-01-13/what-s-causing-those-capital-outflows-from-china-quicktake-q-a>; China State Administration of Foreign Exchange via CEIC database.

Figure 3: Chinese Banks Deposit and Non-Deposit Funding, 2011–2019



Note: Non-deposit sources of funding include bonds issued, central bank borrowing, interbank borrowing, and repurchase agreements.
Source: People’s Bank of China via CEIC database.

Rather than scale back lending, banks increased borrowing through interbank channels to fill the funding hole that opened up after 2014.⁶⁰ They also began issuing large volumes of Negotiable Certificates of Deposit (NCDs)—a commonly used instrument for high-volume, short-term (the most common maturity is three months) borrowing on interbank markets. Until 2017, banks were not required to report NCDs as interbank liabilities, enabling them to circumvent a regulatory rule limiting the amount a bank can borrow from other financial institutions to one-third of its total debt.⁶¹ Between the second quarter of 2015—the first full quarter in which the PBOC published data on NCDs—and the end of 2018, quarterly NCD issuance rose from \$153.5 billion (RMB 950 billion) to \$770.3 billion (RMB 5.3 trillion) and reached 14.4 percent of total bank assets.⁶² Initially, large banks were the main issuers, but joint-stock banks and then city commercial banks soon became the most active sellers in the NCD market.⁶³ The rapid rise of NCDs and other interbank instruments has exposed regional banks to significant liquidity risks, as these are less reliable than standard deposits in the face of market volatility. The aftermath of the Baoshang Bank episode (discussed later in the report) brought these risks into sharp relief and contributed to 2019 seeing the first annual contraction in NCD sales since the PBOC first approved them for China’s market.⁶⁴

Another way banks continued to generate credit was through their channel business with NBFIs. In these arrangements, banks carved out a profitable role for themselves as intermediaries that channeled funding from depositors to various NBFIs—mainly trust companies and securities brokerages—that then extended shadow loans to subprime borrowers.⁶⁵ Although the specifics of these arrangements have changed over time, their basic function is to repackage loans as investments for accounting purposes, allowing banks to avoid meeting loan-loss reserve requirements* that apply only to loans.⁶⁶

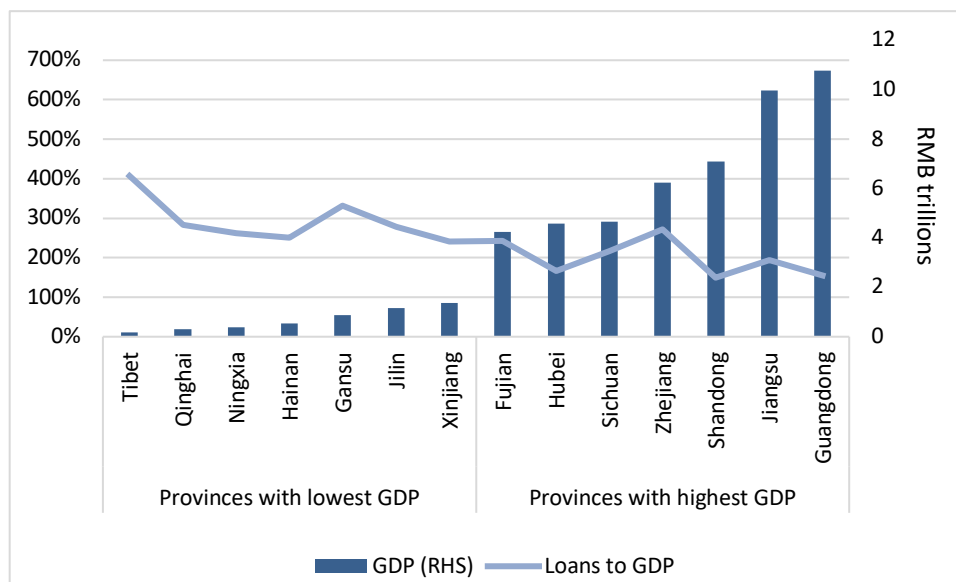
To raise funding for their channel business, banks sold wealth management products (WMPs) to depositors. In China, WMPs are uninsured investment products offered by banks and other institutions that provide significantly higher returns than standard deposits—4.1 percent annually on average compared to 0.3 percent on standard deposits, as of February 2020—and typically have shorter-term maturities than the underlying loans.⁶⁷ The PBOC maintains tight control over interest rates paid to depositors, and WMPs provide a way for banks to offer depositors higher-yielding products that skirt government controls.⁶⁸ However, they also expose banks to liquidity risks due to the maturity mismatch on their balance sheets and the higher returns they must pay to investors.⁶⁹ These risks are

* Because one of the chief risks in commercial banking is that borrowers will not repay loans, regulators usually require that banks set aside a certain amount of capital to cover potential losses. The required amount is typically expressed as a percentage of the value of the NPLs on the bank’s balance sheet. Since March 2018, the CBIRC’s loss-provisioning capital requirement is 120–150 percent of NPLs. See *Xinhua*, “CBIRC Adjusts Regulatory Requirements for Bank Loan Loss Provisions” (银监会调整银行贷款损失准备监管要求), March 7, 2018. Translation. http://www.xinhuanet.com/fortune/2018-03/07/c_129824425.htm.

magnified when WMPs are sold on interbank markets rather than to retail depositors because such cross-selling transfers the liquidity and repayment risks of the issuing bank’s WMP onto the balance sheet of the purchasing bank. The practice of using funds raised through WMPs to purchase other banks’ WMPs became widespread prior to 2017 when the CBIRC began cracking down on this kind of behavior.⁷⁰

These issues with the structure of bank liabilities might have been less problematic if the asset side of their balance sheet (i.e., the loans they extended) were based on a sound assessment of borrower creditworthiness. Instead, balance sheet expansion was predicated on the assumption that the government would backstop the loans and bail out any bank that ran into trouble. This widespread assumption that the full fiscal firepower of the Chinese government stands behind the financial system is often referred to as the “implicit guarantee.” The implicit guarantee has distorted capital allocation and disincentivized banks from accurately pricing risk. A regional comparison of bank assets to GDP in 2019 shows the heaviest speculative activity has been concentrated in weaker provincial economies, generating asset bubbles along China’s rust belt (see Figure 4).⁷¹

Figure 4: Comparison of Regional Bank Loans to GDP in 2019



Note: GDP figures are for full-year 2019. Bank loan figures are total outstanding based on the latest published data.

Source: China National Bureau of National Statistics and China Banking and Insurance Regulatory Commission via CEIC database.

China’s impoverished western regions of Tibet, Qinghai, Ningxia, and Gansu are among the largest loan recipients relative to the size of their economies. Economic growth in these provinces has not been proportional to the rate of credit expansion, suggesting a speculative dimension to the loans.⁷² Meanwhile, lending to wealthy coastal provinces like Guangdong, Jiangsu, and Shandong is much lower in proportion to their economic weight.⁷³ Overlending to economically unproductive regions is symptomatic of the lack of market pricing mechanisms and reflects the distortive impact of political interference in the financial system.

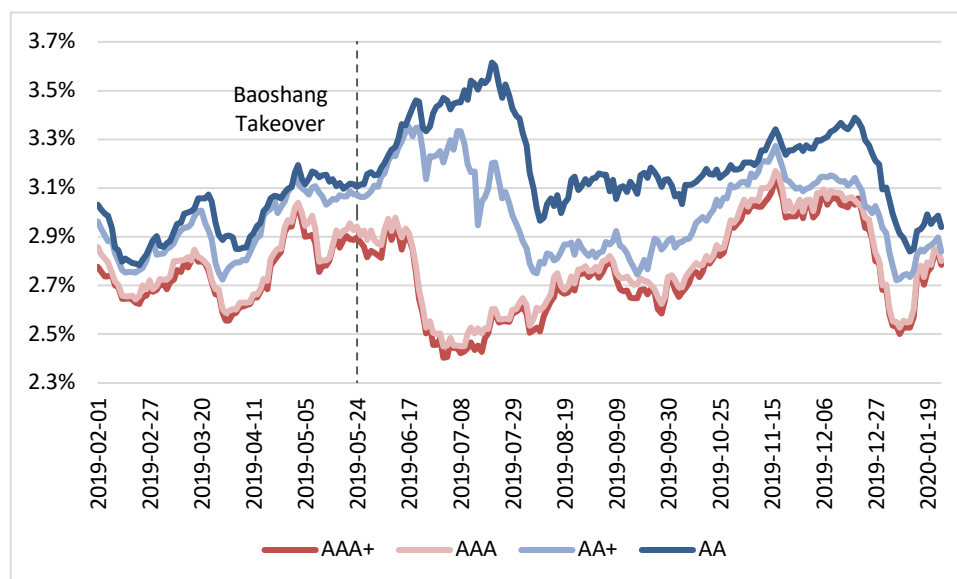
2019: Year of the Bailouts

The problems with bank balance sheets led to the Chinese government intervening in six regional banks and one joint-stock bank since May 2019. The first and most significant of these interventions occurred in May 2019, when the CBIRC, citing “severe credit risks,” took over direct control of Inner Mongolia-based Baoshang Bank through a one-year government receivership. At a press conference shortly after the takeover, the PBOC announced it would guarantee deposits and interbank liabilities up to \$7.1 million (RMB 50 million) but force Baoshang’s larger creditors to accept losses of up to 30 percent.⁷⁴ This protected retail depositors while also warning other banks against reckless lending. In subsequent months, central and local authorities also directly and indirectly intervened to varying degrees in six other banks (Bank of Jilin, Bank of Jinzhou, Hengfeng Bank, Harbin Bank, Chengdu Rural Commercial Bank, and Bank of Gansu) by acquiring strategic stakes and assembling bailout coalitions.⁷⁵

So far, however, Baoshang remains the only instance where the government forced creditors to take losses on their investment—raising some limited questions as to the absoluteness of the implicit guarantee. This is partially due to

special circumstances in the case of Baoshang. In the years prior to the takeover, Baoshang had become captive to the interests of its former majority shareholder, Tomorrow Group, whose chairman, Xiao Jianhua, ran afoul of authorities and was detained in 2017.⁷⁶ In other ways, however, Baoshang was less unique. Before the takeover, former UBS analyst Jason Bedford identified 24 other banks with similar lending and funding structures to Baoshang (e.g., lending repackaged as investments, a low share of deposits to liabilities, and overreliance on interbank funding sources).⁷⁷ Although the PBOC sought to present Baoshang as an isolated case, the bank was just more aggressive than its peers in pursuing growth during the years before the financial de-risking campaign. According to Chinese media reports, Baoshang’s interbank liabilities accounted for about 44 percent of its total liabilities before the bailout, a significant portion of which were in NCDs.⁷⁸ This explains the significant interest rate spread between banks at different credit rating tiers that suddenly appeared in the NCD market following the Baoshang takeover (see Figure 5). After Baoshang, banks with a credit rating below AAA experienced a significant funding squeeze* as lenders increased the premium charged on loans to struggling banks to more accurately reflect their risk profiles.

Figure 5: Three-Month NCD Yields by Credit Rating, February 2019–January 2020



Source: China National Interbank Funding Center.

The severity of the interbank market reaction appears to have taken regulators by surprise. In addition to substantial short-term liquidity injections into the market, on June 6 the PBOC lent \$72 billion (RMB 500 billion) to banks through its MLF—the second-largest such single-day injection on record at the time—to ease the liquidity shortage for small and medium banks while simultaneously applying informal pressure on shadow banking intermediaries to keep credit taps open.⁷⁹

Alongside substantial liquidity injections, subsequent bailouts of Bank of Jinzhou, Hengfeng Bank, and others—in which creditors did not take losses—seem to have assuaged market jitters. By the end of 2019, the spread on funding costs between different banks had basically returned to pre-Baoshang levels. Analysts largely agree the Baoshang takeover was an experiment that served as a warning against overly aggressive expansion by regional banks and perhaps as an initial step in rolling back the implicit guarantee. However, regulators’ actions on the six other banks suggest they are unlikely to take a similar approach to other banks in the immediate future.⁸⁰

* The CBIRC requires that banks and insurance companies only invest in bonds rated AA or higher. This gives domestic credit ratings agencies—the majority of which are state owned—little incentive to give ratings below a grade of AA. This results in a high concentration of AAA and AA ratings compared to developed markets such as the United States. In testimony before the Commission, University of Chicago Booth School of Business professor Zhiguo He said that although credit ratings in China are clearly inflated, market participants can discern the creditworthiness of borrowers from their relative credit rankings. U.S.-China Economic and Security Review Commission, *Hearing on China’s Quest for Capita: Motivations, Methods and Implications*, oral testimony of Zhiguo He, January 23, 2020, 95; Asia Securities Industry and Financial Markets Association, “China’s Capital Markets: The Pace of Change Accelerates,” June 2019, 64. <https://www.asifma.org/wp-content/uploads/2019/06/final-english-china-capital-markets-report-2019.pdf>.

Beijing's approach to the string of regional bank failures over the last year suggests financial regulators believe the best way to strengthen regional banks is to overhaul their shareholder structure. The CBIRC is scrutinizing banks' shareholders, and it claims to have discovered 3,000 violations relating to 1,400 shareholders.⁸¹ It is also looking to potentially restructure China's small banks through a sweeping set of mergers.⁸² But while the CBIRC characterizes these measures as "vigorous reform," Beijing's solution has thus far amounted to forcing state-backed companies to make or increase investments in banks that are performing poorly.⁸³ This rescue template merely swaps troublesome private shareholders for state-owned ones, some of which have their own financial difficulties, and does not resolve the fundamental problem that the government is on the hook when the bank's loans go bad.⁸⁴

Nonperforming Loans and Capital Replenishment

A key ingredient to the massive growth in bank assets was the undercounting of loans on bank balance sheets. Although shadow banking is by design opaque and difficult to account for, analysts at Moody's estimate that by the end of 2019 the scale of China's shadow banking sector reached \$8.3 trillion, equal to about one-fifth of total bank assets.⁸⁵ The process by which Chinese banks generated shadow credit involved collaborating with NBFIs to disguise loans as investments on their balance sheets. Booking loans as investments has allowed Chinese banks to effectively underreport the extent of NPLs on their books and avoid complying with minimum capital requirements.

Officially, China's NPL ratio* was only 1.9 percent as of the fourth quarter of 2019.⁸⁶ However, this number is not credible and significantly understates the true extent of NPLs.⁸⁷ This is demonstrated by the fact that in 2018, write downs and disposals of NPLs exceeded the total amount of outstanding NPLs officially recognized in December 2017.⁸⁸ In testimony before the Commission, Dinny McMahon, former *Wall Street Journal* reporter and expert on China's debt issues, said Beijing's continuing toleration of low NPL recognition is "strategic" because it buys time for regulators to deal with the problem. Mr. McMahon noted, "If Beijing were to acknowledge a significantly higher NPL ratio, then the banks would have to immediately raise huge amounts of capital, all at once, and at fire sale prices."⁸⁹ However, since the financial de-risking campaign began in 2016, Beijing seems to be encouraging banks to accelerate their disposals of NPLs.⁹⁰

Several factors have lent urgency to the need for banks to clean up their books. In the aftermath of the global financial crisis, the Basel Committee on Banking Supervision† developed a set of revised international prudential standards (collectively known as Basel III) to strengthen bank stability. As a signatory to Basel III, China designed regulations in 2012 to increase the minimum available capital banks are required to hold in proportion to their risk-weighted assets.‡⁹¹ However, Beijing allowed a six-year grace period for banks to comply, setting the deadline for December 2018.⁹² Although Chinese banks are nominally compliant with Basel III requirements—the CBIRC reported capital adequacy ratios of 16.3 percent, 13.4 percent, and 12.7 percent for the big six, joint-stock, and city commercial banks, respectively, at the end of 2019—this is only because they have yet to recognize the true extent of NPLs on their balance sheets.⁹³ Doing so would require them to raise large amounts of additional capital as NPLs carry a significant risk premium in terms of minimum capital requirements under Basel III.⁹⁴ This also helps explain multiple delays to the implementation of new rules for asset management products, which would have forced banks to bring many off-balance-sheet loans back onto their balance sheets.⁹⁵

In 2018 and 2019, the CBIRC also rolled out new regulations on how banks disclose NPLs. The changes forced banks to change the way they classify NPLs, broadening the definition to include other asset categories in addition

* The NPL ratio is the ratio of nonperforming loans on a bank's balance sheet to total loans in its portfolio. The CBIRC regularly publishes the combined NPL ratio of all commercial banks, which is referenced here.

† The Basel Committee on Banking Supervision (BCBS) is the main global standards-setter for banking regulations. Its membership comprises representatives of central banks and other bank supervisory authorities from 28 jurisdictions, including the CBIRC. Bank for International Settlements, "The Basel Committee – Overview." <https://www.bis.org/bcbs/>; Bank for International Settlements, "Basel Committee Membership." <https://www.bis.org/bcbs/membership.htm>.

‡ Risk weighted assets (RWA) is a concept used by international banking regulators to determine how much capital a bank must hold in reserve to cover potential losses. Each asset class is assigned a risk weighting (expressed as a percent) that is multiplied by the total value of assets in that class. Therefore, RWA is the sum of all assets multiplied by their respective risk weights. The minimum capital requirement under Basel III for banks not designated as systemically important is 10.5 percent of their RWA. As a signatory to Basel III, China also requires banks to maintain capital equal to least 10.5 percent of their RWA. See Basel Committee on Banking Supervision, "Basel III Monitoring Report," *Bank for International Settlements*, October 2019, 17, 105. <https://www.bis.org/bcbs/publ/d477.pdf>; China State Council, *CBRC FAQ on Capital Management Methods for Commercial Banks* (银监会就《商业银行资本管理办法（试行）》答问), June 8, 2012. Translation. http://www.gov.cn/gzdt/2012-06/08/content_2156787.htm; *Financial Times*, "Lexicon, Definition of Risk Weighted Assets." http://markets.ft.com/research/Lexicon/Term?term=risk_weighted-assets.

to loans.⁹⁶ New regulations also removed banks' discretion to designate loans more than 90 days overdue as "overdue but not impaired"—a category previously not counted toward their NPL ratios.⁹⁷ All of these regulatory changes require banks to either raise additional capital to cover NPLs or dispose of the NPLs themselves. Banks are pursuing both strategies simultaneously.

Tighter regulations have spurred banks to dispose of large volumes of NPLs over the last three years. Between 2016 and the end of 2019, Chinese banks disposed of \$900 billion (RMB 6.4 trillion) worth of NPLs, with annual disposals doubling from \$144.1 billion (RMB 1 trillion) to \$287.4 billion (RMB 2 trillion) over this period.⁹⁸ This pace of disposal is likely not sustainable. As banks began offloading NPLs, the market experienced a surge in supply. This initially attracted a wave of new investors to the secondary distressed asset market. The competition made it easy for Chinese asset management companies to purchase NPLs from banks and resell them for a profit, pushing up NPL prices to unrealistic levels in 2017 and early 2018.⁹⁹ According to Chinese media reports, some buyers were paying 70–80 percent of face value to acquire NPLs. By the second half of 2018, the glut in supply overwhelmed the market and prices cratered.¹⁰⁰ Lower prices make it more difficult for banks to extract value from NPLs, and if asset management companies do not purchase them in sufficient quantities, then increasing numbers of NPLs will need to be written down at a loss.¹⁰¹

At the same time, increased minimum capital requirements and changes to NPL recognition standards have made recapitalization an urgent priority. Throughout 2019, the State Council and the PBOC encouraged commercial banks to rebuild their available capital and cleared away regulatory and technical obstacles to facilitate new capital raising. Capital replenishment has taken three main forms: new equity, new debt, and government-orchestrated capital injections:

- *Equity*: Exchange-listed banks have the option to raise capital by issuing new equity; however, few banks have been able to avail themselves of this avenue because their shares are trading at historical lows.¹⁰² Chinese regulations prevent listed Chinese banks from conducting new share issues unless their traded share value is equal to at least 100 percent of their last audited book value (i.e., their price-to-book ratio is at least 1).^{*} As of January 2020, less than half of China's 36 A-listed banks were trading above book value.¹⁰³ Unlisted banks can issue shares through private placements, but were previously required to first sell shares on over-the-counter markets. In July 2019, the CBIRC removed this requirement, making it easier for unlisted banks to raise capital.¹⁰⁴
- *Debt*: Encouraged by Beijing, banks have leveraged a variety of innovative capital-raising instruments—such as bonds that convert to equity—to refill their coffers. But in 2019, regulators appeared to settle on perpetual bonds as the preferred tool for new capital raises. Perpetual bonds—a type of fixed income security with no maturity date[†]—count toward minimum capital requirements under Basel III, and are an option available to both listed and unlisted banks. The State Council initially approved the use of perpetual bonds in December 2018, and in November 2019 began allowing regional banks to raise capital this way. In January 2019, the PBOC also created a central bills swap tool that allows bond market dealers to swap perpetual bonds for central bank bills—usable as high-quality collateral—to facilitate perpetual bond issuances.¹⁰⁵ In its 2019 third-quarter monetary policy report, the PBOC characterized perpetual bonds as a “breakthrough” solution to the recapitalization puzzle.¹⁰⁶ In total, Chinese banks issued \$167.2 billion (RMB 1.2 trillion) in new debt instruments in 2019, of which perpetual bonds accounted for \$81.8 billion (RMB 569.6 billion).¹⁰⁷
- *Capital injections*: For banks whose financial or liquidity troubles are severe enough to preclude raising new capital through market channels, central and local authorities have demonstrated a willingness to arrange capital infusions. For example, to avoid an outright takeover (as happened with Baoshang), the

* A company's price-to-book ratio is calculated by dividing its market price per share by its book value per share. A company's book value is the value of its net assets (assets minus liabilities) according to its audited financial statements. In China, banks whose price-to-book ratio is less than 1 are prohibited from issuing new equity.

† Although perpetual bonds have no maturity date, they often have a callable feature, which enables the borrower to pay back the principal at a predetermined price on certain dates established at the time of issuance. They can also be written down at the behest of regulators if the issuing bank's capital falls below a certain threshold or it becomes insolvent. Wu Hongyuran and Denise Jia, “China's Regulator Revises Rules on Banks' Capital Replenishment Tools,” *Caixin Global*, November 30, 2019. <https://www.caixinglobal.com/2019-11-30/chinas-regulator-revises-rules-on-banks-capital-replenishment-tools-101489026.html>; BNP Paribas, “What Are Perpetual Bonds or Perpetuals?” <https://www.bnpparibasfortis.be/rsc/contrib/document/1-Website/5-Docserver/BNP/F04824E.pdf>.

PBOC organized a bailout coalition of three state-owned enterprises (SOEs) to acquire strategic stakes in the Bank of Jinzhou in July 2019.* This demonstration of government support was sufficient to enable a new ICBC-supplied board of directors to seek an \$866 million (RMB 62 billion) share placement just two months after the bailout.¹⁰⁸ In the case of Harbin Bank, it was local SOEs that took stakes in the company.[†] It is worth noting that capital injections have not been limited to the banks that grabbed headlines in 2019. In June 2019, Shengjing Bank, which was severely undercapitalized, quietly received a significant capital transfusion from Evergrande—the bank’s largest shareholder—through a private share placement, enabling it to maintain compliance with NPL coverage rules.¹⁰⁹ Evergrande, a property developer with ambitions to move into electric vehicle manufacturing, initially acquired a stake in Shengjing in 2016, and returns on its initial investment have been poor. It is highly unlikely that absent government pressure it would have increased its stake on the business merits of the move.¹¹⁰ Moreover, the company itself is already heavily indebted and had to raise \$2 billion from offshore investors to recapitalize Shengjing.¹¹¹

Although recapitalizing China’s banks is a positive step toward greater financial stability, the efficacy of this strategy ultimately hinges on whether Beijing will hold banks to a higher regulatory standard and whether the banks can effectively dispose of NPLs. Effective NPL disposal in turn requires at least moderately high levels of economic growth. This is because rapid economic growth transforms at least some once-delinquent borrowers into profitable companies. Conversely, if economic growth stagnates, then indebted companies are unlikely to turn their businesses around.

In fact, China’s banks have been through this process once before in the late 1990s and 2000s. In 1999, the PBOC created China’s original four asset management companies (AMCs), or “bad banks,” to buy up \$170 billion (RMB 1.4 trillion) worth of NPLs at face value.¹¹² They financed these acquisitions by issuing bonds to the banks themselves. The AMCs thus effectively warehoused these loans for several years and enabled the banks to transform the loans into investment receivables on their balance sheets.¹¹³ These AMCs were only able to eventually extract some value from the NPLs because China’s double-digit economic growth increased the worth of the collateral.¹¹⁴ Even so, the AMCs were unable to fully resolve their original NPL portfolios, and the Ministry of Finance was forced to provide financial backing. The State Council assisted by extending the tenure of the AMCs’ bonds when they came due in 2009.¹¹⁵

It is far from clear that even this mixed performance can be repeated now that China’s economy is contracting due to the impact of COVID-19.¹¹⁶ Nonetheless, financial regulators appear ready to try the old playbook once more, but this time secure foreign buy-in as well. On March 5, 2020, the CBIRC approved the creation of a fifth national AMC—the first such approval in more than 20 years.¹¹⁷ The new AMC’s controlling shareholder is a subsidiary of China’s sovereign wealth fund.¹¹⁸ At a press briefing on the approval, CBIRC chief risk officer Xiao Yuanqi suggested that more new AMCs could soon follow, especially as the Phase One trade agreement with the United States has enabled foreign distressed asset managers to purchase NPLs directly from Chinese banks.¹¹⁹

Pandemic Banking

The COVID-19 pandemic that began in Wuhan in late 2019 has added to the challenges China’s banks face as they try to clean up their balance sheets and offload risky assets. The biggest risk for banks is a potential surge in NPLs as corporate borrowers struggle to regain their financial footing in the wake of the government’s travel lockdown and disruptions to the global supply chain. A February 2020 survey conducted by Tsinghua University and Peking University of 995 coronavirus-impacted small and medium enterprises showed that 85 percent did not have enough cash on hand to survive a three-month shutdown.¹²⁰ The survey also cited bank loan repayment as among the top three financial burdens facing these firms.¹²¹ If these companies fail, banks that have loaned to them will see a sudden increase in new NPLs on their balance sheets. To mitigate this challenge, on March 2, 2020, the CBIRC preemptively ordered banks to postpone loan repayments until after June 30 and allowed them to postpone recognizing the affected loans as NPLs until after that date.¹²² Whether or not the loan forbearance will be sufficient

* For more information on the bailout of Bank of Jinzhou, see U.S.-China Economic and Security Review Commission, “Bank of Jinzhou Receives Different Treatment from Baoshang,” in *Economics and Trade Bulletin*, August 2019, 10. <https://www.uscc.gov/trade-bulletins/august-2019-trade-bulletin>.

† For more information on the Harbin Bank bailout, see U.S.-China Economic and Security Review Commission, “A Regional Bank Gets Government Backing,” in *Economics and Trade Bulletin*, December 5, 2019, 4. <https://www.uscc.gov/sites/default/files/2019-12/December%202019%20Trade%20Bulletin.pdf>.

to salvage corporate financials depends on the future course of the epidemic. But even an optimistic scenario will likely entail a spike in NPLs after the extensions expire and will put additional pressure on the balance sheets of many banks.

To help fight the economic impact of COVID-19, the PBOC has also established a new preferential lending facility for companies deemed essential to fighting the disease. Through this “relending” facility, the PBOC has allocated \$114.8 billion (RMB 800 billion) in discounted financing to designated national and Hubei-based banks, which can then relend it to their choice of eligible companies.¹²³ Eligibility is jointly determined by the National Development and Reform Commission and Ministry of Industry and Information Technology through a “list of key enterprises for guaranteeing epidemic prevention and control.”¹²⁴ The interest rate on these reloans is capped at 3.15 percent—well below the current one year LPR of 3.85 percent—and is further subsidized by the Ministry of Finance, lowering the actual interest rate to 1.6 percent.¹²⁵

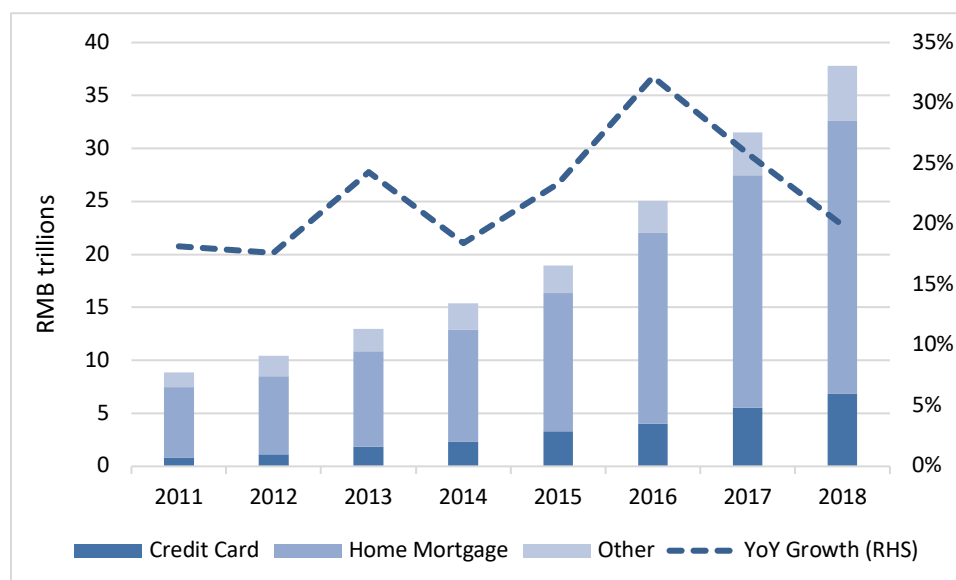
Despite these measures, the companies most in need will likely not receive the majority of funding as banks still prefer to lend to financially strong or politically connected firms that they view as safer bets.¹²⁶ Moreover, oversight problems have emerged as companies seeking to game the system have applied for loans under the program. As a consequence, the PBOC removed 48 companies from the eligibility list less than a month after the program launched.¹²⁷ For example, one state-owned coal company was removed after it was caught falsely claiming it manufactured disinfectant.¹²⁸

Spotlight: Retail Banking

About three years ago, analysts inside and outside the Chinese government started sounding the alarm on China’s rapidly rising household debt.¹²⁹ According to the Bank for International Settlements, China’s household debt grew from 23.5 percent of GDP at the end of 2009 to 54.4 percent in the third quarter of 2019—faster than in any of the other 44 economies tracked by the bank.¹³⁰ Although this presents certain macroeconomic challenges, it represents a fast-growing new market for commercial banks. Chinese media reports and bank financial statements frequently reference a “retail transformation” (i.e., a structural shift away from corporate lending and toward a greater emphasis on consumer lending) that many of China’s major banks have taken advantage of to expand their business.¹³¹ A combination of generational changes in spending habits (young Chinese save less than their parents) and a decline in corporate demand for new credit amid slowing economic growth and financial de-risking has led many bankers to regard consumer lending as a significant driver of future profits.¹³²

Consumer loans comprise an increasingly important portion of bank balance sheets. Between 2015 and 2019, consumer loans in China increased from 9.8 percent of all commercial bank assets to 17 percent.¹³³ This is significantly higher than in the United States, where consumer loans account for 9 percent of total commercial bank assets.¹³⁴ The vast majority of Chinese banks’ consumer loans are mortgage loans, but credit card debt has grown at a much faster clip, averaging 29.5 percent year-on-year growth between 2015 and the third quarter of 2019 (see Figure 6).¹³⁵ This is partly because it started from a low base. According to the Global Findex database, only 21 percent of people in China have a credit card, compared to 66 percent in the United States and 68 percent in Japan.¹³⁶

Figure 6: Composition of Consumer Loans, 2011–2018



Source: People’s Bank of China via CEIC database.

Not all commercial banks are equally positioned to take advantage of rising consumer borrowing. Even among national joint-stock commercial banks, which have been the most aggressive in pursuing an expansion of their retail customer base, there remains significant differentiation (see Table 1). Some banks are better equipped to cope with slowing credit demand among corporate customers than others and will have a competitive edge over their peers as China’s economy continues to transition toward consumption-led growth.

Table 1: Selected Banks’ Retail Share of Operating Revenue, 2017–H1 2019

Bank Name	Classification	2017 (% of total)	2018 (% of total)	2019 H1 (% of total)
Ping An Bank	Joint-Stock	44.1	53.0	56.9
Zheshang Bank	Joint-Stock	11.0	13.0	16.9
China Merchants Bank	Joint-Stock	49.1	50.6	54.5
China Citic Bank	Joint-Stock	34.7	34.7	36.2
Minsheng Bank	Joint-Stock	35.2	36.0	36.6
Everbright Bank	Joint-Stock	38.7	42.1	40.8
Bank of Beijing	City Commercial	16.6	20.0	21.2
Bank of Shanghai	City Commercial	19.1	24.4	26.8
Bank of Jiangsu	City Commercial	16.4	18.2	22.5
Bank of Nanjing	City Commercial	11.9	15.8	16.1

Note: The six joint-stock banks excluded from this table either do not publish disaggregated operating revenue figures by business segment or have not yet published their 2019 interim financial report and therefore do not have directly comparable data. The four selected city commercial banks are the largest banks at this tier that publish disaggregated operating revenue figures.

Source: Various.¹³⁷

The banks that have been most effective in expanding their retail segments are those that have successfully leveraged technology. For example, Ping An Bank, China Merchants Bank, Everbright Bank, and China Minsheng Bank have all established fintech units.¹³⁸ The biggest losers from the scramble for retail customers are China’s city commercial banks, most of which generate a comparatively small portion of their operating revenue from their retail business.¹³⁹

The Rise of Fintech and Its Disruption of Banking

Expansion via the consumer segment has brought banks more directly into competition with China's technology giants. Since 2013, e-commerce companies such as Alibaba and Tencent have launched a variety of fintech products, including payments platforms, money market funds, and peer-to-peer lending platforms. These products provide consumers with new investment and borrowing opportunities that directly compete with banks. Chinese commercial banks are latecomers to the fintech business, and only six have established independent fintech units.¹⁴⁰

Fintech has already started to impact banks' retail market share. For example, bank card penetration rates* essentially plateaued after 2013—when Tencent launched WeChat Pay—increasing only from 44.4 percent in the fourth quarter of 2012 to 49.04 percent in the third quarter of 2019.¹⁴¹ Meanwhile, investors in Alibaba's \$157.8 billion Yu'e Bao money market fund—until recently the largest in the world—have consistently enjoyed higher returns than traditional bank depositors.¹⁴² As of March 5, 2020, Yu'e Bao had a seven-day annualized yield of 2.3 percent, compared to 0.3 percent for standard bank deposits and between 1.5 and 2.25 percent on one-year fixed deposits.¹⁴³

The proliferation of online peer-to-peer lending platforms, through which Chinese consumers can easily lend money to one another through mobile phone apps, initially threatened banks' consumer lending business. However, the government's regulatory crackdown on peer-to-peer lending has largely removed this challenge. Between 2015 and 2019, regulators reduced the number of such lending platforms from 3,600 to just 427.¹⁴⁴ Nonetheless, fintech competitors still represent a significant source of competition for retail deposits. Despite selling off nearly a third of its assets in 2018, Yu'e Bao's manager, Tianhong Asset Management, saw a 24 percent expansion of its customer base during the same year.¹⁴⁵

A 2018 Bank for International Settlements report on fintech points out that the growing prevalence of fintech products around the world creates liquidity risks by improving the ease with which customers shift funds between accounts as they search for better returns.¹⁴⁶ However, some Chinese fintech companies have opted to partner rather than compete with banks as they try to capitalize on the growing retail banking boom. For example, in April 2019 consumer finance company Lexin Fintech announced a partnership with 19 commercial banks to use its consumer data to match lenders to borrowers with good credit histories.¹⁴⁷

Impact on Consumption

Although China's rapidly rising household leverage has boosted short-term consumption and fueled a boom in retail lending, in the long term it may weigh on future growth. Recent scholarship on the relationship between household debt and economic growth reveals that while a rapid increase in household borrowing can increase consumption and growth in the short term, it usually leads to reduced GDP growth in the longer term as households adjust their consumption to meet debt obligations.¹⁴⁸ The COVID-19 pandemic has accelerated this process. Retail sales crashed as the economy shut down, contracting 20.5 percent year-on-year in January and February and 15.7 percent in March.¹⁴⁹ Although retail sales may see an uptick as the economy reopens, households are likely to curtail spending for some time as economic uncertainty persists. There is also a risk that as the majority of consumer loans are for mortgages, a correction in China's property market could erase a substantial portion of household wealth and expose banks to repayment risks. The widespread purchasing of investment homes has left China with 65 million empty apartments.¹⁵⁰ Any risk of a price decrease, therefore, could lead to a sudden supply glut as speculators seek to cash out and minimize their losses.

Analysts at S&P Global pointed out in July 2019 that the upsurge in China's credit card lending is reminiscent of similar booms experienced in Hong Kong, South Korea, and Taiwan in the early 2000s.¹⁵¹ Like China, banks in these countries contended with declining corporate demand for credit and competed with one another for retail customers to drive growth. When the economy came under pressure and employment conditions worsened, consumer NPLs surged.¹⁵² The COVID-19 pandemic could be a catalyst for a large increase in consumer NPLs in China as employment conditions have worsened significantly. China's official unemployment rate rose to 5.9 percent in March 2020, up from 5.2 percent in December 2019, and some economists estimate the real number of

* The PBOC defines bank card penetration as the consumption via bank cards as a percentage of total retail sales' value. See People's Bank of China, *PBOC Report: Average National Per Capita Bank Card Ownership Is 3.99* (央行报告：全国人均持有银行卡 3.99 张), April 5, 2016. http://www.gov.cn/xinwen/2016-04/05/content_5061472.htm.

jobless could be more than twice as high.¹⁵³ In May 2020, *Financial News*, the official media outlet of the PBOC, highlighted growing repayment risks in the consumer lending segment due to layoffs and lost wages.¹⁵⁴

Conclusion and Considerations for Congress

China's banking system has reached an important juncture. Banks of all sizes are under pressure to clean up their balance sheets, raise new capital, and dispose of bad loans. At the same time, Beijing is forcing them to boost lending to struggling companies at nonmarket rates to forestall a further slowdown in the pace of economic growth. China's large state-owned banks and national joint-stock banks are better positioned to adapt and take advantage of new business opportunities in retail banking. Regional banks are much less prepared to meet these challenges. Nonetheless, U.S. policymakers should be cautious about interpreting the troubles of regional banks as indications of an imminent financial crisis. Although Beijing is seeking opportunities to roll back its implicit guarantee, bailouts by central and regional authorities in the second half of 2019 clearly demonstrate that the PBOC and the CCP leadership remain committed to ensuring stability. Authorities have so far successfully contained isolated bank failures and prevented sector-wide contagion, though the economic shock of COVID-19 could complicate this strategy by hurting overall bank profitability. If the current pandemic does lead to sustained problems in China's financial sector, exchange rates are the most likely channel through which economic pain could be transmitted to U.S. investors, as an RMB devaluation would reduce the dollar value of their mainland assets.

U.S. Investor Exposure: How the Chinese government manages the banking system is significant for U.S. investors and fund managers even if Beijing successfully forestalls a financial crisis. U.S. investor portfolios have growing exposure to China's banking sector through MSCI and FTSE Russell's inclusion of Chinese A-shares* into widely tracked benchmark indexes. Both the MSCI Emerging Market Index and FTSE Russell Global Equity Index Series now include shares of Chinese state-owned banks, which may have political priorities that are misaligned with their fiduciary duty to U.S. shareholders.¹⁵⁵ For example, ICBC, which is included in the MSCI Emerging Market Index, answered Beijing's call to deploy \$430 million (RMB 3 billion) to shore up Bank of Jinzhou.¹⁵⁶ ICBC's investor announcement provided no explanation for the acquisition.¹⁵⁷ Such episodes demonstrate how China's banking system remains captive to state and Party interests, and banks may make decisions on a political basis that harm U.S. investors' financial interests.

Even absent direct political interference, it is very difficult for U.S. investors and creditors to determine the true level of risk to which Chinese banks are exposed. Not only do Chinese ratings firms systematically inflate the ratings of bonds sold on China's interbank bond market, but the routine booking of loans as investments also enables Chinese banks to drastically underreport the extent of NPLs on their books. Banks that appear stable and compliant with international prudential standards may in reality be undercapitalized and exposed to large, undisclosed risks. The opacity of China's NPL market is also a challenge for U.S. distressed asset investors, who are now beginning to buy NPLs directly from Chinese banks. Without access to accurate market and pricing information, investors cannot accurately assess asset values and may wind up footing the bill for China's financial cleanup. Moreover, asset quality in China's NPL market is such that even domestic AMCs often struggle to profit from their ostensibly core business domain of resolving NPLs.¹⁵⁸

Opportunities and Tradeoffs: The challenges facing China's banking system may also present some opportunities for U.S. financial companies. Despite its unprecedented expansion after the 2008–2009 global financial crisis, China's financial system remains underdeveloped and lacks robust mechanisms for pricing risk. Chinese policymakers know this and would like to harness foreign expertise to professionalize the financial sector and find innovative solutions to current problems. Although the moderate expansion of market access to China's financial markets over the last two years stems in part from a need for capital,[†] stresses in the banking sector do underpin legitimate demand for the services of foreign ratings agencies, insurers, fund managers, and distressed asset

* A-shares are RMB-denominated securities of companies incorporated in China that trade on either the Shanghai or Shenzhen stock exchanges. A-share trading is restricted to Chinese residents, and foreigners can only access the A-shares market through special investment programs such as the Qualified Foreign Institutional Investor program and the Stock Connect programs. A-shares are distinct from other Chinese share classes such as H-shares (shares in Chinese incorporated companies listed on the Hong Kong Stock Exchange), trading of which is not restricted to Chinese residents. FTSE Russell, "Guide to Chinese Share Classes," May 2019. https://research.ftserussell.com/products/downloads/Guide_to_Chinese_Share_Classes.pdf

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managers. The question is, how much will the U.S. economy benefit from this and is it in the United States' interests to encourage U.S. financial firms to help Beijing fix China's banking system? Some companies certainly stand to profit from aiding China's financial cleanup. Yet the historical record also suggests that since China joined the WTO, U.S. efforts to encourage China to adopt market-oriented reforms have had little success. This is unlikely to change now. Ultimately, Congress must decide if the extent of market access on offer is worth the potential risks to U.S. investors. It must also evaluate the desirability of greater U.S. participation in a financial market that remains warped by the political priorities of a strategic competitor.

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