BIZCOMMUNITY

China and shadow financing: Part 1

In the first of a two-part series, Mark Mobius of Franklin Templeton Investments looks at the phenomenon of shadow financing in China.

For the first time ever, the president of China was in attendance at the World Economic Forum Annual Meeting in Davos this month. President Xi Jinping joined a roster of presidents, prime ministers, central bankers, executives and other officials from around the world at this prestigious event, which carried the theme this year of “responsive and responsible leadership.”

With China at centre stage, I thought it might be appropriate to talk about an aspect of China’s economy that I think many people misunderstand: so-called “shadow financing” or “shadow banking,” which is said to be a significant contributor to China’s growth rate.

Shadow financing

In simple terms, shadow financing refers to activities outside the formal banking system that perform similar functions. Shadow banks can make financial services (namely loans) more widely available to the public, but since they are not subject to the same regulations, there is concern about the risk they pose to the financial system. The growth of shadow financing is reflective of an overall boom in consumer-oriented products and services in China. The consumer sector in China is one we are excited about in general.

Bank reform gone wrong

Some people believe that shadow financing in China is banking reform gone wrong, and is a sign that banks have been circumventing regulations in order to increase or even protect their profit margins. Critics say that this has resulted in the possibility of much higher amounts of bad debt on the books of the banks. Since the Chinese government considers banking to be a strategic industry, it is a big issue.

Quite transparent

Shadow banking has been associated with China but is practised in many parts of the world. There is really nothing “shadow” about the term, since it is actually quite transparent. And, it is not “banking” in the true sense of the word since it involves all kinds of investment products, including mutual funds and private equity. Shadow financing is often called "bank loans in disguise," because a bank is often at the core of the transaction, for example, offering an implicit guarantee for the various wealth products it sells to the non-banks it engages with. This is similar to the major US banks that have affiliated brokerage-end fund sales organisations to sell various wealth-management products.

Shadow banking has been growing in China. Some estimates indicate shadow financing currently amounts to roughly Rmb58trn (as of 2015), representing 80% of China's gross domestic product (GDP). It started in 2007, when banks were allowed to invest in trust plans, then by 2010 wealth-management products became popular. In 2012, securities, insurance and mutual fund companies entered the market.

Are banking fears founded?

The fears regarding shadow financing activity are similar to other fears or misconceptions we have found about China, including the fear that the country's total debt is much greater than officially reported. Some say there is not enough disclosure for retail investors in terms of the risk they are taking, and that they are being misled.

Of course, concerns about debt and the financial system are not unique to China. In Italy, for example, many banks found themselves saddled with non-performing loans (bad debt), and some small banks faced restructuring.

New European Union rules now require stock and bond holders to absorb losses before a government bailout can be implemented. The fate of Italy's third-largest bank still currently hangs in the balance.

Not operating outside mainstream banking

Many consider shadow financing in China to be operating outside the regulated banking system, but the People's Bank of China, which carries out monetary policy and regulates financial institutions in mainland China, is aware of these activities.

Securities regulators are also aware of them. In China, there is generally a lag in financial reform because of the conflicting interests of wanting to have a modern market economy, while at the same time wanting to keep control of it. This is a challenge for China in many areas of the economy, not only in banking.

Chinese banks are now among the most profitable in the world, and the government certainly wants to keep it that way in light of the banks' position as the home of the country's financial structure.

Bank loans in disguise

If we look closely at shadow financing that includes various types of wealth-management products such as trusts, mutual funds and other instruments, some critics say these are in fact bank loans in disguise where the banks take the greatest part of the implied risk but use insurance companies, brokers and trust companies as the middlemen.

So in effect, the banks are intermediating the shadow-bank products. For example, a wealth-management product may be based on a pool of underlying assets that could be a group of loans, including in risky industries such as mining, property and even local government infrastructure projects.

The potential problem with these is that they are not standard to credit assets that might be traded on the interbank or stock exchange markets. They can include bankers' acceptance bills, letters of credit and accounts receivable.

Within the norm

It's important to note that the G20's Financial Stability Board 2015 Global Shadow Banking Monitor estimated that China's shadow financing was about 26% of GDP in 2014, which was much lower than the 59% average for 26 other major countries.

Therefore, we might say that China is somewhat behind the other major countries in terms of developing a non-bank financial system. Of course its definition of shadow financing may be different for China, but in any case, it doesn't seem as if this activity in China is way off the norm.

The second installment of Mobius' insights into China will be published tomorrow (27 January)

ABOUT THE AUTHOR

Mark Mobius has been a key figure in developing international policy for emerging markets. In 1999, he was selected to serve on the World Bank's Global Corporate Governance Forum as a member of the Private Sector Advisory Group and as co-chair of the Investor Responsibility Taskforce. Mobius is an emerging markets fund manager at Franklin Templeton Investments, having stepped down from leading the Templeton Emerging Markets Investment Trust (TEMIT) in 2015.