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China Financial Policy Focus (Q3, 2016)

China Economics Network

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SUMMARY

State Council takes multi-faceted approach to tackling corporate debt through mergers, debt-equity swaps, and bankruptcies. Financial stability worries remain with concern over increase in mortgages and soaring property prices in China's biggest cities. At the same time, crackdown continues on bank's wealth management products and peer to peer lending industry. Progress on capital account opening, with reformed RQFII, improved Shanghai Stock Connect and the Shenzhen Connect expected in November.

Banking sector risks on the rise

Analysts concerns about China's corporate debt increased over Q3. China's debt to GDP ratio is now 228% of GDP, three times higher than the level which the Bank of International Settlements consider dangerous. Non-performing loans (NPLs) are also increasing and ratings agency Fitch estimate that their true level is 15-21%, compared to the official figure of 2%.

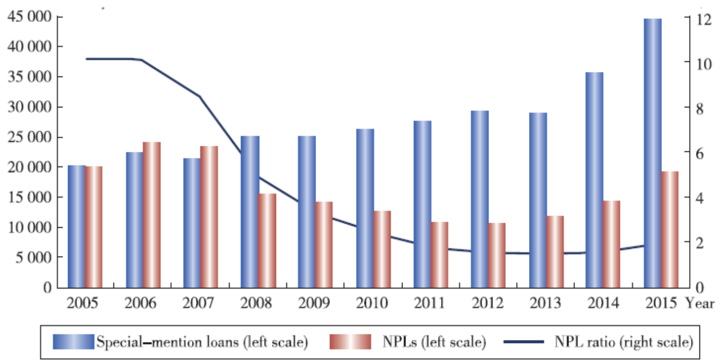

Figure 1: Changes in special mention loans and non-performing loans. Source: PBOC Financial Stability Report July 2016

In October the State Council suggested a multi-faceted approach to tackle debt, including mergers, debt-to-equity swaps, developing equity financing, and bankruptcies. Recent announcements also included the launch of instruments such as credit default swaps and NPL securitisation, indicating new attempts to handle stressed credit. Doubts remain over the authorities' ability to resolve debt problems through write-downs and resolutions, with Goldman Sachs noting a slow-down in high value bond defaults (value over RMB250m) in the last quarter. Nonetheless, there have been bankruptcy announcements for Guangxi Non-Ferrous Metals (notable as the first company to go bankrupt that has issued interbank market bonds) and Dongbei Special Steel (formed from the merger of three steel makers in 2004) at the end of September.

Private sector companies are limiting new borrowing, while mortgages are growing. PBOC credit data for July showed that loans to non-financial firms fell for the first time in 10 years, suggesting companies may be focused on repaying debt. Most new loans have been for mortgages, which Gavekal Dragonomics estimate will finance over 40% of housing sales in 2016 compared to 25% in 2014. The PBOC estimate that there are now over RMB20 trillion in outstanding mortgages, as much as 80% of which were issued since 2012. As worries of property price bubbles increase many city governments have reintroduced or tightened measures such as higher minimum down-payments and restrictions on purchases of 2nd or 3rd properties. In October governments of the Guangdong towns of Huizhou and Dongguan, where prices are over 40% higher than last year, introduced a 'circuit breaker' which prevents prices rising more than 10% and 15% respectively from their initial guide price

Analysts are also concerned about the risk contagion between Chinese banks, as they are increasingly relying on each other for funding. Moody's estimate that wholesale funding now accounts for 34% of small banks' financing, up from 29% in January 2015. The big five banks though, which still account for 39% of the market, barely use this facility. As well as banks, companies with excess capacity frequently have reciprocal loans and cross guarantees with other companies in the sector.

The PBOC acknowledges that destabilising factors are on the increase in their Financial Stability report released at the end of June. In particular the PBOC highlight risks emanating from high leverage ratios, illegal fundraising and contagion across sectors. Overall thought they maintain that the market is "generally stable", with banks' capital adequacy ratios still high and stable. Companies have also largely paid down foreign debts, reducing the risk of a crisis.

<u>Shadow banking crackdown continues</u>

Tackling debts in the shadow banking remain a key priority with CBRC publishing draft rules for banks' wealth management products. The draft rules target smaller banks or financial institutions packaging riskier assets products exposure to non-standard assets and curbing the issuance of "multi-tier" which divide assets into several risk tranches.

At the same time, new CBRC regulations will force almost all peer to peer (P2P) lending companies to change their operating model to become information intermediaries, not financial ones. The CBRC's regulations were subsequently followed by a new plan to "Rectify Internet Financial Risk" from the State Council and all the regulators in October. As a result, lenders will be banned from selling wealth management products, issuing asset-backed securities and will operate under a borrowing cap. Crucially the regulation clarifies and stipulates that P2P platforms will only be allowed to operate as information intermediaries, and so will have to use a third parties custodian account for funds - the CBRC estimate that less than 3% of P2P platforms currently operate in this way. The CBRC will also specifically target risks posed by P2P lenders that advertise guaranteed returns and blocking real estate enterprises from engaging in online finance without licences. It is likely that the new rules will lead to much needed consolidation in the P2P market where almost 4000 firms currently operate across China.

RMB facing depreciation pressure

Downward pressure remains on the RMB. Market concerns remain about the debt situation in the Chinese economy and the prospect of a rise in US interest rates continue to drive sentiment on the RMB. At the same time, significant depreciation of currencies (such as sterling) in the RMB tracking basket, have also led to the PBOC setting a lower RMB fix. On October 10 however, the PBOC set the fix to the dollar to its lowest level in six years at RMB 6.70. This follows three consecutive months of falling foreign exchange reserves. Over Q32016 China's foreign exchange reserves fell by around $39 billion, compared to the fall of $195 billion over Q42015.

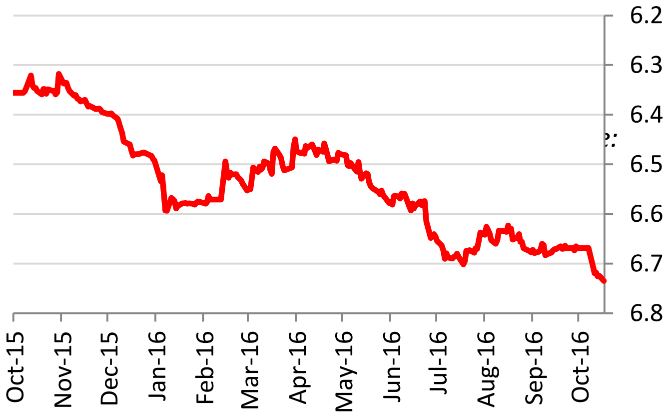

Figure 2: RMB (CNY) to US Dollar exchange rate. Source: Bank of England

RQFII reforms mark a continuation on reform of inbound investment restrictions. In August the CSRC announced reforms to the Renminbi Qualified Foreign Institutional Investor (RQFII) quotas which relaxed restrictions on repatriating profits and reduced the lock-up period for non-open-ended funds. Demand has been tepid though, with RMB 950 billion of the RMB 1,460 billion of quotas issued remaining unused. Meanwhile outbound quotas (the largest being the Qualified Domestic Institutional Investor quotas) remain scarce. Asset managers report their quota have been fully used up for many months now, with little prospect of new quotas being issued.

Channels for RMB internationalisation widening

The CSRC announced in August that the long delayed Shenzhen–Hong Kong Stock Connect will be launched in late 2016. The Shenzhen Connect will more than double the number of Chinese companies listed in the A share market that international investors can buy. In particular it will allow greater exposure to China's tech companies, which comprise around a fifth of the Shenzhen market. The average price to equity ratio in Shenzhen is high though at around 46, more than double that of Shanghai and US markets. Tests will be run on the Connect from 19th October to 9th November, and if successful the Connect could launch as early as 21st November.

Looser restrictions on Shanghai Connect are leading to greater southbound investment flows. In August, CSRC announced the removal of aggregate quotas for the Shanghai-Hong Kong Stock Connect and within weeks 'Southbound flows' from the mainland to Hong Kong exceeded previous highs. Furthermore, in September CIRC also permitted qualified insurers to invest in equities through the Connect.

Mainland investors are buying in Hong Kong assets through the Mutual Recognition of Funds (MRF) scheme. Figures from the State Administration of Foreign Exchange showed that from January to August this year mainland investors bought RMB 8.45 billion of Hong Kong MRF products. This was more than ten times the amount of 'northbound flows' from mainland products buying by Hong Kong investors.

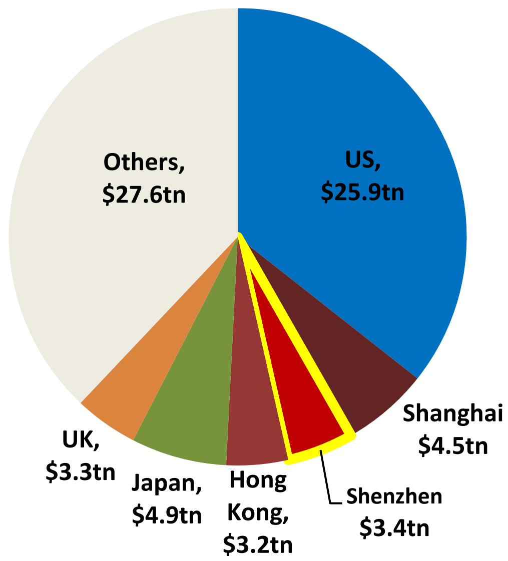

Figure 3: Market capitalisation of global stock exchanges in trillion US$. Source: World Federation of Exchanges, LSE, Feb

The RMB formally entered the IMF's Special Drawing Rights basket in October. Accession to the basket has been a key priority for the Chinese government, and the PBOC in particular. The PBOC has also been seeking to encourage greater issuance of SDR bonds with the World Bank Group in August, and Standard Chartered bank in October both issuing SDR bonds in the China interbank bond market (both settled in RMB).