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China

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BLACK SWANS AND GREY RHINOS: DEMYSTIFYING CHINA'S FINANCIAL RISKS AND THE FINANCIAL REGULATORY REFORM

China now has a gigantic financial industry worth trillions of dollars. Its banks and insurance companies are among the largest in the world. It also holds three of the most active stock exchanges and thousands of public companies. Fintech firms have sprung across the country including top global players such as the Ant Financial Services Group.

The rapidly growing size of the financial industry, coupled with fintech innovations, have produced various financial risks endangering China's financial stability and economic growth. Such risks include asset bubbles, mounting debt, shadow banking and $3.8trn of capital flight. Some predictable financial risks in China are described as "black swans" while other unpredictable elements are referred to as "grey rhinos".

Accordingly, China has undertaken large regulatory reforms recently. It created a super regulator, the Financial Stability and Development Committee (FSDC) to strengthen macro-prudential supervision and enhance the co-operation of sector-based regulators. It has merged the banking and insurance regulators. The People's Bank of China (PBOC) has been given greater powers of rule-making. More financial technocrats have been appointed to top positions of financial authorities.

INTRODUCTION

The phrase "black swan" denotes highly unexpected risks and it has been popularised by Nassim Nicholas Taleb's book of the same name in 2007.[1] Some recent black swan incidents include the Trump presidency in the US and the UK's vote to leave the European Union (Brexit). In contrast, the term "grey rhino" has been used to describe large and predictable risks that are often ignored. It was invented by Michele Wucker.[2] One typical example of a grey rhino incident is the 2007/08 global financial crisis which was preceded by some early warning indicators. Nonetheless, both metaphors have been recently used by *People's Daily*, China's official media, to describe mounting financial risks in the country's financial industry.[3]

The financial industry in China has been growing rapidly over the past three decades. According to Relbank's global bank ranking 2018, China's big four banks (Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China and Bank of China) plus China Merchants Bank have occupied five positions out of Top 10 banks in the world in terms of market capitalisation.[4] Regarding its securities markets, China holds three of the most active stock markets in the world (Shanghai, Shenzhen and Hong Kong) where thousands of conglomerates such as China Mobile, Petro China, Lenovo, Tencent and Citic Group are listed. Most recently, the China Securities Regulatory Commission (CSRC) has been drafting new rules to allow overseas-listed Chinese companies to dual-list their shares in mainland China by issuing Chinese Depositary Receipts (CDRs).[5] Obviously, CDRs will further boost the quality, liquidity and diversity of China's stock markets. Moreover, the insurance industry in China grew 1,200% between 2000 and 2014. Top insurers like China Life Insurance, Ping An, China Pacific Insurance and Anbang have become industry leaders internationally. In 2018, China announced further financial reforms to allow foreign financial groups to take majority stakes in securities, fund management, futures and life insurance companies in mainland China.[6]

Aside from the rapid development of traditional banking, securities and insurance businesses, China has also seen the rise and proliferation of fintech firms. Ant Financial Services Group, backed by the e-commerce giant Alibaba, has become the world's largest fintech group as its valuation is even higher than the market capitalisation of Goldman Sachs.[7] Alipay, the mobile payment service offered by Ant Financial, has attracted 450 million users worldwide. In addition, blockchain technology and cryptocurrencies have gained huge popularity in China once accounting for 90% of global bitcoin trading and it has some leading bitcoin exchanges.[8]

The speedy growth of the financial industry and widespread financial innovations have given rise to different financial risks. While some predictable financial risks in China are described as black swans, other unpredictable elements are referred to as grey rhinos. Against this background, this briefing deciphers major financial risks in China's financial industry, ranging from asset bubbles, mounting debt to capital flight. It then evaluates how China has been reforming its financial regulatory framework to curb excessive risks and maintain financial stability. It will be of interest to investment bankers, international lawyers and management consultants whose clients are doing businesses in China.

ASSET BUBBLES

China has observed multiple asset bubbles over the past decade. The SSE Composite Index climbed from 2,000 points in July 2014 to a peak of 5,166.35 points in June 2015. The stock market mania was partly driven by leveraged investment instruments, as numerous investors had borrowed funds from either stock brokers or shadow banks to purchase shares.[9] In its heyday, the P/E ratio of ChiNext board (China's equivalent to Nasdaq) reached 130, considered more than twice a reasonable level for businesses with strong growth prospects. Contrary to stock markets in the US and the UK where institutional investors play a main role in making transactions, retail investors in China account for 90% of daily trading. From June 2014 to May 2015, over 40 million securities dealing accounts were opened by retail investors hoping to take a bet on the rising trend.[10] After the SSE Composite Index reached its peak in June 2015, it began to fall rapidly and lost 30% of its value within the next three weeks. In particular, the Index slumped by 8.49% on 24 August 2015 which was dubbed "Black Monday". Global financial markets were significantly affected by China's stock crash. The Dow Jones Industrial Average dropped 1,000 points when it opened on Black Monday.[11] There has since been a bear market for three years. As of July 2018, the SSE Composite Index was standing at 2,733.88, 53% of its peak in 2015.

Aside from the equity bubble, China's property market has been on a rising trajectory since the early 2000's. Although the rise in property prices seems to be a global phenomenon, China's problem is extremely serious. According to Savills, in 2017, thirteen global cities witnessed double-digit house price growth and eight of them were from mainland China.[12] The average housing prices for prime residential properties in Beijing and Shanghai are $1,500 and $1,580 per square feet respectively, while the figures for London and New York are $1,770 and $1,570. The fundamentals of a rising population, income and employment have collectively created real demand powering housing prices to grow over 600% in major Chinese cities over the past decade. This has not only triggered people's discontent over housing affordability, but also has an impact on the safety and soundness of the banking system. This is because the majority of funds in the property market come from state-owned banks. Property developers derive their working capital from bank loans while property investors borrow mortgage loans to finance their purchases. Moreover, local governments rely heavily on selling land as a vital source of revenue. Thus, the question of how to halt rapid housing price growth while ensuring financial resilience and fiscal health remains an important and tricky task for policymakers.

THE DEBT AND LIQUIDITY PROBLEM

A series of asset bubbles have revealed other critical issues such as the mounting debt in China's economy. The stock market craze and the continuing property market boom have been fuelled by debt. Investors borrow considerable capital through official financial institutions or grey-market shadow banks to fund their asset purchases. China's gigantic shadow banking system is worth CNY4-5trn and provides funds for entrepreneurs and investors who have limited access to official banks.[13]

After the global financial crisis, the Chinese government launched several stimulus packages, most notably the 4-trn-yuan stimulus plan, to inject liquidity into the real economy.[14] However, the liquidity created did not go entirely to where it was needed most. The extra money produced by quantitative easing poured into certain state-dominated industries such as iron and steel, resulting in an overcapacity issue and creating zombie enterprises. It has also led to a high ratio of bad loans for large lenders. The excessive cash contributed to the asset price explosion, indicating the misallocation of financial resources in the economy. The disorderly flow of capital hinders the effectiveness of monetary and industry policies.

The mounting debt has posed great challenges to economic growth. The rising debt-to-GDP ratio around the world has raised concerns about the occurrence of the next global financial crisis.[15] China is no exception. The IMF predicted that China's debt-to-GDP ratio was 230% in 2016, and it will reach 300% in 2022.[16] The rampant credit expansion has been described as unsustainable by some commentators. An economist from Deutsche Bank warned that the probability of a financial crisis in China is as high as 13%.[17] Others justify China's mounting debt by pointing out that the country has the highest savings rate and current account surplus in the world. There is more credit in China's financial system compared to other countries. Whether a Minsky moment materialises in the coming years remains to be seen.

CAPITAL FLIGHT

Capital flight has been another dark cloud over China's economy. Over the past decade, capital worth $3.8trn has left China.[18] Chinese citizens and companies have been moving money out of the country for various reasons. Some companies are using funds to acquire overseas business ventures. For example, the automobile maker Geely Holding which owns Geely Cars, Volvo Cars and Lotus has recently acquired 10% of shares in Daimler that owns Mercedes-Benz.[19] The overseas mergers and acquisitions require Chinese corporations to exchange a large amount of renminbi into foreign currencies. Recent times have seen a group of Chinese private conglomerates actively purchasing companies around the world, in particular, HNA, Anbang, Fosun and Wanda. The overseas buying spree included Anbang's $2bn purchase of New York's Waldorf Astoria, Dalian Wanda's takeover of Hollywood studio Legendary Entertainment for $3.5bn, and HNA's $40bn acquisition of stakes in companies including Deutsche Bank and Hilton Hotel.[20]

Moreover, an increasing number of Chinese people studying, travelling or emigrating to other countries has boosted the demand for foreign currencies. China has been the largest source of overseas students in universities in the UK, the US, Canada and Australia. In 2016/17, there were 95,090 students from mainland China enrolled in British higher education institutions.[21] The tuition fees, living expenses and travelling costs amount to tens of billions of pounds each

year. Moreover, Chinese citizens made 136.8 million overseas trips in 2016.[22] They spent $292bn abroad in 2015, three times as much as the second biggest spender.[23] Clearly, the capital fight problem has eaten into China's enormous foreign currency reserves and creates depreciation pressure on the renminbi.

THE FINANCIAL REGULATORY REFORM

Preventing and mitigating financial risk, especially those threatening financial stability, has remained the top priority for China's financial authorities. In order to tame the black swans and grey rhinos, they have carried out a series of financial reforms, such as the restructure of the financial regulatory architecture. For a long time, China's financial regulatory system has been described as "one bank, three commissions". One bank refers to the People's Bank of China (PBOC) which oversees monetary policy, while three commissions means the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC) and the China Insurance Regulatory Commission (CIRC). These are responsible for conduct and prudential regulation in their respective areas. However, this sector-based regulatory framework is considered too fragmented to detect and manage systemic risks in the entire financial industry as banking, securities and insurance activities have become highly intertwined. It has resulted in unclear responsibilities, cross-regulation and other regulatory loopholes.[24] For instance, the 2015 stock market bubble has highlighted the popularity of leveraged investment instruments that derive funding from both official banking and unofficial shadow banking channels. There have been calls for co-ordination and co-operation between banking and securities regulators to resolve the excessive use of margin finance in securities markets. Moreover, the insurance giant Anbang Group's aggressive overseas M&A activities have been largely funded by premia collected from policyholders. The investment operation relying on debt and leverage generates huge credit, liquidity and systemic risks, which can only be effectively regulated via the collaboration of multiple regulators.

In order to deleverage the financial industry and limit financial risk, China has been conducting financial reforms to streamline the regulatory framework. In November 2017, a brand-new cross-sector regulatory body, the Financial Stability and Development Committee (FSDC), was officially launched.[25] The FSDC, dubbed as the super financial regulator, is a specialist committee under the central government and cabinet (State Council). It has been tasked with the mandates of strengthening macro-prudential regulation and preventing systemic risks. Ma Kai, then the vice premier, served as the inaugural chairman of the FSDC, indicating the important status of this new organisation. The functions and powers of the FSDC are similar to that of the Financial Policy Committee in the UK. The FSDC oversees urgent and important matters relating to financial resilience. It facilitates high-level coordination between the PBOC, CBRC, CSRC and CIRC. In July 2018, the first meeting of the new FSDC was held and the current vice premier Liu He who is in charge of China's economic and financial affairs began to serve as its chairman.[26]

According to the *State Council Institution Reform Plan*, passed during the 2018 annual session of the National People's Congress, the PBOC has been given increased powers in terms of prudential financial regulation and to make laws and regulations in the area of banking and insurance. Meanwhile, the CBRC and the CIRC have merged into the China Banking and Insurance Regulatory Commission (CBIRC). The CBIRC is an institution-based regulator supervising banking and insurance institutions, especially those with systemic importance. The CSRC is still functioning as the market-based regulator overseeing matters relevant to stock markets and other securities trading venues.

Apart from institutional changes, more financial technocrats have been appointed. Yi Gang, a well-known economist who served as the deputy governor of the PBOC from 2008, was recently appointed the governor of the central bank.[27] Mr Yi obtained his PhD in Economics from the University of Illinois in 1986, and he taught economics at Indiana University and Peking University in the 1980s and 1990s. The vice premier Liu He was also educated in the US and received his Master of Public Administration from Harvard University. Clearly, the new leadership of financial authorities have both the expertise and international vision to fulfil their arduous tasks at a critical juncture when China's financial industry is undergoing massive transformation. ■

DIAGRAM 1:
The Latest Institutional Structure of China's Financial Regulatory System

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