Guest post: China courts danger with increasing leverage

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By Andrew Collier, Orient Capital Research

Beijing's desire to pump up the Chinese economy is leading it into dangerous territory.

Although China has piled on debt, the country has been relatively cautious about one of the big areas that led to the U.S. financial crisis: leverage. It was the slicing and dicing of mortgages into digestible bite-sized chunks called derivatives that was a key contributor to the U.S. financial meltdown in 2007. Once they unwound, they threatened the banking system itself.

Until recently, China has avoided complicated derivatives and other forms of leverage. However, desperate to keep the economy from slumping, the Chinese reluctance to wander down the leverage path seems to have faded.

In June, Chinese bank regulators threw their backing behind reverse mortgages. Citizens age 60 and older in Beijing, Shanghai, Guangzhou and Wuhan will be allowed to take out bank loans against their homes to pay for living expenses. Also, in the past year or so China has quietly let the financial system issue derivatives through Shadow Banking channels.

Why are these forms of leverage? Older home-owners are pulling cash out of their homes by using them as collateral for debt. It is not as dangerous as creating the famous collateralized debt obligations that were sold again and again to many buyers before the U.S. crisis. But it's still a form of leverage.

The second area of leverage in the Chinese economy has sprouted from the weeds of the shadow economy. Most shadow banking products are corporate-to-corporate or individual-to-corporate loans. A Trust gathers money from big state firms and lends it out, or a bank sells a wealth management product to wealthy individuals and relends the money to companies.

The problem with this apparently straightforward system is that in most cases there are numerous agents between the lender and the borrower. During an examination of 30 trust products we discovered that these loans have as many tentacles as an octopus. One RMB1.1 billion loan was issued by a government Trust, then backed by a host of other groups, including a provincial investment firm, a real estate company, a venture capital firm, and another company whose function wasn't spelled out. That doesn't even include the lenders themselves.

Those long chains between buyers and sellers are like financial derivatives because they expand the amount of debt in the system – albeit without Wall Street in the middle.

What are the risks here?

On the mortgage front, Chinese policymakers argue that most residents buy their homes with cash so the country is unlikely to suffer from a mortgage crisis. It is true that mortgages are about 15 per cent of GDP in China compared with around 80 per cent in the U.S. And household debt is about 10 per cent of GDP versus over 100 per cent in the U.S.

Analysis of the Potential Size of Reverse Mortgages in China

Pop 60+ (Mln)	Loan (RMB)	Total Loans (RMB Bln)	10% Total (RMB Bln)
200	1,000	200	20
200	5,000	1,000	100
200	10,000	2,000	200
200	15,000	3,000	300
200	20,000	4,000	400
200	25,000	5,000	500
200	30,000	6,000	600
200	35,000	7,000	700
200	40,000	8,000	800

Source: PBOC, Orient Capital Research

Source: Orient Capital Research

But there are 200m people, or 15 per cent of the population, over 60. If they get bank loans against their houses, this would increase debt in the system. If we speculate that 10 per cent of retirees (who we assume own property) borrow Rmb20,000, total debt would increase by Rmb400bn.

If property prices fall – and in May half of 70 Chinese cities reported declining prices –many of these retirees could find their debt rising as a percentage of their biggest asset, the value of their property. If your apartment is worth Rmb200,000, you may not mind paying down an Rmb20,000 loan; but if it falls to Rmb100,000 you may start worrying about your net wealth.

For the multi-tentacle shadow banking products, the risks are twofold. First, all those companies in the food chain may be using the underlying property projects as collateral for additional loans. There are so many parties involved that a collapse of one of the speculative property projects could lead to bankruptcy among a host of other connected parties.

The project described earlier, the prospectus for the Rmb1.1bn "Helen Growing Collection and Real Estate Trust Fund Plan," is connected to a number of local companies, developers and even the Guangdong Government. They are putting up money for a property project in Xian, thousands of miles away. If the project goes bust there will be a cross-provincial fight over the assets and who owes what to whom. The People's Bank of China, the central bank, would have a tough time getting all those parties to agree on a settlement.

Imagine Detroit and Chicago fighting over a bankrupt loan.

How much capital is involved in all these linkages in the Shadow Banking market? Local debt is Rmb24tn with about half tied up in local government investment companies. A collapse of the property market could cause a good chunk of Rmb12tn of those investments to go up in smoke. There are more than 10,000 LGFVs. If each has five agents, that's 50,000 parties arguing nationally.

For the elderly with reverse mortgages, the macroeconomic impact would be mild, but there would be a deep sigh of resentment against the political system.

If this all sounds very complicated, that's because it is. Shadow lenders purposely keep their goals vague in order to beat the system. China's economy is now thick with complex loans arranged behind the backs of the regulators.

All that debt is going to be tough to unwind as the economy slows. To go back to the cephaloid metaphor, the financial tentacles are becoming so thick they threaten to strangle the octopus' head.

Andrew Collier is managing director or Orient Capital Research, an independent research company based in Hong Kong.

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Arjen van der Woerdt 2 days ago

Well spelled out (article)!

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Mojito 4 days ago

Most people would agree with this analysis .... And yet, we have been hearing the same warnings for at least 5 years. There is financial deepening in China ... Isn't it a positive development?

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Andrew Collier 2 days ago

@Mojito Financial deepening is fine and needs to be done in China. But not in backroom deals by a lot of unregulated financial groups. The growth of the local bond market is a step in the right direction. Some analysts complain that this will increase local debt but at least these bonds will have a tradable value and will be based on reported financials.

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