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Capital Flight in China

Growing Use of Service Sector

"A VAT invoice issued by a restaurant in China could have more legal power than the receipt provided by an overseas company" -- foreign commercial banker in Shanghai.

The National Audit Bureau "never audited the overseas investments of state owned companies." Dong Dasheng, Former Deputy Director of the National Audit Office.

Chinese and western banks have discovered a new way to illegally transfer funds abroad – payments for services through false invoices, fake subsidiaries, and study abroad schemes.

New Ways to Beat the Regulators

The declining opportunities for quick returns in the property market through the Shadow Banking channels of Trusts, banks and other institutions, has increased the motivation for wealthy Chinese to move their money offshore. This is coupled with lower expectations for gains in the Renminbi. The typical channel for capital flight used in the past several years has been false trade invoicing. Companies over-paid for goods purchased offshore, submitting an invoice for the false amount to obtain regulatory approval, and investing the funds overseas.

According to interviews we conducted among bankers in China, the China Banking Regulatory Commission has increased its regulatory scrutiny over false invoicing, making this route a more difficult method for moving funds overseas. Instead, our interviews – coupled with analysis of the data – indicates that the trade has moved to the ***services sector.*** How is this happening? The service sector includes a number of legal and illegal channels for capital flows. These include small money lenders (called money shops), study abroad programs, and foreign consulting fees.

We first look at the basic services data. Then we explore the channels used on-the-

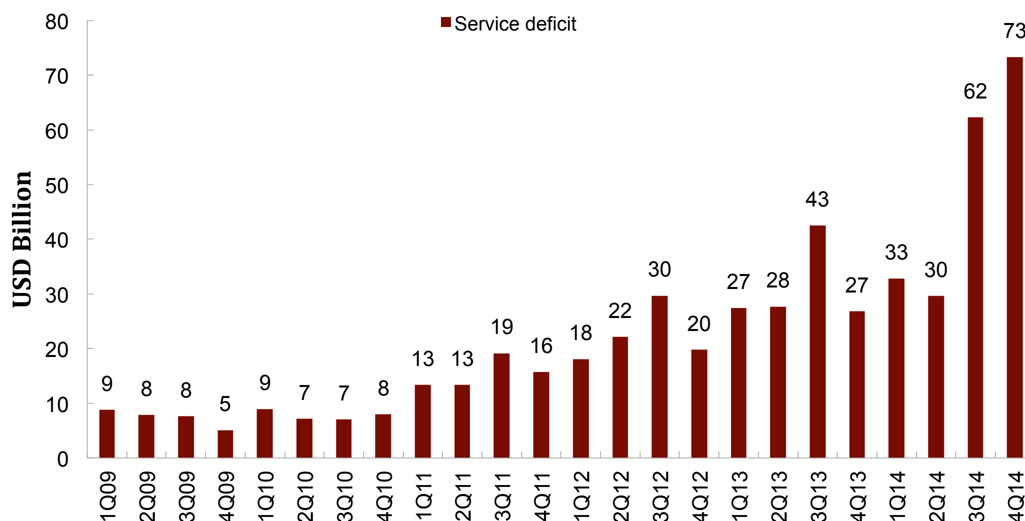
ground for offshore capital flight. Finally, we analyze the size of the problem and what it means for overseas assets and China's foreign exchange holdings.

Big Jump in Service Sector Flows

We examine data on the balance sheet of international payments issued quarterly by the State Administration of Foreign Exchange (SAFE): the current-account balance, which consists of the inflow and outflow of services. Service fees is a large category that includes transportation, tourism, telecom, construction, insurance, financials, computer & information services, copyright, consulting, advertisement, movies, other commercial businesses, other governmental services, staff payments, and investment gains. A number of points jump out:

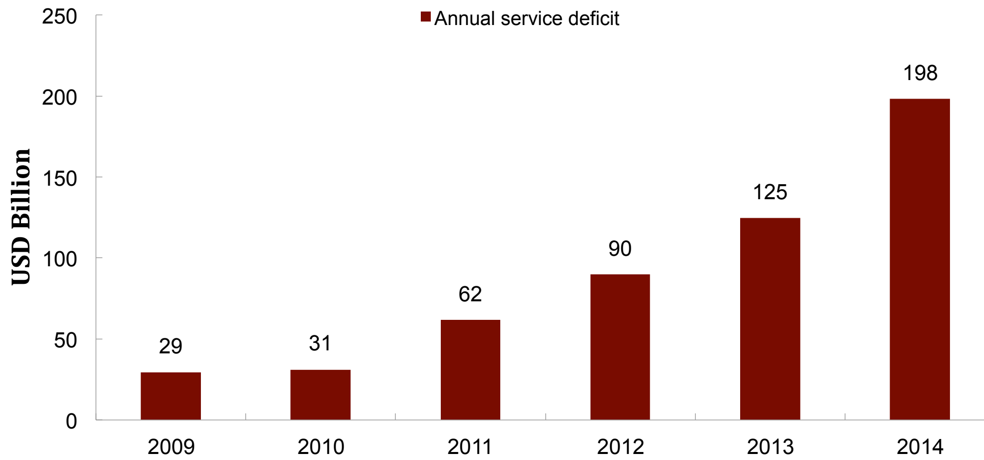
1) Rising Service Deficit. The service deficit is widening in terms of both quarterly and accumulated values. In 2014, the service deficit was US$198 billion, 59.1% higher than in 2013. For the fourth quarter of 2014, the service deficit was 170% higher than in 2013.

Figure 1: Quarterly service deficit



Source: SAFE, OCR

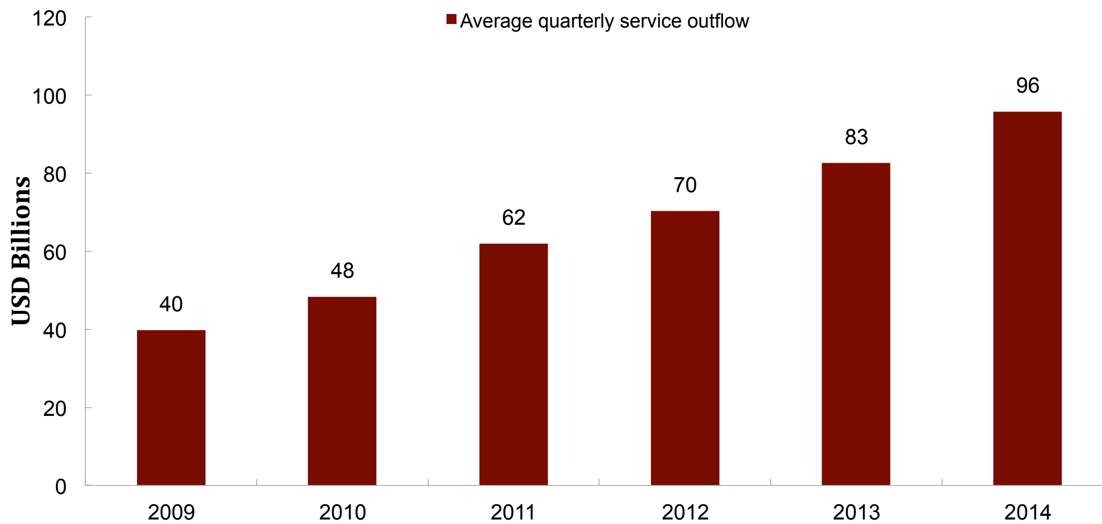
Figure 2: Accumulative service deficit (Yearly)



Source: SAFE, OCR

2) Rising Average Service Outflows. Similarly, the capital outflow through services is increasing. On average, the quarterly service outflow more than doubled from US$40 billion in 2009 to US$96 billion in 2014.

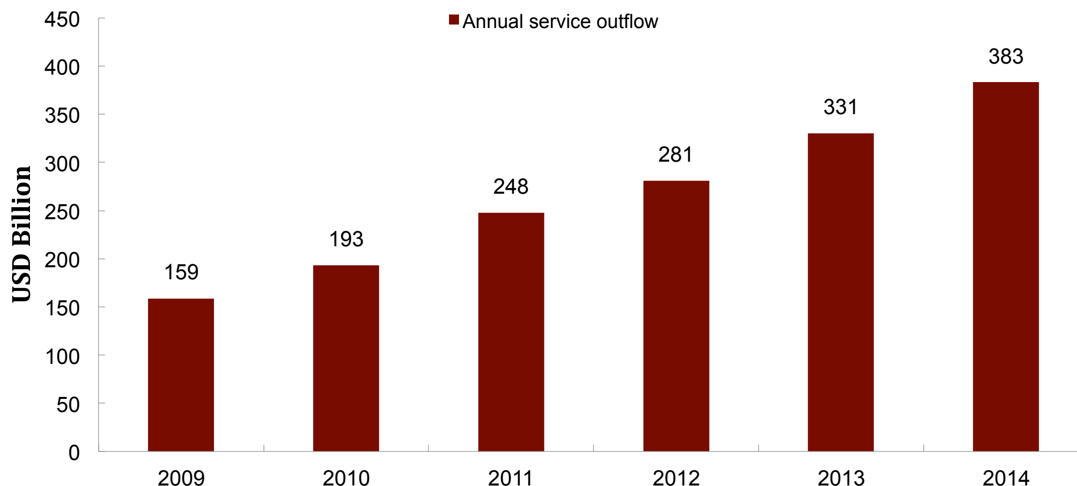
Figure 3: Average quarterly service outflow



Source: SAFE, OCR

3) Cumulative Outflows. In addition, the accumulative service/consulting outflow has risen from US$159 billion in 2009 to US$383 billion in 2014 (+140%).

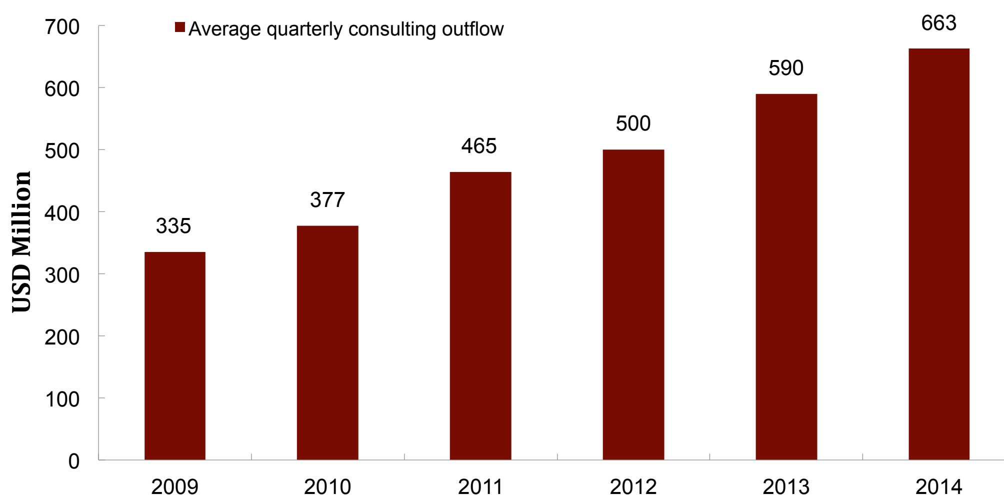
Figure 4: Accumulative service outflow (Yearly)



Source: SAFE, OCR

4) The Consulting Portion of Service Fees Also Rising. There is a breakdown of one category of service fees: consulting. Over the past few years we see increasing outflows under the name of consulting fees. On average, the quarterly outflow through consulting payments has almost doubled from US$335 million in 2009 to US$663 million in 2014.

Figure 5: Average quarterly consulting outflow

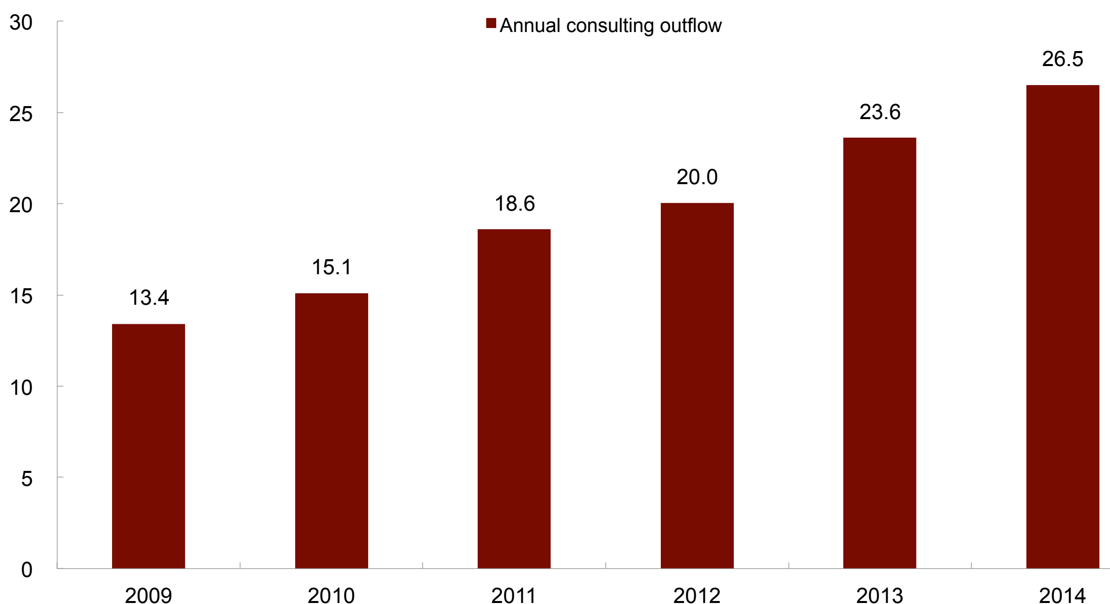


Source: SAFE, OCR

Accumulated Service Outflow Rises 98%

Meanwhile, the accumulated service outflow has increased from US$ 13.41 billion in 2009 to US$26.5 billion in 2014 (+98%).

Figure 6: Accumulative consulting outflow (Yearly)



Source: SAFE, OCR

Many Ways to Misuse Service Fee Payments

How is this service outflow occurring? In general, apart from false trade invoicing of imports and exports, there are two ways to transfer capital overseas.

- **Small Transfers.** The first is to divide the transfer into several small units under Rmb50,000 as there is no requirement for payment under Rmb50,000. However, since this only applies to small transfer amounts it requires a huge amount of time and labor.
- **Consulting Fees.** The second way -- which in the past few quarters has

become the most popular method used by both foreign and domestic banks -- is to alter the type of transfer to overseas consulting or service fees.

The Consulting Fee Method Falls Through the Cracks

Currently, SAFE has the loosest regulations on transfer of consulting fees with the least document requirements. "It's simple for our clients to get the proof of materials as long as they know an overseas company that is willing to write a receipt. In fact, a VAT invoice issued by a restaurant in China could have more legal power than the receipt provided by an overseas company," one foreign commercial banker in Shanghai told us.

Although there's no limit on the maximum amount of consulting fees allowed to be transferred abroad, SAFE has its own system of monitoring these kinds of illegal transfers. But their methods thus far have failed to screen out many of the excessive transfers. "Simply, at the end of each quarter, SAFE automatically filters all single transfers beyond a preset amount. Next, auditors are sent to these companies to conduct an on-site investigation. More complicated standards are included in this automatic filter system that only a small portion of people (at SAFE) know," the banker noted.

The Advantage for Domestic Banks

Domestic banks have significant advantages in doing this. Foreign banks have a much higher level of regulatory scrutiny. According to one operations executive with a foreign bank in China, "They (domestic banks) are much less regulated by SAFE in terms of the total amount and variety of disguised types (of money transfers). We have received tons of complaints from our clients who have tried domestic banks' transfer services before. We often hear them say things like 'why can't you do this? The domestic banks we used before could.' Subsidiaries of multinational companies located in China keep criticizing our services in order to switch back to the domestic banks used before even when we are directed to be used by their parent company. You can see how flexible and powerful domestic banks are in illegally transferring capital overseas."

Case Studies of False Consulting Fee Payments

In our interviews, we discovered a number of ways companies are able to convince

banks and regulators that their overseas service payments are legitimate. We document a few here to give an example of how this trade works.

1) Study Abroad Schemes

More than half of the study-abroad agencies in China have a second identity as underground money shops, which help clients transfer wealth overseas. In the first half of 2014, most underground money shops operating under the guise of study-abroad businesses were located near the Lo Wu Customs Point on the Shenzhen border with Hong Kong. Due to the increasing clampdown on this trade by the border police, most of these shops have moved to Hong Kong, forcing them to be more careful with their business. According to one person involved in this trade, "Now, we barely accept unknown new clients. You must be referred by someone who has done business with us. "

They also have certain informal rules regarding the kinds of funds they will transfer. It appears the corruption crackdown has had some effect on their willingness to deal with government officials."There are two types of money we never touch. First is the enormous sum of money from civil servants. Second is money from unknown sources. In other words, you have to at least submit basic proof about where you got the money."

In general, the client calls half-an-hour earlier to specify the amount of money and specific currency to transfer. "We will tell him the floating exchange rate (black market). If he is ok with the exchange rate, he needs to transfer the money into our domestic banking account in 30 minutes. We promise our clients they will receive the money in their overseas accounts about in an hour." This banker said he handles hundreds of millions of yuan weekly under this exchange system. "We control thousands of accounts to do the transfer as we have to control the frequency below a minimum threshold so that we won't be caught by the regulatory agencies."

Regulators are Unaware of the Scale

Most underground money shops of any significant scale conduct business with private banks of domestic banks. "Last week, we helped a private banking client from a medium-size regional bank transfer Rmb30 million to Hong Kong. We've charged 1ppt handling charge beyond the exchange rate." Much of the growth is reflected in the positive correlation between the Hong Kong stock market and capital outflows.

2) Interbank Borrowing

There is also private interbank borrowing. According to one moneylender, "The way we build up our scale, which allows us to accept more clients, is to take in overseas clients who want to invest in China at the same time. We offer them faster and cheaper transfer services by matching their requests with domestic clients who want to transfer their money abroad. In fact, there's a similar inter-bank market among underground money shops. In general, transfer exceeding Rmb100 million need the "inter-bank" market since we have to find similar amount of overseas transfer to China. Sometimes, we either borrow from peers through the "inter-bank" market or use our own money to fill the gaps."

3) Fake Trade Invoices

The fake trade invoice channel continues to function. One freight forwarder we spoke to estimates that one-third of trade invoices are fraudulent. But we were told this method is declining in importance due to the heightened scrutiny by SAFE, the banks and other regulators.

In order to overstate imports, domestic companies usually work with the foreign firms. However, this only applies to the imports of equipment and materials, where it is not easy to detect the illicit money flows. Once the foreign seller receives the payment for goods, the extra portion is transferred into foreign accounts of the domestic purchaser. In general, it is much easier to export goods at a much lower price than to import goods at a higher price. High priced imports draw more attention from regulators. So exporters tend to sign contracts below the actual export value. There is a dual benefit. On the one hand, domestic exporters enjoy higher tax rebates. On the other hand, the exporters largely reduce their foreign funds receivables by leaving part of the balance due abroad. But money lenders said the trade is lower in 2015 than in 2014. Before 2014, custom and importers blatantly worked together, but that is declining.

4) Overseas Branches of Domestic Companies

The fake invoice trade has increased partly with the use of overseas company branches. Since the Chinese government began encouraging domestic companies to expand overseas, millions of subsidiaries have been set up offshore. In recent years, these overseas branches have been widely used to transfer domestic capital abroad.

The foreign branches operate separately from headquarters. For accounting purposes, these overseas branches are made responsible for the company's profitable businesses. In contrast, domestic companies retain the least profitable businesses. This way, they can keep the profits in their overseas accounts as a way

to move capital offshore. “In the past, it didn't matter whether a state company made money or not. As long as the consolidated financial reports don’t look terrible, no one cares about who actually contributes the profits, especially for the heads of the state firms. They can always find a way to privatize part of the profits and assets under the name of these international branches,” said a senior executive with a large state owned company.

5) False Joint Ventures

In order to enjoy favorable policies for capital flight, many domestic companies have established joint-venture companies with their own overseas subsidiaries, even though this is technically illegal. The domestic company is responsible for all of the registered capital but transfers the profit to its overseas subsidiaries. In addition, the domestic company can use the joint venture partner to issue debt overseas. Then, the domestic company makes an international transfer to pay the interest. “In fact, we (domestic company) never receive the borrowed money,” an executive who has a joint venture overseas told us. This executive estimates that more than 40% of private companies with annual revenue over Rmb5 million are involved with capital flight, especially those in Beijing that are close to the central government.

Fake joint ventures are also involved with something that is informally known as transitional capital flight. Transitional means that the capital eventually will flow back to China. It is estimated that 25% of FDI is the result of transitional capital flight

What Does This Services Capital Flight Mean for Global Assets?

It’s not clear how the regulators, including SAFE, the CBRC and the PBOC, will handle this growing problem of use of the service sector to channel capital overseas. The SAFE, CBRC and other regulators in Beijing may be knowledgeable about these transfer schemes but appear to be unaware of how large they are. “Given the central bank’s anti-money laundering investigation on transfer of large-amount of money, our bank doesn’t accept transfers of more than Rmb1 million each time. In fact, we prefer cash no matter how large the sum is. We have hired professional guards to pick up the cash,” a moneyshop owner said.

These international flows are an important component of domestic economic activity. It is hard for the regulators to distinguish between legitimate and

illegitimate capital flows, particularly when services don't have an easy "comparable" for the regulators to examine to see if the flows are too large.

There are some steps they can take. For example:

1) Examine joint ventures to see if they are conducting "real" business overseas.

2) Improve oversight of small money shops that are acting as conduits for overseas transactions.

3) Check for patterns of overseas transactions at a single bank branch or related to a particular corporate account (similar to what western banks do to monitor money laundering).

However, given the shift from trade invoicing to service invoicing, it appears clear that the financial system is generally one step ahead of the regulators when it comes to illegal money flows, either in Shadow Banking or in capital flight.

How Large is the Problem and What are the Economic Implications?

How much of overseas service fee payments are actually capital flight in disguise? Bankers involved estimate that as much as 40% of the larger service transactions do not involve actual services. This suggests close to $200 billion of all service payments are in reality permanent exports of capital. That number could double in 2015. Clearly, if $300 billion to $400 billion of China's money supply leaves the country in 2015, that would have numerous macroeconomic effects globally. These would include the value of the Renminbi, the domestic money supply and the ability of China to stimulate the economy. It also would affect the costs of the sterilization of incoming flows that is now paid by savers, the PBOC, and the Ministry of Finance. Last, there is a huge impact on the value of global assets where the money is being invested, such as in property in London, New York, Sydney and San Francisco.

Domestically, as political scientist Victor Shih of the University of California at San Diego noted in a report several years ago, "As companies pay overseas counterparties and as HNWIs (High Net Worth Individuals) withdraw money from banks to sneak out through the underground banking system, banks will quickly become unable to make new loans since 60% of banks' loan balance is trapped in medium to long term loans with maturity above 1 year."

Most important, though, is the impact on the value of the assets held by China as

foreign exchange. The country declares official foreign exchange reserves of $3.9 trillion, although it does not provide a precise breakdown. The known reserves include bonds in the U.S. and other western countries. However, there are likely to be substantial holdings outside of government bonds, including gold, equities (declared to be more than $100 billion), European Stability instruments, non U.S. dollar deposits, and other assets. It is unlikely that the recurring services deficit will result in the sale of U.S. Treasuries. But these other foreign exchange instruments, most of which appear relatively liquid, are likely targets for sale, which would lower their value. Another unknown investment by SAFE is the purchase of the equity and bonds of foreign listed Chinese companies, such as the banks and insurance firms. Rapid disposal of their shares by the state would have a strong negative impact on share prices, not to say the additional signaling this would entail.

Estimating which instruments and the amount of sales is difficult without more precise data. But it is reasonable to assume that SAFE's ability to control the exit of capital is less than widely assumed.

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