Insurance companies are China's new shadow banks

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The ever ingenious Chinese financial system has developed a new kind of Shadow Bank – insurance companies.

China's $586bn stimulus package in 2009 caused a flurry of lending through the country's financial arteries. Some of this money ended up leaking out of the banks into unofficial channels, including the country's state banks and the giant provincially-owned pseudo banks called Trust Companies. By the end of 2014, these off-balance sheet loans accounted for 18 per cent of all financing, up from less than 2 per cent a decade earlier.

However, as this flood of cash poured into the economy, mainly into the property industry, it caused a tremendous asset bubble, and Beijing became nervous about the potential for the a collapse if all the air burst out of the market at the same time.

So, in 2014 the regulators including the China Banking Regulatory Commission and the People's Bank of China put in place stricter rules about shadow loans. As a result, in the first two months of this year, bank loans rose to 77 per cent of total financing, up from 64 per cent a year earlier. It looked like shadow finance was on the wane.

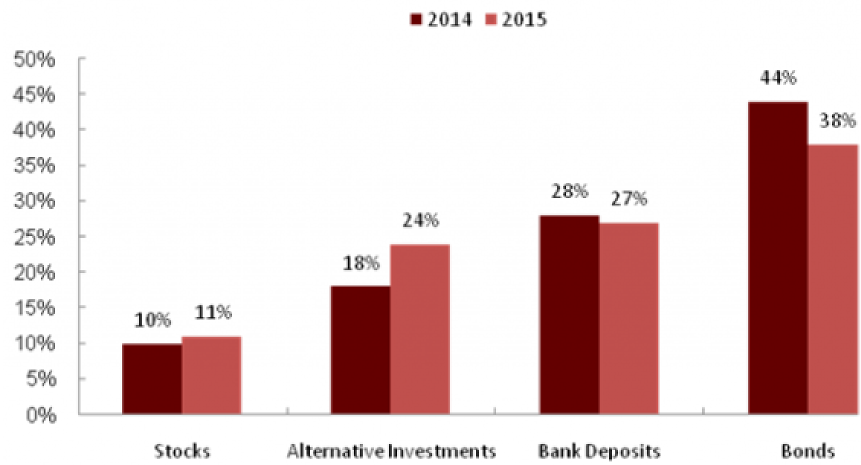
Ah, but not so fast. China's slippery financial system is not so easily tied down. Egged on by provincial leaders desperate to keep the wheels of GDP growth rolling forward and cash-strapped property developers, other institutions have jumped into the fray. And one of the biggest are Chinese insurance companies.

By the end of January 2015, alternative investments surged 66.4 per cent year-over-year to Rmb2.3tn, accounting for a whopping 24 per cent of total insurance investments. In contrast, investments in bank deposits and bonds grew no more than 9 per cent, and even money socked away in China's booming stock market rose only 17 per cent – one-quarter as fast as in alternative investments.

What are these alternative investments? The insurance industry guards this information carefully. However, at the insurance industry's annual meeting earlier this year, participants let slip that insurance is the biggest source of capital for China's infrastructure construction.

According to the data presented, in 2014 the insurance industry's infrastructure investment rose 57 per cent to Rmb1.1tn. This includes everything from bridges and local property developments to more than Rmb100m in affordable housing.

But the story becomes much more interesting when we look at the main conduits for these investments. Much of this was invested in debt issued by local governments through Local Government Financing Platforms (LGFV). LGFVs are off-balance sheet companies that were established in local towns across China as a way to avoid lending caps to governments for infrastructure investment.



Source: Orient Capital

One of our interviewees, who works for the business promotion office at a Jiangsu province LGFV, said insurance investments have been promoted by provincial officials to meet the financial needs of their infrastructure projects because:

1) Insurance companies have stable long-term sources of funds, which match the five-to-ten year construction period of infrastructure projects.

2) Insurance companies are willing to lend capital at lower interest rates than another large source of shadow capital, trust funds, namely, 7.5 per cent. "Most importantly, unlike trust companies, we don't have any other implicit costs," the official noted. Trusts often have to pay additional fees to banks and other third parties.

Take Taikang Life Insurance Company. It bought debt issued Wenzhou Shoal, managed by the Wenzhou Port City Development Co., in Zhejiang Province. According to our research, Wenzhou Port City Development Co., Ltd is an independent company, controlled by Oujiang Construction, Investment & Development Co., which is an LGFV. Oujiang is assumed to have an "implicit" government guarantee – although local governments have no legal basis for providing this.

Another firm, Changjiang Pension Insurance bought a seven-year debt investment plan worth Rmb2bn invested in several municipal construction projects managed by Shanghai Shenjiang Group – an LGFV. This was the first pension insurance fund investment in Shanghai urban construction. The capital will be used to pay the debts of seven completed public welfare projects.

What is the problem with the insurance companies investing in China's booming construction industry?

- First, the insurance firms are not transparent to shareholders or investors about where their money is going.

- Second, there is an implicit assumption of government backing for these projects, an assumption which has no legal basis and will be sorely tested as China's economy slows.

- Third, these are highly risky investments. Local governments are seeing dwindling revenue from land sales and are increasingly desperate to generate new sources of cash, and are thus probably not the safest place to invest insurance premiums.

But there is a bigger, more worrisome issue that speaks to the nature of China's opaque and distributed political and economic system. With a slowing economy, Beijing is searching for mechanisms to simultaneously generate growth and cope with the country's total debt, now approaching 200 per cent of GDP.

Understandably, Beijing's leaders in the State Council and the central bank are reluctant to lean too much on the country's banks, which are considered the trigger of last resort. So they are tapping whatever cash pools they can – and insurance companies currently are in Beijing's sites. In essence, the insurance companies are functioning asproxy Keynesian stimulus levers.

As one insurance executive noted; "To my knowledge, many LFGVs now consider the insurance funds as their life-saving straw to improve the debt structure as the whole country keeps a watchful eye on the risks related to local government debts."

By involving almost every area of the economy in a quasi government stimulus, often through the lightly regulated Shadow Banking system, China risks a fiscal crisis much larger than the current data would suggest. That's a potential financial time bomb both for China and the rest of the world.

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