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China's Hidden Stimulus

Rapidly Growing Bank Investments Replace Bank Loans

Summary
China's leaders in Beijing are struggling between the poles of new liquidity injections to stimulate the economy and forceful crackdown on debt. Political scientist Susan Shirk calls this the battle between the "spenders" and the "savers." The spenders generally are in the State Council and in the provincial and lower level government. They depend on fiscal revenue for growth and career advancement. The savers are allied with the Ministry of Finance, the People's Bank of China, and the China Banking Regulatory Commission. Their careers rely on preventing inflation and halting asset bubbles.

The current policy is a clear compromise between the two poles. Instead of issuing more government bonds, and increasing explicit government debt, the leadership prefers to use less obvious sources of growth -- – what I call a "hidden stimulus. The latest "hidden" stimulus is coming from the banks themselves. They are moving capital from the lending side of the balance sheet to asset purchases called "investments.". As of the end of October, banking assets stood at roughly 285% of GDP, up from 270% at the end of 2014. But this form of stimulus has less transparency and regulatory oversight, and is forestalling an inevitable collapse in the property bubble.

The Latest Form of Shadow Lending

Shadow Banking in China has adopted a new guise. During the 2009 Rmb 4 trillion stimulus, shadow lending was transmitted by Trusts, investment banks, and commercial banks, through the sale of Trust and Wealth Management Products (WMP). Although loosely regulated, these shadow loans were reported in financial statements by the Trust Association, WMPs tracked by the People's Bank of China (PBOC), and bank P&Ls. The transparency has not been perfect -- there has been little detail on the destination of loans – but there was an attempt to provide relevant data.

As shadow lending has grown, officials at the PBOC and the China Banking Regulatory Commission (CBRC) have become more concerned about rising debt levels and the rising issue of moral hazard among local governments and corporate borrowers. But these regulators face a group of politically powerful actors in the State Council and the National Development and Reform Commission that are intent on protecting Provincial and sub-Provincial financing. This is the battle between "spenders" and "savers."

As a compromise, the leaders have turned to what I call "pools of capital" that are not obvious forms of stimulus. This satisfies the PBOC's call for fiscal discipline while (hopefully) providing adequate capital to prevent the collapse of local governments and the property bubble from turning into a rout.

As examples, the insurance industry is one of the largest sources of capital for infrastructure, to the tune of Rmb 1.1 trillion, much of it in local government companies. (*See Orient Capital Research, Insurance Shadow Banks, April 2015).* Yet this funding is buried in their financials with little transparency. We also saw this in the failed attempt to boost the stock market. This inept policy was partly the result of a power vacuum caused by Xi Jinping's self-appointment as head of many of the key Leading Small Working Groups. As a result – at least according to one theory of elite Chinese politics -- the economically unsophisticated Party Ideologues saw a rising stock market as a cost-free method of stimulating the economy.

More recently, the banks have jumped in to become a significant new source of Shadow Loans through the banks' investment portfolios. This change is highly significant because the banks form the heart of the financial system due to their large branch network (more than 200,000), direct control by Beijing (local branches report directly to headquarters and not to the local Party Commissioner or local governments), and the support of the Ministry of Finance. These investments have risen faster than the loan book and – in essence -- are replacing the loan book, with little regulatory oversight.

The New Shadow Loans: Investments

We examined the 1H 2015 balance sheets for the Bank of China, ICBC, and China Merchants Bank to understand how the banks are using investments. We were interested in the size of the portfolio and where it is being invested. Will these bank flows be beneficial to GDP or simply fueling bad debt? How large are they?

The BOC's Investments Rose Faster than Loans

The chart below details the BOC's financials in the first half of 2015 compared with the year earlier period. Loans grew only 4.9%, and accounted for 54.4% of total assets. What is striking is the 21.3% increase in investments, rising from 17.8% of the balance sheet in 1H 2014 to 20.2% in 1H 2015. In terms of actual capital, loans rose by Rmb 405.7 billion, while investments surpassed this by increasing by ***Rmb 578 billion to Rmb 3.3 trillion***. This is a significant source of capital for the economy from a single bank. As a comparison, this increase in investments is the equivalent of 14% of the 2009 Rmb 4 trillion stimulus.

Table 1, BOC's Financial Statement (1H 2015)

BOC's Consolidated Financials	1H 2014	% Total	1H 2015	% Total	YoY %	YoY Rmb Bln
Loans and advances to customers, net	8,294.7	54.4%	8,700.4	53.4%	4.9%	405.7
Investments	2,710.4	17.8%	3,288.4	20.2%	21.3%	578
Balances with central banks	2,306.1	15.1%	2,174.5	13.3%	-5.7%	-131.6
placements with banks/other financial institutions	1,130.2	7.4%	1,263.5	7.8%	11.8%	133.3
Other Assets	809.9	5.3%	871.4	5.4%	7.6%	61.5

Mainly Domestic Bonds

To understand the assets the bank was purchasing, we looked at a more detailed breakdown of the purchase. Most of the assets the BOC bought were debt securities, both domestic and foreign. The domestic portion – referred to as listed outside of Hong Kong – is the largest. These domestic instruments account for nearly half of the outstanding balance of funds in the investment balance sheet, or Rmb 1.4 trillion out of Rmb 3.2 trillion. The year-over-year increase in domestic purchases was one-third of the total increase in the investment portfolio, or Rmb 170.5 billion out of Rmb 563 billion.

Table 2, BOC's Investment Portfolio by Destination

Financial Investments by Type	1H 2014	% Total	1H 2015	% Total	YoY %	YoY Rmb Bln
Debt Instruments Available for Sale						
Listed in Hong Kong	34.7	1.3%	41.7	1.3%	20.2%	7.0
Listed outside Hong Kong	430.4	16.5%	515.9	16.3%	19.9%	85.5
Unlisted	247.1	9.5%	324.4	10.2%	31.3%	77.3
Equity Available for Sale						
Listed in Hong Kong	4.6	0.2%	5.1	0.2%	10.9%	0.5
Listed Outside Hong Kong	0.4	0.0%	0.2	0.0%	-50.0%	-0.2
Unlisted	33.6	1.3%	35.8	1.1%	6.5%	2.2
Debt securities held to maturity						
Listed in Hong Kong	16.4	0.6%	21.6	0.7%	31.7%	5.2
Listed Outside Hong Kong	1,229.2	47.2%	1,399.7	44.2%	13.9%	170.5
Unlisted	178.9	6.9%	193.6	6.1%	8.2%	14.7
Financial investments classified as loans and receivables						
Unlisted	430.7	16.5%	630.8	19.9%	46.5%	200.1
Total	**2,605.8**		**3,168.9**		**21.6%**	**563.1**

Where's the Money Going?

A key question when analyzing the impact of the rise in bank portfolios on the macro-economy is where the money was invested. The bank's financials provide some clarity. The increase in investments includes a group of assets classified as "loans and receivables." This category jumped 22% YoY to Rmb 3.2 trillion, an increase of Rmb 563.1 billion. About half of the increase was in government bonds. The most startling change was the near doubling of investments in Trusts, from Rmb 154 billion in 1H 2014 to Rmb 335 billion in 1H 2015, accounting for 42% of the increase in the BOC's investment portfolio. Trusts, which are quasi-banks owned mainly by Provincial governments, are grabbing capital from the banks as fast as they can. Are these investments going into the economy or helping to patch over bad loans? The Trusts don't provide enough information to say.

Table 3, BOC's Investments by Destination (Financial Investments Classified as Loans and Receivables)

Rmb Bln	1H 2014	% Total	1H 2015	% Total	YoY %	YoY Rmb Bln	% Tot
Trusts	154.1	5.9%	335.8	10.6%	118%	181.7	32.
Government	1,019.2	39.1%	1,255.7	39.6%	23%	236.5	42.
Financial Institutions	268.0	10.3%	355.4	11.2%	33%	87.4	15.
Corporate	337.4	12.9%	323.6	10.2%	-4%	-13.8	-2.
Policy Banks	404.9	15.5%	459.7	14.5%	14%	54.8	9.
China Orient Bond	160.0	6.1%	160.0	5.0%	0%	-	0.
	262.2	10.1%	278.7	8.8%	6%	16.5	2.
Total	**2,605.8**		**3,168.9**		22%	**563.1**	

Source: BOC Financial Statements

Similar Growth in Investments at CCB and ICBC

We performed a similar analysis of the financial statements of China Construction Bank, another state owned bank that would have similar regulatory requirements as the Bank of China. Although the magnitude of growth is not as large, there still was a significant increase in the bank's investment portfolio in the first half of 2015. While loans provided the lion's share of the growth in outflowing capital (54%), the investment portfolio rose by a substantial Rmb 396 billion or 22.9% of the growth. The nearly Rmb 400 billion increase in investments is a large injection into the economy.

Table 4, China Construction Bank's Asset Growth

China Construction Bank	1H 2014 Avg Balance	% Total	1H 2015 Avg Balance	% Total	YoY %	YoY Rmb	% Tota Increas
Loans	8,889.2	58.3%	9,824.3	57.9%	10.5%	935.1	54.0
Investments in Debt Securities	3,098.4	20.3%	3,494.4	20.6%	12.8%	396.0	22.9
Deposits with Central Banks	2,482.6	16.3%	2,606.4	15.4%	5.0%	123.8	7.1
Deposits with non-banks	540.1	3.5%	729.3	4.3%	35.0%	189.2	10.9
Financial Assets held for resale	233.3	1.5%	321.3	1.9%	37.7%	88.0	5.1
Total Interest Earning Assets	**15,243.6**		**16,975.6**		11.4%	**1,732.0**	

Source: CCB Financials

Within the portfolio of debt securities, the biggest increase, 8% YoY or Rmb 98.9 billion, came from the increased investments in government bonds. However, bank and non-bank bonds came in as a close second, rising 8.3% or Rmb 85.7 billion. The entire portfolio going to banks and non-banks in by the 1H 2015 was a whopping Rmb 1 trillion, while the policy banks were recipients of Rmb 539 billion. That's just from CCB, a single bank.

Table 6, CCB's Investment Portfolio in Debt Securities

	1H 2014		1H 2015			
Breakdown in Debt Securities	Amount	% Total	Amount	% Total	% YoY	YoY Rmb Bln
Government	1,234.20	35.51%	1,333.10	36.79%	8.0%	98.9
Central Bank	188.20	5.41%	160.90	4.44%	-14.5%	-27.3
Policy Banks	537.10	15.45%	539.40	14.89%	0.4%	2.3
Banks and non-banks	1,030.90	29.66%	1,116.60	30.82%	8.3%	85.7
Public Sector Entities	20.00	0.01%	20.00	0.01%	0.0%	-
Other Enterprises	485.30	13.96%	472.90	13.05%	-2.6%	-12.4
	3,475.70		**3,623.00**		**4.2%**	**147.30**

Source: CCB Financial Statements

ICBC's Increasing Investment Portfolio

We see a similar fast-growing trend in ICBC's investments compared to its loans. While 1H 2015 loans rose 5.6% or Rmb 616 billion, they accounted for just one-third of the overall increase in ICBC's outstanding credit. One-quarter, or Rmb 450 billion, of the Rmb 1.8 trillion increase came from a 21.8% rise in investments.

Table 7, ICBC's Assets

ICBC's Assets	1H 2014		1H 2015				
(Rmb Bln)	1H 2014	% Total	1H 2015	% Total	YoY %	YoY Rmb Bln	% Total Increase
Total loans and advances to customers	11,026	53.5%	11,642	51.9%	5.6%	616	34.1%
Corporate Loans	7,613	36.9%	7,944	35.4%	4.3%	331	18.3%
Personal loans	3,063	14.9%	3,266	14.6%	6.6%	202	11.2%
Discounted bills	350	1.7%	433	1.9%	23.5%	82	4.6%
Allowance for Loan Impairment	258	1.2%	267	1.2%	3.7%	10	0.5%
Investments	4,433	21.5%	4,883	21.8%	10.1%	450	24.9%
Total	**20,610**		**22,417**		**8.8%**	**1,807**	

However, the composition of ICBC's investments are slightly different from those of the BOC. ICBC's balance sheet shows a significant increase in purchases of unlisted debt securities. These are less transparent and marketable than listed securities and show the bank's appetite for greater risk compared with its competitors.

Bank Strategies for Increasing the Investment Portfolio

Why are the banks making these investments? There are two reasons. One is to take advantage of more lax requirements on risk weightings, provisioning and impairments, allowing greater use of the bank's capital. The risk weightings for investments are 25% compared with loans at 100%. The higher the risk weighting the more capital the bank has to set aside to meet international guidelines for its capital adequacy ratio (CAR). Higher risk assets are subtracted from total assets for purposes of calculating the CAR. Under regulations from the China Banking Regulatory Commission (CBRC), corporate loans have a risk weighting of 100%. Other assets, however, have a lower risk weighting. According to the CBRC:

- Claims on specific debts issued by asset management companies to purchase state owned bank non-performing loans have a risk weighting of 0%.
- Claims on the central government and the People's Bank of China have a risk weighting of 0%.
- Claims on domestic banks have risk weights of 20% to 25%.
- Claims on off-balance sheet items including revolving credit or securities as collateral have a risk weighting of 50% to 100%.

The second is to evade lending restrictions and reporting requirements. Banks currently have a maximum limit of 25% of their loan book in the property sector. However, there is no such limit on the investment side of the balance sheet. It is likely that the majority of the loans are going to proscribed sectors including property or to favored state firms that have exceeded internal quotas established by the CBRC or the banks themselves.

Healthy Profits from the Investment Portfolio

We can also see the incentive for the banks in terms of the returns it earns on its investment portfolio compared to other assets, including loans. As one example, we look at the Bank of

China. While the highest return is generated by loans, at 5.11%, placements with banks and other financial institutions came in at second at 3.79%, followed by investments, at 3.56%. In addition, the return on investments rose 0.05% YoY while that on loans fell 0.06%.

The investments may even generate a higher return depending on what risk weighting they have and how much additional capital this allows the banks to lend. In the future, with lending rates gradually being liberalized, there will be a growing margin squeeze on loans. This would make the investment portfolio even more attractive over time.

Table 8, BOC's Interest Income by Segment.

Interest Income	1H 2014		1H 2015	
	Interest Income (Rmb B)	Interest Rate	Interest Income (Rmb B)	Interest Rate
Loans	207.8	5.18%	220.7	5.11%
Investments	41.4	3.51%	50.1	3.56%
Balance with central banks	17.4	1.53%	15	1.30%
Due from banks and financial institutions	27.6	4.78%	22.6	3.79%
Total	**294.2**	**4.26%**	**308.4**	**4.12%**

Source: BOC Financial Statements

Conclusion: Stimulus in a New Form

We've been arguing in this report that the Chinese banks are increasing their total exposure to the economy increasingly through their investment portfolios, rather than via the loan book. What does this mean for the macro-economy?

We lump together the various products that we consider direct injections into the economy. This would include investments in corporate securities, bank products, policy banks, and other financial intermediaries. We are somewhat arbitrarily excluding central government bonds as we assume they would form part of central government debt. In the case of the Bank of China, its investments that we are categorizing as a "stimulus" rose 22.8%, or Rmb 370.8 billion to Rmb 1.99 trillion. That compares with the bank's 5.1%, or Rmb 405 billion, increase in loans to Rmb 8.32 trillion. ***The increase in investments excluding government bonds was almost equal to the growth in loans***, at least in the case of the Bank of China.

A Stimulus in China is A Different Animal

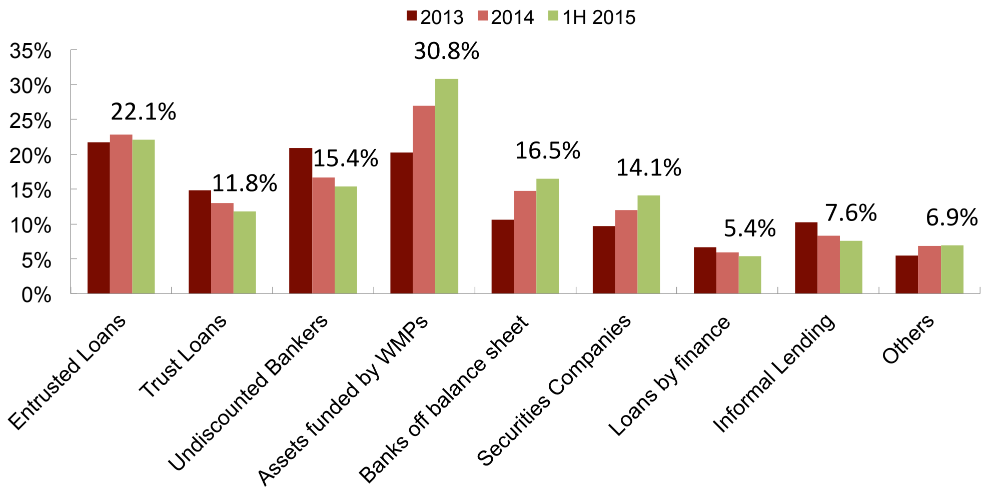
In traditional western economics, a stimulus is implemented through monetary or fiscal policy. Monetary policy includes lowering interest rates or, as we saw recently, quantitative easing by purchasing financial products from banks to increase the money supply. Fiscal stimulus refers to lower taxes or higher government deficits. In China, this distinction is blurred. Any monetary stimulus, including lowering interest rates or reducing bank Reserve Rate Requirements (RRR), allows new capital to flow into the economy. But this capital must be intermediated by banks (and some non-bank financials), which are political agents responsible to different actors in the system. State banks report both to the PBOC and the Ministry of Finance, and also to some degree to Provincial officials. City and Commercial Banks have local city officials to answer to. And so on…these banks thus use monetary stimulus for government ends.

The banks have become the central nexus for negotiations between different political groups. The State Council and Provincial Governments are intent on increasing investment to prevent economic downturn or even collapse. However, the PBOC and CBRC are concerned with excess debt and asset bubbles. The use of bank investment products as a "hidden stimulus" is a compromise between different groups with opposing agendas.

Declining Efficiency of China's Stimulus

The stimulus injections, whether by direct loans, or indirect investments, are less and less effective over time. The ratio of fixed asset investment to gross capital formation has steadily declined. Annual real growth in gross capital formation fell to 6.6% in 2014, down from 10.2% in 2013 and a peak of 25% in 2009. Accounting for depreciation, it may be negative. Meanwhile, total Social Financing, which includes loans and other capital outlays, is rising. Domestic loans rose 14% in Q3 2015 to Rmb 90.5 trillion to but it's not clear the lending has had much of an impact. Meanwhile, other forms of lending, mainly entrusted loans between corporates via banks, and net bond financing, are rising rapidly.

Table 9, The Growth in Chinese Shadow Banking



China is reaching the point where whatever stimulus it adopts – through bank loans, Shadow Banking loans, or bank investments – these measures are having less and less impact on the country's economic growth.

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