Chinese authorities launch probe into financial system fearing “Lehman moment”

Nick Beams
24 June 2017

China’s bank regulator has ordered a probe into some of the country’s largest overseas investors, citing the possibility of “systemic risk” to the entire financial network because of the practices investors have employed in acquiring assets.

The probe to be conducted by the China Banking Regulatory Commission (CBRC) is described as a “fact finding” mission. It will target the connections of Chinese banks to four companies: the property-entertainment giant Dalian Wanda, the consumer group Fosun International, the conglomerate HNA, all of which are listed firms, and the unlisted insurer Anbang.

According to one estimate, the four companies have been responsible for $56 billion in overseas deals during the past five years.

Their acquisitions include the purchase of New York’s Waldorf Astoria Hotel, the US cinema firm AMC Entertainment, the theatre production group Cirque du Soleil and a 10 percent share in Deutsche Bank.

The listed companies experienced a sell-off of their stocks and bonds on Friday, even as they sought to counter the effects of the investigation by issuing assurances that it was business as usual. Large state banks also declared they had no intention of cutting off funds to the companies involved.

A report in the *Financial Times* cited “people briefed on the investigation” who said the CBRC would examine “how and whether these companies used high-interest financial products and overseas loans for their buying spree, which took place largely outside the purview of Chinese regulators.”

The CBRC move comes after the detention earlier this month of Wu Xiaohui, the head of Anbang, over concerns about his purchases of overseas assets as regulators sought to control the outflow of capital from the country.

Speaking to journalists on Thursday, Liu Zhiqing, deputy head of the CBRC’s risk department, said the commission was concerned about “the systematic risk of some large enterprises” and that this risk could be transmitted to the financial system and other institutions, including smaller Chinese banks.

Liu declined to give specific details of the companies that were the focus of the investigation, saying only that the risks applied “broadly.”

Central bank governor Zhou Xiaochuan highlighted concerns over the stability of the financial system earlier this week. “The experience of the global financial crisis tells us that the first priority is to keep financial institutions healthy so that financial crises could be prevented,” he said. “We cannot tolerate phenomena such as heavy leverage, low capital and non-performing loans.”

The seriousness of the CBRC investigation was underscored by comments to the London-based *Financial Times* by Frederic Cho, the founder of a specialist China investment consultancy. “This is a thorough investigation into large groups with overseas investment exposure in order to prevent a ‘Lehman Brothers moment’ happening to the Chinese financial system,” he said.

Chinese financial authorities are fearful that a crisis or even bankruptcy of one or more of the country’s major overseas investors would cause enormous damage to the country’s financial reputation and severely affect the government’s drive to more closely integrate it into the global financial system.

CBRC chairman Guo Shuqing has vowed to clean up the Chinese banking and financial system. He was quoted earlier this year as saying he would resign “if the banking industry becomes a complete mess.”

There are major problems, however, associated with any financial cleanup. Banking and financial interests are closely intertwined with different and sometimes competing factions within the ruling Chinese Communist Party (CCP) regime that exercise considerable political and therefore economic influence.

There is also widespread concern about the rise of the considerable and largely unregulated shadow financial sector. Authorities would like to bring it under control, recognising the dangers it poses. However, at the same time, the regime relies on it to provide the finance for local government authorities and sustain economic growth.

The entire CCP regime lives in fear of a major economic crisis leading to a slowdown in growth or a recession because its sole source of political legitimacy rests upon its ability to sustain Chinese economic expansion.

The Beijing government hopes to be able to do that by having China recognised as part of the global financial system. But this goal depends on its ability to ensure that China is not regarded as a "wild financial East."

While most Chinese overseas asset purchases are financed with loans from state reserves or with funds provided by Chinese and foreign banks, and are therefore subject to the purview of regulators, some companies use offshore financing and the issuing of financial products to get around state regulations.

HNA, one of the companies targeted in the investigation, is a case in point. It has purchased some $40 billion in overseas assets in the past two years, often by using the targeted company as collateral for overseas loans. This puts its deals outside the reach of the controls on capital flows and domestic bank loans.

International focus on the Chinese financial system also increased this week with the decision by MSCI, the most influential indexer of emerging market equities, to include Chinese A-shares in its main global indices.

By August 2018, Chinese stocks will make up 0.7 percent of the MSCI Emerging Market Index. While this is only small portion of the index, the changes are expected to lead to an inflow of $17 billion of foreign capital into Chinese equity markets. Much more could follow because the Chinese A-shares market is now the world's second largest by capitalisation, only behind the US.

Goldman Sachs calculates that some $430 billion could flow into Chinese markets if China is fully included. For that to happen, however, MSCI will want to see sweeping changes in the Chinese financial system, including to address concerns about the suspensions of share trading and corporate governance, particularly of state-owned enterprises.

There are also worries about the often-murky connections between major Chinese companies and financial institutions and the shadow financial system, which has tripled in size over the past five years to be worth $9.4 trillion, or 87 percent of gross domestic product (GDP).

Another issue is the level of debt. China's corporate sector is the most indebted in the world, owing an amount equivalent to 170 percent of GDP. Some of the 222 companies to be included in the MSCI index are among the most indebted. There are concerns that some would struggle to pay off their loans if the economy were to slow.

Chinese authorities welcomed the MSCI decision, seeing it as another lever to improve the regulatory regime of the financial system. But given the dependence of the economy on debt and the shadow financial system, the road of "reform" is fraught with contradictions and conflicts.