

# THE SNAKE THAT ATE ITSELF: FINANCIALIZATION OF CHINA'S NEGOTIABLE CERTIFICATES OF DEPOSIT

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China's rapid growth and enormous size have turned it into a global financial leader. Much like China's digital giants, China's closed-off financial sector quickly came to house some of the world's largest banks and mutual funds. But while foreign actors' involvement in China's financial system have been carefully regulated, that level of regulatory care and attention does not necessarily describe China's financial regulatory system writ large.

Risks to China's financial sector have been explored before, from "off-the-books" shadow banking, to systemic debt accumulation by local governments. This paper focuses on one often overlooked and relatively recent aspect of

interbank lending in the People's Republic of China: the negotiable certificate of deposit (NCD).

## INTRODUCTION TO NEGOTIABLE CERTIFICATES OF DEPOSIT

NCDs are bonds that banks can issue to one another that generally have a short-term payback window and a minimum face value of \$100,000. In an NCD exchange, Bank A lends cash to Bank B, and Bank B issues a negotiable certificate of deposit, which Bank A holds until Bank B returns its capital with interest. The certificates can be re-sold to other banks or other institutions like Money Market Funds (MMF). Put another way, NCDs are "IOUs with interest" issued by banks to other banks.<sup>1</sup> Since NCDs must be bought and sold between banks, they are a useful tool for liberalizing interest rates and giving banks greater flexibility setting their own interest rates. This was the case when the first NCDs were invented in the United States in the early 1960s and appears to be why China introduced them in December 2013.<sup>2,3</sup>

In the short time since their introduction, the use of NCDs in China has grown rapidly, from just 28 billion yuan in 2014<sup>4</sup> to 8.69 trillion yuan in March 2018.<sup>5</sup> As of July 2017, NCDs made up approximately 17 percent of all Chinese bonds.<sup>6</sup> By April 2018, NCDs made up the fourth-largest type of bond in China's rapidly expanding bond market, coming after sovereign, local, and policy-bank bonds.<sup>7</sup> China's NCD growth comes at a time of record-slow deposit growth and slow Wealth Management Product (WMP) growth.<sup>8</sup>

Not every kind of bank has used NCDs to the same degree. Joint-stock commercial banks—a bank with both a public and private owner—and city commercial banks issued 98.5 percent of all NCDs as of August 2017.<sup>9</sup> For some small banks, these NCD "IOUs" comprised a significant amount of their funding—as much as 40 per-

cent.<sup>10</sup> This is likely because smaller banks are less attractive to depositors and thus small banks were forced to borrow money through NCDs so as to maintain enough capital to continue operating.

Small banks' debt problems did not originate with NCDs. Even before the advent of NCDs, interbank lending and small bank debt was a problem China's financial regulators recognized and tried to address. After an interbank credit crisis in 2013,<sup>11</sup> the People's Bank of China (PBOC) and China Banking Regulatory Commission (CBRC) decided interbank credit was growing too quickly and in May 2014 set ceilings on interbank loans to not exceed one third of a bank's total liabilities.<sup>12</sup> However, due to a loophole in regulations, from 2013 to 2017 NCDs were not required to be listed as interbank loans on banks' balance sheets, meaning that regulators were not tracking NCD risk as stringently as other risks.<sup>13,14</sup>

In only three years, NCDs quickly became a prominent part of China's bond market and did so while evading strict bank debt caps and regulatory inspection from the PBOC. During that time, it is likely that central authorities grossly undervalued banks' interbank debts—and therefore those banks' levels of risk. In some cases, banks' interbank lending ratios doubled when NCDs were finally incorporated.<sup>15</sup> Furthermore, the proportion of NCDs to all outstanding bonds has grown, meaning NCDs make up an ever larger portion of China's outstanding bonds.<sup>16</sup> This suggests NCDs were substituting other types of bonds—filling a demand that had previously been serviced by a different type of bond rather than meeting the needs of new demands.

The NCD-bank balance sheet oversight was finally addressed by regulators in 2017, when new rules limiting the use of NCDs were announced.<sup>17</sup> In September of that year, China's central bank banned issuance of new NCDs with maturity rates longer than one year, and in so doing, removed some of the NCDs with the highest interest rates.<sup>18</sup> In early 2018, NCDs were officially recategorized to become part of banks' interbank loan total.<sup>19</sup> The PBOC also started requiring banks to request permission both to issue new NCDs and to determine annual NCD quotas. Many banks have already cut down new issuance dramatically. The Bank of Jilin and Bank of Guangzhou, for example, cut NCD issuance by one third and one quarter, respectively, after the new requirements were announced.<sup>20</sup>

## RISKS ACROSS THE VALUE CHAIN

Still, these piecemeal reforms do not solve the most worrisome aspect of NCDs. In addition to the debt accrued by individual institutions, there is now an even larger problem: compounded risk built up as non-bank institutions trade and re-trade NCDs. As China's overall economic growth slows, large banks seek out low-risk, low-yield investments including NCDs purchased from medium-sized banks. Medium-sized banks then use the funds they received from selling NCDs to large banks to purchase investments with slightly higher risks and slightly higher yields, including purchasing NCDs from small banks. Small banks then use the funds they received from selling their own NCDs to invest in higher risk and higher yielding wealth management products.<sup>21</sup> In other words, these products must profit enough to allow small and medium bank

intermediaries to fulfill their respective obligations up the value chain. Thus, large bank lenders are increasingly, though indirectly, dependent on high-risk wealth management products.

Compounding this problem is the trend at the bottom of the value chain. When NCDs first came onto the market, the majority of NCDs were issued to allow higher-risk small, commercial, and rural banks to receive capital from safe, deposit-rich state-owned banks. Yet over time, small banks began selling NCDs to non-bank intermediaries.<sup>22</sup> Between December 2013 and September 2015, state-owned banks were the primary purchasers of NCDs, but after September 2015 MMFs held 30-40 percent of all NCDs.<sup>23</sup> After selling NCDs, many small banks used the cash they received from large banks to invest in higher yielding MMFs.<sup>24</sup> Thus, small banks became both the client and the creditor of non-bank intermediaries.

Each transaction is accompanied with a slightly higher degree of risk with the promise of slightly higher returns. And if these two sectors purchase and sell NCDs between each other without investing in the real economy, both entities' balance sheets become more departed from real value creation—what is sometimes referred to as “financialization,” where profits occur through financial trading instead of through trade or production.

Selling NCDs to investment funds transforms NCDs into something beyond an interbank problem. In fact, mutual funds now make up about 2.5 trillion yuan of such debts, with NCDs making up over 20 percent of many funds' portfolios.<sup>25</sup> For example, Yu'e Bao is the world's largest money mutual fund and is owned by Ant Financial, the payment affiliate of Alibaba Group Holding Ltd. According to Macrobusiness, an Australian economics and markets blog, a major driver of Yu'e Bao's asset growth for the last few years has been the increase in Yu'e Bao's investment in NCDs.<sup>26</sup> As recently as 2014, Yu'e Bao's NCD holding made up 87 percent of their overall portfolio.<sup>27</sup>

The pressure is now on for Yu'e Bao and other funds to perform well—not only to pay back investors on their promised high rates of return, but also to pay back rural banks who invested in them. Rural banks expect to get back enough profit on their investments so as to repay the medium and large banks they sold NCDs to. In other words, large banks which are considered “safe” investments are purchasing NCDs from smaller banks which are considered “riskier” investments. Small banks in turn are selling NCDs to mutual funds as well. The ability to repay NCD capital plus interest requires other NCDs to be repaid. Debts can only be repaid if other debtors make good on their payments.

Evaluating the losses incurred from NCDs and their risks relative to other financial instruments can be difficult. Efforts to reduce the most unstable aspect of the NCD bond system—small banks selling NCDs to MMFs and purchasing WMPs and other securities—have been central. Analysts of China's bond market have speculated whether PBOC officials would allow smaller banks to default on their NCDs. Instead, Arthur Lau of Pinebridge Investments suggests that “they [the PBOC] are likely to ask strong banks to take over, especially to avoid any systematic crisis”<sup>28</sup> rather than risk allowing smaller banks to default on their securitized NCDs en masse. This suggests that such a default could have an

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## THE STORY OF THE NCD PAINTS AN IMPORTANT PICTURE FOR HOW “WHACK-A-MOLE” PIECEMEAL REGULATIONS WITHOUT A COHESIVE REGULATORY FRAMEWORK CAN FAIL TO CONTROL GROWING FINANCIAL RISKS.

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existential risk on China’s bond market. As of April 2018, it seems that big banks are indeed issuing more NCDs. In Q1 of 2018, China’s five largest lenders issued 424 billion yuan in NCDs, doubling the previous record set in Q3 of 2017, supposedly in reaction to low deposits over that time.<sup>29</sup>

### LARGER IMPLICATIONS

While the growing rate of banks in China dependent on interbank lending and NCDs may sound dry and obscure, they play into a larger trend the Chinese Communist Party (CCP) is very aware of: China’s economy is overly dependent on unstable investments. At the 19th Party Congress, Xi Jinping

identified financial risk as one of China’s three biggest priorities. Dubbed the “Three Battles,” (三大攻坚战) reducing financial risk alongside reducing pollution and poverty has become a key focus of the CCP. Having been set as a goal by Xi Jinping himself, losing the financial risk “battle” is not an option. Yet local governments and banks are struggling to balance this alongside the needs of the real economy.<sup>30</sup> The lack of available credit is already preventing banks from lending to China’s private sector, which is contributing to defaults among small, medium, and large enterprises.<sup>31</sup>

The story of the NCD paints an important picture for how “whack-a-mole” piecemeal regulations without a cohesive regulatory framework can fail to control growing financial risks. This normally benign, low-risk loan has been used to skirt restriction policy meant to curb overspending. Though NCDs have existed in other contexts, China’s financialization of NCDs is unique and creates the illusion of profits while creating little real value in the economy.

NCDs are also a keyhole into the often-locked door of policy decisionmaking within China’s financial system, especially as it pertains to reeling back financialization and securitization. One method demonstrated was to cauterize the way that Chinese banks had begun to use the NCD in non-traditional ways, mainly by removing the inordinately long repayment period of five or more quarters back to the Western standard for NCD repayment of less than one year.

It’s important to avoid over-extrapolating based on one poorly performing aspect of China’s financial system, though their size and scale warrant analysis as a real risk to China’s financial system. In isolation, NCD purchases seem like sound investments, but on a grand scale the financialization of this product amounts to a slowly decreasing pile of money being passed between institutions. Or put more viscerally, for lack of other sources of meat (high-return investments) this snake (the banking system) is eating its own tail. In a worst-case scenario, if not properly managed NCDs could easily assume the same role in China’s economy as housing mortgages played in the United States in 2008.

Within the context of a trade war with the United States, pressure is now on China’s financial system in a way that has not been in recent years. Such pres-

sure may reveal holes in China's economic policy infrastructure that, if not smartly plugged by policy in the future, will continue to beguile central policy-makers and slow or freeze whatever real economic growth China is producing. China doesn't just need smart financial policies; it needs a comprehensive policy framework to avoid these types of risks.

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## ENDNOTES

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