CHINA INSIGHT: Foreign Banks Invited to End of the Credit Party

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(Bloomberg Economics) -- In the 2000s, China invited foreign banks into the domestic market, as it tried to manage down a legacy of bad loans. HSBC bought a share of Bank of Communications, Royal Bank of Scotland took a minority stake in Bank of China and Bank of America purchased a piece of China Construction Bank – helping them on their way to listing. Fast forward to 2017 and the bang is bigger. Based on an announcement Friday, limits on foreign ownership of Chinese banks and asset managers will be removed, and foreign firms will be able to take a 51% stake in securities and life insurance firms. But the aim is the same – helping clean up a financial mess, and prevent it from happening again.

Bloomberg Economics had flagged financial market opening as one of the possible deliverables from this week's U.S. - China summit. Recognizing that the devil will be in the as-yet-unknown details, here's our take on the implications:

* There's potential for a grand bargain here. China's financial system will receive an influx of foreign capital and expertise.

That will help deal with the aftermath of a credit binge that has seen debt swell to 259% of GDP, and engineer efficiency gains that may help prevent a repeat occurrence. After paying the price of entry, foreign firms will get a piece of the Chinese market – the second largest and fastest growing in the world.

* China is not about to surrender control of its financial system to foreign banks. The state-owned banking system remains a critical instrument for managing development strategy (allocating credit to priority industries and projects) and the economic cycle (opening and closing the loan spigots as needed to boost growth or control inflation). The giant state banks – Industrial and Commercial Bank of China, Agricultural Bank of China – and others, will retain a dominant role.

* Even in the absence of market-access or regulatory controls, starting from zero or very limited branch networks foreign banks will face an uphill struggle to gain market share. One possible short cut could be to acquire a troubled joint stock commercial bank or city bank. Many of China's smaller banks have strong growth prospects but weak balance sheets and poor risk management. An infusion of capital and know-how from a foreign acquirer could help pay down bad debt and strengthen operations.

Shadow Loans as a Share of Total Bank Assets

* Based on BE analysis of the balance sheets of 41 Chinese banks, joint stock and city banks were substantially more exposed to risks from shadow banking, and significantly more reliant on high-cost wealth management products for funding. As of 2016, shadow loans accounted for 17.2% of assets at joint stock banks, compared with 1.1% for the big state-owned banks.

Banks with weak balance sheets, but strong branch networks and growth potential, could be the focus for foreign firms looking to enter the market.

* The announcement, which came just after U.S. President Donald Trump wrapped up a two-day visit to Beijing, should help deliver on the promise of a more balanced economic relationship. The outcome should be an increase in earnings for U.S. financial services firms in the Chinese market. It won't help out Trump's constituency of blue-collar workers, priced out of global labor markets by low cost-Chinese competitors, though some could benefit if China lowers tariffs on vehicle imports.

* A critical unanswered question is what this means for cross- border capital flows. China will doubtless welcome inflows from foreign buyers. The question is how profits are treated, and what happens to capital if foreign buyers decide to sell out.

Will getting out be as easy as getting in? Those questions are compounded for securities firms and asset managers, which by the nature of their business manage high-volume, short-term flows.

China is just exiting two years in which massive outflows triggered hardening of capital controls.

* Coming hard on the heels of the end of the 19th Party Congress, the move to financial market opening raises the question as to whether other major policy shifts could be forthcoming. Most notably, could the People's Bank of China be preparing for aggressive monetary tightening as they attempt to deleverage? BE's view on this remains that policy makers are more likely to prefer deleveraging solutions that don't have a high price tag in lost growth. Market opening fits squarely into this category.

Foreign Banks as a Share of Total China Bank Assets

* Finally, a note of caution. Friday's announcement looks significant. So far though, details are lacking. There are many ways in which Chinese policy makers could slow-walk market opening. There are many reasons foreign firms might be cautious about stepping into the Chinese market. Sixteen years after China's entry into the World Trade Organization, the share of bank assets controlled by foreign firms is low, just 1.3% as of 2016. That's now set to rise. How fast it does so, remains to be seen.

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