Baoshang, Jinzhou, Hengfeng: The Rise of China's Regulatory Regime

The Chinese banking sector has been rocked by a series of debt-fueled crises in recent months. The trigger: a small regional bank by the name of Baoshang Bank (包商银行). In May, China's banking and insurance regulator announced the takeover of Baoshang Bank. The announcement of the seizure sparked fears of interbank liquidity issues and pushed up yields on money market instruments. Notably, yields on negotiable certificates of deposit – a large-sum deposit sold on secondary markets – rose over ten basis points.

Following Baoshang Bank, Hong Kong Stock Exchange-listed Bank of Jinzhou (锦州银行) – another regional commercial bank in China whose shares have been suspended from trading since April – received a de facto bailout from Chinese state investors in July. A month later, China bailed out yet another regional bank – HengFeng Bank (恒丰银行).

A common issue ran through all three cases: a disproportionate debt-to-asset ratio leading to severe capital adequacy problems.[1] Unsurprisingly, this issue is prevalent across the Chinese financial sector and is emblematic of deep-rooted structural issues from decades of poorly regulated economic development.

Debt-fueled growth is not new or interesting from a purely economic perspective, as it is a development model used by both states and enterprises. However, the model is particularly exposed to global macroeconomic variables. As China is quickly learning, a national model of debt-fueled growth works fine when the global macroeconomic environment is accommodative, but in the absence of a mature regulatory regime capable of overseeing and correcting economic development, external and internal shocks can derail the economy very quickly. One need to look no further than the rapid rise of China's shadow banking sector, which played a major role in the ballooning of private sector debt. In other words, an economy pursuing debt-fueled growth has unlimited exposure when improperly regulated.

Following the 2008 financial crisis, the Chinese regulatory authorities have been gradually gaining new powers to referee the ballooning domestic financial sector. With the merging of the once-separate insurance and banking regulators in 2018, the central government has demonstrated both a more mature understanding of the risks of high finance, and the increasing need to regulate the sector's activities. However, the development of the Chinese regulatory regime has faced substantial roadblocks. Notably, politics oftentimes prevents the regulators from playing their role properly. Similarly, vague policies along with retrograde and seemingly random application of regulations do more to instill chaos within the financial sector, as opposed to making the sector more transparent.

With a commitment to the global community to further open up its financial sector, the central government issued 12 new rules for foreign institutions in May this year. These rules, assuming proper implementation, give foreign enterprises unprecedented access to China's financial sector. While a deeper liberalization of this sector is always welcomed by the global community at large and inspires confidence in investors, a close reading of the rules raises the question: are domestic financial institutions up to the challenge?

Chinese financial institutions are not world class, and do not get named among global investment banks and hedge funds. Despite having gargantuan assets, Chinese banks and investment firms are not sophisticated – given that they are mostly state-owned, their mandate is to service the economy, rather than make profit. This is compounded by the fact that Chinese markets suffer from a dearth of financial instruments, which is due in part to the central government's worry that uneducated investors could lose a substantial amount of money trading these instruments and could cause societal problems. At the same time, regulatory authorities are worried that they would be unable to contain the risks rising from financial instruments. In short, Chinese financial institutions will have a hard time competing against their more experienced and more sophisticated foreign counterparts if there is further liberalization of the financial sector. As the structural impediments for foreign investors get slowly dismantled, the central government will need a new method to ensure that its domestic players do not get overrun.

[1] This is not even mentioning the ties of Baoshang Bank and HengFeng Bank to Xiao Jianhua (肖建华) – the now-arrested "Banker of the Princelings".

Cercius Group projects that the Chinese central government will increasingly rely on domestic financial regulators – as opposed to structural policies – to support Chinese financial institutions in a climate of further financial liberalization. This will lead to the rise and consolidation of the Chinese regulatory regime, and the central government will have to cede certain legislative and executive powers to the regulators, so as to allow them to function properly.