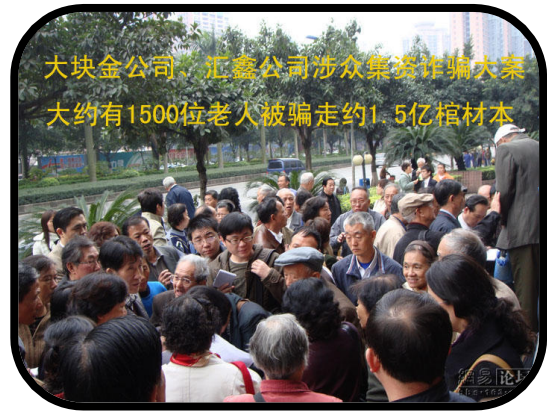


Chinese Shadow Banking System

Composition of the Chinese Banking Sector

China presently has five state-controlled megabanks operating within the supervision of the central government, of which the government is a majority shareholder, and seventeen additional “shareholder banks.”¹ Because China’s state banking sector operates as a direct subsidy-funding channel for state-owned enterprises (as opposed to acting in the capacity of risk analytics-based credit institutions), the largest state-owned banks have required periodic recapitalization every decade over the past sixty years as the constant generation and cumulative exposure to non-performing loans exceeds the banks’ total equity. The circumstances comprising the present situation, however, will include monetary exposure by international asset management firms which have acquired both direct equity-stakes in the banks as well as exposure to Hong Kong-listed shares.



Street Protest in Guangzhou:
Elderly Chinese Demanding Return of Money Lost in a Shark Loan
Ponzi Scheme Organized, Operated and Promoted by Local
Government Officials

State Control and Politically Mandated Loans

The banking system is generally considered to represent the weakest link in China’s political economy. Loans are typically a form of direct subsidy by the central government to the various state-owned enterprises. According to Victor Shih, a professor at Northwestern University who specializes in China’s political economy and is considered an expert on China’s banking system, prior to 1997 there had been no comprehensive audits, nor general ledgers, nor any capital stock at any of the five largest banks, as such was considered unnecessary.² The central government, which controls 98% of China’s financial sector, maintains control over the banks in order to finance various political and socio-economic policy objectives, maintain capital controls and set

¹ The [People’s Bank of China](#) (PBoC) is China’s central bank and is responsible for implementation of monetary policy. The China Banking Regulatory Commission (CBRC) is responsible for regulation of the banking sector on the Chinese mainland. China’s five large state-controlled banks are the [Industrial and Commercial Bank of China](#) (ICBC); [China Construction Bank](#) (CCB); [Bank of China](#) (BOC); [Agricultural Bank of China](#) (ABC or AgBank); and the [Bank of Communications](#) (BoCom). China also has three state-controlled “Policy Banks” including the [Agricultural Development Bank of China](#) (ADBC); [China Development Bank](#) (CDB); and the [Export-Import Bank of China](#) (Chexim).

² Source: Hightable interview with Victor Shih (Associate Professor at Northwestern University) and Carl Walter (Former COO and Managing Director of JP Morgan China). The interview consists of four video segments which are accessible at:

Video: Carl Walter and Victor Shih on the Chinese Banking System, Part 1 -

<https://www.hightable.com/banking/video/video-carl-walter-victor-shih-chinese-banking-pt-1>

Video: Carl Walter and Victor Shih on the Chinese Banking System, Part 2 -

<https://www.hightable.com/banking/video/video-carl-walter-victor-shih-chinese-banking-pt-2>

Video: Carl Walter and Victor Shih on the Chinese Banking System, Part 3 -

<https://www.hightable.com/banking/video/video-carl-walter-victor-shih-chinese-banking-pt-3>

Video: Carl Walter and Victor Shih on the Chinese Banking System, Part 4 -

<https://www.hightable.com/banking/video/video-carl-walter-victor-shih-chinese-banking-pt-4>

fixed interest rates, comprising in effect a self-referential sector, resulting in inefficient capital allocation which deprives China's small and medium-sized enterprises ("SMEs") of access to credit through the supervised banking system.³

Rejection of Western Credit Practices: Global Financial Crisis Doomed Reforms

The government halted and subsequently reversed reforms, and began moving away from western banking practices in late 2008 in response to the global credit crisis, ordering banks to originate loans to both local and centrally-planned investment projects in order to prevent a rapid slowdown in growth.⁴ The credit expansion undertaken by banks in 2009 at the direction of Chinese president Hu Jintao resulted in approximately \$3.1 trillion in new loans created by the end of 2010.⁵ The National Development and Reform Commission ("NDRC") fast-tracked and granted approval of virtually 100% of all fixed-asset investment projects submitted for funding by local governments.⁶ The NDRC was created to address the response to a survey by the central government asking local government officials to identify those projects for they had been unable to obtain credit financing. The role of the NDRC is to approve the projects rejected by the banks, thus in essence having approved the worst projects for financing in 2009 and continuing to approve such projects through the present.⁷

³ Although the private sector (which is presently shrinking) employs 80% of China's workers, private businesses receive only 20% of all Chinese bank loans according to MIT professor Yasheng Huang, author of the book, *"Capitalism with Chinese Characteristics."* The Chinese Communist Party has penetrated all aspects of the country, especially the financial sector and banking system. As a result, China's financial sector as a share of the country's GDP is much higher than is typical of emerging market economies. Although China formally recognized the legality of privately-owned enterprises in 1988, China's stock market was established in 1991 for the primary purpose of concentrating trading in government bonds. Banks subsequently displaced individuals as investors in government bonds. A senior executive at a large Chinese bank reportedly stated, "Right now, China's banks are ill-equipped to lend to small- and medium-size enterprises partly because of a lack of expertise in assessing risks." Source: *"China Tests Looser Financial Model,"* by Lingling Wei, Dinny McMahon and Tom Orlik, Wall Street Journal (March 29, 2012).

⁴ Before the central government's policy reversal, the next planned phase of financial sector reform consisted of two components; the first would have been to clean up and list many of the hundred or so other financial institutions which remain in government hands and secondly, to centralize the thousands of rural co-operatives quietly operating outside of the government's direct control. That would not have proven easy, as many unlisted outfits are run by local municipalities that derive substantial benefits from them, either directly or through politically directed loans. It would have been unlikely that entrenched interests would have surrendered control without a protracted and contentious effort. Source: interview with Victor Shih and Carl Walter (Id. at 51). See also: *"Undoing Chinese Bank Reform,"* by Patrick Chovanec, Wall Street Journal (May 07, 2009). The report is accessible at: <http://online.wsj.com/article/SB124164190279492955.html>
See also: *"Corruption May Undo China's Economic Miracle,"* by Victor Shih, Financial Times (August 19, 2011). The report is accessible at: <http://blogs.ft.com/beyond-brics/2011/08/19/guest-post-corruption-may-undo-chinas-economic-miracle/>

⁵ *"Beijing's Financial Day of Reckoning is Near,"* by Carl E. Walter and Fraser J.T. Howie (*Wall Street Journal*, June 21, 2011).

⁶ Victor Shih interview video (#2). Projects automatically granted approval by the NDRC included construction and expansion of airports; railroads; stadiums; roadways and bridges. In numerous instances, existing facilities were demolished and rebuilt. The NDRC approved \$300 billion in loan requests by municipal governments within a period of four weeks, including project reviews.

⁷ In 2009, new loans originated by China's state-controlled banks equaled approximately 127% of GDP. According to a Q3 2012 research note issued by Charlene Chu at Fitch Ratings, China's banking sector assets increased from \$9 trillion in late 2008 to \$21 trillion at present. Ms. Chu stated that even a mild economic tremor could "wipe out the sector's entire earnings."

Capital Formation in China: Access to Domestic and International Capital Markets

I. China's Domestic Stock Markets

There are presently two major stock exchanges located on the Chinese mainland, the largest in Shanghai and the other in Shenzhen. On both exchanges, there are four basic types of shares which exist: state shares, legal person shares, individual shares, and foreign capital/person shares. State shares refer to shares held by government agencies or authorized institutions on behalf of the state. State shares are not allowed to be traded on an open market. Legal person shares or 'C' shares are shares of a joint stock company owned by another company or institution with a legal person status. The transfer and trading of legal person shares is also restricted. Individual common stock shares, referred to as 'A' shares, may only be owned by Chinese citizens. 'A' shares are denominated in Chinese yuan and can be freely traded and transferred in China's domestic markets. One-third of the total outstanding 'A' shares are available for purchase and trading, while two-thirds of 'A' shares are owned by the Chinese government, rendering them inaccessible to investors.⁸ Through the Qualified Foreign Institutional Investor (QFII) program, foreign investors may also invest in 'A' shares.⁹ The QFII program has a newly-assigned quota of \$80 billion, recently increased from \$30 billion in an attempt by the central government to try to stimulate share price performance.¹⁰

Foreign capital shares include 'B' shares (introduced in 1992) and shares listed on foreign stock exchanges. 'B' shares are publicly traded Chinese stocks in which both foreign and domestic investors are permitted to invest. 'B' shares are issued, traded, and are payable in various foreign currencies including the U.S. dollar, although the face value of a 'B' share is denominated in Chinese yuan.¹¹ Many of the publicly traded companies issue both 'A' shares and 'B' shares, although the current trend is unfavorable with respect to the relevance of the 'B' share market, which has become highly illiquid as an ever greater number of companies delist.¹²

⁸ Source: Asian Equity Research Institute. A description of the various types Chinese securities, including tradable foreign and domestic shares, is accessible at: <http://www.aeriresearch.com/Services/InvestingInChina.aspx>

⁹ According to a statement appearing on the China Securities Regulatory Commission website, foreign investment under the QFII program accounts for 1.1% of the total market value of domestic 'A' shares. According to David Semple, Director of International Equity at the Van Eck Emerging Markets Fund in New York, the increase in the QFII quota may attract some investors, but cautioned: "...there are still restrictions in terms of the amount, the transparency and repatriation of money. It's still a long way from being ideal for a foreign investor." Source: *"China Accelerates Markets Opening as QFII Quota Doubles,"* by Ye Xie and Belinda Cao, Bloomberg News (April 03, 2012). The report is accessible at:

<http://www.bloomberg.com/news/2012-04-03/china-increases-qfii-by-50-billion-and-rqfii-by-50-billion-yuan.html>

¹⁰ In an effort to counter the negative economic effects of the increase in capital flight, which began in 2011 and which remains underway, the China Securities Regulatory Commission also increased the official quota for the importation of local currency by offshore persons to 50 billion yuan (approximately \$8 billion). The new quota represents an increase of 30 billion yuan over the previous quota of 20 billion.

¹¹ 'B' shares listed on the Shanghai Stock Exchange are denominated in U.S. dollars, while those listed on the Shenzhen Exchange are denominated in Hong Kong dollars.

¹² The Chinese class 'B' foreign currency-denominated stock market has performed poorly over the past decade, with few new listings as a result. As an example of the anticipated migration away from 'B' share listings, China International Marine Containers (Group) Co. Ltd. (CIMC), the world's largest manufacturer of shipping containers and whose class 'B' shares trade at a steep discount to the company's 'A' shares, recently applied for regulatory approval to delist from the mainland exchanges and move the listing to Hong Kong. The new "par value" standard adopted by the China Securities Regulatory Commission exposes numerous companies listed on China's 'B' share

Other share classifications include ‘H’ shares referencing shares of companies incorporated in mainland China which are floated and listed on the Hong Kong stock exchange and are denominated in Hong Kong dollars. ‘Red Chips’ refer to shares of companies which are listed on the Hong Kong exchange and which are not incorporated in mainland China, but which have the concentration of their business activities focused on the mainland. ‘N’ shares are issued as American Depositary Receipts (ADRs) on the NYSE and NASDAQ exchanges. ‘L’ shares are issued on the London Stock Exchange. ‘S’ shares reference Chinese companies listed on the Singapore Stock Exchange.

- Shanghai Stock Exchange (SSE)

Originally founded in 1891 as China’s first stock exchange and then re-established on November 26, 1990, the Shanghai Stock Exchange (SSE) is China’s largest stock market and the world’s sixth largest based on a market capitalization of \$2.4 trillion as of mid-2012 (down from being fifth-ranked in December 2011).¹³ The SSE presently has in excess of 900 companies listed and operates as a non-profit organization under the direct supervision of the China Securities Regulatory Commission (CSRC).

SSE Price Indices

SSE indices encompass the full spectrum of securities including equities, funds and bonds, and include the SSE 180 Index (Code: 000010, Abbreviation: SSE 180), SSE 50 Index (Code: 000016, Abbreviation: SSE 50), SSE Dividend Index (Code: 000015, Abbreviation: SSE Dividend), SSE New Composite Index (Code: 000017, Abbreviation: New SSE Index), SSE Composite Index (Code: 00001, Abbreviation: SSE Index), various Sector Indices, SSE Fund Index (Code: 000011, Abbreviation: Fund Index), SSE Government Bond Index (Code: 000012, Abbreviation: Government Bond Index) and SSE Corporate Bond Index (Code: 000013, Abbreviation: Corporate Bond Index).¹⁴ The Shanghai Stock Exchange Composite Index (SHCOMP), initiated on July 15, 1991 with a Base Day of December 19, 1990, is a capitalization-weighted index which tracks the daily price performance of all shares listed on the Shanghai Stock Exchange including both ‘A’ and ‘B’ shares.¹⁵

board to the risk of imminent delisting, and many listed firms have suspended trading in listed shares to avoid involuntary delisting. Source: “*First Chinese B share firm seeks switch to Hong Kong*,” by Pete Sweeney and Donny Kwok, Reuters (August 15, 2012). The report is accessible at:

<http://www.reuters.com/article/2012/08/15/chinamerchants-cimc-idUSL4E8JF0PP20120815>

¹³ Source: World Federation of Exchanges. The organization’s website is accessible at:

<http://www.world-exchanges.org/>

Statistical data for the Shanghai Stock Exchange is accessible at:

<http://www.world-exchanges.org/files/files/1st%20half%20%202012%20WFE%20market%20highlights%20with%20comments.pdf>

The Shanghai Stock Exchange website is accessible at: http://www.sse.com.cn/en_us/ps/home.shtml

¹⁴ A comprehensive listing of SSE indices is accessible at: http://www.sse.com.cn/sseportal/en_us/ps/sczn/zstx.jsp

¹⁵ See: http://www.sse.com.cn/sseportal/en_us/ps/sczn/zstx_home.shtml

Also: <http://www.bloomberg.com/quote/SHCOMP:IND>

The global benchmark designed to capture the Chinese equity universe is the MSCI China Indices which consist of a range of country, composite, domestic and non-domestic indices for the Chinese market, intended for both international and domestic investors including Qualified Domestic Institutional Investors (QDII) and Qualified Foreign Institutional Investors (QFII) licensees. Further information is accessible at:

http://www.msci.com/products/indices/country_and_regional/domestic_equity_indices/china/

- Shenzhen Stock Exchange (SZSE)

Established on December 01, 1990, the Shenzhen Stock Exchange (SZSE) operates a multi-tier capital market comprising the Main Board, SME Board, ChiNext (established on October 23, 2009) and the OTC market (which began operations in January 2006).¹⁶ As of June 2012, the SZSE had a market capitalization of just over \$1 trillion and 1,499 listed companies.¹⁷ Many of the listed companies are subsidiaries of state-owned enterprises in which the Chinese government maintains a controlling interest. The SZSE is regulated by the CSRC.

SZSE Price Indices

The Shenzhen Stock Exchange's primary index is the SZSE Component Index.¹⁸ Various other indices also exist including five new thematic indices: SZSE Consumer 50 Index (Code: 399646, Abbreviation: SZSE Consumer 50), SZSE Health Care 50 Index (Code: 399647, Abbreviation: SZSE Health Care 50), SZSE SME Dividend Index (Code: 399649, Abbreviation: SME Dividend), SZSE SME CORP Governance Index (Code: 399650, Abbreviation: SME CORP Governance) and the SZSE SME CSR Index (Code: 399651, Abbreviation: SME CSR).¹⁹

A new index was launched on August 20, 2012: SINO Real Estate Index (Code: 399393, Abbreviation: SINO Real Estate), which is designed to reflect the return of real estate stocks. The index references December 31, 2004 as the Base Day with 1000 points as the Base Point

- Hong Kong Exchanges and Clearing (HKEx)

Hong Kong Exchanges and Clearing Limited (HKEx) owns and operates a securities market (The Stock Exchange of Hong Kong Limited), a derivatives market in Hong Kong (Hong Kong Futures Exchange Limited) and the clearing houses for those markets (Hong Kong Securities Clearing Company Limited).²⁰ HKEx is one of the world's largest exchanges based on the market capitalization of its 1,500 listed companies, which totaled nearly \$2.4 trillion in mid-2012. The company operates the exchanges and clearing companies under the supervision of the Securities and Futures Commission.

The first formal market for shares, the Association of Stockbrokers in Hong Kong, was established in 1891. The Association was renamed the Hong Kong Stock Exchange in 1914. A second exchange, the Hong Kong Stockbrokers' Association was incorporated in 1921. The two exchanges merged to form the Hong Kong Stock Exchange in 1947 and re-establish the stock market after the Second World War. The Stock Exchange of Hong Kong Limited (SEHK),

¹⁶ The Shenzhen Stock Exchange website is accessible at: <http://www.szse.cn/main/en/>

¹⁷ Source: World Federation of Exchanges. The organization's website is accessible at: <http://www.world-exchanges.org/>

Market capitalization statistics are accessible at: <http://www.world-exchanges.org/focus/2012-07/m-5-3.php>

Statistics for listed companies are accessible at: <http://www.world-exchanges.org/focus/2012-07/m-5-4.php>

¹⁸ See: <http://www.szse.cn/main/en/marketdata/Indiceslist/#>

¹⁹ See: <http://www.szse.cn/main/en/marketdata/Indiceslist/>

Also: <http://www.szse.cn/main/en/AboutSZSE/SZSENews/SZSENews/39748206.shtml>

Also: <http://www.szse.cn/main/en/AboutSZSE/SZSENews/SZSENews/39748324.shtml>

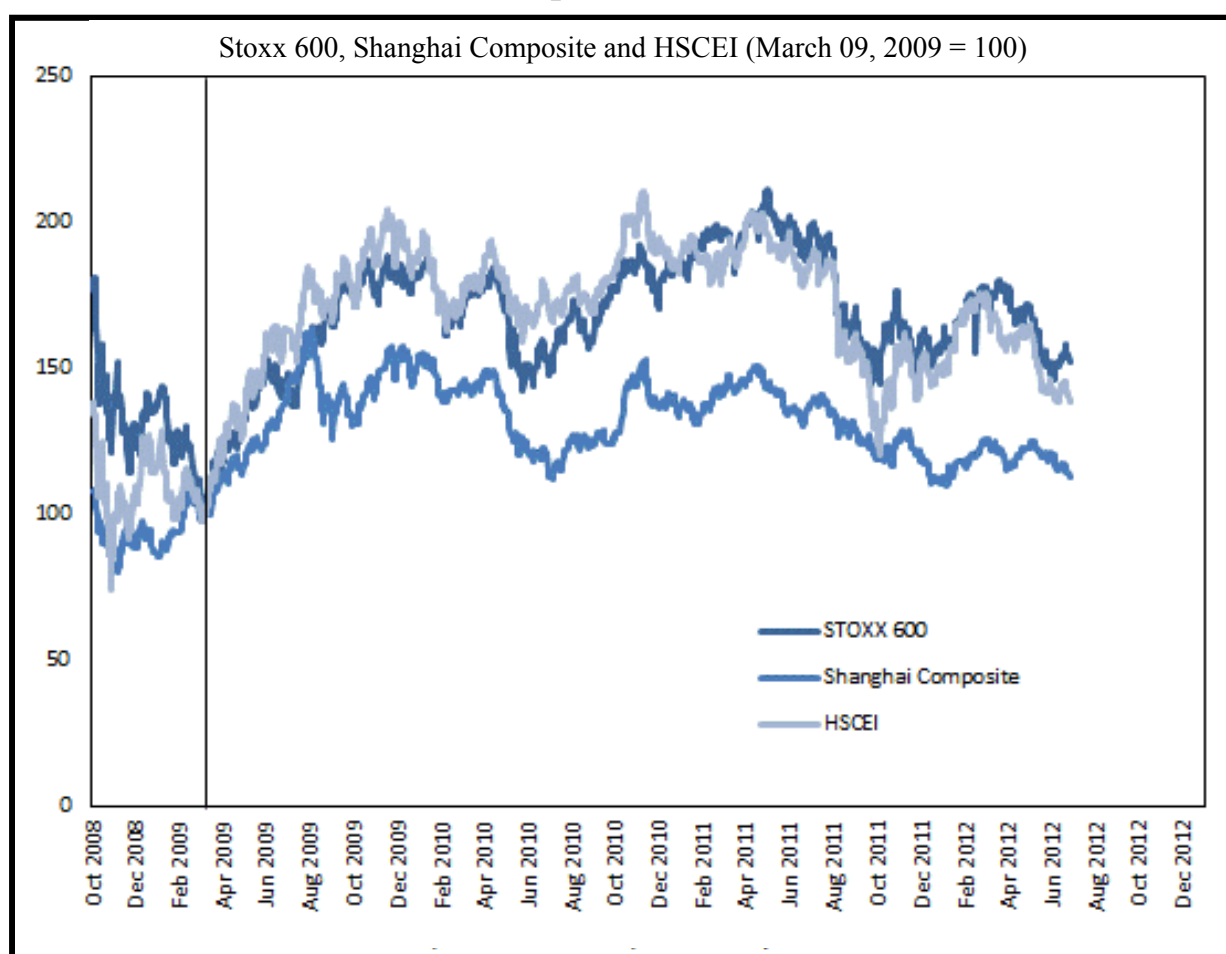
²⁰ The Hong Kong Exchanges and Clearing website is accessible at: <http://www.hkex.com.hk/eng/index.htm>

Hong Kong Futures Exchange Limited (HKFE) demutualised and together with Hong Kong Securities Clearing Company Limited (HKSCC), merged under a single holding company, HKEx. The merger of the three institutions took operational effect on March 06, 2000.

HKEx Price Indices

Hang Seng China Enterprises Index (HSCEI or H-shares Index) is the major index that tracks the performance of China enterprises listed in Hong Kong in the form of 'H' shares. Initiated on August 08, 1994, the market capitalization-weighted index is published by the Hang Seng Indexes Company Limited and comprises the largest and most liquid 'H' shares, although no single company may comprise in excess of 10% of the total index (to prevent single stock domination).²¹ It is the primary indicator of the overall market performance in Hong Kong. The 48 constituent companies represent about 60% of capitalization of the Hong Kong Stock Exchange.

U.S. Dollar-Based Comparative Historical Performance



Source URL: <http://www.alsosprachanalyst.com/markets/china-is-not-europe.html>

As is evident from the above comparative analysis, European equities have outperformed, and continue to outperform, Chinese equities despite the enduring European Union fiscal crisis.²²

²¹ See: http://www.hsi.com.hk/HSI-Net/static/revamp/contents/en/dl_centre/factsheets/FS_HSCEIe.pdf

²² On a "local currency" comparative basis, the results are substantially the same.

U.S. and European Indices Have Consistently Outperformed China



Source URL: <http://www.zerohedge.com/news/so-much-great-buy-brics-trade>

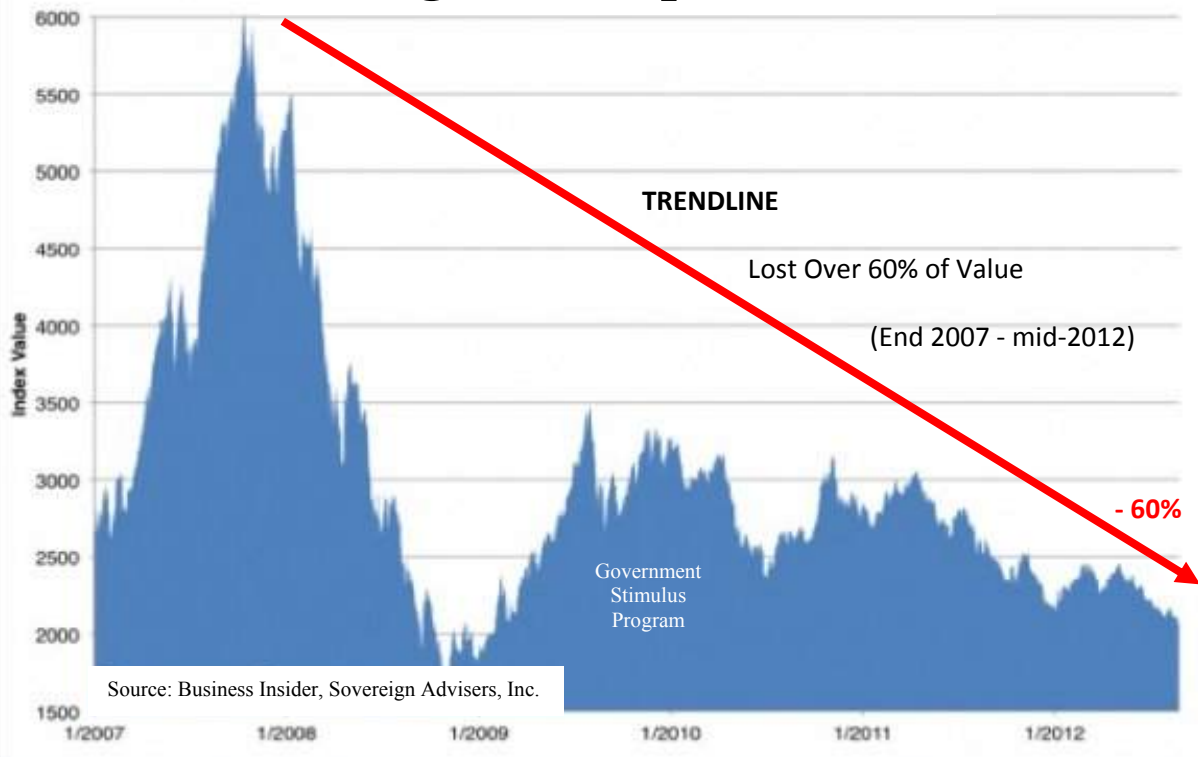
As illustrated in the above chart, China's Shanghai Composite consistently underperforms both the U.S. and European markets as China's political economy with its emphasis on non-economic investment-led growth continues to marginalize the profitability of exchange-listed companies, rendering the country's stock markets increasingly irrelevant to capital formation. The government's investment policies act to constrain private equity investment since the domestic stock market fails to deliver an attractive exit option in terms of equity valuation. As a consequence, stakeholders in private enterprises are increasingly likely to seek a buyout from a Chinese state-owned enterprise or joint-venture partner in order to exit illiquid investments.

- *Key Finding:*

➔ The SSE Composite Index does not capture exposure to China's national GDP growth. As noted above, the likely explanation is that as both the central government and local governments continue to allocate resources into investment in non-revenue generating fixed-asset infrastructure projects as an economic substitute for the lack of domestic consumption, and which projects do not cover the cost of funding, the country is propagating the destruction of economic value even as GDP increases. The resulting overcapacity constrains investment by the private sector, as well as revenues. The continuation of directed investment by the state-owned corporate sector will generate GDP, but in the process will create ever-increasing overcapacity and thus diminishing return on investment. Ultimately, both state-owned and private sector corporate profits will achieve a negative value, even as the country's maintains an 8% annual GDP growth mandate. Thus, Chinese equities fail to provide investors with economic returns which are commensurate with China's overall GDP growth.²³

²³ For further discussion on this point see the report entitled, "This is the China You Don't Want to Invest In," by Also Sprach Analyst (July 13, 2012). The report is accessible at: <http://www.alsosprachanalyst.com/economy/this-is-the-china-you-dont-want-to-invest-in.html>

Shanghai Composite Index



Shanghai Stock Exchange

Market Capitalization: USD\$2,411Bn (mid-2012) / (%) Δ : -14.0% (vs. mid-2011)

Number of Listings: 945 (mid-2012) / (%) Δ : 3.1% (vs. mid-2011)

Value of Share Trading: USD\$1,473Bn (YTD) / (%) Δ : -33.6% (vs. Jan. – June 2011)

Shenzhen Stock Exchange

Market Capitalization: USD\$1,149Bn (mid-2012) / (%) Δ : -10.4% (vs. mid-2011)

Number of Listings: 1,499 (mid-2012) / (%) Δ : 14.3% (vs. mid-2011)

Value of Share Trading: USD\$1,282Bn (YTD) / (%) Δ : -17.3% (vs. Jan. – June 2011)

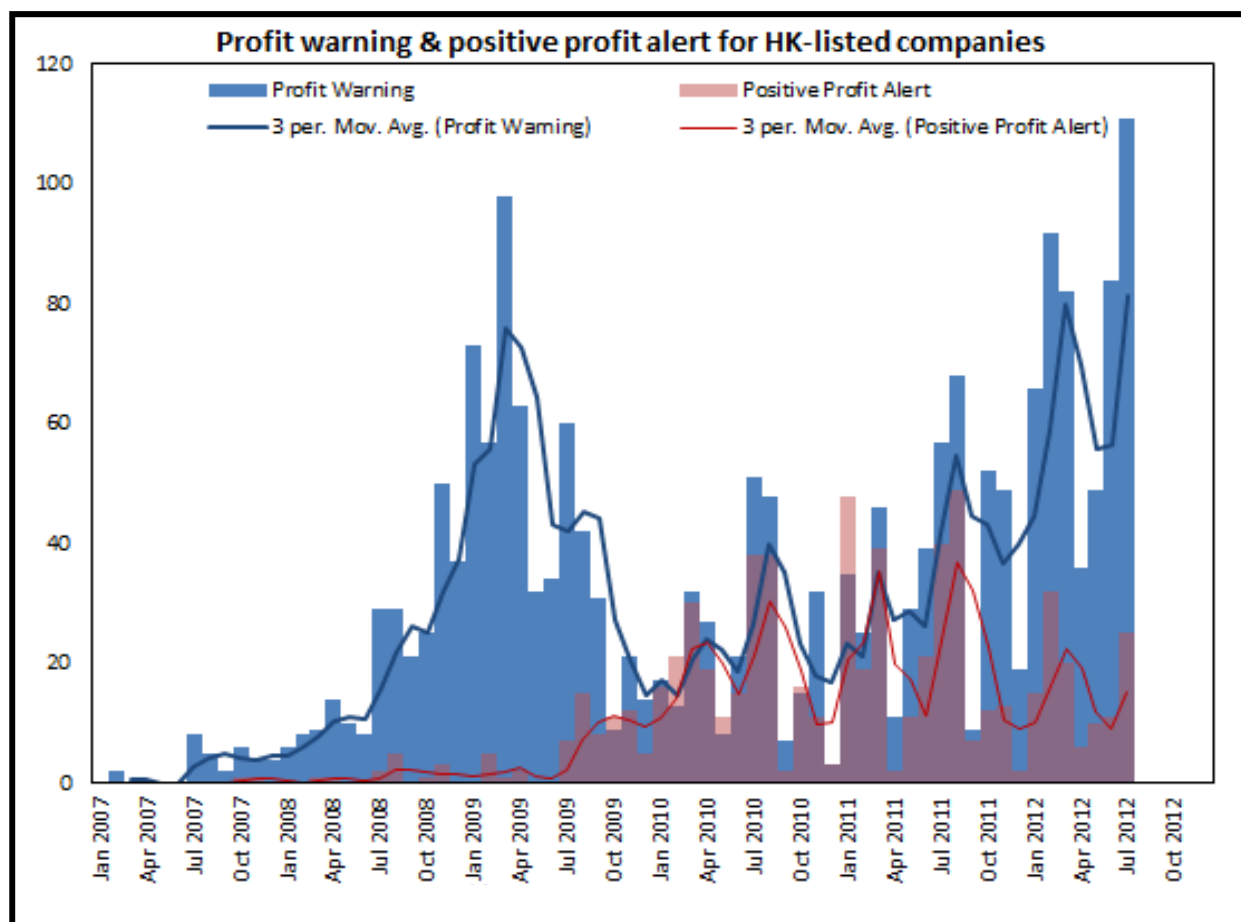
Hong Kong Exchanges

Market Capitalization: USD\$2,376Bn (mid-2012) / (%) Δ : -12.4% (vs. mid-2011)

Number of Listings: 1,519 (mid-2012) / (%) Δ : 4.9% (vs. mid-2011)

Value of Share Trading: USD\$575Bn (YTD) / (%) Δ : -25.8% (vs. Jan. – June 2011)

Sources: "Market Highlights for First Half-Year 2012," World Federation of Exchanges (July 23, 2012). The report is accessible at: <http://www.world-exchanges.org/files/files/1st%20half%20%202012%20WFE%20market%20highlights%20with%20comments.pdf>
 Year-to-Date monthly statistics tables published by the World Federation of Exchanges (data set range: mid-2012 relative to mid-2011).
 The report is accessible at: <http://www.world-exchanges.org/statistics/monthly-reports>
 Source URL (Chart): <http://www.businessinsider.com/chinese-hard-landing-2012-9#>



Source: HKEX and Also Sprach Analyst

Source URL: <http://www.alsosprachanalyst.com/companies/for-many-companies-it-feels-like-a-hard-landing-already.html>

Hong Kong-listed Chinese companies have issued a record number of profit warnings during 2012, surpassing the peak reached during the height of the 2008-2009 financial crisis, and the rate of such warnings continues to increase.²⁴ The fact that corporate profitability is shrinking even as China's GDP continues to increase (predominantly as a function of state-directed non-economic investment) further strengthens the evidence for a decoupling between corporate profitability and China's macroeconomic growth and thus confirms the thesis that China's stock market does not provide investors with the means to capture exposure to China's macroeconomic growth story.²⁵

²⁴ According to data released by Credit Suisse, at the start of the second half of 2012 profit warnings had increased 145% compared to the same period of the previous year. The Credit Suisse report states that many Chinese companies are experiencing a double-digit year-on-year decline in profit during 2012. Source: "Hong Kong-Listed Companies Issue Profit Warnings at a Rate close to 2008/09," Also Sprach Analyst (July 17, 2012). The report is accessible at: <http://www.alsosprachanalyst.com/companies/hong-kong-listed-companies-issue-profit-warnings-at-a-rate-closed-to-200809.html>

²⁵ As the Financial Times recently noted, "Even before the economy's current slowdown, Chinese shares had been among the world's worst investments." Source: "Chinese Exchanges Seek Foreign Funds," by Simon Rabinovitch and Paul J. Davies, Financial Times (September 19, 2012). The report is accessible at: <http://www.ft.com/intl/cms/s/0/a0cf6724-0241-11e2-8cf8-00144feabdc0.html>

In an attempt to stabilize China's stock markets and Chinese share prices, the report also notes that officials from the Shanghai and Shenzhen exchanges have undertaken the highly unusual step of engaging in a global road show, touring Europe, the U.S. and Japan and "...meeting every day with nearly 10 foreign institutions, including pension funds and insurance companies." In an effort to widen the pool of prospective investors, the government has also reduced the mandatory threshold of assets under management for foreign institutions to \$500 million from \$5 billion and has accelerated QFII approvals of foreign investors.

A-Shares CSI 300 Index Year-on-Year Earnings Growth (Excluding Financials)

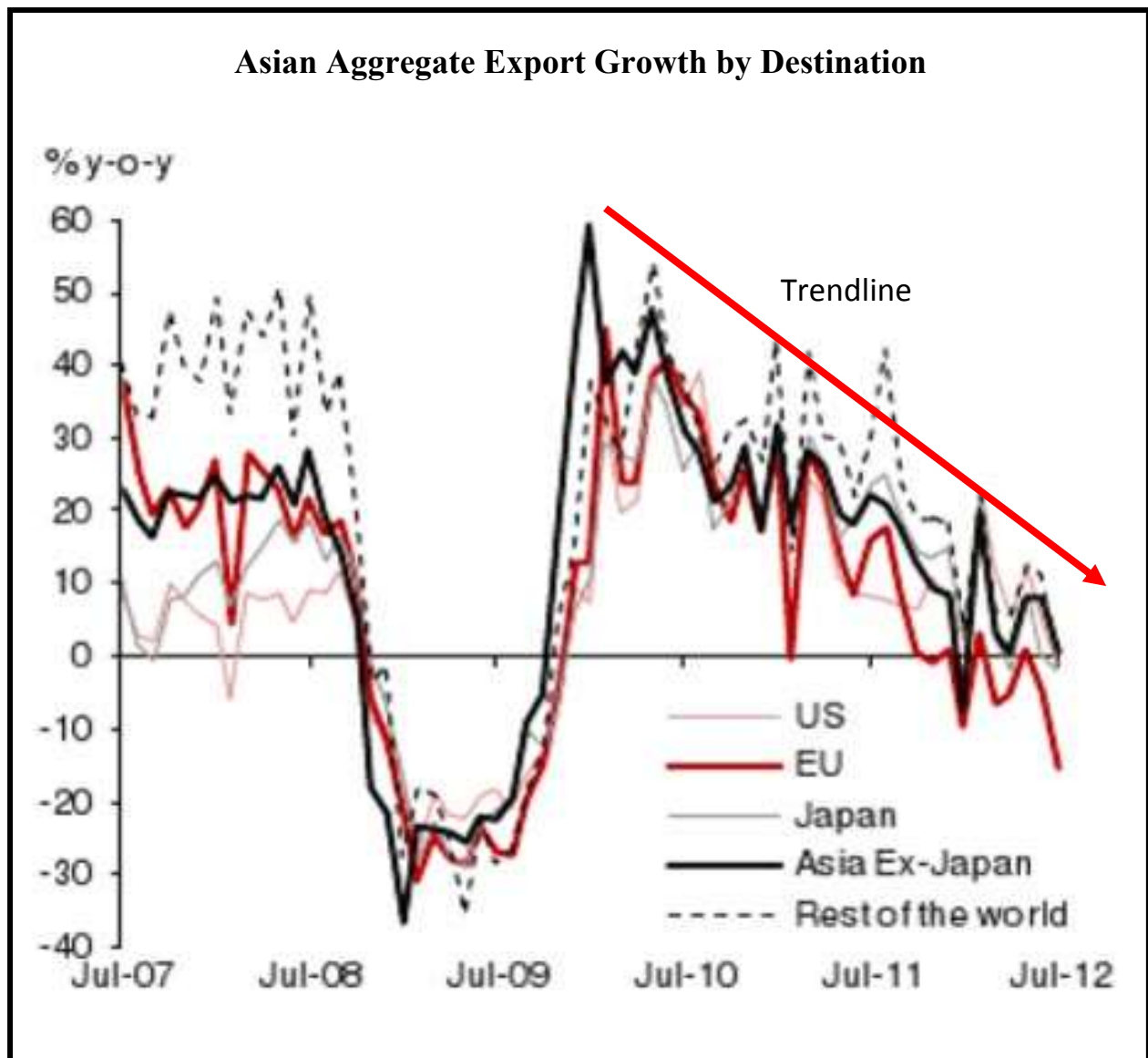
H2 2011	Q1 2012	Q2 2012
- 2.9%	- 11.5%	- 17.6%

Data Source: Goldman Sachs

Chart URL: <http://static.alsosprachanalyst.com/2012/08/image110.png>

Chart Source: "Chinese Corporate Earnings Have Collapsed," Also Sprach Analyst (August 27, 2012). The report is accessible at: <http://www.alsosprachanalyst.com/economy/chinese-corporate-earnings-have-been-destroyed.html>

China's major manufacturing centers are on the brink of bankruptcy (see [here](#) and [here](#)).



Data Source: Nomura

Chart URL: <http://blogs.telegraph.co.uk/finance/files/2012/09/chart.jpg>

Chart Source: "Asian Exports Crumble," by Ambrose Evans-Pritchard, Telegraph (September 04, 2012). The report is accessible at: <http://blogs.telegraph.co.uk/finance/ambroseevans-pritchard/100019794/asian-exports-crumble/>

The China ‘Value Trap’

The record number of profit warnings issued by Hong Kong-listed Chinese companies in 2012 and the dismal economic outlook is reflected in the following data points:

- 1 in 3 publicly-listed Chinese companies suffers cash outflows as downturn spreads to key sectors (read more [here](#))
- Deal volumes in Hong Kong are down 85% over last year (read more [here](#))
- Continuing PMI contraction (read more [here](#))
- Declining rail cargo volume (read more [here](#))
- Declining electrical production (read more [here](#))
- Disappearance of corporate loan collateral from bonded warehouses (read more [here](#))
- Extremely bearish sentiment expressed by Chinese elites attending the World Economic Forum in Tianjin and the Ambrosetti Forum at Lake Como (read more [here](#) and [here](#))

The poor share performance of Chinese companies is a function of structural issues which constrain corporate profits:

- Over-dependency on new incremental fixed-asset investment and misallocation of capital
- Declining export competitiveness (wage and price spiral) and ‘[Triangular Debt](#)’ profit squeeze
- Declining domestic household demand
- Inflation threat: QE3 (U.S.) / risk of increase in food prices leading to food riots and social unrest

The above indicators suggest that in regard to Chinese equities, investors should be wary of falling into a classic ‘value trap’.

*“China was in a bubble and their bubble’s bursting. They have a domestic demand problem that’s emerging, they have an export problem ... and they have an efficiency problem in terms of allocating capital.”*²⁶

- Ray Dalio, Founder of Bridgewater Associates

*“Now we’re starting to hear rumblings out of Hong Kong. Could Hong Kong be the next bastion of fraudulent revelations? It’s difficult to say. But investors need to be wary.”*²⁷

- Carson Block, founder of stock research firm Muddy Waters

*“After what I’ve heard, I’m really worried now about being the dumb foreigner sitting across the negotiating table from the locals who are packed and ready to run to the airport.”*²⁸

- Senior executive from a ‘very large western fund manager’

²⁶ “Investors Risk Fall into China Value Trap,” by Robert Cookson, Financial Times (September 18, 2012). The report is accessible at: <http://www.ft.com/intl/cms/s/0/2369540a-f7da-11e1-8c9d-00144feabdc0.html>

Bridgewater Associates is the world’s largest hedge fund with \$130bn AUM.

²⁷ Statement by Muddy Waters founder Carson Block, speaking at the Council of Institutional Investors spring conference in Washington, D.C. The research firm specializes in uncovering accounting fraud and other illegal practices by Chinese companies trading on U.S. and Canadian stock exchanges (e.g., Sino-Forest). Noting that accounting firm Deloitte Touche Tohmatsu recently resigned as auditor of two Hong Kong-listed companies, Mr. Block advises investors to be wary of Chinese companies trading in Hong Kong. Source: “Muddy Waters: Be Wary of Hong Kong Listed Chinese Companies,” by Hibah Yousuf, CNN Money (April 03, 2012). The report is accessible at: <http://money.cnn.com/2012/04/03/markets/muddy-waters-hong-kong/index.htm>

²⁸ “Bears at the Heart of the Dragon,” by Jamil Anderlini, Financial Times (September 12, 2012). The report is based upon conversations with Chinese officials and analysts attending the World Economic Forum in Tianjin, China. The report is accessible at: <http://www.ft.com/intl/cms/s/2/b0a4db7e-fce3-11e1-ba37-00144feabdc0.html>

II. China's Domestic Bond Market

- China's Bond Market Operates as an Instrumentality of the State

During the first half of 2012, the volume of bond issuance by Chinese non-financial companies had increased approximately 60% from a year earlier, reaching \$134 billion during the first six months of the year compared to just over \$137 billion for all of 2011. Bond issuance by mainland companies had previously increased by 52% in 2011 over the previous year. Chinese companies raised an average of \$8 billion annually from bond issuance prior to 2008, when the PBoC implemented changes to the domestic bond market, most notably changing from an approval-based government agency review to a registration system, which no longer requires government approval for companies to issue bonds.

Chinese state-owned enterprises comprise the largest market participants and state-owned banks are the dominant bond investors. Nine of the ten largest local currency corporate bond sales in Asia during 2011 were by Chinese state-owned enterprises, including China Coal Energy and China National Petroleum Corp. Sinopec and China National Nuclear have also recently issued bonds.

Chinese banks, in addition to being the primary source of capital in China, are among the largest underwriters and investors in corporate bonds, which effectively constitutes the bond market as an extension of the bank loan market. Chinese commercial banks also hold two-thirds of all outstanding bonds in China's domestic market, including government and central bank bonds.²⁹ Such circumstances demonstrate that there has not been a significant dispersal of risk and China's large banks remain directly exposed to issuer debt defaults, whether occurring in the bond market or in the loan market. According to Credit Suisse, China's total reported outstanding bank loans were equal to 123% of GDP at the end of 2011.³⁰

China's nascent bond market remains dominated by the state, and has not yet evolved into an efficient mechanism for capital allocation whereby credit is properly priced. Owing to the relatively recent nature of bond defaults by Chinese companies, default risk has not been extensively utilized as a pricing mechanism for corporate bonds. Instead, bank deposit and lending rates set by the central government represent the primary influence on bond pricing.³¹

²⁹ Source: data obtained from China Bond and cited in a report published by the Financial Times entitled, "*Boom in Chinese Bond Sales Masks Problems*," by Robert Cookson (November 02, 2011). The report is accessible at: <http://www.ft.com/intl/cms/s/0/88bec99e-0554-11e1-b8f4-00144feabdc0.html>

The report notes that, in contrast to the Chinese situation, the primary investors in this asset class in the western developed countries are fund managers (e.g., pension funds).

³⁰ "*China's Corporate Bond Market Booms*," by Simon Rabinovitch, Financial Times (July 12, 2012). The report is accessible at: <http://www.ft.com/intl/cms/s/0/839017b4-cbf8-11e1-839a-00144feabdc0.html>

³¹ Such complacency may be about to change drastically, however, as investors continue to experience a significant increase in bond defaults and develop a corresponding realization for the need to devote greater attention to credit analytics, including independent verification of the assets and revenues claimed by Chinese companies.

III. Access to International Financial Markets by Chinese Companies

Although in recent years numerous mainland Chinese companies including SMEs have obtained listings on Hong Kong and overseas stock exchanges, such ability is constrained by Chinese state secrecy laws which prohibit U.S. and other foreign regulators from having access to audit records of Chinese companies.³² The secrecy laws also do not permit non-Chinese regulators to conduct inspections in China.³³

- Chinese Companies Delisted from Foreign Securities Exchanges

Of the more than 400 Chinese companies which acquired listings on U.S. stock exchanges as a result of the recent wave of reverse mergers and initial public offerings, at least 67 issuers have had auditors resign and at least 126 companies have since been delisted from U.S. exchanges or have halted filing required disclosures with the Securities and Exchange Commission following the emergence of financial and accounting frauds beginning in late 2010.³⁴

*“Probably all these companies have some questionable accounting, so they may prefer to move out of the U.S., not to come under too much scrutiny.”*³⁵

- Marc Faber, Managing Director of Hong Kong fund management company
Marc Faber Ltd.

Instances involving U.S. and Canadian exchange-listed Chinese companies which are alleged to have engaged in operating fraudulent schemes have cost investors the loss of several billion dollars and many of the companies involved in reverse mergers remain under investigation by both the Securities and Exchange Commission and the Federal Bureau of Investigation.³⁶

³² China enacted the country’s secrecy laws in October 2009, immediately prior to the wave of U.S. stock exchange listings by mainland Chinese companies and the subsequent emergence of financial, accounting and operating frauds committed by numerous such companies. Under Chinese law, all accounting records of a Chinese company is considered a state secret. Auditors in Hong Kong are also prevented from allowing access to company records by foreign regulators. See e.g., “*HK Regulator Files E&Y China Secrecy Test Case*,” by Paul J. Davies, Financial Times (August 28, 2012). The report is accessible at:

<http://www.ft.com/intl/cms/s/0/13e9cd1c-f0ea-11e1-89b2-00144feabdc0.html>

³³ In September 2011, the U.S. Securities and Exchange Commission filed a civil suit in United States District Court against accounting firm Deloitte Touche Tohmatsu for failing to produce documents related to the SEC’s inquiry into alleged fraud by Longtop Financial Technologies Ltd., a Chinese company listed on the New York Stock Exchange (NYSE).

³⁴ “*China Agrees Accord with U.S. Audit Agency*,” by Shahien Nasiripour, Financial Times (September 21, 2012). The report is accessible at: <http://www.ft.com/intl/cms/s/0/b2ca0960-042c-11e2-b91b-00144feabdc0.html>

“*Delisting Chinese Groups Worry Insurers*,” by Paul J. Davies, Financial Times (September 02, 2012). The report is accessible at: <http://www.ft.com/intl/cms/s/0/e9635a98-edc1-11e1-a9d7-00144feab49a.html>

³⁵ “*Chinese Companies Pull Out of U.S. Stock Markets*,” by Joe McDonald, Associated Press (August 14, 2012). The report is accessible at: <http://finance.yahoo.com/news/chinese-companies-pull-us-stock-095649722.html>

The report notes that many of the private Chinese companies which acquired listings on U.S. exchanges were unable to raise money on Chinese exchanges and quotes Carson Block, founder of stock research firm Muddy Waters Research, as stating that the stocks of Chinese companies are unsuitable for relatively unsophisticated “...mutual funds and other public shareholders.”

³⁶ In late 2007, our firm wrote a letter to the Office of the Chairman, General Counsel, Director of the Division of Enforcement, and the Director of the Division of Corporation Finance of the United States Securities and Exchange

According to one prominent research firm which specializes in discovery of Chinese company frauds, a mainland China investment bank deliberately assisted private Chinese companies in preparing fraudulent overseas listings for placement on foreign exchanges.³⁷

“This fraud school teaches those Chinese enterprises which are eager for quick profit through their sophisticate mechanism how to make fake sales contracts, fake government filings, and manipulate financial statements to achieve the goal of collecting money by being listed on OTCBB, NASDAQ, AMEX and/or the NYSE.

*According to a source, the “fraud school” is a small investment bank and financing counseling company. It uses a network of accounting firms and law firms based in HK and US to jointly operate to present “trash” enterprises as fast-growing and huge-profitmaking super stars, thus catching the foreign investors’ eyes, gaining private funding, and subsequently going public in the US.”*³⁸

- John Caines, Analyst,
Muddy Waters Research
(Hong Kong)

The Chinese government has also made it more difficult to access public records and has warned the ‘Big Four’ global accounting firms not to provide audit records to overseas regulators.³⁹ In the wake of pervasive stock fraud, the Bloomberg China Reverse Merger Index which tracks 82 small Chinese companies that acquired U.S. listings via the reverse merger process has declined by 67% since early 2010, and a report published in early 2012 predicts a new wave of Chinese company accounting frauds to hit the New York and Hong Kong stock exchanges in the months ahead including additional auditor resignations at Hong Kong-listed companies.⁴⁰



Commission, warning of the danger to investors of inadequate disclosure by Chinese companies seeking to list shares on U.S. stock exchanges. To date, we have not received any acknowledgment of the letter from the Commission. The letter is accessible at:

[http://www.globalsecuritieswatch.org/Complaint Filed with NYSE and NASDAQ.pdf](http://www.globalsecuritieswatch.org/Complaint%20Filed%20with%20NYSE%20and%20NASDAQ.pdf)

³⁷ See video presentation by Muddy Waters Research entitled, “Fraud University” at: <http://vimeo.com/40098291>
Slides (pdf format) appearing in the video are accessible at:

http://www.muddywatersresearch.com/wp-content/uploads/2012/04/MW_FraudSchool_20120410.pdf

³⁸ “Learning the Secrets of the Disaster of ‘China Concept’ Stocks,” by John Caines, Muddy Waters Research (April 2012). The monograph comprises a post-mortem forensic examination of certain documents related to recent Chinese company frauds occurring within the U.S. financial markets. The monograph is accessible at:

http://www.muddywatersresearch.com/wp-content/uploads/2012/04/MW_FrauducationSupportingDocs.pdf

See related publication: “Frauducation Part I: The Fraud School,” White Paper by Muddy Waters Research (April 2012). The monograph is accessible at:

http://www.muddywatersresearch.com/wp-content/uploads/2012/04/MW_FrauducationWhitePaper.pdf

³⁹ “China’s Auditing Train Wreck,” by Carson Block, Wall Street Journal (May 03, 2012). The op-ed is accessible at: <http://online.wsj.com/article/SB10001424052702304746604577381630586235646.html>

⁴⁰ “Auditors on Alert Over Chinese Results,” by Robert Cookson, Financial Times (March 25, 2012). The report is accessible at: <http://www.cnbc.com/id/46851977/>

- Increased Issuance of Chinese Corporate Bonds Linked to Wave of Defaults

China's domestic bond market remains dominated by large state-owned enterprises and although the central government recently authorized the issuance of 'junk' bonds in an attempt to provide capital to SMEs, both domestic and international issuance of bonds by Chinese corporations face severe constraints including past waves of international corporate bond defaults by Chinese companies.⁴¹ A new wave of bond defaults is poised to commence beginning in 2014, at which time many Chinese corporations which presently have outstanding international bonds will experience refinancing needs.⁴²

International Chinese Corporate Bond Yields Jump
Bonds Issued in April 2011 Image credit: Financial Times



*"It needs to be highlighted to investors that they're not going to get their money back unless there's either a vibrant equity or refinancing market offshore for those borrowers."*⁴³

- Michel Lowy, co-founder of Hong Kong-based investment firm SC Lowy

⁴¹ Banks account for 80% of all corporate financing in China, which is far above the average of 50% or less in other countries (both developed and developing nations). Source: Chinese government official data cited in "China's Financial Slow Boat Speeding Up," by Simon Rabinovitch, Financial Times (July 17, 2012). The report is accessible at: <http://www.ft.com/intl/cms/s/0/95ee0dd6-d007-11e1-a3d2-00144feabdc0.html>

Chinese companies have established a history of serial defaults on the international financial markets, but such defaults have been relatively rare on China's domestic bond market where, according to the above report, regulators have begun fast-tracking approvals and encouraging more bond issuance by Chinese companies. According to a report published by the Wall Street Journal ("Lenders Want Their Money from Chinese Milk Supplier," May 05, 2010), the recent wave of international bond defaults by Chinese companies began in early 2009, often involving the disappearance of corporate CEOs as in the instance of China Milk Products Group Ltd., which defaulted on \$170 million in debt owed to U.S. and European bond investors including \$56 million owed to BlackRock Inc. The report is accessible at: <http://online.wsj.com/article/SB10001424052748704866204575224763824551400.html>

⁴² "Investors Warned of Chinese Bond Risks," by Robert Cookson, Financial Times (July 20, 2011). The report is accessible at: <http://www.ft.com/intl/cms/s/0/383a46f4-b2e0-11e0-86b8-00144feabdc0.html>

The report notes that defaults by Chinese groups, from Guangdong International Trust and Investment Corporation (GITIC) in 1999 to Asia Aluminum in 2009, have demonstrated that foreign bondholders have no recourse when mainland issuers default. Although mainland investors recovered a portion of their investment when steelmaker FerroChina collapsed in 2008, offshore creditors received nothing. A Hong Kong-based partner at law firm Clifford Chance is quoted as stating, "[A]s very rarely does an enforcement work, it is usually more a theoretical rather than practical issue unfortunately." Ivan Chung, a Hong Kong-based senior analyst at Moody's Investors Service, also warned investors of the risks endemic to internationally-offered Chinese corporate bonds: "Basically the foreign bondholders are taking the equity risk." According to the report, onshore cash flows will be insufficient for most Chinese companies to meet repayment obligations of internationally-issued bonds, necessitating continued international borrowing in order to avoid defaulting. The report cites an Asian bond fund manager at Manulife Asset Management as stating that in regard to Chinese bonds, "...you'll be punished more if you get it wrong compared to other markets."

⁴³ Id. SC Lowy pioneered investment strategies for illiquid assets within the Asia-Pacific region. The firm's website is accessible at: <http://www.sclowy.com>

Beginning in 2012, several imminent bond defaults on China's domestic market have been narrowly averted, including AAA-rated Angang, one of the country's largest steel producers and whose profits plunged by 91% in 2011 on weak steel prices. Another instance involved Beijing DG Telecommunications Equipment Co., an SME manufacturer of wireless systems, which became unable to repay its debt and invoked a bond guarantee issued by guarantor Beijing Zhongguancun Sci-tech Guarantee Co. In another instance, which required intervention by the local government, rayon manufacturer Shandong Helon received a bailout from state-owned banks just prior to defaulting on corporate bonds which the company was unable to repay.⁴⁴

*"Defaults will be increasingly frequent because so much was borrowed over the past few years that has to be paid back now."*⁴⁵

- Wang Jing, head of fixed-income research at Jinyuan Securities

- Foreign Investment in Chinese Corporate Bonds

- A. Dollar-Denominated Bonds Issued by Offshore Special Purpose Vehicles

China maintains strict capital controls which prevent private mainland companies including SMEs from borrowing from foreigners directly. Thus, the majority of Chinese companies which issue bonds internationally do so through offshore holding companies or special purpose vehicles. The proceeds are then invested directly in the onshore company in the form of a minority equity stake.⁴⁶ In essence, foreign bondholders are holding obligations issued by an

⁴⁴ "Defaults Spotlight China Credit Risks," by Simon Rabinovitch, Financial Times (January 06, 2012). The report is accessible at: <http://www.ft.com/intl/cms/s/0/2847cfc6-384d-11e1-9f07-00144feabdc0.html>

In reference to the bank bailout of Shandong Helon, see "China's Corporate Bond Market Booms," by Simon Rabinovitch, Financial Times (July 12, 2012). The report is accessible at:

<http://www.ft.com/intl/cms/s/0/839017b4-cbf8-11e1-839a-00144feabdc0.html>

The Chinese bond market is regulated by three separate entities: The National Development and Reform Commission supervises bond issuance by state-owned enterprises; the China Securities Regulatory Commission oversees bonds issued by exchange-listed companies and traded on a public exchange; and the PBoC regulates the issuance of commercial paper and medium term notes, which are restricted to the interbank market. In 2008, the PBoC established a new regulatory regime which encompassed all three regulatory agencies and which abolished the approval-based system and replaced it with a registration-based system, effectively transferring responsibility for assessment and evaluation of credit risk from bond market regulators to bond investors. In June 2012, the CSRC established a new high-yield 'junk' bond market, also based on a registration (versus approval) system. According to data from Thomson Reuters, the issuance volume of exchange-listed bonds is approximately equal to that of medium term notes.

⁴⁵ "Defaults Spotlight China Credit Risks," by Simon Rabinovitch, Financial Times (January 06, 2012).

⁴⁶ Id. Similarly, one of the chief reasons frequently cited for the poor performance of China's Shanghai Composite stock exchange, which has consistently ranked as the worst performing equities market in Asia, is the propensity for state interference in the operations of listed companies at the expense of minority shareholders. The principal motivation for government interference in corporate governance is that listed state-owned enterprises are charged primarily with performing national service. Rather than providing an effective means of accessing the country's economic performance, China's stock market has barely kept abreast of inflation over the past decade and functions in a manner analogous to a casino gaming operation, characterized by an average annual portfolio turnover of 700% by retail investors and 300% by mutual funds, which are evaluated on the basis of weekly performance. It is notable that **neither the China Insurance Regulatory Commission (CIRC) nor the National Social Security Fund (NSSF) permit Chinese pension and insurance funds to be invested in shares listed on the Shanghai Composite** yet the government has invited additional participation by foreign investors, increasing the ceiling on

empty shell, which then acquires a stake in the operating company in China. The investors thus have no direct security interest in the underlying company assets. Additionally, since the offshore bonds are not treated as debt on the mainland company's balance sheet, foreign bondholders are subordinated to onshore creditors and are therefore extremely unlikely to recover any portion of their investment in the event of distress.⁴⁷

*"Even if the bondholders get their money back in five years, they are not being paid an appropriate rate of return. They have been taking equity risk for a bond return."*⁴⁸

- Tom Jones, Co-Head of Asia for Alvarez & Marsal

B. 'Dim Sum' Bonds: Next Chinese Reverse Merger Fraud?

The other manner in which foreign investors have acquired exposure to bonds issued by Chinese companies is through renminbi-denominated 'dim sum' bonds issued in Hong Kong and in London.⁴⁹ These debt obligations have been issued by both Chinese issuers (predominantly property developers; municipal governments; and SMEs) and by European corporations unable to raise funds in their own national markets. In addition to exposure to macroeconomic systemic risks endemic to the Chinese economy (including a systemic debt crisis), investors in dim sum bonds are also exposed to corporate re-leveraging risk as typical covenant protections for

foreign ownership of listed Chinese equities and bonds to \$80 billion and increasing the range of foreign institutions which may apply for investment quotas. Chinese retail investors have reportedly lost almost all faith in domestic Chinese stocks, known as 'A' shares, and have instead turned their focus to property, gold and fixed-income products. Source: *"Domestic Investors Lose Faith in Chinese Stocks,"* by Robert Cookson, Financial Times (July 03, 2012). The report is accessible at: <http://www.ft.com/intl/cms/s/0/188247c2-c418-11e1-850c-00144feabdc0.html>. See related report: *"China Reforms Fail to End Stocks' Bad Run,"* by Simon Rabinovitch, Financial Times, (August 07, 2012), which notes that more than 150 listed companies have been classified 'ST' (for "special treatment"), indicating that such companies have failed to generate a profit for two consecutive years. The report also references an online petition launched by retail investors, who account for three-quarters of daily trading volume in the Chinese market, demanding that the China Securities Regulatory Commission (CSRC) halt additional IPOs. The language of the online petition stated: "Behind every retail investor, there stands a family that has been deeply hurt by the endless IPOs and the poor performance of stocks." The report is accessible at:

<http://www.ft.com/intl/cms/s/0/b3960666-e07b-11e1-ac0d-00144feab49a.html>

⁴⁷ Id. Another concern, potentially even more serious, is that under China's capital controls domestic Chinese companies cannot easily remit funds offshore with which to service the interest and principal on foreign debt. Because the debt investment has been converted into equity, companies may only remit monies to the offshore shell in the form of after-tax dividends and, since regulatory approval is required for such remittances, only in the event that the company is earning a profit. Despite such risks, foreign investors have purchased over \$33 billion in private Chinese corporate bonds from the beginning of 2010 through mid-2011, representing five times the amount of issuance during the entire preceding decade. The majority of this investment has been undertaken predominantly by inexperienced managers including clients of private banks in Asia and U.S. and European fund managers seeking greater yields in emerging markets. A majority of the Chinese corporate bonds issued through offshore special purpose vehicles are now trading at distressed levels, portending yet another wave of defaults.

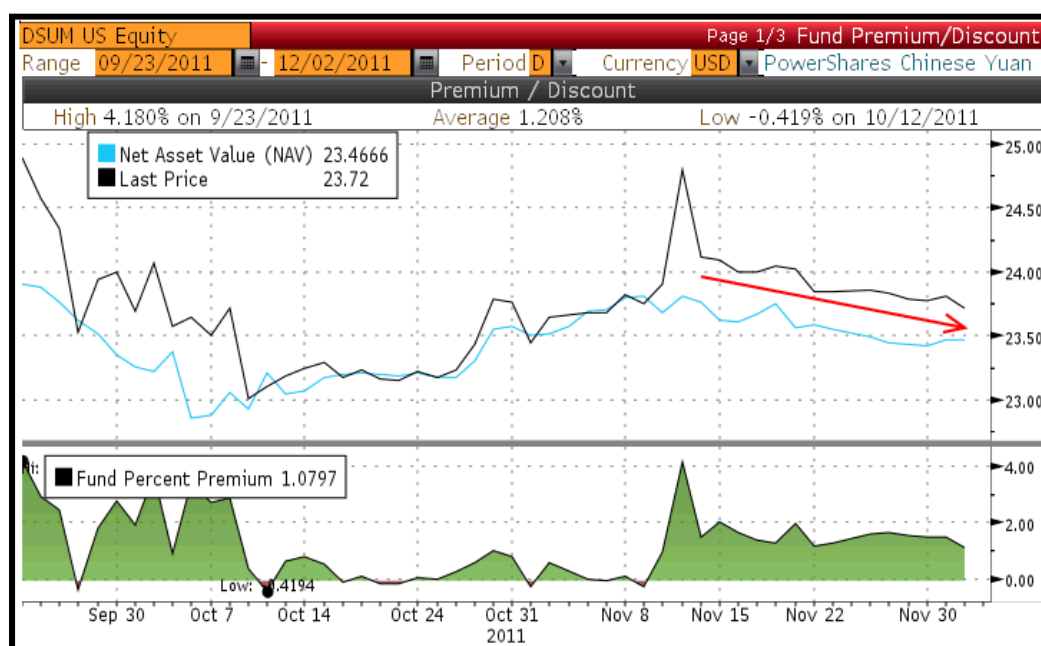
⁴⁸ Id. Alvarez & Marsal specializes in debt restructuring. The firm's website is accessible at:

<http://www.alvarezandmarsal.com/>

⁴⁹ During the first 11 months of 2011, 76 Chinese companies issued yuan-denominated dim sum bonds in the Hong Kong market and reportedly raised almost CNY 100 billion, nearly triple the total raised during all of 2010. Source: *"Jan-Nov Dim Sum Bond Issuance Reaches CNY 99.1 Bln – HKMA,"* by Fiona Law, Dow Jones Newswires (December 08, 2011). The report is accessible at: <http://online.wsj.com/article/BT-CO-20111208-704957.html>

creditors are absent with respect to dim sum bonds. Of the non-financial corporate securities listed on HSBC Holding Plc's Offshore Renminbi Bond Index, 60% contain no leverage limits or restrictions on the issuer's debt-to-equity ratio.⁵⁰ In the absence of such protection, companies are able to borrow additional funds to the brink of default without any restrictions, resulting in the deterioration of the credit profile of issuers of dim sum bonds and leading some industry observers to speculate that the dim sum bond market may constitute the next wave of investor fraud.⁵¹

*"...there appears to be a **sucker-of-last-resort** where Dim Sum bonds (offshore/HK Yuan-denominated bonds) have seen issuance almost triple in the first 11 months of the year."*⁵²



PowerShares Chinese Yuan Dim Sum Bond Fund ETF

Image Source URL:

http://www.zerohedge.com/sites/default/files/images/user3303/imageroot/2011/12/20111208_DSUM.png

Of concern to holders of Chinese corporate debt obligations, including investors in dim sum bonds, a disturbing new trend is starting to emerge as secured lenders holding defaulted loans have begun to discover the non-existence of commercial loan collateral in bonded warehouses in China.⁵³ In some instances, it appears that the non-existent assets had been pledged as collateral to multiple lenders.

⁵⁰ Review of issuer marketing materials, including offering circulars.

⁵¹ "Dim Sum Investors Lack Protection on 60% of Bonds: China Credit," by Rachel Evans, Bloomberg News (December 01, 2011). The report is accessible at: <http://www.bloomberg.com/news/2011-12-02/dim-sum-investors-lack-protection-on-60-of-bonds.html>

⁵² "Are Dim Sum Bonds the Next Chinese Reverse Merger Fraud?" by Tyler Durden (pseudonym), ZeroHedge.com (December 08, 2011). The report is accessible at: <http://www.zerohedge.com/news/are-dim-sum-bonds-next-chinese-reverse-merger-fraud>

⁵³ "Ghost Warehouse Stocks Haunt China's Steel Sector," by Ruby Lian and Fayen Wong, Reuters (September 16, 2012). The report is accessible at: <http://www.reuters.com/article/2012/09/16/us-china-steel-warehouse-idUSBRE88F0EJ20120916>

Emergence and Operation of the Shadow Banking System

The term ‘shadow banking’ references the vast amount of unregulated financial transactions such as non-bank loans and credit facilities, mortgage-backed securities and repurchase transactions among individuals, businesses, banks and various other institutions (both financial and otherwise) which occur outside the supervised traditional, i.e., regulated, channels and which are considered illegal in China. The operation of China’s shadow banking system comprises three principal categories: (1) private trust companies operating in tandem with regulated banks to securitize bank loans into “wealth management products” for sale to private investors, thereby effectively transforming banks’ balance sheet NPL exposure into hidden, off-balance sheet exposure; (2) local government-owned entities referred to as local government financing vehicles (LGFVs) which engage in land sales and development; and (3) informal lending networks consisting of private credit conduits serving real estate and stock market speculators, business owners including both property developers and SMEs, and individuals.

I. Private Trust Companies and Securitization of Bank Loans

Recently, in response to restrictive regulatory constraints including annual lending ceilings, a “shadow banking system” has emerged which has enabled the banks to continue large-scale loan generation outside of regulatory oversight.

The China Banking Regulatory Commission expressed concerns regarding both the amount and quality of loans issued by state-controlled banks in 2009.⁵⁴ In order to both allay the CBRC’s concerns and also attract customer deposit accounts in a fixed interest rate environment, banks have created ‘wealth management products’ to offer to high-net worth / high-income persons through private trust companies. Such products generally comprise participatory interests in new loans originated by the bank, enabling the institution to disguise new lending activity and circumvent loan origination targets set by the CBRC.⁵⁵

● Chinese Subprime Collateralized Debt Obligation (“CDO”) Contagion

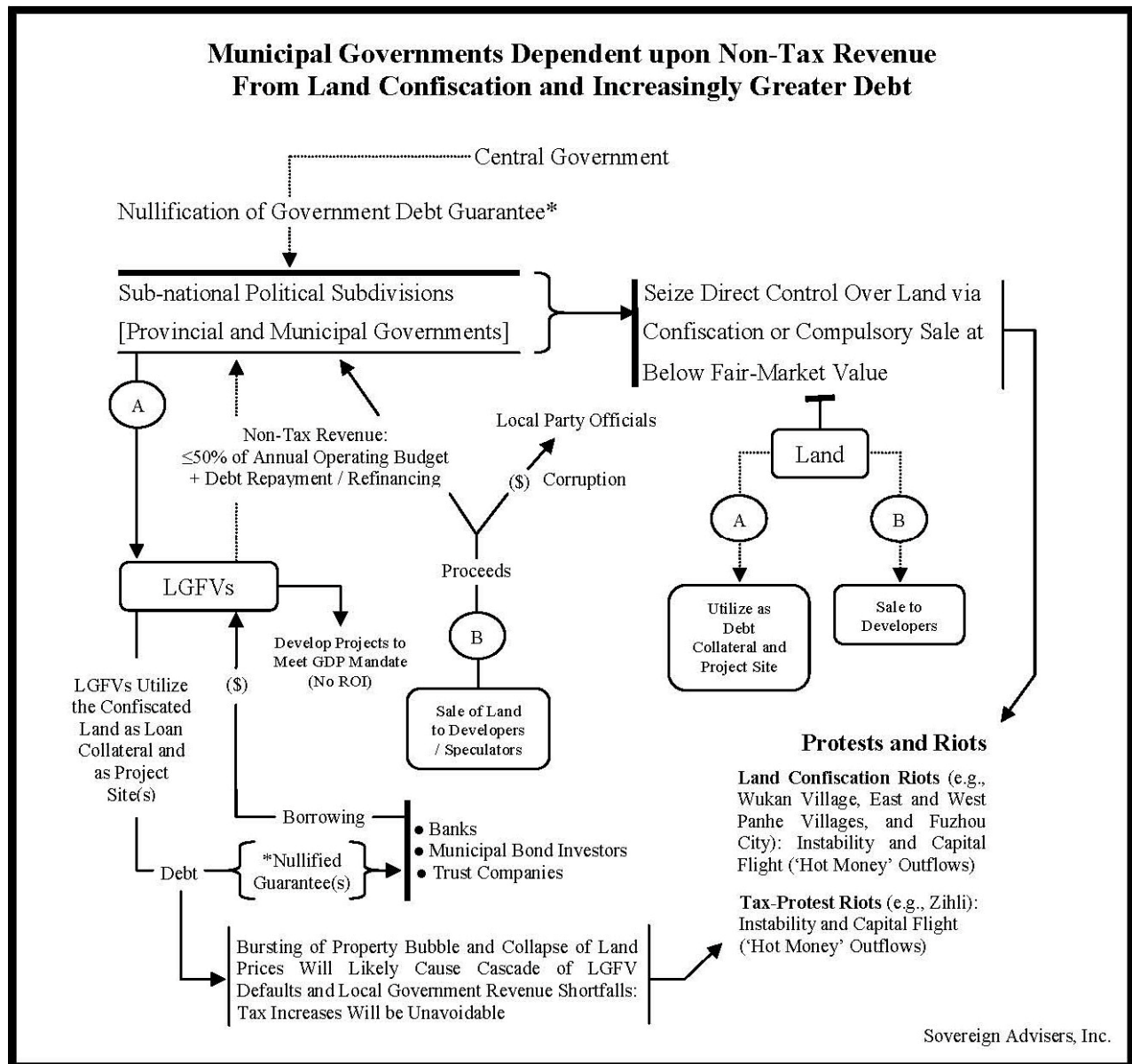
Private trust companies (packaged and sold to the banks’ customers as “wealth management” products). Such products are comparable to U.S. subprime collateralized debt obligations (“CDOs”) which were falsely-rated as ‘investment grade’ and then sold internationally by Wall Street institutions, resulting in the global credit crisis beginning in 2008. Customers are predominantly affluent Chinese persons seeking higher interest rates than the state mandated rate allowed on bank savings and deposit accounts. A commonly-held perception is that real estate-backed obligations are safe because property prices only move higher, and home purchasers are eager to buy additional properties to resell (i.e., ‘flip’), as happened in the U.S.

⁵⁴ China Banking Regulatory Commission annual report for 2009 (released June 15, 2010).

⁵⁵ Prior to the widespread proliferation of private trust companies beginning in 2010, loan origination by the large state-owned banks reached 20% of the entire loan target for 2010 in just the first two weeks of the year.

II. Local Government Financing Vehicles Utilized to Conceal True Debt-to-GDP

Local governmental entities are largely dependent upon non-tax revenue to fund operating budgets.⁵⁶ The primary manner in which local governments monetize land resources is via (a) outright confiscation or below-market purchase and subsequent sale to property developers and speculators; and (b) pledging of land as collateral for bonded debt issuance.



Land inventory and anticipated revenue from land sales therefore occupy a central role in rationalizing otherwise irrational lending practices.⁵⁷ The result of such non-economic allocation

⁵⁶ Revenue derived from land sales account for approximately 50% of total municipal operating budgets.

⁵⁷ "China Cities Value Land at Winnetka Prices with Bonds Seen Toxic," by Henry Sanderson and Michael Forsythe, Bloomberg News (July 13, 2011). The report investigated the circumstances related to municipal bonds sold by three Chinese cities including Loudi in central Hunan province, the coastal city of Cangzhou and Yinchun near China's northeast border with Siberia. The investigation determined that in the instances in which the bonds

of capital is empty and unfinished buildings including abandoned universities decaying and sinking into the ground (e.g., Yunnan and Gushi).⁵⁸

In order to circumvent restrictions on municipal borrowing and thus shield the true level of indebtedness of municipal and provincial governments from regulators, local party officials create corporations which act as the borrowers.⁵⁹ These corporations, which are entities separate from the municipality and are known as Local Government Financing Vehicles (“LGFVs”), effectively enable local governments to conceal actual debt-to-GDP and thereby create false debt ratios.⁶⁰ There are presently as many as 10,000 or more such entities in China.⁶¹ Based upon the results of studies conducted last year by the People’s Bank of China and the China Banking Regulatory Commission, in conjunction with an audit conducted by the National Audit Office, the amount of local government debt outstanding is estimated at between CNY 14.8 to 20.1 trillion, equivalent to \$2.3 to \$3.1 trillion. China’s true debt-to-GDP figure is nominally estimated at 80% of GDP.⁶² However, Fitch Ratings has estimated that based upon total credit

were secured by land as collateral, the land value was overstated by three to four times the actual value. In one instance, local officials were not even certain as to the location of the specific property securing the debt, reportedly stating “[I]t’s somewhere north of town, I don’t exactly know where. It’s like the land outside the city, you know, with the big piles of salt.” The investigation also revealed a disturbingly noncommittal and dismissive attitude by local government officials towards repayment of the debt. The report is accessible at:

<http://www.bloomberg.com/news/2011-07-13/china-cities-sell-land-at-winnetka-values-with-bonds-seen-toxic.html>

Related article: <http://chovanec.wordpress.com/2011/07/15/bloomberg-on-chinas-runaway-local-debt/>

⁵⁸ “*Special Report: China Bets Future on Inland Cities*,” by Chris Buckley and Simon Rabinovitch, Reuters (August 03, 2010). The report is accessible at:

<http://www.reuters.com/article/2010/08/03/us-china-urbanisation-idUSTRE6721D320100803>

⁵⁹ Local and provincial governmental authorities are responsible for the majority of infrastructure expenditures in China. Such governments have established majority-owned financing entities, including infrastructure development companies; local state asset management companies; expressway, ports, airports, and water companies; and provincial railroad and energy companies.

⁶⁰ Local Government Financing Vehicles are a form of Special Investment Vehicle (SIV) long-utilized in Western financial markets to securitize underlying collateral into investment products.

⁶¹ Estimate provided by the People’s Bank of China in a report dated June 01, 2011. The report stated that “more than 10,000” LGFVs exist with a combined indebtedness of CNY 14.38 trillion. During 2011, central government authorities conducted three separate inquiries in an attempt to assess the true extent of LGFV lending, including the PBoC study. Based upon an inspection of the major Chinese banks’ loan books, the CBRC also determined that 10,000 or so LGFVs presently exist, with a total combined indebtedness of CNY 9.09 trillion. The National Audit Office (NAO) reviewed the records of all of the LGFVs whose debt is directly guaranteed by the affiliated local government(s), and found CNY 4.97 of guaranteed debt and an additional CNY 5.7 trillion of guaranteed municipal government debt outside the LGFV system. The NAO’s audit excluded entities classified as LGFVs by the banks, which did not have an explicit guarantee. Source: “*China’s Investment Boom: on the Edge*,” Pivot Capital Management (September 22, 2011). The report is accessible at:

<http://www.scribd.com/ValueWalk/d/74974616-PGVF-2011-China-Investment-Boom-on-the-Edge>

⁶² In early 2010, the central government disavowed government guarantees of debt obligations issued by municipal governments and political subdivisions. Source: “*China to Nullify Financing Guarantees by Local Governments*,” by Luo Jun and Kevin Hamlin, Bloomberg News (March 08, 2010). The report is accessible at:

<http://www.bloomberg.com/apps/news?pid=newsarchive&sid=alcTfdm5rWdY>

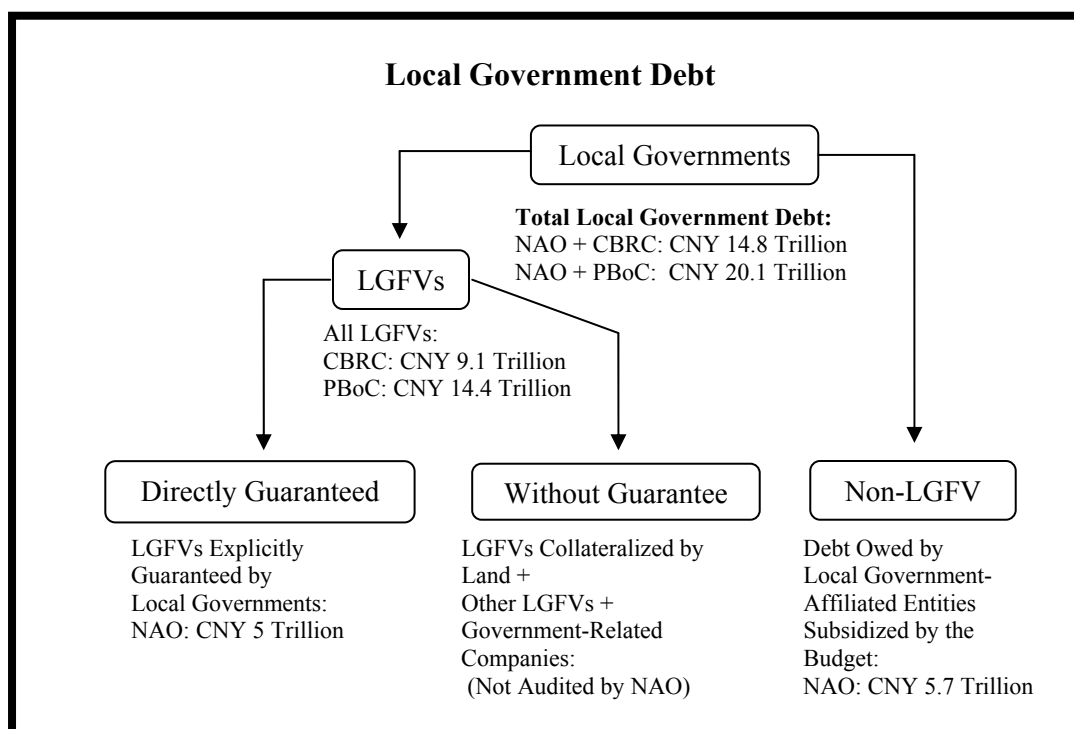
See also: “*Shell Game*,” The Economist (March 11, 2010). The report is accessible at:

<http://www.economist.com/node/15675590>

See related report describing China’s 150% debt-to-GDP: “*Falling Star*,” by Jonathan R. Laing, Barron’s (July 02, 2012). The report is accessible at:

http://online.barrons.com/article/SB50001424053111903857104577467200405790354.html#articleTabs_article%3D0

expansion for 2011 of 38% of GDP, China's debt-to-GDP ratio would be approximately 187%, an increase of 61% in just three years.⁶³



Source: PBoC, CBRC, NAO, Pivot Capital Management

- Local Government Bonds Capture Both Project and Collateral Transfer Risks

The default risk inherent to any specific issue of local government debt obligations is not restricted to the willingness and ability of the issuer to repay the obligation, but also encompasses exposure to stealth asset transfers, collateral transfers and re-hypothecation (re-pledging) of the underlying bond collateral.

*“Angry institutional bond investors holding a Sichuan Province highway construction company’s debt are stirring a hornet’s nest over a financial practice that’s apparently commonly used by local government financing platforms across China. The practice is called internal asset transfer, and investors who purchased bonds backing Sichuan Expressway Construction & Development Corp. recently learned the hard way that it can be used by local governments to burn corporate debt holders.”*⁶⁴

- Lead paragraph by Caixin staff reporters Zheng Fei and Yang Na:
“These Bonds, Investors Say, Were Made in Hell”

⁶³ “Growth of Leverage Still Outpacing GDP Growth,” Fitch Ratings (July 13, 2011).

⁶⁴ “These Bonds, Investors Say, Were Made in Hell,” by Zheng Fei and Yang Na, Caixin (May 06, 2011). The report is accessible at: http://english.caixin.com/2011-05-06/100256291_3.html

*“It’s very likely that senior government leaders have no way of knowing which numbers provide the best picture of the evolving lending binge China’s banks seem to be on.”*⁶⁵

- Carl Walter, recently retired Chief Operating Officer in China for JPMorgan Chase & Co.

As a consequence of unbridled lending to fund local government-sponsored projects, the banking sector incurred an estimated \$450 billion exposure to municipal government NPLs for this period.⁶⁶ Following three years of unrestrained loan generation in an attempt to stave off the adverse domestic effects of the decline in export growth attributable to the global financial crisis, China is now constrained from adopting western banking practices as there is a huge inventory of bad loans and it is imperative to preserve the liquidity of those loans. An audit of LGFVs in Liaoning Province discovered that 85% of the 184 LGFVs audited lacked sufficient revenue to cover interest payments on outstanding debt. The audit also revealed that 30% of the LGFVs were actively involved in fraudulent activities (e.g., falsifying projects).⁶⁷ In other instances, collateral pledged to secure specific debt was withdrawn and re-pledged to secure new debt. Inflated land valuations are also utilized to secure local government bonds.⁶⁸

*“China is playing with fire, just like we played with fire.”*⁶⁹

- Carl Walter, recently retired Chief Operating Officer in China for JPMorgan Chase & Co.

⁶⁵ *“China Debts Dwarf Official Data with Too-Big-To-Finish Alarm,”* by Michael Forsythe and Henry Sanderson, Bloomberg News (December 18, 2011). The report is accessible at:

<http://www.bloomberg.com/news/2011-12-18/china-debts-dwarf-official-data-with-too-big-to-complete-alarms.html>
Approximately 53% of China’s local governments’ outstanding debt will come due by end of 2013, according to the national audit office. Source: *“Defaults Spotlight China Credit Risks,”* Financial Times (January 06, 2012).

⁶⁶ Id. at 52. The CBRC survey revealed that only 30% of LGFV loans had sufficient cash flow to allow for restructuring into conventional commercial loans. The NAO audit implies that the central government will recognize an obligation to guarantee CNY 10.7 trillion of local government debt, leaving banks, trust investors and bondholders exposed to losses on the excess debt. Based upon the CBRC survey, total local government loans likely to enter into default are estimated at CNY 10 to 14 trillion, equivalent to \$1.5 to \$2 trillion or 20% to 30% of China’s GDP.

⁶⁷ *“Auditors Point to Widespread Insolvency in Liaoning Provincial Government Assets,”* Caixin (September 08, 2011). The article is accessible at: <http://china-wire.org/?p=15605>

⁶⁸ See, for example, bonds issued by the City of Loudi, which were secured by land which had been falsely ascribed a value of \$1.5 million per acre. Source: *“Chinese Cities’ Risky Borrowing Binge,”* by Henry Sanderson and Michael Forsythe, Bloomberg News (July 21, 2011). The article is accessible at: <http://www.businessweek.com/magazine/chinese-cities-risky-borrowing-binge-07212011.html>

The city issued \$185 million in bonds to finance community facilities including a 30,000 seat stadium, gymnasium and swimming complex, in a city located in central Hunan Province where the average household income is \$2,323. City officials aren’t worried about the repayment risk. When queried on the subject, Yang Haibo, an official with the city’s finance authority, stated: “When we get to the end of our loan, we’ll just pay it back.”

⁶⁹ Id.

Key Finding:

➔ The Chinese political economy is directing resources into non-economic “investments” that do not generate a financial return above the cost of funding. The government is thus destroying economic value even as it simultaneously produces GDP “growth.”

The continued generation of overcapacity will also limit profitable opportunities available to the private sector, thereby further increasing the role of the state (both central and local governments) as the primary agents which will borrow and invest, generating ever-increasing overcapacity and diminishing economic benefit. Such a situation is unsustainable and will ultimately cause irreparable harm to both the state-owned and private sectors, even while achieving 8% annual GDP with zero corporate profit.

“It’s a huge myth that land sales are going to be able to even support the interest payments, let alone the principal payments.”⁷⁰

- Stephen Green, Head of Greater China Research at Standard Chartered Bank (Hong Kong)

Bloomberg Video - Local Government Financing Vehicles:
<http://www.bloomberg.com/video/82991554/>

China’s Hidden Debt:
<http://blogs.wsj.com/marketbeat/2011/07/05/35770/>

III. Unregulated Private Credit and Informal Lending Networks

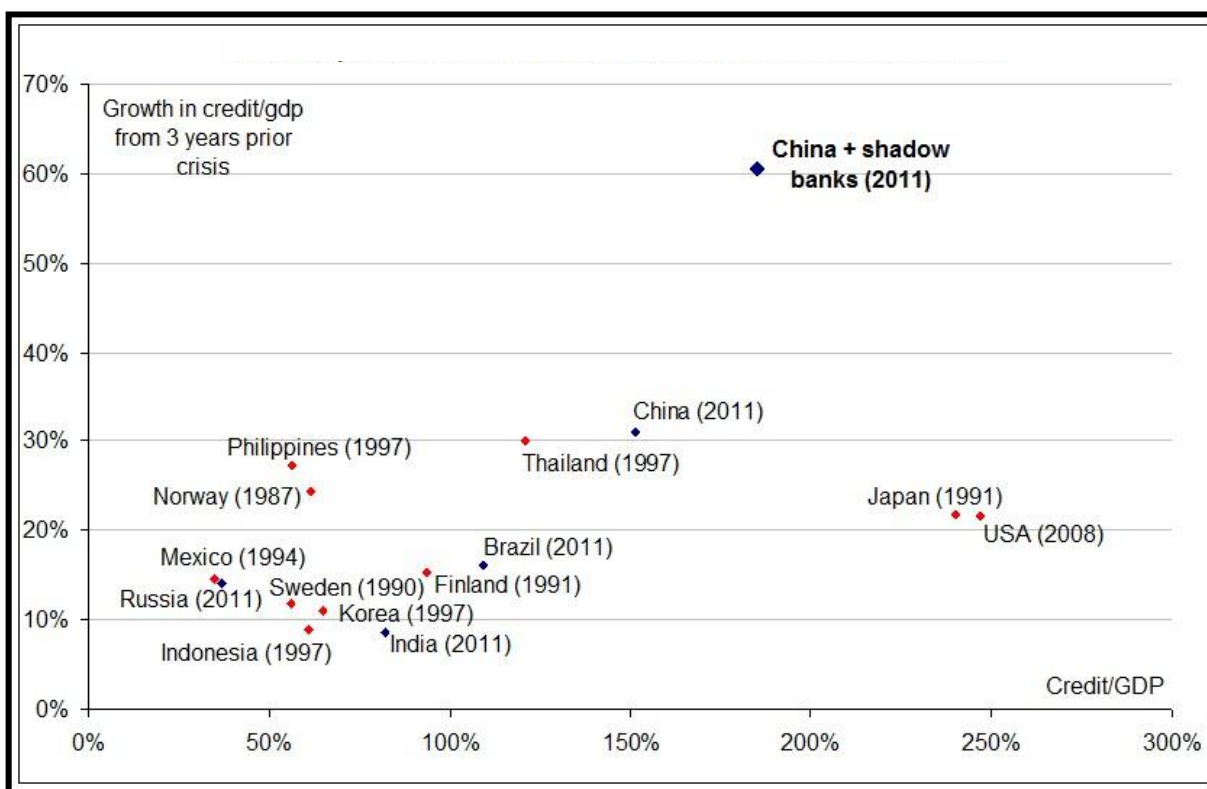
The size of China’s shadow banking system, exclusive of the off-balance sheet loans of banks, trust companies and inter-company lending and consisting only of the illegal, unregulated and unsupervised informal lending channels, is estimated to total \$1.3 trillion (which is equivalent to the size of the 2011 U.S. government fiscal deficit).⁷¹ The size of China’s entire shadow banking system is estimated to total approximately \$2.4 trillion, one-third the size of China’s official loan

⁷⁰ Id.

⁷¹ Ren Xianfang, an economist at HIS Global Insight Ltd. (Beijing), cited in “*Shadow Banks on Trial as China’s Rich Sister Faces Death*,” by Jun Luo and Yidi Zhao, Bloomberg News (April 11, 2012). The article describes the travails of Wu Ying, a convicted shadow banker accused of defrauding investors and using investors’ monies to support a lavish lifestyle, including the purchase of a \$500,000 Ferrari. Her lawyer, Yang Zhaodong, has expressed the sentiment that “Entrepreneurs are paying attention to it (the case, which is on appeal) because today’s Wu Ying could be any of them tomorrow. There are so many of them doing the same thing Wu Ying did.” The article is accessible at: <http://www.bloomberg.com/news/2012-04-10/shadow-banks-on-trial-as-china-s-rich-sister-faces-death.html>

market and nearly equal to total outstanding U.S. consumer debt (estimated at slightly over \$2.5 trillion by the U.S. Federal Reserve).⁷²

Credit Expansion and Ratio to GDP in Credit Crises and BRIC Countries



Source: Pivot Capital Management

The shadow banking system is the primary capital formation mechanism (i.e., funding source) for China's small and medium size enterprises which are unable to source loans from state-owned banks, providing credit to an estimated 42 million Chinese business owners.⁷³ Private entrepreneurs account for approximately 60% of China's total economic activity and provide jobs for 80% of the country's urban population, according to China's National Development and Reform Commission.

- Credit Guarantee Companies, Inter-Company Guarantors and Investment Schemes

Encouraged by local governments, private credit guarantee companies have proliferated in response to the difficulties experienced by SMEs attempting to gain access to bank credit. In addition to insuring companies' loans against default, some guarantee companies sponsor 'wealth management' schemes promising an 18% return over a period of 30 days, and also

⁷² Source: Yao Wei, an economist at Societe Generale SA (Hong Kong). Id.

⁷³ Interest rates on loans contracted through China's informal lending network may reach 20% per month. Source: "China's Investment Boom: On the Edge," by Pivot Capital Management (September 22, 2011). According to a survey conducted during August, 2011 by the Financial Times' 'China Confidential', a record 24% of respondents reported a markedly increasing rate of delinquency of loans and NPLs within the shadow banking system. Source: "Macro View: China's Sub-Prime," FT/China Confidential, Financial Times (September 8-12, 2011).

reportedly routinely forge documents in order to obtain bank loans, apparently involving the willing complicity of the banks.⁷⁴

*“There really are two related but distinct things people have in mind when they talk about a ‘hard landing’ for China. The first is a rapid deceleration of GDP growth - below, say, 7%. The second is some kind of financial crisis. I think we’re already seeing some signs of the first, and the second is a bigger risk than most people appreciate.”*⁷⁵

- Patrick Chovanec, Associate Professor at Tsinghua University

The credit insurance underwritten by China’s many credit guarantee companies is analogous to credit default swaps (CDS), whereby the ability to pay the coverage in the event of default is predicated upon the insurer’s avoidance of correlated risks. In the instance of China, however, the reverse is the case whereby the insured risks are concentrated with overexposure to property and export-manufacturing sectors, thereby leaving the system prone to cascading defaults among borrowers and causing the collapse of the credit guarantee providers.⁷⁶

Another incident evidencing the systemic financial instability of China’s shadow banking system is the recent crisis in Hangzhou in Zhejiang Province involving a network of reciprocal credit guarantee arrangements existing directly between borrowers, which occurred immediately following the collapse of property developer Tianyu Construction Co. Ltd. The 62 companies were financially linked to Tianyu through a province-wide private financial network.⁷⁷ Subsequent to Tianyu’s collapse, banks began calling loans to other firms guaranteed by the defunct development company.

Key Finding:

⇒ The reciprocal nature of the guarantee network deprives loan guarantees of value, as it renders the participants mutually vulnerable to an economic downturn, thereby further increasing systemic risk. The widespread propagation of inter-company guarantees increases the exposure of Chinese banks beyond the risks inherent to credit guarantee companies.

⁷⁴ “Fool’s Gold Behind Beijing Loan Guarantees,” by Yang Na and Ma Yuan, Caixin (March 20, 2012). The report describes the failure of Zhongdan Investment Credit Guarantee Co. Ltd., one of China’s most prominent credit guarantee firms. According to the report, a branch manager at one of the affected banks stated that most bankers are fully aware that a majority of companies provide falsified contracts to qualify for loans. The report is accessible at: <http://english.caixin.com/2012-03-20/100370485.html>

Related article: <http://chovanec.wordpress.com/2012/05/19/no-guarantee/>

⁷⁵ “Should China be bracing itself for a hard landing?,” by Patrick Chovanec and Andrew Batson, The Guardian (March 22, 2012). The article is accessible at:

<http://www.guardian.co.uk/world/2012/mar/22/china-economy-hard-landing>

⁷⁶ According to the China Banking Regulatory Commission, China had 8,402 credit guarantee companies at the end of 2011. These companies reported a growth in assets (loans guaranteed) of 57.2% over the previous year..

⁷⁷ “Domino Risk Grips Zhejiang Bankers, Borrowers,” by Zhang Yuzhe, Zhang Bing, Shen Hu, Wen Xiu and Zheng Fei, Caixin (June 26, 2012). The report quotes a bank credit manager as stating: “Zhejiang’s business owners were spoiled by easy access to credit, especially in 2008 and 2009. Back then, they could always get loans using land as collateral and could always make money by investing in property.” The report is accessible at: <http://english.caixin.com/2012-06-26/100404274.html>

Related article: <http://chovanec.wordpress.com/2012/06/27/falling-dominoes/>

A bank loan officer reportedly noted that many private businesses in Hangzhou have been forced to survive on credit after exhausting company cash on property speculation.⁷⁸ In response to the crisis, Hangzhou city officials have announced a bailout plan under which the local government will finance bridge loans to indebted companies and city officials have also ordered local banks to continue lending.⁷⁹ This plan is similar to the manner in which city officials in Shaoxing, another city in Zhejiang Province, rescued a failed petrochemical company in 2008 which had issued similar credit guarantees through a private financial network of companies. The local government assumed half of the debt (through a state-owned enterprise) owed by Zhejiang Hualian Sunshine Petro-Chemical Co. Ltd., and provided government support to companies in the lending network.⁸⁰

- Wenzhou Crisis and Private Lending Network Pilot Program

Many enterprises have resorted to private finance networks over the past few years as an alternative to bank loans, predominantly in response to reduced bank lending to SMEs. For example, according to the PBoC, the total amount of private lending in the city of Wenzhou, a manufacturing center located on the southeast coast of Zhejiang Province, had reached 110 billion yuan in mid-2011, involving 89% of local individuals and families, and 60% of companies.⁸¹ Businesses in Wenzhou are continuing to experience a serious financial crisis which also began in mid-2011, following the proliferation of private lending networks which have fueled speculation in real estate and other speculative ventures in response to the loss of demand in China's export markets, resulting in a rash of bankruptcies and suicides as business owners are unable to repay debts. Dozens of CEOs reportedly disappeared or fled the country after defaulting on high-interest underground loans originated through informal private lending networks.⁸² In the space of just ten days, at least seven local Wenzhou business owners fled following defaults on loans which they either relent to property developers or used to speculate on other ventures.⁸³ As of the end of September of last year, more than 40 business owners in Wenzhou had disappeared according to the Wenzhou Public Security Bureau.⁸⁴

Zhejiang property development firms have also recently begun filing for bankruptcy, including Hangzhou Glory Real Estate Co., after borrowing CNY 2.5 billion from individuals.⁸⁵ In

⁷⁸ Id.

⁷⁹ Id. The report notes that some officials knowledgeable about the matter have blamed the latest crisis on the 'loose credit policies' maintained by the banks, which also led to the development of the Tianyu network, and states that "[O]ne credit analyst said Zhejiang banks have been blindly trusting loan guarantors while failing to properly examine and screen loan candidates."

⁸⁰ Id. An executive at Hangzhou furniture manufacturer Rongshi Group is also among those who fault the banks for the crises, stating, "[M]ost banks care only about how to get themselves out of the mire," and without a broad solution for both companies and banks, "no one will escape."

⁸¹ "China Sees Biggest Illegal Private Lending Case Yet," Caixin (February 07, 2012). The report is accessible at: <http://english.caixin.com/2012-02-07/100354116.html>

⁸² "China Sees Biggest Illegal Private Lending Case Yet," Caixin (February 07, 2012).

⁸³ "Subprime crisis sweeps Wenzhou as bankrupt bosses flee," Shanghai Daily (September 24, 2011). The report is accessible at: <http://english.peopledaily.com.cn/90778/7603606.html>

⁸⁴ "Cash Crash for Wenzhou's Private Loan Network," by Zhang Bing, Zheng Fei and Zhao Jingting, Caixin (October 11, 2011). The report is accessible at: <http://english.caixin.com/2011-10-11/100312831.html>

⁸⁵ Id.

Zhejiang alone, sentences imposed for various shadow banking-related crimes rose to 75 in 2011, up from 8 in 2007.

In the wake of these difficulties and in anticipation of the potential magnitude of the developing crisis in China's property and financial sectors, Chinese Premier Wen Jiabao traveled to Wenzhou and pledged assistance to troubled businesses including easing of restrictions on private lending, which China's State Council subsequently approved.⁸⁶ The CCP leadership has also enacted measures intended to stimulate inflows of speculative capital (e.g., the recent approval of a three-fold increase in the amount of foreign funds allowed to be invested in China's financial markets, to \$80 billion) and called for the "immediate" implementation of a pilot shadow banking operation in Wenzhou.⁸⁷

- The 'Shark Loan Ponzi Finance' Phenomenon

A popular sub-category of shadow banking activity is the 'shark loan ponzi finance' scheme.⁸⁸ The scheme is dependent upon a continuing increase property prices, or else the homeowner will not be able to repay the bank loan. The operation of the Shark Loan scheme is responsible for much of the speculative distortion in Chinese property prices. The issuance of 'dim sum' bonds in Hong Kong by Mainland property developers has largely been an attempt to shift much of the developers' financial risk to investors.

- Public-Private Shark Loan Ponzi Finance Schemes

Local government officials and private entrepreneurs frequently collude to operate shark loan and Ponzi finance schemes, raising funds from local villagers and city residents. The small crab-fishing village of Shiji, located within Sihong County in eastern China's Jiangsu Province, represents a prime example of an instance involving the miraculous transformation of a poor

⁸⁶ "Chinese Premier Blasts Banks," by Dinny McMahon, Lingling Wei and Andrew Galbraith, Wall Street Journal (April 04, 2012). Mr. Wen is quoted as stating that "... we must allow private capital to flow into the finance sector" and referred to the Wenzhou pilot program intended to legitimize portions of China's informal lending system, stating that "Those parts of the Wenzhou trial that prove a success should immediately be expanded to the rest of the country." The article describes China's large state-owned banks as having a preference for lending to state-owned industrial (i.e., export manufacturing) and construction (i.e., fixed-asset investment) firms, thereby depriving smaller enterprises and consumers of credit and constraining domestic consumption. Cornell University's Eswar Prasad is quoted as stating that Mr. Wen's remarks reflect "a growing frustration among reform-minded officials that the large banks are deploying their political clout to preserve their privileges and block broader reforms to the financial system," thus preventing efficient capital allocation to China's SMEs. The article states, "Many in China now believe a crisis will come without economic reform." In a separate article, Mr. Prasad is quoted as stating, "These steps to formalize the underground banking system are no substitute for more basic financial-sector reforms." Source: "China Tests Looser Financial Model," by Lingling Wei, Dinny McMahon and Tom Orlik, Wall Street Journal (March 29, 2012).

⁸⁷ The pilot program was approved by China's State Council on March 28, 2012. The program eases restrictions on private lending and encourages private capital to participate in "innovative financial organizations." See "China Announces Pilot Financial Reform Zone in Wenzhou," Xinhua (March 28, 2012). The article is accessible at: http://news.xinhuanet.com/english/business/2012-03/28/c_131494710.htm

See related article: "China Launches Pilot Financial Reform in Wenzhou," Caixin (March 29, 2012). The article is accessible at: <http://english.caixin.com/2012-03-29/100374311.html>

⁸⁸ <http://israelfinancialexpert.blogspot.com/search/label/China%27s%20Ponzi%20Shark%20Loan%20Finance>

rural village, in which the average per capita annual income is a little over \$2,000, into an apparently ‘wealthy’ community based upon loan sharking and rampant property speculation.⁸⁹

“It all began when a man named Shi Guobao returned to Shiji after working in Beijing. He became a property developer, but he wanted to make a bigger fortune so he decided to also become a loan shark.”⁹⁰

- Zhu Yi, Head Official of the Village of Shiji

In order to capitalize the shark loan operation, Mr. Shi organized a syndicate and solicited funds from fellow villagers, many of whom reportedly committed their entire life savings on the promise of receiving 10% interest each month.⁹¹ The operation lent out funds at monthly interest rates of 30% or more, mainly to local property developers. The local government eagerly participated in the scheme, prospering from the receipt of income from every acre of land sold to the developers.

Operation of the Shark Loan Scheme

- 1) A homeowner in China utilizes the increased equity derived from the increasing value of the home resulting from rising residential property prices, to obtain a low interest bank loan;
- 2) The homeowner then loans the proceeds to a Shark Loan Operator, who promises to repay the loan and provide a 20% - 30% ROI to the homeowner; and
- 3) The Shark Loan Operator then lends the funds at an even higher interest rate to property developers and speculators who are under-capitalized.

Funded by the shark loans, developers encircled the village with a multitude of cranes and began construction of apartment towers which advertised for buyers by utilizing images of English butlers and chandelier-lit dining rooms. During the height of the scheme, residents of Sihong County reportedly purchased 800 BMW automobiles, 600 Mercedes, 500 Audis, 50 Porsches, 30 Jaguars, 1 Ferrari, 1 Lamborghini and 1 Maserati.⁹² Fireworks were set-off in celebration nearly every night in the area.

Ultimately, however, there proved to be little demand for the apartments under construction and borrowers began defaulting on loans, causing the pyramid scheme to collapse. Half-finished apartment towers stand vacant while an estimated 1,700 residents have reportedly lost their

⁸⁹ The per capita income of Shiji residents compares favorably with the average annual income for rural China of slightly over \$1,000. Source: “*Sharks Bitten: Jiangsu’s ‘Beamer Town’ Goes Bust*,” by Chen Hsiu-ling and Staff Reporter, WantChinaTimes.com (November 07, 2011). The report is accessible at:

<http://www.wantchinatimes.com/news-subclass-cnt.aspx?cid=1103&MainCatID=11&id=20110711000034>

⁹⁰ “*‘BMW Town’ Crashes in Pyramid Fraud*,” by Malcolm Moore, Telegraph (September 23, 2011). The report is accessible at:

<http://www.telegraph.co.uk/news/worldnews/asia/china/8783588/BMW-town-crashes-in-pyramid-fraud.html>

⁹¹ Id.

⁹² Id.

investments in the shark loan operation.⁹³ The only luxury cars remaining in the area today are parked outside the local Sihong County government offices.

*“What happened in Shiji is a fraud that plays out every day in some corner of China’s murky economy, as local Communist Party officials and greedy entrepreneurs collude in vast pyramid schemes.”*⁹⁴

- Malcolm Moore, Shanghai-based investigative reporter for The Daily Telegraph

Other reported instances of local government-sponsored shark loan ponzi finance schemes include the city of Fengzhuang and Huang Qiao Town in Taixing County of Jiangsu Province, which allegedly involved the participation of an estimated 80% of local families.

- Chinese Property Development Firms Alleged to Operate as Ponzi Schemes

Evergrande Real Estate Group (Stock Code 3333.HK), China’s largest residential property developer, is accused by Citron Research of engaging in an ongoing massive fraud including the operation of a serial bribery scheme targeting local government officials in order to acquire land at deep discounts to prevailing market prices.⁹⁵ Citron’s research also reveals that Evergrande utilizes Ponzi financing techniques in order to remain solvent, including a pattern of refunding previous loans with new loans bearing ever-higher internal-rate-of-return guarantees (e.g., a \$500 million loan contracted from an affiliate of Credit Suisse which was conditioned on a minimum annual rate of return of 19.5% to the lenders and on which Evergrande subsequently defaulted). Following Evergrande’s default, the company obtained a \$506 million equity-linked financing facility which promised investors a minimum return of between 100% and 200%. Citron’s research further reveals that Evergrande has incurred a cashflow operating deficit since 2006,

⁹³ Id. Following the collapse of the shark loan operation, an investigative reporter who travelled from Shanghai to report on the situation in Shiji was warned by local government officials, “[I]t is not worth looking into too deeply,” and was at first detained by local officials and then deported from the village to the city of Nanjing, some 200 miles away.

⁹⁴ Id. According to the Hurun Report published by the Hurun Research Institute (March 2012), the wealthiest 70 members of the National People’s Congress, China’s legislative body, possess an aggregate net worth of nearly \$90 billion, an average of over \$1 billion per member. Research undertaken by Professor Victor Shih of Northwestern University reveals that the top 1% of Chinese households presently hold as much as \$5 trillion in private wealth. Capital flight by corrupt party members and other wealthy Chinese could easily exceed China’s estimated \$3.2 trillion in foreign currency reserves. The current political leadership of China has achieved the greatest looting of a country by the political class ever witnessed in history, as exemplified by the following statement: “When these guys are done, they’ll leave nothing but a shell of a country behind. The Chinese elite has amassed far more in wealth than all the country’s vaunted foreign reserves put together. That is something people all over the world need to very seriously think about. For now, though, the only true Chinese leader is Pon Zi. Whose inevitable successor will be Domi No.” Source: “Meet China’s New Leader: Pon Zi,” by Raúl Ilargi Meijer, Automaticearth.org (July 04, 2012). The report is accessible at: <http://theautomaticearth.org/Finance/meet-chinas-new-leader-pon-zi.html>

⁹⁵ The Citron research report on Evergrande Real Estate Group (released June 21, 2012) is accessible at: <http://www.citronresearch.com/wp-content/uploads/2012/06/Evergrande-Real-Estate-Research.pdf>

Unlike Tianyu Construction Co. Ltd. which was a relatively small enterprise, Evergrande is one of China’s ten largest property development firms. Thus, the unraveling of the interlinked credit relationships, of which Evergrande is at the center, will undoubtedly prove far more dramatic as well as several orders of magnitude greater than that which occurred following Tianyu’s demise.

sustaining itself through ever-greater levels of debt which Citron contends the company has concealed through the use of off-balance sheet trust company loans and special purpose vehicles (similar to the scheme employed by Enron). Many distressed Chinese property development firms have sequentially migrated across progressively costlier tiers of the financial markets:

1. Domestic Banks;
2. High-Yield ‘Dim Sum’ Bonds (Hong Kong and London);
3. Private Wealth Management Vehicles (Trust Companies); and finally
4. Loan Sharks.

The circumstances comprising Evergrande, Tianyu and other property developers are likely just a minute precursor of the impending cascade of events likely to ensue as a result of the systemic risks embedded across China’s property, banking and local government sectors.

“The potential risks in the fiscal and financial sectors can’t be underestimated.”⁹⁶

- Du Ying, Vice Chairman, National Development and Reform Commission

Endemic Corruption and Capital Flight by Insiders

The greater the scale and extravagance of municipal infrastructure projects, the greater the opportunity for local officials to gain financially in the process, thereby incentivizing ever-increasing levels of mal-investment. According to a PBoC report which was mistakenly published and subsequently retracted, between 1993 and 2008 16000 to 18,000 local government officials fled China with an estimated \$124 billion in embezzled funds.⁹⁷ Of particular note, the period covered by the report was prior to the government’s recent stimulus program and thus excludes the extent of embezzlement and misallocation of capital resulting from the vastly increased lending to local governments occurring over the past several years.

Key Finding:

➔ China’s shadow banking system has created a massive unregulated and unsupervised expansion of credit which, operating in the absence of a market-pricing mechanism to efficiently allocate resources based upon economic merit, has the effect of magnifying systemic risk throughout the Chinese economy.⁹⁸

⁹⁶ “China Faces Difficulties in Maintaining Demand Growth,” by Wang Ying, Bloomberg News (December 15, 2010). The report is accessible at: <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a1ZXfypelwUs>

⁹⁷ “Corrupt Officials Took \$124bn Out of China,” by Jamil Anderlini, Financial Times (June 16, 2011). The report is accessible at: <http://www.ft.com/intl/cms/s/0/1af60a9c-9841-11e0-ae45-00144feab49a.html#axzz21xFzZYMW>

⁹⁸ For example, debt-financed speculation in property development by state-owned enterprises and the construction of non-economic infrastructure projects by local governmental entities.

The pervasiveness of corruption among CCP officials is exemplified by the insight offered by a retired senior Chinese government official:

“If you’re in that system, they’ll say, oh, your son should be a CEO. If you say, no, he shouldn’t, then they say, how can he not? If your son can’t be one then ours can’t be one either. Then they’d push you out of the boat. So if you’re in the boat, you’re corrupt. Everyone has a villa and they give you one. One in Beijing, one in Hangzhou, one in Suzhou, one in Shanghai. You say you don’t want it. What? But even the provincial leaders have villas, how can you not?”⁹⁹

- Bao Tong, former Director of the Chinese Communist Party’s Office of Political Reform and Policy Secretary to former Communist Party General Secretary Zhao Ziyang

Key Finding:

➔ The prevalence and operation of property speculation-fueled shark loan finance schemes ultimately results in the consumption (i.e., destruction) of intergenerational household savings of the individual participants in such programs.

Collapse of Local Government – Sponsored Ponzi Scheme



⁹⁹ “‘In the Current System, I’d Be Corrupt Too’: An Interview with Bao Tong,” interview by Ian Johnson with Bao Tong who served as Director of the Chinese Communist Party’s Office of Political Reform and also as policy secretary to former Communist Party General Secretary Zhao Ziyang, The New York Review of Books (June 14, 2012). The interview is accessible at: <http://www.nybooks.com/blogs/nyrblog/2012/jun/14/china-corruption-bao-tong-interview/>