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China's loan shark economy

What's ailing China? Explanations aren't hard to come by: slowing growth, bloated and inefficient state-owned enterprises, and a ferocious anti-corruption campaign that seems to take precedence over needed economic reforms.

Yet for all that, there is probably no bigger, more detrimental, disruptive or overlooked problem in China's economy than the high cost of borrowing money. Real interest rates on collateralized loans for most companies, especially in the private sector where most of the best Chinese companies can be found, are rarely below 10%. They are usually at least 15% and are not uncommonly over 20%. Nowhere else are so many good companies diced up for chum and fed to the loan sharks.

Logic would suggest that the high rates price in some of the world's highest loan default rates. This is not the case. The official percentage of bad loans in the Chinese banking sector is 1%, less than half the rate in the U.S., Japan or Germany, all countries incidentally where companies can borrow money for 2-4% a year.

You could be forgiven for thinking that China is a place where lenders are drowning in a sea of bad credit. After all, major English-language business publications are replete with articles suggesting that the banking system in China is in the early days of a bad-loan crisis of earth-shattering proportions. A few Chinese companies borrowing money overseas, including Hong Kong-listed property developer Kaisa Group, have come near default or restructured their debts. But overall, Chinese borrowers pay back loans in full and on time.

Combine sky-high real interest rates with near-zero defaults and what you get in China is now probably the single most profitable place on a risk-adjusted basis to lend money in the world. Also one of the most exclusive: the lending and the sometimes obscene profits earned from it all pretty much stay on the mainland. Foreign investors are effectively shut out.

The big-time pools of investment capital -- American university endowments, insurance companies, and pension and sovereign wealth funds -- must salivate at the interest rates being paid in China by credit-worthy borrowers. They would consider it a triumph to put some of their billions to work lending to earn a 7% return. They are kept out of China's lucrative lending market through a web of regulations, including controls on exchanging dollars for yuan, as well as licensing procedures.

This is starting to change. But it takes clever structuring to get around a thicket of regulations originally put in place to protect the interests of China's state-owned banking system. As an investment banker in China with a niche in this area, I spend more of my time on debt deals than just about anything else. The aim is to give Chinese borrowers lower rates and better terms while giving lenders outside China access to the high yields best found there.

China's high-yield debt market is enormous. The country's big banks, trust companies and securities houses have packaged over $2.5 trillion in corporate and municipal debt, securitized it, and sold it to institutional and retail investors in China. These so-called shadow-banking loans have become the favorite low-risk and high fixed-return investment in China.

Overpriced loans waste capital in epic proportions. Total loans outstanding in China, both from banks and the so-called shadow-banking sector, are now in excess of 100 trillion yuan ($15.9 trillion) or about double total outstanding commercial loans in the U.S. The high price of much of that lending amounts to a colossal tax on Chinese business, reducing profitability and distorting investment and rational long-term planning.

A Chinese company with its assets in China but a parent company based in Hong Kong or the Cayman Islands can borrow for 5% or less, as Alibaba Group Holding recently has done. The same company with the same assets, but without that offshore shell at the top, may pay triple that rate. So why don't all Chinese companies set up an offshore parent? Because this was made illegal by Chinese regulators in 2008.

Chinese loans are not only expensive, they are just about all short-term in duration -- one year or less in the overwhelming majority of cases. Banks and the shadow-lending system won't lend for longer.

The loans get called every year, meaning borrowers really only have the use of the money for eight to nine months. The remainder is spent hoarding money to pay back principal. The remarkable thing is that China still has such a dynamic, fast-growing economy, shackled as it is to one of the world's most overpriced and rigid credit systems.

It is now taking longer and longer to renew the one-year loans. It used to take a few days to process the paperwork. Now, two months or more is not uncommon. As a result, many Chinese companies have nowhere else to turn except illegal money-lenders to tide them over after repaying last year's loan while waiting for this year's to be dispersed. The cost for this so-called "bridge lending" in China? Anywhere from 3% a month and up.

Again, we're talking here not only about small, poorly capitalized and struggling borrowers, but also some of the titans of Chinese business, private-sector companies with revenues well in excess of 1 billion yuan, with solid cash flows and net income. Chinese policymakers are now beginning to wake up to the problem that you can't build long-term prosperity where long-term lending is unavailable.

Same goes for a banking system that wants to lend only against fixed assets, not cash flow or receivables. China says it wants to build a sleek new economy based on services, but nobody seems to have told the banks. They won't go near services companies, unless of course, they own and can pledge as collateral a large tract of land and a few thousand square feet of factory space.

Chinese companies used to find it easier to absorb the cost of their high-yield debt. No longer. Companies, along with the overall Chinese economy, are no longer growing at such a furious pace. Margins are squeezed. Interest costs are now swallowing up a dangerously high percentage of profits at many companies.

Not surprisingly, in China there is probably no better business to be in than banking. Chinese banks, almost all of which are state-owned, earned one-third of all profits of the entire global banking industry, amounting to $292 billion in 2013. The government is trying to force a little more competition into the market, and has licensed several new private banks. Tencent Holdings and Alibaba, China's two Internet giants, both own pieces of new private banks.

Lending in China is a market rigged to transfer an ever-larger chunk of corporate profits to a domestic rentier class. High interest rates sap China's economy of dynamism and make entrepreneurial risk-taking far less attractive. Those looking for signs China's economy is moving more in the direction of the market should look to a single touchstone: Is foreign capital being more warmly welcomed in China as a way to help lower the usurious cost of borrowing?

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