INTERNATIONAL SERVICES

UPDATE ON CHINA

Prepared by PNC's Shanghai Representative Office (SRO)

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Doing business in China presents an ever-changing array of challenges and opportunities. Via periodic updates, PNC's Shanghai Representative Office (SRO) will cover banking and business concepts that are common in China but may be unfamiliar outside of the Chinese market. We will also provide snapshots of China's most relevant economic statistics, such as GDP growth, foreign exchange rate and foreign exchange reserves.

CHINA SNAPSHOT

	China GDP Growth (Full-Year)	RMB Central Parity Exchange Rate[1] (USD/CNY, End of Period)	Foreign Exchange Reserves (Billions USD, End of Period)
2014	7.3%	6.2066	$3,843.02
2015	6.9%	6.4952	$3,303.62
2016	6.7%	6.9447	$3,010.52
1st Quarter 2017	6.9%	6.8886	$3,009.09
2nd Quarter 2017	6.9%	6.7805	$3,056.79
3rd Quarter 2017	6.8%	6.6369	$3,108.51

PBOC Reference One-Year Lending Rate	PBOC Reference One-Year Deposit Rate
4.35% (changed 10/23/2015)	1.50% (changed 10/23/2015)

HOW PBOC'S TIGHT CREDIT POLICY COULD AFFECT YOUR ABILITY TO OBTAIN FINANCING

The People's Bank of China (PBOC), China's central bank, announced a new campaign to tighten credit conditions in the second quarter of this year. Officially called a "deleveraging" 去杠杆 policy, the PBOC is signaling that it will limit the pace of credit growth, a response to China's debt buildup, which has made the economy more vulnerable to external shocks. China's total debt-to-GDP ratio grew from 225.8% in the fourth quarter of 2014 to 257% in the fourth quarter of 2016.[2] This buildup was not only of government debt, but also corporate and household debt as well, which rose to 210.6% of GDP in the fourth quarter of 2016 from 185.6% of GDP in the fourth quarter of 2014.[2]

REASONS FOR CONCERN

The buildup is a concern for several reasons. It could create a strain on the economy and health of the financial system if a portion of the debts were to default. Also significant is that the growth of credit creation is outpacing GDP growth. In other words, the economy isn't getting as much "bang for the buck" from credit creation as it used to. Finally, the continued reliance on debt to fuel GDP growth is a concern.

While regulators in China recognize that taking away too much credit from the system can halt economic growth, they also realize that continuing the current path risks creating a bigger issue down the road. This is not a new challenge; there have been concerns about the ballooning debt for some time, though in the past, it took a back seat to economic growth.

This time around, however, the regulators appear more resolute in tackling the debt problem. Since May, the PBOC has been draining liquidity from China's interbank market and raising the cost of funding for lenders, efforts to make loan extension more costly for banks. China's banking regulator is also increasing scrutiny of off-balance sheet lending (or shadow financing). Chinese regulators tolerate shadow financing since it is a viable source of funding for private Chinese companies who often are unable to borrow from China's state-owned banks, but regulators have also periodically cracked down on opaque and, therefore, more-difficult-to regulate business practices in this segment of the financial system.

While tighter credit conditions have created weakness in financial markets, such as stock and bond markets in the second quarter (though the second-quarter GDP figure showed resilience, growing at the same pace as the first quarter), regulators appear to be maintaining their course. While China's overall debt level is still increasing faster than GDP, the gap between credit growth and economic growth has narrowed, a sign that businesses must be prepared for tighter credit conditions to persist in the second half of 2017.

IMPACT ON FINANCING

Companies, including U.S. businesses, can find the new environment challenging if they need to obtain local financing. Foreign companies already face more difficulty, as banks may require fixed assets such as land and buildings as collateral, and many foreign companies only lease or rent.

Local banks are generally risk adverse with respect to lending and would prefer to lend to large corporates or state-owned enterprises as opposed to small-medium enterprises (SMEs), due to their higher default risks. From banks' perspectives, even if the company is not considered an SME in their home country, the local entity in China may be considered an SME due to its local revenue size. While current conditions persist, stricter monitoring and lending quotas by the PBOC may make obtaining financing in China a much more difficult task.

With that said, banking practices are highly decentralized in China, with each bank's branch and sub-branch responsible for maintaining its own clients and business results. As a result, companies can try different banks or even different branches of the same bank to obtain local financing.

As the PBOC continues its campaign, this trend may persist for some time. Should you have any questions about local financing, please contact your relationship manager for further discussion with the SRO. PNC's SRO can provide guidance on this process.

WHAT YOU NEED TO KNOW ABOUT CHINA'S NEW CYBERSECURITY LAW

China's new cybersecurity law came into effect on June 1, 2017, and may have implications for companies operating in China. It implements certain key components[3] and will:

- Define and establish requirements for organizations that are deemed to be critical information infrastructure (CII)
- Define and implement cybersecurity review methodologies and protocols
- Provide technical support to China's security agencies and regulators
- Encourage data localization

While the law has already gone into effect, it is currently more of a framework, with additional details on implementation and policies to be published and finalized in the next few months.

Foreign businesses need to determine whether or not they are a CII, which is defined in the cybersecurity law as:

Public communication and information services, power, traffic, water, finance, public service, electronic governance and other critical information infrastructure that if destroyed, degraded or vulnerable to leaks might endanger national security and the country's economy, as well as people's livelihood and the public interest.[3]

If a company is determined to be a CII, it will need to meet the requirements set by the cybersecurity law, including data localization and security of data.

Regardless of a company's industry or business in China, due to the comprehensive nature of the cybersecurity law, each company should be aware of the law and determine whether or not actions need to be taken to be compliant and whether the local entity in China has the necessary local support to be compliant and mitigate compliance risk.

PNC's Shanghai Representative Office has local resources available that can provide advisory services on this topic.

WHAT IS THE LENDING QUOTA AND WHAT DOES IT MEAN FOR COMPANIES IN CHINA?

The lending quota is a feature in China's banking system that may not be familiar to companies and banks operating in the U.S. While banks are generally governed by Basel III, which stipulates the capital and buffers banks must have on reserve, the lending quota is a lever that China's central bank, the PBOC, can use not only to ensure that banks have sufficient capital, but also to control the money supply and available credit in China's financial system.

Historically, lending has been strictly monitored and guided by the PBOC, with restrictions such as lending quota, loan-to-deposit ratio, required reserve ratio and mandatory loan provisions, etc., to ensure the health of the banking system, and that credit is not provided in excess. With the financial liberalization efforts, some of these restrictions have been loosened. The loan-to-deposit ratio historically capped at 75% was abolished in October 2015. The lending quota, however, is still in place today.

At a high level, the PBOC will determine the overall amount of credit that should be made available to the financial system and will direct commercial banks in China to adhere to each of their specific quota limits.

Depending on macroeconomic conditions, the PBOC may change the quota and set guidance to encourage or discourage specific types of loans, such as mortgages, SME lending, "green" financing, etc. Each commercial bank would then determine how to divide up the available credit to its branches. Due to the decentralized nature of banking in China, every branch/sub-branch may end up with a specific lending quota assigned by their headquarters or regional branch headquarters, as opposed to an aggregate quota that is shared between the bank branches.

If a company is looking to obtain financing in China, in certain market conditions, especially when the PBOC establishes a low quota, they may find that the branch has exhausted its quota and will not have available credit to lend. The bank branch may also be incentivized to lend to its larger or higher-revenue clients to maintain those relationships, leaving smaller clients out of available financing.

As the current drive in China of deleveraging the financial system continues, lending quotas may be a factor in the bank's willingness and ability to extend credit. PNC's Shanghai Representative Office can assist companies in understanding and navigating the current credit market.

ABOUT THE AUTHORS

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READY TO HELP

China's financial environment has experienced significant changes over the last few years, and we expect the trend to continue. PNC's Shanghai Representative Office can provide overall guidance and help you understand the implications of conducting business in China.

For more information, please contact your PNC Relationship Manager or visit **pnc.com/GoChina**.

1 China Foreign Exchange Trade System (CFETS); central parity exchange rate set by the PBOC. http://www.chinamoney.com.cn/fe/Channel/17383
2 Bank for International Settlements (BIS): Long series on total credit and domestic bank credit to the private non-financial sector. http://www.bis.org/statistics/totcredit/credpriv_doc.pdf
3 American Chamber of Commerce Shanghai: Understanding China's Security Law. https://www.amcham-shanghai.org/en/article/understanding-chinas-cyber-security-law

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