

## China Development Bank's financing mechanisms: focus on foreign investments

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China Development Bank (CDB) makes use of different methods to promote overseas investments in infrastructure projects, expand its global portfolio and support Chinese companies abroad. It provides financing to Chinese firms, stipulates energy-backed loans to foreign authorities and national oil companies and invests in private equity funds. This paper outlines and discusses these schemes.

### Background

China Development Bank is a major financial institution in the People's Republic of China. It is at the center of Chinese infrastructural development and has financed high-speed railways, roads, power grids and large-scale projects such as the three Gorges Dam. CDB is also the largest development bank in the world and, by financing Chinese investment overseas, a key player in China's 'going out' policy.<sup>1</sup>

This financial institution was established in 1994 as one of the three Chinese policy banks<sup>2</sup> to support projects in line with government's policy objectives. It is subordinated to the jurisdiction of the State Council, China's highest governing body. The Bank raises its capital by issuing bonds with terms of up to 30 years to institutional investors on China's interbank bond market and foreign markets in both renminbi and other currencies.<sup>3</sup> The Chinese state has full ownership of the Bank and implicitly guarantees its debt. As a result, CDB can provide lower interest rates and longer-term loans than other Chinese banks.

CDB has been able to support the macroeconomic infrastructural development policies of the central government, while at the same time pursuing a very commercially oriented and profit-driven strategy.<sup>4</sup> The story of CDB is inextricably connected to the man at the helm of the organization, Chen Yuan, who has been praised for making the Bank a very successful institution.<sup>5</sup> Under his guidance, the CDB's non-performing loan ratio<sup>6</sup> dropped from 42.65 percent in 1997, the year before he took office, to below 5 percent in only four years and then further to less than 1 percent, a level lower than any other major bank in China.<sup>7</sup> He also depoliticized the lending process by creating a system that separates the people in charge of the credit risk assessments from those responsible for

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May 2013. The views are those of the author. The contents can under no circumstances be regarded as reflecting the position of China Development Bank or other organizations mentioned in the text.

<sup>1</sup> The Chinese strategy that encourage its enterprises to invest overseas, [http://www.gov.cn/node\\_11140/2006-03/15/content\\_227686.htm](http://www.gov.cn/node_11140/2006-03/15/content_227686.htm).

<sup>2</sup> Together with the Export-Import Bank of China (China Eximbank) and the Agricultural Development Bank of China.

<sup>3</sup> BankTrack, Friends of the Earth, 'China Development Bank's overseas investments: An assessment of environmental and social policies and practices' (2012).

<sup>4</sup> For further discussion see Downs, E., 'Inside China, Inc: China Development Bank's Cross-Border Energy Deals', Brookings Institution, (2011).

<sup>5</sup> His biography is available at [http://chinavitae.com/biography/Chen\\_Yuan|1218](http://chinavitae.com/biography/Chen_Yuan|1218).

<sup>6</sup> A nonperforming loan is either in default or close to being in default.

<sup>7</sup> Downs, E. p.12 (2011).

the loan approval.<sup>8</sup>

Therefore, if on the one hand CDB has a very competitive and commercial vision, on the other hand its rating is linked to the sovereign rating, making funding costs relatively low. As it finances itself with long-term bonds rather than short-term bank deposits as other Chinese banks, long-term lending is less risky for CDB. This situation irritates the other banks given the fact that, as CDB costs are lower than the market, the bank can undercut competitors.

In January 2007 Prime Minister Wen Jiabao announced that the CDB and the other two policy banks – the Agricultural Development Bank of China and the Export-Import Bank of China – would become commercial entities. However the process of commercialization is on hold, indicating that there is still resistance to the role of the Bank taking a broader view of China's development objectives (rather than focusing exclusively on its own commercial interests). The financial crisis offered CDB the opportunity to highlight its indispensability in expanding and supporting the economy and to remind the Chinese leadership that a complete commercialization and subsequent higher bonds rates could put this at stake.<sup>9</sup>

CDB is at the heart of the system that has spurred domestic investments in infrastructure – the so-called local government financing vehicle (LGFV). The scheme was created by the CDB as a solution to help local authorities that, as a consequence of China's fiscal recentralization reform of 1994, found themselves with limited control over tax revenue and the impossibility to issue bonds to finance new projects. The LGFV mechanism allows local governments to set up companies that borrow loans from the CDB and other banks, using land as collateral. The authorities pay the interest on their loans by selling or leasing the same land. Therefore the system depends on high land values and on the revenue they generate. The risks for this type of loan could increase if the economy, or the real estate market experience, a slowdown.<sup>10</sup>

## **Financing mechanisms: focus on foreign investments**

The going out strategy has brought the CDB and its combined commercial and policy operational strategy to the international stage. CDB has significantly expanded its overseas portfolio in the last few years and entered into partnerships with governments and companies from over 140 countries; it has become China's biggest lender, financing cross-border transactions with a total foreign currency loan balance of USD 200 billion outstanding.<sup>11</sup> The following section outlines and discusses the financing mechanisms used by the Bank in this context.

### **A) Loans to Chinese companies**

CDB provides lines of credit to Chinese state-owned enterprises and private companies as they expand abroad, raising concerns among western governments.<sup>12</sup> For example, CDB has supported the

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<sup>8</sup> Downs, E. p.14 (2011).

<sup>9</sup> For more discussion, see Downs, E., (2011).

<sup>10</sup> For more information see, Forsythe, M. and Sanderson, H., 'China's Superbank' (2013), or Cohen, D., 'China's Superbank', the Diplomat, 26 Jan 2013.

<sup>11</sup> CDB website, 'CDB International: CDB Launches Offshore Investment Operations in Hong Kong,' 6 Dec 2011, <http://www.cdb.com.cn/english/NewsInfo.asp?NewsId=3906>.

<sup>12</sup> This paper does not enter in the discussion over trade relations among China, Europe and the United States. For an analysis of this issue (China-EU), see for example, Hanemann, T., and Rosen, D., 'China Invests in Europe' (2012).

Chinese telecommunication companies Huawei and ZTE to open up to the overseas market. The telecom firm Huawei received USD 30 billion to reduce its cost of capital and offer financing to its buyers.<sup>13</sup> In this way, Huawei provided funding to the Brazilian land-line company Tele Norte Leste Participacoes SA (TNLP3) to buy its products.<sup>14</sup> In this case, the CDB credit lines were used as so-called ‘vendor financing’, meaning that a company lends money to one of its customers so that the customer can buy products from it. By doing this, the company increases its sales even though it is basically buying its own products.

Furthermore, in 2010 and 2011 CDB extended lines of credit to major companies in the renewables sector - mainly manufacturers, such as Suntech Power Holdings Co., Yingli Green Energy Holding Co., Trina Solar Ltd., JA Solar Holdings Co. and Xinjiang Goldwind Science & Technology Co – for a value of USD 47 million. According to analysts, these energy and wind companies have however left most of the credit lines untapped. CDB’s loans to the renewables sector have different interest rates depending on the currencies and loan maturities.<sup>15</sup> They may even be more expensive than the ones companies find on the market. Therefore, the competitive advantage CDB offers is not the interest rate, but rather the high volume of the credit lines, serving as a guarantee to obtain more short-term loans from commercial banks.<sup>16</sup>

China, the world's largest carbon emitter (although its per capita emissions are still a fraction of those in the United States and the EU), also plans to meet 11.4% of its primary energy requirements from non-fossil sources by 2015.<sup>17</sup> In a few years’ time, Chinese companies in this sector have expanded rapidly, making China the world's biggest producer of solar products. However the sector has become a victim of its own excess: due to overcapacity and the dropping price of solar panels, market leader Suntech Power defaulted and other companies are struggling to be profitable.

CDB has directed its support not only to solar panel manufacturers but also to project developers. In autumn 2012, CDB extended USD 1.6 billion in credit lines to Sky Solar Holdings, a PhotoVoltaic power developer based in Shanghai. This decision indirectly helped the manufacturers, who witnessed the dropping price of solar panels in the last few years, by creating demand for their product.<sup>18</sup>

## **B) Loans to foreign energy companies and government entities**

In recent years CDB has extended lines of credit to foreign energy companies and government entities of countries such as Brazil, Ecuador, Russia, Turkmenistan and Venezuela. The loans are secured by revenue from the oil sold to Chinese national oil companies. They are characterized by their large size - up to USD 20.6 billion - and long term - up to twenty years.<sup>19</sup>

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<sup>13</sup> Hochberg, F., ‘How the US can lead the World in Exports: Retooling Our Export Finance Strategy for the 21<sup>st</sup> Century’ remarks at the Center for American Progress (2011).

<sup>14</sup> Forsythe, M. and Sanderson, H., ‘China’s Superbank’ Chapter 5, (2013), and Bloomberg News, ‘Huawei’s \$30 Billion China Credit Opens Doors in Brazil, Mexico’, 25 April 2011.

<sup>15</sup> Bakewell S., Bloomberg, ‘Chinese Renewable Companies Slow to Tap \$47 Billion Credit’, 16 Nov 2011.

<sup>16</sup> Forsythe, M. and Sanderson, H. (2013).

<sup>17</sup> Ni V, China Briefing, ‘China Sets New Greenhouse Gas Emission Reduction Goals’, 18 Jan 2012.

<sup>18</sup> Bloomberg New Energy Finance, ‘China vs Europe: a great renewables contrast’ 31 Oct 2012.

<sup>19</sup> Downs, E. p.1 (2011).

An energy-backed loan generally includes an agreement over the loan and over the sale of oil. Chinese oil companies buy the oil and deposit the payments into the CDB account of the foreign company. CDB takes the money it is owed directly from the account. Differently from what sometimes is believed, the oil is paid at the market price of the day the oil is received, not at a pre-established price. The agreement normally requires the borrower to buy Chinese equipment for infrastructure development. For example, a CDB loan provided funding, at least partly, for a project where the Chinese CITIC Group is building housing units in Venezuela.<sup>20</sup>

CDB offers commercial, non-subsidized interest rates. Nevertheless, it has used its energy-backed loans and the purchase requirements to reduce the cost of lending to countries that often are not able to borrow as easily on the global markets.<sup>21</sup> The mechanism was invented by Japan in the 1970s. At the time it was Japan that had the role of the borrower in exchange for oil from China. Not all CDB loans to foreign organizations are backed by oil or other natural resources. For example, in December 2011 CDB signed a memorandum of understanding with Kazakhmys plc, a mining company, for a USD 1.5 billion loan facility for a copper project in Kazakhstan.<sup>22</sup> Venezuela's state-owned oil company PDVSA obtained a loan of the same amount for the construction of a refinery in Brazil.<sup>23</sup>

The magnitude and the number of these types of loans is a recent phenomenon that considerably expanded since the global financial crisis. Before the crisis, CDB preferred method to become a more global bank was by acquiring shares in western banks. The internationalization of the bank was one of the reasons behind the acquisition of a 3.1 % stake in Barclays by CDB in 2007. The Chinese bank was also very interested in Barclays' expertise in global commodity markets and a few months later, the parties formed a commodities strategic alliance. However, since western financial institutions were hit by the crisis, the CDB has refocused its interest on energy and natural resources projects.<sup>24</sup>

### C) Equity funds

Another way CDB finances overseas expansion is via equity funds. In the last few years, CDB has invested in strategic Sino-foreign funds, such as the China-Africa Development Fund, the Sino-Belgian Fund, the China-Italy Mandarin Fund, the ASEAN China Investment Fund L.P and Infinity Group (in partnership with Israel's biggest conglomerate IDB Group). In line with its commercial transformation plan, CDB established a subsidiary - CDB Capital - to operate its private equity investment activities. CDB Capital's total assets under management in 2010 exceeded RMB 50 billion (USD 5.1 billion). It is the only Chinese bank-subsidiary licensed to invest in renminbi and played a pioneering role in developing China's equity market.<sup>25</sup> Its investment areas include urban development, fund investment, direct equity investment and overseas investment.

The China-Africa Development Fund (CAD fund) is China's largest private equity fund focusing on

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<sup>20</sup> Downs, E. p.53 (2011);Minaya, E., 'Venezuela Signs New Housing Construction Agreement with China,' Dow Jones International News, Jan 26, 2011.

<sup>21</sup> See Gallagher, K., Irwin, A., Koleski, K., 'The New Banks in Town: Chinese Finance in Latin America', (2012).

<sup>22</sup> Reuters, 'Kazakhmys plc Announces \$1.5 Billion Loan Facility To Fund Aktogay Project', 16 Dec 2011.

<sup>23</sup> Reuters, 'PDVSA gets \$1.5 bln China loan for refinery -paper' 4, Dec 2011.

<sup>24</sup> Downs, E. p. 30-37 (2011).

<sup>25</sup> CDB website 'China's First National RMB "Fund of Funds" Established', 28 Dec 2010, <http://www.cdb.com.cn/english/NewsInfo.asp?NewsId=3516> and 'CDB International: CDB Launches Offshore Investment Operations in Hong Kong', 12 may 2011 <http://www.cdb.com.cn/english/NewsInfo.asp?NewsId=3906>.

African investments and stimulating and facilitating Chinese investments in Africa.<sup>26</sup> In 2007, CDB made an initial investment of USD 1 billion into the fund and it aims to raise USD 5 billion. The CAD fund provides financial advice and invests in infrastructure, manufacturing, energy and agriculture projects. Furthermore, in 2010, CDB, together with the Suzhou Ventures Group, set up Guochuang, China's biggest Fund of Funds, in order to invest in industrial and venture capital projects. In 2011, it launched an overseas investment platform in Hong Kong and signed strategic agreements with global private equity funds KKR, Permira and TPG.

Developing private equity investment is part of CDB's ambition to become a globally competitive institution. Thanks to this strategy, Chinese investors can put their money in funds sponsored by the CDB instead of foreign private equity firms. It also means that the Chinese state has a stake in a potentially very profitable business. However, some observers are questioning if CDB went beyond its original mission and to which extent it is monopolizing capital.

## Conclusions

CDB has so far been able to combine government backing and commercial principles and find a powerful balance between profitability, expansion of its global portfolio and compliance with the State Council's objectives.

It has been innovative in developing new financing models to build infrastructure, looking towards sectors with promising growth-potential such as telecommunication and renewable energy, supporting the global expansion of Chinese firms and secure access to energy and natural resources. According to many, the CDB has been able to show that a strong development bank can be a powerful engine for infrastructure investments. Its model and its dimension challenge banks, companies and policy-makers in the West.

On the other hand, the bank faces significant risks. The rise in local government debts and concerns over the local government financing vehicles (LGFV) system - deeply connected to CDB's domestic financing - were behind the decision of Fitch to cut China's credit rating in April 2013. Since the beginning of 2009 to mid 2012, state-owned banks have issued around RMB 35 trillion (USD 5.4 trillion) in new loans to boost the economy during the global financial crisis. This move fueled housing prices and incentivized local governments to accumulate additional loans that they are struggling to repay, particularly if the real estate market goes towards a more serious slowdown. CDB is the biggest lender to LGFV that have accumulated at least RMB 10.7 trillion in debt.

Furthermore, as previously mentioned, CDB raises its capital by issuing bonds on China's interbank bond market but commercial banks are finding harder to extend credit to CDB. The Bank faces uncertainty also at international level as Venezuela, one of its biggest clients, is going through a new political season following the death of Hugo Chavez.

Besides the risks, CDB will have to make some strategic decisions about its future. It remains to be seen if the Bank will become a fully-commercial institution and raise money at its own credit rate. Several interviewees said the future of CDB's reform is unclear. The debate will continue between

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<sup>26</sup> CAD Fund website, 'Company Overview' <http://www.cadfund.com/en/NewsInfo.aspx?NId=48>.



those who see the CDB as key to stimulate the Chinese economy and the expansion overseas and those who want to open up and reform the Chinese financial system as it grows more complex.

While many analysts in China and overseas foresee a more modest economic growth than previous years and a new leadership have recently taken office, the State Council has expressed readiness to move towards new reforms for the country. The changes may include the liberalization of interest rates, the renminbi convertibility in the capital account and more control over the risk of local government indebtedness. “Excessive reliance on investment in infrastructure construction is unsustainable,” said Jin Liqun, chairman of the board of supervisors of China Investment Corporation.<sup>27</sup>

In April 2013 Mr Chen stepped down as Chairman, replaced by Hu Huaibang, the former head of Bank of Communications. Mr Chen is taking up a new challenge in helping setting up a new development bank for the BRICS. This event is indeed a milestone in the history of the Bank. Hu’s appointment may speed up the process of converting CDB into a commercial lender. “The task of market-oriented reforms is still far from complete. We must have more courage and wisdom,” Hu said at the People’s Daily.<sup>28</sup> However at the moment it is not easy to imagine how to reform the CDB financing structure on which so many local governments, Chinese and foreign companies rely. The double policy and commercial nature is not always easy to manage for CDB either; for some of those who work with the Bank, their internal approval process can be sometimes time-consuming. Many argue that CDB, which has successfully built infrastructure in China and not only, has now to find a clearer identity.

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