WHY MARKETS FROWNED UPON A GOOD DECISION
Source: JFU
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The Hang Seng Index dropped by almost 2.5% on November 9, 2018 when it was reported that a Chinese regulator asked Chinese banks to provide more loans to privately-owned firms.

The rationale of the decision was clear. While privately-owned firms account for 60% of the economy, they only receive 25% of all business loans extended by banks. This decision was intended to rectify this mismatch, and over the next three years, achieve the goal of making at least half of all new bank loans available to private businesses starving for cash. SMEs now has to pay ultra-high interest rates when funds are only accessible outside traditional banking channels. Such a high funding cost environment squeezes SMEs and devalues the entire private sector, according to the capital asset pricing theory. Thus, the decision as reported is a good move. Why, then, does the market behave otherwise?

The situation is paradoxical. The market does not disapprove of the decision from Chinese regulators, but rather reacts as a result of a poor faith in banks' ability to deal with bad debt risk.

Financial activities of SMEs are notoriously opaque. The retired Premier Zhu Rong Ji once urged the state institute of accounting, at the inception of the institute to tell its students "no false accounting." One probably still hears the sense of agony in his voice lingering in the air, when looking at the current environment. The students that Premier Zhu put his hope on, are now working accountants and in the professional position to honor the premier's wishes.

The banking industry has professional accountants as their means to attaining financial transparency—the solution to bad debt risk. Simply put, banks need to demand good accounting, and SMEs, currently starved of good funding sources, will have to comply with bank standards in order to get loans. The banks have the power to turn this situation into an all-win outcome: the private sector grows with better players, the banking industry grows with quality earnings, customers grow with cheaper funding, the value of private business grows with happier investors, and tax revenue grows with more credible producers. The potential beneficiaries are innumerable!

The government's decision to increase private lending can set in motion a virtuous cycle, and must not be retracted.

Some commenters, upon hearing that regulators are prepared to be more accommodating, suggest that banks achieve the 50% SME lending goal by parking their funds with mega private firms. Mega private firms, however, are firms for which cheap funds are already very accessible. This is the type of strategy that worries us.

Regulators must do better to outsmart such risk-aversive behaviors by asking the players (both the banks and the private businesses) to do what is right—good accounting.