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China's shadow banking sector comes into the spotlight

Official encouragement of wealth management products will bring de facto interest rate liberalization

Some observers believe that the recent rapid expansion of China's shadow banking sector threatens financial and price stability. After close examination of the issue we have reached a very different conclusion.

Key Judgments

- China's financial authorities have tolerated the rapid expansion of shadow banking activities because they hope to learn lessons about how to implement future financial sector reforms.
- The authorities will sooner or later crack down on activities they find undesirable such as off-balance sheet lending and securitized finance, while tolerating "good shadow banking" such as wealth management products.
- On balance, wealth management products help to underpin the stability of the Chinese banking system by improving the efficiency of capital allocation in the domestic economy and promoting de facto interest rate liberalization.

The debate over shadow banking

So-called "shadow banking" comprises the activities of depository and non-depository banks and other financial entities that are regulated lightly or not at all, in contrast to regular bank loans, which are strictly controlled by the People's Bank of China (PBoC) and the China Banking Regulatory Commission (CBRC). China's shadow banking sector includes a broad variety of products and activities:

- Entrusted lending, in which a bank acts solely in an agency capacity between the lender and investor without taking any direct credit risk;
- Trust lending, in which bank loans (usually with multiple obligors) are repackaged by trust companies and sold on to investors. The credit quality of the underlying loans may vary considerably and may or may not be guaranteed by the originating bank or trust company. Such loans may also be collateralized by other financial instruments such as exchange bills, acceptances and letters of credit;
- Wealth management products (WMPs), typically yield-enhanced short-term fixed-income products, though some structures offer returns linked to equities and mutual funds;
- Private informal lending, in which some non-financial firms and wealthy families lend their excess cash to other firms and individuals. A lending firm may set up separate financing vehicles to book the loans or carry the claims directly on its balance sheet. We estimate that informal lending accounts for more than 20 per cent of overall shadow banking;
- Credit guarantee companies, which extend guarantees on loans and other financial instruments that are then typically used to raise cash for the purchaser of the guarantee;
- Financial leasing companies, which provide financing in the form of leases;
- Other financial firms such as small loan companies and pawn shops that provide financing to retail clients.

The reasons why shadow banking activities have mushroomed over the past two years are straightforward. China's monetary policy is largely based on direct controls on bank lending, not on interest rates. Whenever the authorities attempt to rein in credit growth the incentives to evade such controls rise sharply. Credit funnelled through shadow banking products thus weakens the effectiveness of monetary policy in controlling overall liquidity. The regulators usually act to bring such activities under stricter control, but there is an inevitable lag between the growth of such lending and the clampdown on it. This encourages a financing pattern in which players in the shadow banking sector attempt to stay one or two steps ahead of the regulators by "innovating" new types of lending that evade government control.Some analysts argue that the seemingly uncontrolled growth of shadow banking activities threatens financial and price stability. A Google search for "China shadow banking" produces over 10 million entries, many of them with menacing words in their titles such as "mysterious", "out of control", "Ponzi finance" and "worrying", to name just a few. The typical argument about shadow banking points to the fact that even though the PBoC has raised reserve requirement ratios (RRRs) nine times and interest rates five times since last October the rapid growth of liquidity in this shadow banking system is fuelling inflationary pressures. Next come stories about various dodgy lending schemes and huge profits that non-financial companies are making by lending their spare cash to hard-up borrowers. The implication is that shadow banking is piling up huge potential losses from such activities and fuelling liquidity growth that is far higher than the official figures indicate.

These narratives have problems. For one, it is highly misleading to draw dire sector-wide implications from a handful of questionable practices. In the absence of more complete data it is impossible to know how widespread such “bad" shadow banking activities are. Second, the scare stories about shadow banking imply that the financial authorities know about such activities but are unable or unwilling to control them. This is simply not credible. Our view is that the authorities will sooner or later crack down on the activities that they find undesirable. For example, in July the banking regulator ordered the suspension of six types of high-yield WMPs with high risk ratings. The fact that they tolerate some shadow banking activities suggests they welcome such practices, what we will call “good shadow banking”. We suggest an alternative view of China’s shadow banking sector. Good shadow banking actually promotes a more rational allocation of savings and investment – savers are able to access higher-yielding savings instruments because borrowers who can use the funds more efficiently than others are able to bid away capital. This interpretation of shadow banking clearly recognizes that such a state of affairs is a second- or even third-best option compared to a liberalized capital market, which is China’s long-term reform goal. However, the activities of the shadow banking sector make the current system of monetary control somewhat more efficient in allocating capital – albeit with certain undesirable consequences that have to be controlled.

By offsetting the inefficiencies and irrationality of China’s current monetary management tools good shadow banking can point the way to future reforms. Implicit in this conclusion is a view that China’s financial reform will move forward gradually via “trials” of more liberalized activity rather than a once-and-for-all change. Thus good shadow banking activities will be tolerated – even encouraged – so long as they do not lead to undesirable results. This is another way of saying that the authorities are conducting a financial experiment to see which liberalized activities can be tolerated and which will have to be stamped out.

Below we survey WMPs which we believe are the types of partially liberalized financial instruments the authorities want to promote.

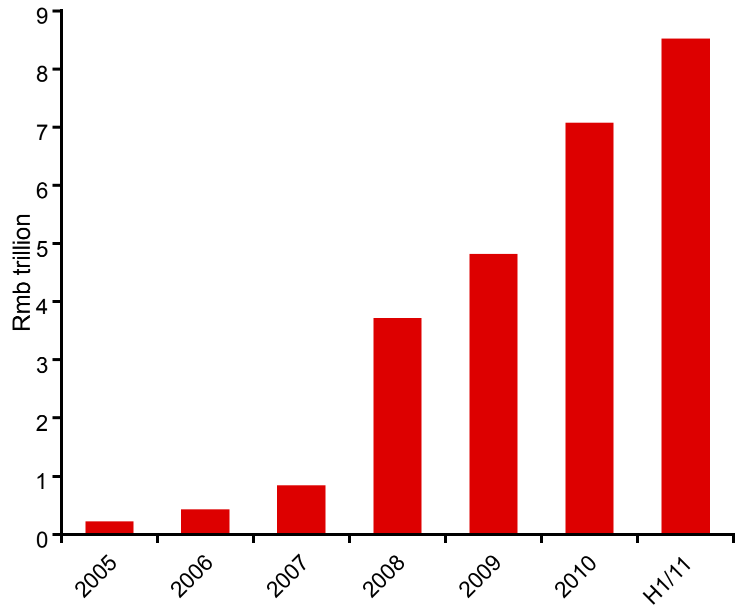
Wealth management products show the way forward for reform

WMPs are investment products that offer investors higher total returns than bank deposits but also carry increased risks. WMPs are originated by banks or third-party independent investment distribution companies that act as intermediates. The product range is wide, from structures that pay rates based on the Shanghai Interbank Offered Rate (SHIBOR) to structures tied to returns on bonds, equities, money market instruments, investment trusts, private equity funds and even other investment funds such as Qualified Domestic Institutional Investors investment funds.

WMPs are sold to both higher-end retail and corporate clients though the minimum investment is relatively low, typically Rmb50,000 (US$7,800). Investors bear the risk of the specific securities included in a given structure, ranging from low-risk money market instruments to much riskier equity-related structures. Financial firms typically offer principal-protected and principal-unprotected structures. Before such products are offered to the public, financial institutions must get them approved by the CBRC. Both bank deposits and WMPs bear the risk of the issuing institutions, many of which are state-controlled.

According to Wind Information, among the various product types there were 8,497 distinct structures worth Rmb8.5 trillion (US$1.3 trillion) issued in H1/11. This exceeded the Rmb7.1 trillion (US$1.1 trillion) issued during the whole of 2010 and is double the amount of total new loans of Rmb4.2 trillion (US$646 billion) extended by the banking system in H1/11.

Chart 1: Total value of new wealth management products issued, 2005-H1/11



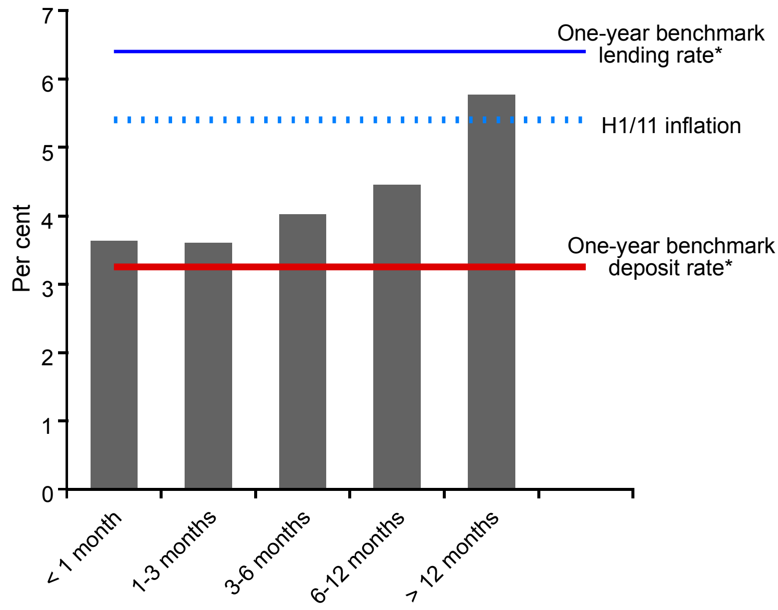
Source: PBoC.

Both local and foreign media have charged that WMPs sold by commercial banks are funding cash-strapped real estate and infrastructure projects. They view these WMPs as off-balance sheet liabilities for Chinese banks that carry an implicit guarantee from the government. This line of reasoning then leads to the conclusion that China faces risks of a large-scale banking crisis that will necessitate government bailouts. We acknowledge that overall commercial bank exposure to local government-sponsored infrastructure projects and the property sector is much higher than figures cited from banks' balance sheets. But we do not agree that those WMPs are simply backdoor channels for banks to evade loan quotas and the authorities' other controls.

Before 2010 banks largely sold credit-backed WMPs. After the CBRC started to regulate risky trust loans and other risky types of WMPs in H2/10, mixed asset pools have gradually become the predominant product model of the banks' wealth management businesses. Mixed asset pools take capital raised by various WMPs and invest in multiple asset classes. Liquidity and maturity mismatches are the primary sources of higher yield. We estimate that over 30 per cent of these funds are allocated to bonds and money market instruments, around 25 per cent are credit assets or projects created by banks and trust companies and another 25 per cent are allocated commercial paper or other bills of exchange.

Yields on WMPs are typically about 100-250 bps above rates on bank deposits, but they are still lower than the banks' minimum lending rate. Often the assets underlying the WMPs are composed of the banks' own top-quality loans (evidenced by the fact that the yields offered on these products never exceed the benchmark lending rate). In addition, the primary investors in WMPS are usually the banks' top-quality customers. In our view, satisfying high-net-worth clients' needs by creating products paying sub-benchmark lending rates can be relatively easily achieved.

Chart 2: Expected annual yield of WMPs issued in H1/11



* As of 30 June 2011.

Sources: PBoC, NBS and Benefit.

The bottom line shows little evidence to suggest that WMPs have significantly increased the potential instability of the Chinese banking sector.

- The total outstanding balance of the WMPs is still manageable because the overall net balance is small.
- Monetary tightening and a negative real interest rate were the primary drivers of the rising popularity of WMPs in China. Since we believe that China's current monetary tightening cycle has almost finished, the new issuance of WMPs will slow down in the next 12 months.
- The emergence of WMPs helps to improve overall domestic capital allocation efficiency, which could in fact improve the stability of the Chinese banking system over the long run.Both foreign and Chinese media have substantially overestimated the size of the WMP market because they typically only add up all of the newly issued WMPs and do not subtract redemptions. The total outstanding balance of WMPs is far smaller than the accumulated size of issuance due to the short duration and rolling nature of these instruments in China. According to the most recent PBoC quarterly monetary report, the total value of all outstanding WMPs was Rmb3.6 trillion (US$554 billion) – equivalent to about 7 per cent of total outstanding bank loans. The net increase in outstanding WMPs in H1/11 was about Rmb800 billion (US$123 billion), compared to Rmb4.2 trillion (US$646 billion) in new bank loans extended during the same period.

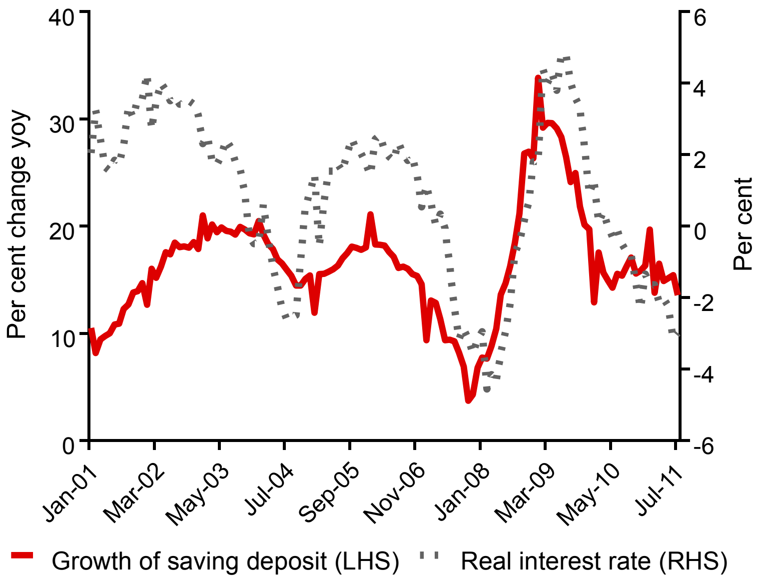
Behind the wealth management boom

The PBoC has used both interest rates and RRRs to slow the growth of credit in the financial system since late 2010 in order to suppress inflation. In addition, the central bank imposed direct administrative limits on how much commercial banks can lend. But this approach only targets the supply of bank credit, not the broader level of liquidity that includes shadow banking activities. This method of monetary control is limited because it focuses only on the volume of lending and has little direct impact on the cost of credit. Banks have a very strong incentive to find ways to keep lending outside the formal banking system because they earn a guaranteed margin on their loans (due to the cap on deposit rates). Negative real interest rates and the recent monetary tightening cycle have triggered an acceleration in such activities and are responsible for the increase in WMPs. In our view, the growth in WMPs will likely slow in the next 12 months as real interest rates improve and the monetary tightening cycle reaches a peak

1. Negative real interest rates

China's strong recovery in 2009-10 after the global financial crisis was accompanied by the bounce back of inflation into positive territory in late 2009. Inflation continued to rise throughout 2010 but the PBoC was reluctant to increase interest rates until October. As a result, real interest rates fell sharply from 4.8 per cent in July 2009 to -2.9 per cent in July 2011. Facing declining real returns on their savings and double-digit food inflation, savers demand higher returns on their savings. As real interest rates fell from the peak reached in July 2009 the growth of retail bank deposits also slowed markedly, levelling off at a year-on-year growth rate of around 15 per cent since mid-2010, from around 30 per cent in early 2009. The slowdown in deposit growth was reflected in surging sales of WMPs.

Chart 3: Banks' total saving deposit growth rate and real interest rate, 2001 – July 2011



Source: CEIC.

2. The tightening cycle and the banks' games

Beijing has signalled that it is serious about enforcing a "prudent monetary policy" by raising RRRs nine times since last November. Compared with restrictions on loans, the RRR has the advantage of limiting the ability of banks to lend by forcing them to set aside more reserves with the PBoC. In order to boost the denominator of the loan-to-deposit ratio (LDR), banks attract new customer inflows by offering WMPs with higher yields than those on deposits. In some cases, smaller banks even finance yields on WMPs from other profit streams via accounting tricks to boost their deposit base (local media reported that some banks booked the cost of issuing WMPs as investment returns instead of net interest income).

Banks often attempt to match their product issuance and expiry dates with PBoC inspection dates so as not to breach their reserve ratios. For instance, the life cycle of banks' WMPs can be divided into four stages: fund raising, pre-investment, investment and maturity. Funds move on and off banks' balance sheet at different stages of the life cycle of a typical WMP. Commercial banks always start their fundraising activities for WMPs after the end of certain months when they have counted customer funds as demand deposits in their balance sheets. Banks typically structure the expiry day prior to the end of a month/quarter when the proceeds of WMPs (principal and investment yield) will likely be converted into bank deposits that are then included in the total deposits monitored by the PBoC. This also explains why more than 90 per cent of WMPs have maturities of less than six months – because banks use WMPs as a short-term boost to their deposit base. Last year the CBRC required commercial banks to meet the 75 per cent loan-to-deposit ratio on a quarterly basis but since 1 January 2011 banks have been required to report data monthly. In response to the surge in WMP issuance in H1/11, the CBRC in June ordered banks to start reporting their average daily LDRs on a monthly basis while the ceiling for the average daily LDR was unchanged. In fact, issuance of short-duration WMPs dropped significantly in July.

Table 1: Structure of wealth management products issued in H1/11

	Share of total (per cent)	Expected annual yield (per cent)
Less than one month	32.8	3.61
1-3 months	29.3	3.58
3-6 months	21.0	4.00
6-12 months	4.0	4.43
More than 12 months	2.3	5.75
Unspecified	0.7	3.31

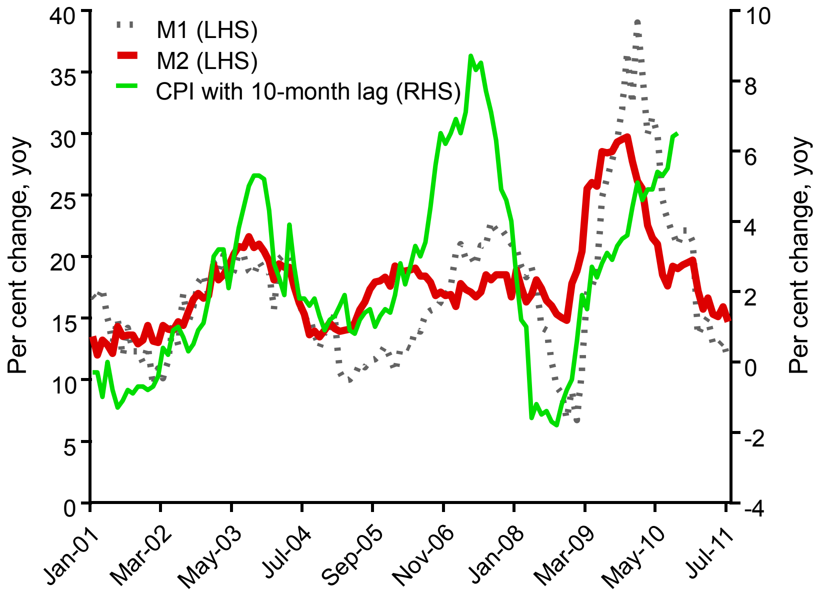
Source: Benefit.

Implications for investors

Financial innovation brings new challenges for liquidity control

Macro liquidity serves as an important indicator for predicting future economic and market trends. The growth rates of M1 and M2, the most commonly used quantitative indicators to measure monetary conditions, have fallen significantly since 2009 and now are at their pre-crisis levels of around 16 per cent. Historically, growth trends of M1 and M2 have led CPI trends by around 10 months. Since they peaked in November 2009 and January 2010 respectively, however, this relationship no longer appears to hold.

Chart 4: Money supply and inflation, 2001 – July 2011

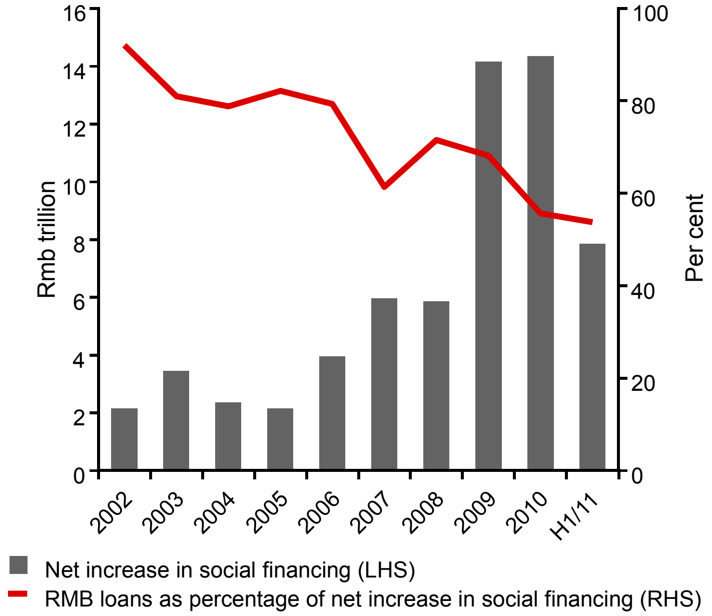


Source: Bloomberg.

In recent years the rapid expansion of China's financial market and the availability of new financial products have altered the composition of broad liquidity, of which M2 has become a less accurate indicator. Some of the WMPs in China are similar to the money market funds of developed economies, which can be easily converted to cash. Therefore, they should be counted as part of broad liquidity but they have not yet been captured in M2. In other words, the PBoC's traditional monetary policy framework does not target this larger pool of liquidity effectively under current conditions. In our view, this means that control of market liquidity via growth targets on bank loans and M2 is much less effective than it was previously.

In order to gauge domestic liquidity conditions more accurately, early this year the PBoC introduced a new measure called "total social financing" (TSF).Similar in concept to flow-of-funds data, TSF adds up bank lending, entrusted loans, trust loans, bank acceptance bills, bond financing and stock market share issuance. Now it is possible to monitor the growth of bank loans (monthly) as well as TSF (quarterly) to gauge the overall liquidity in the market more correctly. New bank loans as a percentage of TSF decreased from 92 per cent in 2002 to 54 per cent in the first half of 2011.

Chart 5: Net increase in total social financing, 2002-H1/11

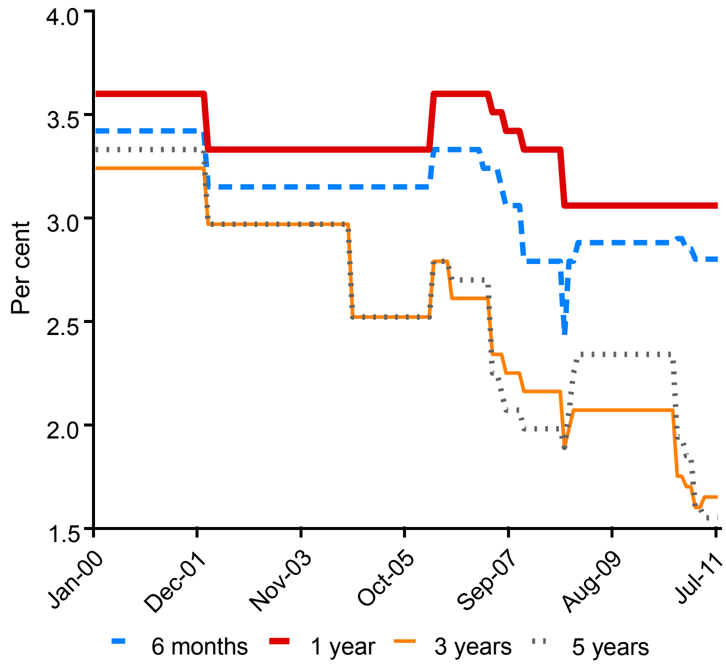


Source: PBoC.

Banks' profit margins suppressed

For years Chinese banks generated the bulk of their earnings from their large net interest margins (NIMs), which were dependent on official interest rate policies that set the statutory minimum lending and maximum deposit rates on maturities beyond one year. Recently the banks' NIMs have been falling, threatening income from this source. The spread between the minimum one-year lending rate and the maximum one-year deposit rate has been at least 300 bps since 1999. However, since the PBoC began hiking interest rates in October 2010 the spread between lending and deposit rates for longer-dated maturities has narrowed. Although monetary tightening may improve NIMs in the very short term, banks' subsidized NIMs will shrink over a longer time horizon (see Chart 6 below).

Chart 6: Chinese banks' net interest margins, 2000 – July 2011



Source: CEIC.

On top of protected NIMs, Chinese banks are nearly 80 per cent deposit-financed. The lack of alternative financial instruments for savers is the reason for China's high savings rate and speculative activities in the property and stock markets. With yields higher than deposit rates, WMPs are good investment options for private households and can fill the gap between the risk-free low-yield bank deposits and high-risk high-yield equity products. This means "financial disintermediation" will force growth of banks' deposits to slow down sharply in the coming three-five years – which also means Chinese banks' profits will be under pressure.

Interest rate liberalization is under way

WMPs have expanded substantially from a low base and offer depositors higher yields, often with guaranteed principal. This to a large extent implies de facto interest rate liberalization because a sizeable number of WMPs were structured to pay SHIBOR, the potential benchmark reference rate for Chinese financial markets. Such innovation has facilitated a free interest rate market beyond the fixed lending rates given by the PBoC. In recent years households have lost out via negative real returns on their savings, while corporates have borrowed at low rates, resulting in overinvestment and deteriorating return on capital. We believe that interest rate reform will improve domestic capital allocation, and in turn help to develop higher productivity outside the industrial sector.

The ceiling on deposit rates still perpetuates a gap between regulated deposit rates and market interest rates. The Chinese government has taken steps to gradually deregulate deposit rates and plans eventually to liberalize them. In such a circumstance, new high-yield financial products would continue to emerge while the role of formal bank loans continues to shrink.

Starting from the early 2000s, interest rate deregulation moved from wholesale to retail, from lending to deposit rates, and from foreign currencies to local currency. This gradual approach was designed to safeguard the profit margins of commercial banks. So far the PBoC has implemented an upward-floating band for lending rates to manage the pace of liberalization. We believe deposit rate liberalization will start with longer maturities and large deposits, later moving on to short-term small deposits. Commercial banks which have higher capital adequacy ratios, healthy LDRs and solid risk-management records could be chosen as pilot institutions with higher price-setting power during the process of liberalizing interest rates.

PBoC Governor Zhou Xiaochuan has also expressed his institution's intention to promote interest rate liberalization during the 12th Five-Year Plan. In our view, the PBoC will continue to standardize various new financial instruments such as WMPs and trust loans under the current monetary framework. In future the increasing substitution of deposits by WMPs will facilitate interest rate liberalization. As the head of the PBoC's statistics and research department Sheng Songcheng said in a recent conference, loans are less sensitive to interest rates than are innovative financial products; financial institutions are encouraged to offer diversified financial products and services. As financial innovation progresses, interest rate-sensitive financial products will likely expand as a percentage of the TSF, making the TSF more sensitive to changes in government interest rate policy.

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