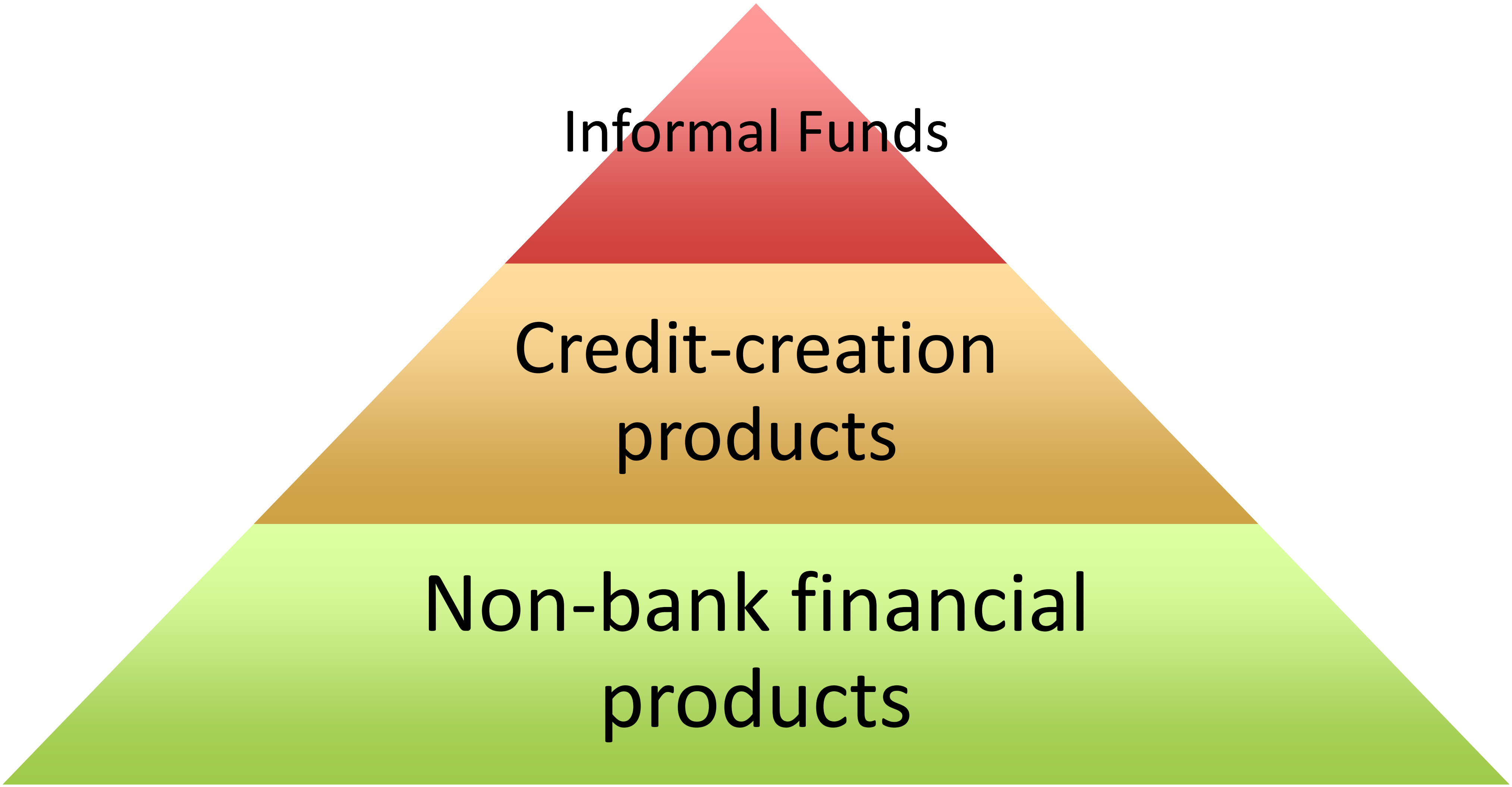
The Wealth Market, the Banks, and China's Local Politics

What Are Shadow Banks and Why Do They Matter?

- Any financial institutions that are not banks
- Two types: documented and truly gray.
- Documented includes bonds, trusts, stock issues, and bank bills. This type represents almost half of the credit now being issued.
- Undocumented type includes private equity, hedge funds, the wealth management market, “entrusted lending,” pawn shops, and private lending groups, which are often Ponzi schemes.
- Two reasons to care:
  - Lightly regulated, the shadow finance sector regularly generates scams and defaults.
  - Shadow banking is undermining the government’s ability to set rates and to rely on deposits to fuel state-directed lending. These are core to the Chinese growth model.

Three Types


Informal Funds
Credit-creation products
Non-bank financial products

Non-Bank Financial Products

- Means for getting higher yields for capital
- Often work closely with banks

Trusts

- Theoretically, capital pooled for a common purpose. Now 66 licensed trusts in China, state-owned, with nearly 4,000 individual funds under management.
- Established with Citic in 1979. The trusts took deposits and financed projects.
- Bankruptcies in late 1990s led to closings and clean-up of industry, ending in 2007.
- Roughly 6 trillion RMB under management, returns 2010-2011: 8-10%, compared with bank deposit rates 3-3.5%.
- Real estate trusts were about half until restricted in May 2011.
- Bank-trust cooperation very popular until also restricted.

What happened with GITIC

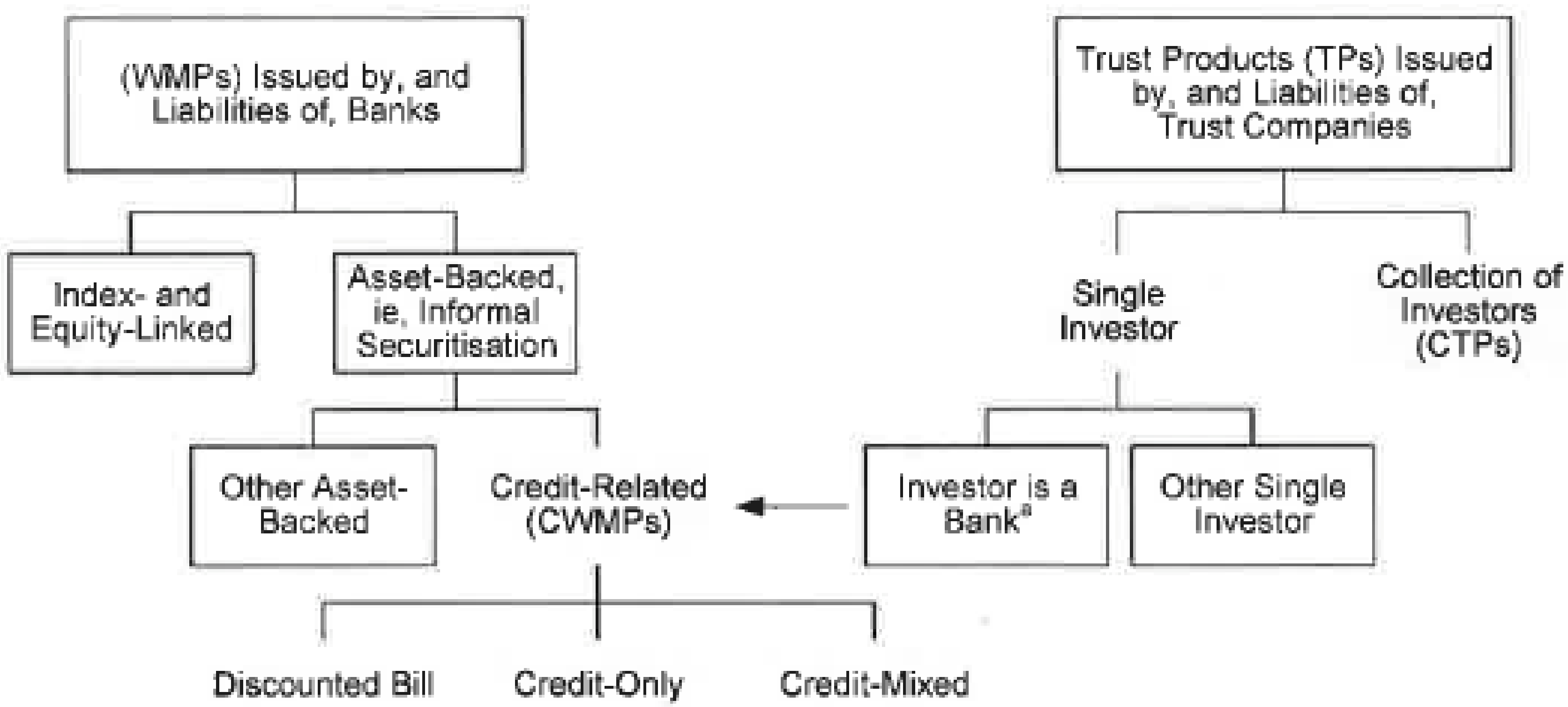
- 1998: Gitic defaults on a $150 mln debt.
- Rather than pay, the central government closes Gitic and forces it to declare bankruptcy. In 1999, 320 creditors claim 38.8 bln in liabilities.
- Eventual payout is 12.5% of recognized debt.
- Proceedings found that Gitic had engaged in uncollateralized lending, unsecured guarantees, investments in Hong Kong and China property markets whose value had declined, and guarantees for overseas investments.

Wealth Management Products

- Similar to term deposits: higher-yield investment packages, skins that are stuffed with any credit instrument but most often, bank loans.
- Roughly 7.1T RMB outstanding Q4 2012.
- Currently represent roughly 3T in loans.
- 90% have terms of one year or less.
- Managed in pools, so new WMPs often pay out the old WMPs. In 2012, about 2.5T of WMPs coming to term per month.
- About 80% now are issued inter-bank to promote bank liquidity.

WMPs vs. Trusts

Types of Investment Products



Risks

- WMPs are really securitized loans. The loans are seen as backed by the banks but actually are not.
- Standards of collateralization, loan diligence are very weak.
- Huaxia issue in December: Henan investment company

Bancassurance

- Low-interest alternative deposit channel. Deposits are locked up for 5-10 years.
- No principal guarantee. Usually contains an insurance component.
- Banks distribute in return for agreement to hold deposits.
- Recent protest over lost principal led regulators to step in and require principal repayment.

Listed Funds, REITS, and Brokerages

- Brokerages manage about $320 bln in assets, acc. To the Financial Times.
- REITS and listed funds really got under way in 2011 and are accelerating quickly.

Credit-Creation Products

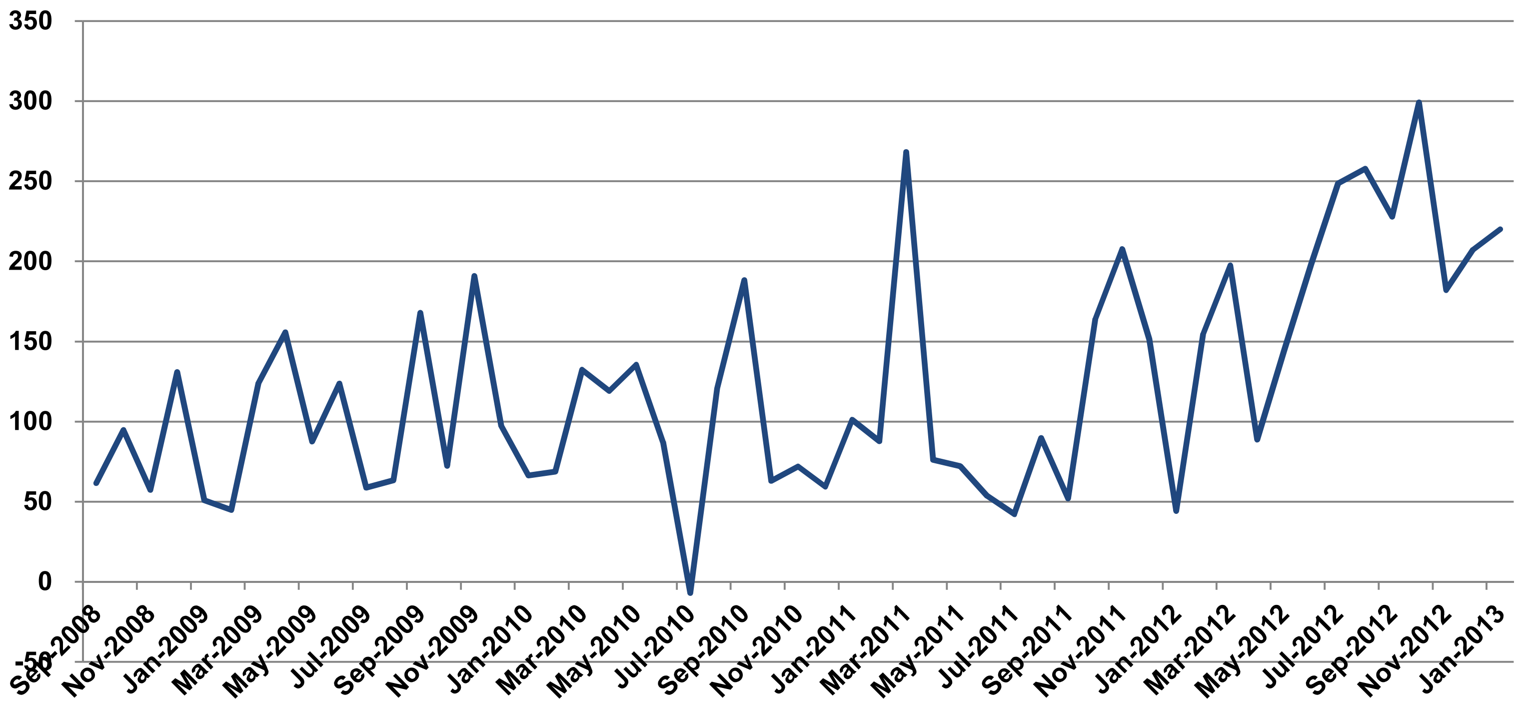
- Entrusted loans
- Private equity and venture capital
- Bank acceptances
- Bonds

Entrusted Loans

- Q1-Q3 2012: 1 trillion RMB
- Zaitech: cash-rich SOEs turn to lending money to others.
- In addition to single SOEs, small companies form associations to engage in entrusted lending.

Bonds

- Now being issued at a rate of about 200 bln/mo. Through 2008 the amount was very small.
- Only banks and SOEs are permitted to trade them, and the market is very thin.



Corporate bond issuance Q4 2008-2012

Source: PBOC

Private Equity, Financial Leasing, Pawn Shops, and Guarantors

- Private equity is now a common method of extending loans secured with equity or warrants. Offshore private equity completed about $250 bln in deals 2001-2012. Onshore private equity started later but tends to be larger in scope. AUM are unknown.
- Financial leasing industry: bank-owned and independent. Independent leasing as of 2011 was about 930 bln RMB. About 12 bank-owned financial leasing companies.
- Pawn shops did 180 bln RMB in business in 2010, according to SAIC. Small loans against collateral. Increasingly, the collateral is land or real property. Often associated with organized crime. Managed by PSB.
- Guarantors are supposed to perform credit checks and maintain cash resources to guarantee loans. In practice, they keep the portion of the loan that is required for the guarantee and start making loans themselves.

Source: Jianjun Li and Sara Hsu, "Shadow Banking in China," New York Times, J Capital

Bank Acceptance Notes

- Essentially a form of currency, or bank check, issued at will by banks against deposits of 10-50% of the BA value.
- Brokers cash them at a discount and lend on the cash.
- 5.8T outstanding in January 2013

Informal Funds

- Micro-lending companies: registered companies in 2011 had 392 bln in loans. But unregistered companies abound.
- Investment companies and loan societies: almost completely undocumented, very common, generally small-scale.
- Internet lending platforms: reported to be worth about 14 bln RMB in 2011.

Why Does It Matter?

- In normal times, the private market exists but is no more than 1% of lending and can be ignored. But in the last few years, this interpersonal credit has grown to more than 10% of the total.
- Often, small lenders have some affiliation with local government, and the investors think their capital is safe.
- Some places have almost universal involvement in thee funds. When the funds become insolvent, grandmothers lose their life savings.

Small Loans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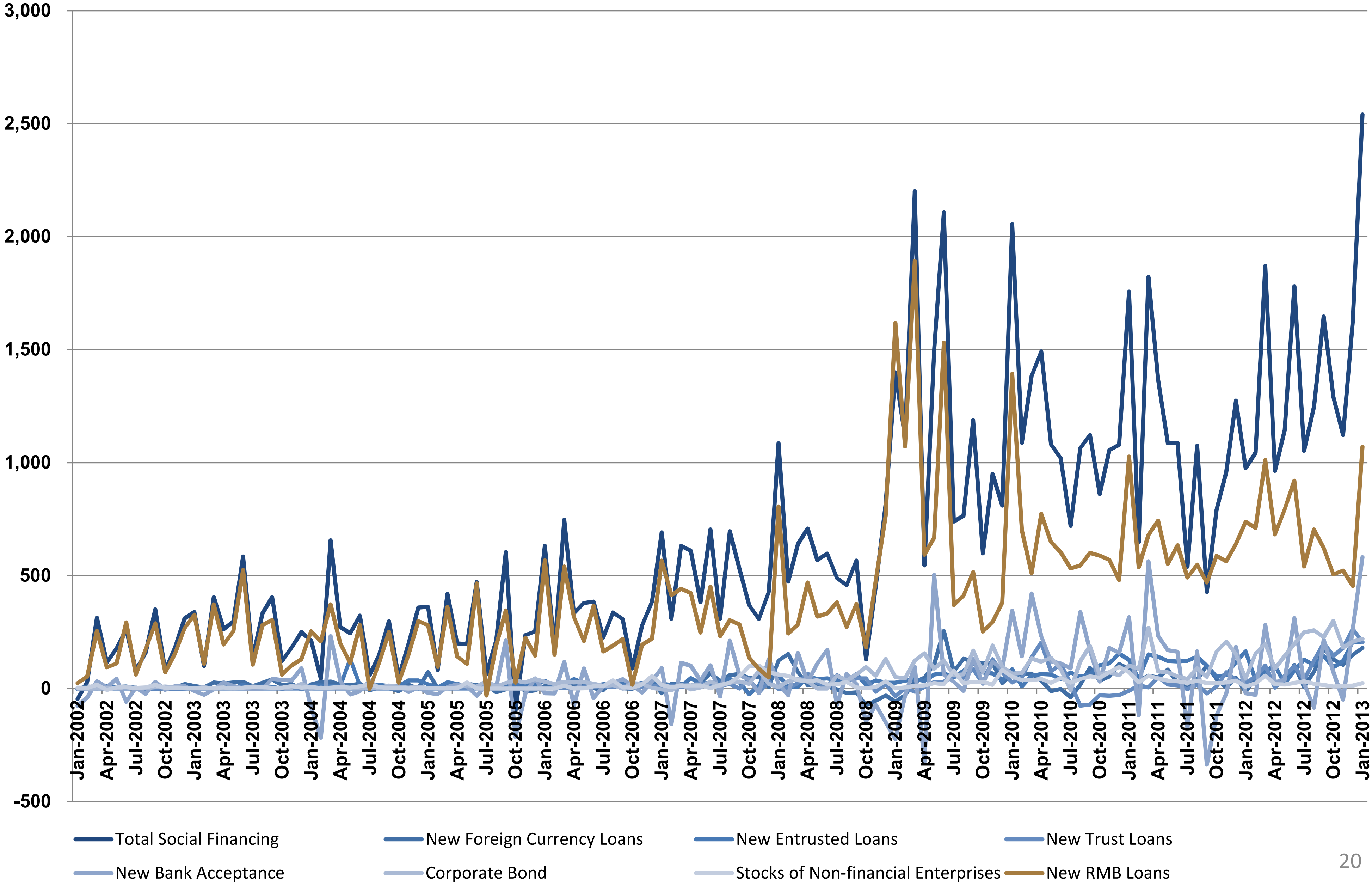
Sizing the Gray Market

(PBOC data, in bln RMB)



Securitization

- In 2009, official lending rose to 140% of GDP. In 2010, under regulatory pressure to cool lending, banks moved many loans off balance sheet. In summer 2010, Fitch estimated the credit growth distortion due to off balance sheet lending at 28%.
- Loans are extended one day by a shadow bank then purchased overnight by the bank, which packages them into a term deposit and sells them to depositors.

The Banks and Their Shadows

Symbiosis

- Shadow banks locally inevitably have participation from the local commercial bank. They are conduits for arbitraging lower-than-market rates from the banks against the borrowers' willingness to pay.
- Shadow banks serve a critical bridge financing function to help banks roll over loans.
- Real interest rates: roughly 20% across categories. Bank rates: 6-8%.
- NPL rates are under 2% nationwide, but this is mostly because of the roll-overs. In 1998, NPLs were over 40%. Bankers say the real numbers now are at least as high.

Local Politics and the Banks

- Local banks are utilities for their governments. Chinese banks fall into four categories, each serving its level of government:
  – The Big Five
  – Shareholding Banks
  – Local Commercial Banks
  – Rural Credit Cooperatives

Some Implications

- De facto deposit rate liberalization
- Shrinking deposits
- Shrinking forbearance ability by banks to keep depositors and shareholders happy when actual capital adequacy is weak.
- Less and less cash to lend
- Financial innovation is occurring so quickly that regulators may not be able to keep up with the defaults.