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vol.126 (15.November.2011)

Off-balance-sheet financing and disintermediation in China

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In China, the emergence of financial products designed to circumvent regulations is changing relationships between conventional monetary aggregates and economic activity. Chinese monetary authorities have started to develop new monetary metrics to better conduct monetary policy.

Growth in off-balance-sheet finance

China's 2011 macroeconomic adjustment policies have been focused on containing inflation and inflationary expectations. On the monetary policy front, Chinese authorities have raised interest rates and reserve requirements in the aim of normalizing overly accommodative monetary conditions with a policy mix of stable monetary policy and fiscal activism. In the latter half of 2011, lending standards for the farm sector, small businesses, and public housing may be eased in response to expectations of a decline in the CPI inflation rate, but China is likely to maintain a generally cautious monetary policy stance.

One hallmark of Chinese monetary policy in 2011 is that it has sought to curb banks' off-balance-sheet lending in response to growth in financial flows that circumvent regulatory restrictions (particularly limits on loan-deposit ratios) against a backdrop of progressive monetary tightening.

In the first half of 2011, banks' wealth-management products garnered considerable attention. Specific products that came under scrutiny include investment products (e.g., REITs) marketed by banks on behalf of trust companies (so-called bank-trust products[1)]) and designated loans[2)], both of which are basically off-balance-sheet instruments. With limits on loan-deposit ratios being tightened, such instruments emerged as a means of circumventing credit controls. The authorities started to become concerned about these instruments in 2009 and imposed restrictions on bank-trust products in 2010.

On August 25, 2011, the People's Bank of China (PBOC) issued a Directive Concerning Inclusion of Margin Deposits in Required Reserves. The directive mandated banks to include margin deposits related to letters of credit, bank acceptance bills, and other such credit instruments in their required reserves[3)]. The measure increased Chinese bank reserves by some RMB900 billion, equivalent to a roughly 1.2 point increase in the reserve requirement ratio.

This measure's true aim, however, was to dampen credit creation driven by leveraging of margin deposits by imposing reserve requirements on margin deposits, thereby increasing banks' costs. Specifically, the measure was targeted at the corporate practice of obtaining bank acceptance bills secured by a margin deposit and then discounting the bill and using a portion of the cash proceeds as a margin deposit for another bank acceptance bill. Some of these bank acceptance bills were apparently packaged into wealth management products and moved off of banks' balance sheets.

Meanwhile, the China Banking Regulatory Commission (CBRC) has been cracking down on online P2P (peer-to-peer) lending. On August 23, the CBRC issued a Warning Concerning Risks of P2P Lending. It did so out of concern that P2P lending was indirectly funding industries subject to credit restrictions (e.g., the real estate industry, industries that are both highly pollutive and energy intensive) in addition to concerns about the risk of illegality and fraud.

Another trend that cannot be overlooked is informal finance[4)]. With bank depositors earning negative real interest rates and small businesses with strong demand for funds increasingly unable to borrow from banks, money is flowing into high-interest informal loans. Recently, however, the risks of informal finance have become apparent in the form of bankruptcies among companies that had borrowed informally in Wenzhou, a hotbed of informal finance. The CRBC's recent warning about P2P lending was partially intended to prevent risk contagion from the informal finance sector to the banking sector in light of the possibility that bank loans are being used to fund informal loans through P2P channels.

Monetary authorities' response

The PBOC is formulating measures in response to the growing difficulty of tracking overall financial flows by focusing exclusively on bank deposits or conventional monetary aggregates.

At a recent press conference regarding August monetary data, the PBOC announced that it is studying the use of M2+, a broader monetary aggregate than M2[5]. The PBOC explained that it developed M2+ to better track actual financial market conditions in light of rapid growth in commercial banks' off-balance-sheet investment products and acceleration of bank deposits' dispersion into financial instruments not captured by M2 since the start of the year. In addition to trust deposits and bank wealth-management products held by real-economy actors, M2+ may encompass interbank deposits, housing provident funds[6], foreign-currency deposits, and local government deposits.

In late 2010, the PBOC started publishing data on the "social financing aggregate" (i.e., the total amount of financing raised in the real economy). Social financing includes notes, corporate bonds, and equity issuance in addition to the aforementioned trust loans and designated loans[7] (Exhibit 1). In the first half of 2011, the social financing aggregate grew RMB7.76 trillion, RMB384.7 billion less than its growth in the year-earlier period. Among the social financing aggregate's constituent components, growth in trust loans slowed substantially in the first half of 2011, while designated loans grew sharply[8].

In an environment of regulated interest rates and loan-deposit ratios, new wealth management and other products have recently been emerging to circumvent regulatory restrictions. Informal finance also is booming, mainly among small businesses unable to borrow from banks. These trends have gained momentum amid China's ongoing monetary tightening. In response to such regulatory arbitrage and, in a certain sense, financial innovation, relationships between conventional monetary aggregates and economic activity have changed, making the task of monetary policymaking more difficult. Developed countries experienced a similar financial revolution in the 1970–80s. China also has now entered such a phase. The Chinese authorities will likely continue to devise new, more-effective monetary metrics.

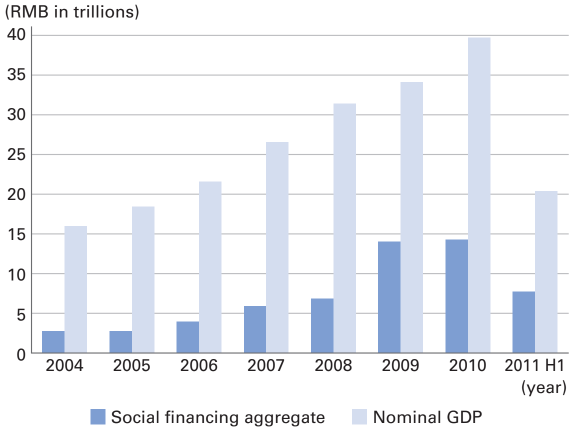
Exhibit.1 Social financing aggregate (growth in first half of 2011)

(RMB in billions)

Component	Increase	Change from year-earlier increase
Total	7,760	-384.7
RMB loans	4,170	-449.7
Foreign currency loans	336.1	+117.9
Designated loans	702.8	+382.9
Trust loans	91.3	-510.2
Bank bill acceptances	1,330	-44.1
Corporate bonds	658.8	+9.0
Domestic equity issuance (nonfinancial companies)	267.7	+27.4

Source: NRI, based on PBOC data

Exhibit.2 Social financing aggregate and nominal GDP



Source: NRI, based on PBOC data

Note

1) With bank-trust products, a commercial bank outsources custody and management of customer assets to a trust bank that acts as trustee of the assets. In 2010, a portion of such assets funded circumventive loans (e.g., to real estate developers) amid tightening of regulations on bank lending. For more details, see *http://www.nri.co.jp/english/opinion/lakyara/2011/pdf/lkr2011114.pdf*.

2) A lending arrangement whereby a client entrusts funds to a bank and the bank lends the funds to borrowers on behalf of the client in accord with terms and conditions (e.g., interest-rate, maturity) specified by the client.

3) The directive took effect on September 5 for the five largest banks and Postal Savings Bank of China and on September 15 for other banks.

4) Informal finance is basically (legal) lending and borrowing between private individuals and/or companies. With informal finance growing and increasingly resembling bank lending, it has entered a legal gray area in certain respects.

5) M2 = M1 (cash + demand deposits) + quasi-currency (business time deposits + retail savings deposits + other deposits (including securities brokerages' customer margin deposits)).

6) A fund funded by contributions from a company or other entity and its employees to help the employees purchase homes.

7) Informal loans are not necessarily reflected in such statistics.

8) In January–July 2011, the social financing aggregate was RMB8.3 trillion.

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