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Risks posed by Chinese banks' off-balance-sheet lending

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Executive Summary

In China, stricter regulation of banks' on-balance-sheet lending has paradoxically increased the overall economy's financial risk as banks have increasingly engaged in circumventive financing through use of off-balance-sheet products.

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Regulatory arbitrage through off-balance-sheet bank lending

The Chinese economy appears to have bottomed in the latter half of 2012, but financial risks still persist. The December 2012 Central Economic Working Conference's economic policy priorities for 2013 include monitoring latent fiscal and financial risks and preventing systemic and regional financial risks. The financial risks currently under scrutiny are problems with shadow banking and local government financing platforms[1). These two risks are interrelated.

Shadow banking is not clearly defined in China but the term apparently refers to credit intermediation other than bank loans reported on banks' balance sheets[2). The scale of Chinese shadow banking, estimates of which vary, is generally said to be around RMB30 trillion. By comparison, outstanding bank loans (on-balance-sheet) to the non-financial sector total some RMB69 trillion[3).

Wealth management products (investment products) sold by banks include off-balance-sheet products (without principle guarantees) that are used as a means of circumventing restrictions on lending[4).

Such wealth management products employ various investment strategies. In 2012, nonfinancial corporate bond issuance[5) increased to roughly RMB3.2 trillion from RMB2.1 trillion in 2011. Urban investment bonds[6) issued by local government financing platforms accounted for much of this total. Bank wealth management products invest in these urban investment bonds. One factor behind recent growth in urban investment bond issuance, in addition to demand for funding for infrastructure projects, is that banks have tightened lending standards for loans to local government financing platforms. Local governments have consequently been issuing bonds to refinance maturing bank loans. Banks account for their wealth management products'

NOTE

1) Local government financing platforms are independent corporations that are established by local governments and borrow funds to finance government investment projects. Bank loans to local government financing platforms increased in response to China's 2009 economic stimulus package.

2) According to a PBoC internal research report, shadow banking instruments include commercial banks' off-balance-sheet wealth management products (investment products) include pooled wealth management products managed by securities firms, separate-account wealth management products, securities investment funds, variable annuity investment accounts, industrial investment funds, venture capital investment funds, private equity funds, corporate pension plans, housing savings accounts, consumer finance companies, and non-bank leasing companies (Century Weekly, October 22, 2012).

3) As of end-November 2012 (Other Depository Institution Statistics).

4) Banks's standing wealth management products total over RMB7 trillion (according to CBRC Assistant Chairman Yan Qingmin on January 29, 2013).

5) Including commercial paper (CP), ultrashort-term CP, medium-term notes, and corporate bonds.

6) Urban investment bonds are issued in various forms including corporate bonds, medium-term notes and CP. For more details, see http://www.nri.co.jp/english/opinion/lakyara/2012/pdf/lkr2012154.pdf.

urban investment bond holdings on an off-balance-sheet basis, thereby circumventing restrictions on deposit-loan ratios.

Trust companies and securities firms are also involved in such circumventive financing. They purchase loans (e.g., real estate loans, infrastructure construction loans) and notes carried on banks' balance sheets and package them into real estate trust products or, in the case of securities firms, asset management plans. Banks purchase these products and repackage and sell them as wealth management products. This is an oversimplified description. In actuality, various complex structures are utilized, but the bottom line is that banks engage in circumventive financing via trust companies and securities firms' products. Trust companies and securities firms' role is limited to providing a financing channel[7)]. Banks in fact capture most of net interest margin earned on the underlying financing instruments. The securities firms and other intermediaries earn fees.

The bank-trust product business, in which banks collaborate with trust companies, has fallen upon hard times as a result of an August 2010 China Banking Regulatory Commission (CBRC) directive ordering banks to switch to on-balance-sheet treatment of bank-trust products by year-end 2011[8)] (nonetheless, bank-trust product assets totaled some RMB1.84 trillion at September 30, 2012[9)]). In place of bank-trust products, banks turned to securities firms' asset management plans in 2012, a year of securities industry deregulation, including replacement of an advance approval requirement for asset management plans with an ex-post-facto registration system and expansion of such plans' scope of investable assets[10)]. Among the different types of asset management plans, individualized plans are most often used for circumventive financing[11)]. According to the Securities Association of China, the securities industry's aggregate assets under management increased sharply in 2012 to end the year at RMB1.89 trillion, up from RMB281.9 billion a year earlier. Most of this increase is attributable to assets purchased by banks for their wealth management products[12)].

Risks posed by banks' off-balance-sheet wealth management products

Among the risks posed by banks' off-balance-sheet wealth management products, the first is maturity mismatch. Wealth management products are rolled over at short-term intervals, whereas much of their underlying assets are real estate and infrastructure construction loans. Additionally, proceeds from issuance of wealth management products sold at different times are pooled together and invested as a single fund. Some banks tout their wealth management products' high returns, but

7) Trust companies and securities firms call this a "conduit" business.

8) For more details, see http://www.nri.co.jp/english/opinion/lakyara/2011/pdf/lkr2011114.pdf.

9) According to China Trustee Association.

10) For more details, see http://www.nri.co.jp/english/opinion/lakyara/2012/pdf/lkr2012151.pdf.

11) An individualized asset management plan manages the assets of a single customer in a separate account. Individualized plans are required to have a minimum gross asset value of RMB1 million. Since October 2012, securities firms are permitted to define individualized plans' investment mandate by agreement with the customer. Margin trades are also permitted. Investable assets were previously limited to equities, bonds, securities investment funds, pooled wealth management products, central bank notes, CP, asset-backed securities, financial derivatives, and other investment products approved by the CSRC.

12) According to the Securities Association of China.

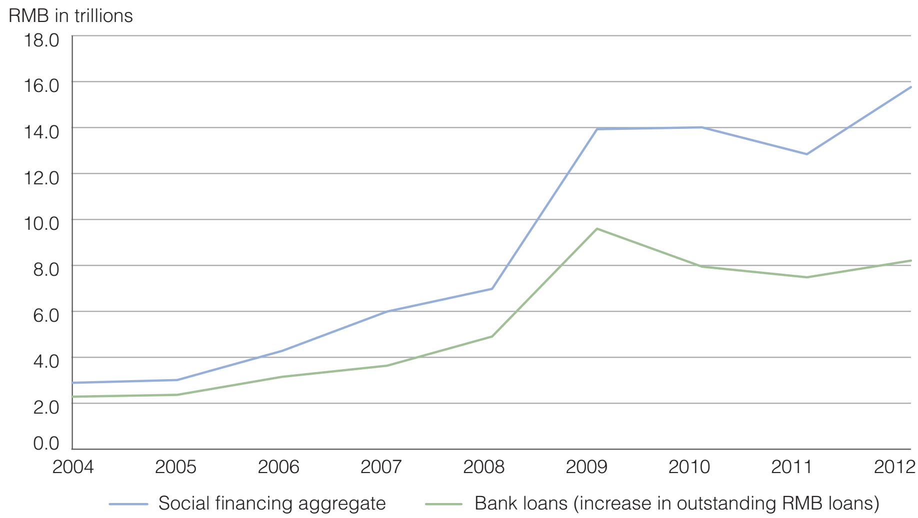
wealth management products have long been criticized for lacking transparency in terms of the source of specific products' returns. Moreover, some banks sell wealth management products to their customers without adequately disclosing the risk of loss of principal. In terms of credit risk, there is a tacit understanding that if a local government financing platform defaults on its borrowings, the national government will end up bailing it out. The national government has essentially bailed out local government financing platforms in certain cases, but its obligation to do so remains vague. Because wealth management products are not principal-guaranteed, their end-investors ultimately bear the risk if the end-borrower defaults, but this risk is not always adequately explained. Seller liability issues consequently could arise.

Future outlook

In sum, as a result of the authorities tightening restrictions on on-balance-sheet loans for the sake of risk management, banks are utilizing lightly regulated products to in essence extend loans. The authorities have been deregulating corporate bond issuance and securities firms' asset management plans to lessen the Chinese financial system's overdependence on indirectly intermediated finance.

Securities firms' asset management businesses have burgeoned since last year, but the innovative asset management plans that the China Securities Regulatory Commission intended to engender through deregulation have not materialized. Securities firms recognize this fact. They also expect that regulators will eventually

Exhibit: Social financing aggregate and outstanding bank loans



Source: NRI, based on PBoC data

clamp down on banks' circumventive financing schemes in which they are currently involved, but they are willing to continue to engage in such schemes as long as they continue to earn profits from doing so[13]. Such an attitude suggests that China's financial system is unlikely to evolve beyond its bank-centric finance model for now.

13) According to responses to an NRI survey.

Growth in off-balance-sheet financing will make it more difficult for policymakers to assess the effects of monetary policy adjustments based on conventional indicators alone. Assessments based on alternative indicators, including the social financing aggregate, which the People's Bank of China (PBoC) began publicly disclosing about two years ago, will likely increase in importance.

In terms of risk management, regulation of banks' on-balance-sheet lending may have paradoxically increased financial risk in China's overall economy. The circumventive financing discussed above exists due to inadequate risk management, risk assessment and information disclosure (particularly to retail investors). The CBRC is already placing increased priority on risk management of banks' wealth management products in 2013, but non-bank financial institutions also are involved in circumventive financing. Chinese financial regulators need to upgrade systemic risk management by reforming the existing silo-based regulatory framework whereby different types of financial institutions each have a separate regulator.

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