BBVA RESEARCH

Banking Watch

China

Hong Kong, 8 March 2013
Banking Watch

Asia

Senior Economist
Le Xia
xia.le@bbva.com.hk

Chief Economist of Asia
Stephen Schwartz
stephen.schwartz@bbva.com.hk

Chief Economist of Emerging Markets
Alicia Garcia Herrero
alicia.garcia-herrero@bbva.com.hk

An update on China's shadow banking activity: have the risks increased?

- **After moderating in 2011, shadow banking activity has boomed again over the past year on the shift toward more growth-supportive policies.**

  While GDP growth has picked up and a hard landing has been averted, it has come at the cost of exacerbating domestic financial fragilities, including an increase in shadow banking activities. Against this background, this note takes stock of recent developments and updates our assessment of the associated risks to the broader financial system.

- **Risks have increased as a result of the pickup in shadow banking activity, but they remain manageable.**

  As flagged in our previous work (see *Banking Watch, November 2011*), we see three risks associated with shadow banking activity: i) lending concentration, especially to real estate developers; ii) maturity mismatches given the short-term nature of funding vehicles; and iii) liquidity shortages from a siphoning off of deposits from the formal banking sector. The more recent rise in shadow banking activity has exacerbated these risks, notwithstanding a strengthening of regulations in 2011. At the same time, enhanced liquidity facilities of the PBoC and the government's substantial fiscal resources and foreign currency reserves should help cushion the impact on the financial sector in the event that risks materialize.

- **The recent growth of shadow banking has given rise to a number of high-profile disputes over investor losses in wealth management and trust company products with potential reputational risks to banks.**

  Central to such disputes is whether wealth management products (WMPs) carry implicit guarantees by their selling agents (typically banks) for impairment of the underlying assets, as some investors may have been led to believe. Such cases have the potential to undermine confidence in the shadow banking system and could put pressure on affiliated banks to assist by providing liquidity or taking losses.

- **While there are risks, shadow banking has played a role in facilitating economic growth and financial development in an otherwise repressed financial system.** Entrust loans and bank acceptances have assisted SMEs in obtaining credit, which the formal banking system has been unable to provide. In cases where the proceeds of WMPs have been used to invest in stocks and bonds, the system has acted as an intermediary between household savings and the capital market. In this regard, WMPs and trust company products may be precursors to a more formal wealth management industry, pending further financial liberalization.

- **To avoid excessive risks, the authorities should press ahead with efforts to improve supervision of the shadow banking industry and accelerate broader financial liberalization.**

  In addition to pressing ahead with financial liberalization and strengthening regulations, the authorities should take steps in the near term to enhance disclosure and transparency requirements of WMP issuance and sales. As a complementary measure, the authorities need to improve the infrastructure for investors' education and protection.

Introduction

After moderating in late 2011, shadow banking activity has boomed again over the past year on the authorities' shift toward a more growth-supportive policy stance. As such, while GDP growth has picked up and a hard landing has been averted, it has come at the cost of exacerbating domestic financial fragilities. Against this background, this note takes stock of recent developments in the shadow banking sector and updates our assessment of the associated risks to the broader financial system (see appendix for a more detailed description of the shadow banking system).

As flagged in our *Banking Watch* on shadow bank lending (November 2011), we see three risks associated with such activity: i) lending concentration (to real estate developers); ii) maturity mismatches given the short-term nature of funding vehicles; and iii) liquidity shortages from a siphoning off of deposits from the formal banking sector.

While a strengthening of regulations in 2011 helped to mitigate these risks, the more recent rise in shadow banking activity has caused them to increase again in the short run. To prevent the risks from rising further, we believe that a further strengthening of regulation is needed (beyond the measures implemented in 2011), including to discourage weaker local governments from borrowing in the shadow banking market and to enhance disclosure requirements of the underlying risks and attributes of wealth management products. We believe the authorities' plans for financial sector reform are in line with these recommendations, and that efforts to improve regulation of the shadow banking system, which were in progress in 2011, will be reinforced in the near future, as the authorities become more convinced that the economy is no longer at risk of a hard landing.

Regulations in shadow banking activity have met with mixed results

To contain risks associated with the growth of the sector, the authorities have implemented a series of regulations in recent years to improve transparency and strengthen supervision of the sector (Table 1). In addition, to prevent overheating and excessive credit growth the authorities also sought to slow the pace of shadow bank lending, for example by raising capital requirements on trust companies. A side effect of these regulations, however, was to encourage innovations by financial firms (including banks) to circumvent them – which, when faced by a renewed threat of an economic slowdown in 2012, the authorities chose not to curtail. For example, as regulations on bank-trust cooperation were increased in 2011, banks began to issue their own wealth management products (WMPs) and cooperate with other financial institutions such as security firms and insurance companies. In the meantime, trust companies tended to expand their asset management businesses independently.

On the positive side, an effect of stricter regulations and supervision has been an increase in reporting of financial institutions, which has led to a more accurate assessment of the magnitude and nature of the shadow banking system.

Table 1
Regulations implemented on WMPs and other shadow banking activities

2010 Aug	The CBRC instructed banks to move certain off-balance-sheet assets back onto their books by end-2011 and hold a provision coverage ratio of 150%. The CBRC also capped the balance of the financing business at 30% of the total bank-trust cooperation business.
2011 Jan	The CBRC tightened regulations on trust companies, including: 1) banks should move off balance-sheet assets related to bank-trust cooperation back onto their books by end of year; 2) trust companies should set aside risk-weighted capital of 10.5% for trust loans extended in the bank-trust cooperation not included in banks' balance-sheets; 3) trust companies should not distribute dividends if the trust compensation reserves fall below 150% of the non-performing bank-trust loans or 2.5% of the total balance of bank-trust cooperation loans.
2011 Aug	The PBoC issued notice to broaden the base for calculating banks' required reserve ratios by including banks' margin deposits. Six large banks required to set aside 21.5% of deposits as of September 5. Medium and small banks to set aside 19.5% of deposits.
2011 Sep	The CBRC released the Notice on Further Strengthening Risk Management of Wealth Management Business of Commercial Banks. Banks are required to improve information disclosure on WMPs and strengthen management operations. Later in Nov 2011, it was reported by the media that CBRC informed banks to suspend sales of WMPs with a maturity of less than one month.
2012 Jan	The CBRC required trust companies to suspend the launch of the bill-related trust products for circumventing loan quotas.
2012 Apr	In the CBRC's Annual Report (2011), the regulator urged to strengthen the supervision of the bank-trust cooperation and off-balance sheet operations, enhance the risk management over the shadow banking and private lending with the formal banking sector.
2012 Dec	The CBRC required the major banks to conduct internal inspections on the sales of WMPs on behalf of third parties to prevent potential risks.

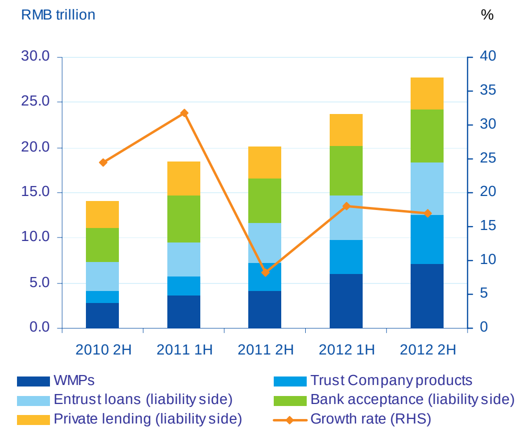
Source: CBRC and PBoC webpage, media reports and BBVA Research

Rapid growth in shadow banking raises concerns

Despite previous efforts to slow down the pace of credit growth, the shadow banking system has expanded rapidly over the past year (Charts 1 and 2), most notably through WMPs and trust loans, due to a mix of regulatory forbearance and financial firms' efforts to circumvent restrictions. According to our estimates the aggregate size of WMPs and trust company products amounted to RMB 7.1 trillion and RMB 5.9 trillion as of end-2012, increasing by 73% and 74% respectively compared to the previous year. Bank acceptances and entrusted loans in particular continued to grow rapidly despite the authorities' vigilance in slowing their expansion. In contrast, the outstanding stock of private lending was almost stagnant through last year, partially due to the authorities' efforts to boost SME lending and a chilling effect from repayment defaults in a few coastal areas such as Wenzhou.

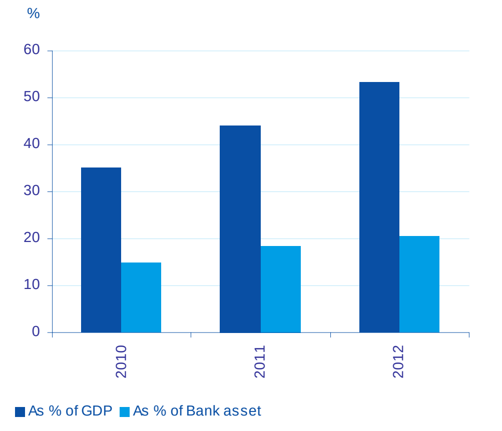
As noted above, an important factor for the pickup in shadow banking activity is forbearance stemming from the shift in the policies toward a more growth-supportive stance. In addition to boosting credit growth, the authorities sought to accelerate infrastructure spending, much of it financed by local governments through borrowing of their local government financing vehicles (LGFVs) from the shadow banking system and domestic capital market. With respect to the latter, the outstanding stock of bonds issued by LGFVs (RMB 2.5 trillion as of end-2012) increased by 86% from the previous year. A large portion of these bonds were acquired by financial institutions, who repackaged them into WMPs for sale to their clients. In addition, a number of trust companies worked together with LGFVs and issued dedicated trust products with underlying assets consisting of LGFVs debt obligations. These kinds of activities have intertwined the capital market and shadow banking sector, potentially adding to the systemic risks.

Chart 1
Shadow bank activities have risen...



Source: Wind, CEIC and BBVA Research

Chart 2
...leading to an increase in the importance of the shadow banking sector in the economy



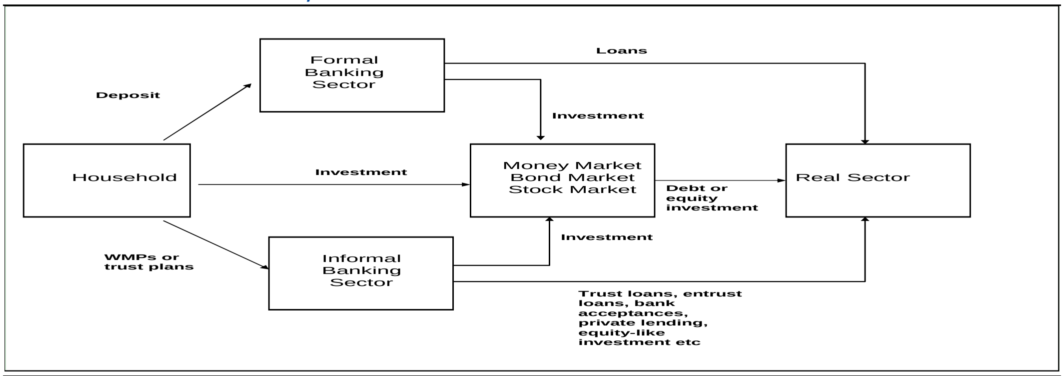
Source: Wind and BBVA Research

A final important development has been the emergence of a number of high-profile disputes over investor losses in WMPs and trust company products. Central to such disputes is whether WMPs carry implicit guarantees by their selling agents (generally banks) for impairment of the underlying assets, as some investors may have been led to believe. Such cases have the potential to undermine confidence in the shadow banking system and could put pressure on affiliated banks to assist by providing liquidity.

Benefits of the shadow banking system

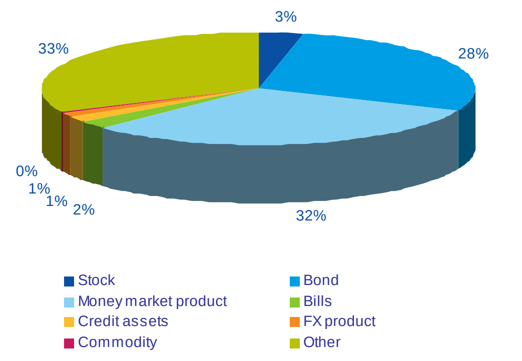
Notwithstanding the concerns discussed above, the shadow banking has played a beneficial role in economic growth and financial development. For example, entrust loans and bank acceptances have assisted SMEs in obtaining credit, which the formal banking system has been unable to provide. In cases where the proceeds of WMPs have been used to invest in stocks and bonds, the system has performed a useful role as an intermediary between household savings and the capital market (Charts 3-5). In this respect, WMPs and trust company products bear some resemble to mutual funds or other asset management products. As such, WMPs and trust company products may be seen as the precursors of a well-functioning wealth management industry, pending further financial liberalization.

Chart 3
Fund flows in the financial system



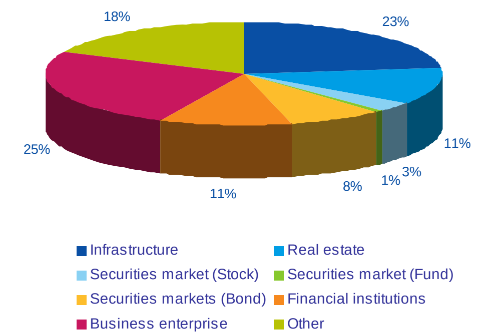
Source: BBVA Research

Chart 4
Asset allocation of wealth management products



Source: Wind and BBVA Research

Chart 5
Allocation of trust company assets

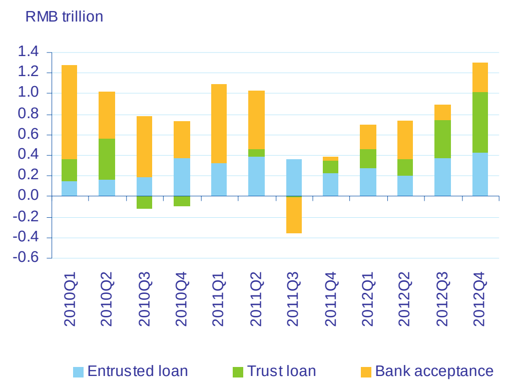


Source: Wind and BBVA Research

Risks are on the rise

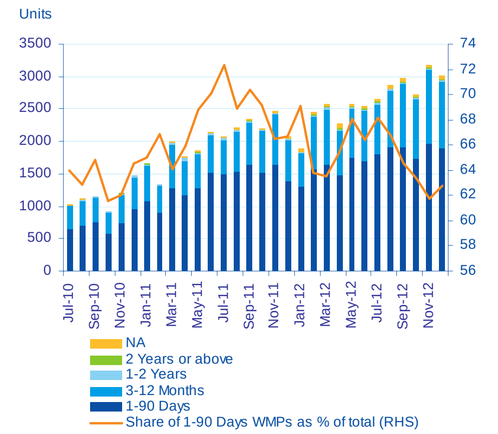
The primary risk of the shadow banking system in our view stems from its growing exposure to the real sector. Credit exposure is concentrated in a number of informal lending channels including trust loans, entrusted loans, bank acceptances and private lending which, except for the latter, have all grown rapidly in the past year (Chart 6). Borrowers typically consist of enterprises having difficulty in accessing funds of the formal banking system, including SMEs and real estate developers. In addition, through financing vehicles local governments have increasingly been using informal credit channels to meet their financing needs. Asset quality of the LGFVs is dubious, and may accelerate the pace of bad debt accumulation in the economy.

Chart 6
Growing exposure to the real sector poses a risk...



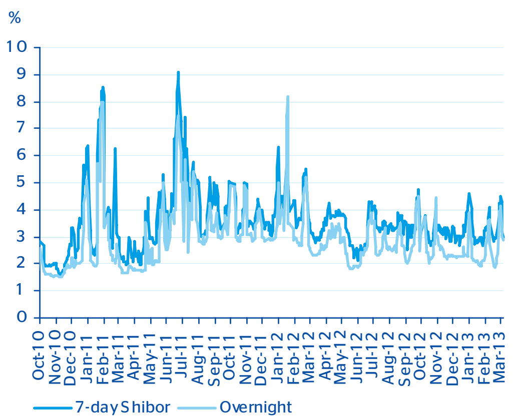
Source: Wind and BBVA Research

Chart 7
...while the share of short-term WMPs has decreased as a result of tighter regulations



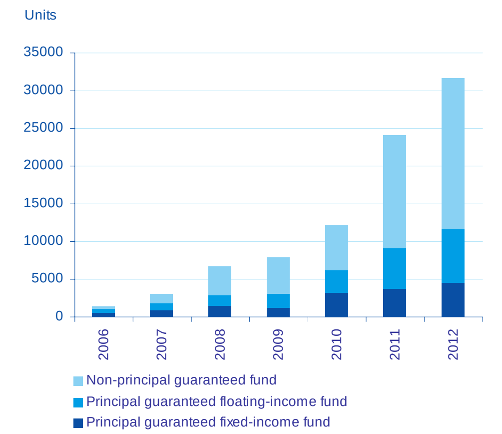
Source: Wind and BBVA Research

Chart 8
Inter-bank rates have been stable since April, reflecting sound liquidity conditions



Source: Wind and BBVA Research

Chart 9
A large share of WMPs are equity-type investments without principal guarantees



Source: Wind and BBVA Research

Another concern relates to potential reputational/legal risks for banks (Table 2). Information disclosure regarding the underlying asset allocation of WMPs has not always been sound. This can lead to disputes between WMPs investors and issuing/selling banks when losses arise. Banks may be pressured to bail out the loss-making WMPs, with consequent losses on the bank's balance sheet. Moreover, given the affiliation between a number of large banks with trust companies and other non-bank financial institutions, dispute cases may carry reputational risks for the affiliated banks and/or place pressure on them to transfer liquidity to the institutions responsible for paying investors of loss-making WMPs.

Table 2
Large banks and their afflicted financial institutions

Banks	Important Affiliated non-banking financial institutions
Bank of China	Bank of China Insurance Co., Ltd.
	BOC International (China) Limited
China Construction Bank	CCB Life Insurance Company Limited
	CCB Trust Co., Ltd.
Bank of Communications	Bank Of Communications International Trust Co.,Ltd.
	BoComm Life Insurance Company Limited
Agricultural Bank of China	ABC Life Insurance Co., Ltd.
Industrial and Commercial Bank of China	ICBC-AXA Assurance Co., Ltd.
China CITIC Bank	CITIC Securities
	CITIC Trust Co.,Ltd.
	CITIC-Prudential Life Insurance Company Ltd.
China Merchants Bank	China Merchants Securities Co Ltd
	CIGNA and CMC Life Insurance Company Ltd

Source: BBVA Research

There are also risks of maturity mismatches given the short-term maturity structure of WPMs and longer term financing for projects. While still present, these risks have receded somewhat following the prohibition in November 2011 on WMP issuance of less than one month; the share of short-term WMPs has declined, although the outstanding stock of WMPs with maturity of less than 90 days has risen (Chart 7). Further reducing this risk is a requirement on banks to better match assets and liabilities and to monitor maturity mismatches.

To mitigate liquidity risks arising from the siphoning of deposits from the formal banking system, the PBoC has introduced new monetary instruments and has been more active in managing market liquidity through reverse repo and short-term liquidity facilities. As a measure of liquidity conditions, it is noteworthy that interbank interest rates have been quite stable since April 2012 (Chart 8). Finally, the government's substantial fiscal resources and foreign currency reserves should help cushion the impact on the overall financial sector in the event that risks materialize.

Policies to contain risks and promote the growth of a healthy financial system

Given the importance of encouraging adequate credit flows to support economic growth, the authorities will likely want to avoid an overly blunt clamp-down on the shadow banking system in the near term. In this regard, the suggestions in our previous Banking Watch remain valid in order to reduce the risks of unregulated activities, while furthering the development of the financial system. Namely, we would suggest to: (i) press ahead with financial liberalization by removing deposit rate caps (some limited progress was made in this direction in 2012), which have given rise to incentives for the issuance of and investment in WMPs; (ii) expand regulation of the shadow banking system, to bring it on par with banking regulation (building on the advances made in 2011); and (iii) introduce more price-based instruments of monetary policy and thereby narrow interest rate spreads conduct adapt to the change of the shadow banking system.

It would also be helpful to take steps in the near term to improve disclosure requirements in the sale and issuance of WMPs, along with enhancements in investor education and protection. This would help to reduce the risk of disputes arising from subsequent investor losses. At the same time, banks and trust companies should strengthen their internal control and risk management systems to adapt to the rapid growth of WMPs.

With respect to credit risk, which is a more pressing issue, the authorities should take steps to isolate the shadow banking system from other areas of the financial system that give rise to vulnerabilities (such as local government debt) in order to safeguard the stability of the broader financial system. In this respect, until regulation is up to speed, local governments with high debt levels should be discouraged from tapping the informal lending market.

Appendix: description of the shadow banking sector

Shadow banking consists of all activities of non-bank financial institutions outside of the formal capital market. To measures its size, we add up the liability sides of all the shadow banking activities including all forms of Wealth Management Products (WMPs), asset management products of trust companies (from which we deduct WPMs under bank-trust cooperation to avoid double-counting), and the corresponding liabilities formed by other shadowing banking activities such as entrusted loans, bank acceptances and private lending. A description of these activities follows:

- Wealth Management Products (WMPs) cover a large range of financial notes issued by banks or other financial institutions. WMPs are sold to individual investors through bank retail channels (off balance sheet?), with the proceeds used to invest in the capital market or to extend credit. Although the principal of WMPs is not typically guaranteed, WMPs are attractive to individual investors as they offer higher yields than bank deposit rates (which are subject to a cap).
- Trust company products are issued because of prohibitions on deposit-taking by these institutions, who manage the assets of enterprises and individuals. Trust companies can extend loans and invest in financial products ranging from simple bonds to exotic derivatives. Their importance has been increasing because they can meet the diverse needs of fund users.
- Entrusted loans are company-to-company credits with banks or other financial institutions acting as a broker (such as finance companies, trust companies and leasing companies). Banks typically monitor the process, including contract signing, loan withdrawals, and repayments. Such banks receive fees, but do not assume credit risk. In this way, entrusted loans are treated as an off-balance-sheet business of banks.
- Bank acceptances are drafts or bills issued by a company and endorsed by a bank. With a bank's endorsement, companies can use bank acceptances as a means of payment. In essence they are credits of a company backed by a bank guarantee.
- Private lending is the least transparent part of the shadow banking system. Participants consist of enterprises and individuals, who either need liquidity or have excess funds to invest. Small financial intermediaries act as guarantors in these markets. Unlike entrusted loans, private lending activities are not channeled through the formal banking system, making them difficult to monitor or regulate. Indeed, many such intermediaries operate in a legal grey area and charge much higher Interest rates than bank lending rates.

DISCLAIMER

This document and the information, opinions, estimates and recommendations expressed herein, have been prepared by Banco Bilbao Vizcaya Argentaria, S.A. (hereinafter called "BBVA") to provide its customers with general information regarding the date of issue of the report and are subject to changes without prior notice. BBVA is not liable for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, or to undertake or divest investments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. The contents of this document is based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. BBVA accepts no liability of any type for any direct or indirect losses arising from the use of the document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, options and securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances, investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying stocks. Investors should also be aware that secondary markets for the said instruments may be limited or even not exist.

BBVA or any of its affiliates, as well as their respective executives and employees, may have a position in any of the securities or instruments referred to, directly or indirectly, in this document, or in any other related thereto; they may trade for their own account or for third-party account in those securities, provide consulting or other services to the issuer of the aforementioned securities or instruments or to companies related thereto or to their shareholders, executives or employees, or may have interests or perform transactions in those securities or instruments or related investments before or after the publication of this report, to the extent permitted by the applicable law.

BBVA or any of its affiliates´ salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates' proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

In the United Kingdom, this document is directed only at persons who (i) have professional experience in matters relating to investments falling within article 19(5) of the financial services and markets act 2000 (financial promotion) order 2005 (as amended, the "financial promotion order"), (ii) are persons falling within article 49(2) (a) to (d) ("high net worth companies, unincorporated associations, etc.") Of the financial promotion order, or (iii) are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the financial services and markets act 2000) may otherwise lawfully be communicated (all such persons together being referred to as "relevant persons"). This document is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is available only to relevant persons and will be engaged in only with relevant persons.The remuneration system concerning the analyst/s author/s of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

BBVA is not a member of the FINRA and is not subject to the rules of disclosure affecting such members.

"BBVA is subject to the BBVA Group Code of Conduct for Security Market Operations which, among other regulations, includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. The BBVA Group Code of Conduct for Security Market Operations is available for reference at the following web site: www.bbva.com / Corporate Governance".

BBVA is a bank supervised by the Bank of Spain and by Spain's Stock Exchange Commission (CNMV), registered with the Bank of Spain with number 0182.