Subprime Redux?: Retail Investors and Shadow Banking in China

April 2014

The rise of Wealth Management Products (WMPs) in China, along with the rise of off-balance sheet lending practices since the global financial crisis (generally referred to as "shadow banking"), potentially puts both Chinese banks and Chinese retail investors in the line of fire. WMP is the broad term used to describe securitized cash flows that are often opaque, which commonly have maturity periods of 6-12 months, and may be tied directly to overleveraged local governments and corporate borrowers already at production capacity or in overcapacity sectors. As Chinese WMP sales peaked in late 2012 and early 2013, a large proportion of these products are due to mature in 2014, which may result in defaults if corporate and government borrowers are unable to repay obligations. We analyzed:

- ***shadow banking operations by region***, bank fee growth in WMPs, and WMP issuance trends, together with
- ***WMP-related controversies*** including defaults, customer complaints, and official warnings and penalties, ***drawn from MSCI's proprietary database*** that is built on ongoing tracking of Chinese media and regulator sources,

to identify banks we believe could be most affected by the potential shadow banking squeeze:

- E.g. ***China CITIC***, which has a higher exposure to shadow banking in over-leveraged regions and is making a relatively late and active foray into WMP sales;
- E.g. ***Bank of China***, which has aggressively issued more WMPs than any other large Chinese bank and seems more vulnerable to a spike in WMP-related controversies in the near term.

Cheap post-crisis credit, banks' and borrowers' efforts to avoid regulatory control, and the chase for higher yields in a liberalized interest rate market, are the key drivers of shadow banking system growth.

In its response to the financial crisis of 2008-09, the Chinese central government's stimulus package led to a flood of cheap capital and rapid credit expansion – the National Audit Office recently estimated 70% growth in local government debt since end-2010.[1] While it was traditional bank loans that primarily boomed in 2009, the continued credit growth after 2009 has been driven by non-loan products such as entrusted loans, banker's acceptances, bank guaranteed trust loans, and corporate bonds – collectively, these kinds of products form China's shadow banking sector.[2] Coupled with liberalization of interest rates and the emergence of competitive alternatives for depositors' funds, bank margins have been squeezed – creating new incentives for banks to generate higher yields in the regulatory shadows. The results were WMPs and intermediary services (offering WMP sales channels to third parties for a fee), both of which transfer default and due diligence risk directly to retail investors with little or no protections or oversight from regulatory authorities.

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[1] China National Audit Office, 2013 National Audit Results on Government Debt, http://www.audit.gov.cn/n1992130/n1992150/n1992500/3432077.html.

[2] Figure 4. Financial Sector Risks, in IMF, 2013 Article IV Consultation: People's Republic of China, Country Report No 13/211, p11, https://www.imf.org/external/pubs/ft/scr/2013/cr13211.pdf, showing that total social financing in China represented nearly 200% of GDP at end-Q1 2013, and that these financial instruments represented nearly half of financing outstanding; People's Bank of China, 2012 Statistical Data Report on the Scale of Social Financing, 1 October 2013, http://www.pbc.gov.cn/publish/diaochatongjisi/3172/2013/20130109165102866350983/20130109165102866350983_.html ; see also Nicholas Borst, 'From Credit to Crisis', Caixin Online, 24 October 2013, http://english.caixin.com/2013-10-24/100595099.html.

As most of the WMP liabilities are opaque and linked to projects with non-transparent return potential, the WMPs sold to retail clients are embedded with significant product default risks.

Effectively, banks created WMPs to securitize off-balance sheet, high-risk loan types as investor packages for sale to retail clients either directly or as an agent for third party issuers.[3] There are clear parallels here to subprime markets: low or unknown due diligence on highly credit sensitive borrowers, whose loans are packaged into investment vehicles for purchase. The biggest difference is the end user – ***while US subprime MBS purchases were wholly institutional, WMPs are widely utilized by Chinese retail consumers who have limited on-shore channels for investment.***

The lack of transparency into banks' WMP liabilities has been brought into sharp focus by recent defaults on off-balance sheet loans included in WMP products earlier this year. These incidents have also highlighted ***a worrying proliferation of WMPs among at- or over-capacity extractive/heavy production sectors and local government projects***, which face strong economic headwinds and an increasingly hostile regulatory environment.

ICBC's RMB 3 billion trust product, sold through ICBC branches to retail customers, derived cash flows from a coal mining and processing company which defaulted at maturity this January. Although the stakeholder of the trust issuer ultimately repaid the principal, investors were not paid any promised interest income. In February, **China Construction Bank** was involved in a similar trust product payment crisis regarding a RMB 1 billion investment in a coal company. According to Haitong Securities, a major Chinese investment bank, ***around RMB 5.3 trillion of trust loans issued in 2012 and early 2013 will fall due in 2014, a 50% increase on those due in 2013; thus, these early cases may signal the beginning of a wider rash of defaults.***[4] One source estimates around 8,547 trust products will fall due in 2014 in China, with a total scale of RMB 1.2 trillion.[5]

We overlaid our bank data on regional shadow banking exposure, WMP fee growth, WMP issuance trends, and WMP-related customer controversies, and flagged that **Bank of China** and **CITIC Bank** face higher levels of concern on this issue than other industry peers in China.

To understand the potential scope of the issue, we first synthesized Chinese government, bank, and news estimates of where shadow lending was most prevalent on a regional basis. Using People's Bank of China data, we identified the Bohai Region, Western China, and Pearl River Delta as highly leveraged regions (~25-30% debt/GDP) in China where shadow banking is also highly prevalent, i.e. gauged as an estimated proportion of overall regional lending (see Figure 1 over page).

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[3] 'China's Shadow Banks: The Credit Kulaks', The Economist, 1 June 2013, http://www.economist.com/news/finance-and-economics/21578668-growth-wealth-management-products-reflects-deeper-financial-distortions.

[4] Haitong Securities, '2014 likely to see more defaults of trust loans', Fixed Income Research Desk, 9 January 2014.

[5] Tao Ying Zhou, China Times, 28 February 2014, http://www.chinatimes.cc/hxsb/news/jinrong/140228/1402282211-133866.html .

FIGURE 1 **Shadow Banking Risk in China by Region**

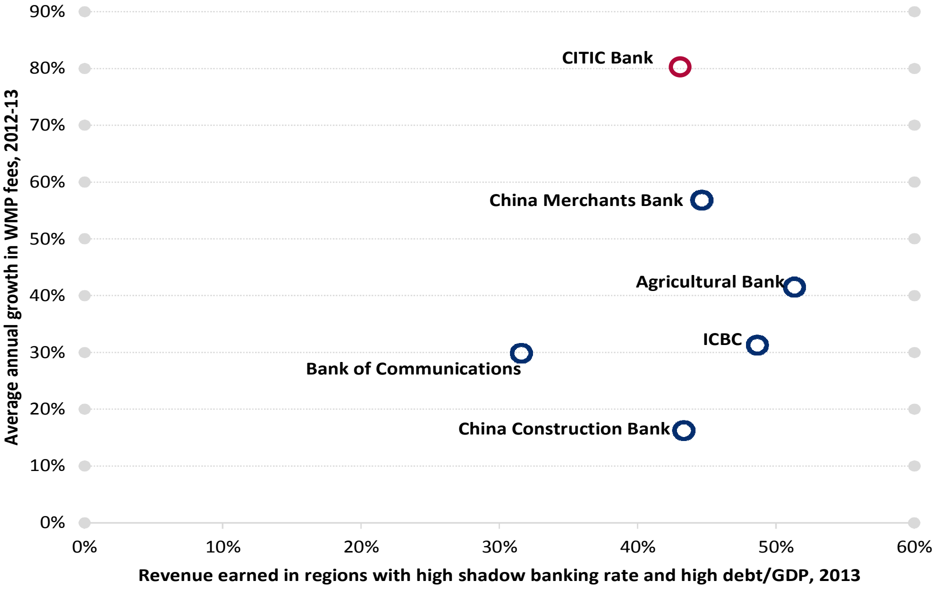
Legend

	Low shadow banking level in provinces with low leverage (20% debt/GDP)
	Low shadow banking level in moderately leveraged provinces (20-25% debt/GDP)
	High shadow banking level in moderately highly leveraged provinces (25-30% debt/GDP)
	High shadow banking level in highly leveraged provinces (>30% debt/GDP)

Source: MSCI ESG Research, People's Bank of China

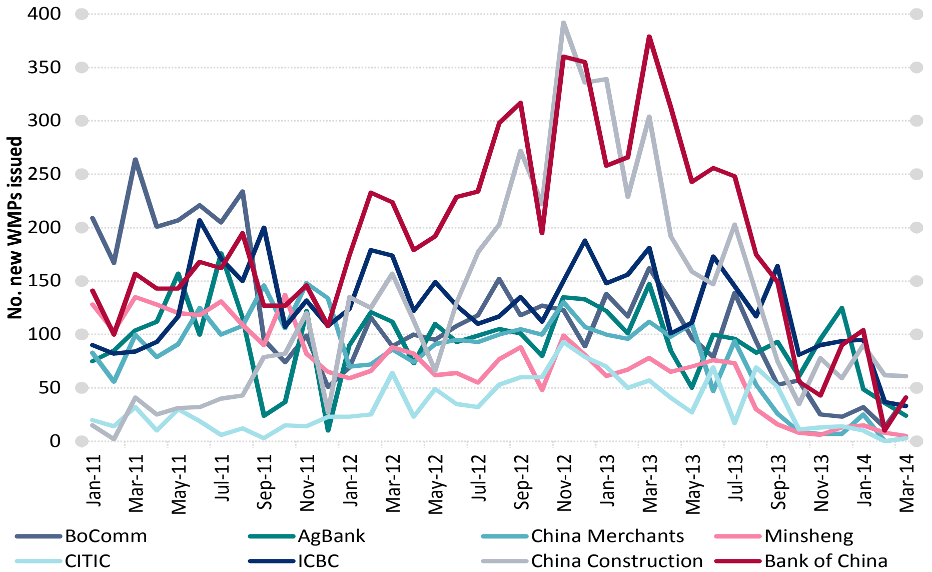
Using these regional hotspots as a basis, we mapped Chinese banks' revenues derived from these regions and two-year average growth rate of WMP fees (in the absence of disclosure into WMP liabilities) to estimate which banks were likely to have a strategic focus on shadow loan securitization revenues (see Figure 2 over page). ***This highlighted China CITIC as an outlier among peers, with higher exposure to shadow banking in over-leveraged regions and a relatively late foray into WMP sales.*** In contrast, Bank of Communications and, to a lesser extent China Construction Bank, stand out as potentially conservative compared to their peers.

FIGURE 2 **CN Banks' revenue exposure to shadow banking at end-2013**



Source: MSCI ESG Research, People's Bank of China

FIGURE 3 **New WMP issuance by Bank, 2011-14**



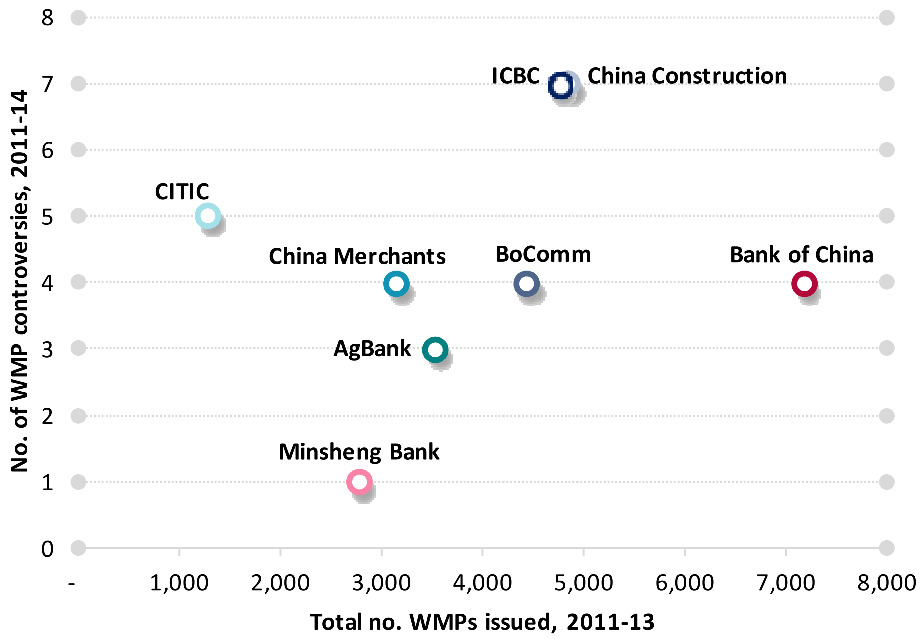
Source: Hexun Financial News

While new WMP product issuance peaked in late 2012 and early 2013 (Figure 3), most institutions have rapidly pulled back in the last year as regulator concern and scrutiny has grown. We cross referenced our controversial activity database with the overall number WMPs issued to understand which banks may have already begun to internalize costs associated with WMP defaults and which are likely to experience defaults in the future.

Among the top three issuers of WMP products (Figure 4), ***China Construction Bank and ICBC have recorded the most controversies to date and as such have internalized the most known costs from defaults to date.*** In this respect, MSCI ESG Research's 2013 analysis of these banks' product safety controls indicates that ICBC already had in place structures to review pricing and customer profiles, and respond to product complaints prior to the January 2014 default; whereas CCB is among the least prepared of Chinese banks to respond to retail product failures.

The clear outlier is the ***Bank of China, which has aggressively issued more WMPs than any other large Chinese bank and therefore seems more vulnerable to a spike in controversies in the near term. CITIC can be again flagged for concern, with a relatively higher incidence of WMP-related failures despite having issued the least variety of products*** – suggesting possible gaps in the bank's product controls and risk monitoring.

FIGURE 4 **WMP default controversies (at 30 April 2014) vs. WMPs issued (2011-13)**



Source: MSCI ESG Research, Hexun Financial News

As financial sector reform and liberalization continue, banks are less likely to enjoy favorable policies and government subsidies for bad debt in the future, placing the onus on bank management to monitor product risks and pay back the losses independently. For investors seeking to understand the risks and opportunities in this sector, it is increasingly important to understand the hidden risks under banks' diversified products and their ability to identify and monitor these risks.

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[1] *As of September 30, 2013, as reported on January 31, 2014 by eVestment, Lipper and Bloomberg* *Feb 2014*