Orient Capital Research

Orient Capital Research
Andrew Collier, Managing Director
852-9530-4348
andrew@collierchina.com

Juilice Zhou, Analyst, Shanghai
Pat Chan, CFA, FRM Hong Kong

December 19, 2016

Liquidity Problems in the Private Market in China

Private Investors are Becoming Nervous

Summary

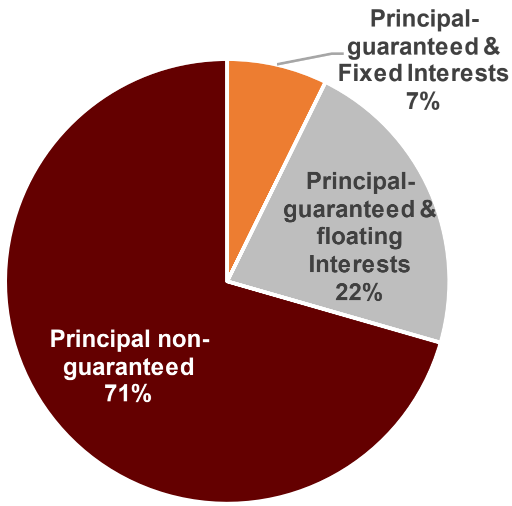
Chinese banks have been relying on two sources of credit for liquidity – interbank loans and private loans through the Shadow Banking market. Interbank loans are controlled by bank policies and by the central bank (PBOC). Shadow loans are issued by private creditors. The liquidity crunch over the past week has been blamed by analysts and the media primarily on rising interest rates from the PBOC as it seeks to restrain overall credit, targeted both at excess investment generally and at the property market in particular. This has led to the widespread sale of corporate bonds owned by the banks. According to a senior commercial banker in Beijing, there is a crisis among many financial institutions. "More than 20 securities firms and banks are involved," the banker noted.

However, ***the reaction and impact of the private market on bank liquidity has been widely ignored.*** We think this is a mistake. There is an estimated Rmb30 trillion in private loans sold as investments, called Wealth Management Products (WMPs). These investors are very sensitive to changes in both financial factors (such as interest rates) and the economic decisions coming from Beijing. Any indications of instability could quickly lead to a withdrawal of this source of liquidity from the private sector and a potential credit crisis throughout the economy – affecting banks, personal loans, and corporates that have relied on private credit. The past week has shown ***an alarming rise in interest rates and a shortening of duration in the WMP market, indicating a high degree of nervousness among private investors.***

Urge for liquidity push up WMP interest rates

Last week, banks issued 2,370 wealth management products (WMP), up 23.4% YoY and 5.1% QoQ. The majority of these WMPs, 70.6%, did not have the principal guaranteed by the issuers. "In a departure from recent issuance, the majority of bank-issued WMPs now are not principal-guaranteed as investors are seeking higher interest rates while banks won't take as much responsibility as before," said a retail sales person at a commercial bank. We think this is due to rising controls by the regulator, the China Banking Regulatory Commission, and a reluctance among banks to back these shaky products.

Figure 1: Breakdown of WMPs by type

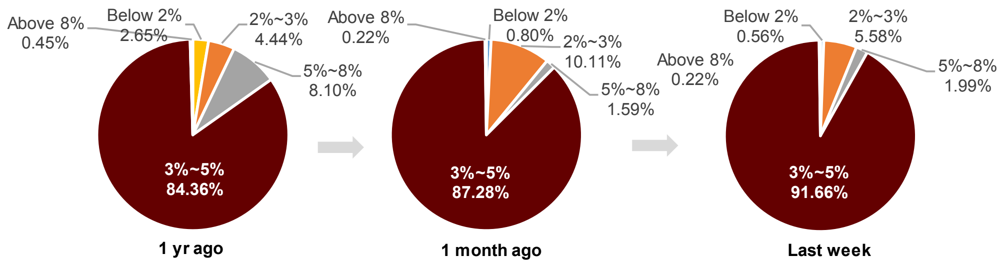


Source: Wind, OCR

Nervous Investors Demand Shorter Maturities

WMPs with interest rates between 3%~5% accounted for 89.41% of weekly issuance, up ~4ppt MoM and ~8ppt YoY. Accompanying the increase in WMPs with higher interest rates is the rise of WMPs with shorter maturities. For instance, WMPs due in 1~3 months accounted for 56.2% total issuance, up 2.2 ppt MoM & YoY, respectively. As a result, the annualized interest rate of WMPs issued by the big four banks due in one month rose more than 30% in one month from 3%~3.2%, to 4.0%~4.2%.

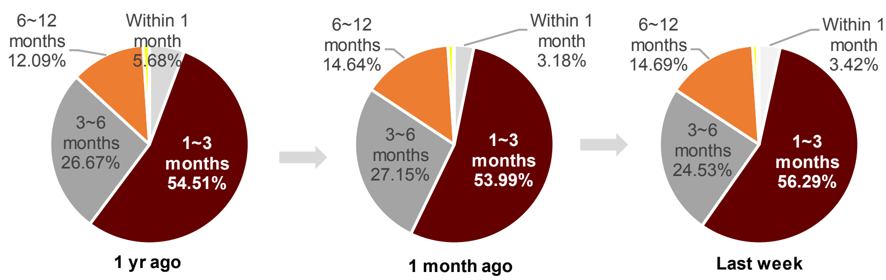
Figure 2: Rising proportion of WMPs with higher interest rates



Source: Wind, OCR

"You cannot attribute the robust issuance of new WMPs with higher interest rate and shorter maturity to seasonal effects this time," said a senior manager in charge of the retail business of a large commercial bank. **"Declining liquidity is the main factor."**

Figure 3: Rising proportion of WMPs with shorter maturity

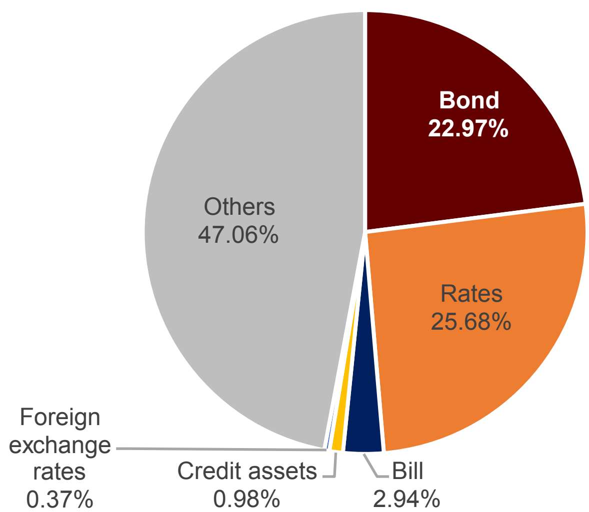


Source: Wind, OCR

"We've also noticed the "reverse" nature of interest rates with a few newly issued WMPs; meaning rising interest rates for short-term loans. For example, the annualized interest rate for a new WMP issued by one of our competitors, which is due in one month, is 4.5% compared to 4.4% and 4.2% for the current two-month and 1-year products. The mismatch between interest rates and maturity is a signal of how eager banks need money," the bank retail sales person said.

Shorter maturities of 1~3 months is another warning sign. Banks have invested most of their money raised through WMPs in bonds and interest rate products, which together account for 47.3% of total issuance. However, bonds and rates products that offer such high interest rates usually have longer durations of 1~2 years. In other words, the maturity mismatch is a serious – but increasingly common -- problem for newly issued WMPs. They offer higher interest rates but have a shorter investment cycle. ***Banks are entering a dangerous cycle equivalent to a ponzi scheme of issuing new WMPs to pay the interest and principal on old WMPs that will soon come due.*** "We're worried about the rolling short-term WMPs with higher interest rate especially when the bond market is in a total mess. However, this is the most cost-effective way for us to get money now. Recently, the highest transaction rate of interbank overnight pledged repos rose to 9% while one-month shot to 8%," said the senior manager of Wealth Management at a large commercial bank.

Figure 4: Breakdown of WMPs by maturity



Source: Wind, OCR

Conclusion

This trend – the private market for loans through the WMP market -- should be watched carefully. It looks like the financial markets are getting really nervous. Private lenders have pumped Rmb30 trillion into the economy. This past week, interest rates jumped and the length of the financial products got much shorter, as investors became concerned. Some argue a financial crisis could be caused by the collapse of a weak bank. I tend to think that nervous investors could quickly stop buying these dodgy ponzi-like wealth products and cause a lot of corporates and banks to default.

In reaction, the PBOC tried to squeeze the banks to stop lending so much but found the markets reacted strongly. The banks were scrambling for money, so they quickly sold a lot of their corporate bonds (basically loans they were treating as bonds to get around regulatory limits). There's a lot of lending going on behind the scenes so whenever it hits the public markets it's usually a sign that conditions in the broader lending market are worse.

Institutionally, I see this as ***a pitched battle between the scrooge-like PBOC and the profligate CBRC***, which more and more looks like it opens its pockets (in a regulatory sense) every time the banks clamor for money. The PBOC desperately tries to slow the freight train while the CBRC quietly undermines these efforts. One Beijing commercial banker told me recently "The CBRC doesn't care about the economy."

END