A $4 Trillion Reason for China's Smaller Banks to Worry: Gadfly

2017-12-11 06:35:43.199 GMT

By Nisha Gopalan

(Bloomberg Gadfly) -- If there's a lesson to be had in Chinese finance this year, it's that small isn't beautiful.

A crackdown on wealth management products, the short-term deposit-like instruments sold by just about every financial institution, will take an especially hard toll on the country's smaller banks. So it's understandable that joint-stock lenders are protesting the tightening of regulations, as Reuters reported last week.

The WMP squeeze is a problem for these mid-tier banks, which include institutions such as China Minsheng Banking Corp., because they don't have the deposit base of the state-owned big four. That leaves them much more dependent on selling wealth products for revenue.

While the WMP market has started to shrink under the strain of Beijing's campaign to curb leverage and shadow-banking risks, it remains huge at more than 28 trillion yuan ($4 trillion) as of the end of June, having expanded threefold in the past four years.

The real damage has yet to come.

Among measures announced last month and set to come into force in June 2019:

* WMP issuers can no longer roll over products. (The instruments usually have terms of a few months but funds are often repackaged into a new product on maturity rather than being returned to the investor, turning them into a quasi-permanent source of finance.)
* Issuers must set aside 10 percent of fees for provisioning.
* Issuers will need to invest in liquid assets such as bonds and stocks, rather than long-term projects such as real estate or debt-to-equity swaps.
* Perhaps most painful of all, WMPs will lose their implicit guarantees.

Regulators are considering extending the deadline to comply with the new rules until the end of 2020, Bloomberg News reported Monday, citing people with knowledge of the matter, after banks asked for more time and less stringent requirements.

The perception that banks -- and in the last resort the government -- will stand behind these products in the event of trouble has helped to turbo-charge growth of the WMP market.

Three years ago, the government fueled such beliefs by helping bail out a high-yield trust sold by Industrial & Commercial Bank of China Ltd., the nation's largest lender.

With authorities now cutting the cord, investors may demand higher interest rates or shun WMPs altogether, causing sales to dwindle further. Most wealth products yield around 4 percent to 5 percent according to CICC Research. That's still far better than what's available from bank deposit accounts: The benchmark one-year savings rate is 1.5 percent.

Sales are unlikely to dry up completely. After all, the warning that investments can go down as well as up is a staple of mutual fund advertisements the world over. And in China, capital controls mean investors are restricted to a limited menu of alternative choices, chief among them a volatile stock market and an equally erratic real estate sector.

But two things look clear: The WMP market's years of torrid growth have ended; and in an environment of higher risk, investors will prefer products sold by large state-owned lenders that are seen to be safer and of better quality.

That will put pressure on smaller banks, which have limited scope to increase lending. Minsheng, China CITIC Bank Corp., Ping An Bank Co. and China Everbright Bank Co. all had loan-to- deposit ratios exceeding 90 percent as of the third quarter, according to Francis Chan of Bloomberg Intelligence --

much higher than their bigger rivals. Shares of Minsheng and CITIC Bank have fallen in Hong Kong this year, while ICBC has jumped 27 percent.

A reckoning is approaching. As with all measures to rein in China's debt, the WMP clampdown is likely to be a stop-go process. But smaller banks will need to start looking for another source of growth, and fast.

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