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Equity Research

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Macro report

Where are we in the financial sector deleveraging process?

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Regulatory clampdowns will add short-term liquidity pressure in the market

In the past 10 years, with the ongoing financial disintermediation and financial market innovation, the leverage in the financial system has significantly increased. The asset management industry also rises to become the conduit for banks to invest into bond/equity market and non-standard credit assets. Since end of 2016, the regulators started to roll out a series of regulations aiming at reducing systemic financial risks. We believe this deleveraging process will last throughout 2018 until interbank liability, conduit type of asset management business and non-standard credit have significantly come down. We view this positive for the sustainable growth of China's financial market and it will help improve the capital allocation efficiency. However, short-term pain is unavoidable. We expect to see more mini liquidity crunches in certain parts of the financial system for the rest of the year.

Interbank liability and asset management industry ballooned in 2012-2016

As of end-2017, we estimate financial institutions' interbank liability reached Rmb 90trn, and the big asset management industry AUM reached Rmb 100trn backed by funding from banks. This is meaningful compared to total banking system assets of Rmb 250trn. Systemic risks have been built up with increasing bank assets being leveraged up with duration mismatch and investing into the bond/equity market and flowing into the real estate market and LGFVs. The onshore bond market was pushed to an unsustainable level with 10yr treasury touching 2.5% in 2016. With the ongoing cleanup in interbank liabilities, non-standard credit and asset management industry, 10yr treasury is now standing at 3.9%.

Watch out for the onshore developer bond maturity wall in 2H18 and early 2019

Developers and LGFVs are the two largest groups of borrowers in the non-standard credit market. They are likely to feel the challenge to refinance during the cleanup of non-standard credit. According to WIND data, there are Rmb 158bn of developer bonds that mature in 2018 and Rmb 305bn in 2019. In addition, a historical high of Rmb 383bn of developer bonds will reach puttable date in 2018 and Rmb 361bn in 2019. We remind investors to watch out for high maturity months in 2H18 and early 2019. Developers will have higher incentive to borrow at higher cost in offshore market.

Unwinding leverage in the stock market

On 1st February 2018, there were 265 stocks that hit the daily 10% down limit in the A-share market. What these companies have in common is that they have trust asset management schemes among their top 10 public shareholders. We believe Vanke's Independent Director's public letter to CSRC triggered a panic unwinding of the asset management scheme under trust companies. The letter highlights one of its major shareholder Baoneng has violated the leverage cap requirement for asset management business. The trust company's schemes still have 2-3x leverage backed by funds entrusted by banks. We advise investors to avoid companies with trust schemes among top public shareholders in the near term as the unwinding process will take time. There is low visibility on the trust schemes' holding in Hong Kong stocks through stock connect. Investors should be alerted to such risks.

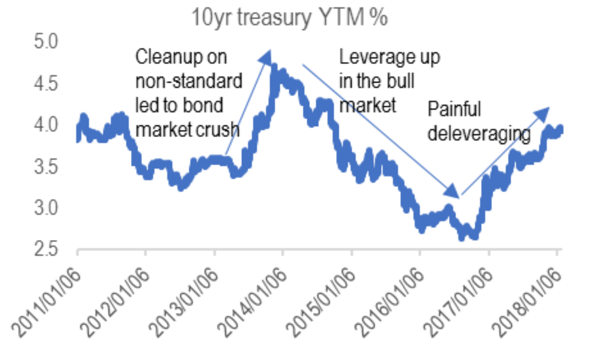
Economic growth to slow down on slower credit growth

We expect the broad credit growth as measured by total social financing growth to significantly slow down from current run rate of 12%. However, bank loan growth is likely to remain stable to partly offset the likely drop in non-standard credit. Developers and LGFVs may experience rising financing cost and shortage of new credit which may drag down property investment and infrastructure investment from a high base in 2017.

Please read the Important Disclosures and General Disclosures on Page 14.

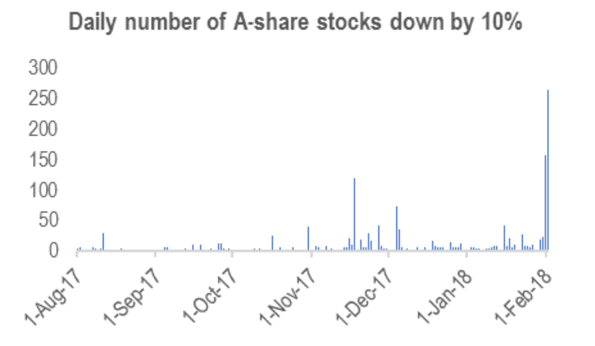
Key figures

Figure 1: A bull bond market led to increasing leverage since 2014; the deleveraging process since 2016 proved to be painful and long-lasting



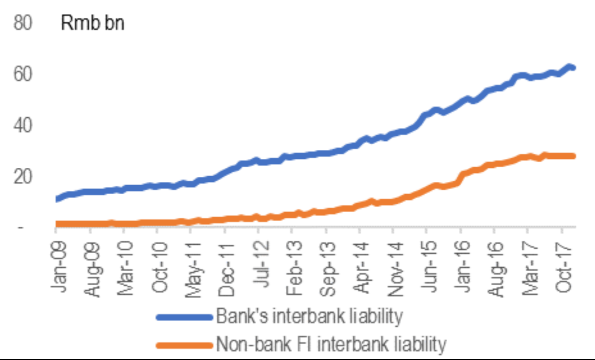
Source: WIND

Figure 2: Number of A-share stocks hitting the 10% down limit jumped to 256 on 1st Feb, likely due to the unwinding of leveraged position of trust products



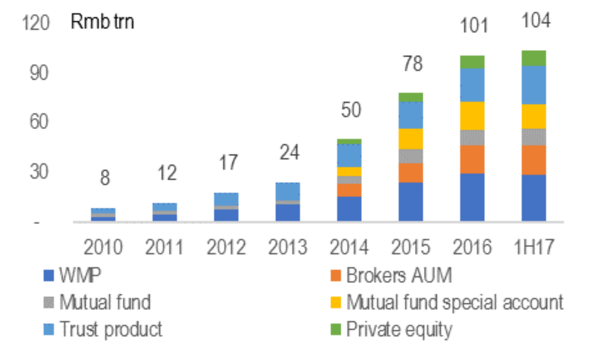
Source: WIND

Figure 3: Commercial banks and non-bank financial institutions interbank liability ballooned



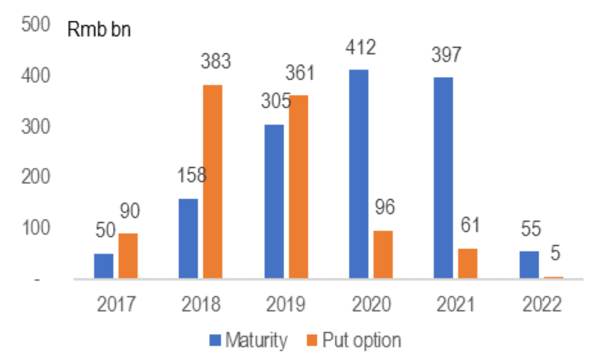
Source: PBOC; Note: We include bond in interbank liability

Figure 4: The asset management industry AUM



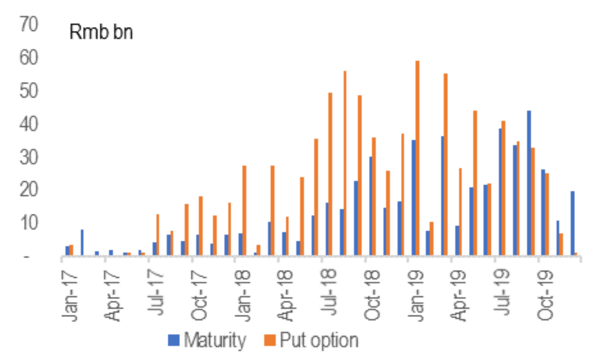
Source: PBOC, CBRC, CSRC

Figure 5: Onshore developer bond will hit maturity and put option wall in 2018-2019



Source: WIND

Figure 6: 2H18 and early 2019 will see large amount of onshore developer bonds mature and reach puttable date

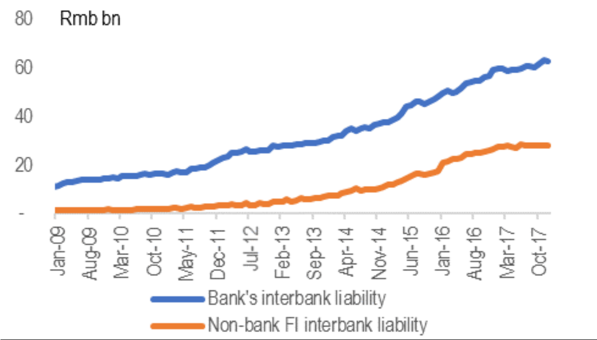


Source: WIND

Deleveraging in the financial sector

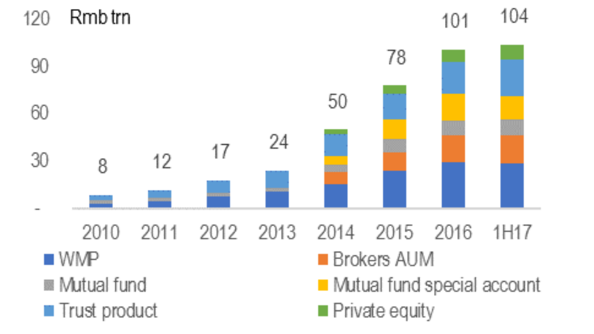
In the past 10 years, with the ongoing financial disintermediation and financial market innovation, the leverage in the financial system has significantly increased – a notable trend was that interbank liability especially for joint-stock banks and regional banks has ballooned. The asset management industry also rises to become the conduit for banks to invest into bond/equity market and non-standard credit assets. As of end-2017, we estimate financial institutions' interbank liability reached Rmb 90trn (Figure 7), and the big asset management industry AUM reached Rmb 100trn with funding backed by commercial banks (Figure 8). This is meaningful compared to total banking system assets of Rmb 250trn.

Figure 7: Commercial banks and non-bank financial institutions interbank liability ballooned



Source: PBOC; Note: We include bond in interbank liability

Figure 8: The asset management industry AUM

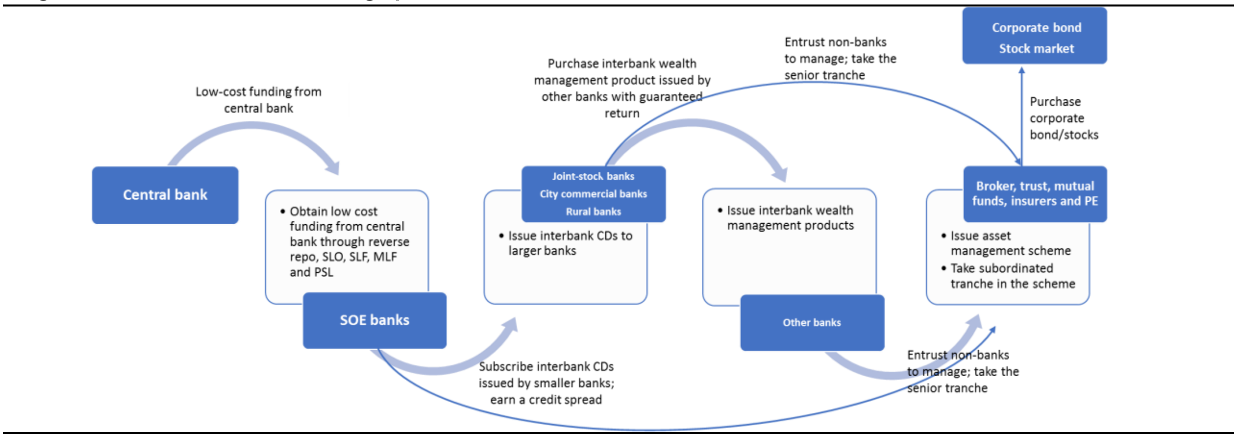


Source: PBOC, CBRC, CSRC

However, systemic risks have been built up with increasing fund being leveraged up with duration mismatch and investing into the bond/equity market and flowing into the real estate market and LGFVs (Figure 9). Since end of 2016, the regulators started to roll out a series of regulations aiming at reducing systemic financial risks. Containing the bubble in the real estate market and cleanup of local government debt have also been put on the top of the agenda.

We believe this deleveraging process will last throughout 2018 until interbank liability, conduit type of asset management business and non-standard credit have significantly come down. We view this positive for the sustainable growth of China's financial market and it will help improve the capital allocation efficiency. However, short-term pain is unavoidable. We expect to continue seeing more mini liquidity crunch in certain parts of the financial system for the rest of the year.

Figure 9: Illustration of the leverage process in interbank market



Source: PBOC, CBRC, AMTD Research

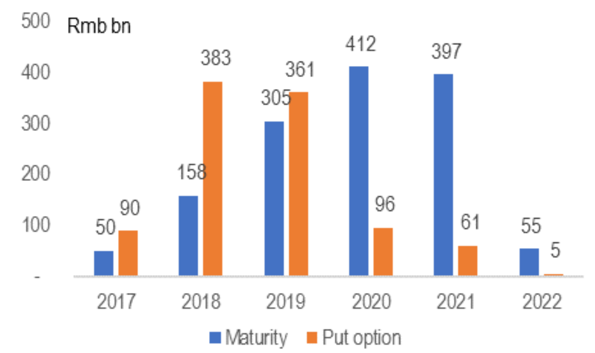
Implication to the onshore and offshore bond market

Onshore bond market was the first to feel the pain as it is liquid and where the most leverage lies in. However, we believe the goal is a normalization of credit growth and to force the credit into the real economy. Real estate developers and LGFVs are likely to feel very tight refinancing environment as they are the two largest group of borrowers in the non-standard credit market. Therefore, their incentive to borrow in offshore bond market is likely to significantly increase in 2018.

For developers, their incentive to recycle cash from fast sales will be higher in 2018 despite very tight price cap policy in tier 1 and tier 2 cities. Sector consolidation will intensify.

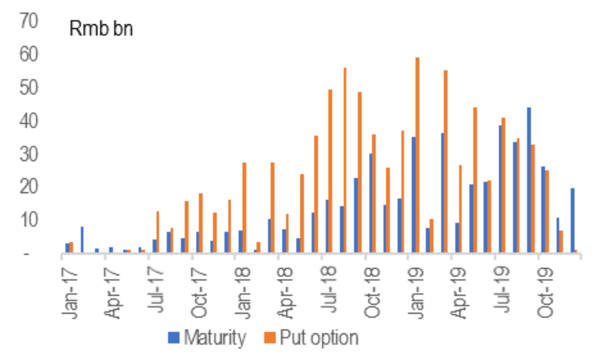
Due to the bull physical market in 2015-2017 and the loosening of onshore bond issuance for developers, a lot of onshore developer bonds reach mature or puttable date in 2018-2019. According to WIND data, there are Rmb 158bn of developer bonds that mature in 2018 and Rmb 305bn in 2019. In addition, a historical high of Rmb 383bn of developer bonds will reach puttable date in 2018 and Rmb 361bn in 2019. We remind investors to watch out for high maturity month in 2H18 and early 2019. Some of these developers may find it hard of refinance through the onshore bond market.

Figure 10: Onshore developer bond will hit maturity and put option wall in 2018-2019



Source: WIND

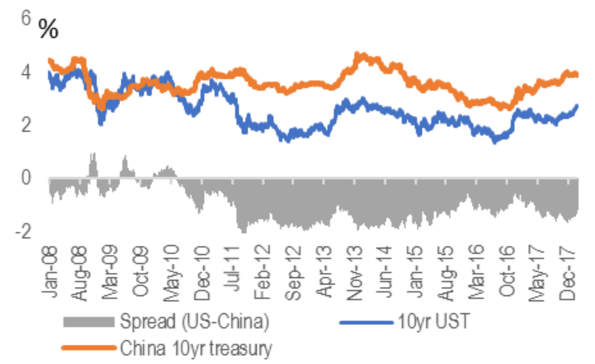
Figure 11: 2H18 and early 2019 will see large amount of onshore developer bonds mature and reach puttable date



Source: WIND

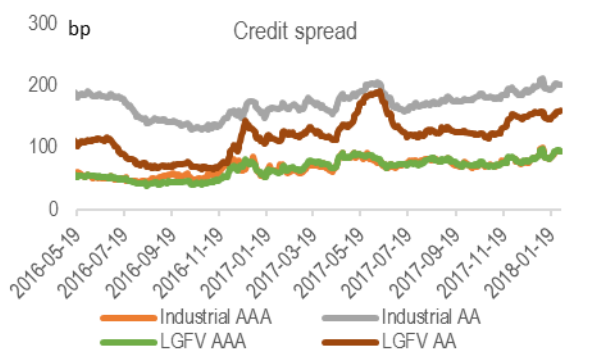
The onshore bond market looks very attractive with China – US spread in the 150-200bp range. We expect more foreign inflows into the onshore bond market through CIBM/RQFII/QFII.

Figure 12: China – US 10yr treasury spread very attractive



Source: WIND

Figure 13: China onshore credit spread likely to continue widening



Source: WIND

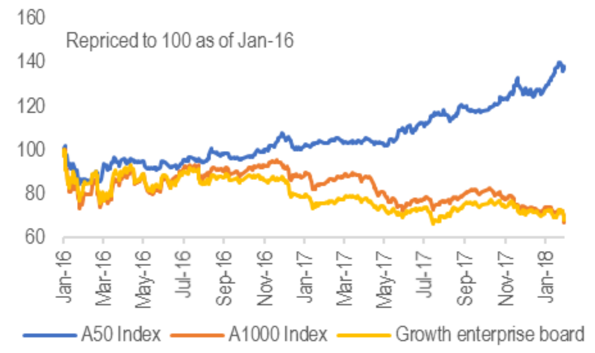
Stock market may continue to see liquidity pressure

On 1st February 2018, there were 265 stocks that hit the daily 10% down limit in the A-share market. What these companies have in common is that they have trust asset management schemes among their top 10 public shareholders. We believe Vanke's Independent Director's public letter to CSRC triggered a panic unwinding of the asset management scheme under trust companies. The letter highlights one of its major shareholder Baoneng has violated the leverage cap requirement for asset management business. While brokers' asset management scheme has largely reduced their leverage in the equity market schemes. The trust company's schemes have not done this yet with 2-3x leverage funded by funds entrusted by banks.

We advise investors to avoid companies with trust schemes among top public shareholders in the near term as the unwinding process will take time. The overall A-share market has been in a de-rating process since 2016, although the re-rating of blue chips has masked the overall de-rating, especially for the smaller companies with high multiples. We believe this is healthy development and eventually will lead to a more rational valuation of the A-share market.

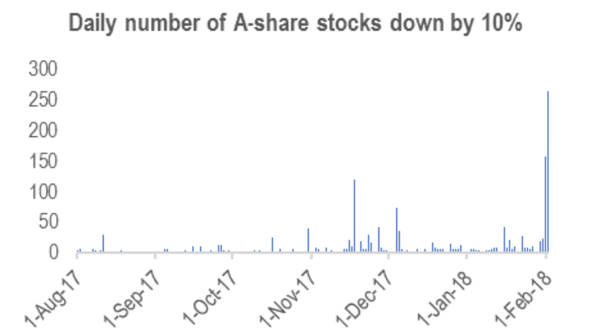
It is not clear whether the trust schemes have participated in the Hong Kong stock market through stock connect. Investors should be alerted to such risks.

Figure 14: The rise of A50 blue chips mask the overall derating and deleveraging of stock market



Source: WIND

Figure 15: Number of A-share stocks hitting the 10% down limit jumped to 256 on 1st Feb, likely due to the unwinding of leveraged position of trust products

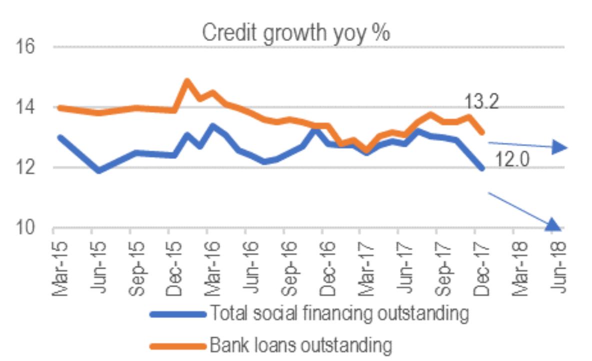


Source: WIND

Macro economy growth may be affected by slow credit growth

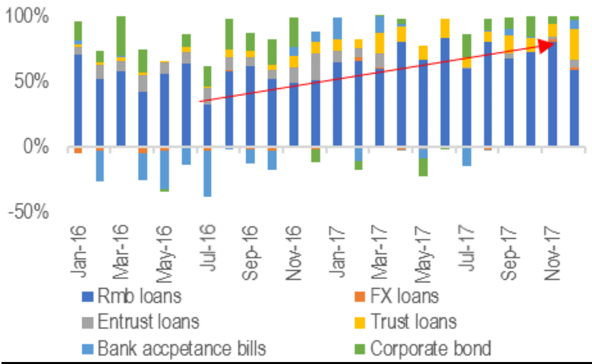
We expect the broad credit growth as measured by Total Social Financial growth will continue to trend down with significant drop in non-standard credit such as entrust loans and trust loans while bank loan growth likely to be stable to absorb the unwinding non-standard credit. Overall real estate developers and LGFVs are likely to find it very hard to refinance onshore and their funding cost is likely to significantly increase in 2018.

Figure 16: Credit growth likely to trend down; total social financing growth likely to slow down significantly



Source: PBOC, WIND

Figure 17: New total social financing mix will shift heavily towards bank loans in 2018

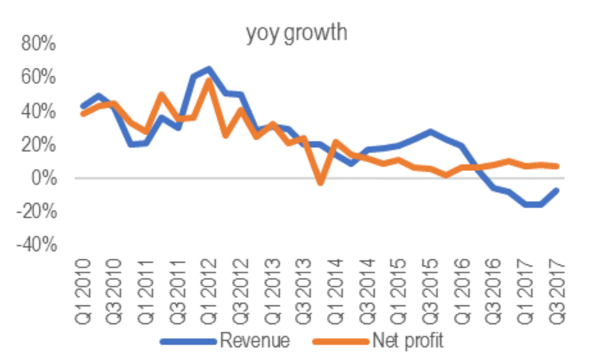


Source: PBOC, WIND

Smaller banks may see further headline and asset quality pressure

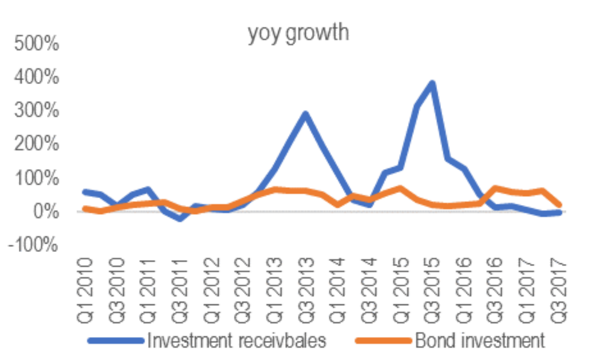
Non-standard credit will need to be securitized through ABS market or come back to the bank loans. This will add asset quality pressure as loan quota will still be limited by capital ratios and funding. Financial market operations had been a very important profit driver for regional banks and joint-stock bank before 2017. The combined size of interbank assets, investment receivables and bond investment had even exceeded that of loans. However, this is changing under regulator's determination to deflate the bubbles in the bond and reduce leverage in the interbank market. In 2018, regional banks' financial market operations may suffer from regulatory clampdown and their revenue growth is likely to remain under pressure. However, this may partly be compensated by the rising spread.

Figure 18: Industrial Bank (601166.SS) one of the biggest player in the interbank market experienced revenue contraction in 2017



Source: Company data

Figure 19: Industrial Bank investment receivables heading to south



Source: Company data

Implication to non-bank financial institutions

We expect to see a notable decline in the asset management business of non-bank financial institutions, including trust products, brokers' asset management schemes, and mutual fund's special managed accounts. 2018 will be a tough year for non-bank financial institutions especially for the trust companies and brokers. The acute unwinding of leveraged positions in the bond market and equity market may result in significant losses. In addition, the overall regulatory discouragement in their conduit business for non-standard credit assets will drag down their revenue as it has been a very important profit growth driver in the past few years.

What's the leverage mechanism in the interbank market

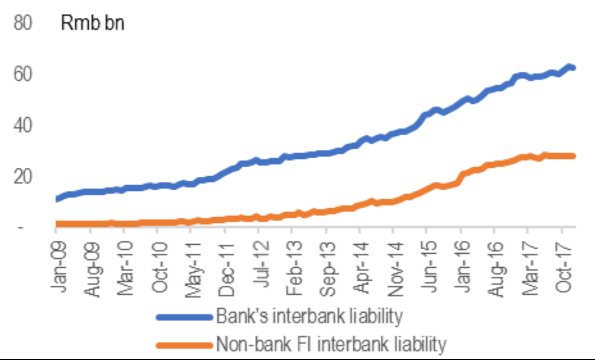
Interbank liability and wealth management fund set to decline

In the past 10 years, the leverage in the financial system has significantly increased – a notable trend was that interbank liability especially for joint-stock banks and regional banks has ballooned. Wealth management fund offered by banks and asset management schemes at non-banks also reached to a meaning size even compared to bank deposits. Non-bank financial institutions (brokers, trust companies, insurance companies etc.) have been used by banks as conduit to leverage up, invest into the bond market, invest into non-standard credit assets and bypass various requirements on banks. This had compressed the bond market yield till 2016 with a huge leverage built up and led unregulated credit flowing into real estate market and local government financing vehicles (LGFVs).

Since 2016, containing risks in the financial system was put on the top of agenda of policy makers. Deleveraging in the financial market was kicked off with tightening rules on bond market, interbank CDs and wealth management funds. Most importantly, the launch of the super financial regulator and the new asset management industry regulations mark the start of illuminating regulator arbitrage between banks and non-bank financial institutions.

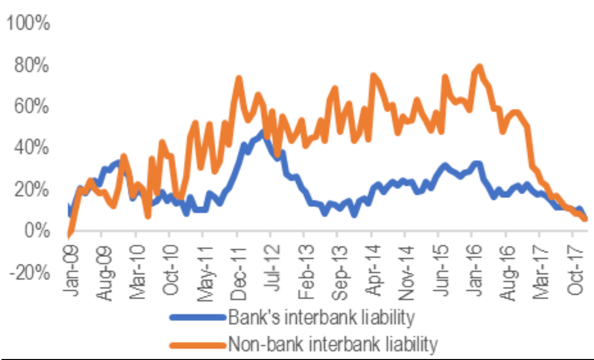
Many other rules followed throughout 2017 and in early 2018. We expect the deleveraging in the financial system will continue in 2018. Interbank liability and wealth management fund are likely to shrink, while bond market rates likely to remain at high levels.

Figure 20: Commercial banks and non-bank financial institutions interbank liability ballooned



Source: PBOC; Note: We include bond in interbank liability

Figure 21: Interbank liability growth likely heading to negative territory due to regulatory clampdown since end-2016



Source: PBOC; Note: We include bond in interbank liability

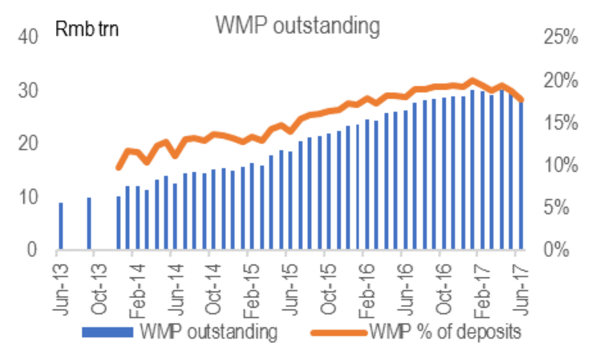
Non-standard credit assets and interbank CD are all result of financial disintermediation

With the growing household assets but limited return from bank deposits, the asset manage industry recorded unprecedent growth and reached to a meaning size compared to bank deposits. However, the asset management product such as wealth management products issued by banks and trust products issued by trust companies embed implicit guarantee by the issuers to the investors. This is what the regulators target to change.

Non-standard credit assets emerged around 2012 when smaller banks experienced fast deposit outflows into wealth management products and suffered from tight loan quota management, loan/deposit ratio cap, capital and provisioning requirements. Off-balance sheet wealth management product funds were used to invest into so-called non-standard credit assets to provide credit to LGFVs and real estate developers whose loan demand was tightly monitored by regulators. After CBRC's No.8 Circular in 2013, WMP investing into non-standard credit assets was capped. Banks started to add more layers of conduit and hide non-standard credit assets in interbank repos and later in investment receivables.

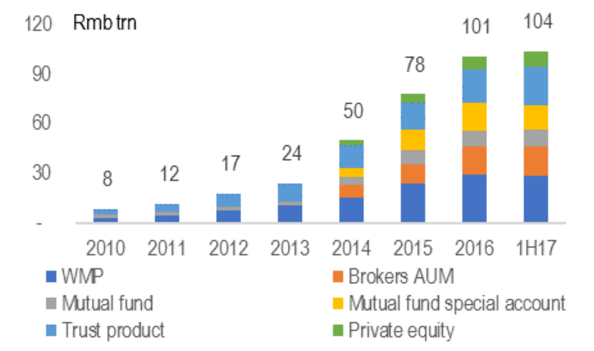
With the falling interest rates and a bull bond market, interbank CDs emerged in 2014 as an important tool for regional banks to obtain additional funding to leverage up and invest into the bond market. Interbank CDs were not included into interbank liability which is capped at 1/3 of total liability according to CBRC No. 127 Circular.

Figure 22: Wealth management product



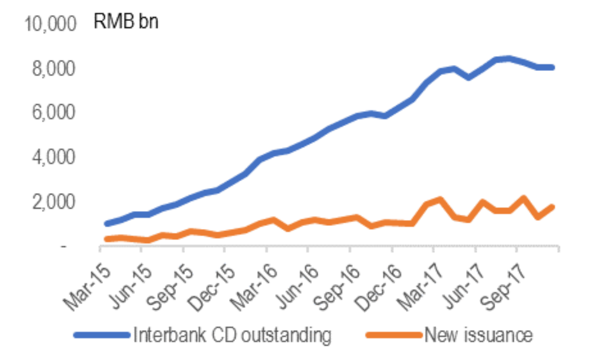
Source: PBOC, CBRC, CSRC

Figure 23: The asset management sector AUM



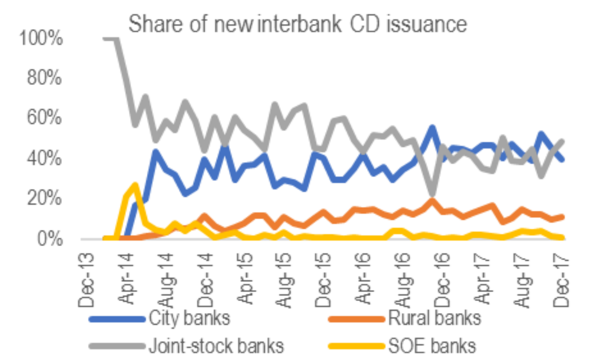
Source: PBOC, CBRC, CSRC

Figure 24: Interbank CD outstanding and new issuance started to decline



Source: WIND

Figure 25: Interbank CD new issuance dominated by regional banks

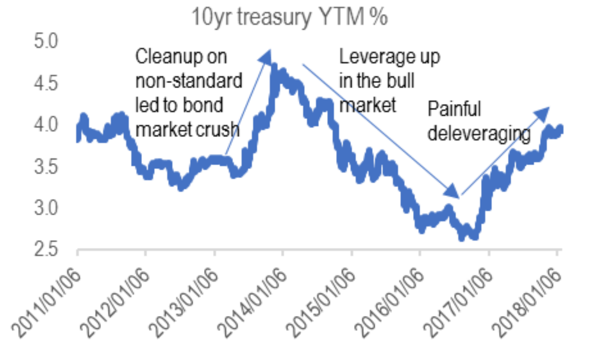


Source: WIND

The fast built-up of leverage significantly increased system vulnerability

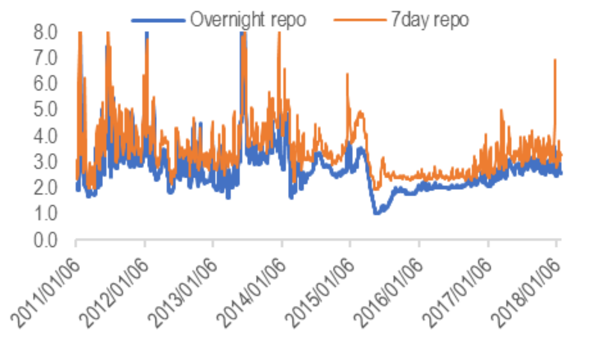
Apart from investing into non-standard credit assets, a significant portion of wealth management funds and interbank assets are leveraged up and invested into the bond market and interbank CDs. Significant leverage and duration mismatch were built up in the interbank market. The ultimate funding support behind this process was the low-cost liquidity provided to the larger banks by the central bank through SLF (Standing Lending Facility), SLO (Short-term Liquidity Operations), MLF (Medium-term Lending Facility), PSL (Pledged Supplementary Lending). We illustrate this process below.

Figure 26: A bull bond market led to increasing leverage since 2014; the deleveraging process since 2016 proved to be painful and long-lasting



Source: WIND

Figure 27: Interbank rate midpoint gradually moving up



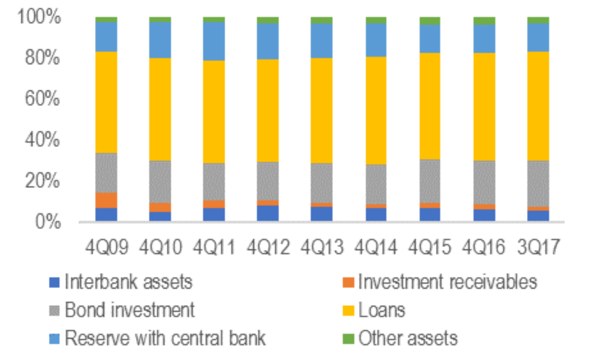
Source: WIND

Unwinding of the position may be painful for smaller banks

Joint-stock banks and regional banks profit growth had been driven by financial market operations-unwinding of the position may lead to painful headline contraction. As the loan-deposit spread narrowed, under the constraint by loan/deposit ratio, loan quota and capital charges, joint stock banks and regional banks (city commercial banks and rural banks) significantly increased their asset allocation into investment (bond and non-standard assets) and interbank assets. These assets are backed by interbank liability which can be scaled up in a short period. Profit from the financial market operations has been driving the profit growth for these smaller banks in the past five years.

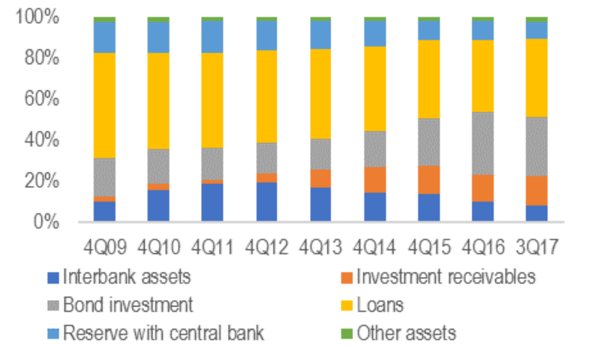
We expect these smaller banks' revenue and profit growth to be under pressure with the contraction in receivables and proper capital/provisioning charge on the non-standard credit.

Figure 28: SOE banks asset mix relatively stable



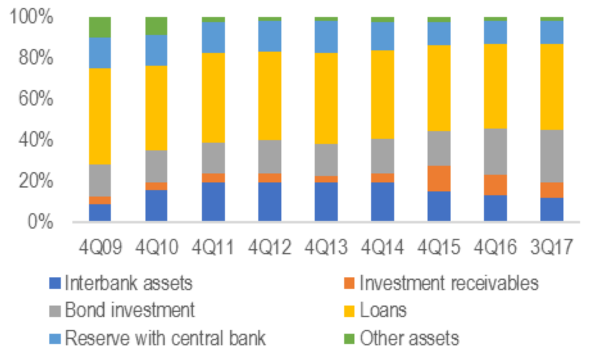
Source: WIND, company data

Figure 29: City commercial banks heavily shifting asset mix to receivables and bond investment; loans only accounting for less than 40% of assets



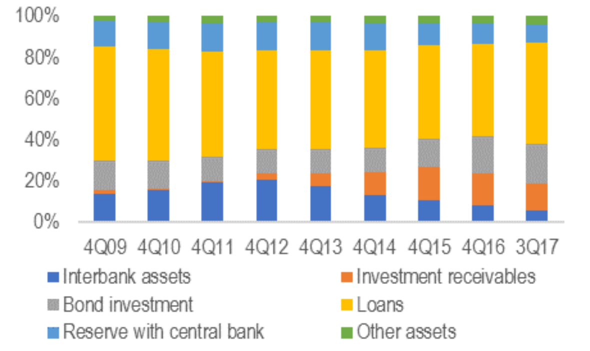
Source: WIND, company data

Figure 30: Rural banks shifting to interbank assets and bond investment



Source: WIND, company data

Figure 31: Joint-stock banks also allocate significant assets to investment receivables and bond



Source: WIND, company data

Appendix – Outline of recent regulations

Figure 32: Recent regulations in the financial sector

Date	Regulatory body	Regulation details
Jan-18	CBRC	Circular on Further Regulating and Adjusting the Market Chaos in the Banking Industry (No. 4 [2018] of the China Banking Regulatory Commission)
	CIRC	Guiding Opinions on Strengthening on the Management of Insurance Funds and Support Prevention and Diffusion of Local Government Debt Risks
	CIRC	Interim Measures for the Administration of the Utilization of Insurance Funds
	CBRC	Measures for the Administration of Large-scale Exposure of Commercial Banks (Exposure Draft)
	CBRC	Notice of the China Insurance Regulatory Commission on Issuing the Measures for the Administration of Entrusted Loans of Commercial Banks (No. 2 [2018] of the China Banking Regulatory Commission)
	PBoC, CBRC, CSRC, CIRC	Notice of the People's Bank of China, the China Banking Regulatory Commission, the China Securities Regulatory Commission and the China Insurance Regulatory Commission on Regulating the Bond Transactions of Bond Market Participants (No. 302 [2017] of People's Bank of China)
Dec-17	CBRC	Measures for the Liquidity Risk Management of Commercial Banks (Revised Exposure Draft)
	CBRC	Notice of the China Banking Regulatory Commission on Regulating the Bank-Trust Business (No. 55 [2017] of the China Banking Regulatory Commission)
Nov-17	PBoC	Zhou Xiaochuan: Hold the Bottom Line of No Systemic Financial Risks
	Financial Stability and Development Committee	Financial Stability and Development Committee began operations and held first meeting.
	CSRC	Regulatory briefings: providing “channel service” for other institutions is risky and will be held responsible.
	PBoC, CBRC, CSRC, CIRC	Guiding Opinions on Regulating Asset Management Business of Financial Institutions (Exposure Draft)
Oct-17	The 19th CPC National Congress	To improve the two-pillar framework of monetary and macro-prudential policies and strengthening financial regulatory system to prevent and control financial risks and safeguard financial security.
Sep-17	CSRC	Provisions on the Administration of Liquidity Risk of Publicly Offered Open-End Securities Investment Funds
Aug-17	PBoC	Q2 Monetary Policy Report: Starting from 2018Q1, NCD issued by banks with assets of more than RMB 500 billion will be included in MPA framework and banning NCD with a tenor exceeding one year.
Jul-17	The National Financial Work Conference	Financial work must focus on making the financial sector better serve the real economy, containing financial risks and deepening financial reforms. Prevention of systemic financial risks is the eternal theme of financial work. To establish a Financial Stability and Development Committee under the State Council to coordinate financial oversight and further open up the financial market.
Jun-17	CBRC	Notice of the China Banking Regulatory Commission on Further Regulating Banking Institutions' Deposit-taking Activities of Public Funds
May-17	CSRC	Banning channel business and no transfer of management responsibility. CSRC requested major brokerages to clear capital pool products.
	CBRC	Notice of the China Banking Regulatory Commission on Issuing the Guidelines for the Collateral Management of Commercial Banks
	Banking Wealth Management Registration & Depository Center	Notice on Further Standardizing Banking Wealth Management Product Registration

Source: PBOC, CBRC, AMTD Research

Figure 32: Recent regulations in the financial sector - continued

Date	Regulatory body	Regulation details
Apr-17	CBRC	Guiding Opinions of the China Banking Regulatory Commission on Risk Prevention and Control of the Banking Sector (No. 6 [2017] of the China Banking Regulatory Commission)
	CBRC	Notice on Carrying Out Special Governance of Regulatory Arbitration, Spinning Arbitrage and Related Arbitrage in the Banking Industry（No. 46 [2017] of General Office of the China Banking Regulatory Commission）
	CBRC	Notice of the General Office of the China Banking Regulatory Commission on Carrying out the Special Campaign against the "Inappropriate Innovations, Inappropriate Transactions, Inappropriate Incentives, and Inappropriate Collection of Fees" in the Banking Industry（No. 53 [2017] of General Office of the China Banking Regulatory Commission）
	CBRC	Guiding Opinions of the China Banking Regulatory Commission on Enhancing the Quality and Efficiency of the Banking Sector to Serve the Real Economy (No. 4 [2017] of the China Banking Regulatory Commission)
	CBRC	Circular on Regulating and Adjusting the Market Chaos in the Banking Industry
	CBRC	Notice of the China Banking Regulatory Commission on Effectively Covering the Supervision Shortness and Enhancing the Supervision Efficiency (No. 7 [2017] of the China Banking Regulatory Commission)
	CIRC	Notice of the China Insurance Regulatory Commission on Further Strengthening the Risk Prevention and Control of the Insurance Industry (No. 35 [2017] of the China Insurance Regulatory Commission)
	CIRC	Notice of the China Insurance Regulatory Commission on Enhancing Insurance Regulation, Cracking Down on Violations of Laws and Regulations and Addressing Market Irregularities (No. 40 [2017] of the China Insurance Regulatory Commission)
Mar-17	PBoC	Raised reverse repo rate.
	CBRC	Notice of the General Office of the China Banking Regulatory Commission on Carrying out the Special Campaign against the "Violations of Laws, Regulations and Rules" in the Banking Industry (No. 45 [2017] of General Office of the China Banking Regulatory Commission)
Feb-17	PBoC	Guiding Opinions on Regulating Asset Management Business of Financial Institutions (Internal Review Draft)
	PBoC	Raised reverse repo rate and interest rate on SLF loans.
Jan-17	PBoC	NCD may be included in interbank borrowings and interbank liabilities must not exceed one-third of total liabilities.
	PBoC	Raised interest rate on MLF loans.
Dec-16	Central Economic Work Conference	The meeting has made preventing financial risk an economic priority. Monetary policy will be kept neutral and money supply should be controlled.
Nov-16	PBoC	Q3 Monetary Policy Report: currently considering including off-balance sheet WMPs into MPA to guide banks to strengthen the risk management of off-balance sheet activities.
	CBRC	Guidelines for the Management of Off-Balance-Sheet Business Risks of Commercial Banks (Revised Exposure Draft): Emphasize the significance of classified management, internal control, the principle of substance over form and transparent information to manage the risks of off-balance sheet activities.
Oct-16	Politburo meeting	Keep a prudent and neutral monetary policy. Liquidity remained neutral and appropriate and containing bubbles and mitigating risks.
	PBoC	Circular on Including Off-balance Sheet Wealth Management into Board Credit Examination: Starting from 2017Q1, banks' off-the-balance-sheet wealth management products will be included in its examination of broad credit in its MPA risk-tool.
Sep-16	CSDC, SSE, SZSE	Guidance for Risk Control on Trading, Settlement in Collateralized Repo of Bonds
Aug-Sep 16	PBoC	Reboot and frequent operation of 14- and 28-day reverse repos. Campaign to push interbank lending into longer, higher interest rate tenors.
Jul-16	Politburo meeting	Prevention of financial risks and implement of five major tasks including cutting industrial capacity, reducing the housing inventory, cutting leverage, lowering corporate costs and improving weak economic links. The key to de-capacity deleveraging is to deepen the fundamental reforms of state-owned enterprises and the financial sector.
	CBRC	Administrative Rules on the Overseas Wealth Management Business of Banks

Source: PBOC, CBRC, AMTD Research

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