

HANDS-ON CHINA REPORT April 19, 2012

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Around the Country - New Financial Reform Takes Shape?

While in Beijing this week, we had discussions with financial sector experts about the gathering momentum for financial reforms around the country. Chinese authorities have taken steps in recent months to usher in financial reforms that support financing for SMEs and private firms, and that broaden the scope for cross-border Renminbi investment. These developments indicate that the central government is bolstering financing support for SMEs, while embracing greater private involvement in the financial system.

In practice, it is typical for Chinese authorities to experiment with complex reforms in designated localities before rolling them out across the nation. As such, it is instructive to examine the pilot reforms unfolding in three cities: Shenzhen – the border city to Hong Kong, Shanghai – which has a mandate to become an international financial center by 2020, and Wenzhou – dubbed the nation's capital of private entrepreneurship (and a center for export-driven private business, which has been a hotbed for grey-market lending).

- **Wenzhou.** On March 28, the State Council approved the designation of Wenzhou as an appointed pilot region for financial reform. The city of Wenzhou was tasked with 12 reform objectives, the two most notable of which are i) allowing eligible informal lending institutions to be converted into rural banks, and ii) allowing private individuals to make direct investments overseas in non-financial companies (up to a cap of USD3 million per project per year, or USD200 million in total per year). Last year, the Wenzhou PBoC branch estimated underground lending in the city at RMB110 billion, and suggested that most of the funds went to speculative investments. On a nationwide basis, the PBoC has estimated that underground lending amounts to 5.6% of total lending.

The major impact of the Wenzhou reform is to promote private participation in the bank-dominated financial system and to liberalize private capital outflows. There is, however, a lack of clarity in two important respects: i) whether the new rural banks would have the ability to set their own interest rates, and ii) whether the biggest sole shareholder of the new financial institutions must be an existing banking institution, as required by the current policy.

- **Shanghai.** The Shanghai Municipal Office of Financial Services indicated that the city is planning to launch a pilot program that would allow qualified foreign limited partners (including certain hedge funds, private equity and venture capital funds) to raise RMB funds on the mainland for investment in overseas markets. No timetable was given for the launch of the so-called *Qualified Domestic Limited Partner* (QDLP) initiative. According to media reports, approved LPs will be required to register a liaison fund in Shanghai and the initial quota for the initiative will be USD5 billion. It is yet unclear how these funds and their profits will be taxed.
- **Shenzhen.** Last week, it was reported that the Shenzhen city government has included a cross-border RMB lending pilot project in its work schedule for this year, under which banks in Hong Kong and

Shenzhen will be permitted to lend RMB directly to clients from each others' cities. According to the *China Securities News*, the Hong Kong-Shenzhen cross-border RMB lending scheme has been submitted to the State Council for approval. The work paper also noted that RMB-loans from Hong Kong (where lending rates are substantially lower than on the mainland) could be used to develop Shenzhen's Qianhai new economic zone. J.P. Morgan's Hong Kong banks analyst Joseph Leung expects the size of the initial pilot scheme to be insignificant. However, if 30% of Hong Kong's RMB deposits are allocated to onshore lending at 10% discount to the PBOC rate, he estimates a potential NIM impact of 7bp and EPS impact of 2% to Hong Kong banks under coverage. Further plans for the development of the Qianhai district include establishing a fund in support of strategic new industries, establishing a fund management and MNC global settlement centre, a possible new OTC exchange, as well as bond market innovations.

Around the country – new financing channels for small firms

Regional OTC markets

China's securities regulator has recently indicated that preparations are underway to launch new over-the-counter equity markets around the nation (subject to State Council approval) as part of efforts to provide new financing channels for small firms, particularly high-tech companies.

CSRC chairman Guo Shuqing said this week that authorities will support the expansion of new OTC boards (known as the "Xin San Ban"), similar to a trial board launched in 2006 in the Beijing Zhongguancun Science Park. He also voiced support for regional OTC markets to be established at a faster pace, subject to two key guidelines, i) there must not be collective trades; ii) participating companies should not have more than 200 shareholders. He further indicated that regional OTC member companies may later graduate to the national OTC board, the Growth Enterprise Board or even the A-share market.


SME private bond placements

Regulations for the private placement of bonds by SMEs without case-by-case administrative approval should be finalized in the first half of 2012. The CSRC announced in early-April that the regulatory framework has been completed and will be finalized soon. The private placement plan, however, will first be piloted in areas that have high concentrations of SMEs. Thus it is very likely that private placements for SME loans will be piloted in Zhejiang province, or more specifically, in the Wenzhou financial reform pilot.

The Wenzhou financial reform experiment

Wenzhou's financial reform plan includes 12 major tasks:

1. Developing a fundraising market for private enterprises.
2. Accelerating the development of new types of financial organizations, including joint-stock village and township banks, loan companies and rural financial co-operatives. Qualified informal lending companies may be developed into village and township banks.
3. The development of professional asset management institutions to direct private capital into venture capital and private equity funds.

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4. Exploring the development of individual overseas direct investment programs and the creation of direct investment channels.
 5. Deepening reforms of regional financial institutions and encouraging State-owned banks and joint-stock banks to establish micro-lending programs for SMEs.
 6. Developing financial services geared towards SMEs and agricultural enterprises.
 7. Developing regional capital markets and encouraging the transfer of property rights (e.g. intellectual property rights) among private companies.
 8. Develop fixed income securities to benefit smaller enterprises.
 9. Broadening the scope of insurance services.
 10. Strengthening the credit system and improving regulation of the credit market.
 11. Improving the local financial regulatory system.
 12. Developing a comprehensive risk management system and establishing local government responsibilities.

During his visit to Wenzhou in early-April, PBOC governor Zhou Xiaochuan emphasized that the objective of the reform initiative is to “reduce regulatory control”. He also mentioned that the tasks included in the pilot scheme should be approved at a time when conditions are ripe.

Wenzhou’s economy has not seen much improvement since last summer’s well-reported credit crisis. The number of local companies going bankrupt increased by 60 to a total of 234 companies as of end-February. Of this number, 152 had received bank loans totaling RMB4.07 billion, or 36.22% of Wenzhou’s total NPL balance. Wenzhou’s total NPL ratio has increased by 1.43 percentage since last June to 1.74%. The city’s total outstanding loan balance had declined by 7.1% YoY as of end-February, with the January-February new lending figure down RMB9.44 billion compared to the same period last year. Of the 25 municipal banks in Wenzhou, 12 institutions have loan-to-deposit ratios above 100%, with the highest standing at 179%.

According to Zhang Zhengyu, chief officer of Wenzhou Financial Office, a top priority is to encourage micro-lending companies with a good credit history and adequate capital to transform into county banks, in order to fill the void of Wenzhou’s financial system that resulted in a very high prevalence of shadow banking and even usury. Wenzhou has also announced plans to hire 108 experienced financial professionals, mostly in roles relating to risk management and regulatory supervision.

The package of reforms does not directly address certain highly debated topics, such as interest rate liberalization and the establishment of truly private banks without government shareholders. This perhaps reflects a degree of caution towards completely overhauling current financial regulations. Additionally, Wenzhou’s predicament was not solely attributable to issues with its financial system, but rather that its original strength on foreign trade is diminishing. As of February, Wenzhou’s exports decreased by 30.87% yoy and trade surplus decreased by 8.23%. Wenzhou originally took pride in labor intensive products’ exports, such as shoes, apparels, glasses, and valves, which all fell by more than 20% yoy in February, with shoes and apparels falling more than 40%.

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