China's Answer to Subprime Bets: The 'Golden Elephant'

By Kelvin Soh and Michael Flaherty

The Chinese investment vehicle known as "Golden Elephant No. 38" promises buyers a 7.2 percent return per year. That's more than double the rate offered on savings accounts nationally.

Absent from the product's prospectus is any indication of the asset underpinning Golden Elephant: a near-empty housing project in the rural town of Taihe, at the end of a dirt path amid rice fields in one of China's poorest provinces.

"They haven't even built a proper road here," said Li Chun, a car repairman, who said he lives in the project. "The local government is holding onto the flats and only wants to sell them when prices go up."

Golden Elephant No. 38 is one of thousands of "wealth-management products", instruments aimed at monied investors, which have shown phenomenal growth over the last five years. Sales of them soared 43 percent in the first half of 2012 to 12.14 trillion yuan ($1.90 trillion), according to a report by CN Benefit, a Chinese wealth-management consultancy. They are usually created in China's "shadow banking" system - non-banking institutions that are not subject to the same regulations as banks - which has grown to account for around a fifth of all new financing in China.

Like the subprime-debt lending spree in the United States that helped spark the 2008 financial crisis, the products are often opaque, and usually dependent on high-risk underlying assets, such as the Taihe housing project.

WARNING BELLS

Financial instability in the world's second-largest economy could have global ramifications, and warning bells have begun to sound about the way these products are marketed in China.

It has become a mammoth industry, comprising an array of financial products. Analysts have different ways of measuring the size of the sector. Barclays estimates some 22 trillion yuan worth of wealth management products will be issued this year. Fitch Ratings says China's banks had about 10.4 trillion yuan in wealth management product liability at the end of June this year

Reuters reviewed more than 50 wealth-management and trust loan products, available online and at bank branches in China, with the aim of tracking, for the first time in certain cases, where investors' money in these products ends up. All, except two, failed to explain or even display the underlying asset behind the product.

The China Banking Regulatory Commission, which oversees banking products, said more than 20,000 wealth management products were now in circulation, from a few hundred just five years ago.

In an email response to the questions raised in this story, the regulator told Reuters new banking regulations require more transparency about these products. "It is uncommon to find wealth management products that fail to clearly specify the underlying securitized assets," it said, adding that a regulation issued last year "clearly states that WMP prospectuses must indicate how the money is being used, and the percentage of money that is being put into each asset class." The commission is looking into further strengthening the regulatory framework over these products, and "will continue to encourage the wealth management industry's growth under the principles of transparency and sufficient risk control".

"PONZI SCHEME"

After a five-year bonanza in sales of these products, signs of trouble are building. China Credit Trust Co, one of the country's biggest trust companies, has disclosed that one of its wealth funds, Jinkai #1, is at risk of default because of money it lent to coal company Zhenfu energy Group. Zhenfu's boss has been arrested, amid reports he owed a total of 500 million yuan.

"Zhenfu Group and related companies have already been sued three times in the second quarter, all because of off-the-balance-sheet fundraising from underground channels," China Credit Trust said on its website, adding that government teams were trying to sort out who was owed what. If the fund were to fail, it would be one of the first in China's fast-growing trust industry and open up a test case on who is ultimately liable when investment products go bad.

It called to mind the massive losses and widespread bankruptcies in China's trust industry a decade or so ago, when the Guongdong International Trust and Investment Corporation, then one of China's largest state-owned companies, went bankrupt. Some analysts are warning of potential fraud in the industry. "Some banks have been using new (wealth-management product) proceeds to cover losses from previous products in the pool," said David Cui, a strategist at BofA Merrill Lynch. "In our view, this is not fundamentally different from a Ponzi scheme. The music may stop at a certain point if and when WMP asset size stops expanding."

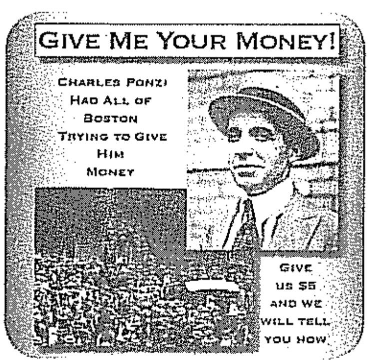
MANAGING TROUBLED LOANS

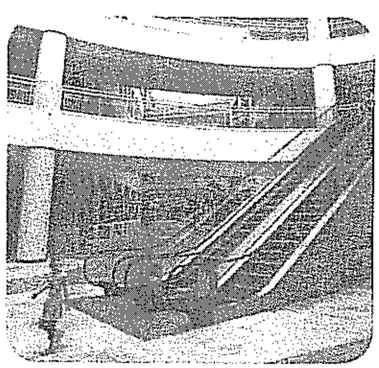
Wealth management products are investment tools with a short maturity that banks market as a low risk vehicle for returns higher than savings deposits. The products pool money to invest in a variety of different assets. Some of them, such as the Golden Elephant and Jinkai #1, are linked to high-risk trust loans, with the banks playing a middleman role between the trust company and investor.

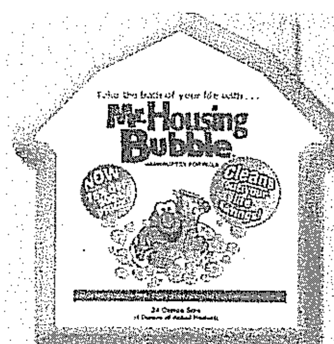
At first, products such as Golden Elephant were viewed as a beneficial way for China's banks to manage troubled loans and for its citizens to grow their money by investing beyond the government-set savings rate. But as China's growth engine slows, concerns are rising that the mountain of products, many with a maturity of a mere four weeks, will struggle to keep the money flowing in. That would leave banks and investors on the hook for any bad lending stemming from these products and strain the financial system at a time when the country's economy looks fragile.

"The concern is if some investors begin to experience losses in these products, this could create a panic among other investors," said Mike Werner, an analyst at Sanford Bernstein. "This could result in investors fleeing these products and result in a liquidity squeeze for this market."

Especially worrisome is the quality and transparency of the products. Liu Shiyu, a vice-governor at the country's central bank, said in June many banks had failed to sufficiently disclose the risks involved in investing in these products, but he did not announce any measures to curb the sector's growth.







ENGINE OF WEALTH?

The 14-page prospectus for "Wealth Management Plan No. 350", sold by China Merchants Bank, says it aims to raise 200 million yuan ($35 million). Not until page 5 is it revealed that the product is linked to the Railway Ministry - whose 2.2 trillion yuan debt ($346 billion) exceeds the combined worth of all major U.S. banks. The railway operator is seeking to refinance 2.43 trillion yuan ($392 billion). The state-run Beijing Times said it lost 7 billion yuan in the first quarter of this year alone, hit by debt repayments of more than 28 billion yuan in January-March.The prospectus also says up to 70 percent of the product's proceeds can be used for investments in "other assets", without saying what these assets are. Bank officials said the money is usually put into a common pool for investments, but said they were unable to say exactly where the money was invested.

In the American subprime-mortgage bubble, much of the credit-derivative obligations and other investment instruments underpinned by risky home loans were deemed AAA by ratings agencies. In China, domestic agencies give the railway ministry's bonds their highest ratings -- higher even than U.S. treasuries. A product called "Wealth Accumulator," sold by Bank of China, only states that the money is being put into high-quality assets that will yield guaranteed returns "significantly higher than term deposits of similar tenor." No other details are offered.

"The problem is that not even high net-worth Chinese people may fully understand the risks involved," said Gigi Chan, who runs the China Opportunities Fund at Threadneedle Investments, which manages more than $123 billion in assets globally. "They're being told there are guaranteed returns, and people need to consider if these returns are really guaranteed."

SUBPRIME SIMILARITIES

The 5 trillion yuan trust industry, sometimes referred to as "shadow banks", emerged soon after China began opening up in 1979. It was meant to encourage innovation within the financial services sector by lending to higher risk companies that traditional banks would not lend to. Initially, the trust companies handed out loans by channeling money from institutional investors to companies that needed them, taking a cut in the process. That has changed in the past few years.

Banks started working closely with trust companies by packaging trust loans into bite-sized wealth management products to cater to yield-chasing depositors, or by selling trust loan products directly to its depositor base at their retail branches. Banks also began transferring non-performing debts to roughly 60 trust companies, which in turn packaged the debt into investment products that were sold back to retail customers or marketed with a bank. These vehicles typically focused on property investments, because Beijing was cracking down on bank loans to developers. Around the same time, many Chinese banks began offering higher returns on securities they labeled "wealth management products" to people looking for a better return on their money.

CASH PRESSURES

Deposit growth at Chinese banks, meanwhile, slowed to around 13 percent last year, its slowest pace in decades. Money flowing out of saving deposits and into wealth-management products poses a potential threat to banking stability, because it reduces the amount of money banks have on hand to lend and could lead to cash pressures, analysts warn.

"Fitch has long emphasized that the greatest risk associated with Chinese banks' wealth management activity is the strain it places on funding and liquidity," Fitch analyst Charlene Chu said in a research note. "The risk was easily controllable when the amount of outstanding products remained small. But it is increasingly difficult for Chinese banks to manage."

Chinese banks say they prefer straight deposits, but that the wealth tools are a response to the demands of a market that has shown explosive growth. "Customer expectations on financial services have been rising," China Construction Bank President Zhang Jianguo told Reuters. "To ensure our wholesome development, to keep customers and attract new ones, wealth management products have now become an essential part of any financial offering." All other banks mentioned in this report declined to comment.

TWO-WEEK TENURES

The banking regulator implemented rules last year to curb sales of some of the riskier products, including those with one-month or less maturity dates, and those linked to Chinese pawn shops. But most products still carry tenures of less than one year -- advisory firm KPMG says only 3 percent extend beyond two years. Information is opaque, rules are open to interpretation.

"One of the key problems is that short-term financing is being used to pay for a long-term project," said May Yan, head of China bank research at Barclays in Hong Kong. "Infrastructure projects should be funded by long-term bonds. Unfortunately, China doesn't have that."

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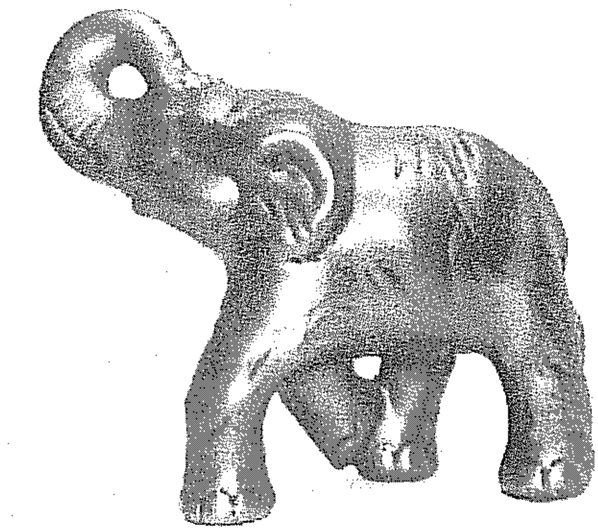
The banking regulator has tried to protect the small investor with a rule issued last year requiring that only individuals with more than 1 million yuan in cash could invest directly into trust products. At bank branches in two Chinese cities visited as part of the Reuters review, that rule was easy to get around. Customers at banks in Nanchang and Shenzhen, unable to cough up the initial 1 million yuan investment, were offered the option of pooling their money together with others to meet the minimum sum required.



"ON PAPER..."

The trusts, also called "shadow banks", create the wealth management products and then give them to banks to sell to their customers. The bank staff Reuters spoke to stressed the low-risk nature of the products, despite the higher-than-normal returns being promised. They often could not say where the proceeds of the product would be invested.

"On paper, these are not principal guaranteed but you don't have to worry about that," said a wealth manager at a local branch of Bank of Communications, China's No. 5 lender. "All our clients who've previously bought these products got their principal plus interest back."

It is not entirely clear who bears the risk if the products default. China's courts have in the past ordered banks to compensate investors who had lost money buying mutual funds and other financial products, prompting some to suggest a string of such defaults could weigh heavily on China's major lenders. But the fine print in most of the documentation for these products puts the onus squarely on the investor.

"The question really is, at the end of the day, who is on the hook?" said Werner at Sanford Bernstein. Hao Xueqi, a homemaker who was at Shenzen branch of China Construction Bank, was unfazed. "I've bought these products and have always gotten my money back," she said. "I usually go with the bigger banks because they have a better reputation and won't close down with my money."

SUBSIDISED HOUSING

The proceeds from sales of the "Golden Elephant" product were channeled to Taihe City Construction Co., a local government financing vehicle. Taihe is an agricultural town in impoverished Jiangxi province, where annual incomes reached 4,500 yuan a year in 2010, barely a tenth of Beijing residents.

Taihe City Construction Co. used the 50 million yuan raised to pay off part of the cost of constructing the subsidized housing units, according to the product's prospectus.

"The central government wanted more subsidized housing, so they just removed all the farmers here and told them to leave," said Taihe resident Xiao Hongmei. "The farmers who used to live here were promised flats, but many of them haven't got anything so far."

A spokesman at the publicity department of the Taihe government office declined to comment, referring queries to the Jiangxi provincial government.

Xu Weiguo, a deputy director at the province's economic planning department, said Jiangxi was a model province in keeping any economic risks to a minimum.

"We always study the central government's instructions very closely and follow the rules," Xu said in a telephone interview. **"There will not be any problems with our books."**