鵬元國際 PENGYUAN

# Wealth Management Regulations Likely to be Postponed

## Banks may be short-term beneficiaries, but reforms remain imminent

## Contents



## Summary

We anticipate that the Chinese regulators will take an accommodative approach in pushing through reforms in the wealth management product (WMP) market in the remainder of 2020. This will give the joint-stock banks (JSBs) a much-needed buffer amid a difficult environment, in our view. The new regulations – originally targeted for full implementation by the end of the year – call for fundamental changes in the way WMPs are designed, sold and priced. While the banks have made significant progress in improving their market structures since 2018, a few hurdles remain.

**The JSBs are major distributors of WMPs. We believe it would be unlikely for most of them to meet the initial regulatory deadline, especially as COVID-19 continues to wreak havoc across the economy.** The JSBs manage over 40% of assets under management (AuM) in the WMP market, which are equivalent to 25-45% of their deposit base. Full implementation in 2020 will affect them in three ways. First, commission income may come under substantial pressure. Under the new regulations, products are required to be priced on a net asset value (NAV) basis and do not offer an explicit expected return. This makes WMPs much less attractive to the average retail investor. Second, the banks may not have adequate management resources to comply with the new sales, investment and reporting requirements. Finally, existing assets that do not meet the new framework may have to be brought back onto their balance sheets, affecting the banks' deposit reserves, asset provisions and, ultimately, capital positions.

**Key remaining challenges include conversion to NAV pricing and treatment of illiquid non-standard credit assets.** As of now, only about 35% of WMPs are NAV-based. The banks have made tangible progress towards migrating to NAV product designs, but investor pushback and the lack of secondary market pricing for many asset classes continue to make full conversion difficult. We believe it may be another 1-2 years before NAV-based products account for the majority of sales. Furthermore, non-standard credit assets – which account for around 17% of AuM – present challenges in asset-liability management. Although many of these assets are in run-off and may not be wrapped into new product structures as they mature, their remaining duration is still significantly longer than the WMPs' investment horizons.

**On a more positive note, industry practices and infrastructure have come a long way since the early days of WMP.** A total of 16 banks have obtained licenses to set up wealth management subsidiaries, covering a large subset of the industry. Coupled with a more established trustee structure, these dedicated WMP business units offer a significantly higher degree of ring-fencing from the banks' assets and deposits. Capital or return guarantees on WMPs are now prohibited, with existing products being run-off or converted into on-balance sheet structured or plain-vanilla deposits. Interbank WMPs that are sold among banks represent less than 5% of outstanding AuM, compared to 25% at the peak in 2016. All these factors have contributed to a more prudent operating environment, in our opinion.

**Looking ahead, we expect the regulators to relax the 2020 year-end hard deadline, while requiring banks to develop implementation plans for 2021-2022.** We regard the potential delay in full implementation to be temporary, as a measure to soften the impact of COVID-19 on the sector, particularly the JSBs. We believe WMP regulations are an integral part of the policymakers' financial reform package and will remain a long-term priority.

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# The JSBs Stand to Benefit from a Delay in WMP Rule Implementation

We believe the likely relaxation of the WMP implementation deadline will benefit the JSBs the most. As of the middle of 2019, JSBs accounted for 41% of the RMB22.2 trillion (US$3.2 trillion) of WMPs that were distributed by the commercial banks, followed by the state-owned commercial banks (37%), and city commercial banks (17%) (exhibit 1). As a percentage of deposits, WMP balances accounted for 25-45% of the JSB's total, with CMB, SPDB, IB, CZB and HUAXIA showing the highest exposure (exhibit 2).

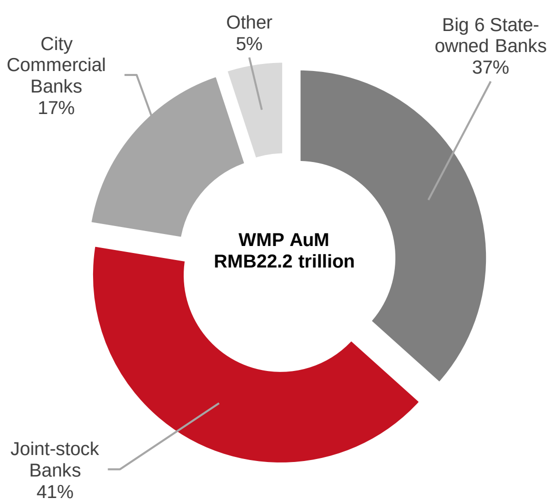
Since the size of WMP balances is not necessarily a credit negative, it is important to put these figures into perspective. Since the new WMP regulations were first introduced in 2018, the market has made significant effort to comply. The initial impact on the market are AuM growth and the implicit or explicit guarantees offered to investors, which are mostly retail customers. In terms of AuM, the market has stayed flat since 2018, as new WMP sales have failed to exceed the maturities of older products. But perhaps more importantly, banks are no longer allowed to provide guarantees on WMPs, explicit or otherwise. Older products that carry guarantees on return or principal have been brought back to the banks' balance sheets and have gradually been retired as they mature. Retail customers that prefer guaranteed returns have since had to place their AuM in structured or term deposits (exhibit 3).

Another useful reference point is the amount of WMP outstanding relative to the banking system's deposit base. After peaking in 2016, this ratio stood at 11.8% as of the middle of 2019 (exhibit 4). In addition, there have been a number of notable improvements in market infrastructure. A total of 16 banks have now set up WMP subsidiaries, which will take over the AuM of externally managed investments, creating a more robust fiduciary relationship and ring-fencing structure. There have also been increased efforts towards improving investor education and selling practices, with the banks implementing much stricter know-your-client (KYC) rules that identify each investor's risk tolerance level.

While these changes in the industry landscape will pave the way for a more sustainable wealth management industry, there are still a number of hurdles that the banks have to address:

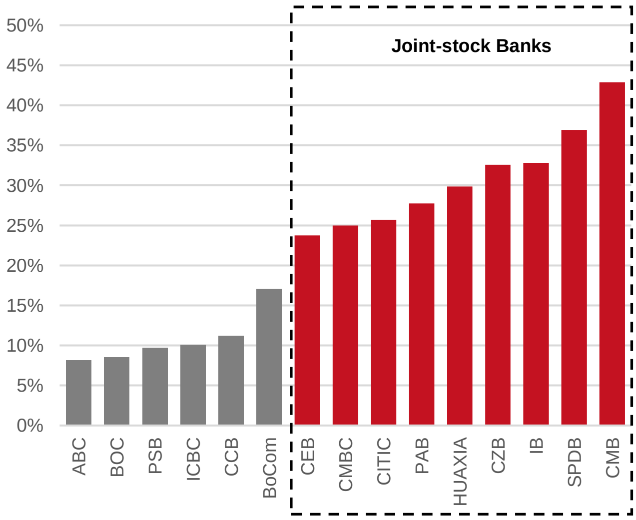
- **NAV Pricing** – Prior to the new rules coming into force, the vast majority of WMPs were sold on an expected return basis. To fully comply with the pending regulations, WMPs have to be quoted on an NAV basis, similar to products sold in more advanced economies;
- **Non-standard Credit Assets** – After the current transition period, it may be challenging for WMPs to invest in non-standard credit assets that do not have liquid secondary markets. The banking system will have to find a way to digest these assets, especially those that have long maturity periods.

**Exhibit 1: WMP AuM by Type of Banks as of end-1H19**



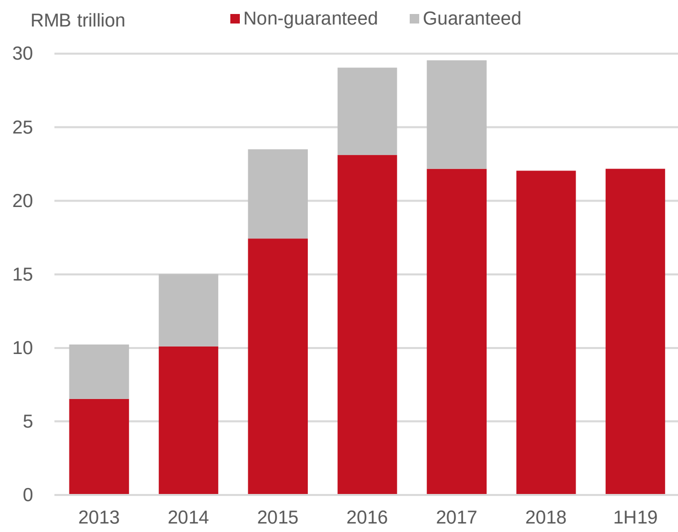

Source: China Banking Wealth Management Registration System: Pengyuan International

**Exhibit 2: WMP AuM as a % of end-1H19**



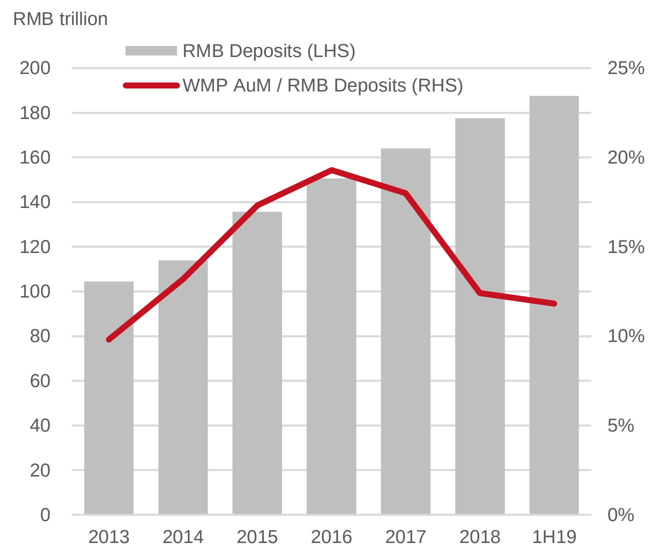

For a list of bank abbreviations, please refer to the appendix.
Source: China Banking Wealth Management Registration System; Company Disclosures; Pengyuan International

**Exhibit 3: AuM of the China WMP Market**




Source: China Banking Wealth Management Registration System; Pengyuan International

**Exhibit 4: Size of China Banking System Deposits vs WMP AuM**




Source: China Banking Wealth Management Registration System; Pengyuan International

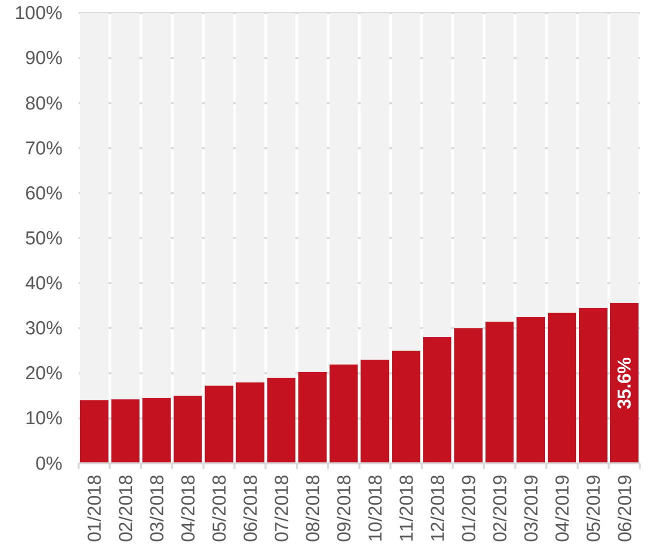
## NAV Pricing and Non-standard Credit Assets are Major Hurdles for Banks

Under the new regulations, WMPs are required to be quoted on an NAV basis, making this a major hurdle for the banks to comply. As of the middle of 2019, only 35.6% of WMPs were quoted on an NAV basis, although the trend has been encouraging since the announcement of the regulations (exhibit 5). The concept of NAV accounting is based on the determination of a fair value of a WMP's underlying asset, and on an aggregate basis, the WMP itself. Fair value may be easy to determine for assets that can be marked to market (such as listed equities and bonds). But they are much more difficult to estimate for illiquid assets, including non-standard credit assets such as beneficiary certificates, trust loans, entrusted loans and receivables.

As of the middle of 2019, 56% of WMP assets were allocated to bonds. Another 17% and 9% were invested in non-standard credit and equities respectively (exhibit 6). While interbank assets have declined from their peak (exhibit 7), non-standard credit assets are still a significant portion of the WMP market portfolio (exhibit 8).

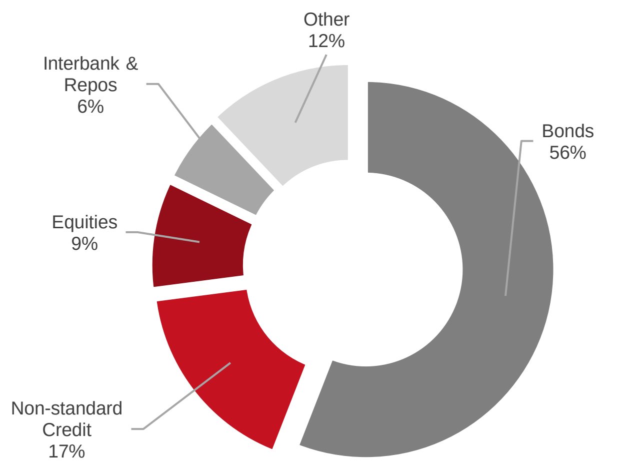
Given the current asset allocation, transitioning towards NAV presents a few challenges for the banks. First, the banks must develop robust pricing mechanisms for illiquid assets. This may involve the use of inhouse modelling and the development of a price quotation system. Second, the banks must have in place an established reporting system, so that NAVs can be calculated and reported to investors on a periodic basis. Third, banks must develop more competitive products. Prior to the new regulations, the vast majority of WMPs were sold on an expected return basis. Investors have a much weaker ability to form reasonable expectations in an NAV market and may eventually choose to channel their funds to other sectors. Finally, for non-standard credit assets with long maturities and cannot be refinanced in the WMP market when the new regulations come into full effect, banks have to manage their funding strategy. This is necessary to ensure there are no material disruptions to the financing of the underlying assets.

**Exhibit 5: The Proportion of NAV-based WMP Products**



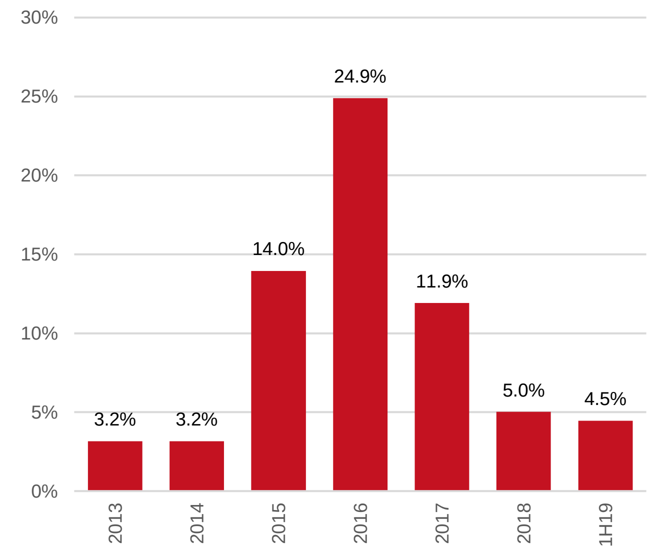

Source: China Banking Wealth Management Registration System; Pengyuan International

**Exhibit 6: Asset Allocation of WMPs as of end-1H19**



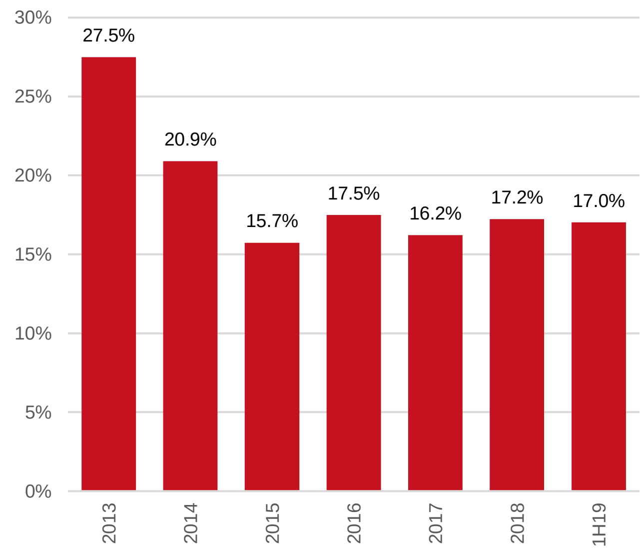

Source: China Banking Wealth Management Registration System; Pengyuan International

**Exhibit 7: WMP Allocation to Interbank Assets**




Source: China Banking Wealth Management Registration System; Pengyuan International

**Exhibit 8: WMP Allocation to Non-standard Credit Assets**




Source: China Banking Wealth Management Registration System; Pengyuan International

# Appendix: Bank Abbreviations Used in this Report

| | |
|---|---|
| ABC | Agricultural Bank of China Ltd |
| BOC | Bank of China Ltd |
| BoCom | Bank of Communications Co Ltd |
| CCB | China Construction Bank Corp |
| CITIC | China CITIC Bank Corp Ltd |
| CEB | China Everbright Bank Co Ltd |
| CMB | China Merchants Bank Co Ltd |
| CMBC | China Minsheng Banking Corp Ltd |
| CZB | China Zheshang Bank Co Ltd |
| HUAXIA | Hua Xia Bank Co Ltd |
| IB | Industrial Bank Co Ltd |
| ICBC | Industrial and Commercial Bank of China Ltd |
| PAB | Ping An Bank Co Ltd |
| PSB | Postal Savings Bank of China Co Ltd |
| SPDB | Shanghai Pudong Development Bank Co Ltd |

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