# Cautionary tale of a Chinese bank and the use of WMPs

## THE SHORT CUT

### with ANDREW MACKEN

THERE is a bank called China Minsheng.

Minsheng used to be an investor's dream: growing earnings consistently above 30 per cent a year, benefiting from the boom that was the Chinese economy.

But times have become tougher for Minsheng of late: the bank recently printed its first year-on-year decline in pre-tax profit since the global financial crisis.

You see, Minsheng is still growing its loan book at a steady rate of 13 per cent a year. But lending in China is not what it used to be.

Net interest margins are being squeezed from both directions: interest rates on new loans are not what they were now that too much credit chases too few economic opportunities; and deposit rates have been deregulated meaning Chinese banks now need to compete with each other for deposits.

Furthermore, Minsheng is being forced to rapidly book impairment allowances (which reduce profit) for existing loans that are deteriorating in credit quality.

The proportion of the total loan book that is now classified as poor quality (impaired and "special mention") has accelerated sharply to over 5 per cent, from around 3 per cent last year.

And Minsheng is not booking enough allowances in its income statement to meet these poor loans — suggesting the bank's earnings and book value are potentially overstated.

So, as the profitability of lending deteriorated, Minsheng needed a new game. Enter fees and commissions from "asset management".

Not a new trick at all — indeed many banks in the world are favouring these sorts of earnings streams as they are less capital intensive and, therefore, carry higher returns on equity.

This strategy has plugged the gap created by the falling profitability of lending. But only just.

And on the recent trajectory, growth in fee and commission income will unlikely be sufficient to offset the declines from lending.

You might ask: from where did these fee and commission earnings fortuitously appear?

Well, Minsheng, along with many peers, have got into the wealth management product origination business. WMPs are short-term (one to three months), high-yielding pieces of paper that have become popular with Chinese investors in place of deposits.

The WMPs are typically backed by very long-term assets, including property and infrastructure projects. While WMPs might sound risky, investors have historically been less concerned if they have been sponsored by a "reputable" bank.

The reason is that investors believe they are granted an implicit guarantee by the bank on the return of their capital. This idea remains untested, though we can get an insight into the credibility of any potential guarantee by looking at the size of the outstanding issues relative to Minsheng's book value of equity.

Based on the company's most recent filings, the combination of WMP trust products sponsored by Minsheng and others (where Minsheng retains an interest), combined with other off-balance-sheet guarantees, equates to nearly eight times book value.

Said another way, it would take only a 12.5 per cent loss on the underlying assets to completely wipe out Minsheng's equity, rendering it insolvent.

This is a large exposure which may limit the future growth of this business.

Minsheng may be looking at some tough times ahead.

As China slows, demand for loans will slow; net interest margins are already narrowing; credit quality of existing loans are deteriorating at an accelerated rate; and the sharp growth in fee and commission income that was being used to plug the gap may well be coming to an end. Earnings appear set to decline.

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