Reform and Stricter Regulation of Bank Wealth Management Products in China

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I. What wealth management products do Chinese banks offer?

1. Rapid growth of bank wealth management products in China

In recent years there has been much foreign interest in China's shadow banking system. In China itself there has, of course, also been an increasingly heated debate on this subject, not only among market participants but also among analysts and regulators. While there is by no means unanimity on what exactly constitutes China's shadow banking system, there is a consensus that it includes the collective investment schemes ("wealth management products")[1] originated and marketed by the country's banks.

As far as the scale of these products is concerned, Wang Yanxiu, director of the China Banking Regulatory Commission (CBRC)'s Business Innovation Regulatory and Collaboration Department, has put the value of products outstanding at RMB7.1 trillion and the number of products issued at 32,152 as of the end of 2012,[2] while in its *Monetary Policy Report* for Q1 2013 the People's Bank of China (PBOC) put the number of bank wealth management products issued as of the end of 2012 at 31,000 and their outstanding value at RMB6.7 trillion[3]. According to a report by the Chinese Academy of Social Sciences' Institute of World Economics and Politics[4], the value of Chinese banks' wealth management products outstanding increased from RMB467 billion as of the end of 2006 to RMB7.1 trillion as of the end of 2012 (Figure 1), more or less in line with the figures for the end of 2012 from the CBRC and PBOC.

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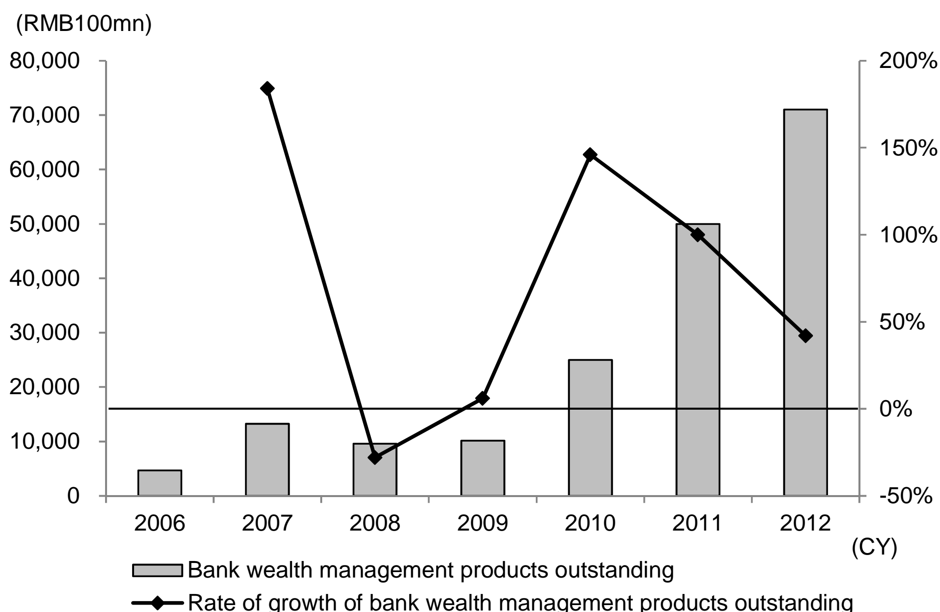
1 The Chinese term used in the original is usually called "wealth management products" (WMPs) in Western media.

2 Wang, Yanxiu, "Development and Regulation of Chinese Commercial Banks' Wealth Management Products," *China Finance*, No. 9, 2013, China Financial Publishing House, 2013 (in Chinese).

3 People's Bank of China, *Monetary Policy Report for 2013 Q1* (http: //www. pbc. gov. cn/publish/zhengcehuobisi/4098/index. html) (in Chinese).

4 Zhang, Ming, "China's Shadow Banking System: Definition, Causes, Risks and Responses," in "Report on Changes in China's Shadow Banking System,", Institute of World Economics and Politics, Chinese Academy of Social Sciences, 25 April 2013 (in Chinese).

Figure 1: Chinese bank wealth management products outstanding



Note: Original data from Shanghai Wind Information Co., Ltd. and the CBRC
Source: Nomura Institute of Capital Markets Research, based on Institute of World Economics and Politics, Chinese Academy of Social Sciences

Since then, the CBRC has put the value of bank wealth management products outstanding at RMB8.2 trillion as of end-March 2013 and at RMB9.08 trillion as of end-June 2013.

2. Overview of bank wealth management products in China

In China, bank wealth management products are regulated as retail financial products (see Chapter II below). Also, they are treated differently from bank deposits, being subdivided into products with and products without capital protection.

Second, they are allowed to invest in (1) fixed-interest products, (2) bank loans, (3) trust loans, (4) portfolios of assets traded on either public or private markets, (5) financial derivatives or structured products, and (6) collective money trust plans (corresponding to privately placed investment trusts). They are originated and marketed by banks as collective investment schemes investing in one or more of these types of product. If a bank is licensed as a qualified domestic institutional investor (QDII) and has been granted an investment quota, it may also originate and market collective investment schemes investing in foreign financial products.

Third, according to the CBRC's annual report for 2012[5], 62% (or roughly RMB4.4 trillion) of the RMB7.1 trillion of bank wealth management products outstanding as of

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[5] China Banking Regulatory Commission, *CBRC 2012 Annual Report*, 24 May 2013 (in Chinese).
http://www.cbrc.gov.cn/chinese/home/docView/18492CCBDD04435A8BFAB3FF6F2CA51C.html

the end of 2012 was held by retail investors, 32% (or roughly RMB2.3 trillion) by institutional investors, and 6% (or roughly RMB462 billion) by high-net-worth individuals. Bank wealth management products have a maturity ranging from less than a month to more than two years, and investors have no right of early redemption. According to the same report, 233 banks, including 29 foreign banks, were offering such products as of the end of 2012.

3. Advantages and disadvantages of wealth management products

One reason for the rapid rise of bank wealth management products has been efforts by the banks to circumvent limits on bank lending (namely, both a 75% loan-to-deposit ratio limit and aggregate lending limits) in order to meet the strong demand for credit from the real economy. Another reason has been the demand for high-yielding financial products from investors dissatisfied with regulated bank deposit rates that are effectively negative as a result of inflation.

However, the above PBOC *Monetary Policy Report* points out that, as well as offering these advantages, some bank wealth management products have been originated, marketed and managed off banks' balance sheets and are similar to the special-purpose vehicles (SPVs) identified as one of the causes of the subprime mortgage crisis in the US in that they pool short-term capital and invest it in a variety of credit assets with different maturities, thereby creating a liquidity pool that poses a systemic risk[6]. Hence, the current debate in China about how bank wealth management products should be regulated.

This report takes a closer look at the rules governing bank wealth management products in China, the products themselves and their risks, as well as, finally, how we can expect the rules to be tightened and reformed.

II. The rules governing bank wealth management products in China

The system of rules allowing Chinese banks to offer wealth management products (initially to retail customers) was put in place in 2005 and relaxed in 2006 to include foreign investments. Since the global financial crisis of 2008, however, there have been moves to tighten the rules to reduce the risks the products may pose to China's financial system. We now take a closer look at these rules and how they have changed.

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[6] The SPVs that proved a problem in the recent global financial crisis were called either structured investment vehicles (SIVs) or conduits. On the asset side these owned asset-backed securities (ABS) and collateralized debt obligations (CDOs), while on the liability side the SIVs issued medium-term notes (MTNs), subordinated debt, and asset-backed commercial paper (ABCP), and the conduits issued ABCP in order to raise funds.

1. 2005 rules governing wealth management products for retail investors

According to the CBRC's Wang Yanxiu (see above), the blueprint for the wealth management products later offered by China's commercial banks was developed by foreign banks, starting in 2002. On 24 September 2005 the CBRC promulgated *Provisional Rules on the Wealth Management Business of Commercial Banks* (with effect from 1 November 2005), officially permitting commercial banks to offer their retail customers specialist services ranging from financial analysis and planning to investment advice and asset management. The rules consist of a total of six chapters with 69 articles covering the following key areas.

1) Definition of "wealth management products for retail customers"

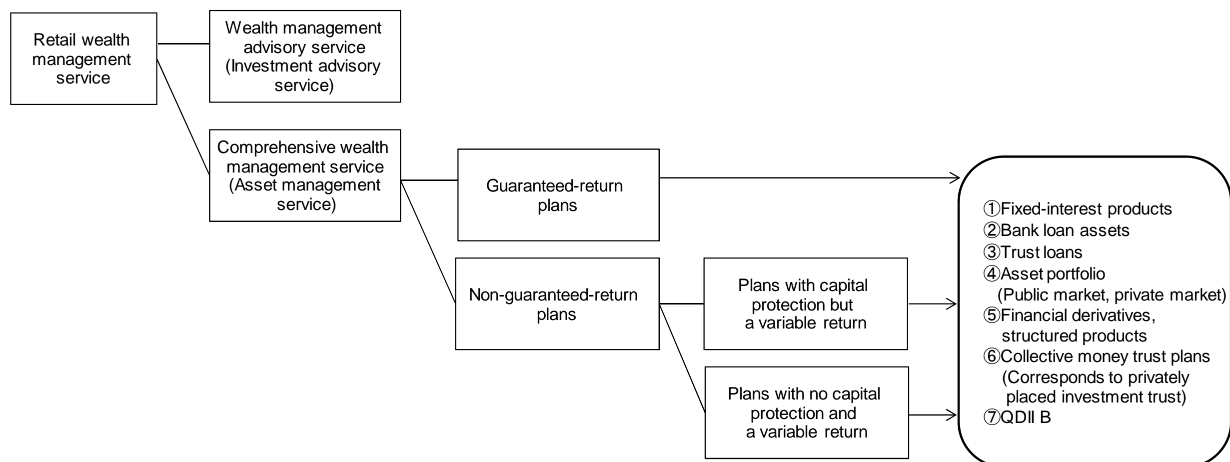
(1) Differences in services offered

Retail customers could be offered two types of wealth management service: either (1) a wealth management advisory service or (2) a comprehensive wealth management service (Figure 2).

Of these, the wealth management advisory service was to consist of financial analysis and planning, investment suggestions, and an introduction to recommended investment products.

The comprehensive wealth management service, on the other hand, was to be a discretionary investment and asset management service presupposing the wealth management advisory service and based on an investment plan and method agreed with the customer in advance at his request and with his permission. Commercial banks offering a comprehensive wealth management service were also permitted to market wealth management plans developed and designed for particular groups of customers.

Figure 2: Legal classification of bank wealth management products



Source: Nomura Institute of Capital Markets Research, based on CBRC data

(2) Differences in products offered

Customers were offered two types of wealth management plan according to how the return on their plan was earned: guaranteed-return plans and non-guaranteed-return plans.

Two types of guaranteed-return plan were envisaged: (1) one where the bank bore the investment risk and paid a fixed return to the customer in accordance with the plan agreement and (2) one where the bank bore the risk and paid a minimum return to the customer in accordance with the plan agreement but where any additional return was divided between the bank and the customer in accordance with the agreement. According to the rules and the *Guidelines on Risk Management in the Wealth Management Business of Commercial Banks*, promulgated on the same day, renminbi guaranteed-return plans would require a minimum investment of RMB50,000 while foreign-currency guaranteed-return plans would require a minimum investment of $5,000.

Two types of non-guaranteed-return plan were envisaged: (1) one where the capital was guaranteed but the return variable and (2) one where the capital was not guaranteed and the return was variable. In the former case, the bank guaranteed the capital but the customer bore the risk for the rest of the investment and would receive a return in accordance with investment performance. In the latter case, the bank did not guarantee the capital and the customer would receive a return in accordance with investment performance. According to the guidelines, non-guaranteed-return plans would require a minimum investment commensurate with the risk awareness and loss-bearing capacity of the target customer group.

2) Rules governing the banks

(1) Establishing special sections and erecting firewalls

The following rules were laid down to ensure that banks managed their retail wealth management services properly.

(i) Banks must establish special management sections and adopt rules for managing their wealth management advisory service and their comprehensive wealth management service in accordance with the differences between the two, ensuring that the responsibilities of the sections involved and their staff are clearly understood.

(ii) Banks must erect firewalls between their wealth management advisory service and their general business consulting activities, and adopt internal rules to prevent mis-selling and possible misunderstandings by customers.

(iii) Banks must establish internal controls and a system of regular inspections of their comprehensive wealth management service, and ensure that the service complies with their rules and customer agreements.

(iv) Banks must establish rules and internal checks for the different aspects of their wealth management services, including R&D of wealth management plans, pricing, risk management, marketing, fund management, bookkeeping, and distributions, and carry out rigorous internal audits and inspections.

(v) Banks must assign staff to provide wealth management services to retail customers and ensure that each employee concerned receives at least 20 hours of training a year.

(2) Rules on design of wealth management plan products

The following are the rules governing the design of wealth management plan products.

(i) The wealth management plans marketed by the banks include structured deposits. Such deposits must be segregated into a deposit component and a derivative component, with the deposit component being managed in accordance with banks' procedures for savings deposits and the derivative component being managed in accordance with their procedures for derivative trading.

(ii) Banks may not market their normal savings deposits separately as wealth management plans. Also, they may not market wealth management plans in which savings deposits have been incorporated as an integral part.

(iii) If a bank offers guaranteed-return wealth management plans with a higher guaranteed rate of return than the rate of interest on its savings deposits for the same period, it must make it clear to customers that the guaranteed return is conditional. In other words, banks may not offer their customers a higher unconditionally guaranteed rate of return than the rate of interest on their savings deposits for the same period.

(iv) Guaranteed-return plans include options for customers to vary aspects of their plans such as their duration, currency, and final payment currency. The risks arising from these options must be borne by customers.

(v) The funds that banks acquire as a result of marketing their wealth management plans must be managed and used in accordance with the terms of their customer agreements.

(3) Disclosing information to plan holders

The following are the rules governing the disclosure of information to holders of wealth management plans.

(i) As well as accounting for and counting the funds they collect from selling wealth management plans, banks must produce a statement of account for each plan.

(ii) Banks must provide their customers with statements of the assets in their plans throughout the plan period. Such statements must inform customers of any changes in their plan assets, their income and expenses, and the value of their plan assets at the end of each accounting period. Unless otherwise specified in the customer agreement, customers must receive such statements at least twice during the period of their plan or at least once a month.

(iii) Banks must prepare a quarterly financial statement for the products in which a plan is invested.

(iv) Banks must provide plan holders with a detailed report on plan investments and returns when a plan terminates or makes a distribution.

(v) Banks providing a wealth management service to retail customers may charge customers a fee but must make the basis of the fee and the method of payment clear in the customer agreement.

(4) Risk management of wealth management services

The following are the rules governing the risk management of wealth management services.

(i) Banks providing wealth management advisory services and recommending/explaining products to customers must establish their customers' risk preferences, risk awareness, and loss-bearing capacity, assess their financial situation, and offer them suitable investment products based on the customers' preferences. At the same time, they must explain to customers about the markets on which their investments are traded and make them aware of any risks.

(ii) Banks must make an independent estimate and calculation of the financial costs and returns of a wealth management plan, and use these to make a rational forecast of the rate of return of the plan's investment portfolio.

(iii) A plan's publicity and explanatory material must include a disclosure of the plan's risks. Also, a bank must provide a customer with the data used to measure and calculate the expected rate of return of a non-guaranteed-return plan and explain the method and main assumptions before the customer signs an agreement.

(iv) Banks must devise indicators for monitoring the market risk of a wealth management plan and establish systems for effectively identifying, measuring, monitoring, and controlling this risk.

(v) As part of their risk management banks must conduct adequate stress tests of the likely impact on their operations of changes in key financial policies (e.g., interest rate and exchange rate policies) and produce plans for dealing with the risks and unforeseen circumstances.

3) CBRC's regulation of the banks

Banks' wealth management services to retail customers are subject to the following regulation.

(i) Banks providing wealth management services to retail customers must obtain the approval of and report to the CBRC.

(ii) Banks proposing to offer wealth management services to retail customers that are subject to the CBRC's approval must first discuss their business plans with the CBRC or its local office and modify their business plans if necessary. Even when banks' retail wealth management services are not subject to the CBRC's approval, they must first report to the CBRC or its local office.

(iii) The CBRC or its local office may investigate and inspect a bank offering wealth management services to retail customers if this is considered necessary.

(iv) Banks must submit quarterly statistical analyses to the CBRC in the prescribed format. Also, they must submit a report to the CBRC on their retail wealth management services at the end of each accounting year.

(v) The CBRC is authorized to impose administrative penalties on banks, and hold those responsible criminally liable, for any infringements of the rules governing retail wealth management services.

2. Investment scope of wealth management products

1) Before global financial crisis of 2008

(1) Adoption of QDII (qualified domestic institutional investor) scheme

Within the above legal framework for bank wealth management services to retail customers the PBOC granted permission (in a circular promulgated on 3 April 2006) for banks to accept renminbi payments from Chinese individuals or companies and convert these to foreign currency in order to invest them in foreign fixed-interest products[7]. This marked the creation of the so-called "QDII" (qualified domestic institutional investor) scheme.

Soon afterwards, on 17 April 2006, the PBOC, CBRC and the State Administration of Foreign Exchange (SAFE) promulgated a joint circular (*Notice of Overseas Wealth Management Business of Commercial Banks on behalf of Their Clients*) permitting banks to operate discretionary accounts for investing customers' money in foreign fixed-interest products (see Figure 2).

When banks were first permitted to act as QDIIs, they were not permitted to invest in foreign stocks (or related products). However, on 10 May 2007 the CBRC promulgated a circular permitting this (*Notice of the Adjustments to the Offshore*

[7] Nomura Institute of Capital Markets Research, Chuugoku Shouken Shijou Taizen (Compendium of Chinese Securities Markets), Nihon Keizai Shimbunsha, December 2007 (in Japanese).

Investment Scope of Overseas Wealth Management Business of Commercial Banks on behalf of Their Clients). As of end-May 2013, 28 banks (with a total investment quota of $10.66 billion) are licensed under the QDII scheme.

(2) Changes to the approval system governing guaranteed-return wealth management plans

On 28 November 2007 the CBRC promulgated a circular easing the rules governing guaranteed-return wealth management plans by making them subject to a reporting requirement rather than an examination requirement (*Notice on Adjusting the Provisional Rules on Commercial Banks' Wealth Management Business*).

2) Since global financial crisis of 2008

(1) Clarifying scope of investment

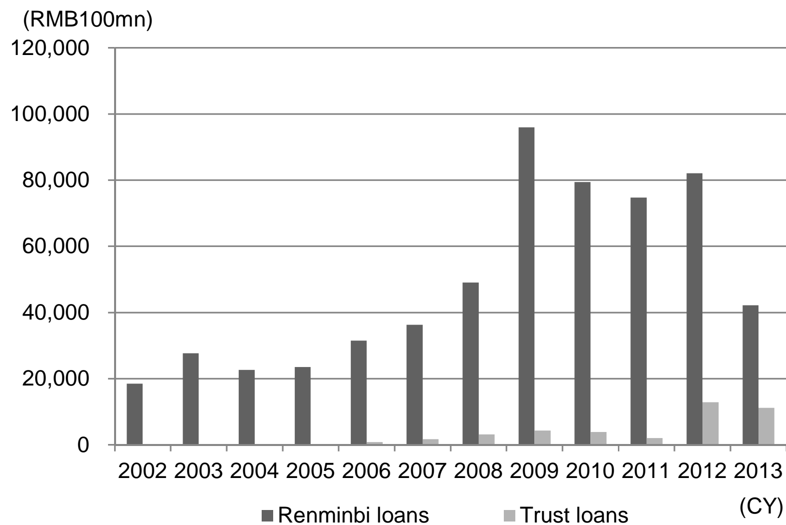
On 6 July 2009 the CBRC promulgated a circular clarifying the investment scope of retail wealth management services (*Notice on Relevant Issues Concerning Further Regulating Investment Management of Individual Wealth Management by Commercial Banks*). As well as clearly defining the range of products in which retail wealth management plans could be invested (namely in (1) fixed-interest products, (2) bank loans, (3) trust loans, (4) portfolios of assets traded on either public or private markets, (5) financial derivatives or structured products, and (6) collective money trust plans (corresponding to privately placed investment trusts) (see Figure 2), the circular defined the conditions under which investment was permitted. It goes without saying that (7) the QDII scheme (see above) is also included in the range of permitted investments.

The circular also made it clear that wealth management plans could not invest in (1) domestic Chinese stocks (or stock investment trusts) traded on public markets or (2) shares in unlisted companies and shares in listed companies not traded on public markets.

(2) Tighter regulation of investments by wealth management plans in trust loans

The Chinese government's response to the global financial crisis of 2008 was a RMB4 trillion economic stimulus package. At the same time, bank lending increased sharply: from RMB3,632.3 billion in 2007 to RMB4,904.1 billion in 2008 and RMB9,594.2 billion in 2009 (Figure 3). Although this fell back to RMB7,945.1 billion in 2010, this was in response to administrative guidance by China's financial authorities. In order to meet the demand for credit within China, there was a sharp increase in the use of other sources of capital than bank lending. One of these sources was trust loans.

Figure 3: Renminbi loans and trust loans



Note: 1. Data for period to May 2013.
2. Data for trust loans for period since 2006.
Source: Nomura Institute of Capital Markets Research, based on PBOC data

Trust loans rose sharply from RMB170.2 billion in 2007 to RMB314.4 billion in 2008 and RMB436.4 billion in 2009. In collaboration with trust companies, which are generally considered to be part of China's "shadow banking system," some banks have marketed trust loans as part of their wealth management plans. In response to this, on 12 August 2010, the CBRC promulgated a circular clarifying and tightening the rules governing wealth management products, services, investments, and risk management (*Circular on Matters Relevant to the Regulation of Cooperation between Banks and Trust Companies on Wealth Management Business*). In particular, the CBRC called on the banks (1) to put back on their balance sheets for two years (2010 and 2011) the assets they had previously removed, (2) to raise their loan-loss reserve ratios to 150%, and (3) to raise their capital adequacy ratios to the required levels.

3. Tighter regulation of wealth management products

1) Tighter regulation of marketing

Since 2011, there have been further moves to tighten the regulation of wealth management products. First, on 28 August 2011 (with effect from 1 January 2012), the CBRC promulgated a circular entitled *Measures for the Administration of the Sale of Wealth Management Products of Commercial Banks*. The circular consists of 11 chapters (Ch1: General provisions; Ch2: Basic principles; Ch3: Management of promotional and marketing documents; Ch4: Risk assessment of wealth management products; Ch5: Assessment of customer risk-bearing capacity; Ch6: Sales management of wealth management products; Ch7: Management of sales staff; Ch8: Internal sales controls; Ch9: Regulation; Ch10: Legal responsibilities; and Ch11: Supplementary provisions) with a total of 80 sections.

While the circular does not mark any change in the CBRC's desire to foster the sound and sustainable development of bank wealth management services in accordance with the basic principle of "calculable costs, controllable risks, and adequate disclosure," it does seek to correct some of the mismanagement and mis-selling that has occurred as a result of the rapid growth of some banks' wealth management services.

2) Tighter regulation of risk management

Then, on 30 September 2011 (with immediate effect), the CBRC promulgated a circular entitled *Notice on Further Strengthening Risk Management of Wealth Management Business of Commercial Banks*. The circular calls on banks to develop wealth management products "objectively," be more transparent in their product disclosure, provide separate plan calculations, and manage their affairs properly. We now explain the reasons and need for separate plan calculations.

III. Actual state of bank wealth management products

The actual state of renminbi wealth management products (one of the types of wealth management product offered by banks) is described in another report by the Chinese Academy of Social Sciences' Institute of World Economics and Politics as follows[8].

1. Distinctive features of renminbi wealth management products

Since 2010, there has been a rapid increase in bank wealth management products (see Figure 1 above). During this time the rate of return on 1-year products has been roughly 150bp higher than that on 1-year fixed-term deposits.

Another distinctive feature during this period has been an increase in the proportion of wealth management products that have been issued without capital protection. Wealth management products without capital protection accounted for more than 60% of all wealth management products issued in 2010 in terms of the issue amount. With this type of wealth management product, customers bear the investment risk while banks charge a commission, and neither assets nor liabilities are recorded on the balance sheet ("intermediary business"). As a result, any liabilities resulting from this type of wealth management product are not subject to the reserve

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[8] Xiao, Lisheng, "Analysis of Renminbi-Denominated Wealth Management Products," in "Report on Changes in China's Shadow Banking System,", Institute of World Economics and Politics, Chinese Academy of Social Sciences, 26 April 2013 (in Chinese).

ratio requirement, while any assets are not subject to either the 75% loan-to-deposit ratio limit or aggregate lending limits[9].

In contrast, wealth management products with capital protection are treated as trading products. As a result, investment products are recorded as assets, while the cash received when wealth management products are issued is recorded as a liability.

2. Maturity structure of renminbi wealth management products

One of the distinctive features of wealth management products is their short maturity. Ultra-short-term wealth management products (i.e., those with a maturity of less than a month) accounted for 13.7% of the renminbi wealth management products issued in 2008 in terms of issue amount. This proportion increased to 24% in 2009, 31% in 2010, and 36.6% in 2011 (Figure 4). The reason for the shortening of the maturity of these products is that the banks found themselves short of cash and were able to raise cash by issuing high-yielding wealth management products with short maturities despite the 75% loan-to-deposit ratio limit.

Since then, however, this trend has reversed. Until 2011 the banks would issue ultra-short-term wealth management products with maturities of less than a month and record them as deposits on their books but then re-enter them as wealth management products at the end of each month and each quarter in order to stay within their loan-to-deposit ratio limits. However, when the monetary authorities restricted or banned the issue of ultra-short-term wealth management products in 2012, the banks began to issue wealth management products with maturities of 1–3 months instead. As a result, 80% of the wealth management products issued in 2012 had a maturity of less than six

Figure 4: Maturity structure of renminbi wealth management products (issue amount)

(%)

Maturity structure	2006	2007	2008	2009	2010	2011	2012
Less than a month	2.60	1.70	13.70	24.00	31.00	36.60	4.91
1–3 months	15.70	19.80	27.40	26.80	30.00	30.20	60.18
3–6 months	35.40	23.20	26.10	22.50	18.10	18.90	21.87
6–12 months	29.80	27.50	22.00	21.00	17.80	11.90	10.01
1–2 years	14.30	18.80	5.50	3.30	2.00	1.50	0.98
More than two years	1.90	5.60	2.40	1.90	0.60	0.40	0.31
N/A	0.30	3.30	2.80	0.60	0.50	0.60	1.74
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Note: Original data from Shanghai Wind Information Co., Ltd.
Source: Nomura Institute of Capital Markets Research, based on Institute of World Economics and Politics, Chinese Academy of Social Sciences data

9 According to the CBRC's annual report for 2012, there was RMB7.1 trillion of bank wealth management products outstanding as of the end of 2012, of which 10% (approx. RMB710 billion) had a guaranteed return, 20% (approx. RMB1.4 trillion) capital protection and a variable return, and 70% (approx. RMB5 trillion) no capital protection and a variable return.

months. Noteworthy was the increase in the issue of products with a maturity of 1–3 months (60.18% of the amount issued) and the sharp decrease in the issue of products with a maturity of less than a month (4.91% of the amount issued).

3. Assets in which renminbi wealth management products are invested

1) Breakdown of assets in which renminbi wealth management products are invested

The report by the Chinese Academy of Social Sciences gives a breakdown of the assets in which renminbi wealth management products are invested by issue amount (interest rate products (bonds and money market instruments), portfolio products, loan products, forex products, equity products, and commodity products) and records changes in the breakdown (Figure 5).

In 2012, forex products, equity products, and commodity products accounted for roughly 3.5% of the total. The proportion of interest rate products declined from 95.9% in 2004 to 37% in 2009 but has since increased again. Interest rate investment products are invested in the call market, government bonds, bank debentures, corporate bonds, subordinated bank debt, T-bills, commercial paper, medium-term notes, repurchase agreements, bank deposits, and other instruments.

The product that has shown the greatest variation is loan products, which accounted for nearly 50% in 2008 but for less than 1% in 2012. This reflects a temporary increase to circumvent aggregate limits imposed on bank lending and a subsequent rapid decline in issuance as a result of tighter regulation (e.g., the requirement to put such products back on banks' balance sheets) in response to the banks' collaboration with trust companies (see above).

Figure 5: Asset structure of renminbi wealth management products (issue amount)

(%)

	2004	2005	2006	2007	2008	2009	2010	2011	2012
Interest rate products	95.93	87.80	60.78	42.74	40.40	37.02	55.27	54.32	62.81
Portfolio products	0.00	0.32	0.78	3.06	1.09	15.63	31.47	37.64	33.21
Loan products	0.00	0.32	22.82	20.21	49.94	42.83	10.81	5.69	0.52
Forex products	3.25	8.19	6.12	1.11	0.75	0.92	0.72	1.12	1.89
Equity products	0.81	1.28	7.92	30.63	5.46	2.80	1.37	0.97	1.05
Commodity products	0.00	2.09	1.57	2.25	2.36	0.80	0.35	0.27	0.52
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Note: Original data from Chinese Academy of Social Sciences, *Annual Report on China's Financial Development (2013).* (However, data for 2012 are through September.)

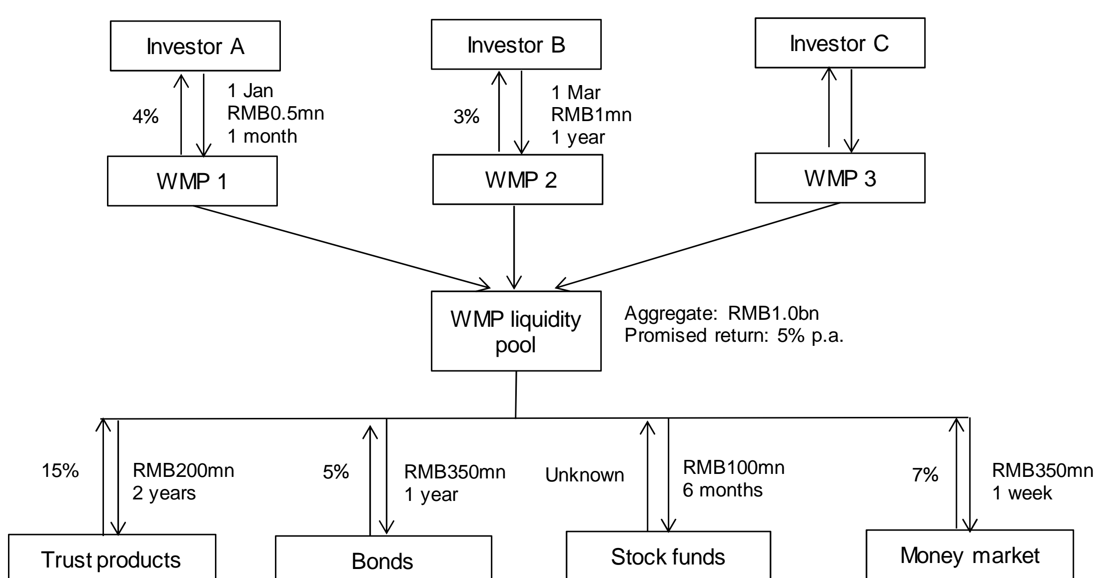
Source: Nomura Institute of Capital Markets Research, based on Institute of World Economics and Politics, Chinese Academy of Social Sciences data

2) Distinctive features of portfolio products

What has increased its share instead is portfolio products, which can invest in bonds, money market instruments, loans, bills, trusts, beneficiary rights, equities, equity investments, or funds. The demand for portfolio products has increased in inverse proportion to the tighter controls that have been imposed on wealth management products, which consist simply of loan assets.

Banks have originated portfolio products to raise cash by combining assets subject to a variety of different risks. As the cash raised by issuing wealth management products is paid into a liquidity pool (Figure 6), it has been argued that these products are similar to the CDOs mentioned in Footnote 7[10]. However, the two types of product differ in two respects. First, in the case of portfolio products, the source of the liquidity is not isolated from the underlying assets. As a result, any interruption to the cashflow from the investment assets inevitably poses a liquidity risk. Second, multiple wealth management products are not used to create overlapping layers of collateral, and the degree of leverage is relatively low.

Figure 6: Structure of liquidity pool wealth management products



Source: Nomura Institute of Capital Markets Research, based on Institute of World Economics and Politics, Chinese Academy of Social Sciences data

[10] An abbreviation of “collateralized debt obligation,” a type of asset-backed security backed by corporate bonds and loan assets.

IV. Risks posed by bank wealth management products

The PBOC (from the point of view of maintaining the stability of the financial system) and the CBRC (from the point of view of regulating financial institutions) have begun to take a common stance on liquidity pools, particularly the liquidity pools of the wealth management products originated and managed off banks' balance sheets. We now present each of these stances in turn.

1. Maintaining the stability of the financial system (PBOC)

1) Definition of "liquidity pool" wealth management products

The above PBOC *Monetary Policy Report* defines the "liquidity pool" of bank wealth management products as "a type of financial investment plan sold and managed by banks" and characterizes it as "generally maintaining the balance between the source and the use of the liquidity by continuously selling a large number of wealth management products with different maturities and investing in a wide range of assets such as bonds, bills, and trust plans." In addition, it points out that "liquidity pool' wealth management products currently account for more than 50% of all off-balance-sheet wealth management products" and have recently been the subject of considerable interest because of the following risks that they pose.

2) Risks posed by liquidity pool wealth management products

(1) Impossibility of identifying the return on individual products

By the very nature of the liquidity pool model, where the money raised by selling a large number of wealth management products is pooled before it is invested, there is no one-to-one match between the source and the use of the money. This makes it impossible to calculate the return earned on each individual wealth management product.

This distinctive feature means there may be a mismatch between the risk and the return of bank liquidity pool wealth management products. In other words, there is a risk that banks may attribute profits from one wealth management product to another.

(2) Maturity mismatch

Bank liquidity pool wealth management products maintain their liquidity pool by issuing new short-term wealth management products (many with maturities of less than six months), often to roll over maturing products. In addition, the portfolio assets, such as loans and bonds, in which this liquidity is invested often have quite long maturities. This therefore creates a maturity mismatch.

There is a liquidity risk if the timing of the issuance of a wealth management product and the timing of the maturity of an existing product do not dovetail properly or if there is a hitch in the rolling issuance of a product.

(3) Off-balance-sheet treatment of both assets and liabilities

The use of liquidity pools by banks has led to bank deposits being converted into off-balance-sheet wealth management products. In other words, liabilities are being shifted off the balance sheet. At the same time, however, the assets in which the liquidity pool is being invested (mainly wealth management products with no capital protection and a variable return) are also being recorded off the balance sheet. In other words, assets are also being shifted off the balance sheet. This poses a twofold risk.

First, there is a risk that the bank concerned may not have enough capital. If a bank that had failed to build up a sufficient capital base overinvested in high-risk assets (and effectively assumed investment risk on behalf of customers)[11], the capital needed to redeem those investments could overstretch the bank's risk management capability.

Second, there is a risk that the line between off-balance-sheet activities and on-balance-sheet activities could be blurred. As the two types of activity are currently linked, the risks posed by the wealth management product pool could spread to other activities.

(4) Lack of transparency

When banks issue liquidity pool wealth management products, they often provide only a general explanation of where the proceeds will be invested. As a result, the disclosure of information about such details as investment products, investment ratios, risks, and profit/loss during plan periods as well as investors' understanding of their investments are likely to be inadequate.

(5) Unclear rights and responsibilities

The division of the rights and responsibilities of banks and investors with regard to bank wealth management products is unclear. On the face of it, with regard to wealth management products with no capital protection and a variable return in particular, banks are only responsible for managing customer assets, for which they charge a fee. They have no joint and several responsibility for the return on those assets. In practice, however, banks have a reputation to consider and find it increasingly difficult to argue that their customers should accept all of the risk. This introduces an element of legal risk for both banks and their customers.

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[11] The parentheses are the author's.

(6) General considerations

In short, bank liquidity pool wealth management services should, strictly speaking, be an asset management service for customers, who should receive all the investment gains (less any fees) in exchange for assuming all the investment risk. In practice, however, any investment gains in excess of the return expected at the time of issue revert to the bank in accordance with the terms of the customer agreement. As this detracts from the supposed objective of wealth management services (namely, to act on behalf of customers), it automatically tends to take on the character of proprietary trading. In particular, if not even investors are going to assume risk, wealth management products could become more like bank deposits.

2. Regulating financial institutions (CBRC)

1) Advantages of bank wealth management products

In a statistical report on bank wealth management products, the CBRC's Business Innovation Regulatory and Collaboration Department's Wang Yanxiu (see above) first points out their following advantages.

(i) He sees bank wealth management products as helping to bridge the gap between direct finance and household assets, and playing a key role in raising capital for the real economy.

(ii) He sees them as an efficient means of attracting private capital and helping to develop the real economy.

(iii) He sees them as helping to optimize the composition of personal financial assets and boost household investment income as well as satisfy investment demand from the general public.

(iv) He sees them as reducing inflation and helping to stabilize the financial system by providing an investment route for private capital.

(v) He sees them as helping to change the model of domestic banking by, for example, boosting fee income and reducing the cost of capital.

(vi) He sees them as helping to improve banks' investment management capabilities and core competitiveness.

2) Disadvantages of bank wealth management products

At the same time, Wang Yanxiu points out the following disadvantages of bank wealth management products.

(1) Lack of knowledge about wealth management products

This is the lack of awareness of some bank boards of directors and senior executives of wealth management services. There is a tendency to think of these services as merely an appendage of banks' proprietary trading arms.

(2) Mis-selling

This is the disarray surrounding the marketing of bank wealth management products and the lack of disclosure. Although the promulgation of the CBRC's circular *Measures for the Administration of the Sale of Wealth Management Products of Commercial Banks* in 2011 (see above) achieved a degree of success, the failure to impose administrative penalties led to the mis-selling of some wealth management products. Some banks have failed to explain properly the risks of the investment products they have been selling, failed to provide adequate disclosure, and had nothing to say about investor education or self-responsibility.

(3) Mis-selling by agents

This is the problem of mis-selling by some banks acting as agents. Some bank branches have failed to adhere strictly to head office rules and operational procedures, and mis-sold some financial products banned by head office. As well as resulting in losses to investors, such mis-selling risks damaging banks' reputation.

(4) Circumventing rules

This is the rapid development of wealth management services and the resulting mixture of good and bad service providers in which some providers have lacked the necessary risk management capability and been imprudent in developing their businesses. First of all, some banks have continued to ignore the CBRC's regulations and to provide a disorganized liquidity pool wealth management service with no separate accounting and computation of individual wealth management products. Second, a number of banks have diverted the money they collected from wealth management products to debt investments in order to circumvent loan-to-deposit ratio limits and aggregate lending limits and, as a result, undermined monetary policy and macroeconomic controls.

V. Reform and stricter regulation of bank wealth management products

Because of their awareness of such risks, the PBOC and the CBRC have each taken the following stances on the reform and stricter regulation of bank wealth management products.

1. PBOC's stance

As well as encouraging banks to develop their wealth management services, the above PBOC *Monetary Policy Report* urges banks to adopt a more prudent and disciplined approach to them. The PBOC's stance is basically as follows.

1) Risk/reward adjustment of bank wealth management products

Regulators need to give particular consideration to whether the risk/reward division of wealth management products is sensible.

In order to achieve this, it has to be possible, first of all, to calculate the risk and reward of individual products. This must be the basis for assessing risk/reward.

Second, a balance has to be struck between risk and reward. In other words, the principle of "high risk, high return; low risk, low return" has to apply. Banks must devise a mechanism for allocating gains and losses, and develop their business prudently in accordance with their (risk) management ability.

2) Better risk management of off-balance-sheet wealth management products

Banks need to improve their management of the risks posed by off-balance-sheet wealth management products.

In order to achieve this, they need, first of all, to have a clear grasp of their risk exposure and ensure that they have enough capital to protect themselves against the risks they face at any given time in line with the credibility, nature, and risks of their business.

Second, they need to erect proper firewalls between their on-/off-balance sheet activities and areas of cooperation with other companies, including securities companies, fund management companies, insurance companies, and trust companies; and the risks posed by off-balance-sheet operations must be prevented from spreading to other markets and intermingling.

3) Need for disclosure system

Banks need to disclose information accurately and in a timely manner about all aspects of the issuance, rolling over, and maturation of wealth management products (e.g., their investments, risk assessment, and returns to customers) in order to make them more transparent.

4) Need for related regulations and clarification of rights and responsibilities

The legal status of wealth management products needs to be clarified, as do the rights and responsibilities of banks and investors as well as those of banks and

investment assets. In addition, the terms of customer agreements must be strictly observed.

Also, banks should always make the interests of the investors in their wealth management products a priority and invest their money carefully as banks have the advantage in terms of specialist knowledge, information, decision making, and negotiating power.

2. CBRC's stance

Wang Yanxiu, director of the CBRC's Business Innovation Regulatory and Collaboration Department, has referred to the following three policies on wealth management products, some of which overlap with the PBOC's stance: (1) banks' boards of directors and senior executives need to clarify the strategic status of their wealth management products and establish a risk management system; (2) marketing of these products needs to be appropriate to the customer and disclosure adequate; and (3) banks should always consider prudence and compliance when developing their wealth management services.

Consequently, on 25 March 2013 the CBRC promulgated its *Circular on the Regulation of the Investment and Operation under Wealth Management Business by Commercial Banks* in an effort to tighten the regulation of wealth management products, especially non-standard debt-based assets, which are not traded on public markets. The following are the main points.

1) Overview of circular

(1) Definition of non-standard debt-based assets

"Non-standard debt-based assets" are debt-based assets that are not traded on the interbank market or on securities exchanges. They include, but are not limited to, credit assets, trust loans, entrusted creditors' rights, bank acceptance bills, letters of credit, accounts receivable, and various types of beneficiary rights.

(2) Improved accounting and managing of separate accounts

Banks must enable matching of individual wealth management products and individual assets. In addition, they must manage, establish accounts, and keep accounts for each product individually.

(i) "Separate management" here means managing the investments of each wealth management product separately.

(ii) "Establishing separate accounts" means producing investment statements for each wealth management product and listing each asset one by one in order.

(iii) “Keeping separate accounts” means keeping separate accounts and drawing up balance sheets, income statements and cashflow statements for each wealth management product.

With regard to non-standard debt-based assets, which cannot be accounted for and managed in this way, banks are required to carry out a risk-weighted assessment and increase their capital in line with the *Regulation of Capital Governing Commercial Banks (Provisional)*, China’s version of Basel III, and in the same way they are required to do when lending on their own account.

(3) Stricter information disclosure

Banks must disclose details of the non-standard debt-based assets in which their wealth management products are invested. These details include the name of the underlying fundraising party, the name of the project, the remaining period to redemption, the proposed distribution at redemption, and the transaction structure. Banks must also inform investors of any changes to the non-standard debt-based assets in which their wealth management products are invested, or any substantial changes in the risk status of these assets, within five days of the change so long as these wealth management products are outstanding.

(4) Banks’ internal control requirements

Banks must adopt similar internal control processes for non-standard debt-based assets to those they use for lending on their own account, including processes for conducting due diligence and assessing pre-investment risk as well as managing post-investment risk.

(5) Aggregate limits

The amount of wealth management funds invested by a bank in non-standard debt assets must not exceed 35% of the bank’s average wealth management products outstanding. Similarly, it must not exceed 4% of the bank’s total assets as disclosed in its latest audit report.

(6) Stricter supervision of third parties

Banks must strengthen their supervision of third parties with which they cooperate on wealth management products. In particular, they must address matters such as the standards and procedures for selecting such entities as well as information disclosure obligations and exit mechanisms in respect of these entities. In addition, they must provide to the CBRC a list of such entities at least 10 days in advance of the launch of any wealth management product.

2) Impact of circular

As a result of the circular and its provision for tighter ex ante and ex post facto rules on investing in illiquid debt-based assets of doubtful creditworthiness not traded on public markets (e.g., local government financing vehicles (LGFVs)), uncontrolled investment is likely to decline.

If we calculate the various aggregate limits on bank lending, we see that there is now also an upper limit on the amount of wealth management products a bank may have on its books (11.43% of total assets) as well as on the amount of non-standard debt-based assets it may hold. As, according to CBRC statistics, banks held RMB7.1 trillion in wealth management assets and ¥133.6 trillion in total assets as of the end of 2012, their ratio of wealth management products outstanding to total assets is 5.3%. According to a 3 May 2013 report on www.stcn.com, however, the same ratio averaged 5.02% for China’s five major commercial banks but 11.1% for its small and medium-sized banks, an indication that the latter are likely to have to scale down their wealth management services.

Finally, the rules on the supervision of third parties are likely to lead to tighter control by the CBRC of backdoor lending and investment such as the collaboration between banks and trust companies aimed at circumventing the rules.

VI. Conclusion

As we have seen, Chinese banks’ wealth management services are now subject to much stricter regulation as a result of the promulgation of the above circular. Provided these rules are properly implemented, the prospect that banks’ wealth management-related off-balance-sheet operations will be placed on a sounder footing and the risk of a liquidity crunch averted should improve. According to the *China Securities Journal* of 2 May 2013, the CBRC has embarked on a revision of its *Provisional Rules on the Wealth Management Business of Commercial Banks*, promulgated on 24 September 2005, and intends to strengthen its regulation of banks’ wealth management services. In the short term it intends to strengthen its inspections of illegal liquidity pool operations in line with the *Opinion on the Regulation of the Wealth Management Services of Commercial Banks (2013).*

At the same time, we have to remember that two of the reasons for the rapid growth of bank wealth management services in the past few years have been (1) a demand from the real economy for financial channels other than those, such as bank lending and direct finance, regulated by the financial authorities and (2) a demand from investors for financial products offering what are, in effect, deregulated interest rates and, therefore, a more effective hedge against inflation than regulated interest rates. The challenges facing bank wealth management products will therefore need to be solved constructively as part of the process of bond and stock market reform, including the creation of a wide range of stock markets and the deregulation of interest rates as advocated by the government.

The trend towards reform and stricter regulation of wealth management products is likely to prompt China's financial authorities and market participants to take a fresh look at the experience of Japan and other foreign countries of deregulating interest rates and fostering the development of direct financial products such as corporate bonds. Similarly, foreign financial institutions may have opportunities to cooperate with Chinese banks, which have an unrivalled sales network in the domestic market, in developing and marketing the kind of financial products sought by Chinese investors. China's financial authorities may also take a fresh look at foreign approaches to investor protection.

It will be interesting to see how regulation of Chinese wealth management products develops.