In Case You Missed It: CSOP's Weekly China Wrap Up

Regulator forces Sealand Securities to honor contract losses

Sealand Securities, the epicenter of China's recent bond market maelstrom, announced that the firm would honor its fraudulent, controversial contracts and bear the resultant investment loss of RMB 16.5 billion.[1]

To contextualize the events, two key managers in Sealand Securities' fixed income department went missing in mid-December, leaving behind significant portfolio losses. After reviewing the deal contracts signed by the missing persons, Sealand Securities found that the stamp used to validate the contracts was forged. Arguing that the counterfeit stamp should void the contracts, the brokerage house refused to accept the portfolio losses. The refusal shattered the market's trust in OTC bond trading; liquidity dried up as banks refused to lend to other non-bank financial institutions. Rates hiked dramatically until the PBOC flooded the system with USD 28 billion in new liquidity.[2, 3]

Despite the liquidity infusion, the damage had been done. Although the firm was eventually forced to honor the contract losses, bond investors started to question the creditworthiness of some market players. The outlook is likely negative for aggressive and smaller bond investors and a major reshuffle in the bond market's regulatory ecosystem may soon ensue.

Premier Li vetoes proposal to reduce annual USD 50,000 exchange quota

An influential Hong Kong magazine reported that Premier Li vetoed a proposal to reduce the annual quota that allows Chinese individuals to exchange USD 50,000-worth of RMB into USD each fiscal year. In light of China's recent currency outflows, advocates for quota reduction are fearful that the onset of the new year will result in untenable currency outflows, exacerbating China's already-depleted foreign reserves. Such advocates posit that if 10 million Chinese residents exchange the maximum allowable RMB sum of USD 50,000 per person, China's USD 3 trillion foreign reserves will fall by an additional .5 trillion dollars

Despite recent RMB outflows, Premier Li reportedly vetoed the proposal and asserted that Chinese residents would lose confidence in the government if the annual quota were reduced. Li urged that the central government should work out alternative solutions to boost market confidence and stem continued depletion of FX reserves.

PBOC announces inclusion of off-balance sheet WMPs in Macro Prudential Assessment

China's central bank officially announced inclusion of off-balance sheet wealth management products (WMPs) in Macro Prudential Assessments beginning in 1Q2017. The PBOC cited two reasons for the policy change:

1. Off-balance sheet WMPs represent an extension of credit and are akin on banks' on balance sheet loans;
2. Banks still implicitly guarantee the off-balance sheet WMPs and thus bear the relevant financial risk.

Because of these factors, regulators believe that off-b/s WMPs should be treated similar to loans in Macro Prudential Assessments.

The potential impact on large banks is less material than the impact on smaller banks. ICBC and PingAn Bank afford an example.[4] One of China's "Big Four" banks, ICBC's YoY growth of credit expansion for on-balance sheet items is 4.13%.[5] For on- and off-balance sheet items combined, the figure is 6.39%.

Conversely, the smaller PingAn's YoY growth of credit expansion for on-balance sheet items is 7.39%; the figure is 26.81% for both on- and off-balance sheet items. Therefore, smaller and more aggressive banks like PingAn may face tighter regulation and more conservative lending growth in 2017.

The impact of this policy change is expected to extend to China's already-shaky bond market. Because most of the off-balance sheet WMPs invest in bond markets, the tighter regulations may drain liquidity from the system. When announced, the policy spread fear among bond investors, resulting in a heavy sell-off in both fixed income and futures markets. Compounding matters, 25 exchange-listed money market funds (MMF) saw RMB 16.5 billion net redemption as banks began pulling liquidity from the market.

Xi announces openness to sub 6.5% growth target for 2017

President Xi indicated openness to a sub-6.5% economic growth rate for 2017, reported participants at a recent meeting of the CCP's Leading Group for Financial and Economic Affairs. Although the 6.5% rate target is a recent creation-- pledged only in 2015-- Xi reportedly signaled willingness and flexibility to revise growth figures downward if the 6.5% figure creates untenable risk.

Although the change of course comes as a surprise to some onlookers, others are heartened by the modification. Analysts purport that the revised target could signal a newfound pragmatism in China's leadership, with Xi taking a realistic posture about issues such as unsustainable debt levels, asset bubbles, and SOE overcapacity.

China levies significant new pollution tax

China passed legislation to reduce air, water, and soil pollution by taxing polluters, a move expected to increase costs for the mainland's worst emitters beginning January 2018. The legislation imposes taxes on power plants, factories, and other industrial processes, though it does not tax cars.

The legislation is significant. It indicates a reversal of existing practices allowing local governments to fine polluters at their discretion. Whereas historical practices rarely imposed burdensome consequences on companies, the new policy holds polluters accountable through criminal punishment.

Notes:

1. RMB: Renminbi, the national currency of China
2. OTC: Over-the-counter
3. PBOC: People's Bank of China
4. ICBC: Industrial and Commercial Bank of China
5. YoY: Year over year