

# **The Development of China's ABS Market**

**Hui Ou-Yang**

# History of China's ABS Market

- China first considered ABS in the late 1990s, but it was then only under discussion and research. There was no real deal done before 2005. The market started to develop in 2005.
- From 2005 to 2008, several ABS transactions were carried out, most of which were public placements i.e. the bonds issued could be sold in the Interbank Bond Market.
- Stage 1: 2005-2006
  - In March 2005, Chinese government approved to start pilot deals of ABS for CCB and CDB, and the approved maximum bond issuance amount was RMB15 bln.
- Stage 2: 2007-2008
  - In April 2007, Chinese government decided to increase the number of participating institutions, and the selected institutions included Pudong Development Bank, China Zheshang Bank, Industrial Bank, ICBC, GMAC-SAIC.
- Stage 3: 2009-2011
  - The ABS market saw very low activities as the regulators, getting cautious about the over-development of ABS and related derivatives in western countries, told the banks to put such transactions on hold.

# Signs that the ABS Market Is Opening Up Again

- There are signs that the restrictions on ABS transactions would be lifted soon due to the following challenges encountered by Chinese banks:
  - Higher requirement of Capital to Risk Weighted Assets Ratio has imposed by CBRC to Chinese banks
  - The bearish stock market discourages the banks' funding plan through equity offerings
- The signs that the market is opening up:
  - In August 2011, PBOC official confirmed that Chinese government has approved to restart the ABS pilot project (public transaction) and will plan to add more banks as participants.
  - On February 7, 2012, PBOC put "to further develop ABS market and other financial innovation" into its missions with particular focus on ABS transactions.
  - CSRC allows ABS to be traded in security exchanges. Also, bilateral quotation is permitted for securities companies, which means that they could be market makers.
  - PBOC, CBRC, and MOF announced an initial ABS program valued at 50bln Yuan for banks.

# Development Prospects for ABS in China

- Estimated by Fitch, at the end of 2012, the debt of local governments reached 12.85 tln RMB, with was 25.1% of GDP, exceeding the 23.4% at the end of 2011. The debt of Chinese governments as a whole were about 50% of the GDP.
- As 80% of the local government debts are bank loans, there will be tremendous demand by Chinese banks for ABS.

# Estimated Market Size (as of Q4, 2012)

- As shown in the below chart, the performing loan amount and NPL amount of medium and small sized banks (i.e. Joint-stock commercial banks, urban commercial banks and rural commercial banks) are huge. Total outstanding principal amount is about 144 times of total asset pool size of the historical ABS issuance amount (public transactions).

|                                      | [RMB bln]                   |                                    |                              |                              |                                  |
|--------------------------------------|-----------------------------|------------------------------------|------------------------------|------------------------------|----------------------------------|
|                                      | Big<br>Commercial<br>Banks* | Joint-stock<br>Commercial<br>Banks | Urban<br>Commercial<br>Banks | Rural<br>Commercial<br>Banks | Subtotal<br>[excl. Big<br>Banks] |
| Outstanding Loan<br>Principal Amount | 31,262.63                   | 11,069.44                          | 5,172.84                     | 3,204.55                     | <b>19,446.83</b>                 |
| NPL Amount*                          | 309.50                      | 79.70                              | 41.90                        | 56.40                        | <b>178.00</b>                    |

\* Big Commercial Banks include Bank of China, Agricultural Bank of China, Industrial and Commercial Bank of China, China Construction Bank, Bank of Communications.

# Demand and Supply

- Supply side, banks would have motivations to securitize their loan assets to improve the liquidity of the balance sheets:
  - For the performing loans, through ABS transactions, banks can immediately get cash back and speed up the turnover of its proceeds, improving the liquidity of their balance sheet.
  - For the non-performing loans, by holding the junior tranche, banks can spread the loss over the holding years if the provisioning is not big enough to cover the loss.
  - According to the annual report 2011, maturity mismatch problem is prominent for commercial banks: short-maturity savings and long-maturity loans. Short deposits constitute around 50% of the total liability of banks.
  - Commercial banks issue ultra-short-term wealth management products to compete for deposits to meet the requirement of loan-to-deposit ratio, in response to the liquidity constraints imposed by regulators.
- Investor side, big SOEs and AMCs have plenty of cash while there are few investment products for them, the ABS fixed income products esp. the performing loan ABS senior tranche bonds would be attractive for them.

# Demand for ABS

- The demand for ABS products might still be insufficient, however.
- As of the end of 2012, commercial banks had total assets of 131.27 trillion yuan; trust industry had total assets of 7.47 tln yuan; insurance industry total assets of 7.35 tln yuan; consigned assets to brokers was only 1.89 tln. The proportion of assets of non-banking financial institutions was only 15% compared to banking financial institutions.
- For the future development of ABS, the regulatory authorities have chosen three key areas: the credit assets, corporate assets, and real estate. About 65 tln yuan of credit assets can be securitized; 50 tln of corporate assets can be securitized; the potential development of the securitization of real estate is also promising: only the Linghui Real Estate investment trust fund and Yuexiu Real Estate Investment trust fund are involved in the business of real estate securitization.
- With such big amount of assets waiting to be securitize, where are the buyers?
- Bank? Banks wish to move their own assets off the balance sheet.
- Non-banking financial institutions? Not big enough.
- Individual investors? The lessons taught by Lehman mini-bonds

# Conclusion: Prospect

- According to the experience of the United States, to create an MBS product with high liquidity, there has to be one or more GSEs to guarantee the mortgage loans, which are independent from the originating commercial banks.
- The structure of the products ought to be simple, and the products need to be international to increase the demand and to diversify the risk.
- Difficulties: no such GSEs; no free convertibility of RMB; the extent to which foreign investors accept the laws of China; information asymmetry, and the current status of the housing market.
- Potential Solutions: internal and external credit enhancement, issuers hold the equity tranche, select relatively high quality loans, and bank guarantees.
- Policy support: encourage QFII RQFII to invest in ABS products.