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Shining a light on shadow banking: China's P2P lending boom, big data and internet finance

Equities

China
Financial

Jason Bedford
Analyst
jason.bedford@ubs.com
+852-2971 8235

Stephen Andrews, CFA
Analyst
stephen.andrews@ubs.com
+852-2971 7821

China's P2P companies are not Lending Club

The loans issued under Lending Club are almost entirely consumer-centric and are aimed at creating interest rate competitive alternatives for consumers. In contrast, the driving force behind peer-to-peer (P2P) lending in China is a combination of financial repression—or more accurately the hunt for yield—and, to a lesser extent, the lack of sufficient access to bank financing by millions of the country's privately owned, small businesses and entrepreneurs.

The P2P craze in China is likely to be temporary…

There are now an estimated 1,728 P2P platforms operating in China. The total loan issuance has grown an eye-watering 466% from Q413 to Q115 to Rmb152bn. While this total loan amount only equates to the balance sheet of a mid-sized city commercial bank, the rapid rate of growth combined with around 40 listed companies setting up internet finance platforms is a cause for concern, in our view. An estimated 162 P2Ps have collapsed or closed down in the first five months of 2015 and more can be expected. We believe impending regulation will greatly raise the barriers to entry.

…but there will likely be entrenched players and opportunities…

The rapid shift of consumer activity from offline to online environments and cash to card is significantly expanding the opportunities for big data analytics to shake up lending processes. Firms like Alibaba and Tencent are going to be at the forefront of this changing environment. Other names like Creditease and Lufax have set up highly sophisticated businesses, which are likely to benefit from the onset of regulation.

…and the banks will be at the table as well

12 banks have already set up P2P subsidiaries or partnerships with P2Ps and they are at the forefront of a rapid expansion of China's consumer finance companies. Internet finance is going to create new competitors for banks but we think the bigger impact will be the shifting goalposts between winners and losers within the banking sector itself.

Lending Club's successful listing in 2014 on the NYSE and the rapid growth of other peer-to-peer (P2P) and crowd-funding platforms since has captured the world's attention and recreated a level of interest in internet finance that has not been seen since the late-1990s and early-2000s. The buzz this has generated has taken particular hold in China, which is now home to some of the world's largest P2P firms. Part of the reason for this is that the opportunity for financial disintermediation and disruption is perceived to be far greater in China, given the banks' dominance over the capital markets.

There is also a sentiment in the market that China's slow moving, behemoth banks will struggle to compete with more nimble competitors like P2P platforms and internet finance companies like Alibaba's Ant Financial Services or WeBank, which opened in Shenzhen in January 2015. There also appears to be strong political support for these internet finance companies; notably Li Keqiang, the Premier of China, performed the formal ribbon cutting on a small loan to a long-haul truck driver at WeBank's opening event.[1]

However, while the opportunity for internet finance is certainly creating attractive opportunities, the reality is a bit more nuanced. The purpose of this report is to better understand how this is occurring and the ways in which P2P lending is reshaping the lending landscape—and not reshaping the lending landscape—in China. It also looks at internet finance's potential to disintermediate activities that sit firmly within the remit of the banks in China.

Could Lending Club be replicated in China?

The US example shows that P2P companies pose competitive threats to the banks, and have capabilities to disintermediate a range of consumer activities out of the banks. The market leader, Lending Club, demonstrates this most clearly. Not only is it seizing consumer lending opportunities away from the banks, but, more importantly, it is stripping out a great deal of revenue from credit card interest payments by refinancing these debt commitments at lower rates. We believe the lack of a real response from US banks to date also indicates they may be defenceless to reverse this trend.

However, Lending Club is in a sense simply a reflection of the deeply mature consumer society in the US. 77% of total loan issuance under the Lending Club platform is to repay outstanding credit card debt or refinance other loans, with another 21.5% directed towards financing consumer spending (see Figure 1). This may also explain Lending Club's relatively large size vis-à-vis the world's first P2P company, UK-based Zopa, which just celebrated its 10-year anniversary in March 2015 but with only roughly 15% of the outstanding loan amount.[2] In short, the driver and hence strategic positioning of Lending Club is the vast amount of consumer debt in the US and its ability to refinance this debt at more cost-effective rates. However, importantly only 1.57% of Lending Club's total lending was for business loans, as at the end of 2014.

How does that compare with China?

Not well, in our view. Lending Club is not being replicated in China and nor could it be in its current form. What is happening in P2P in China and the US are two completely different phenomena with very different business and risk drivers.

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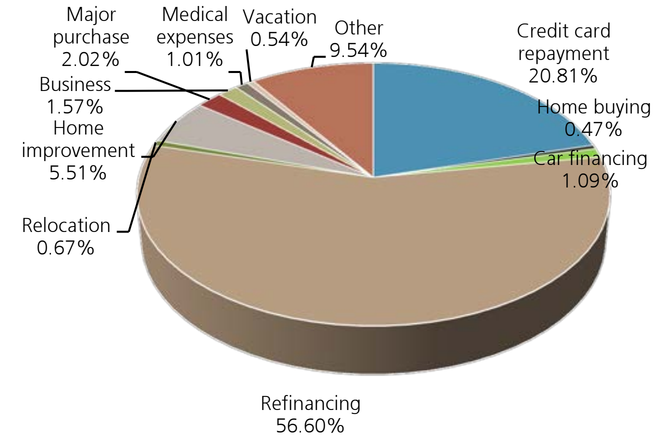
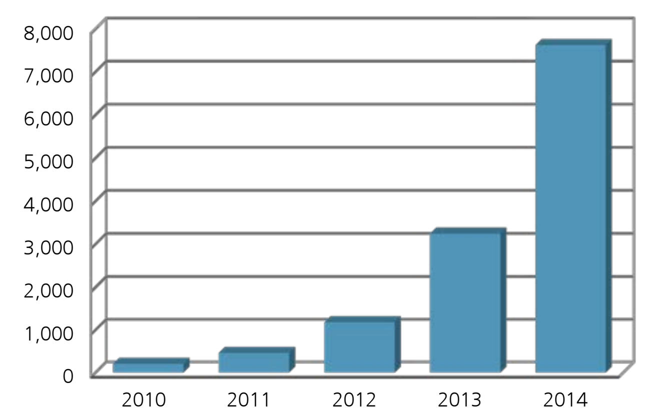
[1] WeBank Launched During a Period of Change for China's Banks, Yibada, 23 January 2015
[2] www.zopa.com

Figure 1: Lending Club loans are primarily directed to existing debt refinancing (2014 year-end)



Source: Lending Club website and UBS

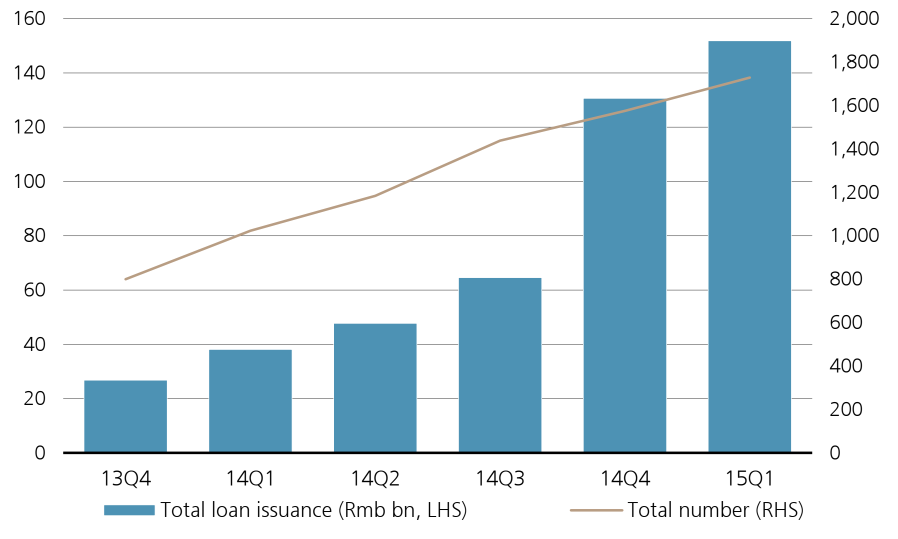
Figure 2: Lending Club total loan issuance (US$ m)



Source: Lending Club website and UBS

The contrast with the Chinese market could not be more different. The driving force behind P2P in China is a combination of financial repression—or more succinctly the hunt for yield—and, to a lesser extent, the lack of access to bank financing by millions of the country's privately owned businesses and entrepreneurs. Most P2Ps though are not competing with the banks but rather with underground and informal lenders; interest rates in excess of 40% are not unusual. However, the core distinguishing feature is that the borrowers are almost entirely business in nature—which significantly alters the risk metrics behind a loan decision.

Figure 3: P2P companies in China have grown significantly over a very short period of time (Rmb bn)



Source: Online Lending House and UBS

However, risk considerations are not a brake on growth

As at Q115, there were 1,728 P2P platforms in China, according to Online Lending House, which describes itself as China's authoritative P2P industry portal, with an outstanding loan issuance of Rmb152bn. However, other estimates of the size of this market vary significantly, with some market watchers putting the number of P2P platforms at over 10,000. However, regardless of how many there are or what

the actual size of this lending might be, from a bigger picture perspective, it is a drop in the bucket when put in the context of total banking sector assets in China of Rmb172trn.

Perhaps the more pertinent question is not how many P2Ps there are in China but what can actually be defined as a P2P. Part of the problem in estimating the size of this space is that there is no defined P2P operating entity. Indeed, even among the key P2P players in the sector, such as Ping An's Lufax and Alibaba's Zhaocaibao, there is nothing in their licensing and registration information that clearly indicates they are acting in a loan agency, internet finance or lending capacity (see Figure 4)—although inexplicably food distribution and electronic components manufacturing are listed within their business scopes.

P2P versus internet finance versus crowd-sourcing

The term P2P is something of a misnomer in China, in our view. Much of the funds that are being raised for lending purposes via these platforms are more often than not being aggregated and lent in large sums to significantly-sized corporates; not in keeping with the term peer to peer. To illustrate, companies like Hanergy Group, with a market cap of more than Rmb100bn, are advertising on itouzi and offering investors annualised yields of 11% (which, after factoring in itouzi's fee and commission income, would likely mean all-in borrowing costs are in excess of 14%).

Figure 4: The licensing of many of these entities does not denote P2P lending

Name	Business scope under licence registration	Registered capital (Rmb m)
Lufax	Research and development of financial products, design, consulting services, non-public offering of equity funds and other types of transactions related support services, financial and economic consulting services, market research and data analysis services, financial application software development, e-commerce, department stores, cultural office supplies, handicrafts, electronic products, communications equipment sales, ticketing services, business services, business consulting, financial advisory (not bookkeeping), pre-packaged food (excluding refrigerated) sales.	836
Sinolending	Software development, product sales, technology transfer, consulting services, enterprise sales planning (excluding advertising), business information consulting.	43
Zhaocaibao (under Alibaba)	Financial information services, research and development of financial products, design, consulting services, financial and economic consulting services, market research and data analysis services, financial application software development, e-commerce (not engaged in value-added telecom services).	10
Jimubox	Information services (only internet information services). Technical extension services; ticketing agents (not including airline ticket sales agents); computer services; data processing; infrastructure software services; software services; economic and trade consulting.	200
itouzi	Technology development, technical consulting; economic information consultation; conference services; data processing; market research; computer system service.	15

Source: Shanghai, Beijing and Shenzhen Administrations of Industry & Commerce

Such aggregated financing would be more accurately described as crowd-funding. And, indeed, there are many reported instances of sizable loans being issued to real estate developers and large, privately owned, enterprises at high interest rates via these platforms. As can be seen in Figure 5, some P2Ps are issuing loans in excess of Rmb900m. This contrasts significantly with Lending Club where the average loan, as at Q115, was US$14,448.

The lack of barriers to entry and regulation is drawing a lot of players

Some developers are even setting up their own internet finance platforms while openly stating their intention to use them to raise funds for their own projects. The most visible of these companies has been Greenland. According to the latest annual report of Greenland (Hong Kong) Holdings Limited:

> '*Greenland Hong Kong will also establish the marketplace lending platform, which is aimed of being one of the largest internet platforms in the world targeting investment and financing opportunities throughout the whole property industry chain. Different from the existing internet finance companies, the internet finance platform of Greenland Hong Kong will cover the entire process ranging from project selection and project financing to project management by fully leveraging Greenland Hong Kong's broad experience in the property industry, its professional talent team and its relationship with Greenland Holding Group. This brand new internet finance business model, featured by a finance intermediary and service platform provided by an industry leader, will fundamentally minimize the credit risk of internet finance investment targets, reduce the information asymmetry between lenders and borrowers, and lower financing costs by fully utilizing the functions of the internet. This platform will reshape China's property market through realizing the total management of financing projects and re-consolidating the real estate resources system.*'

However, developers are not the only entities getting into this space. The consequent stock price improvement following association with internet finance has created its own unique incentive and consequently a wide array of different companies have entered into this space despite a lack of experience in lending or internet. For example:

- **Panda Fireworks Group Co.**, China's largest fireworks manufacturer, renamed (and seemingly reinvented) itself as Panda Financial Holding Corp (SSE: 600599) after taking control of Yinhu.com in 2014 and Shanghai Jiayin Financial Information Services Co. in 2015—a change in business which has seen its stock price more than quadruple.[3]

- Listed real estate developer, **Shanghai Duolun Industry Co., Ltd.** (SSE: 600696), announced a change in name to P2P Financial Information Service (匹凸匹金融信息服务（深圳）有限公司) to accompany its foray into internet finance with the set-up of the aforementioned-named P2P company. A trading halt on the stock was announced by the exchange after it traded up the maximum 10% two days in a row.[4]

- Listed industrial conglomerate, **Kairuide Holding Co. Ltd** (SZE: 002072), acquired eloancn.com as part of its business reorganization.[5]

According to media reports, as of the beginning of this year there were over 40 listed companies with P2P platforms.

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[3] Top fireworks maker to shift focus on P2P lending, Shanghai Daily, 14 April 2015
[4]上市公司更名"匹凸匹" 谐音"P2P"遭网友吐槽, China Daily, 12 May 2015
[5] P2P 平台将迎投资收购潮 更多实体企业参与掘金, Dongguan Daily, 19 January 2015

Can a credit risk assessment for a business loan be done virtually?

Online credit risk assessments are being performed in many countries worldwide and the US in particular is proving that it can be effectively done. However, this has been largely focused on consumer loans in systems with highly developed, mature consumer credit scoring systems.

In China, this is very difficult. Even Home Credit China—which is arguably the market leader in consumer finance in China with total loans issued annually in the hundreds of thousands to finance consumer purchases of iPhones, washing machines, etc.—has struggled to shift away from the requirement for face-to-face credit checks. While many of China's consumer finance companies are now very adept in consumer loan issuance, with many borrowers being accepted or rejected within 30 minutes or even less, the difficulties surrounding online loan assessments are still seen as too high a risk for most. Moreover, this is to make decisions on consumer loans; the risk decision behind a business loan is far more complex and requires much more information than that for a consumer loan.

This dynamic explains why Creditease has in excess of 40,000 employees and branches in over 100 cities as at the end of 2014, versus 600 at Lending Club and no branch network. The risk metrics behind a Rmb100,000 business loan decision are not overly different from those for a Rmb10m loan—they require the collation of certain documentation, credit checks, site visits, follow ups, loan tracking, etc., which, consequently, necessitates a need for far more on-the-ground staff.

Creditease in a sense is thus not really a true P2P platform as it is deeply dependent on offline components to not only source borrowers but also perform and carry out credit risk assessments. In essence it operates as an offline credit assessment company combined with an online fund raising platform.

This is true for many of China's P2P enterprises although it is equally true that many of them are indeed conducting credit checks purely online with limited offline inputs.

The beauty of P2P in China is the lack of data privacy laws…

Few other markets around the globe offer the level of data gathering and data scraping opportunities that China has. According to some P2Ps, borrowers can be assessed on over 1,000 different variables. The moment a borrower entitles a P2P to do a background check, this opens up many different channels by which they can source data:

- **GPS data** – information on location and travel movements can be purchased from telecom providers or tracked via smartphone apps where users allow the app to know the users' locations.
- **Internet search history** – internet search histories can be purchased from telecom companies. These can be very useful in forming a lending decision as they allow lenders to track online purchase activity and, perhaps more importantly, online gambling activity.
- **Point-of-sale machine data** – Payment firms are reportedly providing this data on a fee arrangement and this forms one of the most valuable pieces of data that a lender can gain access to.
- **Travel bookings** – whether you fly economy, business or first class can be an important metric in a loan decision.

- **Social media**
- **Education records**
- **Motor vehicle registrations** and other related data

The sale of data is turning into a valuable new source of revenue for certain companies, particularly in the telecom, payments and social media spaces.

…and the beast is the lack of a centralised consumer database in China

China does not have a centralised consumer credit database. The concept of being concerned about one's credit score is very much a North American preoccupation. The People's Bank of China (PBOC) does however maintain a database for all borrowers in the country and their respective repayment history and outstanding debt levels with all CBRC-regulated entities.

Creditease, with a loan portfolio only slightly larger than Lending Club, has 40,000 employees versus Lending Club's 600

However, it does not provide any sort of credit scoring model and is oriented towards listing existing debt commitments, where and what collateral is pledged and what the holdings of a company are, which rarely forms the primary consideration for issuing a loan to an untested small business. Even with large corporate borrowers it can prove problematic. As a consequence, many financial institutions have developed their own in-house internal credit scoring databases or work with local ratings agencies, like Dagong Credit Rating, to do so. More recently, a number of companies have been granted licences to set up consumer credit companies, not the least of which is Alibaba. The internet company is reportedly using its vast pool of data to assess the creditworthiness of Chinese consumers and businesses that either have insufficient or non-existent track records with CBRC-regulated lenders. This credit-scoring system, called Sesame Credit, scrapes user data and payment histories from Alibaba Group Holding's various e-commerce platforms.

However, while it appears the situation is changing for the positive, presently there is no available centralised system to assess micro small-sized enterprise (MSME) and consumer borrowers.

Can big data analytics allow credit risk to be assessed online in China?

The process behind issuance of a loan has actually not changed much in the modern era and the "five Cs of credit", a credit assessment model long used by lenders to assess credit of potential borrowers, is consciously or unconsciously still the foundation for most loan decisions[6]:

(1) Capacity of the borrower to repay the loan;

(2) Character of the borrower;

(3) Capital invested in the business by owners;

(4) Collateral to secure the loan; and

(5) Conditions of the external business environment (outside the control of the borrower).

[6] New approaches to MSME lending: challenging traditional credit assessment models in electronic cash-flow environments, AMP Credit Technologies Ltd., September 2014

Lending, when broken down into its most basic parts, is ultimately relatively simple in nature and revolves around the question of whether a borrower is an acceptable credit risk or not. This begs the question of whether a 1,000 different metrics are really needed to make a loan decision. The concept behind big data is certainly appealing and the pace at which purchase activity is shifting from offline to online environments is staggering in China. In theory, this data can be packaged and used to analyse clients' behaviours and characteristics with financial services, then tailored to those needs.

However, another way to describe big data is to simply call it information. And it is hard to say that even with all of the above-mentioned information that can be gathered, whether this is sufficient to assess the capacity and character of a borrower to repay a loan.

Having access to additional information resources does not rethink or restructure the key metrics that are behind the decision to issue a loan. It should be kept in mind that not all information is created equal. Clearly e-commerce firms like Alibaba, which process transactions and have see-through on vendor payment and bank activity, have higher quality data resources than many other industries. Big data in most forms has great potential to enhance lending decisions and improve efficiency in the loan decision process within the banks themselves—whether it can entirely circumvent traditional loan decision metrics is still unclear though.

The P2P sector faces three core risks, starting with credit risk

Asset quality issues in the sector are well documented. We believe the P2P platforms are, to an extent, a victim of their own success. Despite the vast proliferation of these entities and their growing public profile, the bottleneck still very much remains on the borrower side of the equation. Even where funds can be aggregated into bigger ticket loans, this is still often insufficient to meet investor demand; in other words, the huge sums of funds being raised on these platforms are often well in excess of the borrower demand that can be realised.

Even sector champion Creditease, with its extensive branch network across the country and offshore, cannot meet investor demand through pure loan sourcing; indeed it has set up new investment management subsidiaries which are investing funds into a wide range of financial instruments, particularly securitized assets and other asset-backed securities.

P2P are not recognized lenders in China and thus lack access to the PBOC's central credit database

The risk is thus that P2Ps, many of whom already have very questionable risk management, start to resort to targeting higher credit risk clients, particularly those who are unable to source bank or other non-bank financial institution borrowing, to meet investor demand. In worst-case scenarios, they could find themselves lending to borrowers with short-term funding used to repay bank loans. P2P are not recognized lenders in China and thus lack access to the PBOC's central credit database—so they have no way to determine borrower's outstanding debt commitments, although some P2Ps do reportedly perform these checks through other channels (conversely, this also creates a risk for the banks who have no clear way to determine if their borrowers are also borrowing off of P2P platforms).

Loan defaults are already taking a significant toll on the sector, with a reported 275 P2P companies in 2014 filing for bankruptcy or running into difficulties after loan defaults. According to Online Lending House, a further 235 P2Ps faced similar problems in the first four months of 2015 alone. This number will likely continue

to increase—with many P2Ps offering rates of 40%, many of these P2P platforms are just a transformation of former high risk players in the private lending market.

Fraud is also taking a toll

The second risk for the sector is reputational risk. This risk takes two forms. First, given the lack of regulation in the sector and the low barriers to entry, there have been many reported instances of fly-by-night P2Ps simply raising funds and then disappearing with said funds (see Figure 5). As the number of such cases expands, this will create significant reputational risk and potentially leave investors loathe to invest with P2Ps. The second type of fraud risk stems from groups or people with no intention or ability to repay seeking to source loans.

However, a number of P2Ps are addressing these concerns by setting up custodian accounts with banks. Jimubox, Renrendai and Minshengyidai have all reportedly signed agreements with China Minsheng Bank to enter into custody arrangements to safeguard investors' funds.[7]

Figure 5: Reported P2P platform failures

Name	Date of problem	City	Estimated loss (rmb mn)	Number of investors	Reported loss reason
Gold Loan (淘金贷)	8-Jun-12	Guangzhou	1.3	NA	Fraud / theft of funds
UE Wang (优易网)	1-Dec-12	Nantong	22.5	47	Fraud / theft of funds
Emarketing (网赢天下)	1-Aug-13	Shenzhen	166	1009	Default
Orient Innovation Capital (东方创投)	8-Oct-13	Shenzhen	52.5	1325	Default
Ego Finance (及时雨)	1-Dec-13	Huaihua	140	1659	Default
China Treasure Investment (中宝投资)	14-Mar-14	Jiezhou	513	1062	Under investigation
Information Network (科讯网)	10-Jun-14	Shenzhen	>50	NA	Fraud / theft of funds
Boliya (铂利亚)	10-Oct-14	Chengdu	36	NA	Default
China Trade Finance (中贸易融)	14-Nov-14	Huzhou	94	1148	Default
Zhonghui Online (中汇在线)	14-Dec-14	Shenzhen	260	3391	Default
Liwai Loans (里外贷)	22-Jan-15	Beijing	934	1830	Default
Sheng Finance Online (盛融在线) Bottom of Form	10-Feb-15	Guangzhou	921	10837	Default
Zhong Da Fortune (中大财富)	15-May-15	Guangzhou	68	NA	Default
Li He (力合)	19-May-15	Zhejiang	52	NA	Fraud / theft of funds

Source: Online Lending House and UBS

The biggest risk overhang though is regulatory, in our view

The question of whether this will become a regulated sector appears to not be a question of if, but when. The CBRC has already voiced its intention to increase oversight over the sector, which should ultimately give rise to a P2P legal entity that is a P2P.

While it is unclear exactly what form this regulation will take, there has been a great deal of discussion and commentary from high up on how this will likely appear. According to Caixin, this will likely include the following:

[7] P2P lender shields funds with bank deal, Shanghai Daily, 12 February 2015

- A ban on high risk products
- A ban on fund raising for related parties, which could dash the hopes of real estate developers setting up platforms for their own projects
- A requirement for P2Ps to custody their funds with banks so as to safeguard investor funds, which should reduce fraud risk in the sector
- A Rmb30m minimum registered capital requirement
- Leverage restrictions (as yet unstated)
- A limit on single loan sizes of Rmb20m or less

The most serious of these possible regulatory requirements are the latter two items. Limiting loan sizes would theoretically make crowd-funding-like operations illegal. As it stands, crowd-funding already operates in a grey legal area and the line between that and what is considered illegal fundraising—which has sent many an executive in China to prison—is unclear at best.

However, the bigger impact would be from leverage restrictions. This would exact a particularly harsh toll on the larger P2Ps depending on what they are set at. As shown in Figure 4, many P2Ps have relatively modest levels of registered capital. And indeed many, if not most, other P2Ps have even lower registered capital levels—sometimes with as little as Rmb10,000. Moreover, there is still a very significant question mark on whether Chinese P2Ps can truly be considered marketplace lenders versus balance sheet lenders. Nearly all P2Ps currently offer guarantees over their loans and it is still unclear whether they would be treated as marketplace lenders or balance sheet lenders in a regulated regime.

However, given some of the egregious behaviour by specific P2Ps, we believe regulation for the sector is needed and long term it should lead to a more sustainable industry.

And there are reasons to be optimistic about the sector.

What does the future hold for P2Ps as a regulated sector?

We believe the implementation of regulation over the sector will give a shock to the system and likely result in large swathes of the P2Ps being forced to shut down. However, long term, this is likely a positive for the sector's healthy future development. The disappearance of executives and rising defaults, combined with excessive risk taking, necessitate a need for regulation, in our view.

There are significant bright spots in the industry and the opportunity for internet finance should not be understated. One of the more sustainable and interesting business model developments taking place within this space has been the marriage of P2P platforms with China's leverage-starved and rapidly growing micro-credit company (MCC) sector. This brings together the capital raising engine of an online P2P with the on-site credit risk assessment resources of China's micro credit sector. We believe this could potentially be a very lucrative arrangement.

In addition, the opportunities for e-commerce firms, like Alibaba, are significant, in our view. Zhaocaibao, the P2P platform of Ant Financial Services Group (the financial arm of Alibaba), could leverage off of the e-commerce platform and Alibaba's banking entity to source a pool of high-quality borrowers for working capital loans and supply chain finance from among the vast network of the firm's

online vendors. Moreover, secure repayment could be assured through automated coupon stripping of cash flows processed by said merchants—a practice which has already been tried and tested on loans issued by two MCC subsidiaries of Ant Financial Services Group. The loans are based on data collected through analysing the borrowers' online activities and transaction histories.

There are also already point-of-sale machines in use which automate this coupon stripping in offline environments as well.

Cooperation with MCCs is expanding

MCCs are under the oversight of the Ministry of Finance and are regulated at the provincial level, with each province typically having in place its own interpretation of only regulatory framework and requirements; this explains the significant variance in size of MCC sectors from province to province. However, leverage ratio restrictions on MCCs are universally low across China, with most provinces in China setting them at 50%, although a few locations, such as Chongqing, allow leverage up to 200%. As shown in Figures 6 and 7 though, most MCCs in China even struggle to achieve these low levels of leverage and are still financed almost entirely through shareholder loans. This inability to source wholesale financing is largely a symptom of bank preferences for state-owned enterprise clients and asset-backed lending. Nearly all MCCs are privately owned and few have any sort of tangible collateral to pledge. Consequently, many of these companies either avoid leverage altogether, or rely on more costly trust company financing to source wholesale funds.

Moreover, because these are non-CBRC regulated entities, their loan exposures are not listed in China's central credit database, which only tracks lending activity of CBRC-regulated entities. However, they function as a key source of financing to MSMEs in China, which typically rely on MCCs for short-term working capital loans. Interestingly, concerns that such borrowers have other borrowing commitments from MCCs forms one of the many reasons why banks are often loathe to lend to MSMEs.

While many MCCs note that the opportunity for financial deepening in their sector is still very significant, they argue that the key impediment to further growth is their inability to leverage up their balance sheet. Even though the sector has grown rapidly despite this, the ability to source wholesale financing would have a marked impact. Recent efforts by some of China's listed micro credit lenders, such as China Credit Holdings (HK 8207), Zuoli Kechuang Micro-Finance Company Ltd (HK 6866), China Commercial Credit (NYSE: CCCR), Sun Hung Kai (HK 0086) subsidiary, United Asia Finance, etc. to set up P2P and other internet finance platforms are deeply strategic and viable moves, in our view.

Likewise, partnerships with certain key P2P players could be mutually beneficial. There are already reportedly cooperation arrangements in place between MCCs and P2P firms like Haodaibao.com and Yooli.com, which has tie ups with seven MCCs.[8] The benefits of these arrangements are that they marry the capital raising platform of a P2P with the capabilities of MCCs to find borrowers, credit assess loans and control risk over the life of the loans.

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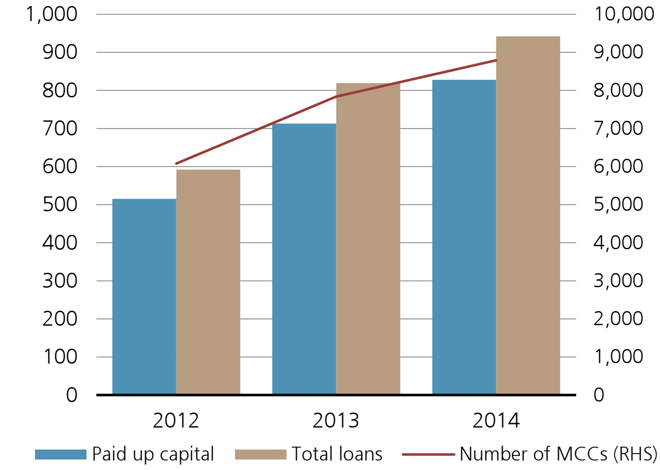
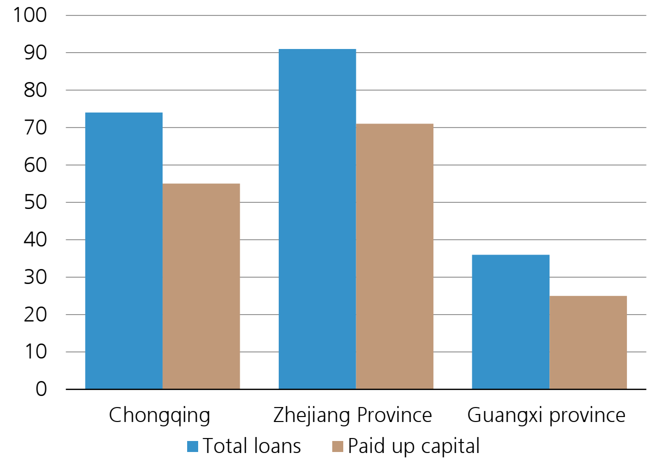
[8] P2P Lenders Heading into Dangerous Waters, Critics Say, Caixin, 18 April 2014

Figure 6: China is home to some of the world's most underleveraged MCCs (Rmb bn)…



Source: People's Bank of China

Figure 7: …and even where higher leverage is allowed, most MCCs struggle to source the financing (Rmb bn)

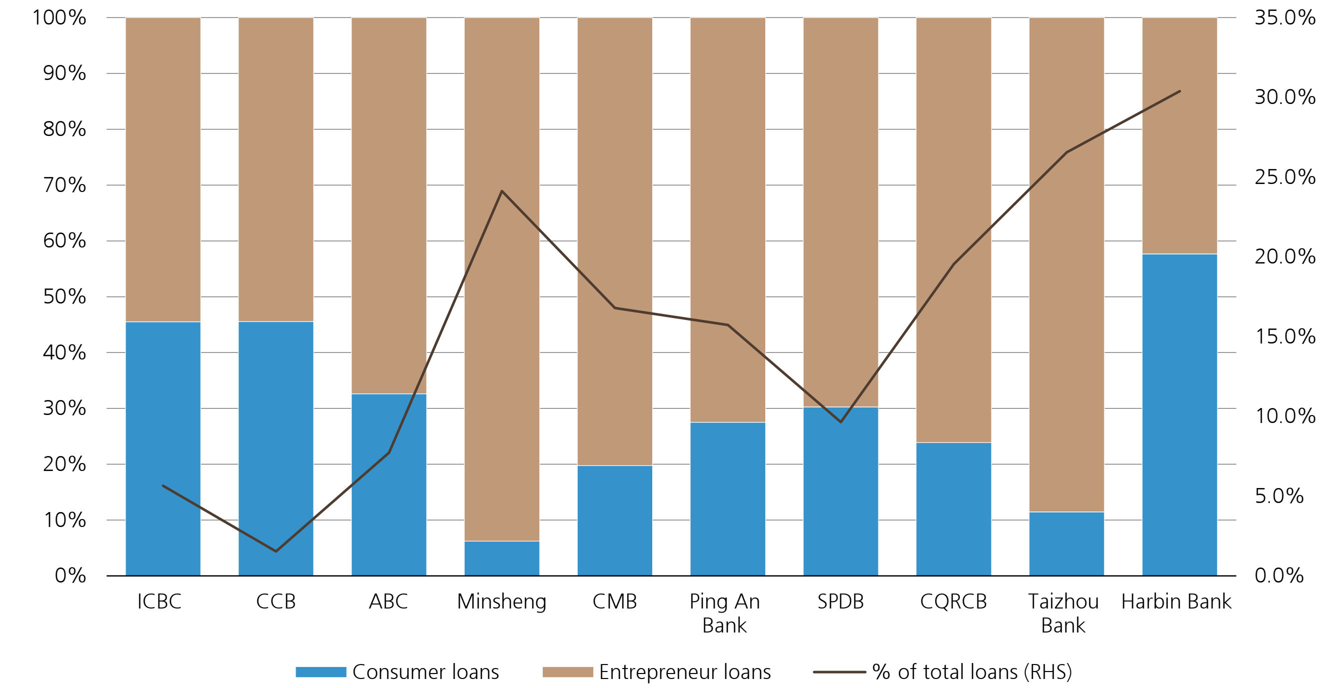


Source: People's Bank of China

The consumer credit market is growing significantly

We believe the opportunity for financial deepening in China is greatest at the consumer level. However, the fight for the consumer borrower will not go uncontested. Excluding mortgages, Chinese consumers, by and large, do not take on significant amounts of debt, although this has been changing over the years; some banking institution's consumer and entrepreneur loan books are forming growing portions of their total loan books (see Figure 8).

Figure 8: The size of consumer and entrepreneur loan books varies between banks (excludes mortgage/auto loans and credit cards), 2014 YE



Source: Companies financial statements

Beyond the banks themselves, there has been rapid growth in China's consumer finance companies. Consumer finance companies as a legal entity were launched

in 2009 by the CBRC as a pilot scheme under the Administrative Measures on the Pilot Program of Consumer Finance Companies with the approval from the State Council. Four consumer finance companies were initially established in Beijing, Tianjin, Shanghai and Chengdu. Originally, these entities were restricted to the issuance of instalment loans for specific consumer durable goods purchases, with general purpose consumption loans only able to be extended to established customers.

However, the pilot scheme was recently ended and the number of consumer finance companies has tripled since Suning Consumer Finance Co. was established in December 2014 (see Figure 9). Moreover, the lending restrictions have been greatly eased and these companies are permitted to operate on a national basis.

With the exception of Haier Consumer Finance Company, all of these entities have banks as major shareholders. Unfortunately, none of these entities are listed and none of them release separate financial statements, but their growth rates have reportedly been staggering and only hindered by ballooning balance sheets. The opportunity for consumer finance companies to establish partnerships with P2Ps is also very viable and some of them are already in discussions.

Figure 9: China's consumer finance company pilot is officially over

Name	Shareholders	Date of establishment
BOC Consumer Finance Co.	Bank of China, Bailian Group, Shanghai Liujiazui Financial Development Co.	15-Jun-10
Home Credit China	PPF Bank	NA
Industrial Consumer Finance Co.	China Industrial Bank, Quanzhou City Corporation, Xtep (China) Co., Fucheng (China) Co.	14-Oct-14
Hangzhou Bank Consumer Finance Company	BBVA, Hangzhou Bank	Set-up still in process
Bank of Beijing Consumer Finance Company	Bank of Beijing and Santander	3-Mar-10
Hubei Consumer Finance Company	TCL and Hubei Bank	18-Apr-15
Haier Consumer Finance Co., Ltd.	Haier Group, Haier Finance Co., Redstar Macalline Global Home Furniture Plaza Co., Zhe Jiang Yirong Investment Co., Ltd., Beijing Tiantong Sai Bo Cyber Information Technology Co., Ltd.	12-Dec-15
Merchants Union Consumer Finance Company Limited	China Unicom, Wing Lung Bank Limited (a wholly owned subsidiary of China Merchants Bank)	3-Mar-15
Immediate Consumer Finance Company	Beijing Zirun Trading Company, Chongqing Bank, Sunshine Property Insurance Co., Zhejiang China Commodities City Group Co., Ltd. and Wumart Holding Group Co.	28-Jan-15
Sichuan Jincheng Consumer Credit Co.	Bank of Chengdu, Hong Leong Bank	1-Mar-10
Suning Consumer Finance Co.	Suning Group, Nanjing Bank, BNP Paribas Personal Finance, Yanghe Group and Simcare	17-Dec-14
China Postal Savings Consumer Finance Co.	China Postal Savings Bank, DBS Bank, Lakala Payment Co., Guangzhou Grandbuy Co., Highsun, and Sangem	6-Jan-15

Source: CBRC, Zhejiang Association of Banks

Are P2Ps platforms a threat to banks' lending franchises?

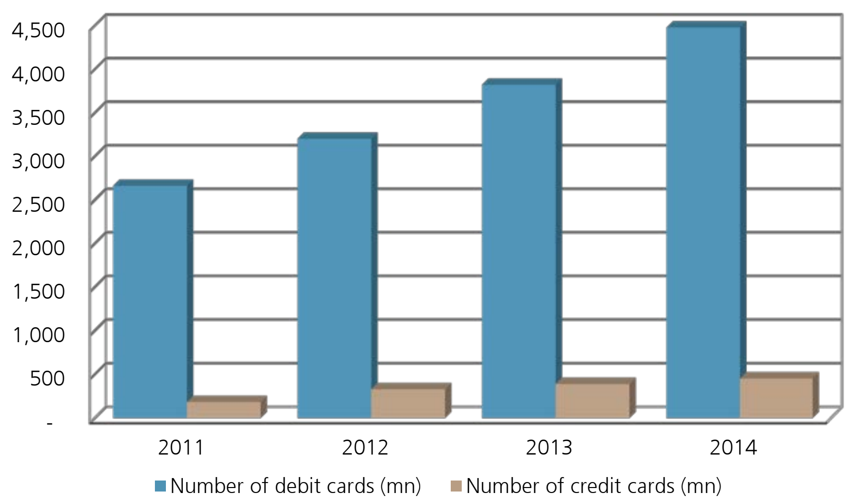
The short answer is, not yet. The types of borrowers that most P2Ps are engaging are typically small businesses that lack access to bank credit. Moreover, there is very little consumer debt that could be refinanced off of banks' balance sheets. The vast majority of consumer credit is in the form of mortgage loans, which are priced far too competitively to be refinanced via P2Ps. And, the amount of overdue credit card debt in China is minimal. Banks' revenues generated off of credit cards are almost entirely in the form of fee and commission income; only an estimated 1.27% of credit cards are overdue at any given time and only about 3-8% of cardholders in China miss payments resulting in interest charges, compared with about 40% in the United States, according to a Boston Consulting Group report.

The Chinese banks take serious measures to discourage late-payment of credit cards—including going to so far as to make late-payment customers perform a "self-criticism", or an apology, combined with a vocal admission of shame, to staff at the credit card centre over the phone.

For more details on China's payments market, please see our 6 March 2015 report: *The changing payments landscape in China: An evolution not a revolution*

Lastly, the interest charged on Chinese credit cards is relatively low by global standards, with interest rates on Chinese credit cards subject to regulatory caps of around 18%, which is often at or below many of the rates being charged by P2Ps in China. However, as the Chinese consumer matures, we expect more and more banks will seek to build out their consumer-finance businesses and consumer-lending businesses.

Figure 10: The vast majority of card payments in China are done on debit cards, while an estimated 70-80% of credit cards are dormant



Source: People's Bank of China Note: Dormant is defined

Regardless, banks are responding

NIM compression among Chinese banks, particularly the more interbank-reliant joint stock banks (JSBs), is forcing many of them to reorient their lending franchises to higher interest-lending opportunities due to increasing cost of funds pressures being exerted by competition for retail depositors and the shift of corporate deposits into interbank positions (see *The unique dynamics of China's interbank market*, 30 October 2014, for more detail on this). While this has the benefit of

increasing the capital efficiency of bank lending in China, in addition to forcing banks to move towards more risk-efficient outcomes, the consequence is that many banks are entering into unfamiliar territory.

However, the extent to which the banks have opened their balance sheets to SME borrowers is still unclear; headline SME lending numbers for banks are not entirely reliable as they do not break down SME loans between those to privately owned enterprises versus SOEs—and much of China's SME lending is centred around state-owned SMEs. Nonetheless, the current situation is clearly a marked change with the situation in China five years ago, when SMEs had virtually no access to bank finance.

Banks' own P2Ps may eventually dominate the sector

The banks are also responding to changes in the market environment by developing their own P2P platforms or creating partnerships with P2Ps. The first bank to do so was Evergrowing Bank, an unlisted joint stock bank, in 2014. According to Online Lending House, another 11 banks have now set up 12 P2P lending platforms or cooperation arrangements as at Q115 (CMB, Ping An Group, Minsheng Bank, China Development Bank with two, Suzhou Bank, Ningbo Bank, Qishang Bank, Bank of Lanzhou, Baoshang Bank, Jiangsu Bank, Bank of Beijing and Suzhou Bank).

While these platforms represent an additional source of revenue, it has also been suggested that the P2Ps can act as a tool to develop borrowers' credit histories, with the intent to eventually on-board them as balance sheet borrowers once they have demonstrated they are an acceptable credit risk. Suzhou Bank specifically noted in its announcement of its P2P venture with Sinolending, that the bank's traditional strengths lay in the accumulation of credit history and customer data, and that the P2P platform was a gateway to understanding customer needs and testing the water for certain MSE borrowers.

However, in many of the cases it does not appear that the P2P platform is directly linked to its banking partner via shareholder relationships, as per corporate registration data with local Administrations of Industry and Commerce (AIC). To illustrate, the P2P reportedly linked to Suzhou Bank, Surongdai, appears to have no clear relationship with the bank. Minsheng Bank-linked Minsheng Yidai's AIC registration filing does not list the bank as a shareholder, although it is listed as a partner on the website. It does however list Minsheng Holdings and Minsheng Royal Fund Management as shareholders (in addition to 10 other companies). One of China Development Bank's two P2P platforms only appears to have a relationship with the Shanxi branch of the bank.

It also appears that these banks are not always treating these entities with the same level of dedicated risk management as their normal lending operations would be subjected to. According to Online Lending House, only four of the banks with P2P operations as at the end of 2014 were directly involved in the risk management processes of those entities, with the relationship between them more around branding.

Statement of Risk

The highly competitive nature of China's securities industry, coupled with potential competition from banks and other financial institutions, present risks. Potentially intense competition could lead to a reduction in market share or lower commission/fee rates. Chinese brokers' revenue is highly dependent on stock market conditions. Brokerage commissions, accounting for a significant portion of revenue, are directly impacted by market turnover. Although investment banking, net interest income and other segments are not directly impacted, they are also largely affected by market sentiment. In addition, market volatility could reduce the value of a company's financial assets, and consequently lower its book value. As the equity market is driven by complex fundamental and regulatory factors, these could also create uncertainty.

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Sell	FSR is > 6% below the MRA.	12%	20%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 31 March 2015.
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