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China's Insurance Shadow Banks

Insurance Firms Replace Trusts as Shadow Banking Channels as Local Governments Seek Capital

"Many LFGVs now consider the insurance funds as their life-saving straw to improve the debt structure as the whole country keeps a watchful eye on the risks related to local government debt." – Chinese Insurance Executive.

Summary: The New Bank on the Block

China's $586 billion stimulus package in 2009 led to the establishment of non-bank lending known as China's Shadow Banking sector. These flows were channeled primarily (although not exclusively) through two institutions: banks, which sold Wealth Management Products to individuals, and Trusts, which acted like quasi-banks by pooling funds together from individuals and corporates. Many of these pools of capital were invested in local government projects in infrastructure and property. This capital also helped to fill a fiscal gap in their revenues. However, in the past year, Beijing has attempted to restrict the flow of funds through the Shadow Bans to local governments and their off-balance sheet companies, particularly from the banks and Trusts.

Our analysis suggests the insurance industry has stepped in to fill the gap. In 2014, investments in alternative investments by China's insurance industry grew at more than double the rate of traditional investments in equities and fixed income to reach Rmb2.3 trillion. Much of this ended up in local infrastructure and property projects. This has become a new channel for Shadow Banking. The increase partly reflects reluctance within the leadership to use state funds to address a slowing economy. This has led Beijing to find other asset pools to use as stimulus measures. This policy is similar to the U.S. government backing of Fannie Mae and Freddie Mac prior to the 2008 financial crisis to support low-income mortgages without relying on funds from the U.S. Treasury. There were no short-term fiscal costs but clearly long-term risks. Also, in China, local governments have actively encouraged the insurance funds to invest in their regions.

We believe the insurance investment in alternative assets is problematic because it:

1) Heightens risks for China's financial sector;
2) Threatens the balance sheets of the major insurance firms;
3) Adds to the excessive investment in property and infrastructure that is fueling the country's property bubble;
4) Confirms that Beijing's leaders are seeking ways to stimulate the economy – not through fiscal measures – ***but by utilizing the savings of average consumers.*** Just as low-interest savings in the banks represent financial repression, so implicitly does this use of capital in the insurance sector.

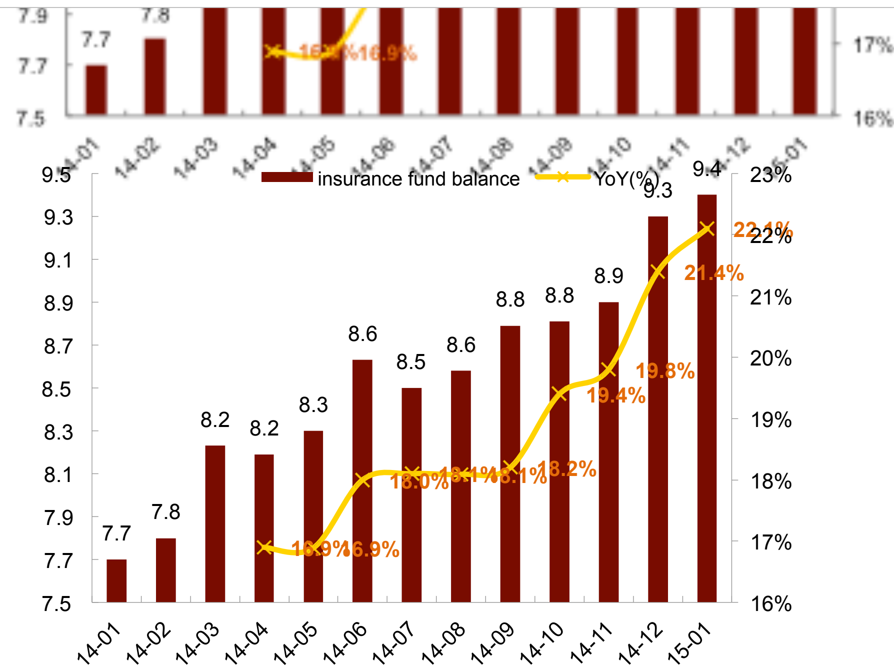
In this report, we look at the insurance sector's returns and assets, and their investment relationships with local governments to understand the capital chain that is creating these risks.

Rising Insurance Profits

The Chinese insurance industry made several records in 2014. First, total assets of the industry exceeded Rmb10 trillion, rising 22.6% year-over-year. Second, net assets reached Rmb1.3 trilling by the end of 2014, 56.4% more than at the beginning of the year. Third, premium income for 2014 increased at the highest rate since the 2008 financial crisis, growing at 17.5% YoY to Rmb2.0 trillion. We expect the industry's net profit to more than double, rising 106.4% YoY to Rmb204.7 billion in 2014.

Given the rapidly expanding assets and related premium income, the CIRC (China Insurance Regulatory Commission) has expanded the scope for insurance investment beyond previous traditional fields such as banking deposits, bonds and the stock market into non-traditional areas such as real estate, stock rights, trust plans, and wealth management products. We believe this is a tacit political decision agreed by the top leadership to create a new investment channel – a private form of fiscal stimulus.

As a result, the insurance industry's balance of funds rose more than 20% YoY to Rmb9.3 trillion due to increasing returns on investment. The integrated yield and ROI for 2014 were 9.2%/6.3%, respectively, 5.1/1.3 ppt more than that of 2013. **In addition, the scale of alternative investment surged to Rmb2.3 trillion at +66.4% YoY, which accounted for 24% of total insurance investment by the end of January 2015.** In comparison, insurance investments in bank d



Source: CIRC, OCR

Figure 2: Increasing returns on insurance investment

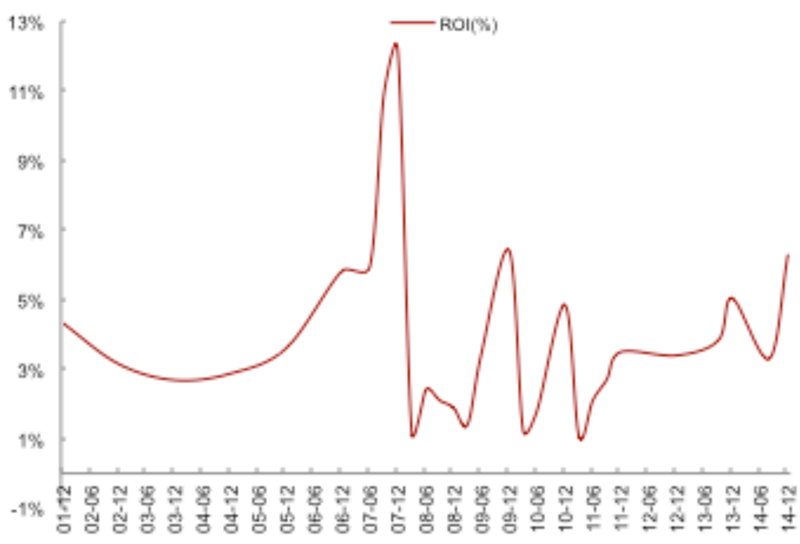
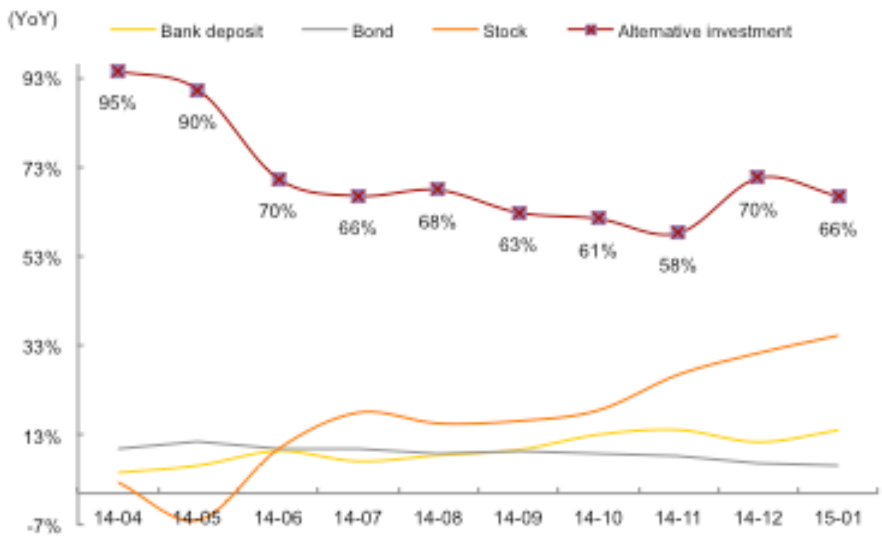


Figure 3: YoY growths of four major types of insurance investment

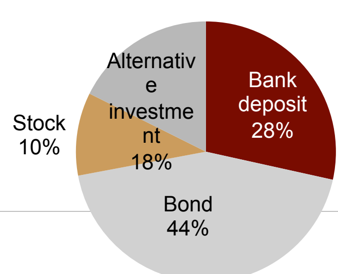


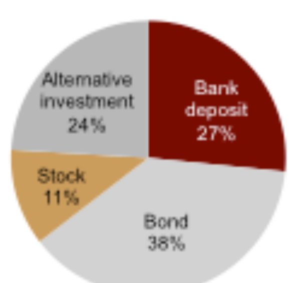
Alternative Investments Primarily in Property and Infrastructure

Alternative investment refers to all other investment fields apart from bank deposits, bonds and the stock market, which is mainly composed of debt investments (infrastructure) and customized trust plans (infrastructure and the property market). Although the investment horizons of the two plans are different, the expected interest rates are the same, around 6%. Given alternative investment's higher returns than in fixed income and lower volatility than equity products, it continues to increase market share from more traditional investments. At the beginning of 2014, alternative investments only accounted for 18% of the whole portfolio. By the beginning of 2015, its share climbed 6ppt to 24%. In contrast, the weight of investment in bonds declined 6ppt from 44% at January 2014 to 38% at January 2015. Even the booming stock market failed to attract insurance investments, which slightly increased its portion of total investment by just 1ppt.

Figure 4: Insurance investment breakdown

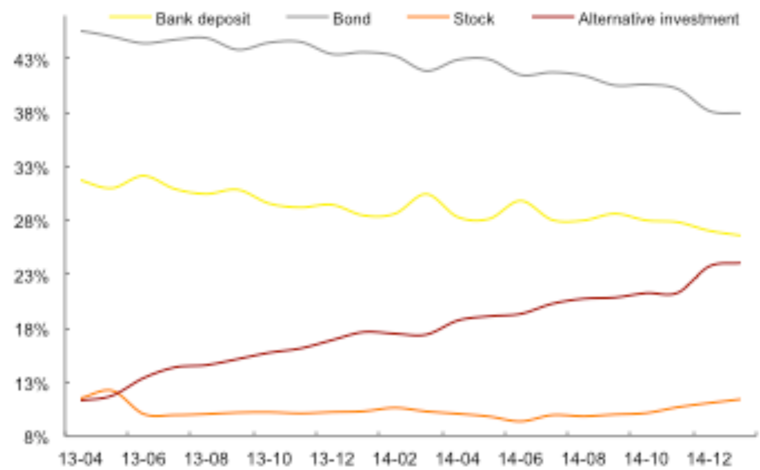
2014 **2015**





Source: CIRC, OCR

Figure 5: Portion of four major types of insurance investment



Source: CIRC, OCR

We believe the growth momentum for China's insurance industry in alternative investments will continue in 2015, particularly in light of gradual interest rate liberalization and the further marketization of the use of the insurance fund balance. Moreover, the alternative investment itself will become more diversified. For example, a survey conducted at the beginning 2015 among 25 domestic insurance companies and insurance asset management companies showed that property market and asset-backed securities investments are the most welcome two asset classes with a popularity degree of 31.25%. Long-term equity investments ranked third with a popularity degree of 28%. As an example, in February 2015, China Life said that its asset management company has a planned target of Rmb150 billion in alternative investments this year.

Insurance investment in infrastructure

According to data revealed during the 2015 CIRC internal working conference, insurance investment was the major source of capital for China's infrastructure investments. The industry's investment totaled Rmb1.1 trillion in 2014 (+56.8% YoY), among which Rmb107.3 billion was for the construction of shantytowns and affordable housing. In general, insurance companies invest in the debt investment plans of infrastructure projects initiated by the local government or Local Government Financing Platform (LGFV) as a way to provide capital for cash-strapped local governments. LGFVs are off-balance sheet companies that were established in local towns across China as a means to avoid lending caps to governments for infrastructure investment. These investments reached a peak during China's stimulus in 2009. One of our interviewees, who works for the business promotion office at a Jiangsu Province LGFV, said insurance investment has been promoted by provincial officials to meet the financial needs of their infrastructure projects. The reasons are as follows:

1) Insurance companies have stable long-term sources of funds, which match the five-to-ten year construction period of infrastructure projects. In other words, insurance fund have maturity match with infrastructure projects, and are less costly than bank loans.

2) Insurance companies are willing to lend capital at lower interest rates than trust funds, namely, 7.5%, according to estimates provided by an official at a large domestic insurance company. "Most importantly, unlike trust companies, we don't have any other implicit costs." Trusts often have to pay additional fees to banks and other third parties.

Taikang Life: An Example of an Local Government Investment

Usually, the insurance company works with its own asset management company to invest in infrastructure projects. For instance, on January 29, 2015, Taikang Life Insurance Company subscribed to a debt investment plan initiated by Taikang Asset Management. The plan raised Rmb475 million for the first phase of the reclamation project for Wenzhou Shoal, managed by Wenzhou Port City Development Co., in Zhejiang Province. Ltd. According to our research, Wenzhou Port City Development Co., Ltd is an independent company, that functions as the construction platform for the local government. It is controlled by Oujiang Construction, Investment & Development Co., which is an LGFV. The companies are assumed to have an "implicit" government guarantee although this is not legally approved. The maturity of the Wenzhou Shoal investment is set at seven years with the total amount raised not to exceed Rmb1.5 billion. The annualized interest rate is estimated to be 6.1%.

Pension Funds Are Funding Local Infrastructure

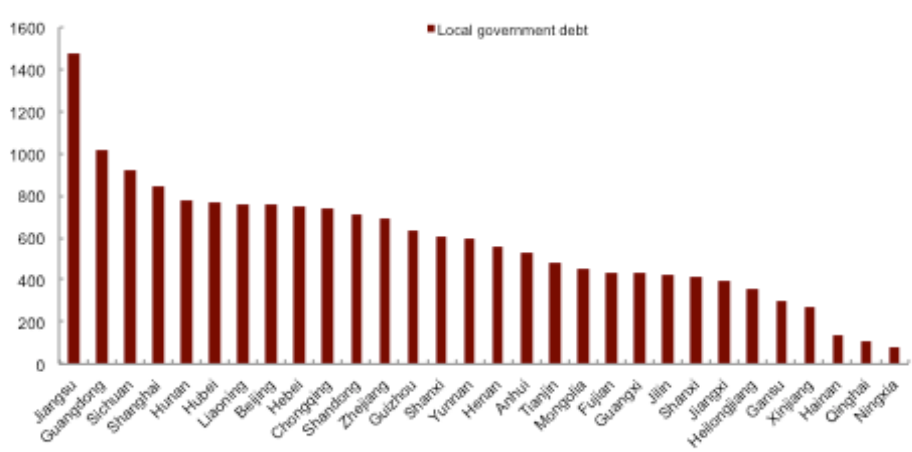
Insurance companies aren't the only sources of non-traditional capital for infrastructure funneled through the Shadow Banking market. Pension insurance funds are also chasing yield through this channel. In October 2015, Changjiang Pension Insurance launched a seven-year debt investment plan worth Rmb2 billion for several municipal construction projects managed by Shanghai Shenjiang Group (an LGFV). This was the first pension insurance fund investment in Shanghai urban construction. The capital will be used to pay the debts of seven finished public welfare projects. ***"To my knowledge, many LFGVs now consider the insurance funds as their life-saving straw to improve the debt structure as the whole country keeps a watchful eye on the risks related to local government debts"*** according to an official at an insurance company. Indeed, Changjiang Pension Insurance has worked with LGFVs and big state firms (SOEs) on their alternative investment capital requirements since the second half of 2013. Flagship projects include the livelihood project in Nanchang and cooperation with China Guodian Corporation, one of the five largest integrated power generation corporations in China.

Local Governments are Desperate for Insurance Investments

According to updates provided by CIRC's local agencies, most local governments included insurance investments for infrastructure construction as an important part of their 2015 government work plans. They have begun offering favorable policies to obtain investment opportunities. In fact, in 2014 more than 30 cities successfully attracted insurance investments for local infrastructure projects, led by Shanghai, Guangdong, Shandong and Jiangsu. "What drives these four areas to actively seek insurance investments is the huge amount of local government debt on their balance sheets and the large capital demand for future development", said an executive at one of big four banks in China. "Nonetheless, the central government has ratcheted up pressure on these four cities to find new capital sources rather than simply issue municipal bonds or borrow from the banks."

According to the latest national audit results, Jiangsu, Guangdong, and Shanghai were among the top five localities with the largest amount of government debt, namely, Rmb1,477 billion for Jiangsu Province, 1,017 billion for Guangdong, and 846 billion for Shanghai. Meanwhile, Guangdong, Jiangsu and Shandong are the top three cities with the most fiscal expenditure at the end of 2013, with Guangdong at Rmb841 billion, Jiangsu at 780 billion, and Shandong at 669 billion. Moreover, the fiscal deficit of Guangdong, Jiangsu and Shandong widened from Rmb68/79/107 billion to Rmb133/123/213 billion between 2009 and 2013. Only Shanghai slightly reduced the fiscal deficit by Rmb3 billion from Rmb45 billion to Rmb42 billion by the end of 2013.

Figure 6: Local government debt (2012)



Source: China's National Audit Office, OCR

Figure 7: Fiscal expenditure (2013)

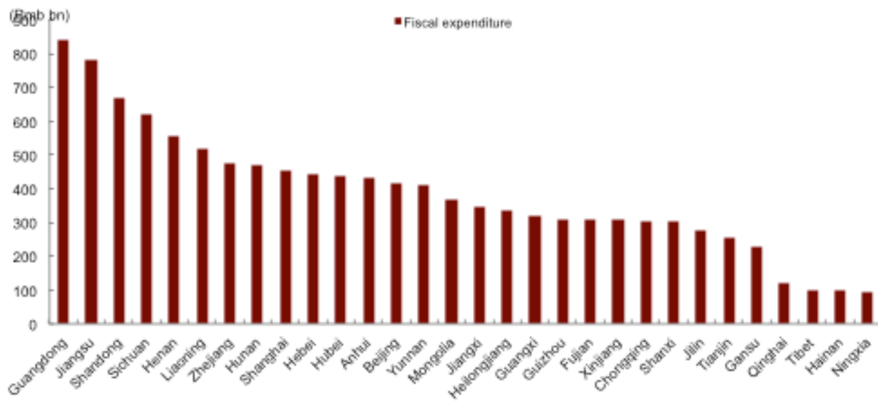


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Figure 8: Fiscal deficit: Shanghai

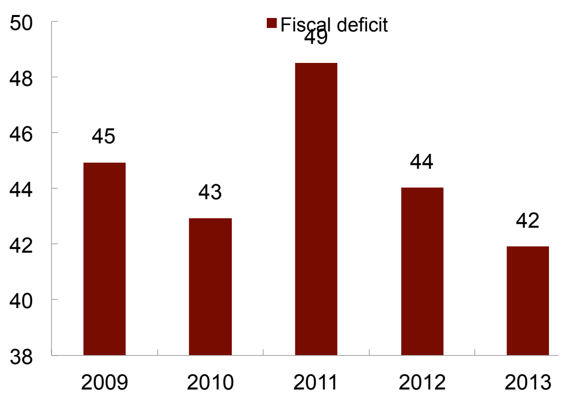
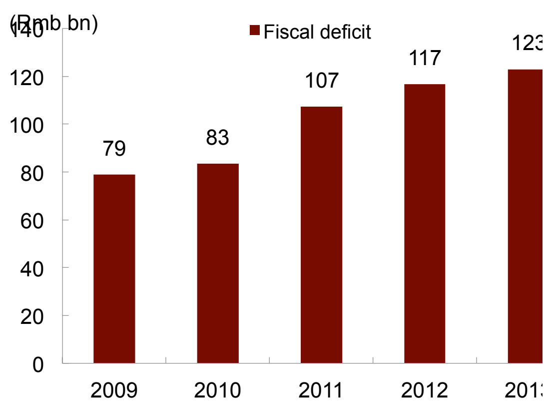


Figure 9: Fiscal deficit: Jiangsu

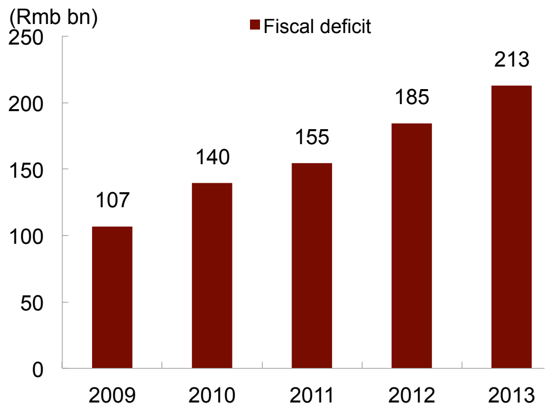


Source: Wind, OCR

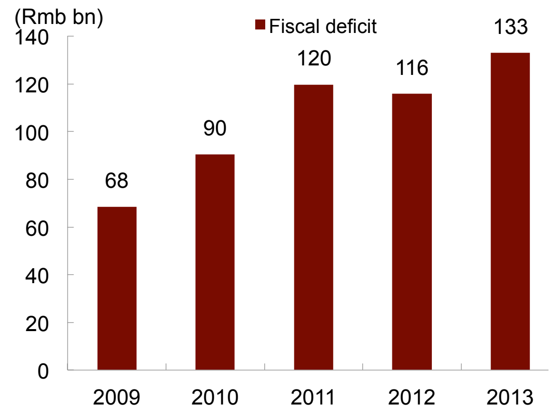
Source: Wind, OCR

Figure 10: Fiscal deficit: Shandong

Figure 11: Fiscal deficit: Guangdong



Source: Wind, OCR



Source: Wind, OCR

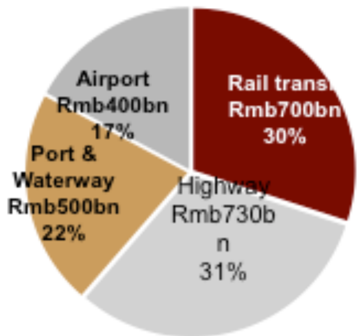
One Province's Success in Attracting Insurance Investment

In 2014, Guangdong accelerated its promotional activity in order to attract non-traditional sources of investment. This included the insurance industry. According to the media, new insurance investment in Guangdong reached Rmb29 billion for the first half of 2014, the largest amount in China. In total, by the end of 2014, insurance companies provided Rmb45.3 billion for twelve infrastructure projects in Guangdong on an accumulative basis, including sectors such as energy, ports, highways. At a recent government meeting, the During discussions of the 13th Five-Year plan (2016 – 2020), the Guangdong National Development and Reform Commission (the local planning board) emphasized the importance of funding local infrastructure construction through more insurance investments.

"We've heard over the past several months that the local government in Guangdong province is actively searching for new insurance investments due to the internal budget plans they just made. More than Rmb2.3 trillion is needed for transport infrastructure construction during the 13th Five-Year period alone. Construction of rail transit/highway/port and waterway engineering/airport requires roughly Rmb700/730/500/400 billion, respectively. Construction and maintenance costs of provincial-level highways for 2013-17 are estimated to be Rmb55 billion. As such, the funding gap is around Rmb26 billion," according to a senior officer at one of the big four banks in Guangdong.

We believe the Guangdong government's anxiety about receiving more insurance investments is not only because of the province's budget deficit, but also due to its huge debt balance. According to public data, Guangzhou has raised more than Rmb30 billion in debt in 2014 for the construction of metros and land development. In January 2015, the spokesman of Guangzhou government said it planned to eliminate 60% of the current debt balance by the end of 2016.

Figure 12: Capital required for transport infrastructure construction



Source: SOE Bank, OCR

- At the Guangzhou 2014 Investment Promotion Conference, China Life Investment, New China Life Insurance (NCI), and Sunshine Insurance Group together signed a Rmb40 billion contract with the Guangzhou government to invest in local infrastructure projects.
- At the end of 2014, China Life Investment signed a cooperation agreement with the Guangzhou Industrial Investment Fund (LGFV) to set up a venture capital fund with a registered capital of Rmb20 billion to provide capital for city development.
- Last summer, PICC (People's Insurance Company of China), Guangdong Financing Department and CCB (China Construction Bank) together set up a Rmb12.1 billion fund, called "Zhenxing Fund". It is the first equity fund established by the combination of a provincial government, SOE and financial enterprise. As the largest investor, PICC contributed Rmb6 billion, followed by GFIH (Rmb4 billion) as the representative of the Guangdong Finance Department, and CCB (Rmb2 billion). The fund will operate for nine years and can be extended twice. Each extension is no longer than one year. By the end of 2014, the fund had completed investments in six new urban district construction projects in Zhaoqing.

Coming to 2015, there are already several insurance investments in local infrastructure construction waiting for approval with a total scale above Rmb35 billion. Companies participating are PICC, China Life Insurance and Pearl Life Insurance.

Examples of Other Local Insurance Investments

1) **Ningxia**

- By the end of 2014, China Life Insurance had invested Rmb2 billion in the construction of the bridge across the Yellow River in Yinchuan through the form of debt investment.
- CPIC (China Pacific Insurance) purchased Rmb35 million in municipal bonds issued by the city of Yinchuan.
- Coming to 2015, PICC has selected six projects related to the construction of Silver West railway for investment. Meanwhile, Sunshine Insurance is going to invest in the local medical establishment.

2) **Hunan**

- In September 2014, the Hunan government held a special investment conference, and only invited major insurance companies to join. Around Rmb16.9 billion in contracts were signed at the conference, among which Rmb13.5 billion received bank guarantees. These companies included asset management divisions of Taikang Insurance, CPIC, PICC, China Life Insurance and General China as well as PICC Investment Holding. Single investments varied from Rmb400 million to Rmb4 billion, mainly in the form of debt investment and industrial investment funds, covering highway and railway construction, shanty town reconstruction, indemnificatory housing, the medical establishment, aged care services and related areas. On average, investment contracts were signed for seven to ten years, with annualized interest rates between 7% and 9%.

3) **Ningbo**

- In May 2014, China Life Insurance signed a memorandum of understanding with the Ningbo government for a Rmb2 billion-debt-investment in an upgrade project of a local rail station. The investment period is seven years.

4) **Jiangxi**

- More than Rmb20 billion in insurance investment is close to being signed. In a guideline issued by local government in February this year, insurance investment was listed as the top capital source welcomed and encouraged by the government.
- Taikang Insurance has plans to invest Rmb10 billion in local major infrastructure projects and strategic emerging industries.

- The asset management firm of PICC also is planning a Rmb3 billion-investment for the city's metro.
- Pearl Life Insurance signed seven-year-debt investment plan with SPD Nanchang branch and Nanchang Water Investment (LGFV) at a value of Rmb1 billion.
- Pacific Insurance signed memorandum of understanding for a Rmb3 billion-debt investment with Jiangxi Provincial Water Conservancy Investment Group (LGFV).

5) Shandong

- Taishan Property & Casualty Insurance became partnered with Sunshine Asset Management and Sun Life Everbright Asset Management to invest Rmb5 billion in local infrastructure projects through issuance of universal life insurance products.

6) Shanghai

- Besides the investment from Changjiang Pension Insurance mentioned above, China Life Insurance, Guoshou Group, and China Life Property & Casualty Insurance together invested Rmb5 billion at the beginning of 2015.

7) Chongqing

- In 2015, the local government has started cooperation with Sunshine Insurance group.

Conclusion: Significant Increase in Insurance Investment in China's Infrastructure Could Lead to Systemic Risk

1) **Short-run:** In January 2015, the National Development and Reform Commission, China's planning board, approved nine infrastructure projects with a total investment of Rmb88.8 billion. Considering the infrastructure projects remaining from 2014 have an approximate value of Rmb1.6 trillion, the total scale of infrastructure investment in 2015 would exceed several trillion renminbi, which would require additional support from sectors such as the insurance industry. Thus, we believe insurance investments will accelerate in 2015 by at least 5ppt.

2) **Long-run:** Last year, the industry forecast that capital required for urbanization construction between 2014 and 2016 would exceed Rmb25 trillion based on the estimate of Rmb42 trillion for 2014-20 given in the new urbanization state plan released by central government in March, 2014. According to our interview with an official at the CIRC Policy Institute, insurance companies could provide Rmb60-80 trillion to urbanization

construction in next twenty years, among which Rmb24 trillion would be through direct investment. This is based on the following assumptions:

- First, the average year-on-year growth of the insurance fund balance in the next twenty years has to remain at 15% versus the past-five-year CAGR of 20.48%.
- Second, in order to reach targeted returns, 20% of the insurance fund will be invested in infrastructure and real estate investments. "We believe industrial investment funds established by insurance companies and LGFVs will be the long-term trend, especially preferred by local governments. The annualized interest rate will reach a level of 7-8ppt higher than the benchmark deposit rate," and insurance official noted.

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