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Subprime Crisis*

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MAKING PRIME USE OF SUBPRIME LENDING FOR CHINA

*Lessons from the U.S.
Subprime Crisis*

Mounting repayment problems from U.S. subprime mortgage lending and ever-increasing losses on securitized credit derivative products are leading to credit contraction, economic slowdown, and falling confidence in the risk-management capabilities of even leading financial institutions in the U.S. Beyond the debate about how China will be affected by the slowdown in the U.S. economy, it is critical to draw the right lessons from problems in the U.S. financial sector for the future development of financing in China. Only by doing so can Chinese financial institutions and regulators better meet the financing needs of Chinese individuals and companies and support the continued development of the Chinese economy.

The danger is that losses in the U.S. will lead to an aversion in China to subprime lending and securitization, on the basis that they are simply too risky. In fact, increased subprime lending—with the right focus—and the growth of securitization both have valuable roles to play in China’s continued growth. The challenge for Chinese financial institutions and regulators lies not in restraining the growth of subprime lending. Rather, it is to develop and implement the distinct business models that allow for profitable and sustainable subprime lending—including at some stage, securitization.

The Benefits of Subprime Lending

Let’s start by remembering what subprime lending really is and the benefits that it can bring. Subprime lending is simply lending to customers who have a higher risk profile than those customers who have normally been the target for bank lending. While recent U.S. problems started in the subprime mortgage sector, there has been extensive subprime consumer credit in personal loans and credit cards in the U.S., the U.K., and Japan. In the same way that “junk bonds” or high-yield debt opened up alternative financing routes to higher-risk companies, subprime lending makes financing available to individuals who have not previously

had access due to their risk levels. Reasons for this higher risk profile could include lower and more volatile income levels, less collateral, or previous repayment problems.

For the individual—either as a consumer or as a small business owner—the benefit of subprime lending is clear: access to financing where none was available before. In China, customers who would welcome and benefit from subprime lending abound. Many individuals, owner/operators, and small businesses find it hard to borrow money except through relatives and the underground financial system. In rural areas, access can be even more limited.

For the lending institution, the key is to ensure the interest charged reflects the higher risk that the customer may not be able to pay back the money. There are two ways to do this: either ensure the interest rate is high enough to cover the extra risk, or manage and monitor the customer relationship in ways that reduce the risk in line with the interest rate charged. Of course, institutions can also do both.

Remember, too, why securitization provides benefits. As the financial sector becomes ever more diverse, investors such as insurance companies, pension funds, and hedge funds have many different preferences for risk, return, and liquidity—and each has capital to invest. Banks have access to lending opportunities through their customer base—in the U.S. case, higher-risk individuals who want a mortgage to buy a property. By allowing the trading of these mortgage loans, institutional investors with capital to invest who value this mix of risk, return, and liquidity more than the banks will offer an attractive price to buy these loans from the bank. This trading reduces the cost of borrowing and

removes the need for the banks to keep capital for these loans.

In the U.S., however, problems with the underlying subprime loan assets were compounded by the ever-increasing complexity of securitized products and flaws in how the financial markets developed and were regulated. The benefit of securitization remains as long as it is done properly. And China's institutional investors are growing in sophistication, with capital to deploy in multiple investment sectors. Arguably, however, this is a lower priority for China's financial sector development, given both the substantial levels of capital in the Chinese banking system and the challenges in building the right market infrastructure to allow effective market functioning.

Making Prime Profits from Subprime

The problem with U.S. subprime lending was not that the customers were higher-risk; it was that banks did not assess, price, and manage this risk correctly. Similarly, in China, banks for the most part have not been able to develop the capabilities to do this well with higher-risk customers, though some of the leading rural credit co-operatives are now doing so. Nor have Chinese institutions historically set interest rates for higher-risk customers that fully reflect the risk—though this too is changing. As a result, those banks with exposure to higher-risk rural lending have been reducing their lending and have focused instead on fee-based businesses. Yet there are many examples in both emerging and developed markets of banks that do undertake subprime lending profitably and sustainably.

First, high-risk customers typically are willing to pay higher interest rates that reflect this risk as other sources of credit are not open to them. For example, Provident

Financial, a U.K. lender to 1.3 million low-income customers, charges interest rates on its credit cards that are around twice the level of rates for lower-risk customers. Similarly, the interest rates that successful microfinance lenders charge provide sufficient revenue to cover both the cost of defaulting customers and operating costs, while still leaving room for profit—typically in the range of 15 to 25 percent annually.

However, setting the right interest rate is not the main challenge. Contrary to what most people would imagine, many successful subprime lenders experience very low default rates, especially so-called micro-lenders who typically make loans of between RMB400 and RMB15,000. In effect, they convert subprime customers into prime or near-prime customers. For example, one Indonesian bank, Bank Rakyat Indonesia (BRI), manages to achieve default rates of less than 1 percent with low-income customers served from its 4,000 mini-branches across all of Indonesia. Its default rates on corporate lending have been substantially higher. In India, SKS Microfinance now serves 1.7 million customers in 20,000 villages across 15 states and makes provisions for loan losses of 2 percent. In fact, actual losses are typically lower. Similar institutions are starting to do business in China with similar results.

This translates into profits, and private-sector investors believe these profits are sustainable. SKS Microfinance is backed by U.S. venture capital fund Sequoia Capital. BRI listed successfully on the Jakarta Stock Exchange in 2003. This is indeed very different from the experience of many Chinese banks, especially those that have extended personal credit in rural areas. How is this possible? How can subprime customers become prime?

In fact, the likelihood that a customer will repay—that customer’s riskiness—is not fixed. It can be managed and improved by the way in which the bank operates, based on the bank’s chosen business model. Our analysis has identified that more than 70 percent of loans go bad as a result of the way the customer relationship is managed after the loan decision has been made. Effective risk management, therefore, means paying close attention to the customer relationship from the time the loan is granted all the way through until it is repaid. Unfortunately, in the U.S. subprime situation, many mortgage lenders operated differently—and did not invest sufficient resources and effort in managing the customer relationship to reduce risks. In an interesting move from East to West, however, Grameen Bank, the Bangladeshi micro-lender whose founder, Muhammad Yunus, won the 2006 Nobel Peace Prize, has just opened up for business in New York. Grameen will offer loans to immigrant workers. The bank believes it can bring what is needed to lend successfully in the subprime market, in the U.S. or anywhere—a distinct business model.

The business model for successful subprime lending has five mutually reinforcing elements. First, and critically, subprime lenders need to set the right *focus* for their lending to ensure that customers have the fundamental capacity to repay the loan. Second, the right *process* needs to be in place to manage the customer relationship from initial application through repayment, including any collection activities required if customers hit repayment difficulties. Third, the right *information* needs to be available to assess risk and determine the appropriate actions—for example, setting the right interest rate on the loan to account for risk and acting early when signs of repayment problems occur. Fourth, the

incentives of the people involved throughout the lending process need to be consistent with achieving sustainable risk-adjusted profits. And finally, *regulation* needs to be appropriate to both ensure customer protection and maintain prudent yet competitive management of financial institutions. Chinese banks that develop their own unique blend of these five elements in their business model will build the base for long-term profits and serve customers in need of financing.

Focus: Successful subprime lending starts from a clear understanding of the economic basis for future repayment. This can come from a variety of sources. Payroll loans advance money for a short time period against the future paycheck; essentially, they are cash-flow financing. Most micro-lenders lend to small businesses or owner/operators who will use the money to invest in a business that generates a return—out of which the loan can be repaid. An example is the financing of mobile phone purchases in the poorest Indian villages to people who then “rent” use of the phone to others to make calls. Consumer loans to buy goods such as washing machines will need to be repaid out of discretionary income, so the bank’s “competitor” for the money to repay the loan may be the temptation to spend the money on an evening in a bar.

Subprime mortgage lending in the U.S. did not always have such a clear focus about how future repayments would be made, especially as interest repayments increased. Since buying a house does not increase an individual’s income, repayment must either come from rising wages as a person’s career progresses—or through continued real estate price increases. But this was often too uncertain a basis given the size of the mortgages that were extended. Similarly, the greatest value in

China will likely come from extending loans to higher-risk individuals to finance fledgling businesses or to tide over short-term cash-flow difficulties. Broadening real-estate lending in the way that the U.S. has done does not appear to be an attractive path.

Process: After setting the focus, successful subprime lenders design their business processes to manage and reduce risks systematically. Regular—typically weekly—face-to-face contact with customers to collect weekly repayments are a frequent feature of the customer relationship. For example, Provident Financial in the U.K. employs 12,000 agents who meet each of its 1.3 million customers every week in their homes. Face-to-face contact makes the relationship more personal, thereby making it harder for customers to “forget” about paying. It also allows bank agents to sense repayment problems at an early stage through body language and casual observation. Moreover, by visiting every week, the repayment amount each time remains small and manageable. Similarly, when rural banks lend on a group basis (i.e., a group of people act as cross-guarantors for a loan to an individual), they typically specify weekly repayments. This means the amount is small and—in the event of problems—the group can more easily raise the funds to help out an individual borrower in trouble. Chinese banks too need to redesign their processes to keep risks firmly under control as they expand lending to higher-risk customers.

Information: Gathering objective, quantitative, and analytical data is usually seen as the starting point in assessing credit risk. This is the underpinning of the way most consumer lending decisions are made in the U.S. and other developed economies. However, the acquisition of this information and the continued development of comput-

ing power, automated consumer score cards, and the mathematics of risk management can lead to the neglect of qualitative information in key situations. In the U.S. subprime market, this led to an overreliance on quantitative analysis without sufficient questioning of how reliable the analysis was when applied to the mortgage market.

In China—and indeed, in the lower-income segments of the U.S. and the U.K.—this quantitative, reliable data simply does not exist. What is really needed is any information that can predict both ability and willingness to repay. This often comes down to individual character and trustworthiness and can be influenced by peer pressure and the surrounding community. This can be hard to quantify. The face-to-face customer-management process provides valuable clues about a customer's potential problems. Building trusted relationships with key individuals in small rural communities often provides a strong, rapid assessment of the character of individuals and their creditworthiness.

Incentives: To ensure that customer agents are on the lookout for the right information and that they put in the required effort for customer management, banks must reward the right behavior. Bonus and commission incentives are effective management tools for motivating strong performance. Their very purpose is to influence how employees behave. It stands to reason, then, that the commissions on new mortgage sales that mortgage brokers received in the U.S. laid the basis for aggressive selling to customers without spending the time to truly assess risk in each case.

By contrast, Provident Financial pays its 12,000 agents only on the loans that they collect—not on the loans that they make. This has an understandable impact on agents'

priorities in choosing which customers to lend to and in ensuring they spend time on collecting repayments from customers. Chinese banks need to make prudent use of incentives and ensure they are rewarding profitable behavior.

Regulation: The final element in the business model is the role of regulation. Regulators play a critical role both in protecting consumer interests and in providing the foundation for profitable business.

Some commentators argue that subprime lenders exploit the lack of financing choices that their customers face by charging interest rates that are too high, or that customers are not aware of the loan burden that they are taking on, and that therefore, such lending should be restricted.

To start with, the regulator needs to ensure that the market is competitive: in other words, that the high interest rates do not reflect a monopoly position. If competition is indeed open, then market principles would point to allowing customers to decide for themselves whether or not to take out a loan. What is most important, then, is education for customers to make sure they understand the price that they are paying and critical loan conditions. Finally, the regulator needs to be alert to the ways in which banks seek repayment of loans. There have been instances of overly aggressive and threatening collection agents in countries around the world, especially where these activities have been outsourced by the banks to collection agencies acting on a commission basis. Close supervision will be important in China too.

In the past, though, banks in China have faced a different challenge—where again the regulator could offer support. Interest rates have

typically not been high enough to offset the increased risk of lending to subprime customers. If banks are allowed to pursue objectives other than profit, then they can continue with these loans. This prevents profit-oriented banks from developing the distinct capabilities required and then earning a profit.

The Role of Securitization

Successful securitization of subprime assets rests on the same elements of focus, process, information, incentives, and regulation as the initial lending. The U.S. has also encountered many challenges in getting these elements right. Given this, and the relative underdevelopment of securitization more generally in China, securitization of subprime assets does not seem a natural focus for immediate development in China. A look at the challenges found in the U.S. highlights why.

First, the sale of loan books in the U.S. to other investors undermined both the process and incentives for the originating banks to monitor and manage the customer relationship and keep risks down. It arguably weakened the pressure on senior bank management to ensure that the loans that commission-driven sales forces were selling really did have acceptable risks. After all, some other institution would be soon be holding the risk instead.

Second, there was a breakdown of information throughout the markets as bonds were given AAA ratings and yet subsequently experienced high default rates. Rating agencies such as Standard & Poor's and Moody's are not immune to the influence of incentives either. Since they are paid for ratings by the issuer, their customers are typically happier when a more favorable rating is given to an issue. Of course, any weakening in objectivity threatens the longer-term reputation of ratings agencies and of the

ratings itself. This is the situation the agencies now face in the U.S.

Finally and critically, once loans are traded between institutions as securities, the question of appropriate incentives, process, and information becomes a question of market design. Since many different institutions are involved, it is harder for all the pieces to come together in the right way without the guiding hand of the regulator. Rapid financial innovation has also made it hard for the regulator to have a comprehensive overview of what risks are held where. This knowledge is critical to the core regulatory task of managing financial sector stability. In fact, many of the new credit derivative products were so complex that many in even the leading investment banks did not fully understand them. The regulators needed to run even faster to catch up and understand what it was that they were regulating.

In China, this would imply a broader role for the regulator—or indeed, regulators in the plural, since securitization typically leads to the risks being held by the full range of banks, insurers, securities firms, pension funds, and others such as hedge funds. China Banking Regulatory Commission (CBRC), China Insurance Regulatory Commission (CIRC) and China Securities Regulatory Commission (CSRC) would all have roles regarding institutions involved in the future development of securitization. This highlights the need for close co-ordination in the current regulatory structure. It also increases the benefits of future integration into a sole financial regulator. And finally, it would ensure that the capabilities of the regulators keep pace with product innovation in China's capital markets.

Implications for Chinese Financial Institutions and Regulators

Chinese consumers and businesses can benefit from a sustained expansion of subprime lending. This can initially take place through balance sheet lending rather than securitization—although securitization will have a valuable role to play as China's capital markets develop in depth, scale, and capability.

However, successful expansion of subprime lending requires careful design and oversight by regulators and senior management of financial institutions alike. Success will rest on five mutually reinforcing pillars:

- A clear focus that ensures loans are made to individuals and small enterprises with an economic basis for repayment;
- Well-defined processes to manage credit risk from initial approval through successful collection in a coherent and mutually consistent way;
- The rigorous use of both quantitative and qualitative information to assess risk and also spot problems early;
- Organizational and individual incentives throughout the process that ensure a consistent focus on profit, not lending volume; and
- An active role for the regulator in protecting and educating customers while maintaining the basis for profitable lending.

For financial institutions that are seeking to capture the substantial opportunities in subprime lending, the priority must be to set a clear focus on customer groups that have the underlying ability to repay, even if they face difficulties in accessing credit today. They must then put in place distinct business models ahead of rapid expansion of lending. This means a detailed definition of the lending and repayment process from the very first

customer contact until a loan is repaid successfully—and then the successful implementation of this process into daily activities by loan officers and relationship managers. It means capturing information—both quantitative and judgment-based—to improve risk assessment and the early identification of problems. Critically, it will require carefully setting incentives that motivate high performance by bank employees in a way that leads to sustainable profitability. And finally, it will require engagement with regulators to demonstrate that capabilities are in place and risks are being managed; to demonstrate that pricing and collection practices are fair and in line with a competitive market; and to ensure that other competitors are acting consistently with the long-term development of profitable business.

For regulators, the priorities are different, but consistent. First, they need to assess and guide the capability development of lending institutions to ensure solid foundations for subprime lending businesses and an appropriate customer focus. They also need to support customer education and set disclosure standards to ensure that customers understand the conditions attached to the loans that they are taking out—and then to protect customers by ensuring appropriate collection practices. Finally, they need to ascertain that lending can indeed be profitable by encouraging loan pricing based on risk rather than standard pricing with potential subsidies from state-owned lenders.

With these pieces in place, China can make full use of subprime lending to further economic growth, satisfy customer needs, and generate new profitable business lines for banks, regardless of developments in the U.S.

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