

China's Financial Circles: Banks, Borrowers and the National Budget

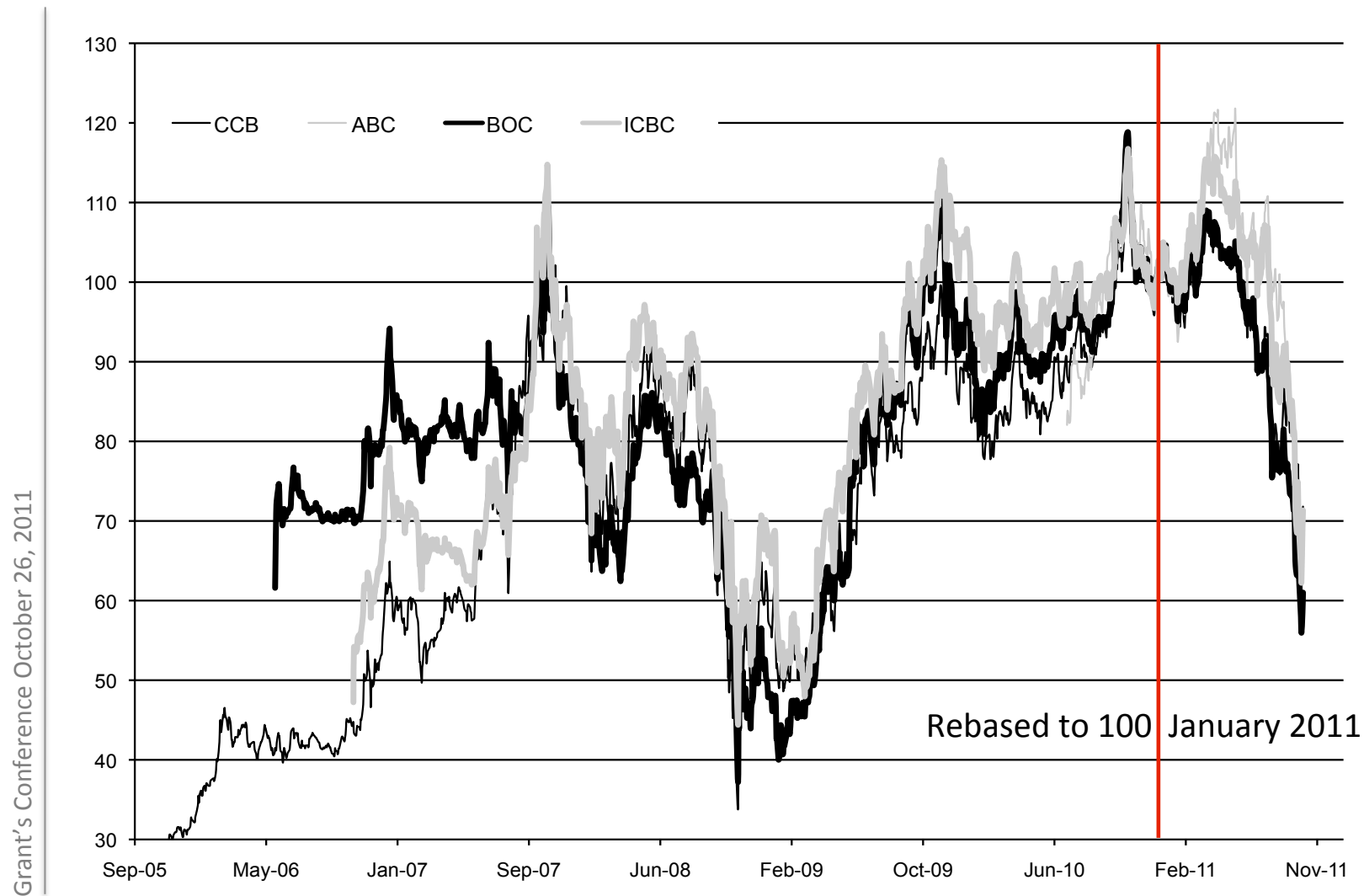
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Grant's Conference

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The Plaza
New York

What doesn't the market know about China's banks?



Source: Bloomberg; Chinese bank H-shares

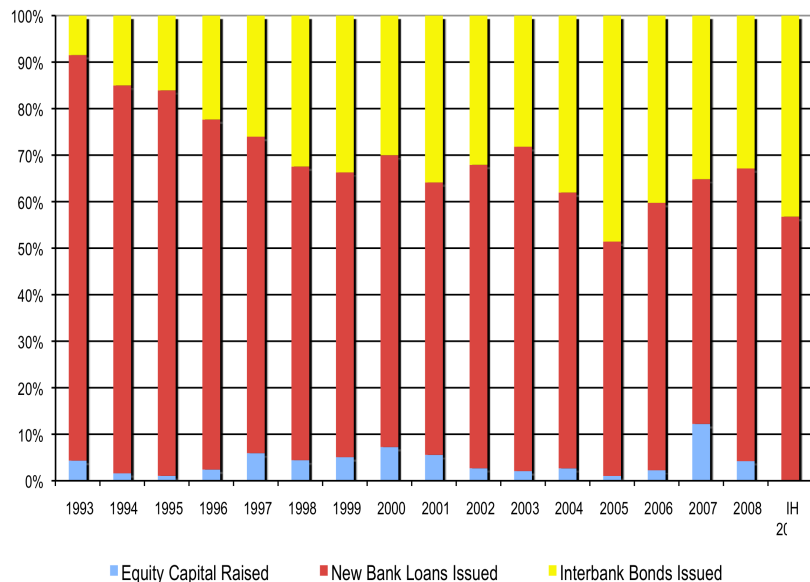
Outline of remarks

- The challenge - enthusiastic, innovative and excessive credit creation
- The solutions – look to the past
- The problem – China's banks are part of the national budget

Part 1: The problem

Banks *are* China's financial system

Corporate capital raised in Chinese markets



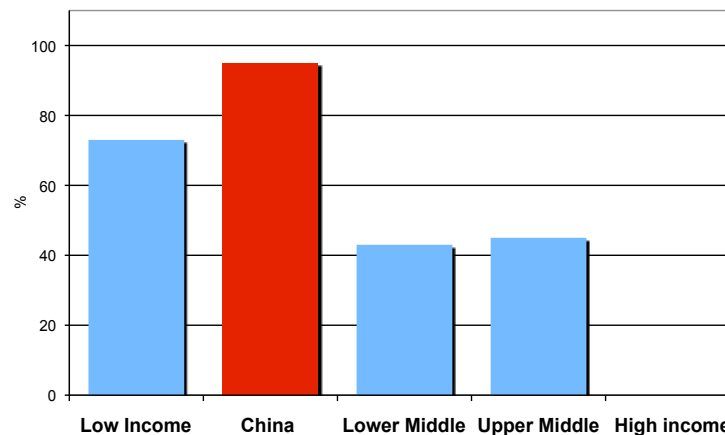
Source: PBOC

The State controls all banks outright

Foreign holdings of Chinese financial assets = < 2%

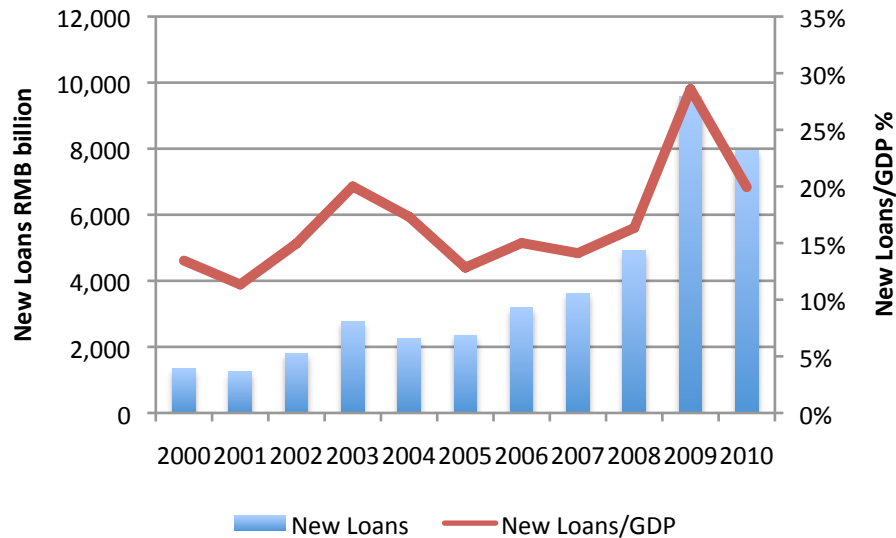
Banks account for over 90% of corporate finance

Equity capital is about power not financing



State controlled commercial bank assets as % of total commercial bank assets

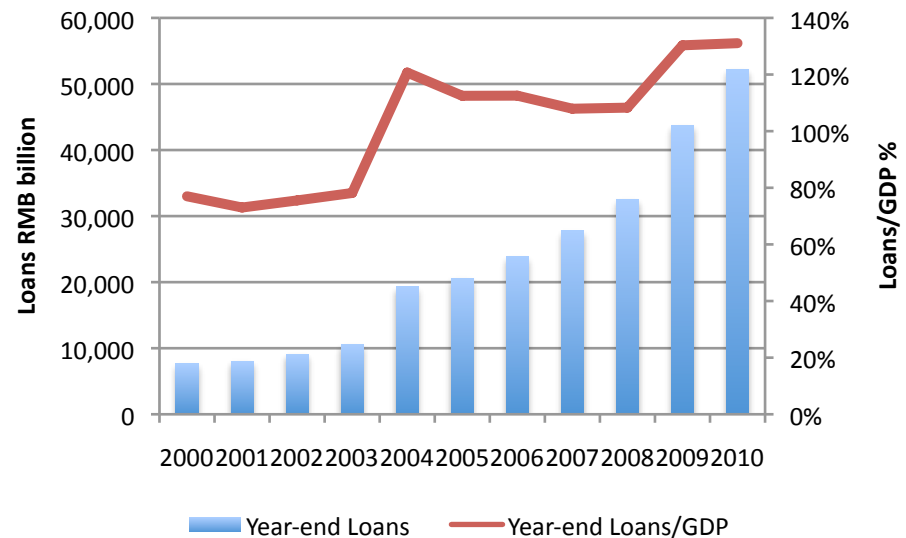
Banks executed China's response to the global financial crisis ...



New bank loans reached nearly 30% of GDP in 2009 then seem to be brought under control in 2010

Source: PBOC

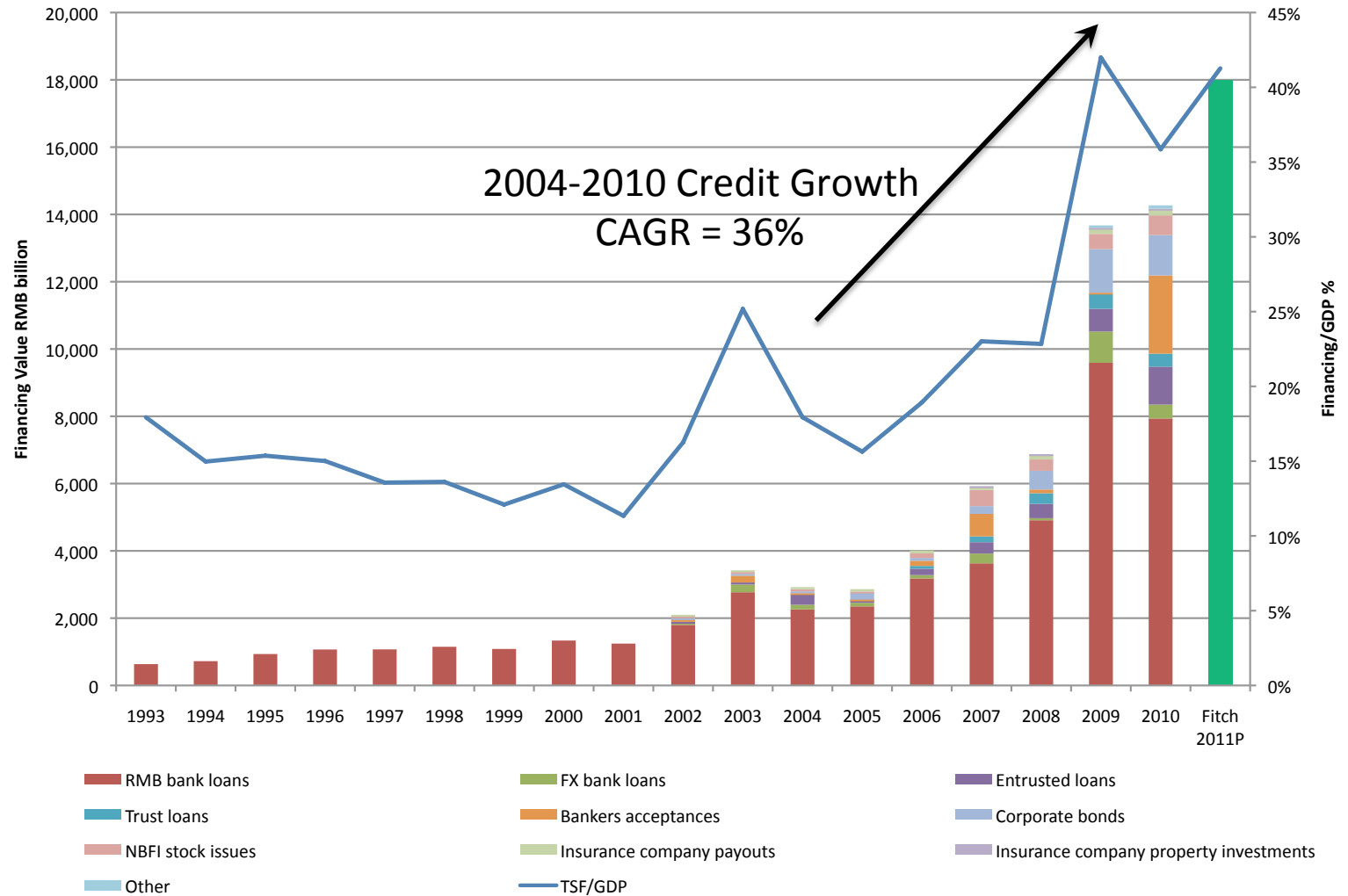
Total outstanding bank loans reached 131% of GDP in 2010



Source: PBOC

... but credit is more than a product called “bank loans” ...

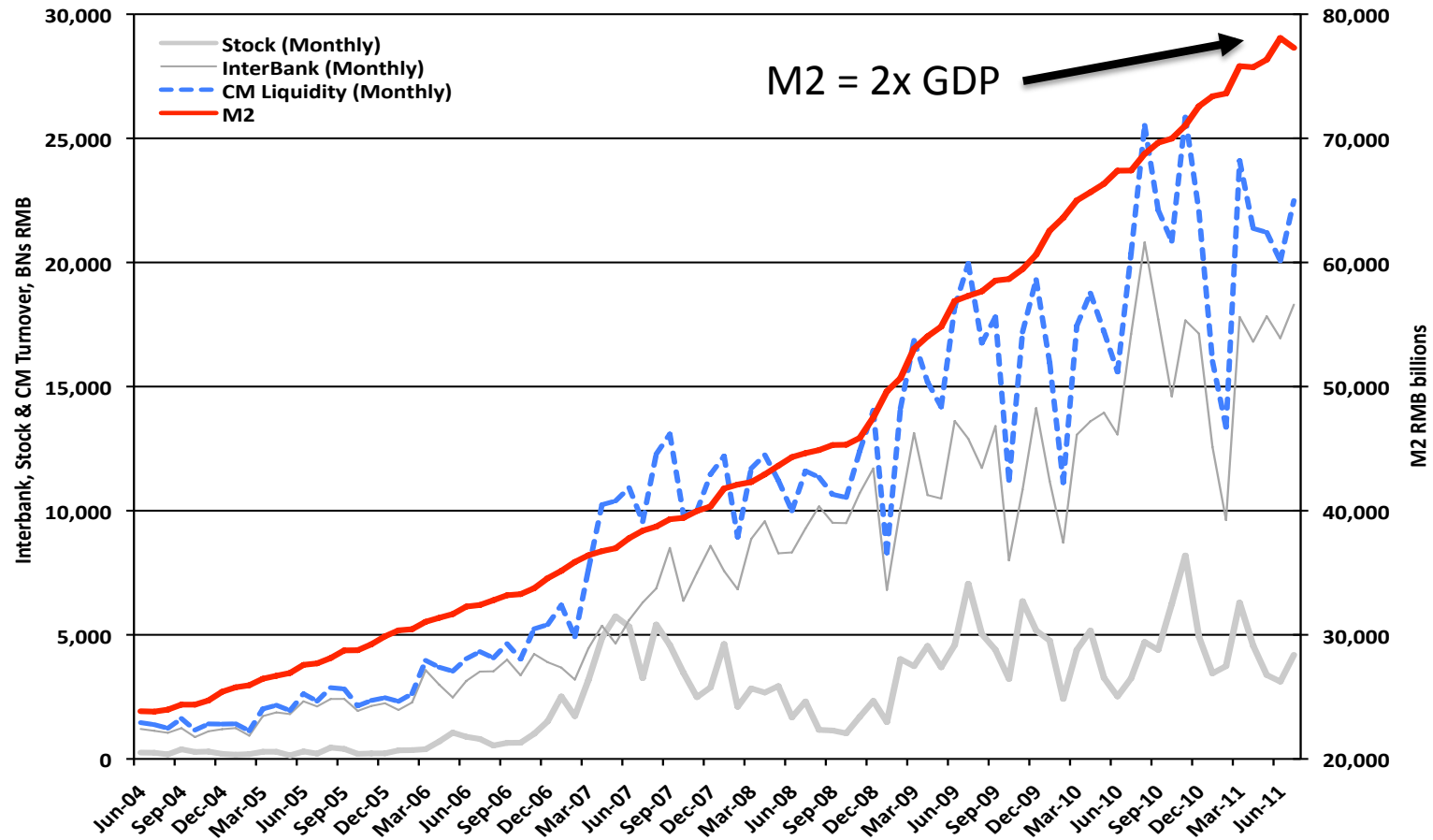
Total lending credit, 1993 – 2011P



Source: PBOC/Wind Information; Fitch

... and it becomes liquidity

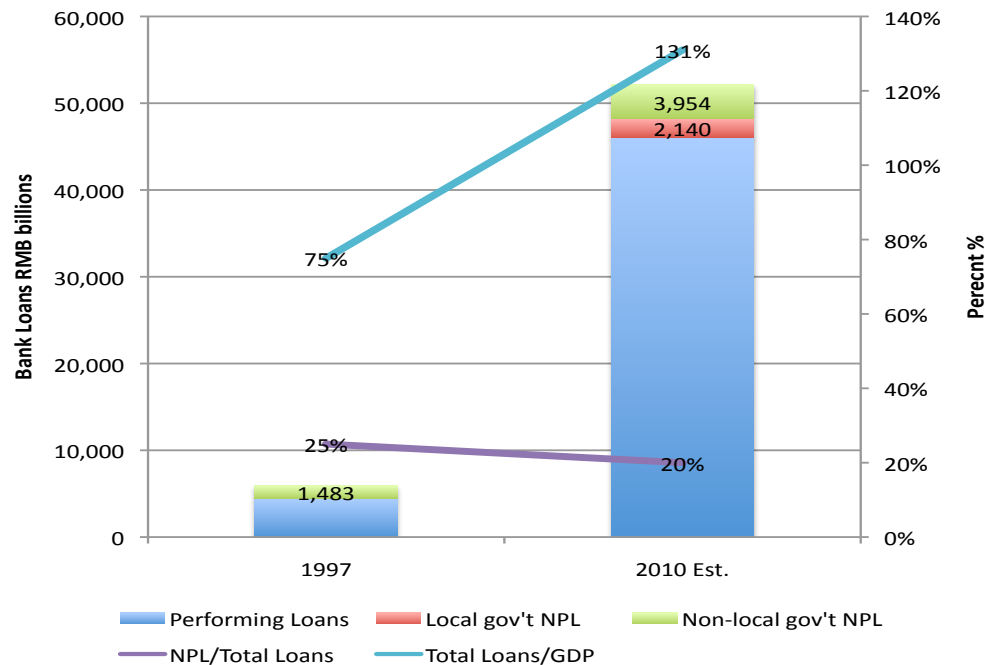
M2 and Capital Markets Turnover, June 2004-June 2011



Source: Wind Information

Part 2: The solutions

Bad loans now and then



Source: 1997: historical data; 2010 estimate based on National Audit Office, PBOC total social finance data

1999-2005 around RMB3 trillion in bad loans were moved off bank balance sheets on a GDP sized about RMB 13.5 trillion

2009-2011 assume RMB6 trillion in bad loans on a GDP sized about RMB36.6 trillion and total bank capital of RMB2.2 trillion

China's banking system

Central Government

Postal Savings Bank

5 large state-owned banks

3 policy banks

Provincial Governments

12 medium-sized state-owned banks

63 trust and investment cos.

Local Governments

147 city commercial banks

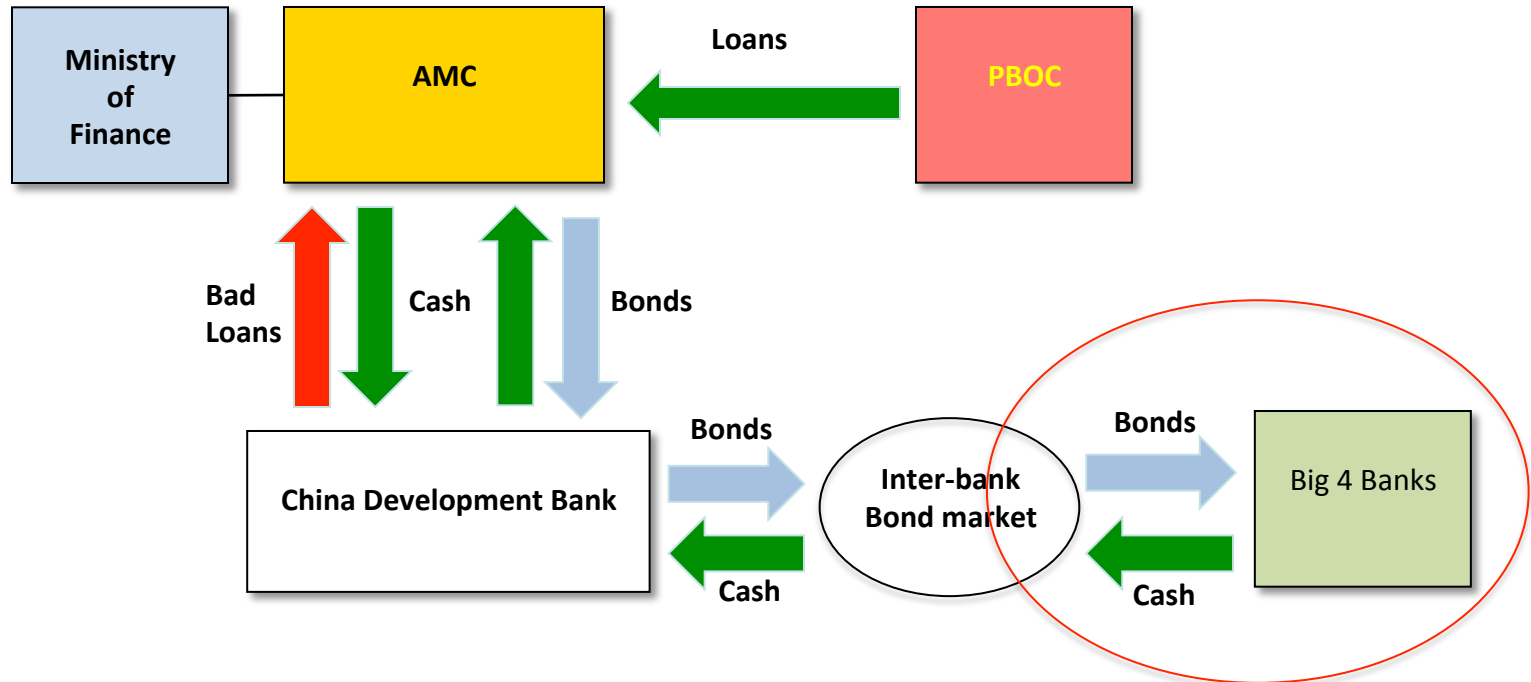
85 rural commercial banks

XXXX? guarantee companies

223 rural cooperative banks

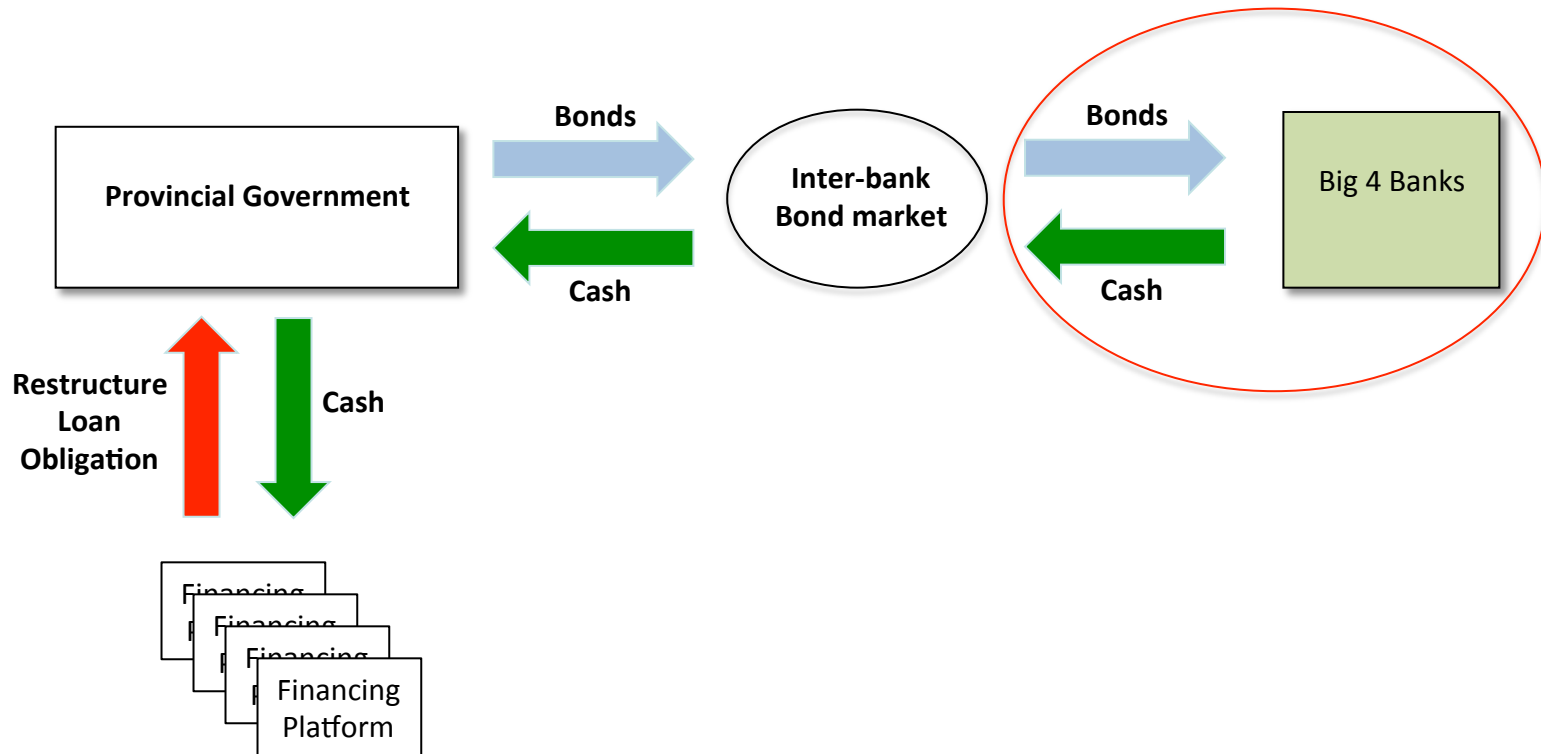
- 3,769 financial entities, 196,000 outlets, 3,000,000 staff
- Provincial bank General Managers are appointed by the local Party

1. Asset Management Company put to use again for certain banks



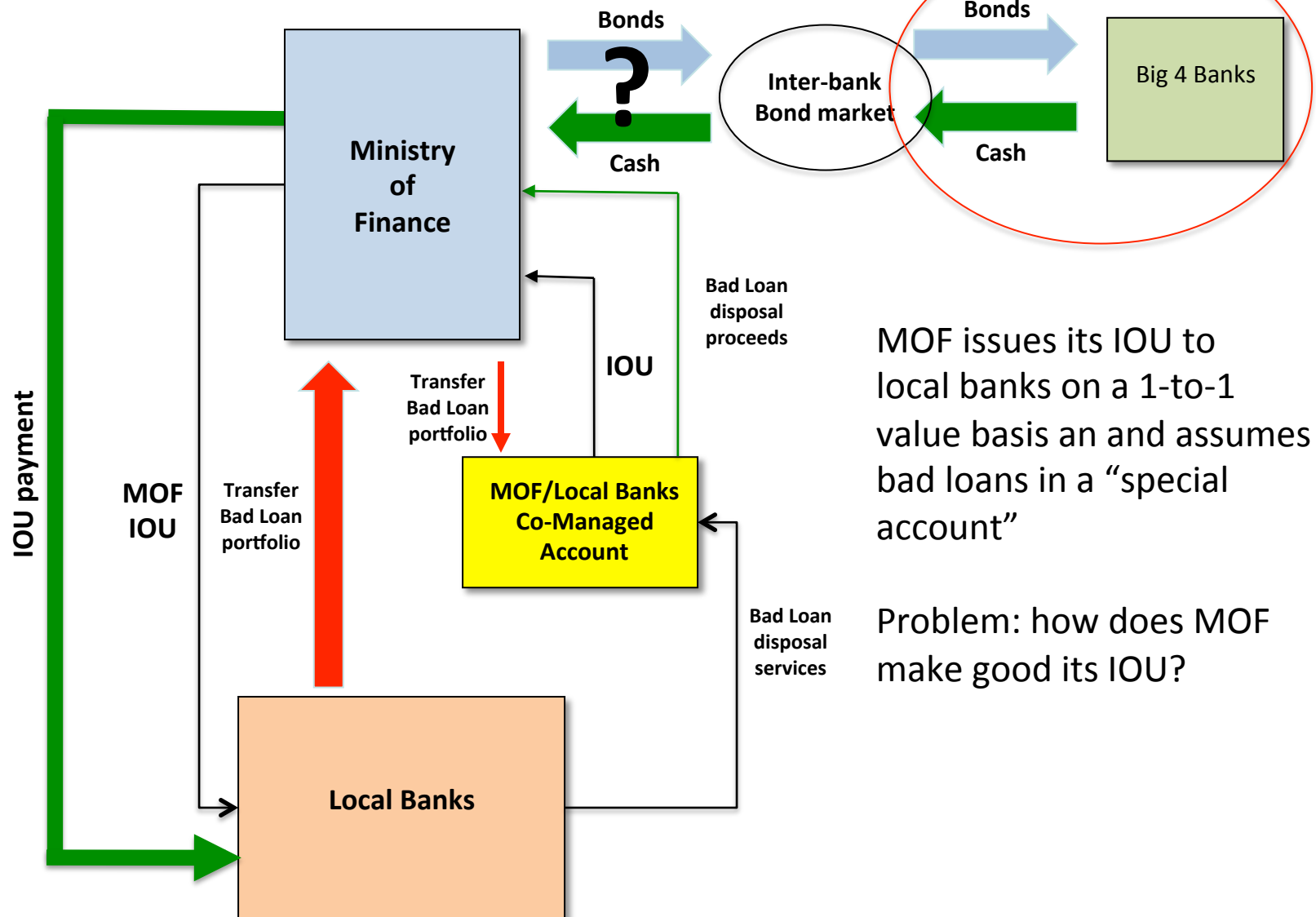
Loans removed from CDB balance sheet on 1-to-1 basis funded by loans from PBOC and the Big 4 Banks.

2. Provincial governments issue bonds alleviating local government pressure



Provinces refinance short term local debt via long term bond issues

3. Ministry of Finance aggregates obligations from weak provinces

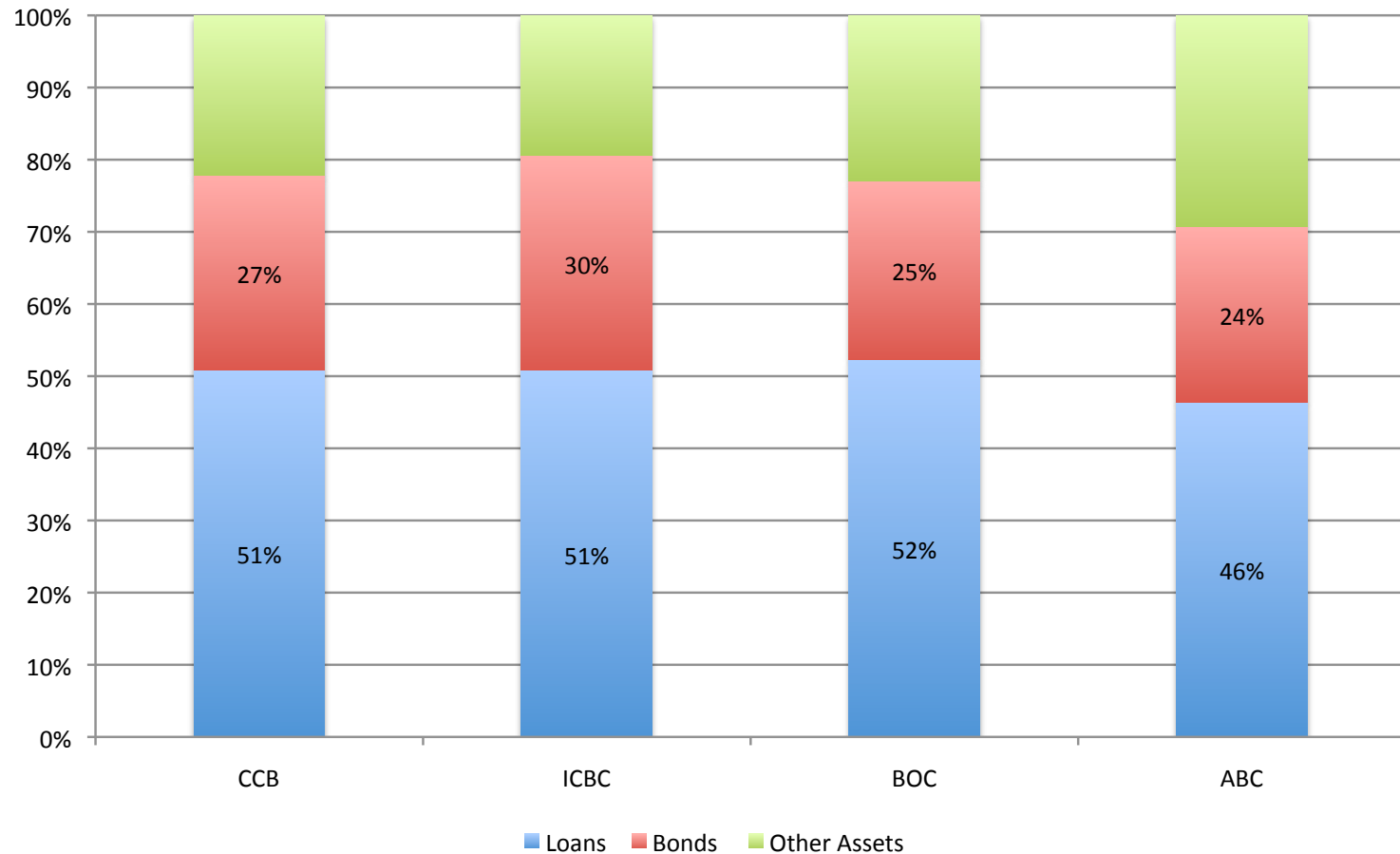


MOF issues its IOU to local banks on a 1-to-1 value basis and assumes bad loans in a "special account"

Problem: how does MOF make good its IOU?

4. Big 4 Banks buy and hold MOF, Corporate, AMC and Provincial Debt

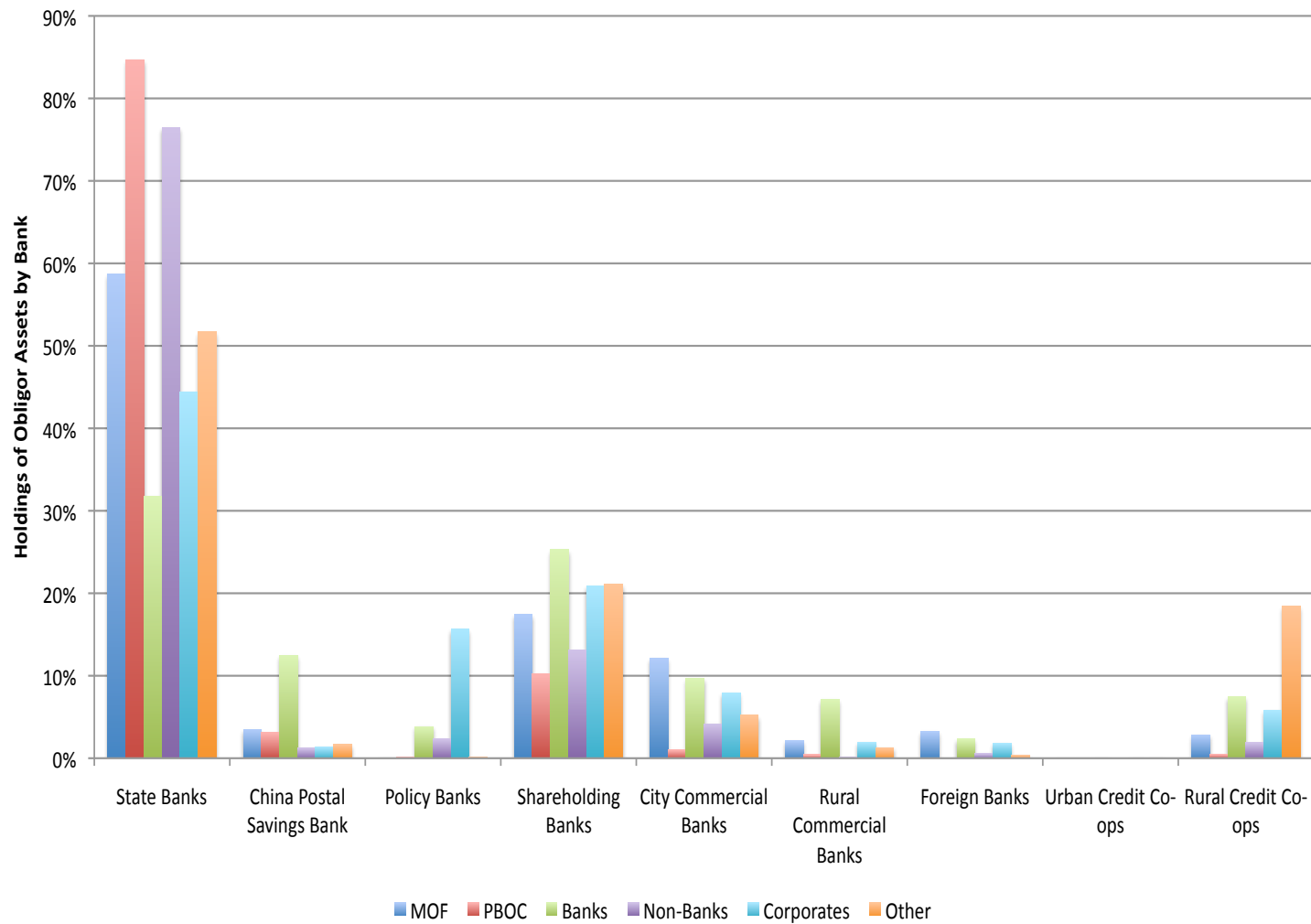
The Big 4 bond portfolios as % of total assets



Source: Bank H-share financial statements, FY2010

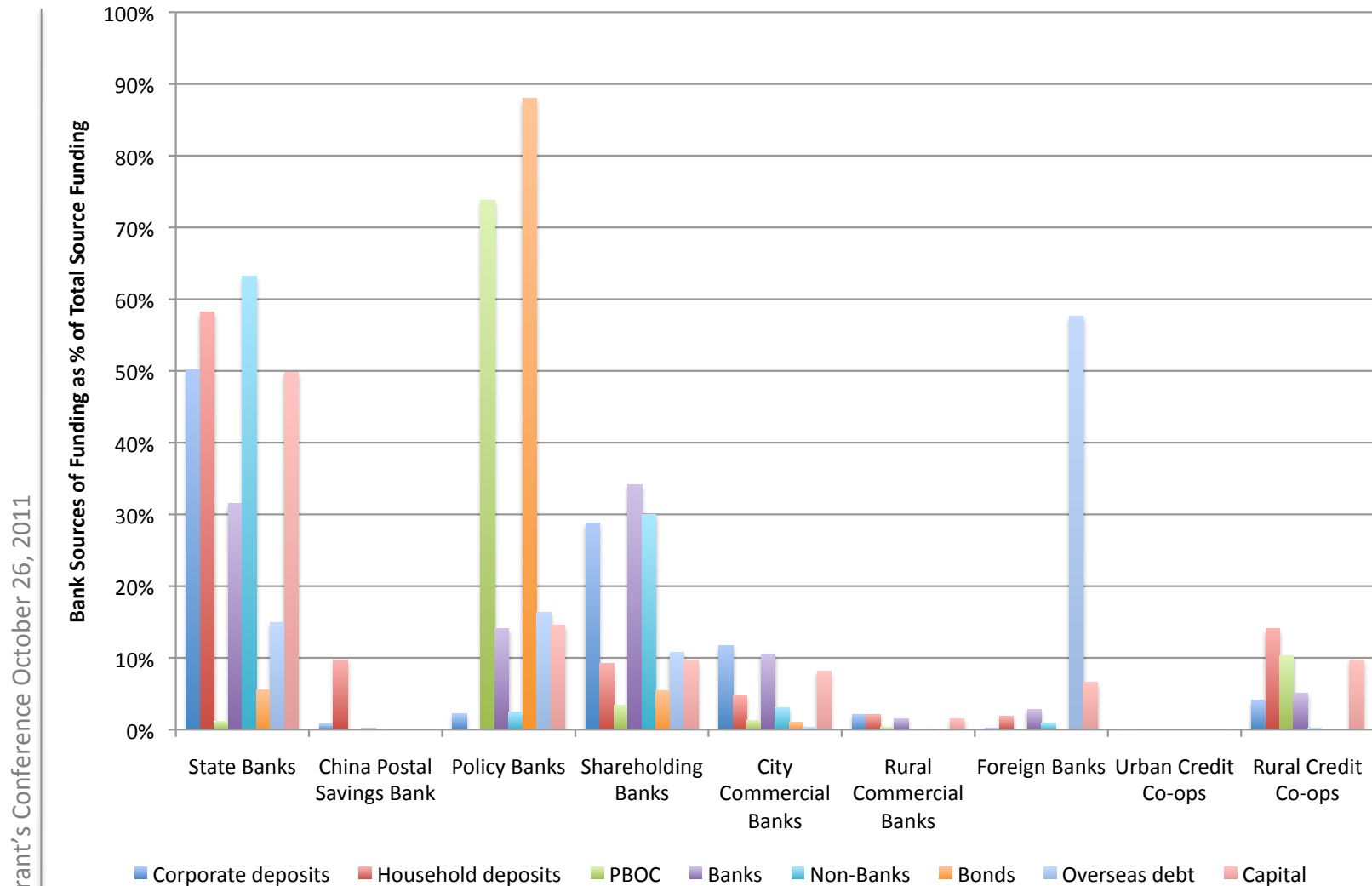
4. the Big 4 hold all the bonds ...

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Source: PBOC; as of FY2010

4. ... because the Big 4 have the funding



4. Yields on investment securities portfolios

Yields on loans, investment and restructuring bonds, 2008-2010

	2008			2009			2010		
	Loans	Bonds	AMC/MOF Bonds	Loans	Bonds	AMC/MOF bonds	Loans	Bonds	AMC/MOF Bonds
CCB	7.16	3.64*	2.01	5.35	3.11*	2.13	5.07	2.83*	2.25
BOC	6.12	3.63*	2.1	4.44	2.73*	2.25	5.07	2.78*	2.25
ICBC	7.07	3.88	2.23	5.21	3.38	2.19	4.99	3.07	2.16
ABC	NA	NA	NA	5.25	2.98	3.18	5.22	3.01	3.15

Source: Bank financial statements

Note: * CCB and BOC bond rates are calculated on portfolios that include the restructuring securities, hence, returns are less; ICBC rates separately calculated.

Investment securities are held to maturity and are not marked to market

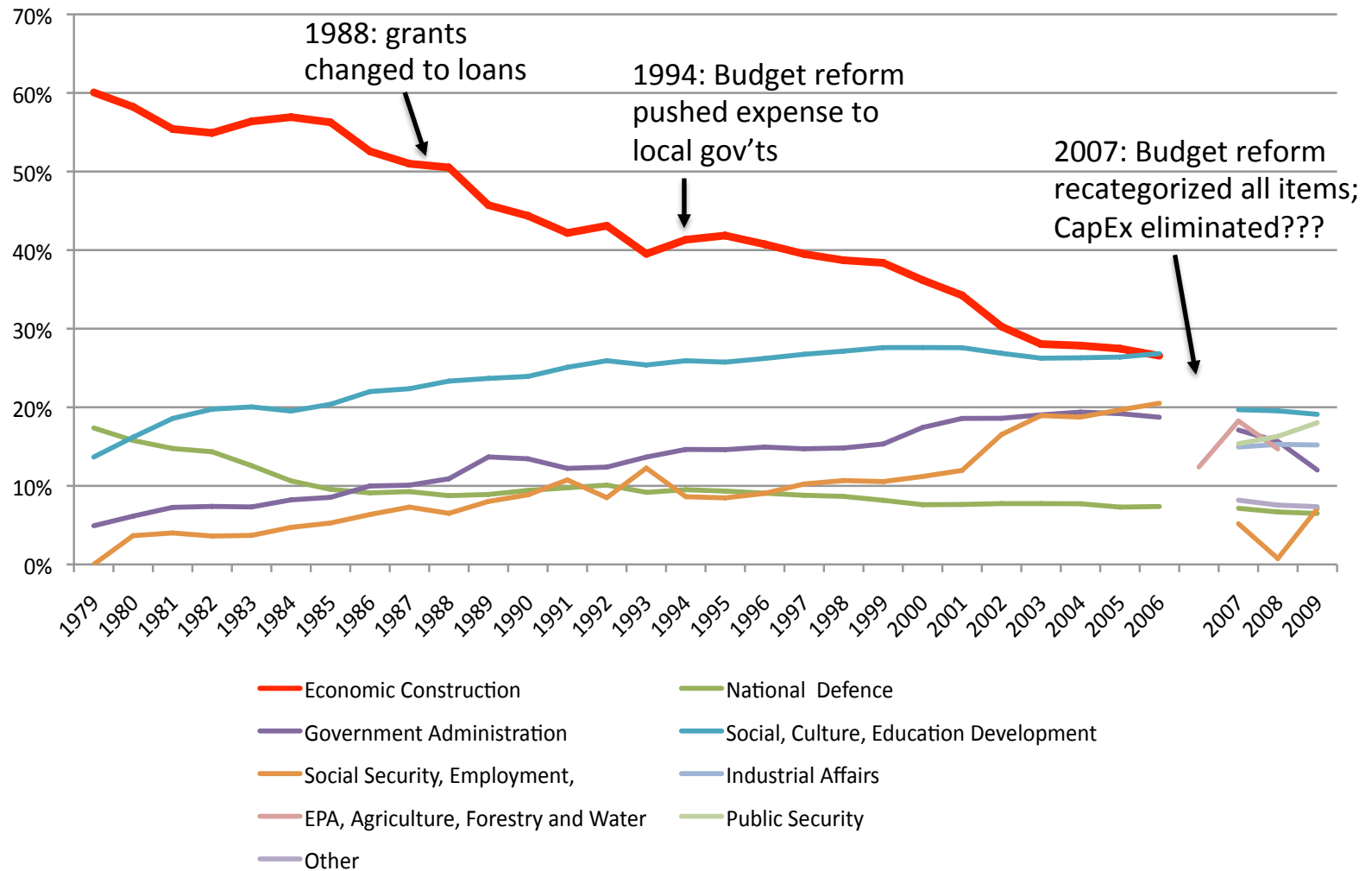
5. Other means

- In first half of 2011 the banking regulator sent works teams to all provinces and “restructured” RMB2 trillion of local government loans, extending maturities and redefining the loans as “corporate,” thereby freeing bank risk capital.
- Banks can simply roll over local debt and extend maturities
- Trust companies can continue to package local debt as long as banks make a true sale

Part 3: The problem

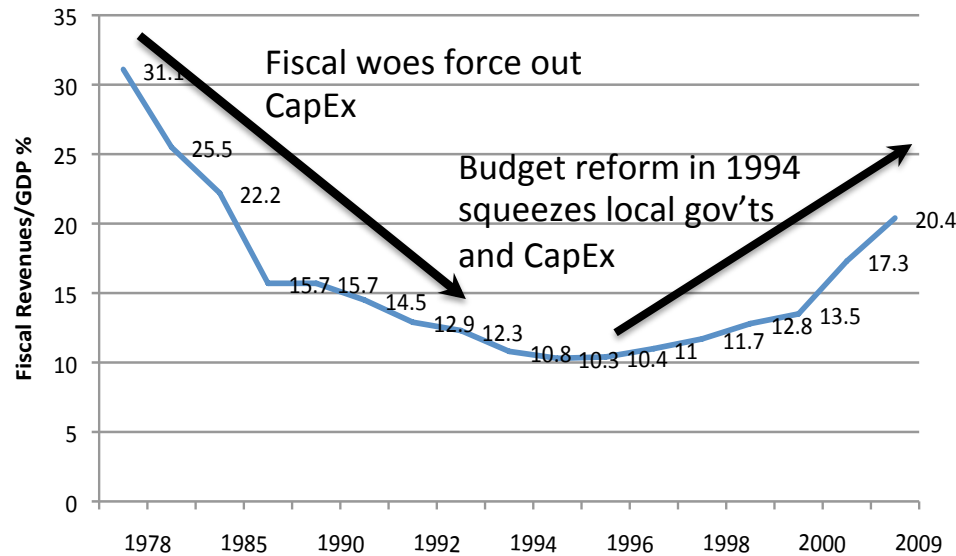
Commercial banks, policy lending and the National Budget

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Source: Wind Information

Scope of National Budget narrowed as revenue difficulties increased



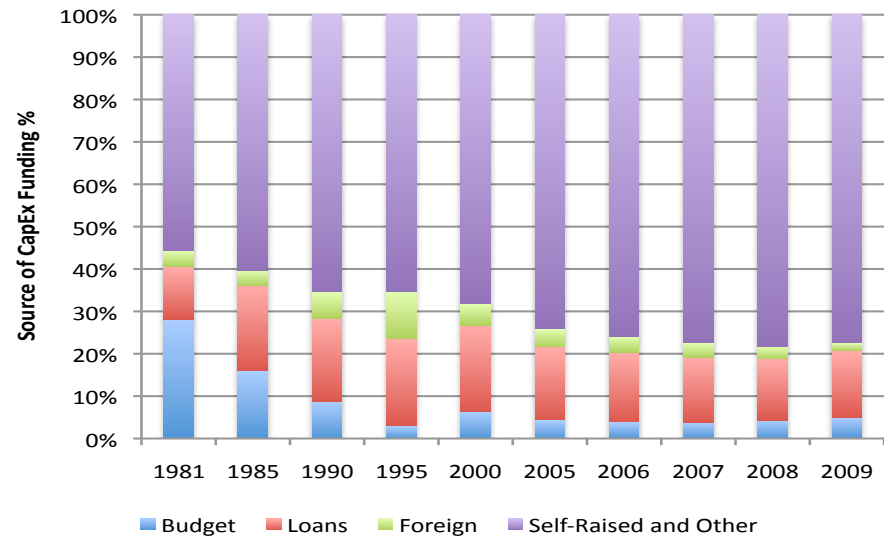
Source: China Statistical Yearbook

Fiscal problems resolved in favor of Beijing by squeezing local gov'ts and CapEx

This is why China's sovereign debt = 20% of GDP

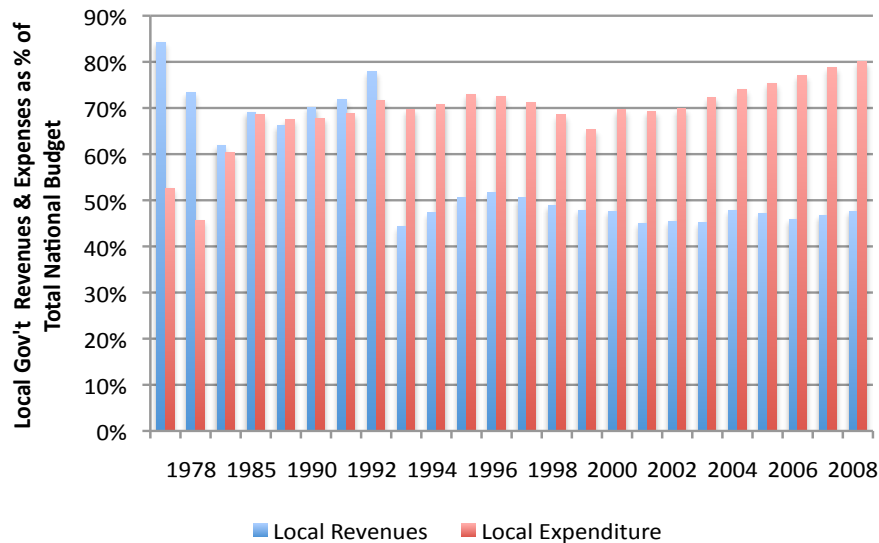
With minimal budget contribution SOEs and local governments are forced to rely on bank loans and self-raised funds. i.e., real estate

Local banks can be willing captives of local governments



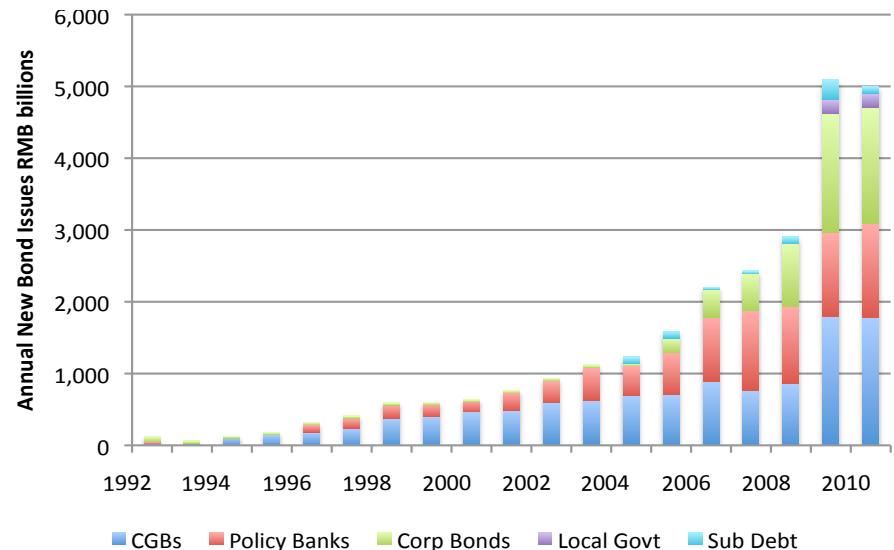
Source: China Statistical Yearbook

Scope of National Budget narrowed ...



Source: China Statistical Yearbook

And “quasi” government bond issuance by policy banks and SOEs explode ... onto bank balance sheets

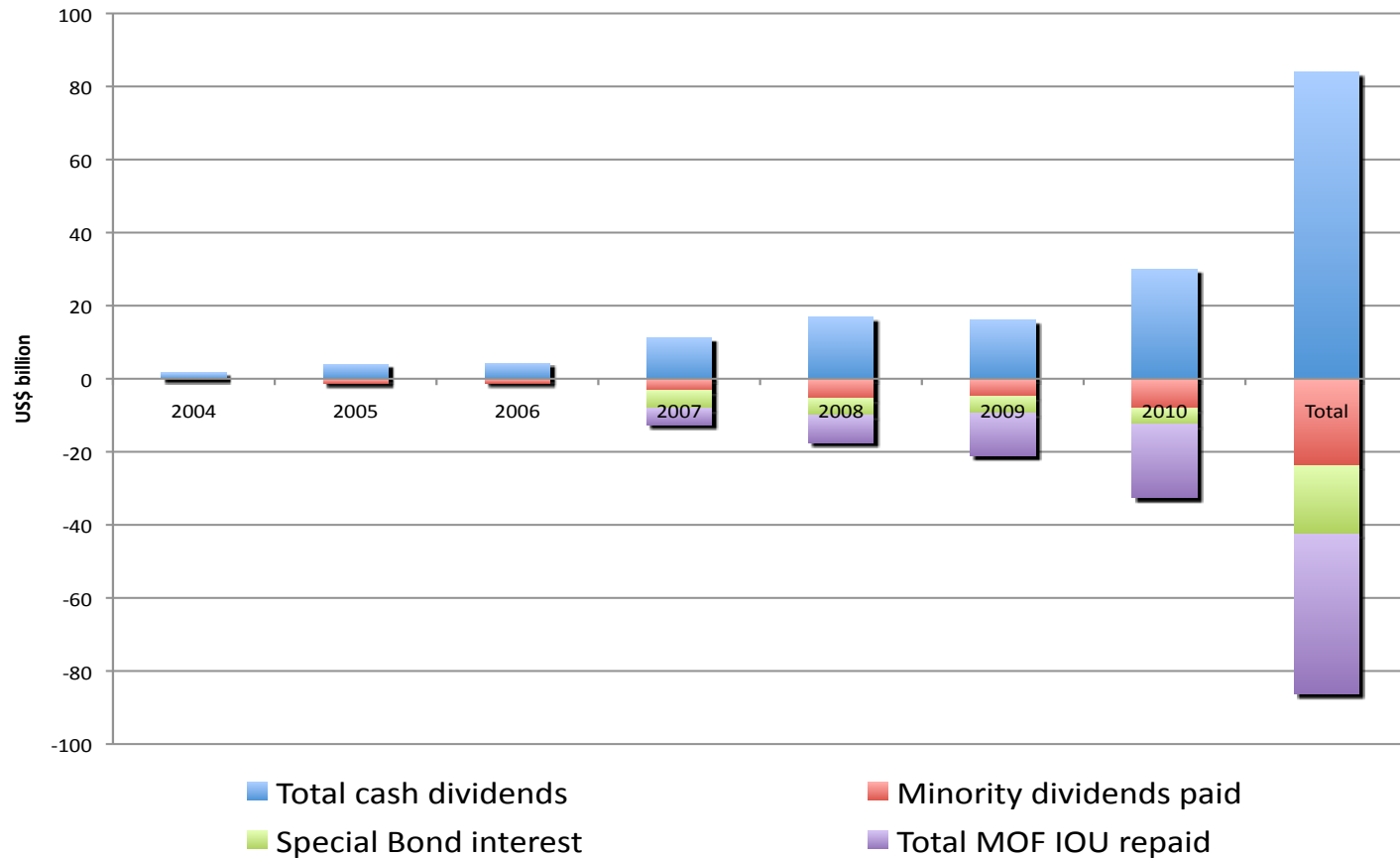


Source: PBOC

To sum up: the financial cycle in China

- Taxation capacity conflicts with desire for rapid economic growth
 - pushes capital expenditures out of national budget and onto SOEs and the banks
- Budget reform in 1994 squeezes tax base of local governments
 - personnel appointment authority plus bank profit motive align local and bank interests
- Internationalization of major banks requires compliance with international asset quality standards
 - bonds placed in investment accounts and held to maturity
 - problem loans moved off onto AMC balance sheet or into MOF contingent liabilities or “special accounts”
- Weak taxation capacity forces MOF contingent obligations to be repaid largely by bank dividends and not by bond issues included in the National Budget: sovereign debt seems not to increase

The Big 4 banks: from 2004-2010 paid **US\$84 billion in cash dividends**



Source: bank H-share annual reports for the Big 4 banks

The four banks raised **US\$106 billion in IPO proceeds =**
ABC 2010 IPO of US\$22 billion + US\$84 billion in cash dividends

Major Chinese banks face a financing gap of up to RMB500 billion: former senior PBOC official, August 2011

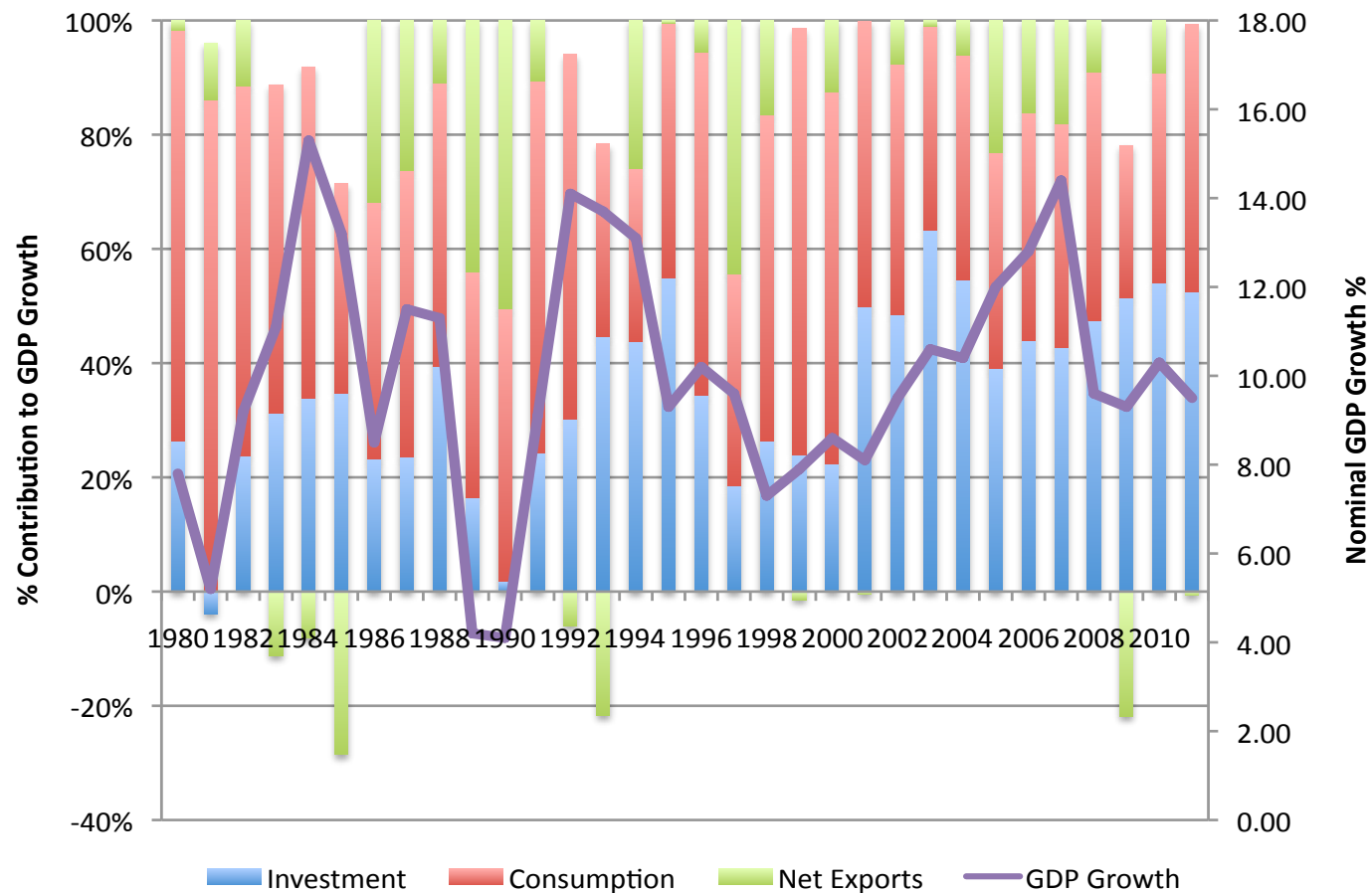


Trends in Core Capital Adequacy Ratio, 2004 – 1H 2011

%	2004	2005	2006	2007	2008	2009	2010	1H 2011
CCB	8.6	11.08	9.92	10.37	10.17	9.31	10.40	10.42
BOC	8.48	8.08	11.44	10.67	10.81	9.07	10.90	10.01
ICBC	-	9.89	12.12	10.99	10.75	9.86	9.97	9.82
ABC	-	-	-	-	8.04	7.74	9.75	9.36

Source: bank audited reports

Where will economic growth come from?



Source: Wind Information; State Bureau of Statistics