

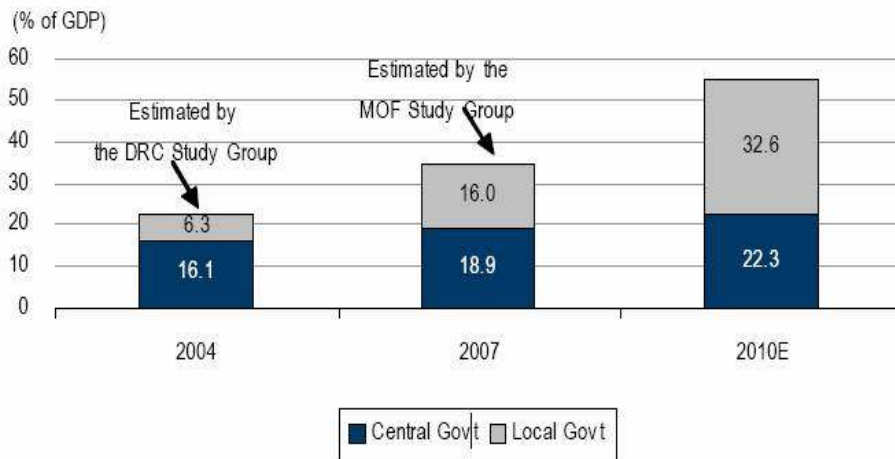
Chinese banking concerns contained?

Recently, investors have been increasingly worried about the potential risk of increasing non-performing loans (NPLs) from Chinese banks. The loans in question are specifically referred to as local government finance vehicles (LGFVs) or urban development and investment companies (UDICs), and they have grabbed investor attention as they have grown significantly and transparency levels are not considered high. Investors are worried over whether or not loans at these levels pose a systemic risk.

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Figure 1: Local government debt has been on the rise



Source: MOF Study Group, DRS Study Group, CEIC, Credit Suisse estimates (July 2010)

Why have LGFV loans grown so significantly?

The global recession in 2008 was a severe drag on China's economic growth, with GDP growth falling from robust levels of 10.6% year-on-year in Q1 2008 to an alarming level of 6.2% year-on-year in Q1 2009, primarily as a result of severe contraction in export demand. To counteract these negative external forces, Chinese authorities, in line with many governments around the world, announced a series of stimulative policies, including the RMB 4 trillion fiscal-stimulus programs for infrastructure projects. To support these infrastructure-building activities, bank lending significantly increased in 2009, particularly in Q1 2009. The majority of loans were long-term in nature, typically covering 10-15 years for industrial projects and 20-30 years for infrastructure projects, and the loans in general were implicitly backed by local governments.

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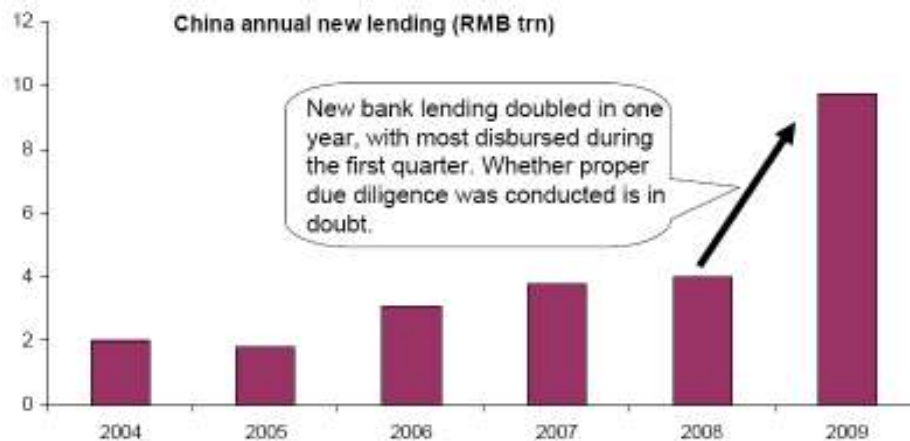
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Figure 2: China annual new lending rose significantly in 2009



Source: CEIC, Credit Suisse (July 2010)

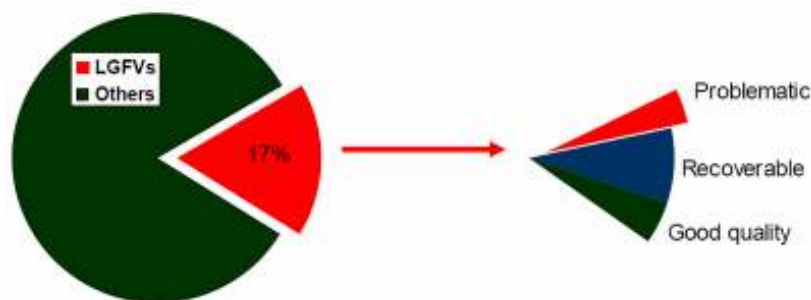
Should investors be concerned?

As at the end of June 2010, LGFV loans grew to RMB 7.66 trillion, or, roughly 17% of system loans. Due to the large amount of loan growth in a short space of time, the terms of each loan and the credit quality of the projects they are lent for are likely to vary significantly. However, given these are long-term loans, most of which were extended last year; it is unlikely that banks will see NPLs this early in the life of the loans. Government authorities have stepped in to ensure greater transparency on the matter, and a detailed analysis to understand the exposure of banks to potentially problematic LGFV was conducted.

According to media sources, 23% of the LGFV loans or 4% of total system loans were tagged as “problematic”. The loans were classified as:

- Good Quality (27%) – sufficient project cashflows to cover the entire value of the loan
- Recoverable (50%) – insufficient cashflows, but with sufficient collateral backing
- Problematic (23%) – neither sufficient cashflows nor collateral backing

Figure 3: Understanding the proportion of problematic LGFV loans



Source: CLSA (July 2010)

4% problematic loans seem high – are you worried?

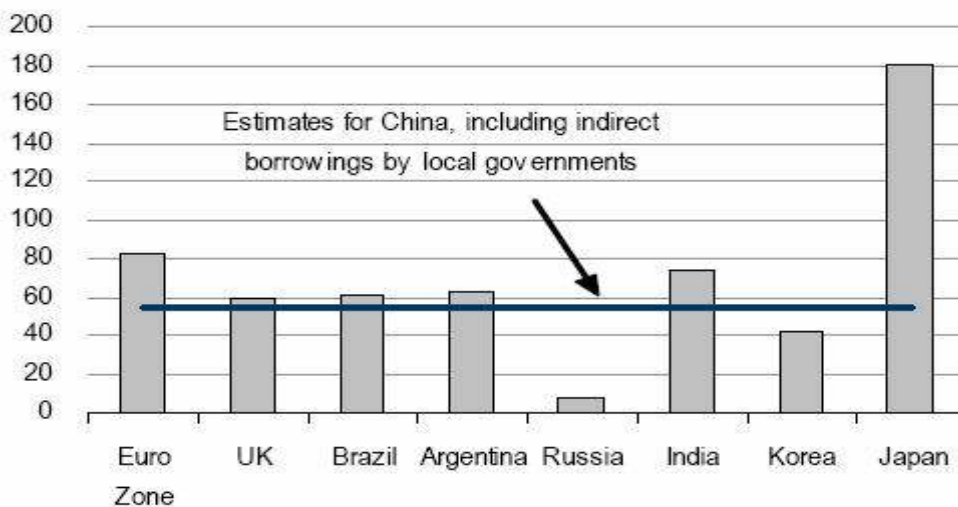
Banks have buffer provisioning - Whether the banking regulator will require banks to downgrade or make large pre-emptive provisions for LGFV loans remains a danger. Simply, assuming the banks make 20% provisions for problematic LGFV loans, additional credit cost would be roughly 80bps. However, a large part of this can be absorbed by the buffer provisioning that the banks have built up. Minimum provisioning ratios of 150% means that with system NPLs of 1.3% at June-end, the buffer is at least 65bps.

The banking regulator aims to reduce LGFV risks through increased collateral or guarantees and disposals. The regulator is also currently asking banks to reassess their LGFV loans, only this time categorizing loans based on different cashflow-to-repayment ratios. Based on our conversations with the banks, we could potentially see a sizeable reduction in problematic loans under this more granular classification system.

LGFV loans were government initiated and had implicit support – Banks’ LGFV loans grew significantly through implicit government backing and in support of government policy. As such, it is highly likely the government will share part of the NPL burden, should it become a serious concern. A stable financial system is crucial for China’s continued economic development and future policy implementation, and China’s leaders understand this.

Overall debt levels are still reasonable - Despite the increase in total debt, China’s total debt to GDP ratio stands at a reasonable level, compared to global economies. Fundamentally, the Chinese economy is also more robust compared to its peers.

Figure 4: China’s debt levels is reasonable compared to peers



Source: MOF Study Group, CEIC, Credit Suisse estimates (July 2010)

Conclusion:

We think the worries of a banking crisis have been overdone, based on the information at hand. Should pre-emptive provisions need to be made, banks’ earnings would no doubt be negatively impacted in the short term, but buffers have been built and the damage appears to be manageable.

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