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China's banking system risks after the 2008-10 stimulus package and the housing boom

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Outline

What has happened?

- The world financial system is recovering from the ashes
- Meanwhile, China's banking system has blossomed from an "unsustainable" situation in the first half of 2000s

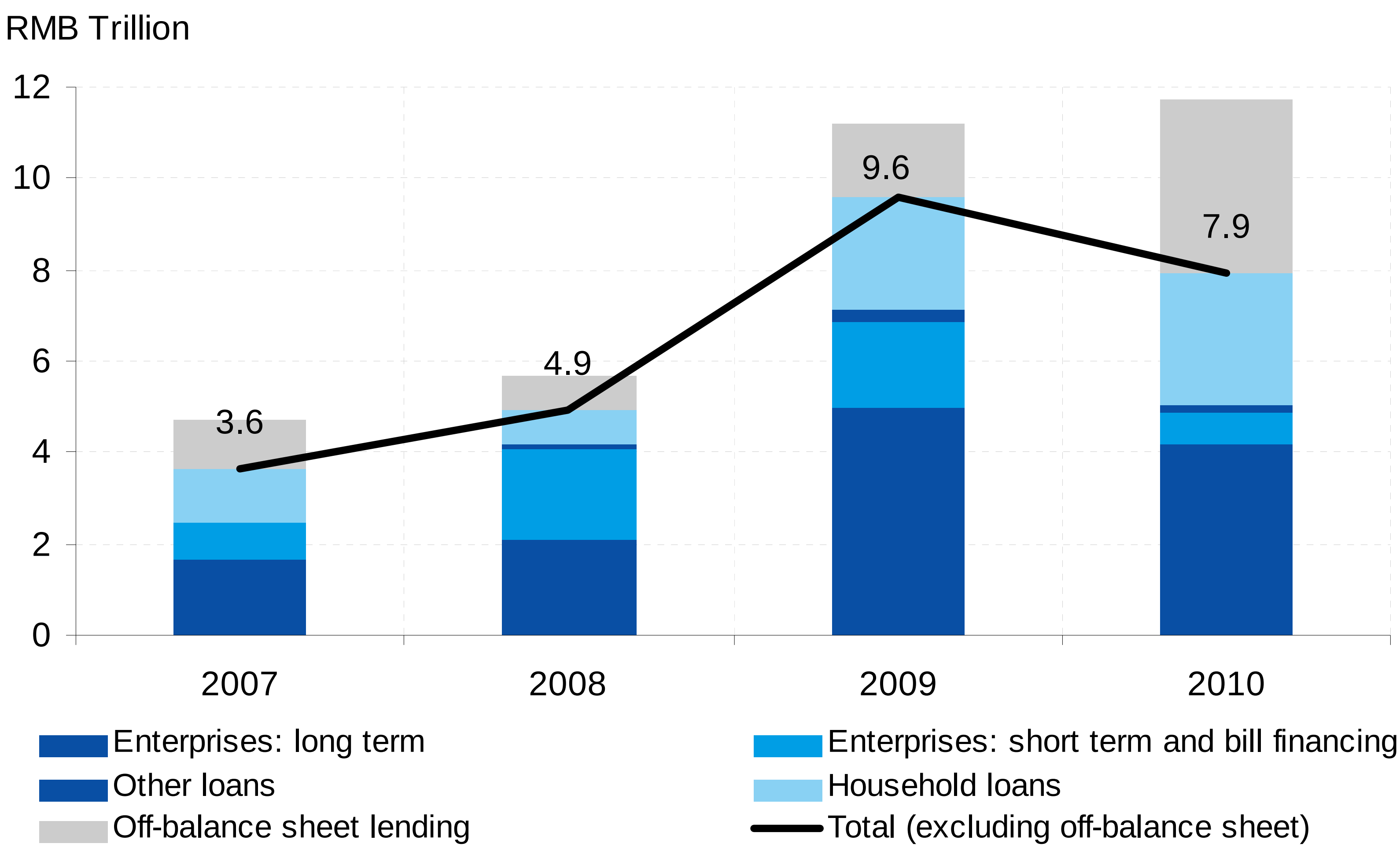
- Is it really true?
  - To some extent yes:
    - Banks are solvent and profitable
    - Bancarization proceeding rapidly
  - But roots of the problem not really addressed:
    - Misallocation of credit due to public interference
  - The jury is still out!

What happened: stimulus package

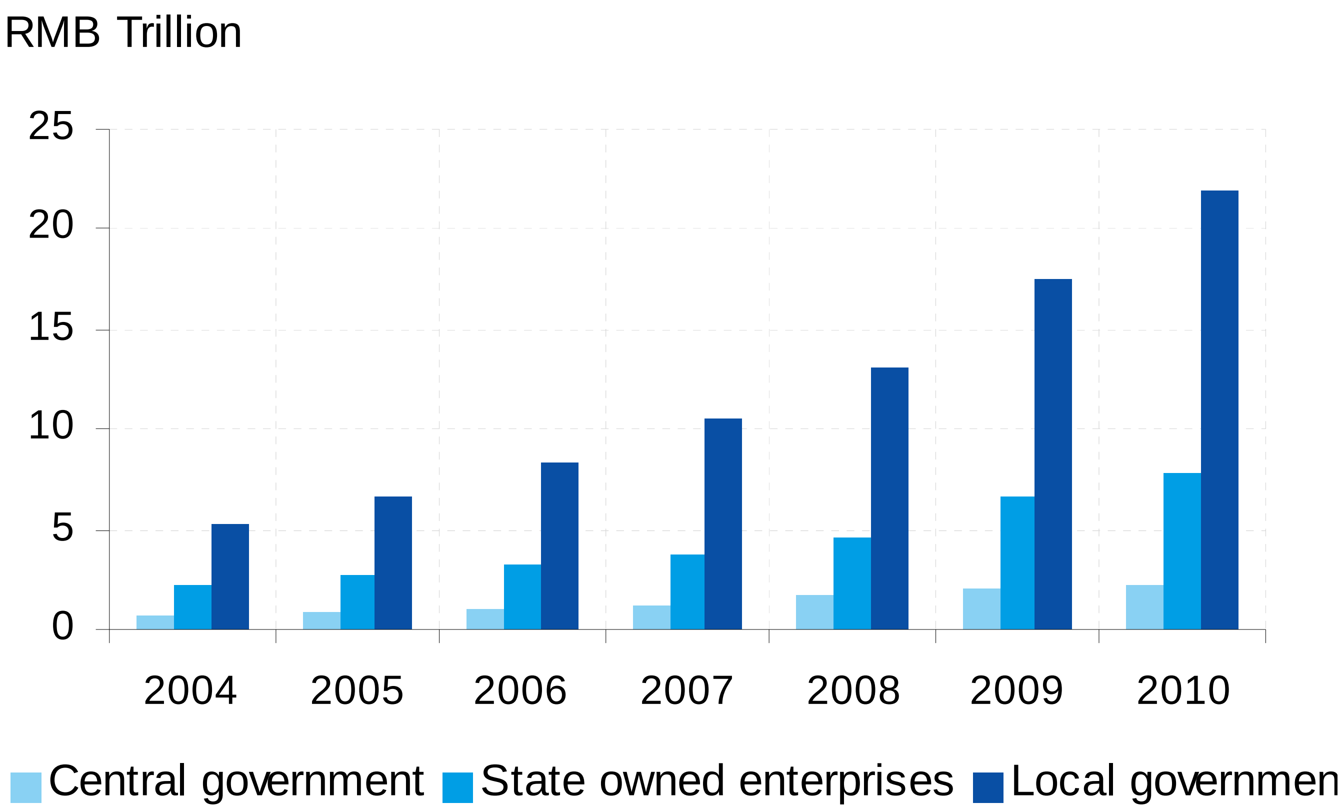
- RMB 4 trn stimulus package to be spent between 2009-10
- 1/3 would born by the central government
- 2/3 by local governments a SOEs but financed through bank loans
- Credit growth points to a much bigger package
  - Nearly RMB 22 trn in new loans in 2009-10 when including off-balance sheet items (about 30% of GDP year by year)

Source: CEIC. *Last observation Q1 2010.*

Changes in outstanding loans (RMB trn)



Investment driven by central & local governments and SOEs



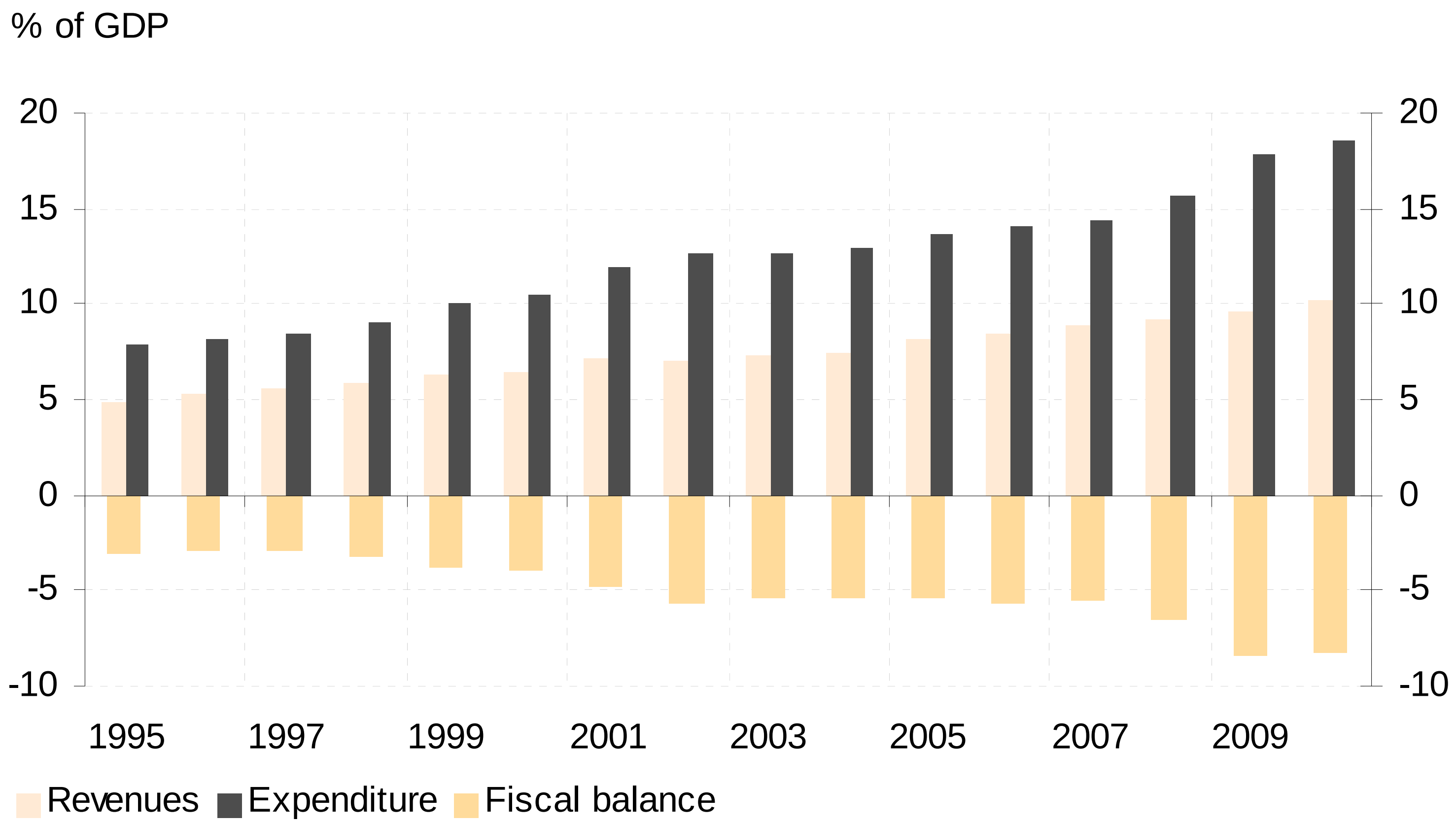
Is it worrisome?

- Rapid credit growth is a good predictor of crisis
- Local government finances worsening
  - More expenses
    - Increasing welfare state
  - Less revenue
    - Land for affordable housing to increase
      - 36 m in 5 years according to 12th Plan
    - Local governments' land sales at market price to be reduced (major source of income)

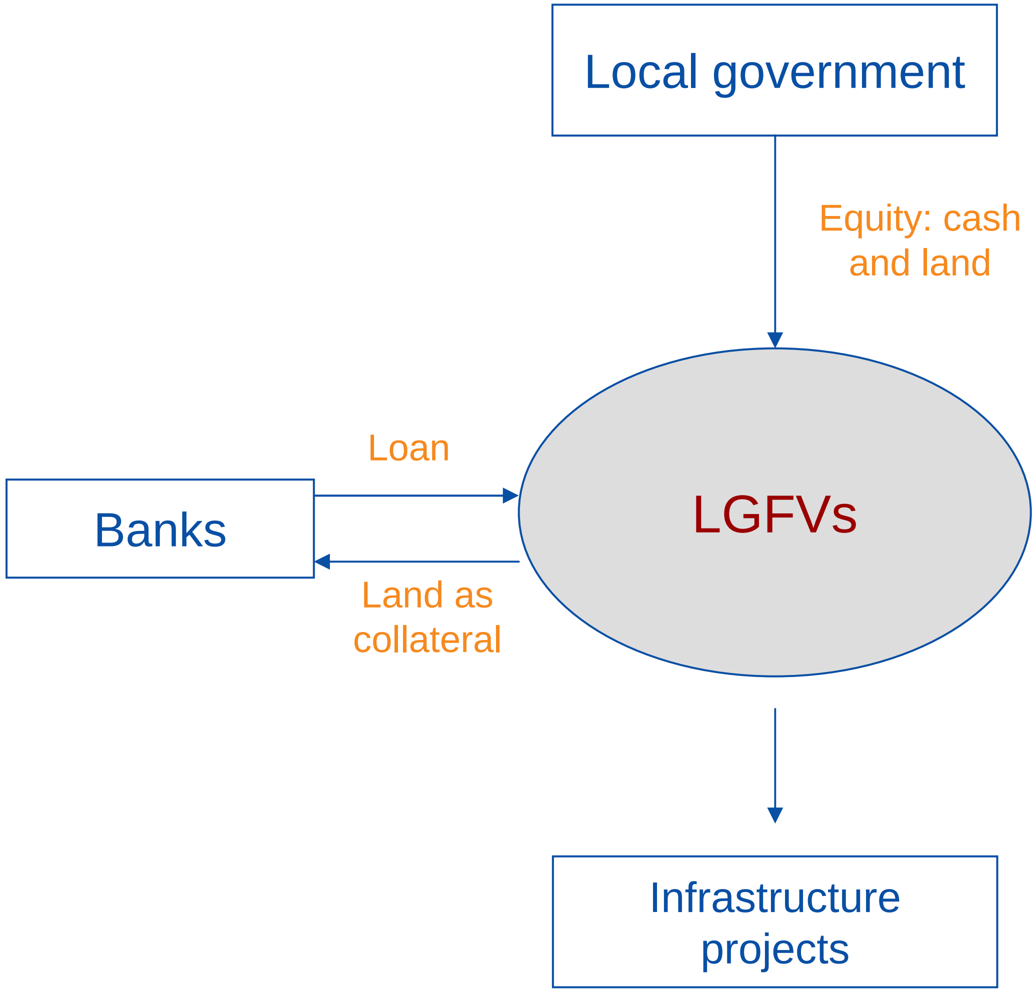
Is it worrisome?

- The vehicle used by local governments (LGFVs) only have implicit guarantee from local governments
- Land used as collateral by LGFVs so
  - Also direct impact of land prices other than local governments' ability to pay
- Most of borrowing by LGFVs into infrastructure projects
  - Very little cash from projects in short term
  - Marginal return of infrastructure projects doubtful after huge investment binge
  - ROE reported by LGFVs only 5%

Local government revenues and expenses



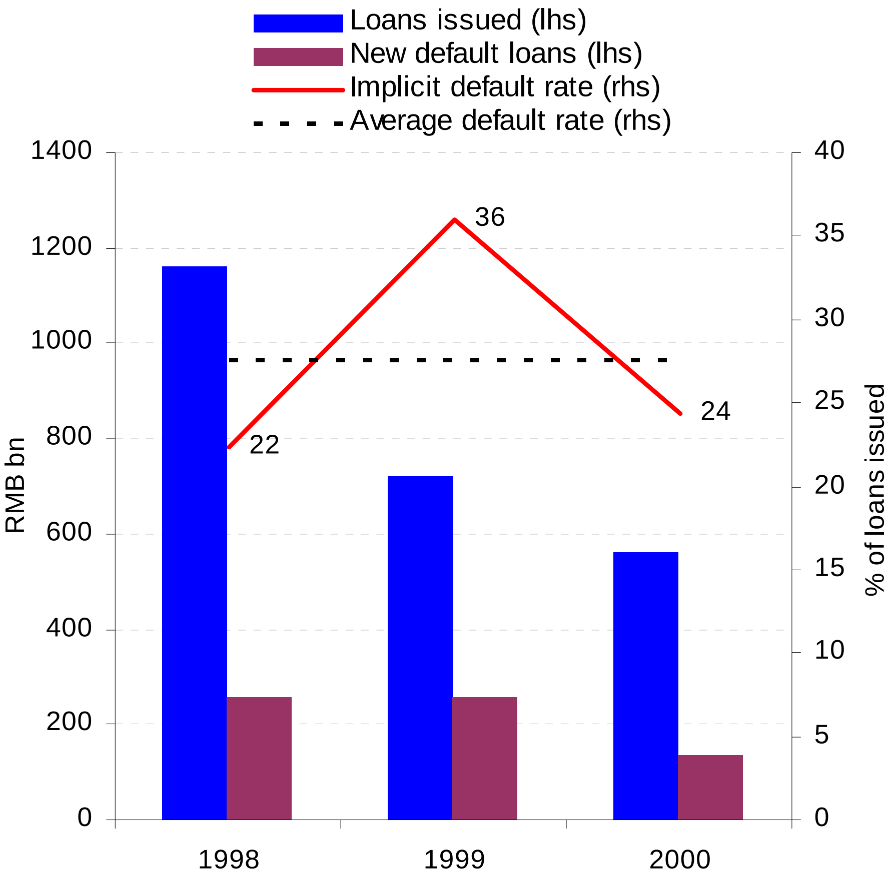
Relationship between Local governments, LGFVs and banks



Outline

Déjà vu?

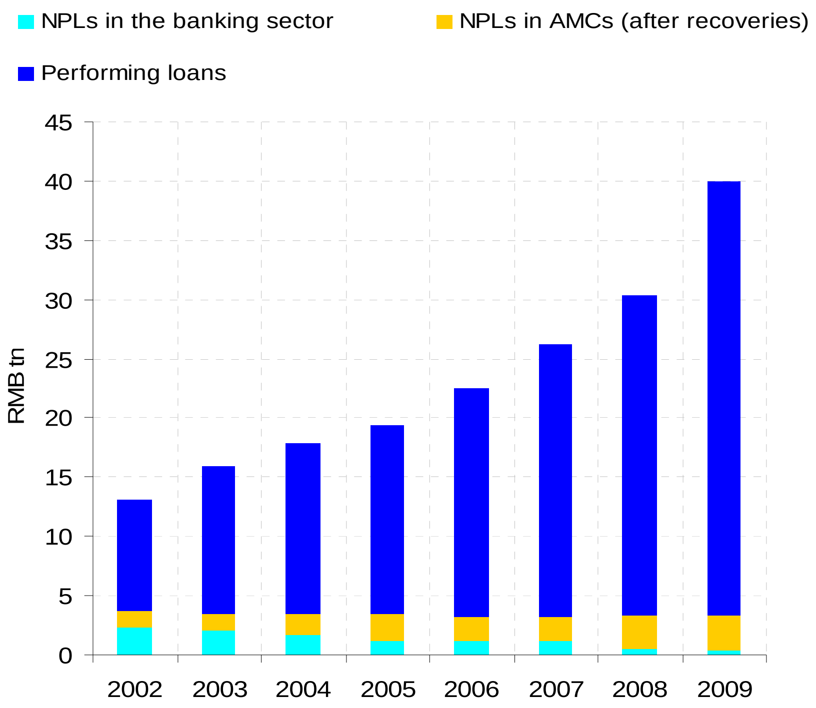
- In 1998, China put in practice a fiscal package that has in common characteristics with the one today.
  - Stimulus relied on bank lending to SOEs and Local Governments
  - About 28% of lending became NPL from 1998-2000
  - NPL ratio (already high due trust and investment corporation crisis) grew from 28% to 41% in 2000
  - However, sharply reduced thanks to restructuring process

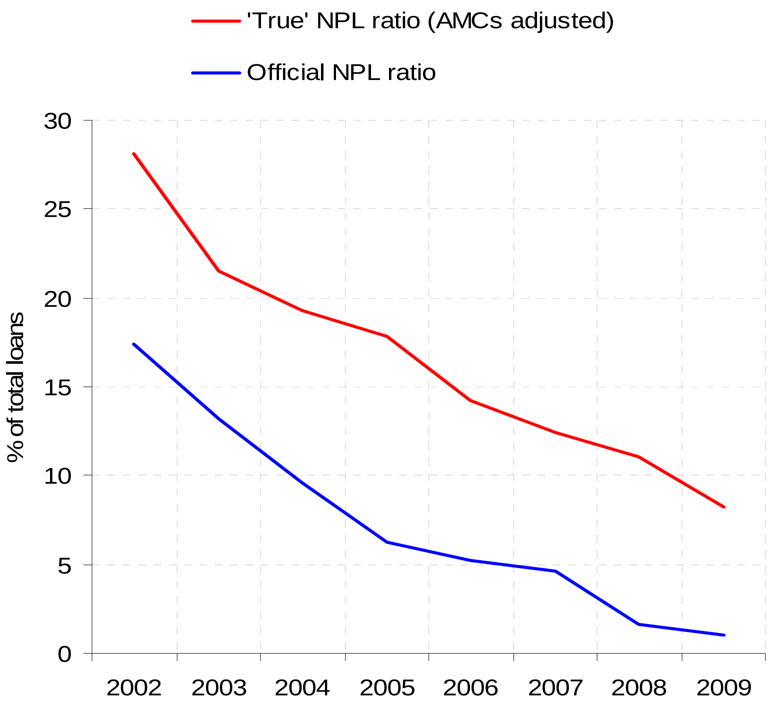


Source: Bankscope. Estimates based on a sub-sample of banks with NPLs available. That sample was skewed towards the best performing institutions.

2008 experience with reducing NPLs

- Transfer of NPLs to AMCs in waves (except for last case of ABC)
- Low recovery ratio of AMCs (25%) but still NPL/total loan ratio vanishing thanks to growth





Outline

How big the losses now?

- Assuming a default ratio between 7% (optimistic scenario) and 25% (pessimistic) of total loans granted between 2008-10,
- Upper bound default loss ratio would be 25%
- Assuming nominal growth at 14% (optimistic scenario) and 8% (pessimistic)
- We focus on optimistic scenario (more likely today)
  - Losses would be between 5-9% of 2008 GDP
  - But high growth will continue to reduce burden to 2-4% of GDP by2020
  - That will imply an increase in the NPL ratio of 1-3 pp

    Quite manageable!
- Even in pessimistic scenario no more than NPL ratio no more than 10%

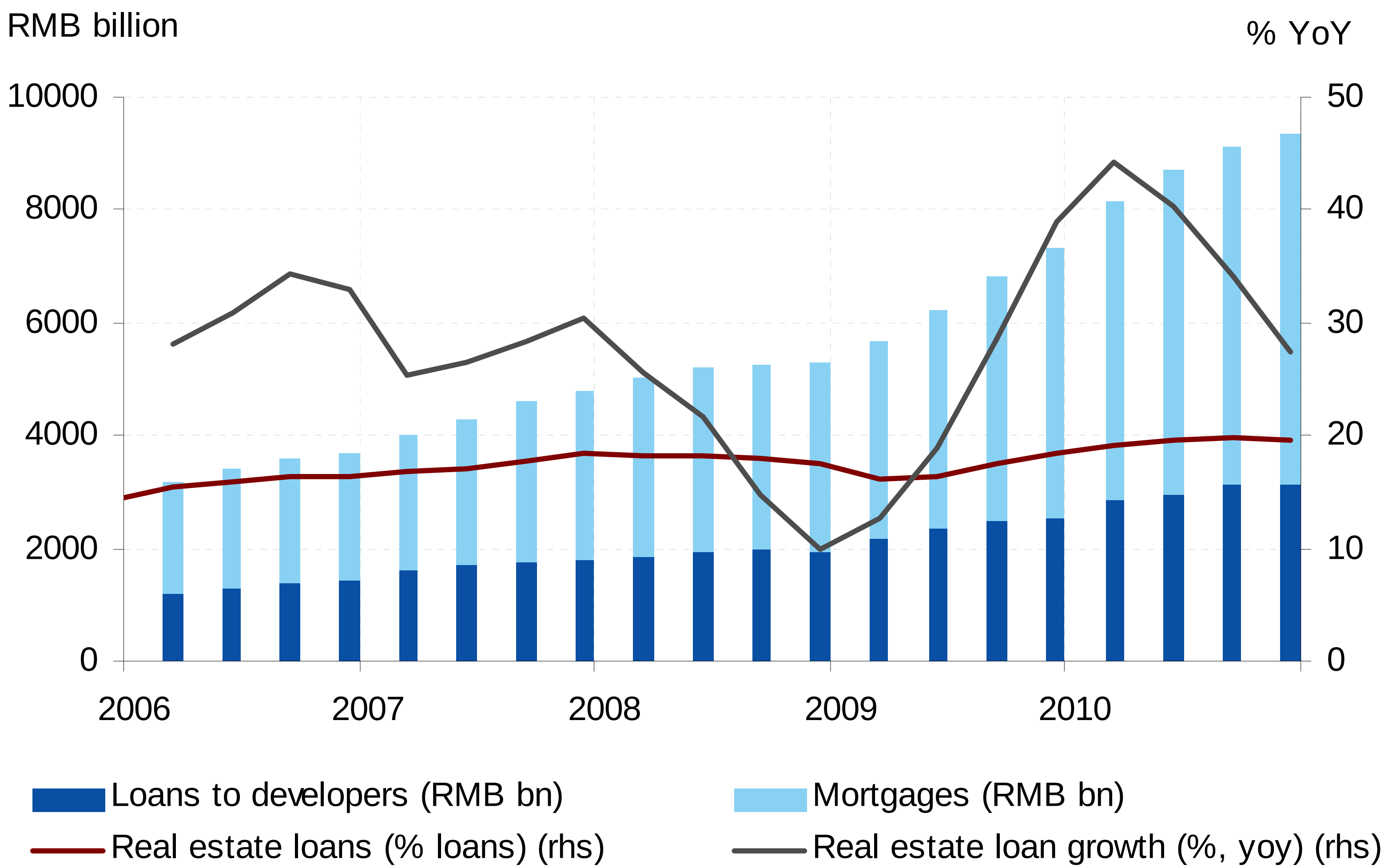
Outline

The housing channel

- Direct impact of fall in housing prices limited
- But indirect impact through collateral of LGFVs could be large
  - Still room for maneuver exists

Urban property prices (%)

Lending to real estate, (RMB bn, %)



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Conclusions

- Even this time it seems China can get away with a huge credit binge and even if housing prices are reduced
  - However LGFVs risk should not be underestimated if not because of direct impact on solvency at least as signal
- Functioning of the banking system should improve before growth is reduced
- Otherwise, the underlying NPLs will surface.
  - Need to reduce government interference in in banking system

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QUESTIONS/COMMENTS

MOST WELCOME

THANK YOU!

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