Orient Capital Research

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Rural Bank Failures

Is This the Next Problem in China?

Rural Bank Failures in China

Investors have been worrying about the potential collapse of the Trusts in China. They should be paying attention to the bank failures in the rural areas.

Earlier this year, three rural credit cooperatives closed shop due to insufficient funds, leaving 80 million in yuan in funds unaccounted for. The coops are in Yancheng, a city of 7 million on the normally wealthy coast of Jiangsu Province. The farmers' cooperatives were part of a program testing out rural lending.

These coops are small companies set up by farmers to share financial resources and meet internal demand for small loans. They do not take deposits from the general public relying on funds from members. They are not owned by the government and do not have access to the lending facilities at the People's Bank of China. As with rural bank failures in the past, instead of making small loans to farmers who would use the money in agricultural activities, some of the cooperatives' managers misused funds by lending to property projects.

This sounds like a classic story of a quasi-ponzi scheme in the hinterlands of China. But this time the story may have more legs. Why? ***As credit tightens in China, the weaker parts of the financial system will be the first to fail – and rural banks are at the bottom of the food chain.***

This contrasts with the Trusts. More than three-quarters of the Trusts are owned by arms of the State, mostly provincial governments, who are likely to backstop them in case of a failure. In contrast, many of the rural banks – which supply the bulk of credit to hundreds of millions of farmers – are either pooling local savings or are connected to the financially strapped local governments. There is no Beijing behind them.

According to Caijing magazine in Beijing, in January 2013, the interest rate on deposits in the rural credit firms in Yancheng was between 7 percent and 10 percent, while the lending rate was 15 percent to 18 percent. This compares to the benchmark deposit rate of 3 percent and the lending rate of 6 percent.

The People's Bank of China warned the Yancheng government in 2013 of the risks inherent in these rural credit unions, according to the 21th Century Business Herald last September. The article states that the central government introduced the Rural Credit banks in 2006 and launched a pilot scheme in Yancheng. By the first half of 2013, there were 138 FFCs in Yancheng, with total membership of about 200,000 households, 2.5 billion yuan in deposits and 2 billion yuan in loans.

Rural Banks Count

This may sound like small beer for China's financial system, but the entire rural financial sector is quite large. Take a look at the chart below.

Total China Banking Assets			
(RMB Bln)	**2Q 2013**	**YoY %**	**Share**
State Banks (5)	63,827	8.0%	44.3%
Joint Stock Banks	25,939	22.5%	18.0%
City Commercial Bank	13,592	18.1%	9.4%
Other Banks	40,894	16.8%	28.4%
Total Assets	**144,248**	**13.8%**	**NA**

Total banking assets in the second quarter of 2013 were 144.2 trillion RMB and grew at 13.8%. The five state banks – Bank of China, Agricultural Bank, ICBC, China Construction Bank, and Bank of Communications – posted slower asset growth of 8.0%. The fastest growth came from the joint stock banks, such as Citic, Everbright, and China Merchants, at 22.5%. However, the picture changes when we break down the "other" category. Rural Credit Cooperatives show assets of 14.5 trillion RMB, about 10.1% of the total. But in the past decade, their assets have grown nearly twice as fast as the state banks – 4.4x versus an average of 2.7x for the state banks.

China's Big Four Banks and Rural Coop Banks			
RMB Billion	**2003**	**1H 2013**	**YoY %**
ICBC	5,279	18,723	*255%*
ABC	3,494	14,222	*307%*
BOC	3,980	13,256	*233%*
CCB	3,553	14,859	*318%*
	16,306	**61,060**	***274%***
Rural Credit Cooperatives (County)	**2,689**	**14,534**	***440%***

Desperate Local Governments

Why such fast growth? We can only hazard a guess, but one reason is rising spending commitments among local governments who most likely tapped these banks for capital for a variety of government-linked projects. In addition, the majority of the 2009 stimulus package was funneled through local governments, and probably included a big chunk through the local rural banks.

How is this a problem? This tremendous rise in assets among a group of poorly regulated local banks, many of which are under the thumb of local governments, suggests a large percentage of inefficient loans are on their books – and non-performing loans.

Farmers Will Get Hurt

Unfortunately, these banks are a crucial source of capital for the hundreds of millions of rural residents and farmers. Any problems there could cause significant hardship. Beijing is going to have a difficult time if millions of farmers lose their wealth.This contrasts with the typical investor in a Trust or Wealth Management Product, who we assume is relatively wealthy (although the data is rather sparse on this point). As we have seen with the near defaults in February of the China Credit Trust and Jilin Trust products, the central government – presumably behind the scenes – swept in and forced all the players involved to come to a resolution. That doesn't seem to be the case for the Yancheng rural cooperatives, where local residents have been left empty handed.

This fits the modus operandi for the Chinese government. Generally, the closer you are to the center – which includes the State Banks, the top cities, and the majority (but not all) of the state owned companies – your chances of a bail-out are pretty good. Two examples will suffice. The four Asset Management Companies (AMCs) were established in the late 1990s to be the "bad banks" for the state banks. They and the banks were repeatedly recapitalized in order to float the banks.

Contrast this with the Rural Credit Cooperative Foundations. Set up to aggregate capital locally for rural businesses, they fell into trouble in the 1990s, partly through aggressive and unprofitable lending directed by local governments. This is not dissimilar to the Local Government Financing Platforms of today. In 1999, the PBOC ordered the Rural Credit Foundations to close – ***but forced most of the debt back onto the balance sheets of local governments where it resides today.***

The lesson here is Beijing has the resources to recapitalize much of the financial system. But it's likely the rural sector won't be part of the package.