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What Kyle Bass is Missing on the Chinese Banks

The Rise in "Unofficial" Credit

By now, everyone has heard Kyle Bass' very negative view on the future of banking in China. His main thesis is that the Chinese banks are woefully undercapitalized given undercounted non-performing loans (NPLS). "We believe that Chinese banks will lose approximately $3.5 trillion of equity if China's banking system loses 10% of assets." China will have to expand the PBOC's balance sheet which will cause the currency to plummet in value by as much as 30%.

Everyone also has probably heard that Bass made a significant error in his calculation of total reserves by counting USD700 billion held by China Investment Corp., which shouldn't be included.

Nevertheless, although exaggerated, he's on to something…but…..

…We think he has ignored part of the problem, and also has not differentiated between the larger, more stable banks and the smaller, weaker banks.

Although the share price of most of the banks in China, and others that do business there, have fallen @20 percent in the past year, we believe there is more pain ahead. This will occur for several reasons.

- **Bond Swap.** First, the 3.2 trillion renminbi agreement to swap bank debt for bonds is likely to be expanded, and is negative for bank margins and profits.
- **Rise in Investment Products.** Second, the rise in investment products on bank balance sheets increases risk due to non-transparency and concentration of assets in high-risk industries such as real estate.
- **Local Risk.** Third, the smaller, joint stock and rural banks in particular have deep roots in economically weaker geographic areas and among less

financially stable customers.

- **Foreign Bank Weakness.** Fourth, in a race for market share some foreign banks accelerated market penetration in ways that are likely to be heighten asset risks.

- **Small Bank Risks.** Although we are not banks analysts and this report is focusing on the macroeconomic risks to the banking sector, we cite in particular concerns about UOB Group and joint stock banks including Citic and China Merchants.

1) Problem #1: Skirting the Rules through Investment Products

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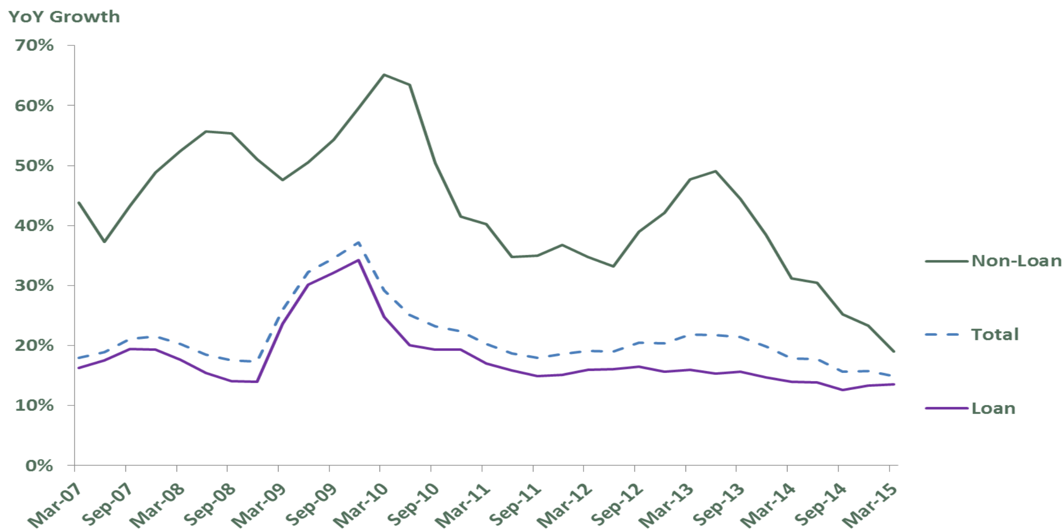
Shadow Banking rose sharply beginning with China's 2009 4 trillion renminbi financial stimulus. However, over the past several years the PBOC has restricted the growth of formal loans and Shadow loans. As the chart below shows, credit growth exceeding 60 percent in 2010 has since subsided to less than 20 percent.

Table 1, Bank Loans and Total Social Financing (Bank Loans, Bank Holdings of Corporate Bonds, Banker's Acceptances)



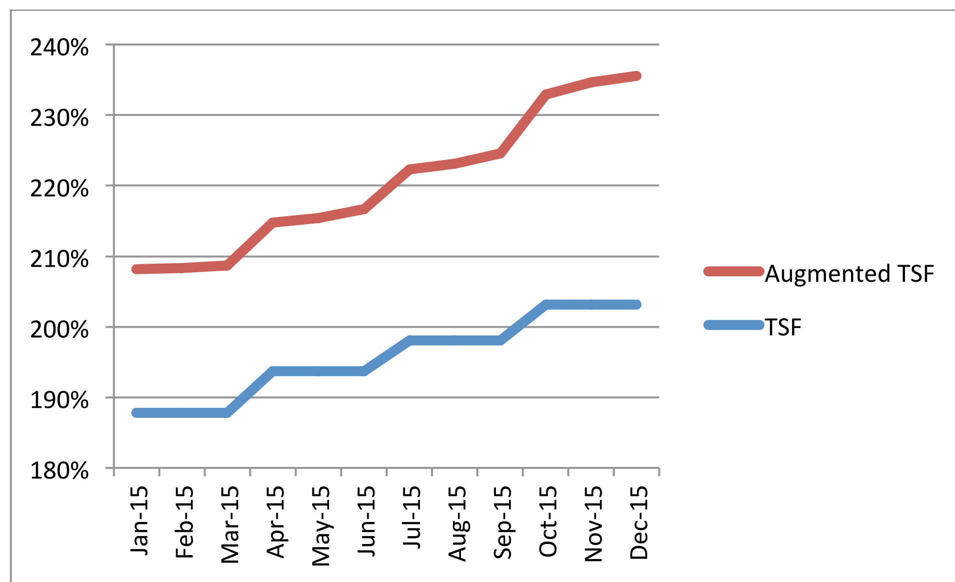
Source: San Francisco Federal Reserve; BI

The PBOC has relied on a new measure called Total Social Financing (TSF) that includes some forms of Shadow Banking. However, the definition of TSF leaves out a large portion of the growth in outstanding credit. This additional credit is not included in the official TSF figures. TSF was created by the PBOC two years ago precisely to capture the non-bank loan portion of credit growth. Banks have adhered to the restrictions on the rise in TSF – but have instead switched their credit to other sources. What are they?

The New "Unofficial Credit"

The TSF numbers don't include claims on non-bank financials (NBFI), claims on government, and any other claims on the economy that aren't loans and bonds. As the chart indicates, these three categories showed significant growth in 2015 as banks took advantage of the regulatory loophole. While TSF rose 15 ppt from 188% of GDP in January 2015 to 203% by December. But if we add in the categories excluded from TSF, outstanding credit increased **28 ppt** from 208% of GDP to 236%. By the end of the year, that was **RMB44 trillion** in additional credit into the economy behind what is calculated by the TSF numbers.

Table 2, Growth in "Augmented" Total Social Financing (TSF)



Source: PBOC

The Growth in Investment Products

Why did this growth occur?

1. **Non Regulated.** These categories are not included in the government's TSF calculations and therefore are not part of the restrictions on credit growth.

2. **Lower Weightings.** According to China Banking Regulatory Commission rules, risk weightings are 100 percent for loans but only 25 percent for investment products.

3. **Lower Provisioning.** They are not subject to the 2.5 percent provisioning that applies to the loan book.

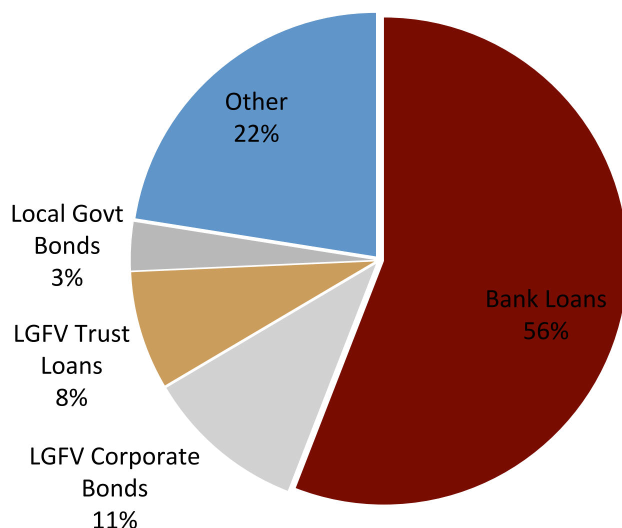
4. **No Lending Restrictions.** These "investment products" are not subject to the CBRC's restrictions on lending categories. There is some anecdotal evidence that three-quarters of these pseudo loans went to property developers – the riskiest category of loans.

2) Problem #2: The Bond Swap Reduces Bank Profits

In 2015 the Ministry of Finance, and the PBOC, instituted a program to reduce interest costs for local governments by replacing high interest rate debt (@8%) with lower interest rate government bonds. The initial tranche of 2 trillion renminbi was raised to 3.2 trillion renminbi. There has been much debate about the impact of this program on bank profits resulting from the bonds' reduced interest income against the benefits of lower risk weightings.

Local debt is about half from bank loans and the remainder from Shadow Banks and other sources.

Figure 1, Sources of Local Debt in China



Source: IMF, NAO

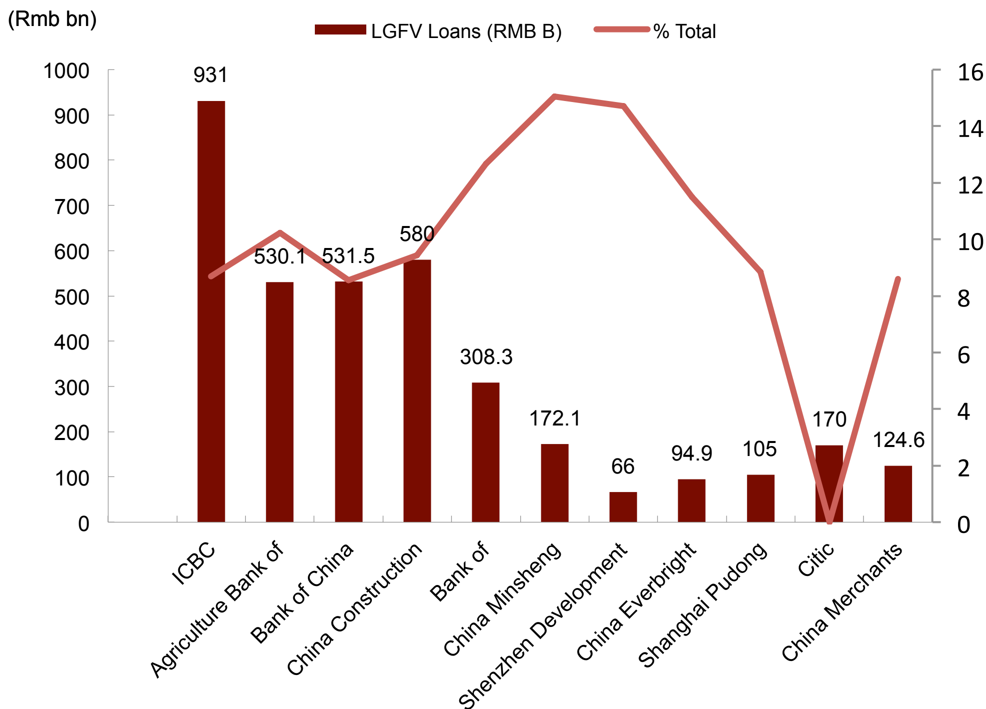
The policy was intended to replace bank debt with bonds on a one-for-one basis, pro-rata for each loan. For example, if the Agricultural Bank has an RMB100 Million loan outstanding to the Sichuan Government, that loan would be replaced by a bond at a lower interest rate.

However, our discussions with Chinese banks suggest that only a portion of the debt is replaced; some remains on bank balance sheets. In addition, whatever funds are paid back to the banks by local governments aren't always in the banks' control and can't be used for profitable loans. What is the total effect on bank profits? It varies by bank branch and location, but one bank said they would suffer a 10% decline in profits for every bond swap.

How Much LGFV Credit is Held by the Banks?

The amount of LGFV/Local debt loans varies by bank. The LGFV loans range from a few percent of the loan book (Shenzhen Devt Bank) to as much as 15 percent (China Merchants).

Figure 2, LGFV Loans by Chinese Bank



Source: IMF, "Risks from Local Government Finance"

The current bond swap program is relatively small, Rmb3.2 trillion. However, official local debt is Rmb 24 trillion. If all that debt were included in future bond swaps, that potentially means an RMB2.4 decline in total bank profits.

Problem #3: Local Bank Exposure to Weak Geographic Regions

The decline in China's economic growth is concentrated primarily in the weaker Tier 3 and Tier 4 cities. Banks whose loan exposure is mainly in these areas will suffer the largest declines as the property bubble deflates.

The China Banking Regulatory Commission (CBRC) categorizes banks into six groups. (We are excluding for our analysis the non-financial institutions in the Shadow Banking sector.) These six groups are:

1) Large SOE banks.

2) Joint Stock Banks.

. 3) City Commercial Banks.

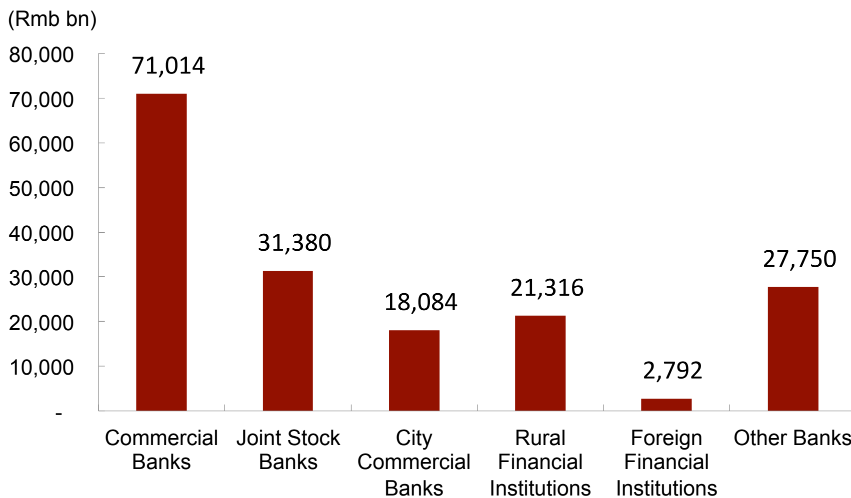
. 4) Rural Financial Institutions.

. 5) Foreign Financial Institutions.

. 6) Other Banks.

The five big state banks dominate the country's banking assets with a 41% share. They are followed by the Joint Stock banks (12) with an 18% share; the City Commercial Banks (133) with an 11% share; and the Rural banks (2,350) with a 12% share.

Figure 3, Chinese Banks By Assets



But the picture changes radically when we start moving down to smaller geographical locations. We examine data from one area due to the listing of the Bank of Jinzhou in Liaoning Province. The market share breakdown in Liaoning Province, with a population of 43.7 million, is much different from the national analysis. In Liaoning, the State Bank share drops to 33% from 41%, and the City Commercial Bank share rises to 26% from 11%.

One Surprising Candidate – UOB

One bank that doesn't fall into the neat categories we have outlined above is UOB of Singapore. We include it as it has high exposure to Chinese borrowers and has some of the features we describe. UOB has increased its exposure to China from 9.8% of the loan book in 1H 2014 to 11.8% in 1H 2015.

Figure 4, UOB's Regional Loan Book

% Total	1H 2015	1H 2014
Singapore	56.8%	58.0%
Regional	35.1%	33.7%
Malaysia	12.5%	13.3%
Thailand	5.4%	5.2%
Indonesia	5.3%	5.4%
Greater China	11.8%	9.8%
Others	8.1%	8.3%

Source: UOB Presentation, September 2015

Surprisingly, the increase in exposure to China has not led to more bad loans. Either UOB has a strong customer base or the problematic loans have yet to be reflected in the loan book. Most foreign banks we have analyzed in China have a weaker customer base as they don't have the contacts state and local banks have.

Figure 5, UOB's NPLs by Geography

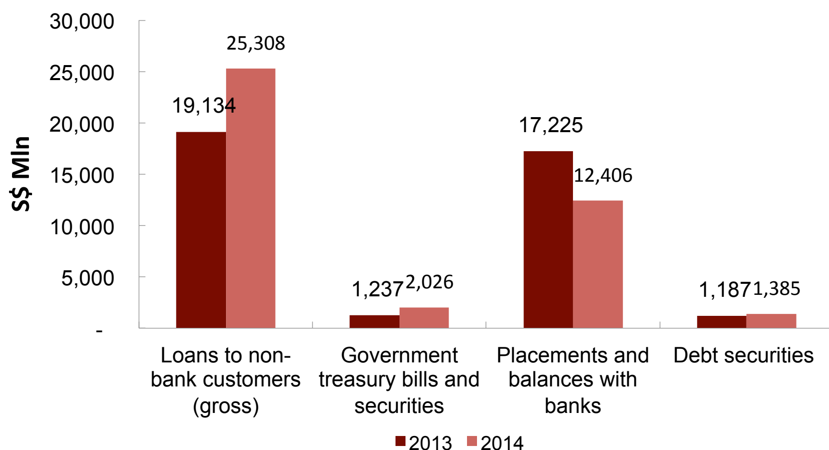
NPLS (S$M)	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Q2 2015
Total	2309	2289	2358	2442	2504
Greater China	120	118	124	127	149
China/Total	*5.2%*	*5.2%*	*5.3%*	*5.2%*	*6.0%*

Source: UOB Presentation, September 2015

UOB notes that overall interregional loans between Singapore and Greater China have grown from 13% of the total in 2010 to 45% in June 2015, so UOB's own growth in China loans is tracking trade flows.

The big increase in China exposure has come from non-banks – we assume these are corporate borrowers. More clarity from UOB would clarify the nature of their China loans.

Figure 6, UOB's China Exposure by Category



Source: UOB Financials

China Merchants

China Merchants' exposure has shifted to investments, which are less regulated and non-transparent, and fees from Wealth Management Products, which increases risk. Investments in 1H 2015 rose 22.5% compared with a 9% rise in loans. Returns for loans fell 46.5%.

Figure 7, China Merchants Balance Sheet

Investments	1H 2014	1H 2015	YoY %
Investments (Rmb Mln)	873,418	1,069,862	22.5%
Interest Income	37749	23249	-38.4%

Loans	1H 2014	1H 2015	YoY %
Loans (Rmb Mln)	2,400,646	2,616,200	9.0%
Interest Income	150,929	80,712	-46.5%

Source: China Merchants Financial Statements

Meanwhile, the bank enjoyed a significant increase in service fees from the sale of Wealth Management Products. Although these technically are off balance sheet, many investors assume the bank is responsible for them in case of default.

Figure 8, China Merchants WMP Sales

WMP Balance (Rmb Bln)			

WMPs	1H 2013	1H 2014	1H 2015
Guaranteed	77.12	71.70	55.60
Non-Guaranteed	582.6	726.5	1586.1
Total	**659.7**	**798.2**	**1,641.7**
YoY %	-	21%	106%

WMP Service Fees (Rmb Mln)			
WMP Service Fees	4,747.4	7,114.5	14,478.0
YoY %	-	49.9%	103.5%
% Total Fee Income	10.4%	30.1%	46.7%
Fee and commission income	14,109.71	23,638	31,020

Source: China Merchants Financial Statements

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