How did China borrow so much so fast?
Sources of financial weakness

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Overview of comments

Why banks are so important in China

After 2008 China’s banks went on a lending binge, but made no bad loans!

Where are the Boards of Directors for China’s banks?

Is there a problem and, if so, how big is it?

What are the implications for Chinese financial reform going forward?
Why are banks in China important?

China’s banks: not such much an intermediary as a channel

- Government
- Corporates
- Banks
- Debt markets
- Loans
- Party
- Depositors
- Hong Kong Banks
- onshore
- offshore

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Boom! Total commercial banking assets, US vs. China

Source: PBOC, World Bank, Bureau of Economic Analysis
Unbelievable! Non-performing loans, 1999-2013

Can this happen?

1949-1998: China’s banks – unconsolidated; coordination based on a central plan and its corollary credit plan
1978 – 1997: Banking system was revived but ...

The cellular economy: even the so-called national banks were unconsolidated agglomerations of provincial entities run by provincial party secretaries

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... only in 1998 was the party governance of banks changed allowing banks to institutionalize...
... and the PBOC was reorganized geographically as well (but bank regulator was not)
1998 - 2008: National banks: consolidated, centralizing ... and listed
When the Party calls: RMB 40+ trillion in 5 years

Incremental new credit created > 30% of GDP 2009 - 2013

2008-2013 Credit Growth
CAGR = 20%

Source: PBOC 2014/Wind Information. Note the Total Societal Financing measure was initiated in 2002.
Great performance! Small banks owned by local governments

Total Assets
Shareholding City banks
¥5.99 trillion ¥2.03 trillion
¥9.61 trillion ¥3.35 trillion
¥28.99 trillion ¥19.56 trillion

CAGR
Policy Banks
State Banks
Shareholding Banks
City Commercial Banks
Foreign Banks
Urban Credit Coops
Rural Credit Coops and Banks

¥26.94 trillion
¥15.18 trillion

Percent of Total Banking Assets %
2005
2007
2012
2013

59%
47%
49%

22%
37%
31%

Source: People’s Bank of China
Note: Local banks refers to shareholding and city commercial banks
Innovative! small bank “wealth management products”

88% of issuance in value is by shareholding and city banks

Source: People’s Bank of China; Fitch
Failure of regulation: WMPs issued by bank type

At FY2013 14,240 products outstanding

- 146 small city and rural banks
- 9 of 12 shareholding banks
- 7 of 10 state banks

Source: Wind Information; FY2013
The Great Leap: an RMB 9 trillion stock of bad loans and bonds

Total bank only credit exposures = 128% of 2013 GDP

Est. NPLs/Total Exposures = 12% vs. 25-35% in 1998

RMB 9 trillion of NPLs on a GDP of RMB 57 trillion

FY2013 total bank capital = RMB 3.3 trillion

<table>
<thead>
<tr>
<th>RMB mm</th>
<th>Total Corporate Exposure</th>
<th>% NPLs</th>
<th>NPL Value</th>
<th>Exposure to &quot;Other Financials&quot;</th>
<th>% NPLs</th>
<th>NPL Value</th>
<th>Total NPL Stock</th>
<th>Total Exposures</th>
<th>% NPL</th>
<th>FY2013 Actual NPL stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large Banks</td>
<td>32,823</td>
<td>4%</td>
<td>1,313</td>
<td>2,277</td>
<td>4%</td>
<td>89</td>
<td>1,402</td>
<td>35,050</td>
<td>4%</td>
<td>350</td>
</tr>
<tr>
<td>Medium size Banks</td>
<td>13,887</td>
<td>7%</td>
<td>972</td>
<td>6,081</td>
<td>7%</td>
<td>426</td>
<td>1,398</td>
<td>19,968</td>
<td>7%</td>
<td>109</td>
</tr>
<tr>
<td>Small Banks</td>
<td>8,888</td>
<td>25%</td>
<td>2,222</td>
<td>1986</td>
<td>25%</td>
<td>497</td>
<td>2,719</td>
<td>10,874</td>
<td>25%</td>
<td>55</td>
</tr>
<tr>
<td>Rural Coops and Banks</td>
<td>6,512</td>
<td>50%</td>
<td>3,256</td>
<td>442</td>
<td>50%</td>
<td>221</td>
<td>3,477</td>
<td>6,954</td>
<td>50%</td>
<td>73</td>
</tr>
<tr>
<td></td>
<td>62,110</td>
<td>12%</td>
<td>7,763</td>
<td>10,736</td>
<td>11%</td>
<td>1,232</td>
<td>8,995</td>
<td>72,846</td>
<td>12%</td>
<td>587</td>
</tr>
</tbody>
</table>

Source: PBOC Financial Stability Report 2014; bank data as of FY2013; CBRC
Note: “Total Corporate Exposure” includes loans and bonds; “Other Financials” refers to non-bank financial institutions.
This is the challenge: ultimate net write-off estimate ...

<table>
<thead>
<tr>
<th>Loans and bonds</th>
<th>Stock</th>
<th>Write-offs</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>¥8.9 trillion</td>
<td>¥890 billion</td>
<td>10%</td>
<td></td>
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</tbody>
</table>

| Total wealth management products | ¥12.3 trillion | ¥615 billion | 5% |

Total write-offs ¥1.5 trillion

Recovery rate for 1990s NPL round = 20% of total NPL stock

<table>
<thead>
<tr>
<th>Total China banking capital by bank type, FY2013</th>
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</thead>
<tbody>
<tr>
<td>RMB bns</td>
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<tr>
<td>--------</td>
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<tr>
<td><strong>Total capital</strong></td>
</tr>
<tr>
<td>Large state banks</td>
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<tr>
<td>Medium size banks</td>
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<tr>
<td>Small size banks</td>
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<tr>
<td>Foreign banks</td>
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<tr>
<td>Urban credit coops</td>
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<tr>
<td>Rural credit coops</td>
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</tbody>
</table>

... means more capital raising for banks
At the center: state banks fund central government debt dependence

Source: Ministry of Finance; China Bond

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Fiscal revenue growth is not keeping pace with expenditure

Source: China Statistical Yearbook; China Finance Yearbook

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Locally: land use right sales are the key off-budget revenue source

Source: Milken Institute 2012
Central state banks invest in local corporate bond issuance

Lengthened maturities

Source: China Bond
Offshore borrowing by banks and corporates spikes

China’s total external debt is now US$1 trillion

Hong Kong alone bank claims on China

= 40% of total HK bank loans

= 165% of HK GDP

Source: Hong Kong Monetary Authority
State banks balance sheets are inflexible in the short term

Cash and PBOC deposits | Loans | Bonds | Other assets

Source: State bank H-share annual reports for 2012

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Continued lending, investing to drive GDP no longer works

Incremental Increase in GDP and New Loans RMB Bns

Change in GDP/Net New Credit %

Source: People’s Bank of China, China Statistical Yearbook
Summing up

Fiscal revenues are insufficient to meet ambitions

The weakness of city commercial banks will become Beijing’s fiscal problem, as will local government borrowing

State banks have been “fiscalized” and balance sheets are overburdened with poor quality, fixed rate loans and bonds; policy banks are AMCs

Continued focus on GDP growth rates as a proxy for social stability only adds financial leverage

Rapid growth of overseas borrowing is a warning signal

Effective regulation of the financial sector has proven impossible

Transparency has improved since the 1990s but is still insufficient