Gateway to China: Hot Topic

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The impact of local finance platforms on Chinese banks

Local governments in China were encouraged to create special purpose vehicles, specifically "local finance platforms" (LFPs), to supplement China's four trillion yuan stimulus package. The LFPs would borrow from banks using future government revenue as collateral to finance packaged-investment projects in Chinese localities.

Local government debt has been an underlying concern for the Chinese economy. As at the end of 2010, the total outstanding borrowing of these LFPs accounted for up to 18.8% of total bank loans, weighing on banks' asset quality as well as earnings.

With the support of the central government, local governments and the China Banking Regulatory Commission (CBRC), Chinese banks started to clear up such lending and improve cashflow. In the near term, we do not expect LFPs to have a large impact on the Chinese banking sector. We still estimate growth in 2012 to be between 15-18% and valuations to remain at historic low levels.

Why LFPs? How large are they?

LFPs are financing vehicles set up by local governments and backed by assets such as allotted land, equity stakes, fees and government bills. These vehicles have solid assets and cashflow and are eligible to raise funds to support local infrastructure and public welfare development. Whenever necessary, local governments will provide funding to LFPs as lending collaterals.

The scale of LFPs has increased gradually after the tax reform in 1994, which weakened local governments' financial power because the transfer payment system was inefficient.

At the same time, there is a large burden on local governments for public spending.

Traditionally, local officials have borrowed substantially as they believe "who borrows more helps greater performance during the servicing period" and they are not concerned about payments as debts normally are paid by the successors. As such, the number and scale of LFPs significantly increased in 2009-10 when Beijing kicked off the four trillion yuan stimulas package.

The estimated value of outstanding loans by LFPs could reach 9-10 trillion yuan, as CBRC and China's National Audit Office (NAO) data showed. The People's Bank of China (PBOC)'s estimation is even higher, at around 14 trillion yuan.

Table 1: Government's estimation of local financing platforms run by listed banks (trillion yuan)

Government bodies	Outstanding balance (trillion yuan)	Number of platforms
CBRC	9.08	9,828
NAO	10.7	6,576
PBOC	<14.4	>10,000

Source: CBRC, PBOC and NAO, data as at 31 December 2010.

Potential risks of lending to LFPs and possible resolutions

At the end of 2010, LFP outstanding lending amounted to at least nine trillion yuan, accounting for 18.8% of total loans. This could post potential risks to the entire financial system if it is not handled properly.

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Risks that might arise due to local financing platforms are as follows:

1. unqualified lending due to insufficient due diligence or improper lending procedures in 2009;

2. cash flow and interest coverage is quite low if excluding the funding provided by local governments as lending collateral;

3. debt-laden governments might be financially incapable to repay interest during a property downward cycle.

The local lending problem has drawn much media coverage and even hit the nerves of the central government. We believe problems due to LFPs could be solved by the following resolutions and actually some have been in place or are expected to be put in place in the near term:

1. increasing local government income streams through financial reform, such as allowing local governments to raise funds through bond issuance, implementing pilot schemes of property and resources tax. Currently, Shanghai, Zhejiang, Guangdong and Shenzhen have been granted the right to issue local government debts, while Shanghai and Chongqing have launched property tax pilot scheme. It is expected new sources of revenue will be generated in the future;

2. reinforcing efforts to clear up irregular LFP lending and enforcing governments and institutions to be responsible for their own lending. According to CBRC, banks need to re-examine due diligence process of all such kind of lending. New loans to non-social housing projects are strictly banned;

3. banks need to set aside more money as provision for depreciation and for those assets which are high risk. According to CBRC, banks should set a higher provision level to LFP loans, regardless of if it is a specially-mentioned loan, subordinated loan or loss-class loan. However, CBRC would allow an appropriate extension of expiry date for part of those lending;

4. for those LFPs which are not covered or only partly covered, banks have to call for guarantee, collateral, repayment commitment, etc to enhance cash flow.

Impact of LFP lending on assets and earnings of Chinese banks under various scenario analyses

The Chinese banking industry is highly leveraged and we could expect significant losses, even bankruptcy if bad loans default in large scale. However, according to published information, listed banks have less exposure than sector average in LFP lending as well as in non-performing outstanding loan. As such, the impact of such lending on their earnings would be limited.

Majority of LFP lending is fully covered and most Chinese banks have minimal exposure (less than 10% of total) to half-covered and uncovered LFP loans. In the worst case scenario as shown in Table 2, banks would not be in the red even but with negative earnings growth if their loss ratio in different types of LFPs increases substantially. In the short term, we expect the risks due to LFP lending are manageable.

Table 2.1: Scenario analysis – scenarios of banks' loan loss rates on LFPs

	LFPs with full coverage (>=100%)	LFPs with base coverage (70%-100%)	LFPs with half coverage (30%-70%)	LFPs with zero coverage (0%)
Best scenario	+0%	+2%	+6%	+10%
Base case scenario	+0.4%	+4%	+10%	+40%
Worst scenario	+2%	+10%	+30%	+100%

Table 2.2: Scenario analysis – bank's net profit growth forecast after taking into account increasing LFP loss as stipulated in Table 2.1

	State-owned banks average	Common-stock banks average	City commercial banks average	Sector average
Best scenario	+18%	+20%	+22%	+18%
Base case scenario	+10%	+7%	+9%	+8%
Worst scenario	-39%	-50%	-45%	-46%

Source: HSBC JinTrust estimates.

We believe that even if non-performing loans (NPL) mount up, the impact on bank earnings is still manageable as their exposure to partially-covered and uncovered loans is limited. As the amount of outstanding loans and cashflow coverage varies across different Chinese banks, it is forecasted that potential risks at common-stock banks would be bigger than at city commercial banks and state-owned banks.

2012 investment strategies for Chinese banks

Steady growth expected

Net interest margin has widened significantly by 10-20 basis points on average in 2011, from a year ago, benefiting from rate hikes and a squeezing loan quota. Accompanied by a steadily growing economy and improving asset quality, NPL and NPL rate at banks both dropped, and as a result it is expected the A-share listed banks could record an average of 28% real earning growth in 2011.

Looking ahead, the macro economy is trending down gradually while monetary policy will be kept appropriately prudent. That said, overall the banking industry will most likely be at its peak of profit cycle in 2011, and come down thereafter. Loan growth is expected to keep at a pace of 13.5-14.5% in 2012. However, as repricing of mortgage loans will push interest margin further up in the first quarter before it starts to fall, full year interest margin could edge up slightly over the course of the year from 2011.

Quality of assets in banks may turn weaker after their honeymoon period ends by 2011. Property market corrections, high delinquency risks in manufacturers and exporters due to a slowing economy, as well as substantial amount of LFP loans which are due, are clear signs that banks' NPL may turn upward. Nevertheless, taking into account a higher probability of an economic moderate slowdown, it is expected that the growth in overall loans may offset the increase in outstanding balance of NPL. As a result, NPL ratio would remain steady or reduce in 2012.

The largest risk to banks still comes from the property sector. Currently, loans relating to land development account for 6% of total loans, mortgage-related loans at 12% and property loans at 18%. If we take all loans related to property and land collaterals, which takes up between 30% and 35% into account, total property related loans account for more than half of the total loan book. However, as property prices are expected to drop by 10-20% in 2012, the impact on the banks' assets will still be manageable.

To conclude, we continue to expect banks to meet earnings growth of 15-18% in 2012, and although banks' asset quality may weaken due to increasing NPL, it is still manageable.

Banks are defensive, cushioned by low valuations

Banks currently have a low valuation with 2012 forecasted price to book (P/B) ratio at 1.1x given their steady growth. The sector is excellent value for investment, despite the prospect of narrowing interest margin and volatile loan quality. Low valuations, and better asset quality and higher provision than global peers indicate Chinese banks may achieve 15-18% profit growth in 2012. We believe low valuations make banks comparatively more defensive.

Table 3: Valuations comparison of the Chinese banking sector

	P/E ratio (x)			P/X ratio (x)		
	2010A	2011E	2012E	2010A	2011E	2012E
Large banks	8.36	6.59	5.58	1.52	1.36	1.16
Medium banks	9.72	6.95	5.69	1.71	1.25	1.06
City commercial banks	10.58	8.08	6.52	1.50	1.30	1.12
Average	**9.46**	**7.05**	**5.81**	**1.61**	**1.30**	**1.10**

Source: Company data and HSBC JinTrust, data as at 8 November 2011.

To conclude, we suggest to focus on the following themes regarding the investment strategies on the Chinese banking sector for 2012:

1. banks are to meet greater challenges due to increasing competition from other non-commercial banks and interest rate deregulation. They need to adjust strategies accordingly to achieve better performance. Already there are signs of differentiation among banks with some of them more successful than others with corresponding strategy change.

We prefer those banks that have exposure to retail banking, micro-enterprise lending, wealth management and social banking business, as these all fit in the future market trend. Those banks which have failed to change and are slow in progress will ultimately be marginalised;

2. after a three interest rate hikes in 2011, some of the loan portfolios have to be re-priced next year. This may be positive to interest rate margin of the banks. Mortgages are among the largest proportion of the loan portfolios and banks with more mortgage loans to be re-priced next year could benefit from improving interest margin;

3. bond markets are expected to be the market focus next year, banks which hold more in bonds would benefit from an increase in value;

4. from the valuation front, we suggest to focus on banks with low P/B valuations as their downside risk is lower even if the economy has a hard landing.

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