The Economic Challenges Facing China

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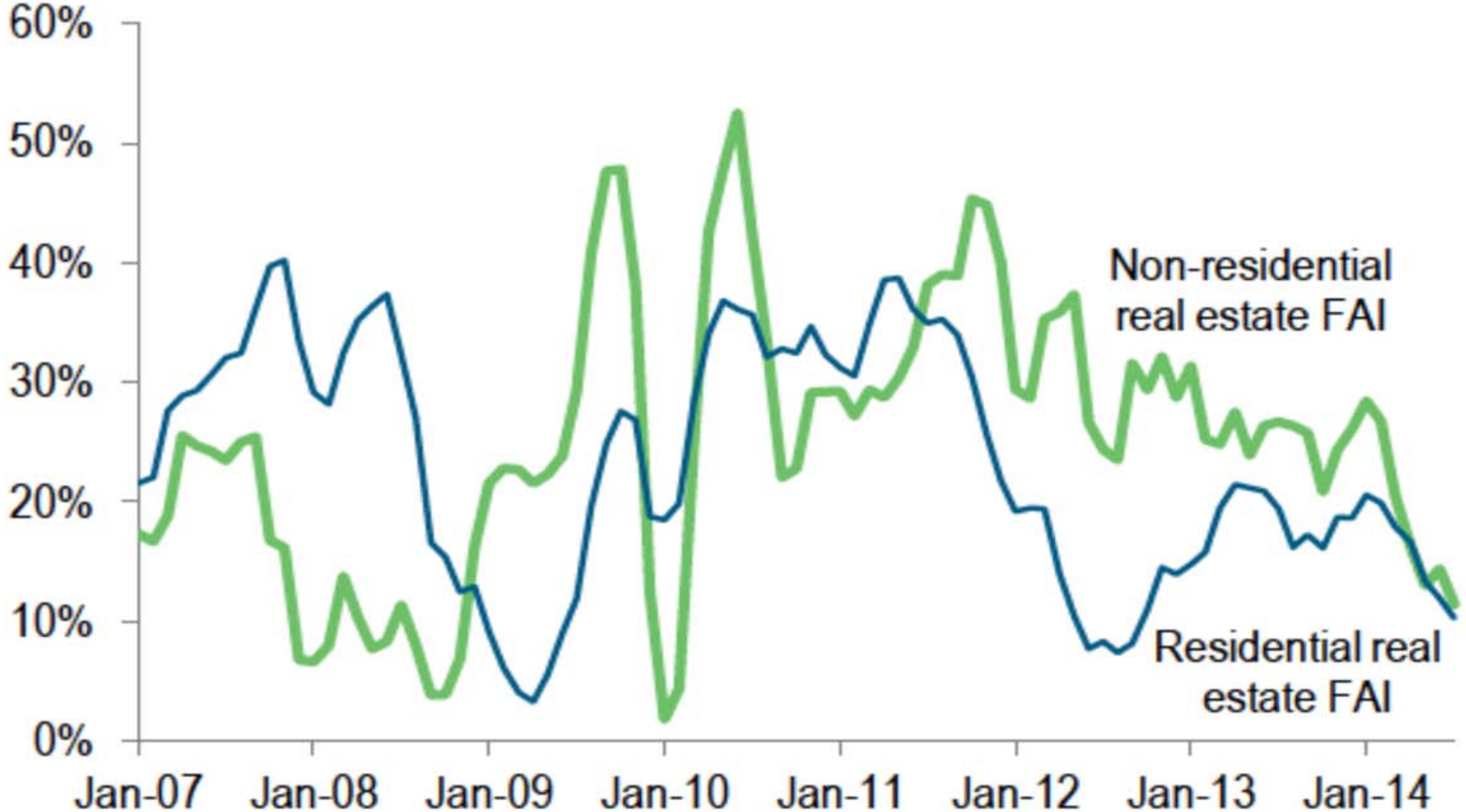
China’s economy is dragging…

- China’s economy runs on fixed asset investment (~40-50% of GDP) and real estate property construction (~15-25% of GDP).
- Slowdown in real estate and fixed asset investment driving down GDP, as other sectors struggle (cement, steel, appliance, auto, home furnishings).
- 2014 has seen declining bank profits and rising NPLs
    - Thinning bank liquidity and margins, lackluster property market, growing developer failures and depressed export demand.
- Double digit decline in property sales in 2014.
    - 60 of 70 cities reporting declines in property sales.
- Recent policy developments unlikely to change buyer sentiment.

…real estate sector remains weak.

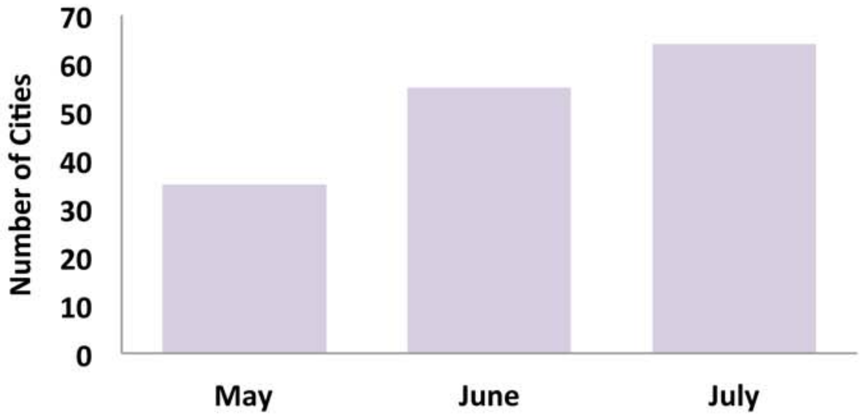
Residential and non-residential real estate FAI, y/y % 3mma



Sources: Standard Chartered, CEIC

The residential real estate market is declining across the board.

Number of big cities reporting declining residential prices m-o-m



- The number of cities reporting declining residential sales prices has nearly doubled from 35 in May 2014 to 64 in July 2014.

- Double digit decline in property sales in 2014.
- Double digit price declines reported in 3rd and 4th tier cities suffering from oversupply.
- Housing affordability remains a major issue in tier 1 cities.
- Recent policies changes regarding mortgage availability unlikely to materially change buyer sentiment in the short-term.

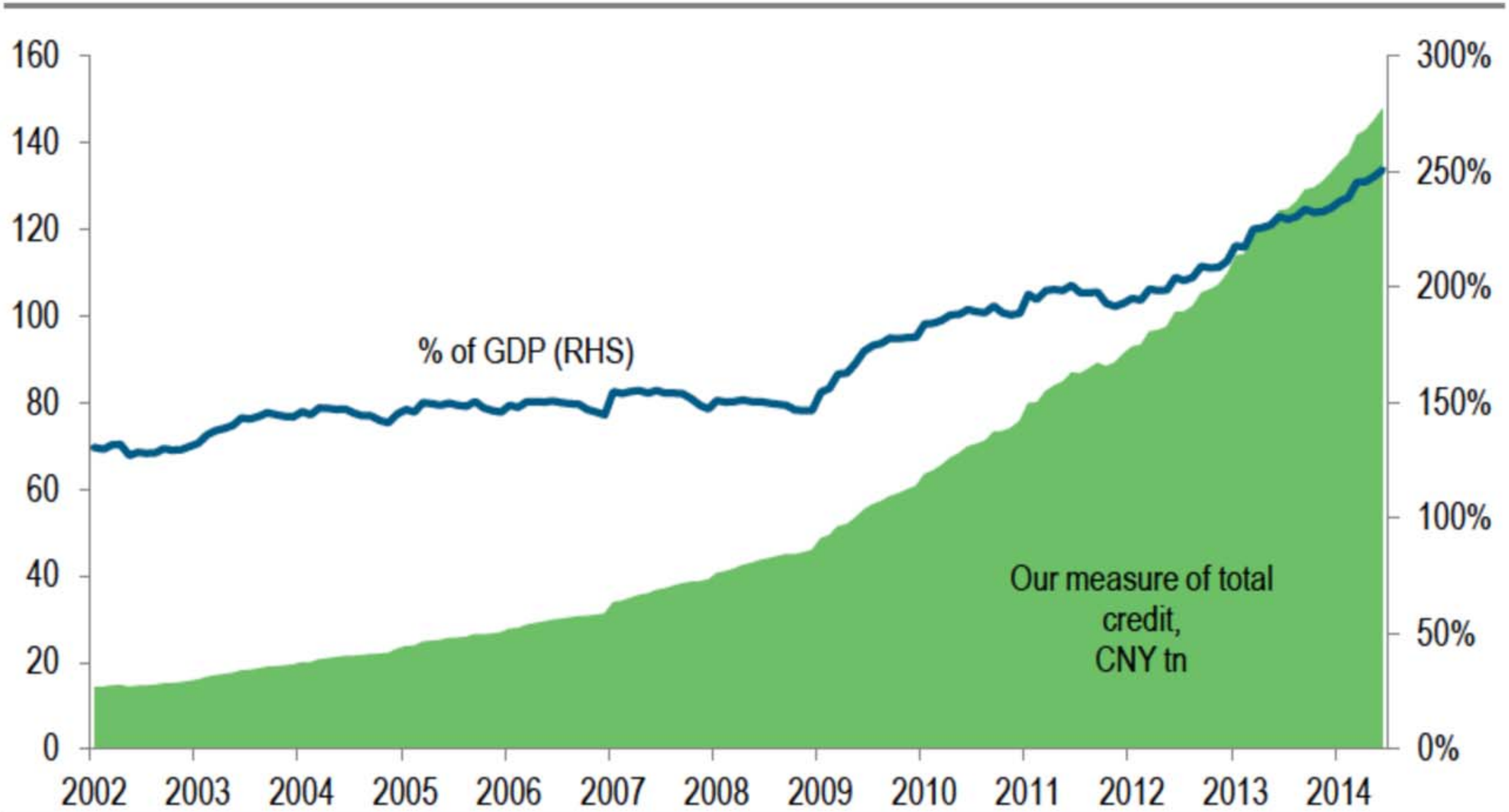
Source: National Bureau of Statistics

China is re-leveraging to boost growth…

- China continues to respond to economic slowdowns with systemic liquidity injections, primarily through its banks.
  - Since June 2014, China has injected RMB1.7 trillion into the banking system.
- Standard Chartered estimates total debt to GDP exceeds 250% as of June 2014.
- Public debt could be well over 70% of GDP as LGFV loans may be underreported and complete exposure to off-balance sheet financing is unknowable.
- The Government continues to increase liquidity to the 20 largest commercial banks ($114 billion) and the China Development Bank ($160 billion) to ensure lending to key projects continues.

…total credit continues to rise.

CNY trillion (LHS), Percent of GDP



Sources: Standard Chartered Research; CEIC

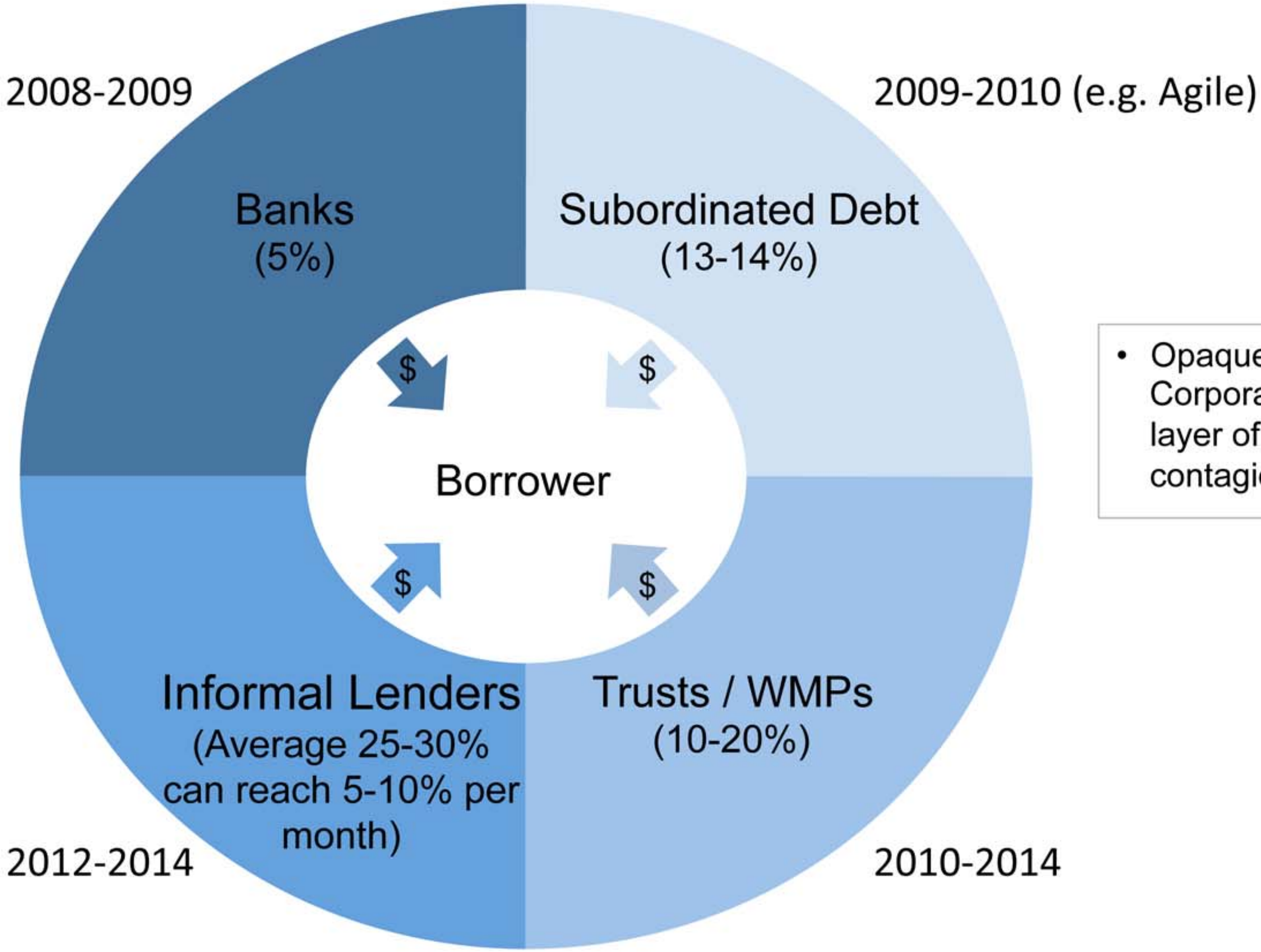
Continued "Extend and Pretend" strategy for dealing with local government debt.

- Official figure for local government debt as of June 2013 is RMB17.9 trillion; Estimates range from RMB20-24 trillion (40-50% GDP) as stimulus projects are completed.
- Outstanding local government debt rose from RMB10.7 trillion in September 2012 to 17.9 trillion as of June 2013…more than a $1 trillion increase.
- Previously the CBRC reported as many as 73% of LGFV loans went to projects with insufficient cash flows to pay interest.
- Local governments are facing challenges in financing their obligations:
    - Moribund land market constrains local governments' ability to raise money to service loans.
- Central Government has declared it will not back local government debt but new regulations allow for local governments to issue new bonds with maturities of 5-7 years.

Debtors and banks are increasingly turning to shadow banking system to access funding.

- The shadow banking system exploded and continues to expand despite recent regulation.
    - ANZ estimates total shadow banking assets exceed RMB30 trillion (more than 50% of GDP).
    - Assets managed by Trust companies have increased 5x since 2010 to RMB 12.5 trillion.
- WMPs may create a significant contagion risk:
    - These products are highly opaque and often backed by a pool of assets whose cash inflows do not match the timing of WMP payouts.
    - Inter-bank loans for short-term financings account for 40% to 80% of WMPs.
    - Shadow banking system provides bridge-loans as borrowers wait for banks to roll-over previous loans; Disruptions to this cycle would have dramatic follow-through effects throughout the system.
- Banks may have to bring these products back on their balance sheets in the event of losses (Credit Equals Gold)
- AMCs have emerged as “White Knights” or “buyers-of-last-resort”.

Developers and SMEs are forced to borrow from the shadow banks to repay loans at higher rates of interest.



- Opaque Credit Guarantee Corporations add additional layer of complexity and contagion risk.

NPLs ratios are understated and likely to rise quickly.

- Analysts predict NPLs will continue to rise – particularly in the real estate and manufacturing sectors.
- In 1H 2014 NPLs increased 21% to RMB695 billion ($113 billion).
- The reported ratio of total NPLs to outstanding credit is 1% but Special Mention Loans are nearly 3x reported NPL levels. Analysts believe the real number of NPLs is closer to 6%.
- Major banks have increased NPL provisioning but the major concern is unknown exposure to shadow banking products and so-called "Credit Guarantee Corporations".
- Large amount of outstanding loans and interdependent financial system mean NPL ratios can rise quickly.
- Rising NPLs will have a big impact on bank's capital adequacy levels and profits.
    - 3Q 2014 PBoC injected RMB100 billion into each of the Big Five Banks to shore up capital adequacy.
    - Additional 4Q 2014 injection of RMB 200 billion into 20 large national and regional banks.

Conclusions

- China's financial system is complex, opaque and far from international "best practices".
- China has relied on liquidity to navigate past crises. Rising NPLs threatens system-wide liquidity, which in turn will spur NPL growth.
- Banks are woefully under-provisioned to handle even conservative estimates of NPL levels.
- At a minimum, banks must double NPL provisioning.
- Government may rely on continued credit expansion to evergreen loans but this does not mitigate the fact that banks do not receive payment.
  - Rolling over loans will crowd out new lending, further weighing on GDP growth.
- Government may transfer bad loans to AMCs without write-downs. Listing the AMCs would transfer the dodgy assets to the public markets (Cinda).
- Growing out of the problem is infeasible as credit growth (15.9%) is already outpacing GDP growth (7.5%).
- China requires structural reforms to boost productivity and a more transparent financial system to ensure financing is directed toward the right sectors.