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CHINA'S BANKS 2010[1]

Danielle Cadieux wrote this case under the supervision of David Conklin solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

In the 1990s, considerable debate arose concerning the strength and stability of China's banks. Of particular concern were the debts owed to the banks by state-owned enterprises (SOEs). Many SOEs had been experiencing financial difficulties, which led to concern they might not be able to repay these loans. Some analysts emphasized that because the banks and the SOEs were both owned by the government, the only relevant concern was the financial strength of the government and its preparedness to take responsibility for any of the banks' non-performing loans. In the early years of the twenty-first century, the government undertook a widespread program aimed at improving the banks' balance sheets by purchasing non-performing loans from the banks and then reselling them at a discount, often to foreign private-sector financial institutions. Prior to 2010, this process had provided a generally accepted faith in the stability and security of China's banks. Total non-performing loans as a percentage of total bank loans decreased from 20 per cent in 2003 to three per cent in 2008.

The year 2010 brought a new realization that the non-performing loan problem had reappeared. However, China's banks now had both private and government shareholders, and so the solution had become more complex. The government's response was to insist that China's banks increase their capital base by issuing new equity.

> Most of China's big banks have announced vast capital-raising plans. On top of the projected $22bn initial public offering of Agriculture Bank of China, announced last week, CCB [China Construction Bank] and Industrial and Commercial Bank of China are between them raising up to $21 billion in fresh capital.
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> The moves follow a directive from China's banking regulator to increase their core tier one capital to more than 9 per cent — higher than the norm in much of the rest of the world — following a vast expansion of lending last year.[2]

[1] *This case has been written on the basis of published sources only. Consequently, the interpretation and perspectives presented in this case are not necessarily those of any of China's banks or any of their employees.*

[2] *Richard McGregor and Patrick Jenkins, "China Bank Chief Warns on Sentiment," The Financial Times, July 10, 2010, p.16.*

To prevent a precipitous decline in aggregate demand in the context of the global recession, the government of China had instructed the banks to greatly increase their loans. In 2009 alone, aggregate loans increased by US$1.4 trillion, which was more then 30 per cent higher than in 2008. This meant that, by the end of 2009, nearly 25 per cent of all outstanding bank loans in China had been extended over the previous 12 months. Once again, the specter of non-performing loans and bad debts had become a serious concern.

Apart from the questionable due diligence involved in loans to SOEs, a new concern emerged that considerable loans had been extended to local governments to finance welfare programs and infrastructure that would not automatically provide repayments to the banks. Furthermore, China's banks had developed extensive off-balance sheet activities, estimated at US$340 billion by 2009. These off-balance sheet activities included the securitization and resale of loans that could still leave the banks responsible for non-payment.

In July 2010, the Agricultural Bank of China initiated an initial public offering (IPO) that raised over US$20 billion in capital. The Industrial and Commercial Bank of China Ltd. (ICBC) also announced it would issue up to 0.6 new shares for every 10 existing shares, raising nearly US$7 billion in a rights issue. Nevertheless, the rating agency Standard and Poor's estimated that if 30 per cent of bank loans to local governments became bad debts, four to six percentage points would be added to the non-performing loan ratios at the banks. While attention was generally focused on the large banks, China had perhaps 100 other financial institutions that were owned by the government, in addition to thousands of rural cooperatives that operated outside of the government's direct control. The solution for these institutions was not clear.

The vast expansion of bank loans created the appearance of an equally vast increase in bank profits. In 2009, for example, the Agricultural Bank of China's earnings rose by 26 per cent. The bad debt potential and the need to raise equity capital added a confusing element to this rosy picture. Furthermore, the government still set a ceiling on the interest rates that a bank could pay for deposits and a floor on the interest rate banks could charge for loans. Perhaps the central question was not the availability of capital equity but rather the confidence in the future of China's economy as a whole. Surely China's government would step in once again to restructure the banks' balance sheets. Now, however, if the government were to purchase non-performing loans, the private shareholders of the banks would benefit, and many would question whether such gains by private investors were appropriate.

It was unclear whether China's new capital requirements would be sufficient to prevent a future financial crisis. If China were to adopt the guidelines of Basel 3, considerably more capital might be required, as well as closer analyses of the loans of each bank.