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China Banks: Wealth Management Products - Should Investors Be Concerned After Huaxia Bank Incident?

Ticker	Rating	CUR	18 Dec 2012 Closing Price	Target Price	TTM Rel. Perf.	EPS 2011A	EPS 2012E	EPS 2013E	P/E 2011A	P/E 2012E	P/E 2013E	Yield
1288.HK (AgBank)	M	HKD	3.76	3.50	-4.4%	0.38	0.46	0.45	8.1	6.7	6.8	3.5%
1398.HK (ICBC)	O	HKD	5.55	5.80	0.4%	0.59	0.66	0.67	7.7	6.9	6.8	4.5%
3988.HK (BOC)	O	HKD	3.49	4.20	3.0%	0.43	0.46	0.49	6.6	6.2	5.8	5.4%
939.HK (CCB)	O	HKD	6.26	7.20	-4.2%	0.68	0.79	0.79	7.5	6.5	6.5	4.6%
3328.HK (BOCOM)	M	HKD	5.82	6.00	-11.4%	0.82	0.86	0.81	5.8	5.5	5.9	4.2%
3968.HK (Ch Merch Bk)	U	HKD	16.60	12.80	-11.1%	1.67	1.96	1.63	8.1	6.9	8.3	2.1%
998.HK (CITIC Bk)	M	HKD	4.48	4.30	-14.8%	0.71	0.72	0.72	5.2	5.1	5.1	3.2%
MXAPJ			462.85			33.43	35.22	38.99	13.8	13.1	11.9	3.0%

O – Outperform, M – Market-Perform, U – Underperform, N – Not Rated

* NOTE - The EPS Ests in the Ticker Table for the Chinese banks are denominated in RMB (and are thus comparable to Consensus).

Highlights

- Recent events at Huaxia bank have led to an increase in investor concern over the fate of banks' exposures to wealth management products (WMPs). Even though the defaulted products sold by Huaxia bank were not WMPs (they were private equity investments), that hasn't eased investor concerns.
- ***We estimate there were total WMPs outstanding about of RMB 9 trillion during Q3 2012 with ~70% of the products non-principally guaranteed*** (i.e., off the banks' balance sheets). That means the non-principal guaranteed market is equivalent in size to 8% of the total deposit base.
- In general, the medium-sized banks have higher exposure to these products (equal in size to 8-16% of their deposit base) than the Big 4 banks (just 3-6% exposure).
- Despite the market/media focus on the high-yielding nature of these products which carry high risks, ***fewer than 10% of outstanding WMPs offer yields of more than 5.0%.***
- We do not expect banks will be asked to backstop losses from these products that are sold via their distribution channel. Certainly, there will be instances of mis-selling of these products and the banks may face liability in those cases, but we do not expect the banks to bail out WMP investors wholesale.
  - The scenario where the banks would be asked to backstop WMPs is if their defaults threaten social stability. However, with the higher-risk/higher yield WMPs typically being sold to HNW individuals and corporates which have high risk appetites and risk tolerances (and not to "mom and pop" investors), we do not see a high likelihood of this occurring.
- In the case the banks are asked, forced, or decide to backstop the WMPs sold via their distribution network by consolidating them onto their balance sheet, ***the medium-sized banks (Merchants and Minsheng) would face the most negative impact to their capital adequacy ratios (90-100bp haircut) while BOC & AgBank will only see a 30bp decline.***
- ***From an earnings perspective, if these products were consolidated and faced 10% credit losses, Minsheng and Merchants would be most negatively impacted as they would take a 55-60% hit to their***

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full-year 2013 earnings (not including the impact of lost commissions). The Big 4 banks would be least impacted as ***CCB and BOC would see just a 15% hit to FY 2013 earnings***.

- We continue to prefer the large banks in this environment. While we do not expect the banks will have to consolidate non-principal guaranteed WMPs or protect investor losses, we fear the market may price this scenario in, negatively impacting the valuation of the small banks. We continue to rate BOC, CCB and ICBC Outperform and China Merchants Bank Underperform.

Investment Conclusion

We continue to maintain our belief that the Chinese banks, as a group, are attractive at current levels. We reiterate our preference for the large banks and our Outperform ratings on CCB, ICBC and BOC. We believe the large banks will continue to outperform the smaller banks on fundamentals going into the Q4 2012 earnings season.

Details

*Following the Huaxia Bank "wealth management product" incident[1], we revisited our analyses on market sizing the risk of wealth management products as a follow-up to the report we published in August 2012 **China Banks: Sizing the Risk of Wealth Management Products; Connecting the Dots Between WMPs & Bank Deposits**). We also talked to the management of a number of banks and several client managers (who sell over-the-counter wealth management products) for a deeper, but more empirical understanding of the wealth management product business. Finally, we aim to assess the spillover effect the Huaxia Bank incident may have on Chinese banks.*

Summarized Conclusions

A lot of noise has emerged from China regarding the recent default of investment products sold to high-net-worth customers at a branch of Huaxia Bank, a medium-sized A-share listed bank. While we do not believe the market is close to impending doom, we do believe that growth will slow and losses will be taken (by investors, not banks) as the market matures.

We would be very surprised to see the banks forced to protect non-principal guaranteed WMP investors from losses especially as the higher risk/higher return products are normally sold to high-net-worth individuals and corporations. There will be less political pressure to absolve losses from those client groups.

We've found that the medium-sized banks (like China Merchants Bank and China Minsheng Bank) are the most exposed to non-principal-guaranteed products with outstanding balances equal to 12-15% of their deposit base vs. 3-6% for the Big 4 banks.

[1] We put wealth management product in quotes as it was not a WMP that defaulted on Huaxia's investors but an investment product (more details to follow).

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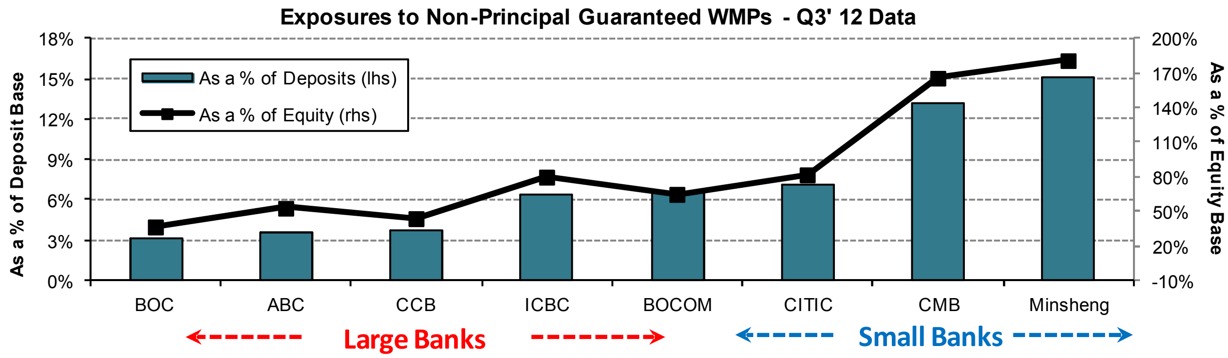
Exhibit 1

Small Banks are More Exposed to Non-Principal-Guaranteed Wealth Management Products Relative to Their Deposit or Equity Bases



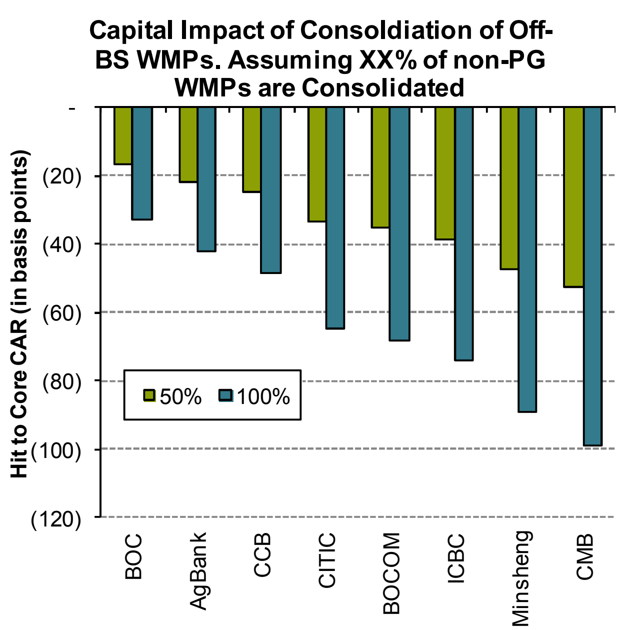
Source: Corporate Reports, Bernstein Analysis & Estimates

As a result, in the scenario where the banks are forced, asked or decide to backstop customer losses from their investments in WMPs sold via the banks' distribution networks, China Merchants and China Minsheng Banks would be most negatively impacted from both an earnings perspective and a capital perspective.

If the banks were to consolidate all of the WMPs as part of a bailout Minsheng and Merchants would face, a 90-100bp decline to their core capital adequacy ratio (vs. just 30-40bp for BOC and AgBank). Meanwhile, if we assume that 10% of these assets would need to be written off, Merchants and Minsheng would see their 2013 full-year earnings fall by 55-60% (vs. just 15% for BOC and CCB).

Exhibit 2

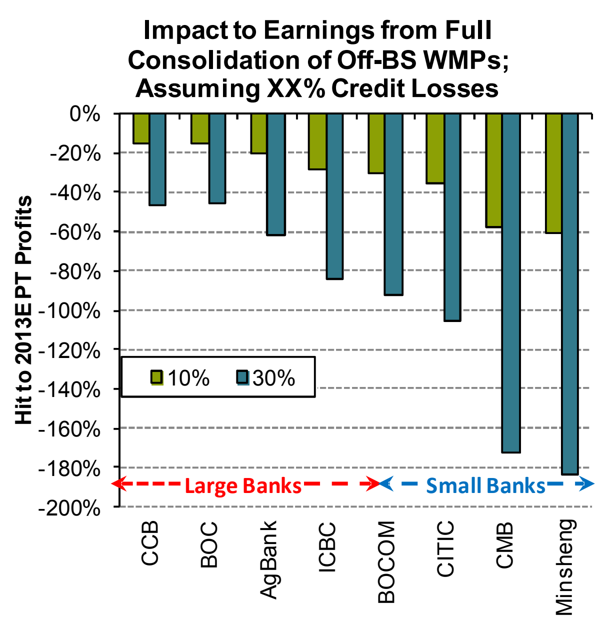
In the Extreme Scenario, CMB and Minsheng Will Take the Greatest Hit to Their Q3 '12 Capital Base if They Consolidate the WMPs They've Sold



Source: Bernstein Analysis & Estimates

Exhibit 3

…Meanwhile the Same Two Banks' 2013E Earnings will be Most Impacted to Credit Losses



Source: Bernstein Analysis & Estimates

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A Brief Recap on Huaxia Bank "Wealth Management Product" Incident

There has been a good amount of press recently over a defaulted "wealth management product" sold via a Jiading -located (a suburb of Shanghai) sub-branch of Huaxia Bank[2]. According to the press reports, a "wealth management product" sold to high-net-worth customers of Huaxia Bank defaulted, resulting in the loss of principal on these investments. In response, these investors began to protest in front of the bank, generating a significant amount of press coverage. In fact, we have described these protests (in a tongue-in-cheek manner) as the one of the most effective protests in the world.

- According to press reports, there have been "dozens" of people protesting in front of the Huaxia Bank in Jiading. Despite the fact that just dozens of people are protesting the bank, these protests were very effective as evidenced by a very high level of media attention that followed. In fact, if we look at the ratio of the number of press reports-to-total protestors, we argue that this was one of the most effective protests in the world in 2012.

Exhibit 4

Key Elements of the "Wealth Management Products" sold by Huaxia Bank that Have Defaulted

Investment Products -Huaxia Bank Zhong Ding Series (Private Equity Investment)							
	Invested Target	**Threshold Amt. for Limited Partners (in RMB)**	**Yield**	**Investment from the General Partner (RMB)**	**Investment from the Limited Partners (RMB)**	**Start Date**	**Term**
No.1	A pawnshop	3 Tiers: - 0.5 million - 1.0 million - 3.0 million	11-13% (For Limited Partners)	10 million	40 million	25-Nov-11	12 months
No.2	A car dealer			5 million	20-25 million	21-Dec-11	12 months
No.3	A entertainment company			15 million	55 million	10-Jan-12	12 months
No.4	Another car dealer			10 million	35-40 million	2-Mar-12	12 months

Source: News Sources, Bernstein Analysis

However, when we dig a little deeper, the actual events of what happened do not fully correspond with the version recorded in the press. First, the "wealth management products" that were sold to investors were actually participations in an investment fund (akin to a private equity fund) – see the details of the product series in **Exhibit 4**. The investment promised an annualized return of 11-13%, much higher than the 3.5-5.5% return we normally see on wealth management products (see **Exhibit 5**). In fact, the average yield provided on wealth management products has declined since the start of the year (see **Exhibit 6**). And over the past 3 months, less than 10% of wealth management products sold to investors promised annual yields of more than 5.0% (see **Exhibit 7**).

[2] Huaxia Bank is an A-share listed Chinese bank. It is one of the 12 joint-stock banks operating in China (the joint-stock banks are privately-held banks in China that have a license to operate nationally). Among the joint-stock banks, China Merchants Bank is the largest; Huaxia is the 7th largest with more than US$160 billion of total assets.

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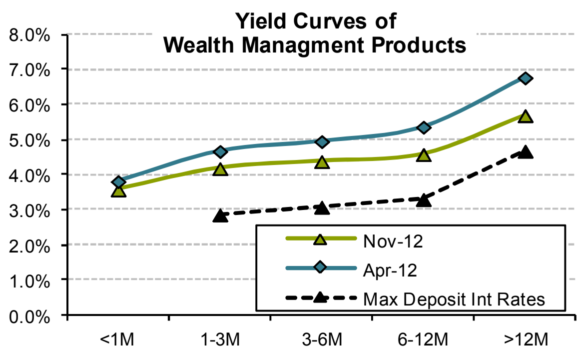
Exhibit 5

China Bankrate.com Statistics: Average Yield of Wealth Management Product Ranges from 3.5% to 6.0% (1.5-3.0% Premium over Deposits of the Comparable Maturities) and the Curve Shifted Downward in the Past 0.5Yr

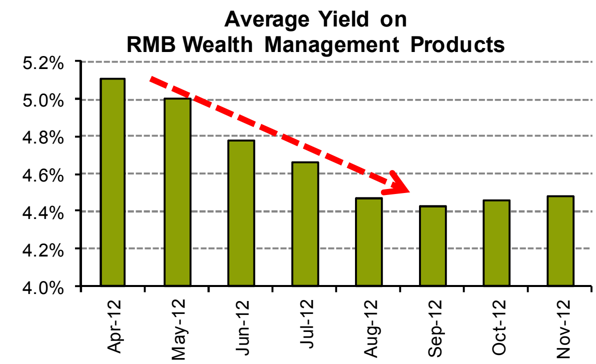


Source: Bankrate.com.cn, Bernstein Analysis

Note – Bankrate.com.cn is a web platform that aggregates information on wealth management products for investors.

Exhibit 6

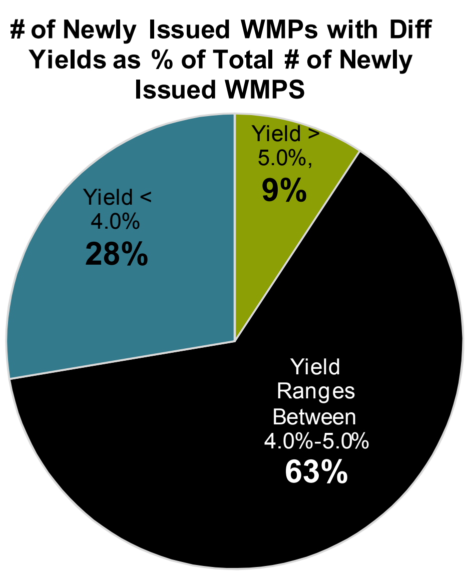
Average Yield on Wealth Management Products in RMB was on the Decline from Apr to Sep of 2012



Source: Bankrate.com.cn, Bernstein Analysis

Exhibit 7

Less than 10% of Newly Issued WMPs Offer High Yield thus Carry High Risks that are Held by Investors



Source: CNBENEFIT, Bernstein Analysis & Estimates

So, if the investment in question wasn't a wealth management product, what exactly was it? In this incident, the investment was tied to an asset management company that was selling a private-equity-like investment.

- The name of the company that sold the product that defaulted is Tong Shang Guo Yin Asset Management (Commercial Finance Asset Management). The company is based in Beijing and runs a number of

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finance-related businesses including asset management, project management, project investment, and consultancy. Based on the company's website (which had recently been blocked), the company makes venture capital and private equity investments in a wide array of sectors – real estate, car dealerships, media, information technology and new energy. The company also claims that it is engaged in the securitization business as well as artwork collection. Given the number of businesses in which the company participates, it is unlikely that the company has much expertise in these businesses, as it was only founded in 2011(according to its website).

The Huaxia Bank incident highlights the fact that it is a natural tendency for investors/depositors to assume every product the Chinese banks sell has implicit backing from the banks. While the bank declared it was even not the bank, but one of its employees who sold this product to investors in the absence of any authorization from the bank, it seems the furious protestors have no intention of letting the bank off the hook.

The Huaxia Incident Has Investors Focus on the Risks of the WMP Market

Given the high level of media interest on the defaulted investment products sold by Huaxia, our investors have refocused their attention on the risks of the wealth management product market. Even though the Huaxia Bank incident was not related to wealth management products, that has done little to alleviate investor concerns that the Chinese banks will be forced to backstop losses on these products.

We wrote an in-depth report on the wealth management market in August this year entitled **China Banks: Sizing the Risk of Wealth Management Products; Connecting the Dots Between WMPs & Bank Deposits**. Given the increased concern over this area of the market, we thought it would be helpful to update our estimates of the size of the market as well as to update our thoughts on the market following our conversations with the banks and participants/managers in the wealth management product market.

Sizing Bank Wealth Management Products from the Bottom up

We estimate RMB 8.0 trillion of WMPs were outstanding at the end of the quarter, accounting for 9.0% of customer deposits (ex-principal guaranteed WMPs) - see **Exhibit 8** and **Exhibit 9**. WMPs have a tendency to mature just before quarter-end as this is a way for banks to inflate their customer deposit balances. As a result, outstanding balance is less representative of the true level of this business than average balance.

- After WMPs mature in the final days of the quarter, investors' saving accounts are credited with these funds which boosts the bank's deposit base and results in an artificially low loan-to-deposit ratio (LDR) for these banks. Then, when the following quarter begins, new WMPs are sold to these investors increasing the size of WMPs outstanding. Small- and medium-sized banks are most active in this "window dressing" as their average LDRs are often 400-800bp higher than their period-end LDRs. We estimate that the total WMP market is ~18% larger than the period-end data would imply due to the tendency of non-principal guaranteed WMPs to expire just before quarter-end.

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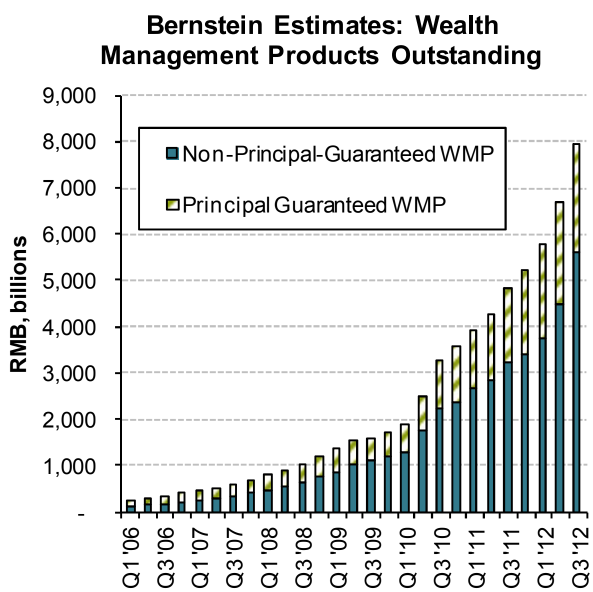
Exhibit 8

We Estimate Total Wealth Management Products Outstanding at the end of Q3 '12 Amounted to RMB 8.0tn with 70% of them Being Non-Principal-Guaranteed

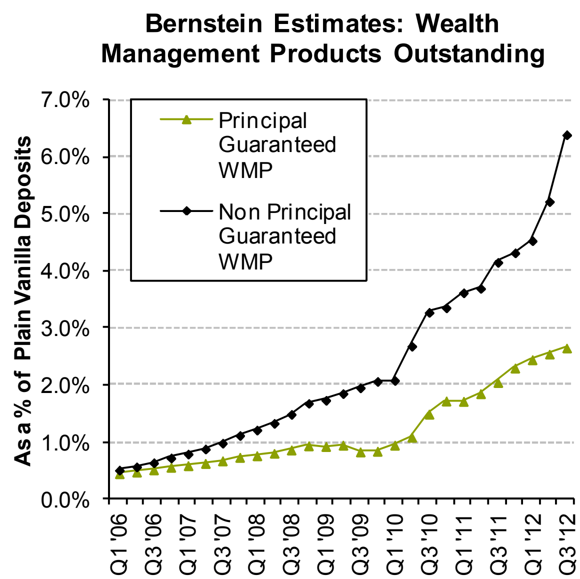


Source: CNBENEFIT, PBOC, CEIC, Bernstein Analysis & Estimates

Important Note - This Figure DOES NOT Capture the 18% that Expired Just Prior to Quarter-End and Converted into Customer Deposits

Exhibit 9

…and Total Wealth Management Products Outstanding Accounted for 8-9% of Deposit Outstanding



Source: CNBENEFIT, PBOC, CEIC, Bernstein Analysis & Estimates

Note - As principal-guaranteed wealth management products count towards customer deposits, we call the remaining part of total deposits, after deducting principal-guaranteed wealth management products, plain vanilla deposits

Important Note - This Figure DOES NOT Capture the 18% that Expired Just Prior to Quarter-End and Was Converted into Customer Deposits

We show our bottom-up approach to sizing the WMP market in **Exhibit 10** as of the end of Q3 2012. As a result of the seasonal nature of non-principal-guaranteed WMPs we mentioned in the last paragraph, we estimated intra-quarter balance (higher than the period-end balance) of wealth management products of the whole industry amounted to RMB 9.1 trillion by Q3 '12. To put this in relation to the overall deposit market, total size of wealth management products is equivalent to 11% of customer deposits. The off-balance sheet portion of the WMP market is equal to about 7-8% of the total domestic deposit market.

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Exhibit 10

A Bottom up Sizing of Wealth Management Product – Q3 '12

Period-end Balance (Q3 '12 Data)					
RMB, billions	**Principal Guaranteed WMP**	**Non-Principal Guaranteed WMP**	**Total WMP**	**Customer Deposits**	**Total WMP as % of Total Customer Deposits**
BOCOM	184	238	422	3,640	12%
CCB	420	400	820	11,059	7%
BOC	450	290	740	9,343	8%
CMB	67	317	384	2,413	16%
CITIC	40	160	200	2,237	9%
ABC	165	385	550	10,791	5%
ICBC	140	859	999	13,634	7%
Subtotal (Bernstein Coverage)	**1,466**	**2,649**	**4,115**	**53,117**	**8%**
Other Banks	*860*	*2,952*	*3,879*	*33,598*	*12%*
Total Period-End Balance (Industry)	**2,326**	**5,602**	**7,994**	**86,714**	**9%**
Total Average Balance (Industry)	**2,326**	**6,790**	**9,115**	**86,714**	**11%**

Avg balance is higher than period-end balance due to the seasonal nature of non-PG WMPs

Source: Bernstein Estimates, Corporate Reports, PBOC, CEIC, Bernstein Analysis & Estimates

We believe the small banks are more exposed than the large banks to non-principal-guaranteed WMP and we incorporated this into our bottom-up market sizing estimation. The reason is that we think small banks spend more window dressing efforts by timing a greater portion of non-principal-guaranteed WMPs to mature by quarter end than large banks. This leads us to estimate a higher percentage of WMPs as in customer deposits for small bank than for large banks (12% vs. 8%).

Which Banks Are Most Exposed to Off-Balance Sheet WMPs?

As we mentioned in the previous section, non-principal guaranteed WMPs are equivalent to about 8% of the domestic deposit market (while total WMPs are equal to 11% of the deposit market). However, different banks have widely different exposures to these products.

In general, among the H-share listed banks, we have found that the small banks tend to be more exposed to non-principal guaranteed products than the large banks (see **Exhibit 11**). For the Big 4 banks, their outstanding balance of non-principal-guaranteed products was equivalent to 3-6% of their deposit balance (BOC was at 3%, ICBC was at 6%). Meanwhile, the smaller banks, who have tighter liquidity and often have to provide WMPs to clients in order for them to maintain their deposit balances, reported exposures of 7% for BOCOM, 13% for China Merchants Bank and 15% for China Minsheng Bank. And these are the period-end balances. We know that the average exposures are actually much higher and with the smaller banks more active in window dressing, we would not be surprised to see their average exposures higher than what is represented below.

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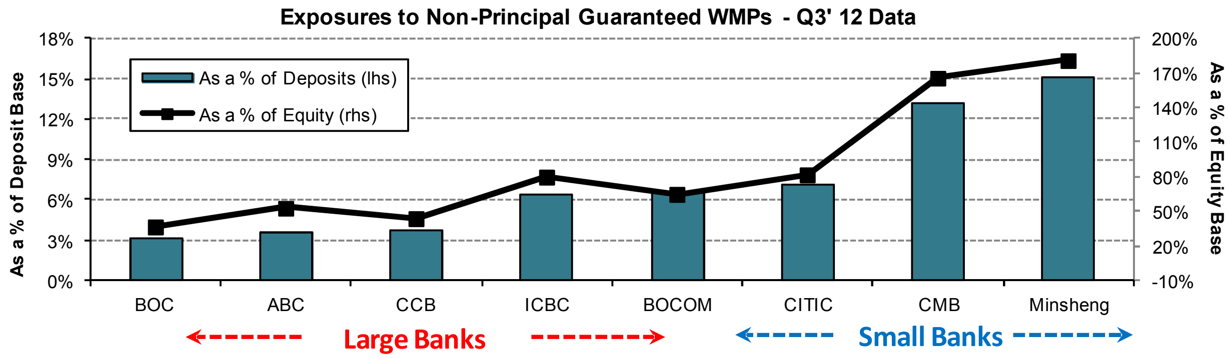
Exhibit 11

Small Banks are More Exposed to Non-Principal Guaranteed Wealth Management Products Relative to Their Deposit or Equity Bases



Source: Corporate Reports, Bernstein Analysis & Estimates

The small banks are more likely to offer non-principal guaranteed WMPs for two major reasons. First, they have weaker deposit franchises which make it difficult for them to meet regulatory LDR requirements (maximum of 75% at quarter-end). As a result, the small banks tend to window dress their balance sheet more than the large banks by offering WMPs that expire just before the quarter-end which allows them to boost customer deposits. Second, corporate clients (who contribute 80-85% of the small- and medium-sized banks' deposit bases) exhibit strong demand for products that yield more than traditional deposits. As a result, the small-and-medium sized banks must ensure adequate supply for these customers in order to win their deposit mandates.

Who will be on the Hook for Losses?

Following the Huaxia bank wealth management product incident, we suspect that regulators will increase oversight on these products. We would view this as a positive for investors in these products (as well as the equity analysts looking for tangible information on the business) as this market is extremely opaque. Very little is known about the investments that are made with the cash raised in the sale of these products. While increased regulation can limit the risks of the market, it cannot completely alleviate them.

As a result, what investors want to know the most is: Will the banks back-stop client losses on wealth-management products? The answer to this question differs depending on who you speak to:

- **If you speak to the regulator**, they say they do not want to see depositor funds used to back-stop the activities of risk-takers (i.e., that the banks will not have to protect investors losses from WMPs). In fact, if the banks were to back-stop these wealth management products, it would become very difficult for the banks to generate deposit inflows. In other words, what customer would give their money to a bank in the form of a deposit at a 3.3% yield if they could get a 4.5-5.5% yield from a wealth management product and be assured that their principal was guaranteed?
- **If you speak to the central bank**, they say that they want to continue to develop China's capital markets. However, in order to do so, they need to establish a Capital Asset Pricing Model that determines the market required rate of return for a particular asset (where the return is correlated to the risk of the investment). Having the banks back-stop losses on WMP investments will certainly hurt this endeavor even more than if there is no CAPM curve to price the risks. Without the CAPM curve, capital markets do not exist.
- **If you speak to the central government,** they would prefer to avoid taking a stance one way or another on the topic (leaving that instead to the regulator and central bank). However, one could rest assured that

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if the problem became large enough that it threatened social stability, then we would expect the government to lean on the banks to back-stop losses in the market. But we do not expect the problem to get to the point where the banks are called in to provide this "national service".

- **If you speak to the banks,** they say that they make investors sign disclaimers which state the banks have ***no legal obligation to provide recourse to losses on these investment products***. That said, banks have been increasingly aware of the importance of maintaining their reputations with customers for fear that they might walk away from a bank due to being sold poorly performing products. One bank we talked to addressed this matter in this way:
  - *"Reputation is strategically critical to banks. As a bank, if you screw up with a loan, your loss is only limited to this loan. But if you lose your reputation to one customer, the impact will spill over to other customers."*

Going forward, Chinese banks will make endeavors (and likely be forced by regulators) to increase the disclosures (both literally and verbally) of wealth management products on what are invested in. For instance, when products are sold over-the-counter, banks will need to better fulfill their responsibilities of educating investors by ensuring that investors have read and understood the risk warnings of the products they invest in. In addition, banks will need to train their client managers so that they can better assess the levels of risk tolerance for each investor. Meanwhile, proper incentivization systems should be put in place to prevent client managers from selling high yield/high risk products, for their own benefits, to mom and pop investors who have low risk tolerance. More importantly, a more stringent review of the investments of wealth management products is necessary for banks to shun excess risk taking that could potentially put their reputations in jeopardy.

We have heard the argument among certain investors that a potential loss of reputation for the banks could cause capital to flow out of the banking sector, creating a liquidity crunch. We think the likelihood of this happening is slim for the sector as a whole. The reason is, given the very limited investment opportunities in China, we believe investors will continue to find banks to be the safest place to park their excess cash in the form of deposits, given the implicit government guarantee on deposits (especially at the state-owned banks).

Who Buys the WMPs Could Determine the Outcome of Losses

According to our estimates, corporate investors account for 35% of the client base of non-principal-guaranteed wealth management products while retail investors account for the remaining 65%. This percentage varies by banks (see **Exhibit 12**).

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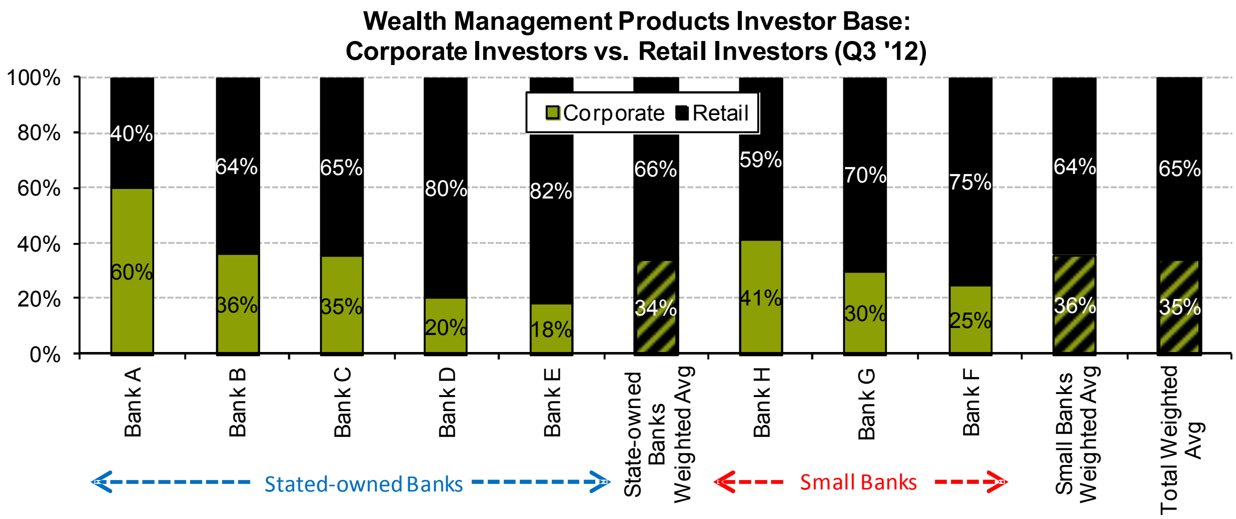
Exhibit 12

Corporate Investors Account for 35% of the Client Base of Non-Principal Guaranteed Wealth Management Products While Retail Investors Account for the Remaining 65% (We Keep the Banks Anonymous when Showing Estimates)



Source: Corporate Reports, Earnings Presentations, Bernstein Analysis & Estimates

Note – for a number of banks, we use the commission fees or sales volumes generated from selling corporate WMPs and retail WMPs to estimate the proportions of corporate vs. retail investors of non-principal-guaranteed wealth management products outstanding

According to our conversations with the banks, Chinese banks segment their wealth management clients into three groups – corporate investors, private banking investors (including high-net-worth individuals) and traditional retail investors (i.e., the simple "mom and pop" investors). **Exhibit 13** shows the customer segmentation based on their risk appetite and risk tolerance for wealth management products.

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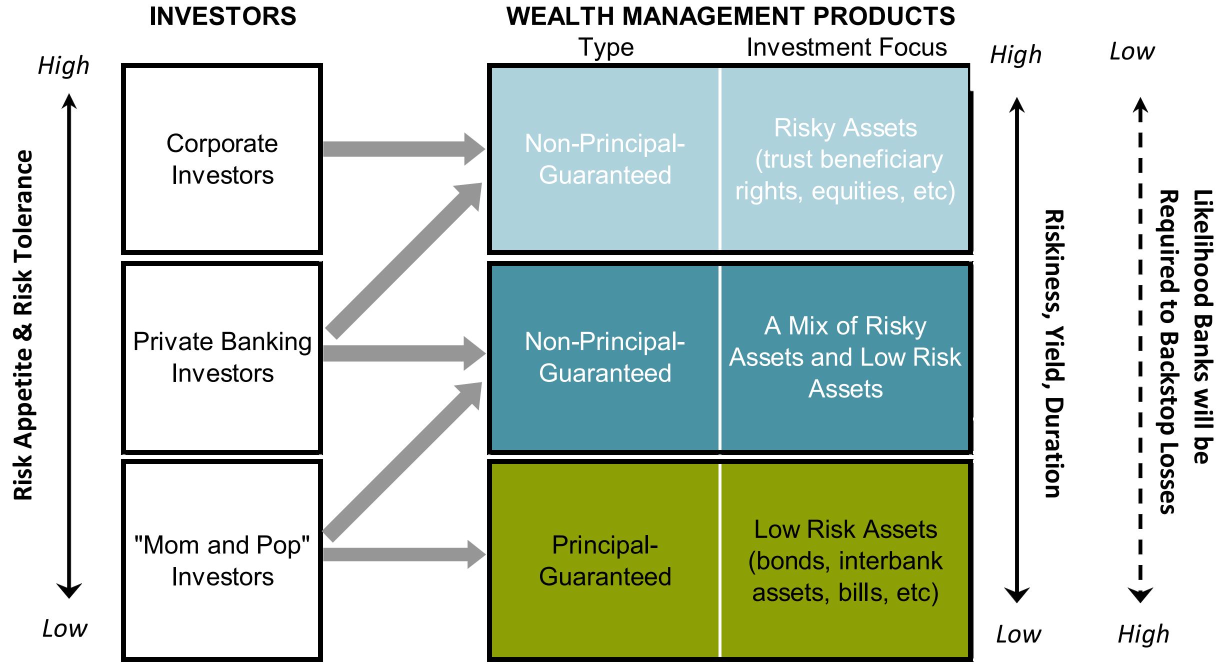
Exhibit 13
Customer Segmentation of Wealth Management Products



Source: Bernstein Analysis

In general, corporate investors are deemed to have higher risk appetite and risk tolerance than retail investors. To cater to their needs, banks tend to offer wealth management products with higher returns which are set to compensate for the higher risks involved. The majority of the high return/long duration wealth management products are not principally guaranteed due to their higher risk profiles. On the other hand, retail investors, with the goal of preserving their wealth instead of aggressively chasing returns, prefer principal-guaranteed products or non-principal guaranteed wealth management products with lower risk/shorter duration. Proceeds collected from issuing such products are invested in low risk assets, such as bonds, interbank assets and bills. Within the retail investor group, private banking clients (and high net worth individuals) are more willing to and also more capable of taking risks than traditional retail (i.e., "mom and pop") investors. As a result, products with increased risk/return profile typically better suit the needs of private banking and corporate clients.

We believe high yield/high risk wealth management products are mostly held by corporate investors and private banking investors due to their demand for higher yield and higher risk tolerance. Since the beginning of this year, banks have felt increasing demand for higher yield products from enterprises, less so from retail investors. They relayed to us that with the economic slowdown in China, corporations find it difficult to generate good returns from investment in their major businesses. Given the narrow range of accessible investment vehicles in China, enterprises essentially have invested their excess cash into wealth management products in China to produce better returns. This also benefits the banks as issuing wealth management products, even the non-principal guaranteed product, enables the banks to attract deposits from these enterprises.

As a result, we have trouble believing the "mom and pop" investors are the major driving force of the high-risk WMPs issued in 2012. This argument essentially foots well with the deposit growth data we show in **Exhibit 14** and **Exhibit 15** which show that since the beginning of 2012, household deposit growth has

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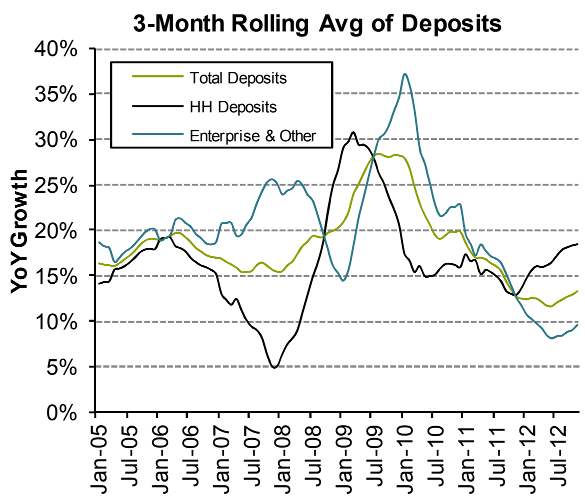
showed strong growth momentum while corporate deposit growth remains to be relatively weak. On a YoY basis, household deposit growth has climbed 19% while corporate deposit growth has struggled at just 8-9% YoY growth. In addition, retail deposits have accounted for 54% of the increase in deposits during the first three quarters of this year, the highest figure since 2008.

Exhibit 14

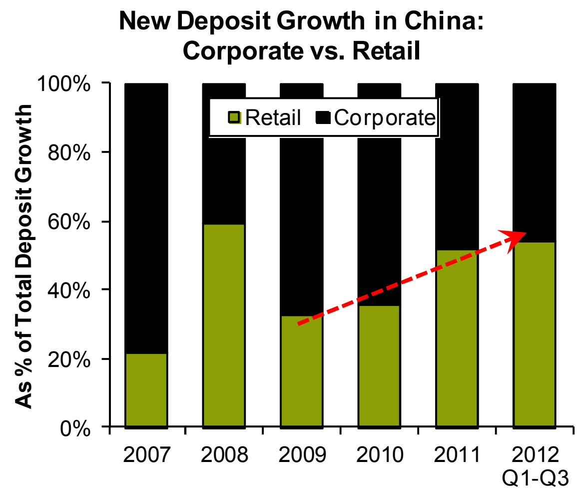
Current Growth of Household Deposits (at 19%) Outpaced that of Corporate Deposits (at 8-9%) in 2012



Source: PBOC, CEIC, Bernstein Analysis

Exhibit 15

We've Seen Household Deposit Growth Accelerated Relative to Corporate Deposit in the Past 4 Years

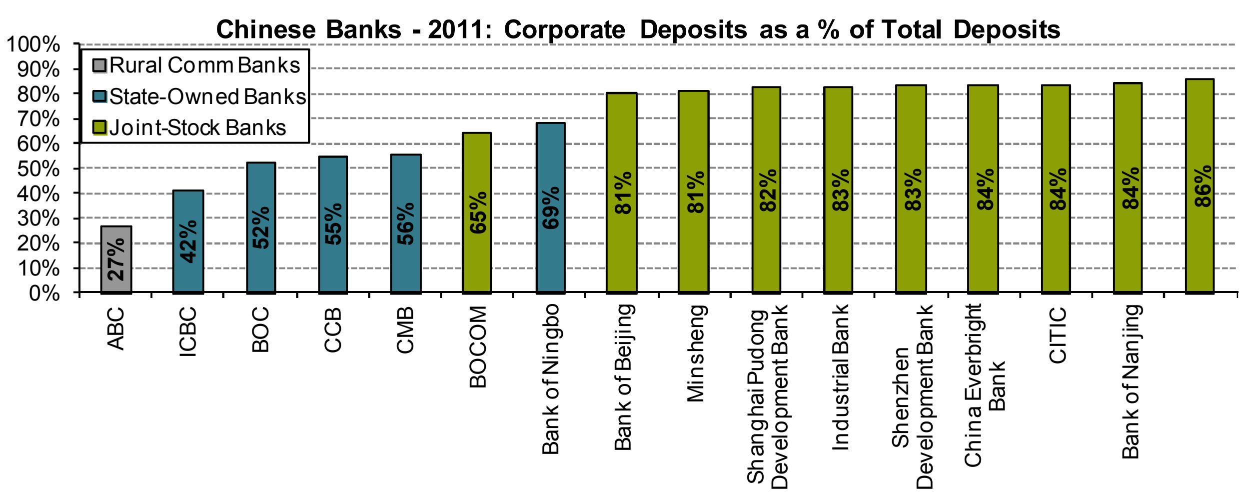


Source: PBOC, CEIC, Bernstein Analysis

But, we also believe small banks feel more pressure from the corporate side to offer higher yielding products than large banks. Small banks are more dependent on their corporate customers for deposit funding than large banks (75% vs. 50% - see **Exhibit 16**), thus are more incentivized to satisfy their corporate depositors' growing appetite for high yield. At the same time, this leads us to believe small banks are more inclined to take losses incurred to their corporate clients which they cannot afford to lose.

Exhibit 16

Joint-Stock Banks are more Dependent on Corporate Clients for Funding than Large Banks



Source: Corporate Reports, Bernstein Analysis

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What Happens if the WMP Market Shuts Down?

The ultimate goal of showing individual banks' exposure to non-principal guaranteed products is to assess the potential earnings and capital impact should the banks be forced to take losses to the extent that they need to bring these products onto their balance sheet. While we view this outcome as unlikely, we believe it is important to measure the impact to the banks if this scenario occurs. One of the challenges of this scenario analysis is that we do not have enough granularity to know which of the banks are offering the riskiest products to investors (and thus would be at the greatest risk should they have to back-stop investor losses).

Potential Capital Impact to the Banks

If banks are required to backstop losses by the regulator/government, they will consolidate the wealth management products, bringing the assets packaged into the WMPs on their balance sheet. In such a scenario, we are not concerned about the liquidity impact (as they would also be able to consolidate the investor funds as deposits) but such a move would have a negative impact to the banks' capital adequacy ratios as they would add to the bank's risk-weighted asset (RWA) base without a capital offset.

In our analysis, we show the impact of the consolidation of 50% and 100% of the outstanding non-PG WMPs at the end of Q3 2012. While we do not know the actual composition of these assets due to the opaqueness in this market, we assign an 80% average credit risk-weighting to these assets (using the standardized approach to measuring credit risk). We show the result in **Exhibit 17**.

CMB and Minsheng have the greatest exposure to non-PG WMPs (relative to their respective deposit bases) among the banks we cover. Not surprisingly, it is the same two banks that would see the most negative impact to their core capital adequacy ratios, which would decline by 90-100bp in an extreme scenario where 100% of non-PG WMPs are consolidated. Among all the banks we cover, Bank of China would be the least impacted from the full consolidation of non-principal guaranteed WMPs as they have the least exposure (as a % of their deposit base). We calculate that BOC's core capital adequacy ratio would decline by just 30bp (the lowest in the group) in the scenario where they brought these products fully onto their balance sheet.

- **Capital impact may actually be larger for the smaller banks.** As we mentioned earlier, a large number of non-PG WMPs mature just prior to the quarter end so that customer funds can flow back into the banking system in the form of deposits. Unfortunately, we do not know how big an issue this is for the different banks. But based on the month-to-month flow of deposits, we estimate these uncounted non-PG WMPs might add an additional 18-20% to the "true" size of the market and we believe this "multiplier" is larger for the small banks than the state-owned banks. We account for this in our estimate for the total industry size (refer back to **Exhibit 10**). But for our capital sensitivity analysis we ignore the impact of these "uncounted" WMPs (as it varies by banks) and use each bank's stated quarter-end balances of non-PG WMPs[3].

[3] In any event, since we believe the banks are already funding some of the assets in the WMPs that expire just prior to quarter-end directly or indirectly on their balance sheet, these exposures should be accounted for in their capital calculations already.

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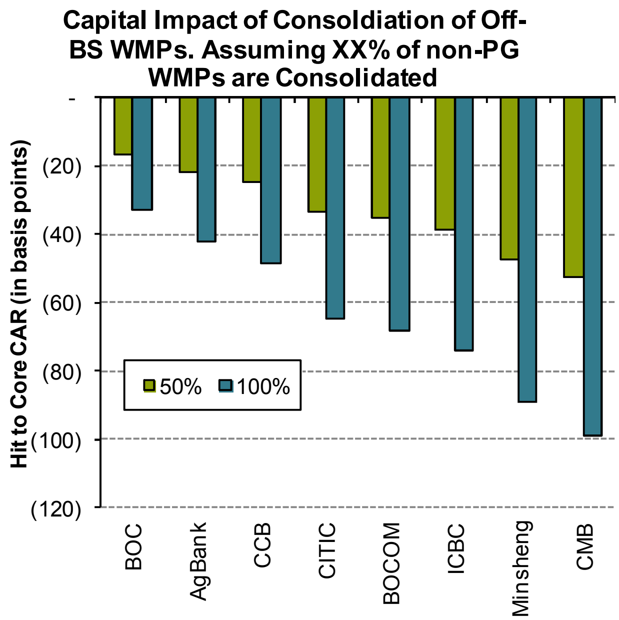
Exhibit 17

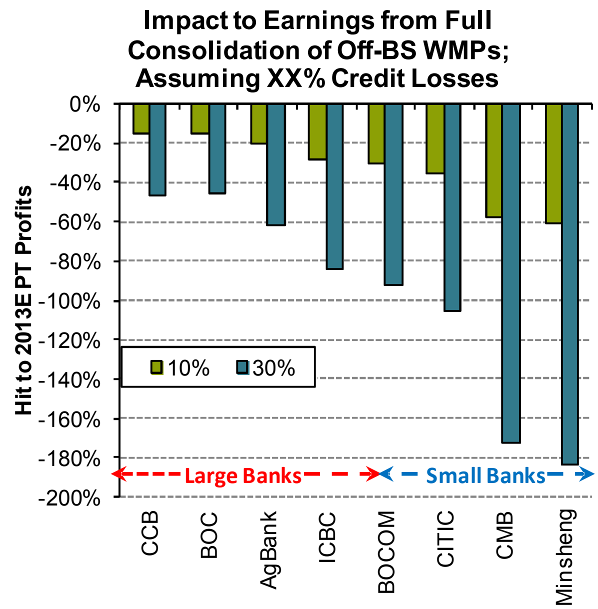
In the Extreme Scenario, CMB and Minsheng Will Take the Greatest Hit to Their Q3 '12 Capital Base if They Consolidate the WMPs They've Sold



Source: Bernstein Analysis & Estimates

Exhibit 18

…Meanwhile the Same Two Banks' 2013E Earnings will be Most Impacted to Credit Losses



Source: Bernstein Analysis & Estimates

Potential Earnings Impact to the Banks

We believe there would also be an earnings impact from consolidating the WMP assets onto the banks' balance sheets. While these assets tend to generate relatively high yields, they also tend to be risky and we would expect this would expose the banks to credit deterioration as China's economy slows. Once again, it is difficult to estimate the amount of credit losses that the banks would face on these assets as we don't have a detailed breakdown of these assets. That said, we believe small banks are more inclined to introduce high risk/high yield non-principal guaranteed products to investors, making them subject to a greater chance of default and losses from these products. The reasons for small banks' inclination to sell high-risk products are two-folds. First, due to their small balance sheet size, their underwriting ability and level of access to the interbank markets (bond market as well as bill exchange) is weaker than large banks. This increases the difficulty of accessing safer assets (bonds and bills) and packaging them into wealth management products. Second, as a result of weaker physical network and deposit franchise, small banks are more inclined than the large banks to offer high-yield products to customers in order to boost their deposit base (by timing these products to mature before period end).

We run a scenario analysis to examine the bottom-line earnings impact of different levels of credit loss. Assuming a 10% credit loss on the consolidated assets, we would expect the banks' 2013E earnings will decline by 33%, on average, for the group – see **Exhibit 18**. We would expect Minsheng and China Merchants Bank to face the sharpest decline in earnings of 50-60% in this scenario. Meanwhile, CCB and BOC would report the least impact to earnings of 15-16% in the scenario described above.

Investment Focus of Wealth Management Products

There is essentially lack of transparency under the current system as to what wealth management products are invested in. Part of this could be attributable to the fact that investors' monitoring of the quality of the assets (for non-private equity) or the operation of the entities (for private equity fund) they invest in is

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nearly absent. The reason is unlike a bank, passive investors lack the time, resources and expertise to monitor the investments. More importantly, they lean on the Chinese banks to the extent that they essentially believe the banks would always return the money to them even if banks allegedly deny such commitment (i.e., non-principal guaranteed wealth management products).

Despite the lack of data from official sources, we are able to gain understanding on this matter by connecting information provided by the banks and a number of other sources such as bankrate.com.cn and CNBENEFIT websites. Our empirical understanding is that non-principal guaranteed wealth management products are divided into two distinct groups – those originated by the banks themselves and those originated by trust companies. The banks we talked to shared with us that for those originated by themselves, they've treated the credit assets, amid off their balance sheet, in the same way as those on their balance sheet. This means pre-credit assessment and post-credit monitoring are put in place to ensure the repayment of investors' money if they invest in credit assets originated and packaged by the distributing banks.

We believe the biggest credit risk lies in the second category where banks only play the role of distributing over-the-counter wealth management products. In this case, the banks are indemnified from any due diligence obligations because it is the trust companies (the originators) that should fulfill the fiduciary duties to investors. We believe investors are exposed to higher default risks if they purchase the wealth management products originated by trust companies for two major reasons. First, lack of regulatory oversight and transparency result in irregularities or probably malfeasance in the trust sector. Second, the presence of banks that breaks the link between the trust companies and the investors complicates the process. This might have misled the investors, the mom and pop investors in particular, to believe that banks will always bail out their customers, which is unfortunately contrary to reality. We believe this presumption remains well-entrenched in China and it certainly takes time and efforts (and probably a devastating shock) to correct the view of these investors.

Our conversation with a number of client managers that sell wealth management products at branches and outlets could shed some light on the risks of trust products:

"Only companies that fail to get listed, fail to issue bonds, and fail to obtain bank financing will turn to trust companies for financing. How can you expect such companies not have problems?"

"Only a small portion of trust products are sold through banking channels. If you want me to rank the risks of trust products from low to high: it would be investments in city planning with some kind of government guarantee, power station and highway, real estate developer, and miscellaneous."

"What is worse is that it is even more difficult for trust companies than banks to dispose of non-performing assets as the auction house will always push down the bidding prices to the lowest possible level as they know trust companies are desperate for money whenever they need to dispose of something. To be honest, we are not surprised if the trust companies rollover the trust products by issuing new wealth management products."

While we have very limited data with regards to how exposed the sector or individual banks are to trust company originated wealth management products, we estimate such high risk/high yield (normally >8%) products account for less than 5% of total products based on data oi **Exhibit 7**, which shows wealth management products with yield exceeding 5% account for 9% of the total.

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Disclosure Appendix

Valuation Methodology

Our approach relies on growth and profitability (using a long-term, sustainable ROE forecast) as the primary, firm-specific variables in our valuation model. We apply our sustainable ROE forecast and terminal growth rate, along with our calculation of the firm's cost of equity, to come up with a fair-value price-to-book multiple for each bank, which we apply to our H1 '13 book value forecast for the individual banks to derive our price targets (see **Exhibit 19**).

Exhibit 19
Bernstein's Valuation Methodology

18-Dec-2012

Valuation Summary	Rating	Long-Term ROE	Ke	Terminal Growth Rate	H1 '13E BV per Share	Price-to-Fwd BV: Target	Price-to-Fwd BV: Current	Price Target (HK$)	Current Price (HK$)	12-Month Appreciation Potential
BOC	O	13.9%	12.8%	3.5%	3.79	1.11	0.92	**4.20**	3.49	20%
BOCOM	M	14.4%	15.3%	4.5%	6.61	0.91	0.88	**6.00**	5.82	3%
CCB	O	17.7%	13.3%	4.0%	4.93	1.47	1.27	**7.20**	6.26	15%
CMB	U	17.2%	16.0%	5.0%	11.57	1.11	1.43	**12.80**	16.60	-23%
ICBC	O	17.9%	13.8%	4.0%	4.12	1.41	1.35	**5.80**	5.55	5%
CITIC	M	14.0%	16.6%	5.0%	5.58	0.78	0.80	**4.30**	4.48	-4%
ABC	M	16.1%	14.3%	4.0%	3.00	1.17	1.25	**3.50**	3.76	-7%
Average		15.9%	14.6%	4.3%		1.14	1.13			**1%**

P/B Value = (ROE - g) / (K_e - g)

Source: Corporate reports and Bernstein analysis and estimates.

Risks

The greatest risk to the Chinese banks is a hard-landing scenario in China. Should real GDP growth slow to the 3-4% range, we suspect that a number of the businesses operating in the country would default under the scenario resulting in a substantial deterioration of credit quality in the banking system. As a result, we expect to see a rise in NPLs and credit costs that would negatively impact the banks' profitability. We are forecasting a decline in China's economic growth rates in the coming years, as real GDP growth slows from the 9-10% annual level reported in China over the past five years (excluding 2008) to 7-8% growth as the central government focuses more on the quality of growth, and not just the quantity. The slowdown in economic growth, coupled with the massive credit expansion at the banks in 2009, will lead to 2.5-3.0% NPLs in our models by the end of 2015. Any further decline in GDP growth would result in higher NPLs and weaker earnings.

Another major risk to investors in the Chinese banks would be a change in the government or regulatory policy governing the operations of the banks. The Chinese banking system is still a heavily regulated industry as it is still in its early stages of development. As a result, the operating environment is heavily influenced by the regulators and the central government. While changes to the regulatory environment in recent years (the increase in minimum capital adequacy ratios, provisioning levels and stricter requirements on sales of wealth management products) have all been a negative for the ROEs of the Chinese banks, they have succeeded in making the banking system more stable and improved its resilience to economic weakness.

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  Market-Perform: Stock will perform in line with the market index to within +/-15 pp in the year ahead.

  Underperform: Stock will trail the performance of the market index by more than 15 pp in the year ahead.

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12-Month Rating History as of 12/17/2012

Ticker	Rating Changes	
1288.HK	M (IC) 07/19/10	
1398.HK	O (RC) 01/07/11	
3328.HK	M (RC) 11/15/10	
3968.HK	U (RC) 02/20/12	M (IC) 01/21/10
3988.HK	O (RC) 06/08/12	M (IC) 01/21/10
939.HK	O (IC) 01/21/10	
998.HK	M (RC) 07/27/11	

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