China's Bank Debacle: The Difference Between Chuck Keating and Angelo Mozilo

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Dear Fellow Investors:

Thanks to a super well-written piece from Emily Kaiser at Reuters, we can frame the discussion about the Chinese housing bubble as the difference between the US Savings and Loan/Bank debacle of the late 1980's/early 1990's and the US housing debacle from 2006 to today. Emily laid out the argument quite well. Many economists and experts believe that the large down payments by Chinese home buyers and the fact that their total mortgage debt is less than 20% of Chinese GDP is a reason for comfort. They argue that the Chinese government is in a position to deal with letting the air out of the bubble because of this big equity cushion. Here is how Reuters explains it:

"As housing bubbles go, China's looks relatively benign. Unlike in the United States, Chinese home buyers typically put down at least 40 percent of the purchase price. That means they don't have to worry about a modest decline wiping out all their equity, and banks have little reason to fear an influx of "jingle mail" from defaulting homeowners returning the keys.

Household debt amounts to less than 20 percent of China's gross domestic product, according to the International Monetary Fund, one fifth of the U.S. ratio.

"In the United States, housing was a borrowing vehicle for households. In China, it's a savings vehicle," said Stephen Green, an economist with Standard Chartered in Hong Kong."

By framing the analysis of China in the context of the US housing bubble, apologists are put in a perfect position to claim that it is not going to be a big problem to deal with for the Chinese government. The 2005 US housing bubble was about banks like Countrywide Credit lending money to people who couldn't or shouldn't have wanted to afford their big "dream" home. They made unbelievably large loans to millions of people who wouldn't be able to pay it back. Countrywide's President was Angelo Mozilo, who sported a great tan, a fat bank account and a fatter investment portfolio. His bank reported a ton of profit until all the bad loans came to roost. The China apologists are correct that China's real estate bubble only has historically large price increases in common with Phoenix or Miami or Las Vegas in 2005 (even though China's price increases are much more ridiculous). The Chinese end buyer puts a great deal of equity into a house purchase because owning a home is a "savings vehicle".

What they should be putting China's real estate bubble into the context of is the Bank and Savings & Loan debacle of the late 1980's. China's housing bubble is huge. In our opinion, it will cripple their financial system in several ways. The negative wealth effect, as their bubble gets unwound, will contribute to a deep recession/depression. For the most part, the impact of unwinding China's real estate bubble will be felt in China, in the emerging markets surrounding it and the countries which have benefitted the most by selling them the inputs to massively over-build in the major cities.

Some review of the debacle in the late 1980's is necessary. Savings and Loan institutions had huge deposits which were insured by the Federal government through an under-capitalized agency called FSLIC (Federal Saving & Loan Insurance Corporation). The leaders of these "Savings" organizations took the liberty to loan these deposits out to real estate developers to build both commercial and residential projects. These loans became a concentrated part of the assets of these companies and the tangible assets as a percentage of outstanding loans became dangerously low. The mortgage borrowers themselves had plenty of equity in their homes and the late 1980's down cycle was not marked by high foreclosure statistics and "jingle mail". Of the 3234 savings institutions in the US in 1987, 747 were eventually closed by the mid to late 1990's.

The poster child was Lincoln Savings and Loan in Phoenix run by Charles Keating. His bank took in deposits through very high interest rates on Certificates of Deposit (CDs). The money was loaned to build projects like the Phoenician Hotel, which Keating just happened to have a financial interest in. Keating was constantly moving money back and forth between Lincoln Savings and Loan and his real estate development company, American Continental Corporation. The Phoenician was the most expensive hotel ever built in Phoenix.

The difference between the US in the late 1980's and China today is that the Chinese government is completely caught up in this debacle. They dictated to the four government-owned Chinese banks that they would provide the economic stimulus in China. The primary vehicle has been spurious loans made to real estate developers. Chinese Communist Party officials and Chinese Army leaders are in control of both the banks and the special purpose vehicles created at the municipal level to build these booming structures. In late 2008, China needed to avoid recession to prevent civil unrest. In the US version, Keating attempted to get the government involved to perpetuate his scheme. His problem was that in the US we have political and speech freedom. The Keating Five Senators got called to the carpet and our system came clean. Who is keeping China's system clean? In case you are wondering, Phoenix has a history of booming and busting and one of those booms was in the 1980's. The theory behind that boom was that retirees would move to Phoenix in droves and because of that fact, it didn't matter how much the real estate you were buying was over-priced. The same logic about people moving from the rural areas to the cities dominates the real estate bubble in China and is used by the apologists all the time.

At the same time that real estate development was running wild from cheap deposits insured by the US government, major money center banks like Bank of America and Citigroup were recycling the massive wealth created by oil production in the late 1970's and early 1980's from Arab investors and Texas oil men. This money was turned into loans to fast growing countries like Brazil and Mexico. These were the hot emerging market nations of the time. These emerging-market loans became a large part of the loan portfolios of these money center banks and when these countries went through their business cycle, they were unable to meet their debt service obligations (if this sounds like today's problem with Greece and other PIGS in Europe, you are starting to track with me properly).

Treasury Secretary Nicolas Brady from the George Bush Sr. administration ultimately came to the rescue with his bailout program called Brady Bonds. The Resolution Trust Corporation was formed by the US government to clean up the Savings and Loan debacle and the US economy languished for many years in a jobless recovery. The clean-up costs were in the hundreds of billions of dollars. The loans involved in these two institutional debacles were development loans and had an enormous impact on US economic growth from 1988-1993, costing President Bush Sr. his job and ushered in the era of the “jobless” recovery.

We believe the only way that the Chinese apologists can feel comfortable about a soft landing in China’s economy is if the development loans in the four largest government-owned banks are not a concentrated part of the loan portfolios. Second, they can be comfortable if the losses the banks will have to take from real estate developer failure don’t wipe out their tangible assets. Thirdly, they can be comfortable if the municipalities in China have a way to replace the 74% of their revenue that currently comes from taxing real estate transactions and creating money out of mid-air by capitalizing raw land much higher as it is developed. Lastly, they can be comfortable if the wealth effect of substantial price drops in the primary risk investments (savings vehicles) of their citizens don’t crush consumer spending. Consumer spending is estimated to be 30% of Chinese GDP. The apologists in Emily Kaiser’s article in Reuters are correct that this isn’t closely analogous to the US real estate bubble of 2005. Unfortunately, we believe they are very wrong about the magnitude of the damage to the economy that the real estate stimulus loans from 2008-2011 will ultimately have on China’s economy.

These loans were estimated to be $2.7 trillion and were originated from late 2008 to today to stimulate the Chinese economy via real estate development. We have seen estimates of loan losses ranging from 30 percent (Fitch) to 70 percent (Yin Zhongqing). The four largest lenders in China would likely have most of the $810 billion to $1.9 trillion in loan losses on their books. We believe this would devastate their tangible equity, force recapitalization and stop new development in its tracks. It would stop the ability of folks to move to the cities to get jobs, it would crush demand for commodities involved in construction and it would cut off surrounding Asian countries which have been suckling on the bounteous teat of China’s boom. The currency outflows and the bank recapitalization could vanquish China’s foreign currency reserves fairly quickly.

In our opinion, China has Angelo Mozilo’s price bubble going, but not his residential mortgages. They have Charles Keating’s development loans. These loans are in a quantity and magnitude relative to China’s $6 trillion economy that Jim Chanos described the potential fallout as “Dubai times 1000”. Let the games begin.

Best Wishes,

William Smead

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