China Keys

Financial reform: short-term risks for long-term rewards

Equities

China
Financial

Tao Wang
Economist
wang.tao@ubs.com
+852-2971 7525

Stephen Andrews, CFA
Analyst
stephen.andrews@ubs.com
+852-2971 7821

Bob Leung
Analyst
bob.leung@ubs.com
+852-2971 5502

Donna Kwok
Economist
donna.kwok@ubs.com
+852-3712 3160

Irene Huang
Analyst
irene.huang@ubs.com
+852-2971 7157

Michelle Li
Analyst
michelle-l.li@ubs.com
+852-3712 2563

Financial reform: Good for bank customers/non-bank financials - bad for banks

Getting both the pace and sequencing of financial reform right is, we believe, one of the most significant challenges for China's leadership. While essential for the medium- to long-term health of China's economy, it has many short-term risks. From an investor perspective, the short-term impact of reform is likely to lead to downward pressure on banks' earnings and capital ratios (before the longer-term benefits of better systemic capital allocation become evident). As reform drives greater disintermediation, the life insurance and brokerage sectors are likely to benefit, in our view.

Meaningful disintermediation of the banks will take a long time

With China banks' assets (including contingent liabilities) at about US$30trn, it is hard to see how reform can result in meaningful disintermediation in this credit cycle. China's demand for credit each year (US$3trn in total social financing (TSF) for FY14E) is now simply too big relative to alternative liquidity pools (e.g., the life insurance industry has just US$1.5trn of assets under management (AUM)). This will change over time, but in the next two to three years we would expect China to continue to leverage up (rising debt/GDP) although lower rates may reduce the debt-servicing burden (at the expense of banks' margins and profitability).

Moving to a 'market-based' system brings increased 'liquidity' risks

China's financial system now operates with a closed capital account, 70-80% state ownership of the banking system and regulated interest rates. This combines to give the authorities significant influence over where liquidity flows within the financial system. We believe a move to a more 'market-based' financial system will result in more efficient capital allocation (lowering NPL creation). However, it will increase transparency and allow freer movement of funds around the system, thus increasing 'liquidity' risk both at individual institutions and systemically.

Hard to see how the banks will benefit in the medium-to-long term

We think the financial reform 'trade' will take years to play out. However, it is hard to see how banks will benefit, at least in the short term. This report addresses investment opportunities across the A-share and H-share markets, including banks and non-bank financials such as insurers, brokers and non-bank lenders. Structurally, we continue to prefer non-bank financials, which should benefit as reform momentum gathers pace.

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Economist
wang.tao@ubs.com
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Analyst
stephen.andrews@ubs.com
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Analyst
irene.huang@ubs.com
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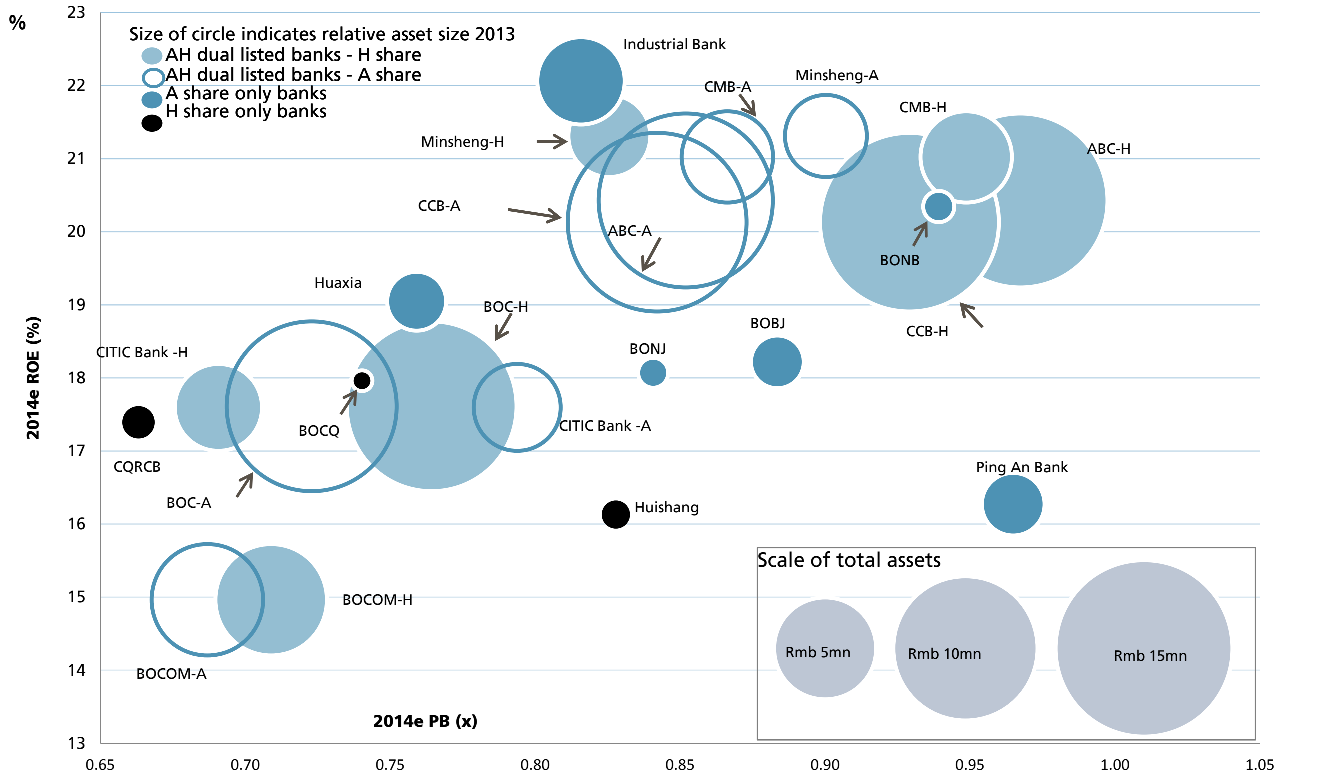
michelle-l.li@ubs.com
+852-3712 2563

This replaces an earlier version in which the amount of assets under management (AUM) by the life insurance industry, as stated in the second paragraph on the cover page, was incorrect.

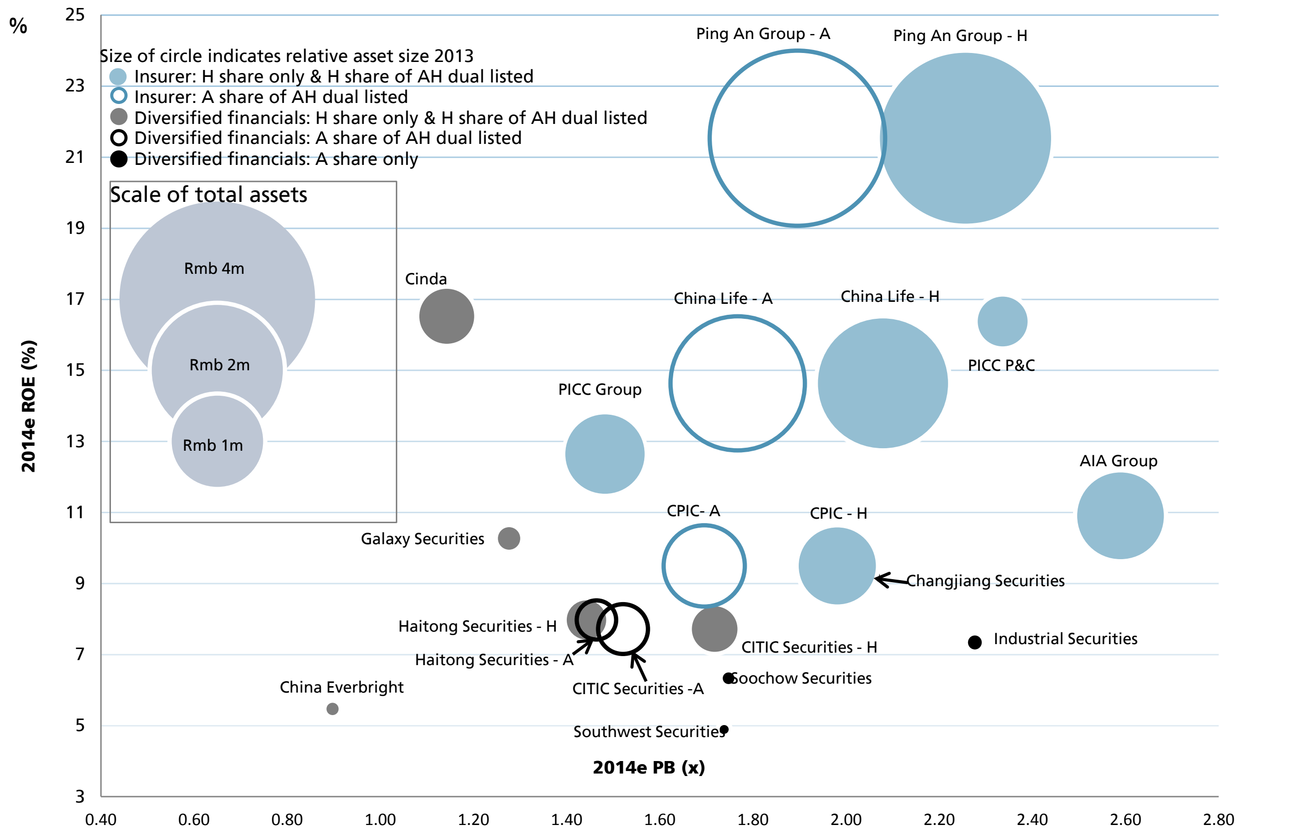
As we approach the launch of the Hong Kong/Shanghai Mutual Market Access (MMA) program, the UBS China Keys series will focus on the key themes and major issues that UBS Global Research expects to shape the future of Chinese equity markets. These views and insights are drawn from collaborative research that utilises our offshore team and our A-share research team based in mainland China.

Figure 1: A-share and H-share banks valuation comparison



Note: As of 17 September 2014.
Source: Company data, UBS estimates

Figure 2: A-share and H-share non-bank financials' valuation comparison



Note: As of 17 September 2014.
Source: Company data, UBS estimates

Financial sector reform: The basics

Few investors dispute that financial reform is crucial to the healthy development of China's economy in the longer term. However, the scope and pacing of the reform required comes not only with long-term benefits but also with sizeable risks. In this report we outline some of the changes we expect. We also attempt to quantify the impact on the bank and non-bank financial sectors and make broad observations as to which sub-sectors of the financial services industry are likely to benefit and which to suffer.

The basics…

China's financial reform to make the 'market' more central in allocating capital in the economy

Financial sector reform is a key component of China's economic reforms that were outlined at last November's Third Plenum, and is one that will help place the 'market' in a more 'decisive role' in allocating resources. It consists of interest-rate liberalisation, capital/financial market reform, banking reform, exchange-rate reform, and capital-account opening, with the first three being very much interrelated. These reforms will also require significant changes in China's monetary policy framework and in the regulation and supervision of its financial sector.

A property market correction could significantly challenge the pace and scope of the reform

These reforms will be taking place against a backdrop of an economy transitioning to growth that is slower and less investment-driven, following a strong credit boom that pushed China's overall credit/GDP ratio up by more than 70ppts in six years. In the next couple of years, a potentially serious property market correction could complicate China's financial sector reform agenda. In our view, the long-term objectives of this agenda may sometimes be at odds with the short-term policy priority of protecting economic growth, often via the non-transparent delivery of credit.

Financial reform in China has progressed steadily in the past couple of years, though not necessarily in a sequenced order and often following the path of least resistance. Policy makers likely hoped that successful reforms in one area would help catalyse those in others. This may still be the future course of Chinese financial sector reform.

What specific reforms should we expect?

While many financial sector reform areas overlap and mutually reinforce one another, broadly speaking we can place them into five categories.

- **Interest-rate liberalisation.** The ultimate goal is to remove deposit rate controls and let the market determine the price of capital. After years of progress in developing the interbank and bond markets, China's money market rates and bond yields are already largely market-determined. The most important steps remaining include the gradual liberalisation of deposit rates, the development of a short-term interest-rate anchor, and the establishment of a deposit insurance scheme.

- **Banking reforms.** Key objectives include stepping up competition amongst banks, increasing their servicing of small-to-medium enterprises (SME), and improving banks' corporate and risk management. Main reform items should include the setting up of more small and private banks, the strengthening of banks' capital buffers, the formulation of a mechanism reducing banks' risk assets, the establishment of an exit mechanism and crisis resolution system, and the strengthening of shadow-banking intermediation regulations.

- **Financial and capital market reform.** A long-stated objective of the government is to increase direct financing via financial markets to reduce the banking system's dominance. Key reforms will likely include implementing further equity market reform (e.g., IPO rules), eliminating legal and regulatory hurdles to bond market development, encouraging the orderly development of non-bank financial intermediation, fostering the development of asset-management and other non-bank financial services, accelerating asset securitisation, and developing the insurance industry via policy changes and public pension reform.

- **Exchange-rate reform.** The government has stated that it wants to increase the flexibility of the exchange rate and reduce its daily intervention in the foreign-exchange (FX) market. We expect reforms in this area to be piecemeal and gradual only and for the currency to remain closely managed in the foreseeable future.

- **Capital account opening.** Full capital-account convertibility is an explicit long-term objective and is widely considered as a pre-requisite for the Renminbi to become a true international currency. After years of relaxing rules restricting capital flows in various areas, the key outstanding restrictions on China's capital account lie mainly in the areas of cross-border portfolio investment, borrowing and lending. Remaining important steps therefore will include a gradual easing of constraints on foreign portfolio investment in China and Chinese investment overseas, as well as a loosening of foreign lending and borrowing restrictions.

Where should we expect progress this coming year?

We expect considerable news flow related to financial reform over the next one to two years. Financial sector reform has progressed steadily since the 18th National Congress of the Communist Party of China in November 2012, partly because it is less controversial than some other areas such as land or state-owned enterprise (SOE) reforms. In the coming year, we expect visible progress in the following areas:

- Establishment of a deposit insurance scheme;

- Launch of provincial-level local government bonds;

- Increase of banks' capital via preferred shares issuance (already in progress);

- Significant milestones in the opening of China's capital account (e.g., mutual market access);

- Further tightening of regulations aimed at formalising the so called 'shadow banking' industry and transferring asset risks back on the balance sheets of financial institutions backed by adequate capital;

- Insurance regulators are expected to move further away from using quantitative quotas and pricing restrictions to regulate the financial system. Overall regulatory regime is expected to move towards a full risk-based capital system supported by regulatory oversight and enhanced market exit schemes; and

- Launch of tax incentives for various forms of long-term retirement saving schemes.

Below we summarise recent key developments as well as important steps we expect in the coming year.

Figure 3: Past and future progress of China's financial reforms

Reform areas	Recent developments	What to expect in next 12 months	What to expect beyond 12 months
Banking reform	Approved the setup of three small private banks; announced preferred shares plan; tightened regulations on banks' interbank business; started pilots on asset securitisation	Issuance of preferred shares; establishment of more private banks and local asset-management companies (AMC); creation of an exit mechanism for (small) banks; unveiling of new regulations and capital provisions for internet financial services	Establishment of a crisis resolution mechanism; full implementation of Basel III by end-2018; more innovative ways to inject capital to banks and greater allowance for further NPL write-offs
Interest rate liberalization	Initiated a pilot prime lending rate; launched marked priced interbank and corporate CDs; started to operate an 'interest rate corridor' for short-term rates; introduced long-maturity open-market operations (OMO) and new monetary policy tools (e.g., PSL) to influence long end of the curve	Expansion of market-priced certificates of deposit (CD) and money market funds; launch of the deposit insurance scheme in 2014; acceleration of the onshore government and corporate bond markets; further development of a policy interest rate	Full liberalisation of term deposit rates; full liberalisation short-term deposit rates; formation of a full yield curve; transition of monetary policy framework to a more market-based and price-based approach
Insurance, investment and capital markets	Launched new rules on the IPO process, disclosure and dividend payments; amended budget law to allow provincial government bond issuance; relaxed regulations on the insurance industry and non-bank financial intermediation (e.g., securities companies); signed up members for a gold exchange set to launch in Shanghai in September 2014; allowed margin trading and short selling under quota limits; streamlined rules on interbank business and trusts	Expansion of money market funds with improved regulations; further regulatory refinement for the domestic equity, bond and credit markets; formal launch of local government bonds; expansion of asset-backed securitisation and REITs; launch of mutual market access (MMA)	Granting insurers' full pricing rights for products such as life insurance premiums; expansion of the MMA exchange link; allowing foreign firms to list in the A-share market; expanding mutual access between the onshore interbank bond market and exchange bond markets
Exchange rate reform	Widened the daily Rmb trading band; allowed increased two-way volatility; developed more FX products; streamlined foreign currency accounts to facilitate cross-border settlements and FX loan transfers	Further gradual widening of Rmb trading band; permission for direct onshore trading of more foreign currencies with the Rmb	Reduction of People's Bank of China's (PBC) daily intervention; reforming CNY (onshore Rmb exchange rate) daily fixing mechanism
Capital account opening	Simplified foreign direct investment (FDI) procedures; approved six foreign hedge funds to raise Rmb-denominated funds from Chinese investors to invest abroad in the Qualified Domestic Limited Partner (QDLP) trial programme; creating the Shanghai Free Trade Zone (FTZ) to experiment with various capital account opening pilot initiatives; loosened controls over foreign borrowing; launched new offshore Rmb centres; added FX swap lines with other central banks; launched Yunnan-Guangxi Financial Reform Pilot Zone to push for financial cooperation with ASEAN	Launch of the MMA scheme between the Shanghai and Hong Kong stock exchanges; further quota expansions for the QFII, RQFII, QDII and MMA programs; additional quotas for local entities (especially SOEs and corporates) to issue offshore Rmb bonds; launch of further new offshore Rmb clearing banks	Gradual removal of most restrictions on cross-border capital flows

Source: UBS

Impact of financial sector reforms

These financial sector reforms will lead to an expansion of financial intermediation channels funding China's economy, an improvement of capital allocation as capital becomes better priced by market forces, and increased competition in the still-dominant banking sector that is likely to face narrowing interest margins too. Regulatory reforms should also lead to more rapid development of non-banking financial services, including the securities, asset management and insurance industries. Relaxation of China's capital controls can help improve the global allocation of capital, but may also heighten capital flow volatility to disturb domestic financial and economic stability.

For the economy, more financial intermediation channels (foreign and local alike) and greater financial services competition can generate more credit to support economic growth, and sustain or further raise China's already high leverage levels. Indeed, other countries' experiences show that financial liberalisation is usually accompanied by further increases in leverage, albeit often accompanied by interest rates rises too.

Impact on the banking sector is likely to be negative, at least in the short term…

Hard for financial reform to greatly lower B/S risk to banking system during this credit cycle

For the banking sector, the impact will be mixed but mostly negative in the short-term. Interest rate liberalisation is likely to lead to a notable narrowing of banks' net interest margins, as banks face increased competition both from each other and from non-bank financial institutions. Asset securitisation, local government bond issuance, NPL reduction and capital increase should help to reduce banks' risk assets, strengthening their capital base and reducing systemic risk in the medium to long term. Reform seems likely to benefit the owners and recipients of capital (depositors and borrowers, respectively) but this will come at the expense of bank profitability (lower margins and RoE).

With the current dominance of the banks in terms of their role in meeting China's pressing credit requirements, it is hard to see how reform can significantly lower bank balance sheet risk on a timeframe relevant for this particular credit cycle. The only exception would be if there was a wholesale transfer of credit risk onto the government balance sheets via the creation of much larger AMCs (to manage NPLs) or through more aggressive use of China's large policy banks. In reality this may be a sensitive area as it would reinforce existing moral-hazard issues that the regulators appear keen to avoid. In the end, we believe the financial sector reforms should improve the banking sector's competitiveness, efficiency and risk controls, but at the cost of greater liquidity and credit volatility as market transparency increases and funds are allowed to flow around the system more easily. We may see further pressure on bank share prices before the longer-term benefits of a more capital-efficient banking system emerge.

Non-bank financials longer-term structural winners…

Longer-term beneficiaries from disintermediation of banks likely to be non-bank financials

The reforms should be generally positive for non-bank financial services, as they are encouraged to develop under the umbrella of a less restrictive and more transparent regulatory environment. We expect equity and bond markets to play a growing role as banks' dominance gradually declines. This should benefit both security companies and asset-management businesses as the pace and scale of dis-intermediation accelerates in coming years to broaden product portfolios and accelerate asset growth.

For the insurance industry, reforms to expand pension, health care, and property insurance should help industry assets grow more rapidly. Relaxed regulations governing the investment of insurance assets should also help improve returns in the industry. In addition to bank deposit and security investments, we expect insurance to become an important household saving tool.

Over time, financial sector reform should raise the degree of sophistication and competition in China's financial services provision, enhance the efficiency of regulations, strengthen banks' capital positions, and establish a clear exit mechanism. In principle, these developments should all help to reduce financial systemic risk. However, during the process of reform, China's financial system may be destabilised by one or more of the following factors: the shadow banking industry's rapid development; the cleansing of toxic assets and failed financial institutions; increasingly complicated financial linkages; and/or potentially large swings in capital flows.

In this context, a proper sequencing of reforms is especially important. The International Monetary Fund (IMF) recommends that China starts first by increasing its exchange-rate flexibility and strengthening its financial regulations, followed by developing a crisis resolution mechanism, a new monetary policy framework, and finally further developing its financial/capital markets. Only after these steps are completed is full interest-rate liberalisation recommended, before China's capital account is finally fully opened. In addition, we think financial sector reform must be complemented by, and ideally not precede, price, fiscal, and SOE reforms. This is because unless key market participants such as local government and SOEs start facing hard budget constraints, financial market reform will stand little chance of success.

Winners and losers from a stock perspective

As we explain in this report, we believe that in the short-to-medium term the Chinese banking sector is likely to be a loser when it comes to the impact of financial reform. In the long term there will be benefits from better capital allocation within the economy lowering NPL formation. However, more immediate concerns about lower margins and profitability as well as rising liquidity risks are likely to dominate, in our opinion. We are particularly wary of banks with weaker funding structures (a high level of price-sensitive corporate deposits), significant exposures to shadow-banking activities (via trust beneficiary rights, directional asset management plans booked in REPO/receivable positions on the balance sheet) and weaker capital positions. From an H-share perspective, this tends to be the joint-stock banks (JSB). We currently rate Minsheng and Citic Bank as Sells as well as Chongqing Rural Commercial Bank. We believe many international investors will also be cautious on the joint-stock A-share banks, e.g., Industrial Bank, because of concerns related to the issues we outlined above.

We believe the biggest beneficiaries of financial reform in the medium-to-long term will be China's non-bank financials. We believe the large Chinese brokers with strong brand recognition in both mainland and Hong Kong could benefit most from the initial launch of MMA, we prefer CITICS-A and Haitong-H. Given the large amount of unused QDII quota and offshore Rmb deposits, as well as the deep A-/H-share discount, we believe capital flow would be stronger into the Shanghai Stock Exchange (SSE) (northbound) than into the Hong Kong Stock Exchange (HKEX) (southbound) initially. We prefer large brokers with subsidiaries in Hong Kong such as CITICS and Haitong. In Hong Kong, we also view China Everbright (165.HK) as a potential beneficiary of reform.

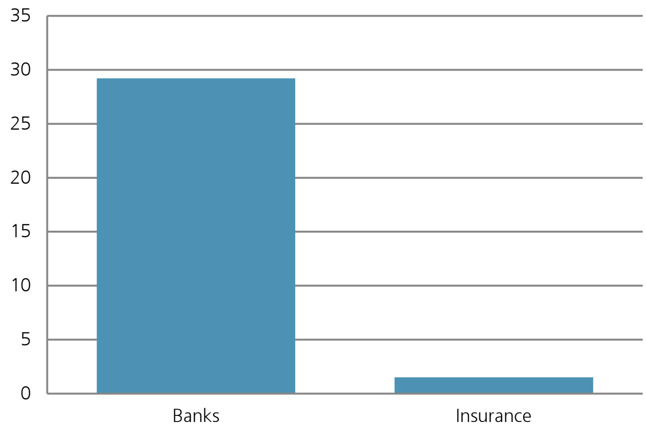
MMA also gives us the opportunity to look at relative value names involving dual-listed stocks. The Ping An-H premium to Ping An-A has declined, from 35% on 9 April 2014, the day before the announcement of MMA, to approximately 20%. The relationship of the premium/discount between A shares and H shares is complicated. It is important to note that the A-share market is not an important component of any major international benchmark index at present. In our view, relative index weights, relative liquid market cap and global demand for Chinese dual-listed insurers are likely to be the main drivers of the long-term A/H discount/premium post the launch of MMA. Considering the strong NBV growth we expect from Ping An Life, we believe Ping An-A is the most attractive, from a valuation perspective, of all the listed A-H non-bank financial names under our coverage.

The impact on Chinese banks

A lack of financial disintermediation means that the vast majority of the US$3trn of new credit required to drive China's economic growth this year will come from China's commercial and policy banks. These are, in essence, the funding vehicles of the Chinese economy. The aggregate assets of the banking system (if we also include an estimate of contingent liabilities in the trust sector/on securities company balance sheets) are likely now to be close to US$30trn or Rmb180trn. By contrast, the total assets of the life insurance sector, the second-largest pool of non-bank-linked liquidity, is currently just US$1.5trn or Rmb9trn (of which roughly a quarter is placed with the banks in the form of deposits anyway). These two numbers, we believe, help illustrate the current lack of dis-intermediation in the Chinese financial system. Not only does this place a huge strain on the banks but it has also leads to a significant concentration in risk on bank balance sheets (e.g., risk-weighted assets (RWA) per employee of the Chinese JSBs are now almost twice those of a typical US commercial bank).We also estimate that over 70-80% of the banking system is still essentially owned by the state and therefore subject to policy-directed lending.

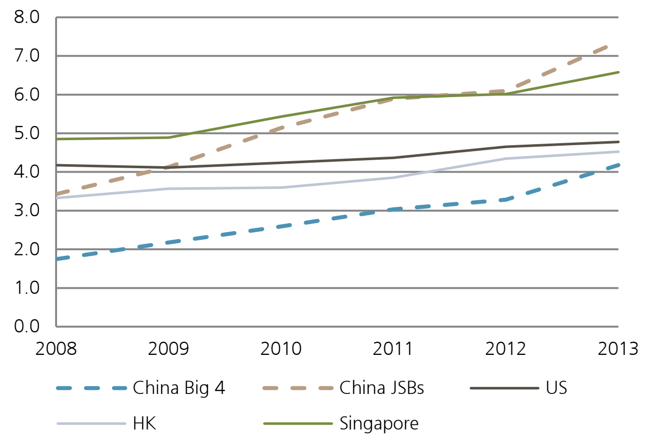
With bank assets of about US$30trn it is hard to see how reform can result in meaningful disintermediation of the China banks in this credit cycle

Figure 4: Estimated relative size of the Chinese banking system's assets vs the insurance sector's (US$ trn)



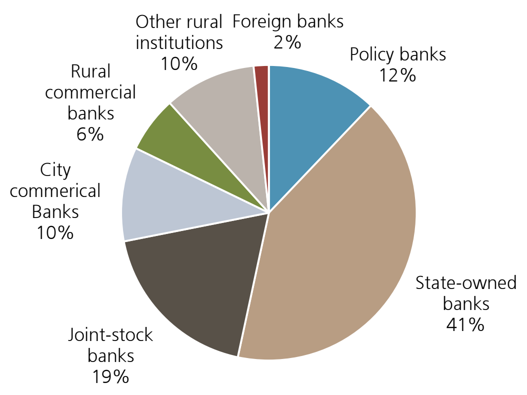
Source: Company data, UBS estimates

Figure 5: RWA per employee as a measure of banking system 'asset intensity'



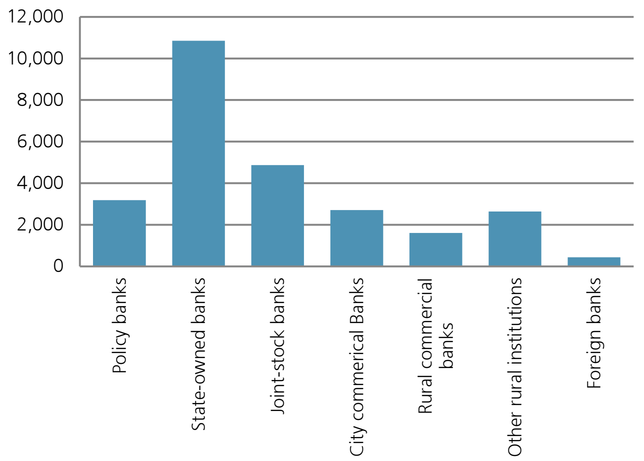
Source: Company data, UBS estimates

Figure 6: Asset split of Chinese banking system by type of bank (H1 14E)



Source: PBOC, CBRC, UBS estimates

Figure 7: Total on-balance sheet assets of different (US$m, H114E)



Source: PBOC, CBRC, UBS estimates

Short- to medium-term impacts of financial reform

Reform more likely to help bank 'users' (so, the 'real' economy) than banks' profitability

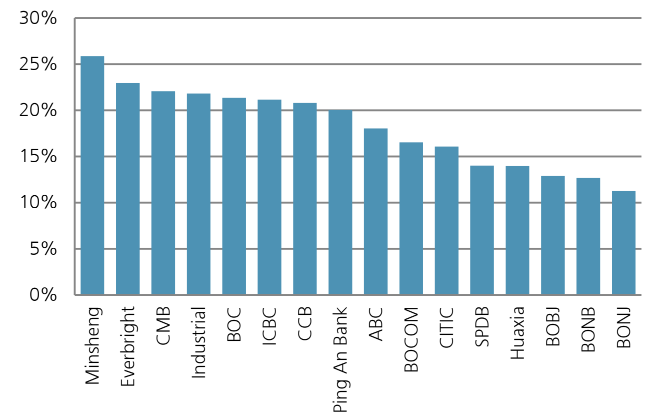
Financial reform is badly needed to better allocate capital around the system (to lower NPL creation), distribute risk (to lower the concentration of risk on bank balance sheets) and lower the impact of financial repression (provide the opportunity for depositors to make a positive real return). The benefits in the longer term for the health of the Chinese economy are clear. However, the 'transition' is likely to be challenging given China has seen a very significant increase in leverage over the past six or seven years (the latent NPL issue that has driven considerable share de-rating of the sector). Below we attempt to quantify the impact of seven reform items (discussed in Figure 1) that we expect in the short-to-medium term (full detailed calculations can be found in the appendix of this report). It is interesting to note that, without exception, all seven are likely to put downward pressure on bank profitability. They will, however, help protect the 'users' of banking services and therefore both directly and indirectly help the real economy at the expense of the banks.

- **The launch of household/corporate deposit CDs:** This will help depositors generate a positive real return on their savings. However, every 5% of deposits that are replaced by certificates of deposit (CD) will drag down bank NIMs by 5-7bps and net profit by 4-5%.
- **An uplift of the deposit rate ceiling** by another 10ppt to 120% of benchmark rates would have 4-6bp and 4-5% negative impacts on NIM and net profit of the bigger banks, and 10-14bp and 8-12% negative impacts for smaller banks'.
- **Approvals for the establishment of privately-owned banks** recently granted by the China Banking Regulatory Commission (CBRC) signals the lowering of entry barriers of the banking sector. The CBRC does not rule out the possibility of more approvals leading to increasing competition (e.g., including online alternatives to 'traditional' banking).
- **Introduction of a deposit insurance protection scheme.** This is an important safety net ahead of full interest-rate liberalisation to protect depositors and lower liquidity risk in the system. However, a fully funded scheme will take a number of years to put in place and require financial contributions from the banks (dragging on PBT).
- **Speed-up of asset securitisation** to increase distribution of risk and facilitate dis-intermediation of the banks. However, due to the limited size of the trial programme (Rmb425bn, or 0.6% of the system's total loans) we currently expect the impact of this to be marginal in the next one to two years, saving only 2bp system tier-1 CAR. Securitisation will also accelerate the introduction of 'mark-to-market' accounting, which, while increasing transparency, may over time also increase the volatility of reported financial statements.
- **Issuance of preferred stocks/alternative tier-1 instruments:** We continue to believe that certain parts of the Chinese banking system are overstating their core tier-1 capital ratios and, as such, are actually relatively poorly capitalised compared with international peers (e.g., many JSBs). However, current valuations and rules restricting stock issuance at a price that is below the last-audited book value per share prevent more widespread equity capital raisings. Instead we are seeing issuance of contingent convertible preferred stock, initially by the larger state-owned banks. While this is 'going-concern' capital it is a poor substitute, in our view, to plain, old-fashioned core equity.

- **Tightened regulation on shadow banking and interbank business.** A lot has been written about the emergence of the 'shadow-banking' industry in China over the past few years, most of it negative. We, however, view many parts of this 'off-balance-sheet' business as contributing to the growth of a broader asset management industry. Issues/concerns arise where it has been abused by banks to take advantage of capital arbitrage and where risk has not been properly transferred on to investors (either explicitly or implicitly). This has exacerbated moral-hazard issues and led to understated leverage in a number of different parts of the financial system. We expect the authorities to continue to close loopholes that have allowed these capital-arbitrage opportunities to flourish. This will need to be managed carefully to avoid a 'capital'-driven credit crunch but should eventually enhance bank balance sheet credibility.

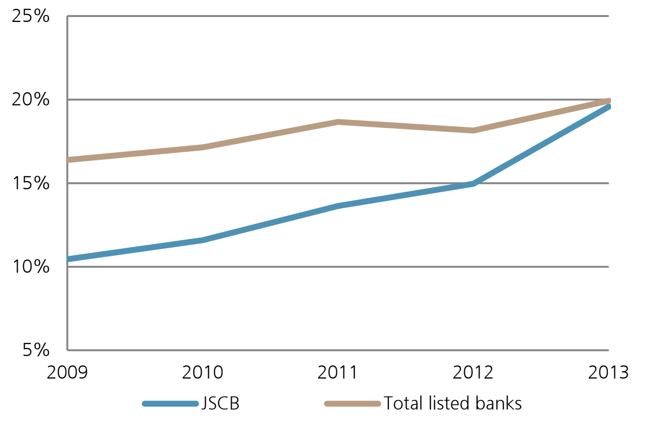
The list above does not leave readers with the impression that reform will be a positive catalyst for the China banks, a view that we would agree with. However, there are some short-term positives of reform. For example, the setting up of asset-management companies (AMC) could help transfer NPLs off bank balance sheets (typically at some cost to bank shareholders). There will also be ongoing development of fee income streams as more assets are moved on balance sheets (with genuine risk transfer this time). For example, net interest income still contributes around 75% of total revenues for the China banking system. This is considerably higher than in most developed market banking systems where it is typically closer to 60%. This income shift is typically viewed favourably by investors as fee income tends to be less capital-intensive. As we show in the charts below the current level of fee income as a percentage of revenues in China is similar to that in the US in the 1980s.

Figure 8: Fee and commission incomes as % of total revenues are already high for some medium-to-small banks (2013)



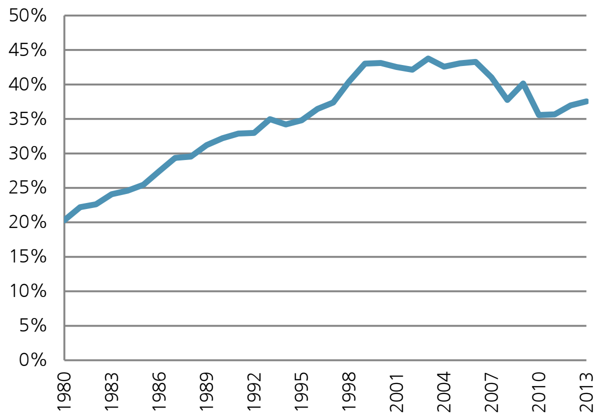
Source: Company data, UBS

Figure 9: Fee and commission incomes as % of total revenues have kept increasing in recent years



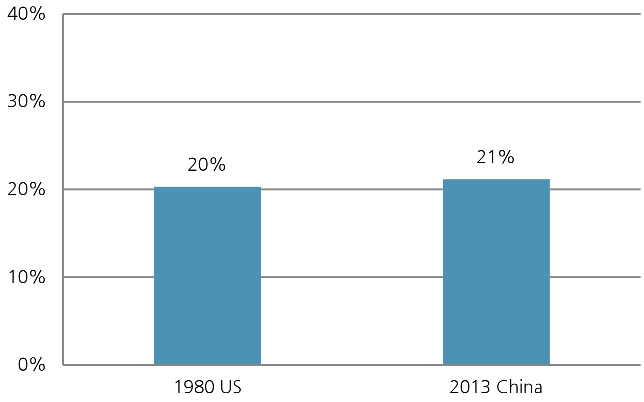
Source: Company data, UBS

Figure 10: Fee and commission incomes as % of total revenues recovered after US interest rate liberalisation



Source: FDIC

Figure 11: China's share of fee and commission incomes resembles that in the US in 1980s



Source: PBOC, FDIC

The increased competition that reform is likely to introduce is also likely to be better for bank customers. Credit is likely to be more readily available for the private sector where small- and medium-sized businesses have often had limited access to funding to date. Over time consumers are also likely to be able to invest in a broader range of financial products, shifting the savings base away from the current focus on bank deposits and real estate investment.

Long-term impacts of financials reform

Long term, reform should allocate capital better in the economy, resulting in fewer new NPLs

The biggest benefit of reform in the long term for the banks is likely to be better capital allocation around the economy, which should ultimately lead to lower NPL creation. However, reform and a move towards a more 'market-based' system also come with risks. For example:

A more market-based system is likely to increase liquidity risk

We are of the belief that it is 'liquidity' events that tend, ultimately, to trigger the emergence of NPLs in banking systems. In this respect a key strength of the Chinese financial system has been the level of state control of capital flows both internally and externally (the government effectively owns some 70-80% of the banks). Absent a policy mistake it is therefore hard to see how a 'liquidity' event can occur that can represent a 'systemic' risk to Chinese banks given the current structure of the banking system. Reform, however, may well change this over the medium-to-long term. As the authorities press ahead with reducing the dominant role of banks in China's credit system, liberalising interest rates and opening the capital account, government control over liquidity flows will naturally be weakened. This brings greater risk of liquidity flight, as changing perceptions of risk could be de-stabilising, both at individual institutions and at a national level, if not managed carefully, hence the need for a deposit insurance protection scheme. This is present in almost every major economy in the world, but not in China.

A shift towards mark-to-market accounting increases transparency… but what if we don't like what we see as visibility increases?

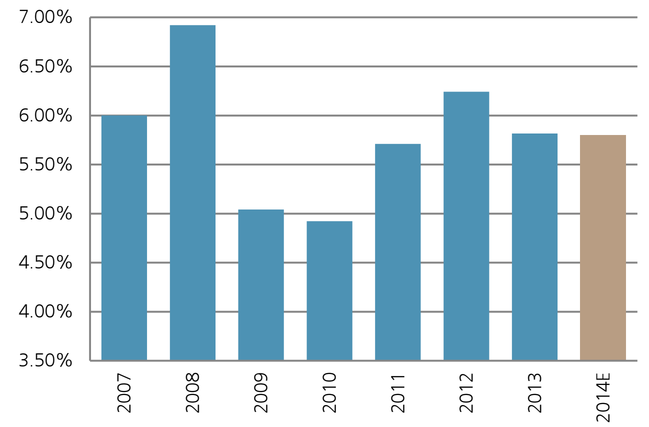
Dis-intermediation will introduce more mark-to-market accounting into China bank financial statements. Unlike loans, bonds portfolios typically have to be marked to market either through the P&L or equity base (unless the bonds are classified as 'held-to-maturity'). This matters as it moves to a more 'market-based' methodology for valuing assets. As such, if there is a risk of impairment (real or otherwise) the market will mark down the value of the bond. This is not something that is currently present with the accrual accounting/subjective impairment tests loan books are assessed on. As we see greater dis-intermediation, information as to the quality of underlying assets will increase.

Asset-yield compression for banks driving lower RoEs

As we have stated above, many aspects of China's financial reform are likely, quite rightly, to benefit the 'users' of banks rather than the banks themselves. This is likely to benefit the 'real' economy at the expense of the bank profitability. It is also likely to continue to facilitate an increase in leverage which, ultimately, will require a lowering of the debt servicing burden on borrowers (i.e., lower interest rates). In a banking system this typically plays out in one of two ways:

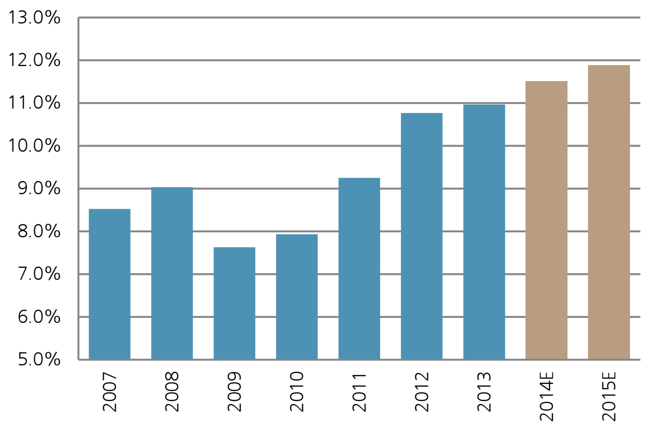
- In a 'western', more market-based system this usually involves some sort of market-driven correction that initiates with liquidity flight, default/NPL creation, write-offs followed by recapitalisation and recovery. However, this often results in the bankruptcy of non-viable business models, rising unemployment and often a change in government. There are a number of reasons why this may not be the preferred route for China.
- A second approach is to delay recognition of NPLs by lowering debt-servicing costs. This can be achieved by simply lowering borrowing rates via interest-rate cuts. China still has considerable room to lower rates. As we show in the chart below the average lending rate on China bank balance sheets is still comfortably above 5.5%, well above the current reported level of inflation. This does, however, mean that we estimate that interest income of the banking system is approaching 11-12% of nominal GDP on an annualised basis (and it has shown a sharp increase in recent years).

Figure 12: Average aggregate loan yield on H-share bank balance sheets is still above 5.5%



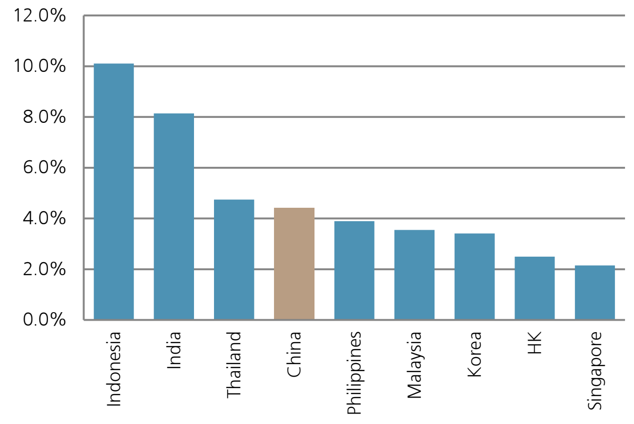
Source: Company data, UBS estimates

Figure 13: Estimated China banking system interest income as a % of nominal GDP



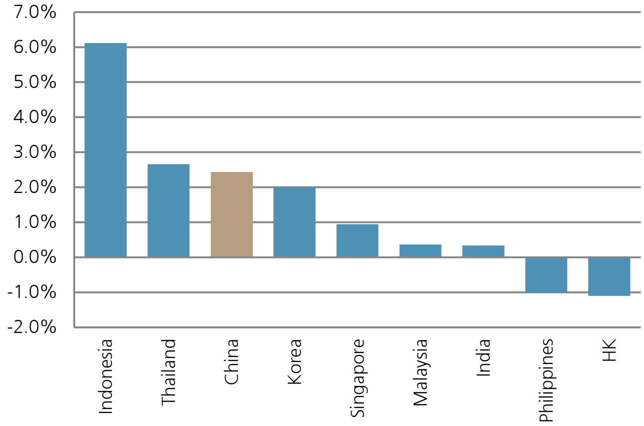
Source: Company data, UBS estimates

Figure 14: Bank interest income as % of assets for Asian banking systems



Source: Company data, UBS estimates

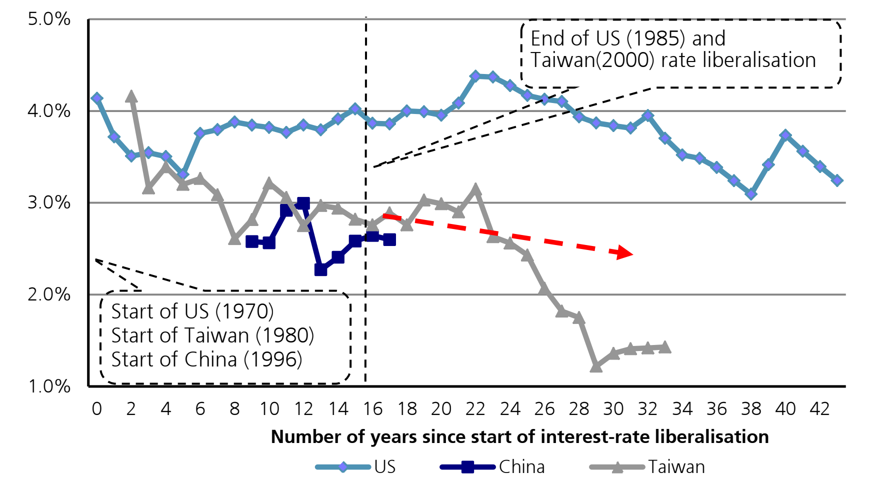
Figure 15: Bank interest income as % of average assets less domestic inflation rate for Asian banking systems



Source: Company data, UBS estimates

We think it is likely that China will start to lower rates, which, coupled with ongoing financial reform, would in coming years put downward pressure on bank assets yields (and hence NIMs). This was certainly the case in other markets that underwent a period of financial reform, as we show in the chart below.

Figure 16: Net interest margin typically declines as a consequence of financial reform



Source: FDIC, Central Bank of the Republic of China (Taiwan), PBOC

With the pace of potential rate cuts and reform still open to debate it is hard to assess accurately just how quickly bank margins in China may decline. To give some sense of sensitivity to returns of lower assets yield, we show a simple DUPONT analysis for the H-share listed China banks in the table below. This divides the P&L by average assets, which can then be adjusted by leverage (equity/assets) to show an implied RoE. In the exercise we take our 2015E interest income/assets and lower this in 10bp increments to simulate the impact of lower asset yields on returns. Note in this simple exercise we have left all other variables constant, which is clearly an oversimplification. However, this does show that, all else being equal, for every 10bps we lower asset yields (and hence pre-tax RoA) RoE falls around 1.5%. We note that lowering the interest income/assets ratio from 4.4% to 3.9% would lower the debt-servicing burden in 2015E from 11.9% to 10.5% of nominal GDP, giving scope to continue to increase systemic leverage.

Figure 17: Illustrative DUPONT analysis of the impact on returns of lower assets yields on the China banking system (P&L divided by average assets)

	2010	2011	2012	2013	2014E	2015E	*-10bps*	*-20bps*	*-30bps*	*-40bps*	*-50bps*
Interest income	3.66%	4.19%	4.53%	4.38%	4.43%	4.40%	*4.30%*	*4.20%*	*4.10%*	*4.00%*	*3.90%*
Interest expense	-1.27%	-1.65%	-1.98%	-1.89%	-1.95%	-1.95%	*-1.95%*	*-1.95%*	*-1.95%*	*-1.95%*	*-1.95%*
Net interest income	**2.38%**	**2.54%**	**2.55%**	**2.49%**	**2.49%**	**2.45%**	***2.35%***	***2.25%***	***2.15%***	***2.05%***	***1.95%***
Non-interest income	0.65%	0.76%	0.74%	0.78%	0.83%	0.83%	*0.83%*	*0.83%*	*0.83%*	*0.83%*	*0.83%*
Revenues	**3.03%**	**3.30%**	**3.29%**	**3.27%**	**3.32%**	**3.29%**	***3.19%***	***3.09%***	***2.99%***	***2.89%***	***2.79%***
Costs	-1.23%	-1.29%	-1.31%	-1.28%	-1.27%	-1.26%	*-1.26%*	*-1.26%*	*-1.26%*	*-1.26%*	*-1.26%*
Operating profit	**1.80%**	**2.01%**	**1.98%**	**1.99%**	**2.05%**	**2.03%**	***1.93%***	***1.83%***	***1.73%***	***1.63%***	***1.53%***
Impairments	-0.28%	-0.31%	-0.28%	-0.28%	-0.42%	-0.45%	*-0.45%*	*-0.45%*	*-0.45%*	*-0.45%*	*-0.45%*
Other	0.01%	0.01%	0.00%	0.00%	0.00%	0.00%	*0.00%*	*0.00%*	*0.00%*	*0.00%*	*0.00%*
PBT	**1.53%**	**1.70%**	**1.71%**	**1.72%**	**1.63%**	**1.58%**	***1.48%***	***1.38%***	***1.28%***	***1.18%***	***1.08%***
Tax/other	-0.36%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	*-0.40%*	*-0.40%*	*-0.40%*	*-0.40%*	*-0.40%*
RoA	**1.17%**	**1.29%**	**1.31%**	**1.31%**	**1.23%**	**1.18%**	***1.08%***	***0.98%***	***0.88%***	***0.78%***	***0.68%***
Equity/Assets	5.65%	6.02%	6.23%	6.45%	6.45%	6.45%	*6.45%*	*6.45%*	*6.45%*	*6.45%*	*6.45%*
Implied leverage	17.7x	16.6x	16.1x	15.5x	15.5x	15.5x	*15.5x*	*15.5x*	*15.5x*	*15.5x*	*15.5x*
Implied RoE	**20.7%**	**21.5%**	**21.0%**	**20.3%**	**19.1%**	**18.2%**	***16.7%***	***15.1%***	***13.6%***	***12.0%***	***10.5%***

Source: Company data, UBS estimates

Capital account opening and MMA

One of the most recent pieces of reform is the proposed MMA scheme between the Shanghai and Hong Kong stock exchanges. This comes under the umbrella of reform of China's capital accounts in that it allows foreign investors another route to invest in the China A-share market (other than using current QFII quotas). From a banks' perspective this gives access to a further seven bank stocks: Bank of Beijing, Bank of Nanjing, Bank of Ningbo, Hua Xia Bank, Industrial Bank, Ping An Bank and Shanghai Pudong Development Bank. Below we highlight some of the key differences between the A-share-only listed banks and the H-share banks that international banks can currently access. In general the A-share-listed banks do tend to be smaller, they also tend to be more involved in 'shadow banking' activities, have weaker funding structure (i.e., more corporate than retail deposits) and weaker capital ratios. As such, it is unclear to us that these stocks will be particularly appealing to international investors unless valuations become more compelling.

A-share banks have weaker ROA but higher B/S leverage than H-share banks:

- A-share banks' ROA in 2013 was 20bp lower than H-share banks';
- However, due to higher balance sheet leverage, A-share banks' average ROEs were similar to H-share banks';
- Industrial Bank has the highest ROE with high leverage, due to its bigger exposures to interbank assets; Ping An Bank had the lowest ROA and ROE in 2013.

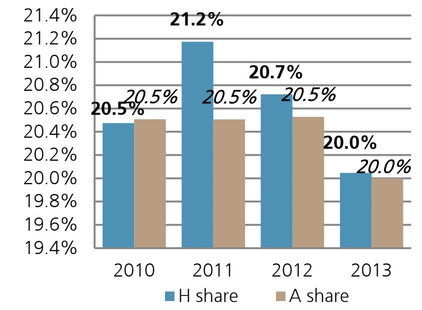
A-share banks' net interest margin in general is weaker than H-share banks' due to:

- Weaker deposit base: A-share banks' deposits are dominated by corporate deposits, which are much more expensive than retail deposits;
- A-share banks are more exposed to interbank assets, which have lower spreads than traditional loan-deposit spreads.

Balance sheet structure:

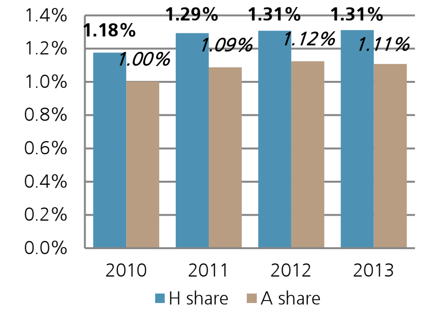
- A-share banks have bigger exposures to interbank assets, which are subject to bigger regulatory scrutiny;
- A-share banks rely more on corporate deposits;
- A-share banks' LDRs are higher than H-share banks'.

Figure 18: A-share banks' average ROE is similar to H-share banks'



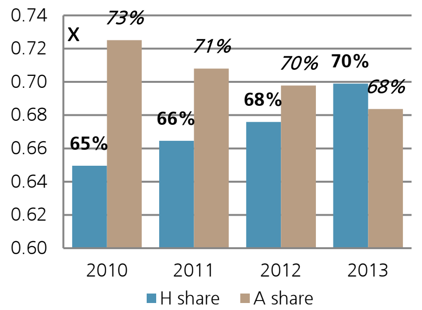
Source: Company data

Figure 19: However, A-share banks' average ROA is lower than H-share banks'



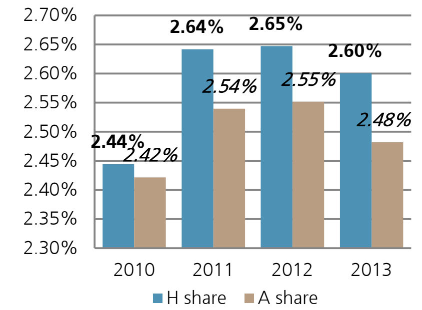
Source: Company data

Figure 20: A-share banks' B/S leverage (asset-to-equity ratio) is higher than H-share banks'



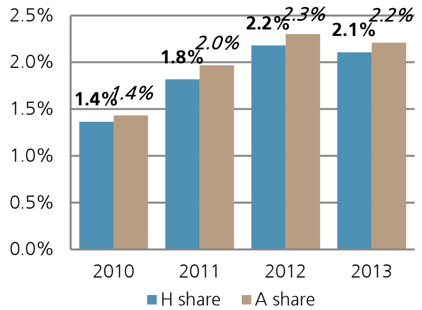
Source: Company data

Figure 21: A-share banks' NIM is much lower than H-share banks'



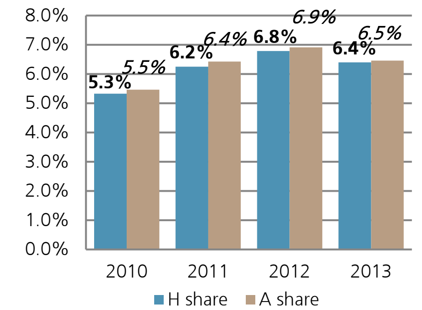
Source: Company data

Figure 22: A-share banks' deposit costs are much higher than H-share banks'



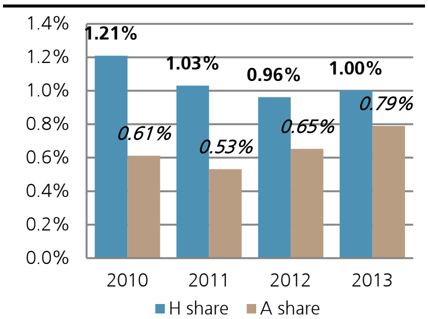
Source: Company data

Figure 23: A-share banks' loan yields are also higher than H-share banks'



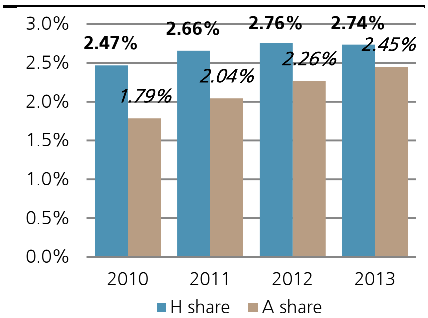
Source: Company data

Figure 24: A-share banks' NPL ratio rising more quickly



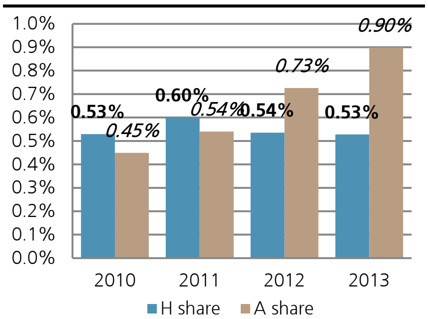
Source: Company data

Figure 25: A-share banks' provision-to-loan ratios are lower than H-share banks'



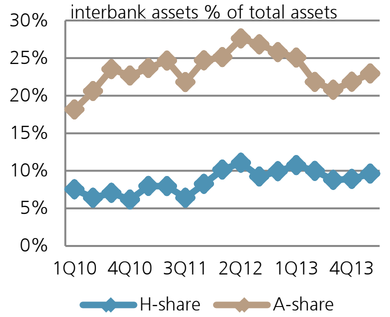
Source: Company data

Figure 26: A-share banks' credit cost (% of loans) are higher than H-share banks'



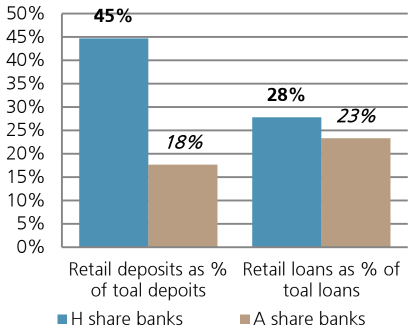
Source: Company data

Figure 27: A-share banks' exposures to interbank assets are much higher than H-share banks'



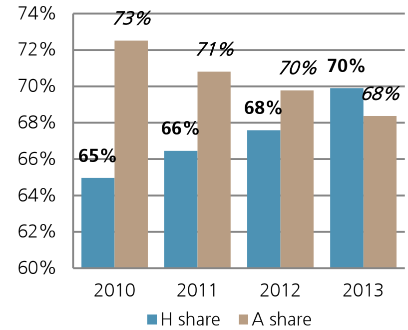
Source: Company data

Figure 28: A-share banks rely more on corporate deposits (YE2013)



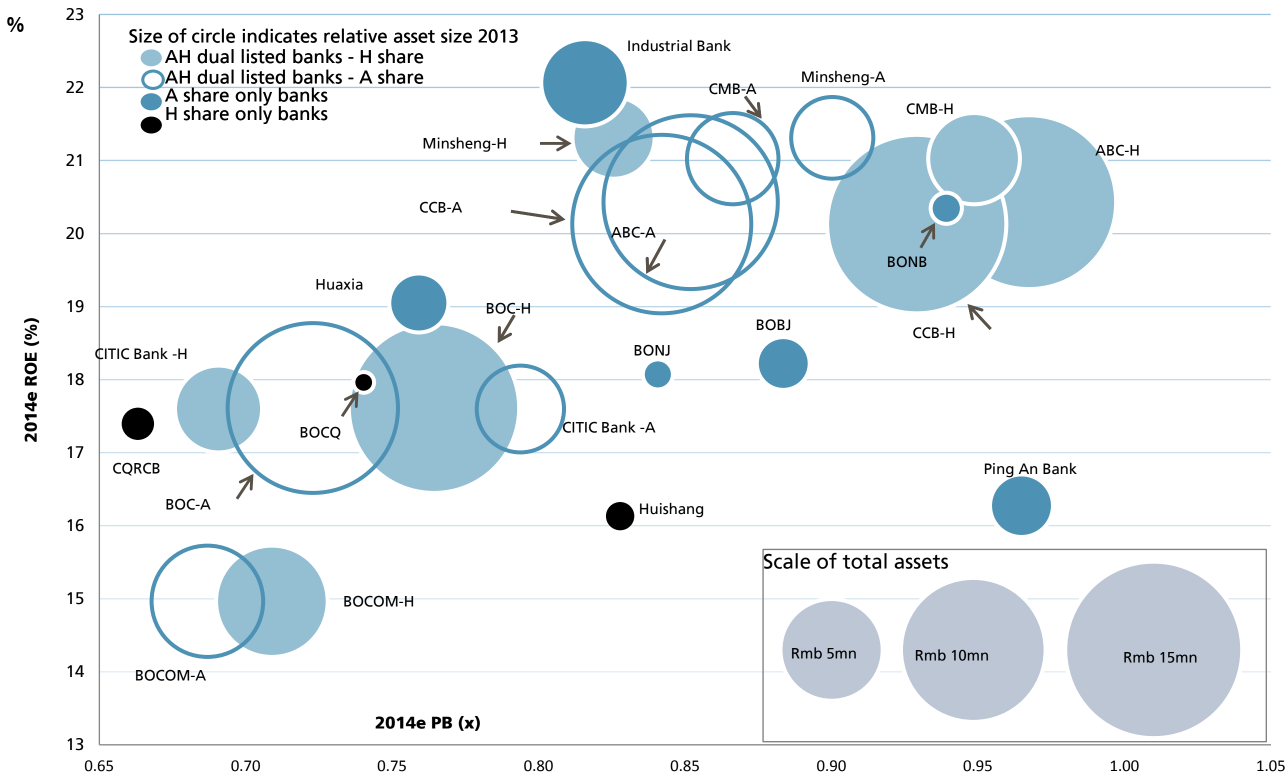
Source: Company data

Figure 29: A-share banks' loan-to-deposit ratio higher than H-share banks'



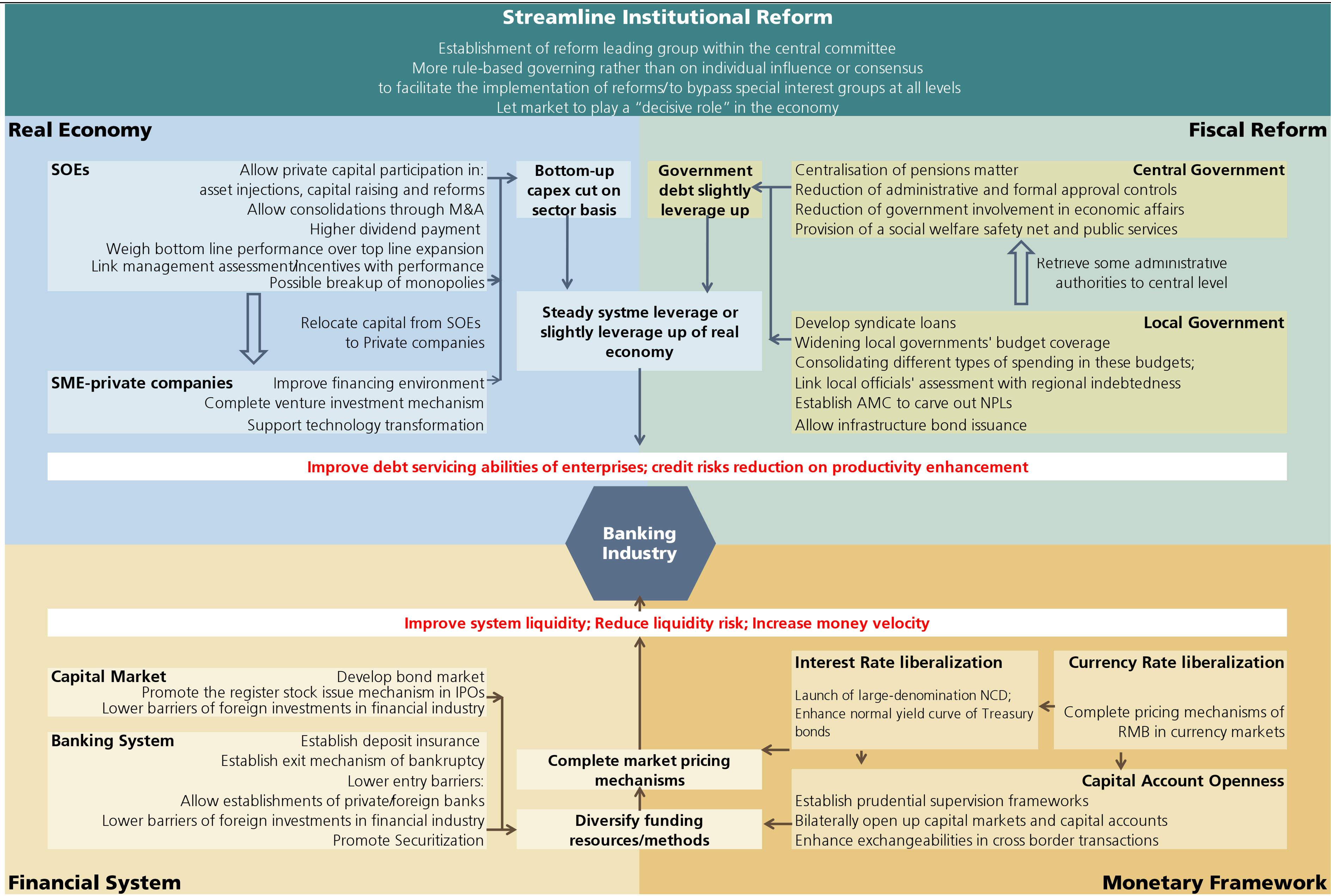
Source: Company data

Figure 30: Valuation comparison: A share-only banks have relatively higher returns and lower valuations in general



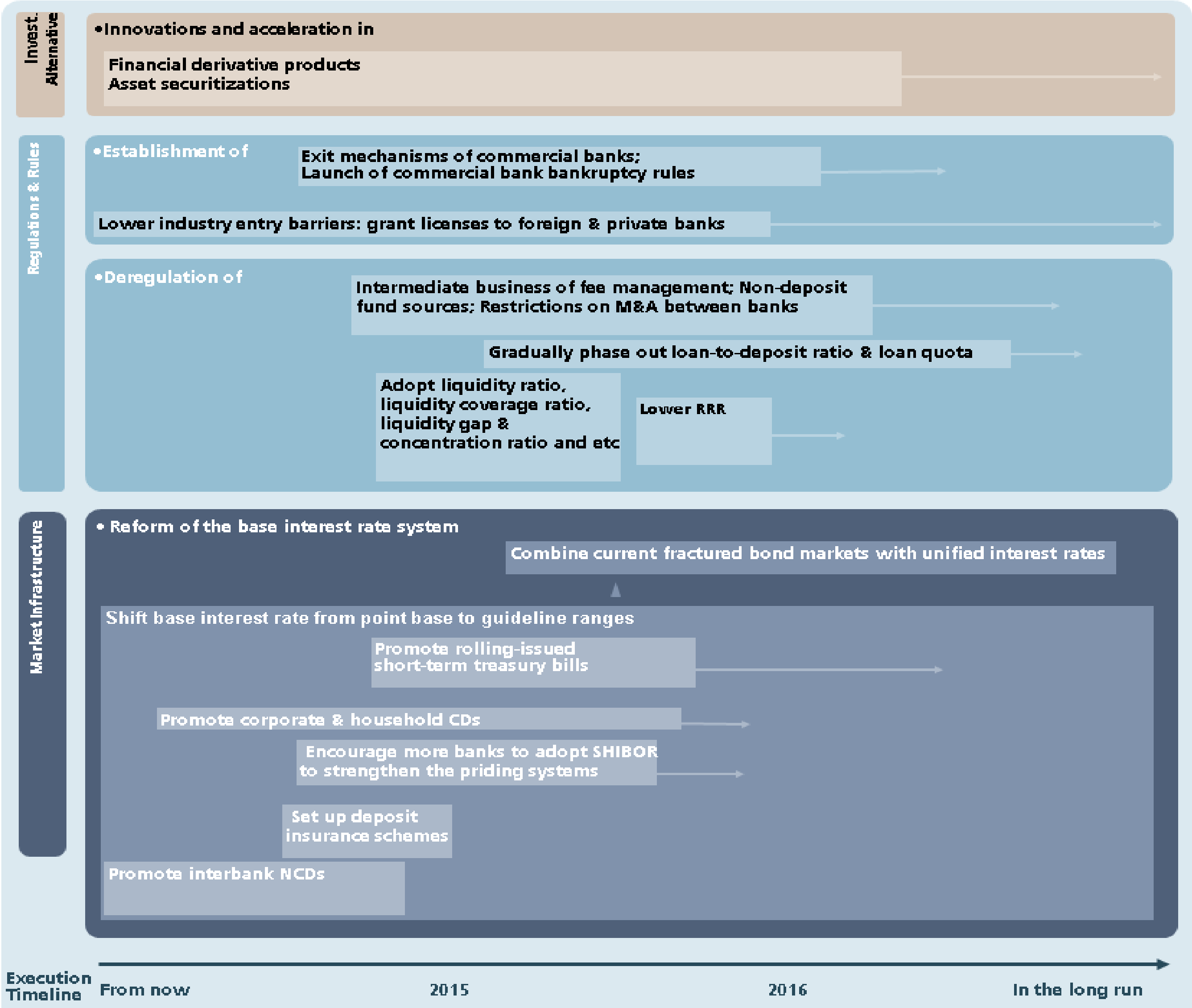
Note: As of 17 September 2014.
Source: Company data, UBS estimates

Figure 31: Reforms announced after China's Third Plenum



Source: UBS

Figure 32: Roadmap of interest-rate liberalisation



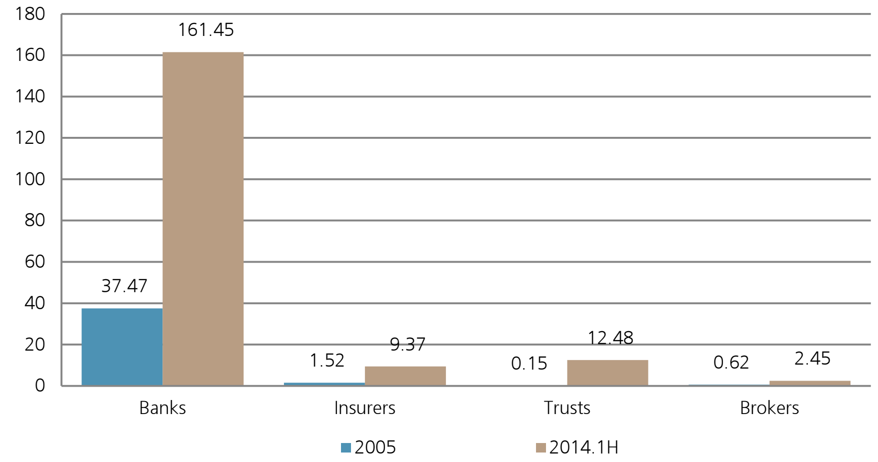
Source: UBS

Non-bank financials – clear beneficiaries, but to what extent?

It is generally expected that, as disintermediation of the banking system progresses, more assets will move off bank balance sheets to the benefit of the likes of insurers and other asset managers (via increasing AUM), brokerage firms (via increasing financial intermediation-related revenues) and other capital market services providers, such as peer-to-peer (P2P) funding internet companies, which are also expected to be beneficiaries of further financial market reforms.

We expect current and potential reforms to encourage the establishment of more market-driven equity and bond markets, where insurers (and other long-term asset managers, such as pension companies), securities brokers and asset-management businesses will see much improved business opportunities and, likely, accelerated growth per significant policy change/reform.

Figure 33: Total asset of insurers, banks, trusts vs brokers for the year of 2005 and H1 2014 (Rmb trn)



Source: CIRC, CBRC, CSRC, China Trustee Association

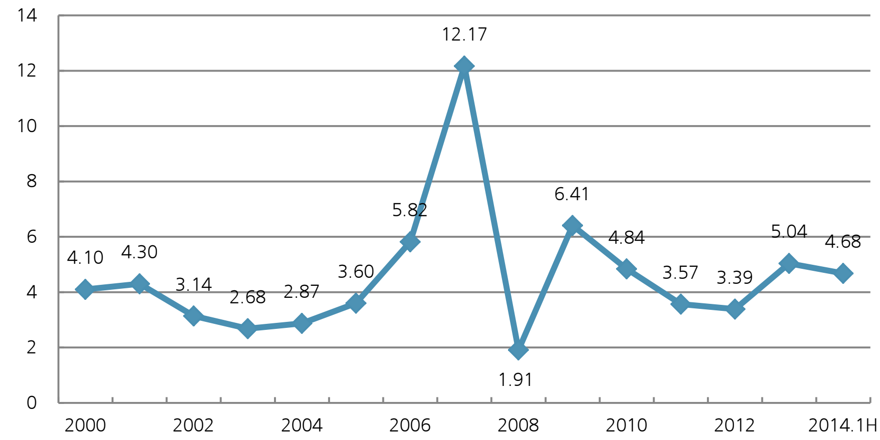
It is worth highlighting that Chinese financial regulation, thus far, comprises regulatory regimes run separately by the CBRC, the China Securities Regulatory Commission (CSRC) and the China Insurance Regulatory Commission (CIRC) – the banking, the securities and the insurance regulators. While we do not expect the merging of these three regulators any time soon, the improved coordination by these regulators and the increased channels for financial intermediation is expected to open up significant opportunities for non-bank financial institutions to operate as financial groups, in our view.

This, in our view, is particularly true for asset-management business, where the CSRC has, for example, signalled its intention to allow life insurers to establish fund management companies. Overall, relaxed regulations governing the investment of insurance asset should help improve returns in the industry. In addition to bank deposit and securities asset investments, insurance is expected to become an important tool of household saving, we think.

Short-to-medium term impacts of financial reform

We expect more rational pricing of credit assets and liabilities together with the establishment of more market-driven equity and bond markets to drive higher returns (for the same level of risks) for investors committing long-term funding in the capital markets. Life insurers, pension firms and other asset managers are expected to see improving yield for their products, and thus making them more attractive to savers, we think. Further regulatory reform (pricing deregulation and simplification of approval processes) is expected to help improve overall business efficiency.

Figure 34: Investment yield (total yield) of China insurance industry (%)



Source: CIRC, Company data

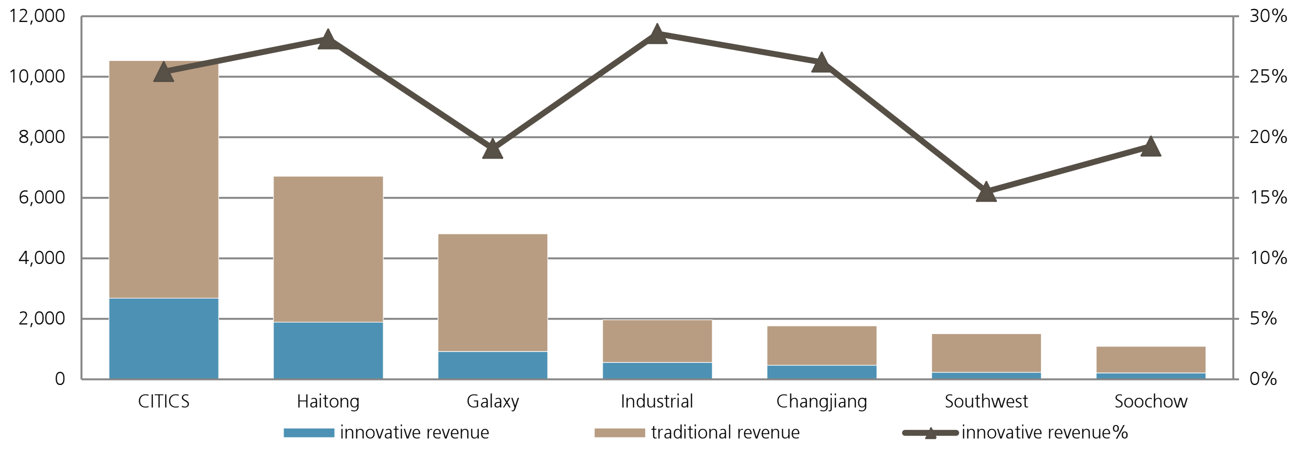
- **Increased investment in alternative assets**: Major insurers have seen their investment portfolios tilting towards higher-risk assets (away from risk-free central government bonds) over the past 18 months. Further credit market reform and the eventual opening up of the capital account would continue to support yield enhancement for insurers, in our view. We expect major insurers' investment yield to improve further, by another 30-40bps over the next 12 months.

- **Further pricing deregulation – both life and non-life:** CIRC is expected to further relax pricing restrictions on most life insurance products and motor insurance products over the next 12 months. Overall, the regulatory stance would swing away from pricing control to risk-based and capital-focussed. This should benefit operators with sound balance sheets and strong distribution channels, such as Ping An Insurance group.

- **More simplified, but standardised product approval and regulatory oversight:** CIRC is expected to remove most administrative approvals process currently in place for many aspects of normal insurance business. Only senior management appointments, major equity investments and the launch of asset-management products will require top regulatory approvals going forward. With similar tone, the CSRC is also expected to remove much of the approvals needed for innovative businesses for brokers, leaving only a 'restricted' list that limits the scope of certain new product launches. In our view, this would help enhance the competitiveness of these non-bank financial institutions significantly.

- **Key regulatory overhaul for all investment product distribution:** It is interesting to highlight that investors continue to focus mainly on the banking sector's involvement in selling such alternative investment products: in our view, major regulatory risks exist for other distributors, such as brokers, over the next 12-18 months as regulators move towards a major overhaul on all investment product distribution regulations.

Figure 35: Revenue contribution of innovative businesses vs traditional brokerages (Rmb m)



Note: Innovative revenue includes margin financing and stock lending, stock pledging and stock repo agreements.
Source: Company data

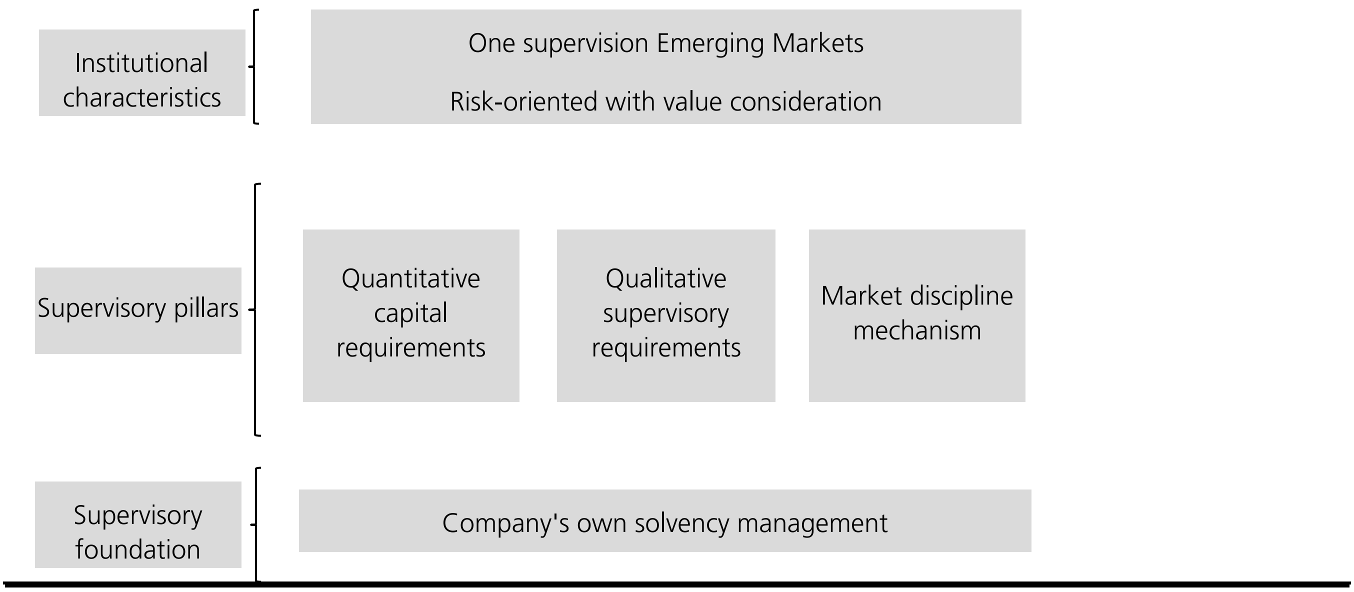
Long-term impacts of financial reform

Regulators are expecting to move further away from using price instruments and quantitative quotas to regulate the financial system. Overall, the regulatory regime is expected to move towards a full risk-based capital system supported by regulatory oversight and enhanced market exit schemes.

It is interesting to note that banks are expected to go through a prolonged period of deleveraging over the next couple of years, while insurers, brokers and other non-bank financial institutions (NBFI), on the other hand, are expected to leverage up via debt issuance and see more efficient capital usage under an enhanced risk-based capital framework to be introduced. We expect further regulatory and financial reform to ignite a swamp of new business opportunities for the securities and investment banking industry over the next couple of years.

- **Enhancing the capital adequacy framework:** China's regulators have focused on bringing the regulatory and capital framework for banks in line with international standards over the past 10 years. In our view, it is expected that the CSRC and CIRC will launch enhanced capital adequacy frameworks for insurers and securities broker firms over the next couple of years. This should see more efficient use of capital by these NBFIs over time that could lead to less volatile earnings profiles.

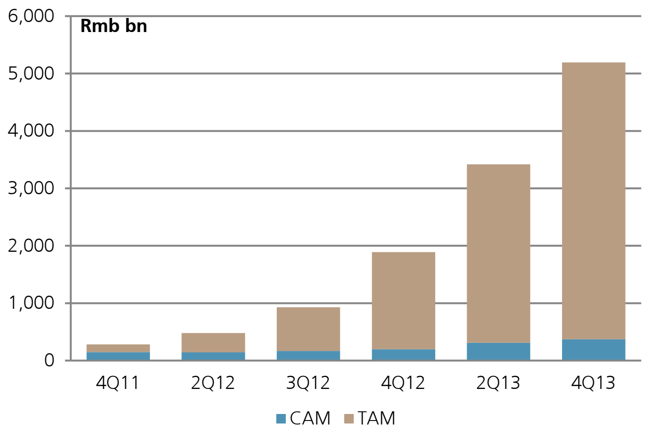
Figure 36: Solvency II regime



Source: CIRC

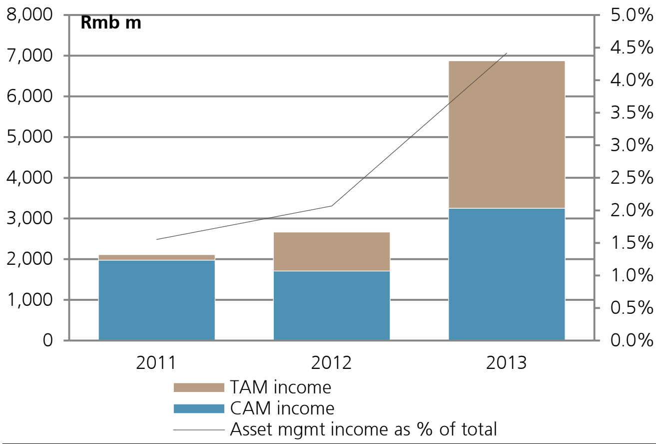
- **More supervision to prevent regulatory arbitrage:** The asset-management business of brokers has recorded strong growth since 2012 with AUM increasing from Rmb281.9bn at the end of 2011 to Rmb5.2trn at the end of 2013. Of the balance, the AUM of collective asset-management plans was Rmb370.0bn (according to WIND) and AUM of targeted asset management was Rmb4.8trn at the end of 2013. Despite the large balance of targeted asset-management AUM, targeted asset management is an off-balance business without an impact on the balance sheets and other business lines of brokers. We expect regulators to further tidy up regulations where CSRC would regulate these asset-management products to eliminate any potential for regulatory arbitrage.

Figure 37: AUM of securities industry



Source: SAC, Wind, UBS

Figure 38: Income from asset-management business



Source: SAC, UBS

Figure 39: Regulations on targeted asset-management business

Regulator	Date	Regulations	Details
CSRC	Oct-12	Implementing Rules on the Targeted Asset Management business of Securities Companies	The investment risk of targeted asset-management business should be undertaken by investors themselves, while securities companies should not make any guarantee about the principal or minimum return.
SAC	Jul-13	Notice on Regulating Securities Companies and Banks in Targeted Asset Management Business Cooperation	The branches and outlets of securities companies should not carry out asset-management business independently (excluding branches of asset-management companies). Securities companies are not allowed to carry out capital pool business, invest entrusted funds into highly polluting, high-energy consuming and other industries prohibited by the country. The cooperating banks should have an asset size of no less than Rmb30bn (raised to Rmb50bn in February 2014) and CAR of no less than 10%; they should not be subject to administrative penalties or major administrative regulatory measures; they should not see significant deterioration or insolvency in financial position. Securities companies should clearly prescribe the rights and obligations of both parties, including the source and use of the entrusted funds, the investment process and instructions, that they should not make any guarantee about the principal and investment returns, etc. Securities companies to carry out targeted asset-management business in cooperation with banks should have the accounts under separate custodian and supervise the effective implementation of the investment oversight custodian, valuation, reconciliation and liquidation duties.
SAC	Feb-14	Supplementary Notice on Further Regulating the Targeted Asset Management Business of Securities Companies	Securities companies should follow principles of due diligence and prudent investment in carrying out asset-management businesses to conduct due diligence for non-standard investments and prevent and control investment risks. The due diligence should include, but not be limited to: A) due diligence of the project financing bodies: securities companies should be concerned about the financing bodies' qualifications, assets, operations, financial conditions, credit records and others. B) due diligence of the projects: securities companies should be concerned about the projects' basic situation, profitability, industry development and others. The cooperating banks should have an asset size of no less than Rmb50bn The member from the third party hired by the securities companies should not have bad credit records in the securities industry; there should be at least five people passing the securities, futures or funds qualification examination and have personal experience of no less than three years.

Source: CSRC, SAC

- **Key regulatory overhaul for all investment product distribution:** It is interesting to highlight that investors continue to focus mainly on the banking sector's involvement in selling such alternative investment products: in our view, major regulatory risks exist for other distributors, such as brokers, over the next 12-18 months as regulators move towards a major overhaul of all investment product distribution regulations.

Capital account opening and MMA

We believe the long-term impact brought by the Shanghai Hong Kong Stock Connect Program, or MMA, should not be underestimated. We expect the quota for MMA to be further enhanced over time, where equity capital markets in both Hong Kong and Shanghai, and, ultimately in Shenzhen, will somewhat converge – not just converging valuations, but, in our view, everything from regulatory approach to market behaviour of these currently separate markets could move somewhat closer over time. A few interesting points to note:

- **QDII quota is still not fully utilized:** Before the implementation of MMA, QDII was one of the vehicles used by domestic investors to invest abroad. However, the QDII quota is only about 40% utilised most of the time, where the low commission rates (0.1%) charged also makes QDII products unattractive for brokerage firms.

- **MMA and RQFII expansion - limited contribution for now:** We note that QFII and RQFII have attracted a large amount of international investment to the A-share market since the announcement of MMA. Taking aside the potential daily turnover increases over time, the contribution to brokerage revenue would be small to listed Chinese brokers for now.

- **Factors of A/H valuation gap are complicated; Ping An-A appears most attractive:** The Ping An-H premium to Ping An-A has declined from 35% on 9 April 2014, the day before the announcement of MMA, to approximately 20%. The relationship of the premium/discount between A shares and H shares is complicated. It is important to note that the A-share market is not an important component of any major international benchmark index at present. In our view, relative index weights, relatively liquid market cap and global demand for Chinese dual-listed insurers will be the main drivers of the long-term A/H discount/premium post the launch of MMA. Considering the strong NBV growth expectation of Ping An Life, from a valuation perspective we believe Ping An-A is the most attractive of all the listed A-H non-bank financial names under our coverage.

Figure 40: Valuation table for all A-H Insurers

				Price target	Price	Implied Upside	Market cap	Price / EPS (x)		Price / BVPS (x)		ROA (%)		ROE (%)	
Code	Company	Country	Rating	(local ccy)	(local ccy)	%	US$m	14E	15E	14E	15E	14E	15E	14E	15E
HK2628	China Life	China	Buy	27.06	22.85	22%	83,322	15.0	13.7	2.1	1.9	1.7	1.7	14.6	14.4
HK2318	Ping An	China	Buy	91.22	63.00	39%	64,339	12.2	10.8	2.3	1.8	1.2	1.2	21.5	19.5
HK2601	CPIC	China	Buy	32.21	28.55	6%	33,378	20.9	18.6	2.0	1.8	1.2	1.2	9.5	9.9
HK1339	PICC Group	China	Buy	4.06	3.35	17%	18,335	12.5	11.2	1.5	1.3	1.2	1.1	12.6	12.4
HK2328	PICC	China	Neutral	12.50	13.98	-1%	24,536	15.1	14.1	2.3	2.1	2.9	2.8	16.4	15.7
HK1299	AIA	Hong Kong	Neutral	44.82	42.10	8%	65,415	24.6	20.3	2.6	2.4	1.8	2.0	10.9	12.2
SS601628	China Life - A	China	Buy	19.71	15.38	37%	70,812	12.7	11.6	1.8	1.6	1.7	1.7	14.6	14.4
SS601318	Ping An - A	China	Buy	63.21	41.91	46%	54,041	9.8	8.6	1.9	1.5	1.2	1.2	21.5	19.5
SS601601	CPIC - A	China	Buy	22.57	19.35	15%	28,563	17.9	15.9	1.7	1.6	1.2	1.2	9.5	9.9

Note: As of 17 September 2014. Source: UBS estimates

Figure 41: Valuation table for all A-H coverage stocks NBFIs

				Price target	Price	Implied Upside	Market cap	Price / EPS (x)		Price / BVPS (x)		ROA (%)		ROE (%)	
Code	Diversified financials	Country	Rating	(local ccy)	(local ccy)	%	US$m	14E	15E	14E	15E	14E	15E	14E	15E
HK6030	CITICS	China	Neutral	19.60	18.44	2%	23,541	23.1	19.8	1.7	1.6	2.4	2.6	7.7	8.4
HK6837	Haitong Securities-H	China	Buy	13.90	12.48	7%	15,624	18.7	15.5	1.4	1.3	2.8	3.1	8.0	9.0
HK0165	China Everbright	China	Buy	19.40	15.82	1%	3,517	16.9	14.6	0.9	0.9	4.6	5.1	5.5	6.0
HK6881	Galaxy Securities	China	Buy	7.00	5.80	24%	5,640	12.9	11.5	1.3	1.2	2.8	2.7	10.3	10.7
HK1359	Cinda	China	Buy	6.18	3.64	40%	17,026	7.5	5.9	1.1	1.0	3.7	4.1	16.5	18.0
600030	CITICS-A	China	Buy	15.32	12.93	18%	23,191	20.4	17.4	1.5	1.4	2.5	2.6	7.7	8.4
600837	Haitong-A	China	Buy	11.67	10.03	16%	15,651	19.0	15.7	1.5	1.4	2.8	3.0	8.0	9.0
601555	Soochow Securities	China	Buy	10.12	8.71	16%	3,829	39.9	28.6	1.7	1.7	2.5	2.9	4.9	5.9
600369	Southwest Securities	China	Buy	11.67	9.75	20%	4,480	30.1	25.0	1.7	1.7	2.9	3.1	6.3	6.8
601377	Industrial securities	China	Buy	13.26	12.09	10%	5,117	31.9	26.5	2.3	2.1	2.3	2.2	7.3	8.3
000783	Changjiang Securities	China	Sell	5.23	5.82	-10%	4,493	22.9	20.2	2.1	1.9	3.4	3.2	9.2	9.8

Note: As of 17 September 2014. Source: UBS estimates

- **We prefer large brokers such as CITICS-A and Haitong-H:** In our view, large Chinese brokers with strong brand recognition in both mainland and Hong Kong could benefit most from the initial launches of MMA; we prefer CITICS-A & Haitong-H. Given the large amount of unused QDII quota and offshore Rmb deposits, as well as deep A/H-share discount, we believe capital flow would be stronger into the Shanghai Stock Exchange (SSE) (northbound) than into the Hong Kong Stock Exchange (HKEX) (southbound) initially. We prefer large brokers with subsidiaries in Hong Kong, such as CITICS and Haitong.

APPENDIX

Quantifying the cost of 'financial reform' on the banks

Reform 1: Interbank/deposit CDs

Currently, the banks can pay only up to 110% of the benchmark rate on deposits from individuals and corporates. If the banks are allowed to issue CDs to corporates and individuals, and freely decide the interest rates they pay on CDs, it essentially liberalises the pricing on a portion of their deposit bases. However, when deciding the interest rates on CDs, the banks have to balance out their consideration between risk and cost controls. We take the following steps to gauge the impact on profitability from CD issued to household and corporates.

Conclusions from our scenario analysis:

- Under all three scenarios, we find CITIC Bank is the most affected. The impact on CITIC under the three scenarios, range from 10-16bp on NIM and 9-14% on net profit.
- We find the least affected are ABC and CQRCB. As we have factored in our view that these two banks' solid funding franchise will help them rely less on CD.
- The impact on CCB seems also relatively small as we believe it will issue fewer CDs than other smaller banks.
- We think BOC's CD costs may be slightly higher than CCB, as its Rmb book accounts for only 77% of its earning assets.

Figure 42: Scenario analysis – different CD exposures and CD interest rate

	CCB	BOC	ABC	BOCOM	CMB	CITIC	CQRCB
1. CDs replace 5% of deposits, and CD's cost is 170bps higher than normal deposits for all banks							
Impact on 2014E NIM (bp)	-7	-5	-7	-7	-6	-7	-6
% impact on 2014E net profit	-4%	-4%	-5%	-5%	-4%	-5%	-4%
2. Different banks have different CD exposures, but same CD cost							
CD % of total deposits	5%	7%	3%	8%	7%	10%	3%
CD's cost higher than normal deposit (bp)	170	170	170	170	170	170	170
Impact on 2014E NIM (bp)	-7	-10	-4	-11	-8	-13	-3
% impact on 2014E net profit	-4%	-5%	-3%	-8%	-5%	-10%	-2%
3. Different banks have different CD cost but same CD exposures							
CD % of total deposits	5%	5%	5%	5%	5%	5%	5%
CD's cost higher than normal deposit (bp)	70	100	60	120	100	140	60
Impact on 2014E NIM (bp)	-3	-3	-2	-5	-4	-6	-2
% impact on 2014E net profit	-2%	-2%	-2%	-3%	-2%	-4%	-1%

Note: to simplify calculations, we assign 1) the same percentage of deposits that will be replaced by CD at 8%; 2) the same premium that the banks will pay on CD over current regulated deposit rates at 100bp. However, this is unlike to happen as bigger banks strength in funding will make they less rely on CD.
Source: UBS estimates

Reform 2: Relaxation of deposit rate ceiling

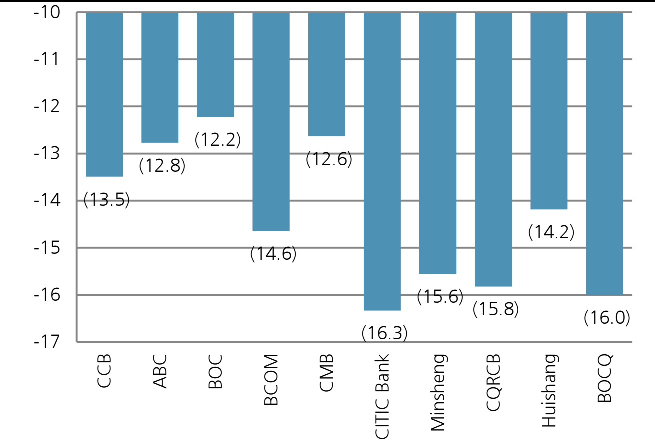
We analysed the impact of moving deposit rates up by another 20% (i.e., 30% over benchmark at maximum) on banks' earnings in the table below. It shows that smaller banks' net profit growth is more sensitive to deposit rate change.

Figure 43: Impact on NIM, revenue and net profit from 20ppt uplift of deposit rate ceiling from current 110% of benchmark rate

Sensitivities	CCB	ABC	BOC	BCOM	CMB	CITIC Bank	Minsheng	CQRCB	Huishang	BOCQ
NIM impact (bp)	(13.5)	(12.8)	(12.2)	(14.6)	(12.6)	(16.3)	(15.6)	(15.8)	(14.2)	(16.0)
Impact on net interest income	-4.9%	-4.9%	-5.5%	-6.6%	-5.0%	-6.9%	-6.0%	-4.7%	-5.5%	-6.1%
Impact on revenue	-3.7%	-3.9%	-3.8%	-5.1%	-3.3%	-5.3%	-4.0%	-4.5%	-4.9%	-5.2%
Impact on net profit	-8.1%	-9.5%	-9.0%	-11.7%	-7.3%	-12.5%	-9.1%	-10.7%	-8.8%	-11.1%

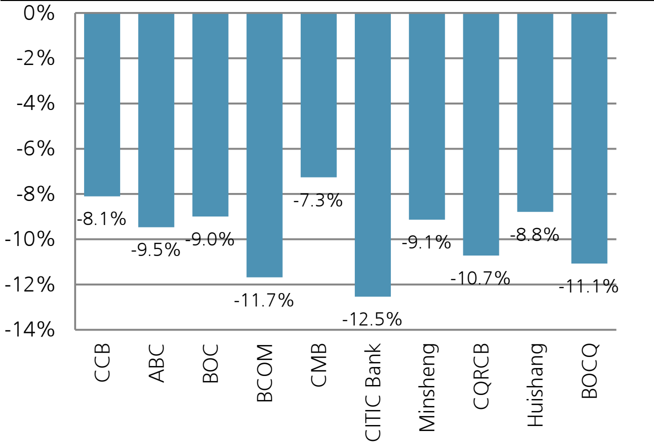
Source: UBS estimates

Figure 44: Impact, in terms of basis points, on 2015 NIM from 20ppt uplift of deposit rate ceiling



Source: UBS estimates

Figure 45: Impact on 2015E net profit from 20ppt uplift of deposit rate ceiling



Source: UBS estimates

Reform 3: Establishment of privately-owned banks

According to finance.people.com.cn, the CBRC chairman, Mr. Shang Fulin, disclosed during a conference that the CBRC had approved the establishment of three private banks (see Figure 46):

Figure 46: Recently approved privately-owned commercial banks

Name	Location	Major shareholder	Business focus
Qianhai Weizhong Bank ('前海微众银行')	Shenzhen, Guangzhou	Tencent, Baiyeyuan and Liye	Consumer finance and microfinance
Wenzhou Minshang Bank ('温州民商银行')	Wenzhou, Zhejiang	CHINT and Huafeng	Microfinance in Wenzho
Tianjin Jincheng Bank ('天津金城银行')	Tianjin	Huabei and Maigou	Huabei and Maigou

Source: finance.people.com.cn, UBS

It is said CBRC will continue to help all these banks to improve their corporate governance, draft company charters, select management personnel and establish risk management frameworks.

Notably, according to abovementioned news source, two other banks set up by Alibaba (in Hangzhou) and Fosun (in Shanghai) have not received approvals. They are said to be improving establishment plans with the help of authorities. Mr. Shang expects the CBRC could extend more approvals in future.

Although the initial operations of these banks could be fully regional, we believe the introduction of privately owned banks to be a major step in interest rate liberalisation in the banking sector, especially in funding/financing costs, by breaking up previous monopolies and promoting competition.

Reform 4: Introduction of deposit insurance scheme

PBOC policymakers have appealed for the establishment of deposit insurance mechanisms to be accelerated. We expect the deposit insurance scheme will be put in place before end of 2014, and deposit insurance premiums will be collected from different banks:

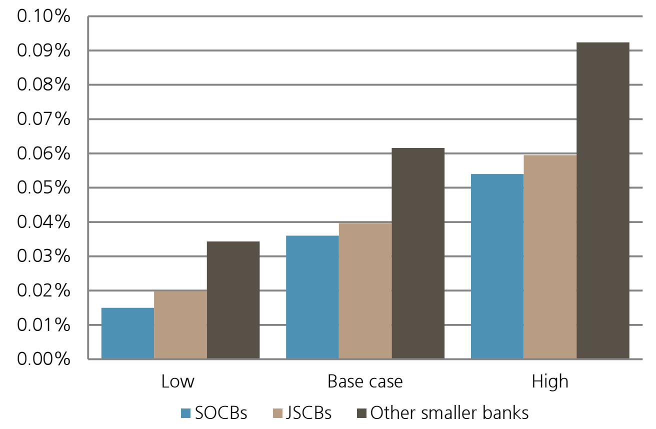
If the deposit insurance scheme is implemented successfully, we expect the possibility of bank runs to be significantly reduced, especially for small city/rural commercial banks/credit cooperatives with weaker risk-management capability. Therefore systemic risk in the banking system will be better managed, in our view.

Deposit insurance itself has relatively small impact on banks' earnings. However, the launch of the scheme would imply the decision makers' determination to push forward interest-rate liberalisation, which will add major pressure to the banks' NIM and profitability.

Our key assumptions for deposit insurance schemes include:

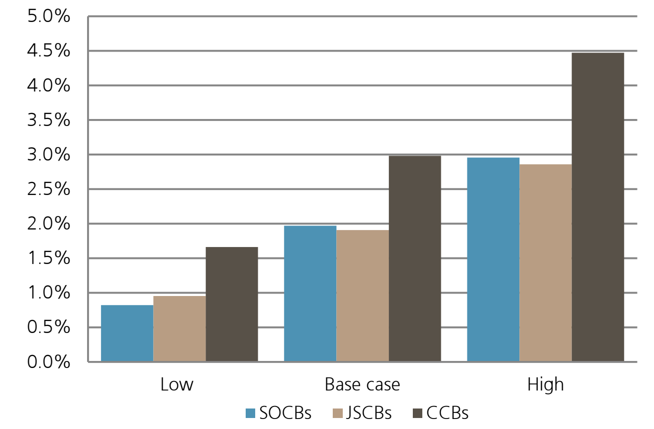
- Target deposit insurance 0.15%-0.45% of total system deposits
- A differentiated (risk-based) deposit insurance premium: bigger banks will pay lower premium than smaller/riskier banks
- A funding period of five or 10 years during which premiums will be collected from the banks until the size of deposit insurance fund reaches the targeted size
- Coverage limit will be Rmb0.2-0.5m per account

Figure 47: Annual deposit insurance premium (% of total deposits)



Source: UBS estimates

Figure 48: Annual deposit insurance premium % of 2015E net profit (assuming 10 funding periods to reach target deposit insurance fund size – 0.15%-0.45% of total deposits)



Source: UBS estimates

Figure 49: Deposit insurance coverage limit (per account) comparison with other countries – China in the range of Rmb0.2 – 0.5m

	2013 GDP per capita (local currency)	2013 GDP per capita (US$)	Deposit per capita (local currency)	Deposit per capita (US$)	Coverage limit (local currency)	Coverage limit (US$)	(x) times of GDP per capita	(x) times of deposits per capita
China	41,907	6,807	80,180	9,463				
Hong Kong	295,701	38,124	1,272,766	137,247	500,000	64,295	1.7x	0.4x
India	90,685	1,499	62,698	929	100,000	1,618	1.1x	1.6x
Indonesia	36,355,429	3,475	14,153,712	1,271	2,000,000,000	165,467	55.0x	141.3x
Korea	2,844,094	25,977	20,447,115	16,584	50,000,000	47,365	17.6x	2.4x
Malaysia	33,128	10,514	51,568	14,410	250,000	76,947	7.5x	4.8x
Philippines	117,346	2,765	70,645	1,149	500,000	11,337	4.3x	7.1x
Singapore	69,050	55,182	187,280	127,783	50,000	39,526	0.7x	0.3x
Taiwan	623,713	20,952	1,179,575	35,275	3,000,000	100,932	4.8x	2.5x
Thailand	177,565	5,779	173,027	4,721	1,000,000	30,475	5.6x	5.8x
Brazil	24,180	11,208	7,863	3,340	70,000	29,737	2.9x	8.9x
Japan	3,756,661	38,501	5,942,741	56,436	10,000,000	94,967	2.7x	1.7x
Australia	65,763	67,468	63,554	55,409	250,000	217,960	3.8x	3.9x
UK	25,171	39,352	40,787	67,979	85,000	141,667	3.4x	2.1x
US	53,143	53,143	32,585	32,585	250,000	250,000	4.7x	7.7x
Average		25,383		37,639		90,878	4.7x	3.8x
China coverage limit using avg coverage to GDP per capita	41,907	6,807	80,180	9,463	195,953	31,829	4.7x	
China coverage limit reported by media	41,907	6,807	80,180	9,463	303,596	35,830		3.8x
China coverage limit using avg coverage to deposit	41,907	6,807	80,180	9,463	500,000	80,645	11.9x	6.2x

Source: IADI, individual country monetary authorities, CEIC, UBS estimates

Figure 50: Deposit insurance annual premium and impact on 2015E net profit

	Premium (% of total deposits)			Premium (% of revenue)			Premium (% of net profit)		
FY2015	Low	Base case	High	Low	Base case	High	Low	Base case	High
Flat rate - 5 years									
SOCBs	0.04%	0.07%	0.11%	0.9%	1.8%	2.7%	1.9%	3.9%	5.8%
JSCBs	0.04%	0.07%	0.11%	0.8%	1.6%	2.4%	1.7%	3.4%	5.1%
CCBs	0.04%	0.07%	0.11%	0.9%	1.8%	2.7%	1.7%	3.4%	5.1%
Flat rate - 10 years									
SOCBs	0.02%	0.04%	0.06%	0.5%	1.0%	1.5%	1.1%	2.2%	3.3%
JSCBs	0.02%	0.04%	0.06%	0.4%	0.9%	1.3%	1.0%	1.9%	2.9%
CCBs	0.02%	0.04%	0.06%	0.5%	1.0%	1.5%	1.0%	1.9%	2.9%
Risk based - 5 years									
SOCBs	0.03%	0.07%	0.10%	0.8%	1.7%	2.5%	1.8%	3.6%	5.3%
JSCBs	0.04%	0.07%	0.11%	0.8%	1.6%	2.4%	1.7%	3.4%	5.1%
CCBs	0.05%	0.10%	0.14%	1.3%	2.5%	3.5%	2.4%	4.9%	6.8%
Risk based - 10 years									
SOCBs	0.02%	0.04%	0.05%	0.4%	0.9%	1.4%	0.8%	2.0%	3.0%
JSCBs	0.02%	0.04%	0.06%	0.4%	0.9%	1.3%	1.0%	1.9%	2.9%
CCBs	0.03%	0.06%	0.09%	0.9%	1.5%	2.3%	1.7%	3.0%	4.5%

Source: UBS estimates

Reform 5: Asset securitisations - short-term relief of liquidity and capital pressures

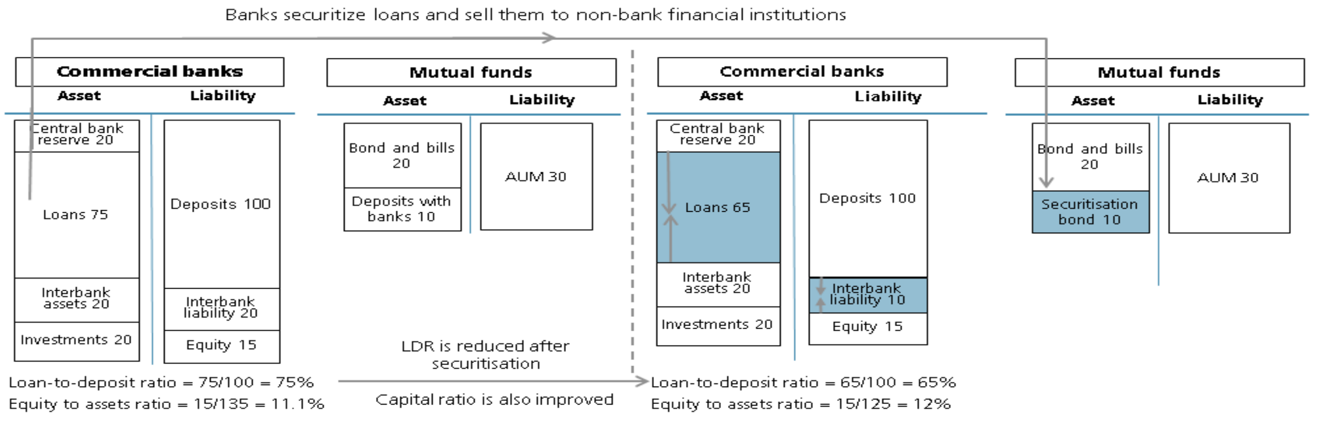
Tightening rules on shadow banking to give rise in securitisation: According to WIND, total new issuance of collateralised loan obligations (CLO) and residential mortgage-backed securities (RMBS) YTD 2014 has been Rmb73.5bn, higher than the sum in 2012-13. The balance of asset securitisation products was Rmb124.5bn as of August 2014. This is partially caused by current policy changes. In China, asset securitisation products can be classified into the following three categories:

- **Credit-linked asset securitisation products** regulated by the CBRC regarding qualifications and by PBOC regarding issuance, including RMBS and CLOs;
- **Brokers' asset-backed securitisation products** based on asset management special-purpose vehicles (SPV) and regulated by the CSRC;
- **Asset-backed notes** regulated by the National Association of Financial Market Institutional Investors.

According to the *Securities Times* (a local newspaper), the regulator will approve a total of Rmb425bn of issuance of securitisation products in the next six months. The underlying assets will mainly be loans to small-and-micro enterprises, infrastructure and railways. This is a big jump in the quota compared with 2013's Rmb50bn. **Asset securitisations to ease liquidity and capital pressures in the short-term by:**

- **Easing liquidity and capital pressures** through risks diversifications both internally and externally, through:
    - **The rebalance of liquidity and capital within the banking system.** Transaction of asset securitisation products can reallocate capital and credits between banks with different capital adequacy and LDR ratios.
    - **The diversification of risks among banks and non-bank entities** by selling these products out of the banking sector**.** It will relieve more capital of banks to prepare for the transferring of non-standard assets back to balance sheets.

Figure 51: LDR is reduced and capital ratio is improved after securitisation



Source: UBS

- **We believe asset securitisation will promote credit restructuring to enhance return of risky assets.** Under the pressures of disintermediation and interest-rate liberalisation in the financial industry, Chinese commercial banks need to accelerate to adjust their credit structure. Asset securitisation business can speed up the process in addition to regular transformation via incremental credits.

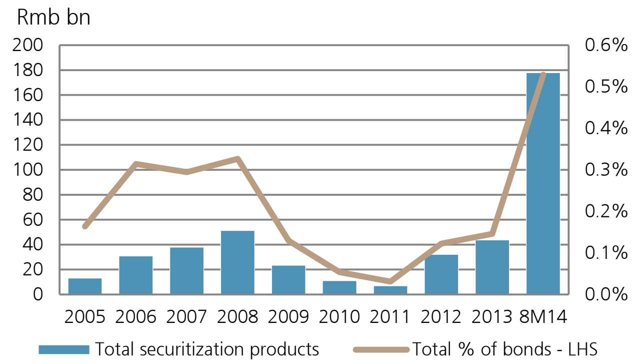
- **Also, the asset securitisation business can generate fees and commission income to improve profitability.** Assuming a commission rate of 50bps for every Rmb of securitised assets and a total securitisation products' quota ranging from Rmb0.4trn to Rmb5trn, the system's fees and commission incomes will be increased by 0.2-0.8%, and improve net profits by 0.1-1.2%. The impact on banks' profit is very limited.

Figure 52: Sensitivity analysis on securitisation's impact on profit and capital

Securitisation quota (Rmb bn)	425	1,000	2,000	3,000	4,000	5,000
Impact on fee income	2	5	10	15	20	25
Impact on revenue	2	5	10	15	20	25
Impact on net profit	2	4	8	11	15	19
Reduction on RWA	159	375	750	1,125	1,500	1,875
Securitisation quota (Rmb bn)	425	1,000	2,000	3,000	4,000	5,000
% impact on fee income	0.23%	0.55%	1.10%	1.65%	2.21%	2.76%
% impact on revenue	0.05%	0.12%	0.24%	0.36%	0.48%	0.60%
% impact on net profit	0.10%	0.24%	0.48%	0.72%	0.96%	1.20%
% reduction on RWA	0.2%	0.4%	0.8%	1.1%	1.5%	1.9%
Ppt improvement on core tier - CAR	0.02%	0.04%	0.07%	0.11%	0.15%	0.18%
% of existing loan balance	0%	1%	2%	4%	5%	6%
% of 2014 new TSF (Rmb17trn)	3%	6%	12%	18%	24%	29%

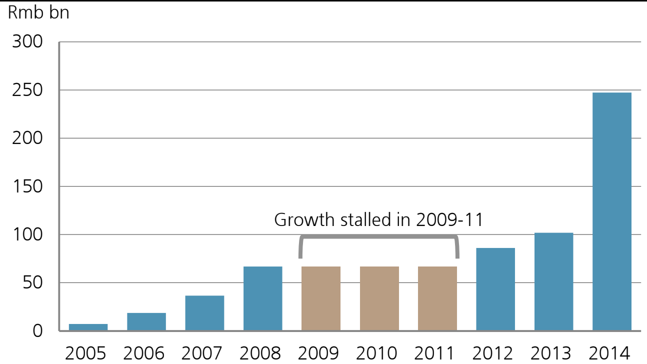
Note: Assuming banks earn 50bp commission income on securitised loans.
Source: UBS estimates

Figure 53: China securitisation products outstanding as % of bond market



Source: WIND

Figure 54: Accumulated issuance of CDOs and RMBS - substantial growth in 2014



Note: 2014 data are as of 3 September 2014.
Source: CEIC, UBS estimates;

Reform 6: Preferred shares – supplementary tools to replenish capital adequacy

The regulators are also pushing for the issuance of preferred shares by the Chinese corporates. We expect more banks to issue preferred shares on a trial basis as early as in the first half of 2014, as they need to meet tougher rules on capital adequacy under Basel III.

- Preferred shares are not common equity. Preferred shares are senior to common equities but subordinate to normal bonds in the event of bankruptcy. Preferred shares can be included in a bank's tier-1 capital but they are not common equity.
- In theory, the 1% difference between the minimum core tier-1 ratio and the tier-1 ratio can be filled in by hybrid instruments such as preferred shares. (For systemically important banks (the big-five banks), CBRC requires a minimum core tier-1 ratio/tier-1 ratio of 8.5%/9.5% by end of 2018. For other smaller banks, a minimum core tier-1 ratio/tier-1 ratio of 7.5%/8.5% by end of 2018 is required.)
- We need to remind equity investors that only common equity or core tier 1 capital represent a bank's ability to absorb losses. Preferred shares take losses only after common equities and only help the banks to leverage up further.

Preference shares dilution on EPS vs common equity issuance

We compare the EPS under two scenarios: 1) preferred share issuance equivalent to 50bp of RWA (i.e., improve tier-1 CAR by 50bps); 2) common equity issuance equivalent to 50bps of RWA (i.e., improve core tier-1 CAR and tier-1 by 50bps at the same time).

Conclusion – preference shares are less dilutive than common equity

We find that within the ROE range of 15-20%, in which most commercial banks' current ROEs lie, the dilutions of EPS from issuing preferred stocks are generally smaller than those from issuing common stocks. This suggests that most commercial banks would have a motivation to issue preferred stocks currently if their tier-1 CARs are below the minimum requirement. However, the marginal benefit could fall in the future as China banks' ROEs begin to decline in the coming years as we expect.

Figure 55: EPS % dilution assuming issuance of preferred shares/common equity equivalent to 50bps of RWAs

		ROE										
		25%	23%	21%	19%	17%	15%	13%	11%	9%	7%	5%
Preferred shares coupon rate	5%	-1.3%	-1.5%	-1.6%	-1.8%	-2.0%	-2.2%	-2.6%	-3.0%	-3.7%	-4.8%	-6.7%
	6%	-1.6%	-1.7%	-1.9%	-2.1%	-2.4%	-2.7%	-3.1%	-3.6%	-4.5%	-5.7%	-8.0%
	7%	-1.9%	-2.0%	-2.2%	-2.5%	-2.8%	-3.1%	-3.6%	-4.3%	-5.2%	-6.7%	-9.4%
	8%	-2.1%	-2.3%	-2.5%	-2.8%	-3.1%	-3.6%	-4.1%	-4.9%	-5.9%	-7.6%	-10.7%
	9%	-2.4%	-2.6%	-2.9%	-3.2%	-3.5%	-4.0%	-4.6%	-5.5%	-6.7%	-8.6%	-12.0%
	10%	-2.7%	-2.9%	-3.2%	-3.5%	-3.9%	-4.5%	-5.1%	-6.1%	-7.4%	-9.5%	-13.4%
	11%	-2.9%	-3.2%	-3.5%	-3.9%	-4.3%	-4.9%	-5.7%	-6.7%	-8.2%	-10.5%	-14.7%
	12%	-3.2%	-3.5%	-3.8%	-4.2%	-4.7%	-5.3%	-6.2%	-7.3%	-8.9%	-11.5%	-16.0%
	13%	-3.5%	-3.8%	-4.1%	-4.6%	-5.1%	-5.8%	-6.7%	-7.9%	-9.6%	-12.4%	-17.4%
	14%	-3.7%	-4.1%	-4.5%	-4.9%	-5.5%	-6.2%	-7.2%	-8.5%	-10.4%	-13.4%	-18.7%
	15%	-4.0%	-4.4%	-4.8%	-5.3%	-5.9%	-6.7%	-7.7%	-9.1%	-11.1%	-14.3%	-20.0%
EPS dilution: Common equity issuance		-6.3%	-6.3%	-6.3%	-6.3%	-6.3%	-6.3%	-6.3%	-6.3%	-6.3%	-6.3%	-6.3%

Note: we assume common equity issuance at an issuing price equivalent to 1x historical book; new issuance of preferred share / common equity equivalent to 50bps of RWA.
Source: UBS estimates

Reform 7: Enhancing regulations on shadow banking – paving the way for further reforms

We believe the development of shadow banking fulfil the financing needs of entities like SMEs uncovered by credit supply of regular banking system in recent years. However, we think current issues with Chinese banks' shadow-banking business via off-balance-sheet non-standard credit assets expansion (i.e., wealth-management products, interbank, and other products) have made banks largely exposed to high-leverage, high-concentration risk, large maturity mismatches and inadequate disclosure.

Recent regulation enhancement has been sharpened on interbank business where credits have been mis-classified as interbank assets or investment receivables. Policymakers have formed a clear blueprint to regulate interbank business by a series of measures recently. In the future, **we expect policy focus to encourage off balance-sheet non-standard credit assets (NSCA) to be brought back to on B/S, and part of them could be transformed to securitization products.** In our report '*Momentum could wane before the end of summer*' released on 8 July 2014, we estimated on- and off- balance-sheet non-standard assets to be Rmb7.8 and Rmb4.9 trn (excluding Rmb1trn overlaps in wealth-management products), respectively, as of 2013. The re-intermediation process could require additional Rmb10trn of RWAs from banking systems, or drag system core tier-1 CAR down by 85bps.

Mid-term re-intermediation pressures are necessary for long-term systemic health: In our view, smaller banks could face more pressure due to relatively larger exposures to NSCAs in the short run. In the medium term, the re-intermediation process could cause pressures in liquidity, asset qualities, provisioning and capital charging. However, it is still necessary to improve long-term systemic health and reduce the reliance of the economy on bank finance. Encouraging policies in asset securitisations, development and financial bonds, and so on, could also mitigate some pressures. In general, following a recent short-term rally, the marginal effect of stock movements on incremental policy easing is fading. We suggest investors refocus on weakening fundamentals and remain cautious on the sector.

Sporadic trust unit defaults could continue to happen:

While we do not rule out the possibility of further sporadic trust unit defaults happening in China over the next couple of years as the overall economy and property market slows, we see that regulators will continue to 'close up' the regulatory arbitrage that currently exists for banks to 'dump' loans off balance sheet via 'bank-trust' coop businesses. We see three major developments in the regulatory space that would potentially help make the industry a more sound alternative financing and investment platform:

- **Reducing over-leverage, removing regulator arbitrage:** We continue to think that the CBRC together with the CIRC and the CSRC will continue to strengthen the capital and regulatory requirements associated with 'bank-like' lending businesses that is currently done via the 'bank-trust coop' channels and will eventually force banks to take it back onto their balance sheets. This would reduce the potential over-leverage issue in the trust sector (at the expense of making bank capital ratios even more stretched) and remove the capital arbitrage that attracted these funds into the trust industry over the last couple of years.

- **Strengthen regulatory oversight on distribution and funding:** We expect regulators to focus on reducing mis-selling risks that currently exist where some trust products are sold via banks without the necessary investment risk disclosures (and, worse, where some of the projects backing these products actually originated at the banks themselves). This should re-establish the trust of the industry's role as key investment product manufacturer as opposed to being an alternative regulatory arbitrage platform for the banking sector.

Figure 56: Impact on net profit and capital for individual listed banks

Rmb bn	CCB	BOC	ABC	BOCOM	CMB	CITIC	Minsheng	CQRCB	Huishang	BoCQ	Industrial Bank	Huaxia	Ping An	BoBJ	BoNJ	BoNB
Credit-assets hidden in interbank assets and investment receivables (Rmb bn)	12	11	168	139	390	315	399	82	1	44	1,035	645	239	393	110	100
Additional credit cost of 50bp, Rmb bn	0.06	0.06	0.84	0.70	1.95	1.58	1.99	0.41	0.01	0.22	5.17	3.22	1.19	1.97	0.55	0.50
% impact on 2014E NP	0%	0%	0%	-1%	-3%	-3%	-3%	-5%	0%	-7%	-8%	-5%	-5%	-8%	-3%	-7%
PPT impact on 2014 NP growth rate	0%	0%	0%	-1%	-3%	-3%	-4%	-5%	0%	-7%	-9%	-6%	-6%	-10%	-3%	-8%
Current 2014E NP growth	5%	4%	5%	3%	10%	6%	5%	6%	5%	9%	17%	14%	13%	19%	13%	13%
Adjusted 2014E NP growth factoring extra provisioning	5%	4%	5%	2%	7%	2%	1%	0%	5%	2%	8%	8%	7%	9%	10%	5%
Additional RWA (assuming 100% risk weighting) Rmb bn	9	8	126	34	133	28	277	42	0	7	549	109	173	157	44	27
Additional RWA % of YE14E RWA	0%	0%	1%	1%	4%	1%	10%	11%	0%	5%	25%	4%	15%	12%	5%	9%
Combined impact on YE14 CT1 CAR (bp)	(1)	(1)	(11)	(8)	(42)	(12)	(90)	(117)	(2)	(66)	(212)	(49)	(118)	(101)	(56)	(92)
of which: from higher provisioning	(0)	(0)	(1)	(1)	(6)	(5)	(8)	(11)	(0)	(16)	(23)	(13)	(10)	(15)	(6)	(16)
of which: from higher risk weighting	(1)	(1)	(11)	(6)	(36)	(6)	(83)	(106)	(2)	(49)	(189)	(36)	(107)	(86)	(49)	(76)
Adjusted YE14 CT1 CAR	11.4%	10.9%	9.0%	9.5%	8.9%	8.3%	8.1%	9.7%	12.5%	10.6%	7.9%	9.1%	7.3%	7.6%	10.0%	9.0%

Source: UBS estimates

Figure 57: Contents of recent bank sector reforms

Subject of reforms	Detailed measures	Short-term impacts on banking sector	Mid- to long-term impacts on banking sector
Fiscal regimes			
Local government	▪ Compile local government balance sheet and consolidating various budgets; ▪ Link local official performance with debt accumulation could help to curtail debt increase; ▪ Move some administrative authority to the central government should help to reduce local spending needs; ▪ Reduce local governments' involvement in production, including by divesting some state-share to private sector (mixed ownership); ▪ Increase local revenue through higher dividend and marginal increase in tax revenue; ▪ Plan to amend budget low to allow local government to issue bonds for infrastructure construction.	▪ Neutral, as it deters banks' LGFV NPL formation but progress will be low.	▪ Benefits are limited as losses in banks' non-performing assets are large, unless amount of issuance is significant.
Tax Reforms	▪ Put amendments to several tax laws on 2014's legislative agenda, including an amendment of China's budget law, real property tax law and environmental protection tax law; ▪ Expand business-for-VAT tax pilot to railway transportation and post services.		
Enterprise reform			
Central SOEs	▪ Allow private capital injections into SOE projects; ▪ Require higher dividend payment to public finance; ▪ Government control SOE mainly through 'manage capital' as investors, not run the companies themselves; ▪ Promote energy and resource price reform to increase competition.	▪ Neutral, given: ▪ Possibly slower-than-expected reform and implementation efficiency; ▪ Competitions caused growth slowed down.	▪ Positive, as it: ▪ Deleverages the real economy from the bottom up; ▪ Capex will be slowed down in over-capacity sectors; ▪ Debt-servicing abilities of the enterprises will be improved.
Local SOEs	▪ Allow asset injections, dynamic methods of capital raising; ▪ Private capitals are encouraged in local SOE reforms; ▪ Allow consolidations through M&A; ▪ Set up allowance of Employee Stock Ownership Plan (ESOP); ▪ Link management incentive package with performance; ▪ Possible breakup of monopolies in telecom, energy and bank sectors.	▪ Positive, as early breakthroughs more likely to happen in local SOEs where resistance to reform is relatively lower.	
SMEs	▪ Improve financing environment of SMEs; ▪ Complete venture investment mechanism; ▪ Support technology transformation.	▪ Positive, as it: promotes systematic capital allocation efficiencies by attracting investment to SMEs from SOEs; deters capex expansion to improve enterprises' debt-servicing abilities.	

Figure 57: Contents of recent bank sector reforms (Cont'd)

Subject of reforms	Detailed measures	Short-term impacts on banking sector	Mid- to long-term impacts on banking sector
Capital Market			
Launch of preferred stocks	▪ Announced (on 30 November 2013) pilot programme for preferred shares; ▪ Commercial banks are flexible in comparison to overall programme.	▪ Positive, as it will reduce common equity-raising pressures for banks.	▪ Benefits are limited as it is not common equity and could negatively affect EPS.
Stock issue and bond market	▪ Promote the register stock issue mechanism; ▪ Develop bond market.	▪ Negative, as it may cause fund outflow to other capital markets from depository institutions.	▪ Positive, as it promotes overall capital market allocation efficiencies and provides more funding sources.
Lower entry barriers	▪ Allow establishments of private banks; ▪ Lower barriers of foreign investments in financial industry.	▪ Negative, as it will lower the entry of barrier and intensify competition.	▪ Positive, as it: Leverages up the overall market efficiencies; Improves the average strength of the remaining competitors.
Deposit insurance & exit mechanism	▪ Launch deposit insurance; ▪ Introduce mechanism of bank bankruptcy	▪ Possible negative, as individual events can cause short-term market volatilities.	
Interest rate liberalisation	▪ Accelerate interest-rate liberalisation	▪ Negative, as it increases systematic uncertainties and risks.	▪ Can be negative if not properly proceeded with in the right sequence, as it may increase the vulnerability of the financial system.
Negotiable CD	▪ Allowed to issue large-denomination negotiable certificates of deposit (NCD) in interbank market (effective from 9 December 2013).	▪ Positive, as: ▪ Non-household NCDs improves the SHIBOR's position as pricing benchmarks; ▪ Non-household NCDs' impacts on liquidities and NIMs are limited.	▪ Possible negative from household NCDs in the medium term as it will affect NIMs/liquidities, leveraging competition; ▪ Positive in the medium term on general economics; ▪ Positive in the long term as it will improve capital allocation efficiencies.
Currency rate Interest rete Capital account	▪ Complete pricing mechanisms of RMBS in currency markets. ▪ Enhance pricing power of Treasury yield curve. ▪ Bilaterally open up capital markets and capital accounts; ▪ Gradually enhance exchangeabilities in cross border financial transactions; ▪ Establish prudential supervision frameworks of foreign debts and capital flows.	▪ Negative if carried out quicker than necessary or in wrong orders as: ▪ It could lead to more foreign borrowing by the corporates; ▪ Increases outward investment by the corporate and household sector.	▪ Positive, as it: ▪ Promotes general economic efficiencies; ▪ Allows participation of China in global economy and competitive strength.

Source: UBS

Figure 58: Summary of key rules by recent regulations on shadow banking and interbank businesses

Document name	Disclosed Date	Authorities	Key rules
Guidelines of administration and supervision of commercial banks on consolidation of financial statements	27 August 2014	CBRC	(1) Define conduit business as 'Commercial banks, or other subsidiaries of banking groups, act as entrusters, use proprietary funds, through internal or external third-party conduits like securities, trust, insurance companies as entrustees, and set up single/multiple layers of investment products like asset-management schemes and trust products, in order to arrange transactions for investment and financing activities of abovementioned entrusters' target clients. Entrusters assume credit, liquidity and market risks generated in such transactions.' (2) Require commercial banks to allocate capital and provisions for business with complicate structures, like conduit businesses. (3) Commercial banks should charge risk weightings, capital consumptions, loss provisions and liquidity requirements for those conduit businesses where banks take credit risk. (4) Commercial banks should include such business into consolidating supervision and pay attention to arbitrage activities and conducts to hide and transfer related risks by its subsidiaries.
Circular No. 178	9 July 2014	CBRC	(1) Categorise interbank accounts into settlement and investment/financing accounts; (2) Centralise approval authorizations of accounts to national headquarters and provincial-level branches; (3) Establish specialised supervising mechanisms, simultaneously monitoring ending balances of interbank accounts.
Circular No. 127	16 May 2014	PBOC, CBRC, CSRC, CIRC and SAFE	(1) Accounting methods (Article 5/6): (2) Interbank financing (credit-linked) activities shall neither be booked under 'the third-party agent payment' nor 'repo assets' categories. Consequently, interbank financing activities shall be booked under the 'interbank investment' category, with capital and provisioning charges. (3) Interbank activities involving three or more counterparties shall not be booked under 'repo assets'. (4) Parties selling repurchase agreements should not transfer related financial assets out of balance sheets in repurchase business. (5) Provisions: Financial institutions should conduct strict compliance reviews on risks profile and uses of funds. Relating risks should be precisely measured and provisions should be recognised based on the nature of the underlying assets. (Article 12). (6) Asset/liabilities durations: Banks should prudently determine durations of interbank financing. The max durations for interbank borrowing and other interbank financing (credit-linked) activities are three years and one year, respectively. No extension is allowed upon expiry (Article 13). (7) Scale limit (Article 14): (8) A commercial bank's interbank assets due from a single corporate financial institution (excluding deposits due from banks and other financial institutions for settlements purpose), after deductions of assets with zero risk weighting, should not exceed 50% of the bank's tier-one capital. (9) The total interbank liabilities shall not exceed one-third of the banks' total liabilities. (10) This specification is temporarily not applied to provincial branches of rural cooperatives, provincial secondary corporate cooperatives and village/ township banks. (11) Other business: Financial institutions should also promote asset securitization business, actively participate in trial experiments of interbank certificates of deposit, and promote active, standardized and transparent asset/liability management (Article 15).
Circular No. 140	16 May 2014	CBRC	(1) Independency: commercial banks should include interbank financing business into overall risk management frameworks, set up an independent division for interbank business, and enhance corporate headquarter management over the division. Other divisions should not conduct such business (Article 3-4). (2) Managerial structure: For interbank business, the credit-line at branch level can be only authorized by the headquarters of the bank. The headquarters need to manage the bank-wise counterparty list and monitor overall counterparty risks. The division should not transfer authorization. (Article 5-7). (3) Deadline: Reforms should be accomplished by September, 2014 (Article 8). (4) Discipline: Commercial banks will be investigated and dealt with regarding any violations to this Circular as breach of prudential management principles (Article 9).

Figure 58: Summary of key rules by recent regulations on shadow banking and interbank businesses (Cont'd)

Document name	Disclosed Date	Authorities	Key rules
Consultative Circular No. 9 *	November 2013	CBRC	(1) Commercial banks should include interbank financing business into overall risk management frameworks and bank-wide credit extending system. (2) Parties on repurchase agreements should not transfer relating financial assets out of balance sheets in repurchase business. (3) A single commercial bank's balance of financing from or lending to a single corporate financial institution should not exceed 100% of the bank's net capitals. (4) A single commercial bank's balance of lending to all non-bank financial institutions should not exceed 25% of the bank's net capitals. (5) A single commercial bank's balance of lending to all corporate financial institutions should not exceed 50% of the bank's total deposits. (6) A commercial bank should neither accept nor offer any direct or indirect, visible or invisible third-party financial institution credit guarantees.
Circular No. 107	January 2014	State Council	▪ Define three categories of 'shadow banking': (1) Credit intermediaries without financial licences or any supervision; (2) Credit intermediaries without financial licences with inadequate supervision; (3) Businesses with financial licences with inadequate supervision or avoiding supervision. ▪ Clarify regulatory bodies: responsibilities for solution falls on the same regulatory body that approves the establishment of institutions. (1) Banks' WMP business will be supervised by the CBRC; brokers and futures companies' asset-management business will be supervised by the CSRC; insurers' asset-management business will be supervised by the CIRC; third-party payment business will be supervised by the CBRC; (2) Local governments will be responsible for the enforcement of national regulations set up by the State Council; (3) The supervision of businesses like asset securitisations, internet finance of third-party wealth management firms and non-financial institutions will be studied by PBOC and other regulatory bodies. ▪ Wealth-management business of financial institutions. (1) Set up independent organisation of wealth-management business in separate management system; (2) Set up separate account management and supervision frameworks; (3) Enhance business procedure supervision.
Circular No. 39	February 2014	CBRC	(1) Prohibit sales of unregistered WMPs: Registered No. in 'National Banking Industry Wealth Management Information System' should be disclosed in marketing materials. Unregistered products should not be sold. Guide banks to set up separate WMP counters with obvious signs in branches. Prevent internal staff marketing WMP privately. (2) On-site scrutiny: Regulatory bodies of all levels should pay special attentions on WMP business. On-site scrutiny should be performed to at least one corporate institution of WMP business. (3) Use of funds: Funds of WMPs should not be mingled with proprietary funds, be used to purchase banks' own loans or be used in capital pool business. (4) Risk management: Banks should strictly control maturity mismatches between products and assets and set minimum levels of liquidity assets.
Circular No. 99	April 2014	CBRC	(1) Enhance risk management: Set up liquidity support and capital-replenishment mechanisms. Shareholders of the trust company should commit or specify in the company charter to provide liquidity support when the trust company encounters liquidity risks. Losses from operations eroding capital should be fully deducted from net capital. Correspondingly, business sizes should be contracted, or capital should be replenished. (2) Clear up trusts of non-standard capital pool: trust companies should not engage in businesses with shadow-banking features like trusts of non-standard capital pools. (3) Specify the responsibilities of involving parties of management business: for cross-sector products and cooperation business between financial institutions, parties assuming risks should be specified by contracts. Parties providing conduit services manage project risks. Regulatory bodies supervising parties assuming risks also supervise such business.

Figure 58: Summary of key rules by recent regulations on shadow banking and interbank businesses (Cont'd)

Document name	Disclosed Date	Authorities	Key rules
Circular No. 11	April 2014	CBRC	(1) Applicable institutions: Medium-to-small rural financial institutions include: rural commercial banks, rural credit cooperatives, rural cooperative banks, village and township banks, micro-lending companies, rural mutual cooperatives. (2) Business qualifications: To invest proprietary and interbank assets on non-standard assets, banks should satisfy regulatory ratings for at least two quarters with total assets over Rmb 20bn; scale of the business should not exceed 30% of interbank liabilities. (3) Risk prevention: parties assuming risks of non-standard asset backed by WMPs' funds should be specified by contracts to prevent 'rigid payment'. Total balances of non-standard assets (WMPs' funds + proprietary and interbank investments) should not be higher than 4% of reported assets at YE2013. Relating risks should be measured and provisions should be recognised on an essential basis rather than on mere appearance. (4) Use of funds: Non-standard assets should not be invested in projects of local government financial vehicles, real estate, industries with high pollution, high energy consumption and overcapacity, projects with equity buy-back clauses, bonds with ratings below AA- and high-risk exchange-traded bonds through private placements. Prohibit transferring wealth management non-standard assets to standard investments through financial asset exchanges and corporate equity investments. (5) Deadline: Reforms should be finished by the end of 2014.
Detailed rules of Circular No. 99	May 2014	Cooperation Division of CBRC	(1) Prohibit trust company from entrusting non-financial institutions to promote trust schemes, cut risks transfers from third parties to trust companies, and prevent legal risks. (2) Simplify review procedures: news business should be reported to regulatory bodies 10 days before promotions. No permissions in advance from regulators needed except for those involving related-parties' transactions. (3) Clear up non-standard capital pool business: Promote clear ups with no delays; no new such business allowed. Trust companies should set up plans based on individual circumstance. No conforming schedules or deadlines. Trust companies should progress gradually to avoid generating new risks.
Circular No. 140	May 2014	CBRC	(1) Commercial banks should include interbank financing business into overall risk-management frameworks, set up independent division for interbank business, and enhance corporate headquarter management over the division. Other divisions should not conduct such business. (2) Only corporate headquarter can authorise, extend credit lines and manage counterparty lists of interbank business division in a centralised manner. The division should not transfer authorization. (3) Discipline: Commercial banks will be investigated and prosecuted regarding any violations to this Circular No.140 as breach of prudential management principles. Deadline: Reforms should be accomplished by September 2014.

Note: The consultative version of Circular No.9 was widely reported by media but was not officially disclosed by the authorities. * See http://money.163.com/14/0516/18/9SCS917F0025335L.html.
Source: CBRC, PBOC, State Council

Statement of Risk

We think the major risks for Chinese banks are: 1) a deterioration in asset quality underpinned by a slower macro environment and domestic property market activity; 2) regulatory risks related to capital and liquidity regulation as well as the off-balance sheet activities of banks; 3) deterioration in the funding structure and weakening balance sheet liquidity positions, driven by a potential roll-over of loans and a lengthening of asset durations; and 4) the liberalisation of interest rates in the medium term and pressure on bank profitability.

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12-Month Rating	Definition	Coverage[1]	IB Services[2]
Buy	FSR is > 6% above the MRA.	48%	33%
Neutral	FSR is between -6% and 6% of the MRA.	41%	30%
Sell	FSR is > 6% below the MRA.	11%	23%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 30 June 2014.
1:Percentage of companies under coverage globally within the 12-month rating category. 2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category. 4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

KEY DEFINITIONS: Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months. **Market Return Assumption (MRA)** is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium). **Under Review (UR)** Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation. **Short-Term Ratings** reflect the expected near-term (up to three months) performance of the stock and do not reflect any change in the fundamental view or investment case. **Equity Price Targets** have an investment horizon of 12 months.

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UBS AG Hong Kong Branch: Tao Wang; Stephen Andrews, CFA; Bob Leung; Donna Kwok; Irene Huang; Michelle Li.

Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Agricultural Bank of China[16a]	1288.HK	Neutral	N/A	HK$3.58	18 Sep 2014
AIA Group[16a]	1299.HK	Neutral	N/A	HK$41.75	18 Sep 2014
Bank of Beijing	601169.SS	Buy	N/A	Rmb7.90	18 Sep 2014
Bank of China[2, 4, 5, 16a]	3988.HK	Neutral	N/A	HK$3.64	18 Sep 2014
Bank of Chongqing	1963.HK	Sell	N/A	HK$5.27	18 Sep 2014
Bank of Communications[2, 4, 16a]	3328.HK	Neutral	N/A	HK$5.73	18 Sep 2014
Bank of Communications - A[2, 4, 16a]	601328.SS	Neutral	N/A	Rmb4.39	18 Sep 2014
Bank of Nanjing	601009.SS	Neutral	N/A	Rmb8.54	18 Sep 2014
Bank of Ningbo	002142.SZ	Buy	N/A	Rmb9.92	18 Sep 2014
Changjiang Securities	000783.SZ	Sell	N/A	Rmb6.07	18 Sep 2014
China Cinda Asset Management[2, 4, 5, 6, 7, 13, 16a]	1359.HK	Buy	N/A	HK$3.64	18 Sep 2014
China CITIC Bank[2, 4, 5, 16a]	0998.HK	Sell	N/A	HK$4.88	18 Sep 2014
China Construction Bank[2, 4, 5, 16a]	0939.HK	Buy	N/A	HK$5.73	18 Sep 2014
China Everbright	0165.HK	Buy	N/A	HK$15.80	18 Sep 2014
China Galaxy Securities Co.[4, 5]	6881.HK	Buy	N/A	HK$5.82	18 Sep 2014
China Life Insurance[4, 5, 16a, 16b]	2628.HK	Buy	N/A	HK$22.65	18 Sep 2014
China Life Insurance - A[4, 5, 16a, 16b]	601628.SS	Buy	N/A	Rmb15.42	18 Sep 2014
China Merchants Bank[2, 4, 5, 16a]	3968.HK	Neutral	N/A	HK$14.22	18 Sep 2014
China Minsheng Banking[2, 4, 5, 13, 16a]	1988.HK	Sell	N/A	HK$7.29	18 Sep 2014
China Minsheng Banking - A[2, 4, 5, 13, 16a]	600016.SS	Neutral	N/A	Rmb6.29	18 Sep 2014
China Pacific Insurance - A	601601.SS	Buy	N/A	Rmb19.37	18 Sep 2014
China Pacific Insurance - H	2601.HK	Buy	N/A	HK$28.15	18 Sep 2014
Chongqing Rural Commercial Bank	3618.HK	Sell	N/A	HK$3.65	18 Sep 2014
CITIC Securities - A[16a]	600030.SS	Buy	N/A	Rmb13.00	18 Sep 2014
CITIC Securities - H[16a]	6030.HK	Neutral	N/A	HK$18.24	18 Sep 2014
Haitong Securities - A[2, 4, 5, 16a]	600837.SS	Buy	N/A	Rmb10.09	18 Sep 2014
Haitong Securities - H[2, 4, 5, 16a]	6837.HK	Buy	N/A	HK$12.48	18 Sep 2014
Huishang Bank[2, 4, 6, 7]	3698.HK	Sell	N/A	HK$3.37	18 Sep 2014
Industrial Bank	601166.SS	Neutral	N/A	Rmb10.29	18 Sep 2014
Industrial Securities	601377.SS	Buy	N/A	Rmb11.82	18 Sep 2014
PICC Group[4]	1339.HK	Buy	N/A	HK$3.34	18 Sep 2014
PICC Property and Casualty	2328.HK	Neutral	N/A	HK$14.04	18 Sep 2014
Ping An Insurance (Group)[13, 16a, 22]	2318.HK	Buy	N/A	HK$62.05	18 Sep 2014
Ping An Insurance (Group) - A[13, 16a, 22]	601318.SS	Buy	N/A	Rmb42.02	18 Sep 2014
Soochow Securities	601555.SS	Buy	N/A	Rmb8.89	18 Sep 2014
Southwest Securities	600369.SS	Buy	N/A	Rmb9.84	18 Sep 2014

Source: UBS. All prices as of local market close.
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