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China**Financial services**

Freddie and Fannie exposed

The US Treasury and the Federal Reserve have announced emergency plans to support the troubled Freddie Mac and Fannie Mae to boost confidence in US's mortgage finance giants. Emergency cash and extension of credit lines will be offered to both entities, and that the US Treasury may step in and take equity stakes in the entities if necessary. We believe these moves underpin the US government's strong support for the two mortgage financiers, and thus believe risks of credit losses on Freddie Mac and Fannie Mae bonds should be well contained. Owing to limited disclosure, we are only able to estimate the exposure based on the maturity profile and currency exposure of investments at individual banks. Our estimates suggest the exposure in bonds issued by Freddie Mac and Fannie Mae at most banks is between 0-1% of total assets, except for BOC where it is estimated to make up around 2.6% of total assets respectively.

US government to the rescue

- In response to mounting fears over the troubled Freddie Mac and Fannie Mae, the US Federal Reserve have extended access of emergency funds to both Freddie Mac and Fannie Mae. The US Treasury also said it would temporarily lift its line of credit to the two mortgage financiers, and purchase equity stakes in them if necessary.
- While the market remains sceptical of the risks involved over bonds issued by Freddie Mac and Fannie Mae, we believe the credit risk is near sovereign as both entities are now effectively backed by the US government.
- Hence we believe the credit risks associated with these agency bonds should be well contained given the strong government backing.

Estimation Methodology

- For HK and China banks, we understand the bonds issued by Freddie Mac and Fannie Mae (Agency Bonds) are classified as public sector debt securities and are mostly available-for-sale (AFS) or held-to-maturity (HTM) securities.
- However, not all exposure classified as Public Sector are Agency Bonds. We estimate the proportion of Agency Bonds of each banks based on (1) Disclosure (2) Maturity – we assume Agency bonds to have a maturity of more than one year; as such our estimates = Public Sector bonds x Proportion of overall bond portfolio that have maturity of more than one year (3) similar to (2) but we use the proportion of US\$ debt instead. The result is shown in Figure 1.

Accounting treatments

- As such, the marked-to-market adjustments on these bonds should be reflected initially in the reserves, and should only reflect the adjustments made up to the balance sheet date.
- Only impairment loss, such as credit rating downgrade, will need to be reflected into P&L. This implies the rapid decline in bond prices since July will not affect the 1H08 results, though selected disclosure may be warranted upon the interim results announcement.

Insurers little impacted owing to limited overseas investments

- China Life has US\$425mn of foreign-currency denominated debts at the end of 2007. China Life has been increasing the amount of RMB to reduce

foreign currency exchange risks which rules out that the company would increase overseas exposure drastically. Assuming the total amount is at risk, it is still 0.34% of investment assets at Rmb850bn.

- Ping An has US\$209mn in fixed maturity investments at the end of 2007. Assuming the total amount is at risk, it is 0.28% of total investment assets at Rmb515.8bn.
- PICC has Rmb707mn of foreign currency debt securities at the end of 2007. Assuming the total amount is at risk, it is 0.89% of total investment assets at Rmb79.14bn.
- Hence, insurers are unlikely to have significant positions in these agency bonds. China Life and Ping An said they have no exposure in Freddie Mac and Fannie Mae.

Figure 1

CLSA's estimated exposure to Freddie Mac and Fannie Mae bonds for selected banks

		Public sector AFS	Public sector HTM	Public sector Total	% of assets	% of equity	CLSA's estimated exposure in Freddie Mac & Fannie Mae	% of assets	% of equity	Comments
Hong Kong		HKD'm	HKD'm	HKD'm						
HSB	11HK	5,688	-	5,688	0.76	10.08	Nil	-	-	Disclosure
BEA	23HK	2,337	664	3,001	0.76	9.86	US\$110mn	0.22	2.82	Maturity
BOCHK	2388HK	9,673	20,530	30,203	2.83	31.77	US\$1.3bn	0.95	10.67	Credit rating
WHB	302HK	107	232	339	0.24	3.22	US\$20mn	0.11	1.48	Disclosure
DSF	440HK	112	11	123	0.10	0.96	Nil	-	-	Disclosure
CIFH	183HK	711	-	711	0.54	2.68	Minimal	na	na	Disclosure
WLB	96HK	121	39	161	0.17	1.29	Minimal	na	na	Disclosure
ICBCA	349HK	811	114	926	0.48	6.17	Nil	-	-	Disclosure
FBHK	636HK	85	-	85	0.14	2.06	Minimal	na	na	Disclosure
CHB	1111HK	-	11	11	0.02	0.18	Nil	-	-	Disclosure
China		Rmb'm	Rmb'm	Rmb'm						
CCB	939HK	22,035	48,174	70,209	1.06	16.63	US\$7bn	0.83	12.93	Maturity
BoCom	3328HK	1,762	4,708	6,470	0.31	4.85	US\$650mn	0.24	3.80	Maturity
BOC	3988HK	136,569	64,178	200,747	3.35	44.55	US\$20bn	2.60	34.62	Maturity
CMB	3968HK	1,970	849	2,819	0.22	4.15	US\$250mn	0.15	2.98	Maturity
ICBC	1398HK	53,665	29,386	83,051	0.96	15.28	US\$1bn	0.09	1.43	Currency; US\$ exposure
CNCB	998HK	5,400	9,895	15,295	1.51	18.19	US\$1.4bn	1.08	12.99	Disclosure

Source: Company annual reports, CLSA Asia-Pacific Markets

Key to CLSA investment rankings: BUY = Expected to outperform the local market by >10%; O-PF = Expected to outperform the local market by 0-10%; U-PF = Expected to underperform the local market by 0-10%; SELL = Expected to underperform the local market by >10%. Performance is defined as 12-month total return (including dividends).

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Note: In the interests of timeliness, this document has not been edited.

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