

developments. These buyers were speculating that real estate prices would continue to rise 20 percent to 30 percent per annum, and many also were speculating on the RMB reevaluation by taking out US dollar-denominated mortgages from offshore lenders. Their goal was to hold and rent their properties for a few years and then sell to Chinese buyers, getting appreciated RMB to pay back devalued dollars.

Moment of truth

Now, the question is whether these practices will lead to a surge in new NPLs. Concerned about an overheated economy and a real estate bubble, the government has been raising interest rates, which has increased mortgage financing costs and dampened property sales. In mid-2005, the government imposed a 5 percent sales tax on property sold within two years of purchase, which has further slowed sales. In recent months property prices have been falling at a rate of 3 percent to 5 percent a month, and some large developers have seen sales fall as much as 50 percent to 70 percent. Adding to the downward pressure on sales, more buyers are remaining on the sidelines, awaiting further declines in property prices. Oversupply of all real estate products makes it difficult for speculators/investors to find tenants for all new units.

On the lending front, the government has effectively 'flatlined' real estate loans by allowing banks to finance projects only when there is minimal risk and the developer invests substantial equity. Banks' real estate loan growth has slowed, and their risks of loan losses have increased because overextended developers have not been able to complete housing projects or sell all the units. More developers are defaulting on their loans, and banks are experiencing higher rates of mortgage delinquency. Furthermore, banks have not had much success in pressuring developers to repay loans made to phantom borrowers (which the developers guaranteed).

One sign of the seriousness of the problem is the estimated buildup in special mention loans. Many of these loans should be classified as nonperforming (substandard or doubtful). If 80 percent of these special mention loans continue to deteriorate, as much as \$65bn in new NPLs could hit the banking system over the next two years as a result of aggressive real estate lending in recent years.

Taking action

Despite the banks' problems, there is reason for optimism. To attract global strategic investors in its banks, and prepare for its largest banks

to launch initial public offerings, the Chinese government is moving to bring greater transparency to the banking system. For example, bank examiners and outside auditors are now providing financial reporting in accordance with International Financial Reporting Standards. China's leading banks are moving to adopt international best practices for setting capital requirements by adapting a modified Basel I standard and planning to meet the Basel II standards in the future. Respected regulators such as Liu Ming Kang at the China Banking Regulatory Commission and Zhou Xiao Chuan at the People's Bank of China are continuing to improve regulatory standards and enforcement.

To be sure, much remains to be done. Government regulators need to increase their inspections of banks' loan portfolios, test the validity of residential mortgage loans, and develop an accurate picture of banks' real estate loan exposure and NPLs. They should demand that qualified property specialists perform appraisals or value estimates of the banks' loan portfolios.

The banks also should move quickly to identify and resolve their real-estate-related NPLs, the values of which will decline by 30 percent or more per year due to deterioration, vandalism, and lack of maintenance funds. The properties could be packaged and sold to international investment consortiums that can complete, repair, rehabilitate and market them. Banks can use the proceeds to reserve against loan losses or for other business purposes.

Finally, Chinese banks should strengthen their underwriting practices to weed out those borrowers that fail to meet commercial underwriting standards. In doing so, they can rely less heavily on real estate as a source of recovery and diversify their risk more in line with China's increasingly diverse economy. The next few years could be difficult for China's banks as they restructure their loan portfolios, take what could be billions of dollars in loan write-downs, dispose of nonperforming assets, and realign their underwriting practices. But by moving quickly, China can restore its banking system to health, attract international capital, and sustain its long-term growth. The important point is to take fast and decisive action. China has only to look to Japan's experience of the past decade to see the consequences of inaction. ■

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SECTOR ANALYSIS

Recent developments in the US power sector

BY RAMESH RAMAN AND SOPHIE GUINY

The robust US power market that followed deregulation activities collapsed following the bankruptcy of Enron, and overbuilding in many markets. The ensuing financial crisis enveloping the sector caused the collapse of merchant energy participants and associated power marketers. These energy merchants, as a means to strengthen their financial

condition, sold off contracted assets to opportunistic financial investors such as hedge funds and investment banks. These investment firms acquired cash flowing assets, while the sellers were able to dispose of high value portfolio assets to the highest bidder, securing a significant capital infusion. The deregulation initiative slowed following the collapse of ►►

the largest electric utility in California and halted Federal support for imposing Standard Market Design for Regional Transmission Organizations (RTOs). Despite the lack of Federal support, many RTOs in the Northeast and Mid-Atlantic, survived this market collapse and today are flourishing, such as PJM LLC, New York ISO, ISO New England. PJM LLC has expanded to incorporate neighbouring states to the west.

The broader crisis

The electric power market collapse was soon followed by a broader energy crisis. Oil and natural gas prices remained high throughout 2004 and early 2005 before being dealt another blow from hurricanes in the Gulf Coast of the US. Surging global oil demand in 2004/2005, followed by disruptions in refinery operations resulting from the hurricanes in the Gulf of Mexico brought awareness of the fragile nature of the nation's energy infrastructure.

Sustained high prices of oil and natural gas have prompted the growth of alternative energy sources. Alternative energy sources include renewables, but also the resurgence of coal and nuclear power projects. Once again at the forefront, advanced coal and nuclear projects are benefiting from numerous tax incentives in the Energy Bill.

The Energy Policy Act

The Energy Policy Act ("the Act") includes numerous tax credits, grants and other incentives to promote production of energy from domestically available supplies, particularly coal gasification, nuclear and renewables.

The Act extends production tax credit, but stops short of making such credits permanent. While a Federal mandate for Renewable Portfolio Standards was sought, such regulation did not prevail in the final bill. More states continue to impose Renewable Portfolio Standards partially mitigating the need for Federal action. With respect to nuclear, the Act

attempts to encourage the construction of new facilities by providing an assurance mechanism that reimburses costs associated with certain delays in reaching full power operations.

Beyond the fiscal incentives, the EPAct deeply reforms the regulatory framework for the US power sector, by repealing the 1935 Public Utilities Holding Company Act (PUHCA). The Act gives authority to the states and the Federal Energy Regulatory Commission (FERC) to examine utilities' books and records against financial abuse. The FERC is given authority regarding mergers of utilities, as opposed to the Securities and Exchange Commission (SEC) under the former system. The repeal of PUHCA makes mergers and acquisitions in the power sector potentially easier. Mergers were already announced prior to the EPAct becoming law, (Exelon-PSEG, Duke-Cinergy, MidAmerican-Pacificorp); the EPAct is anticipated to add to these mergers and the quest for operating efficiencies amongst the regulated utility sector. The Energy Policy Act also eliminated the ownership restrictions imposed on utility ownership of Qualifying Facilities. What was previously restricted to 50 percent no longer has restrictions. The change provides opportunities for utilities to diversify and acquire assets outside of their territory. PURPA itself has been repealed however, only to the extent that the generation company has access to market-based RTOs and rates. Therefore, the repeal of PURPA does not apply across the US.

The Act results in FERC's emergence as a powerful regulatory authority. In addition to its new authority on electric utilities, FERC also manages the approval process and licenses for US LNG re-gasification terminals. The challenge is to manage the implementation of this expanded FERC authority with the prerogatives and jurisdiction of the states.

The new Energy Act is expected to have a strong impact on the power sector. Fiscal incentives make it likely that the new power plants that will be built between 2006 and 2014 will be coal-fired, using mostly coal-gasification technologies. Energy traders have been replaced by the investment banks who bring considerable commodities trading expertise and strong balance sheets to the sector. These financial participants join financially strong energy companies who continue to maintain a presence in the trading markets. Most of these entities possess asset control and depth of trading expertise coupled with a balance sheet that enables them to consummate trades efficiently and cost effectively.

Conclusion

The US energy sector has been through upheavals over the past four years. The fragile balance of supply and demand is being addressed by a number of capacity additions to bring additional supplies into the US. The Act will facilitate diversification of energy sources, while strengthening and streamlining the regulatory framework through the increased role of FERC. Both should have a positive impact on investments in the United States' energy and energy delivery sectors. ■

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