

# China's Banking System:

Challenges Ahead...  
but There are Ways out other  
than a Crisis

**Alicia Garcia-Herrero**

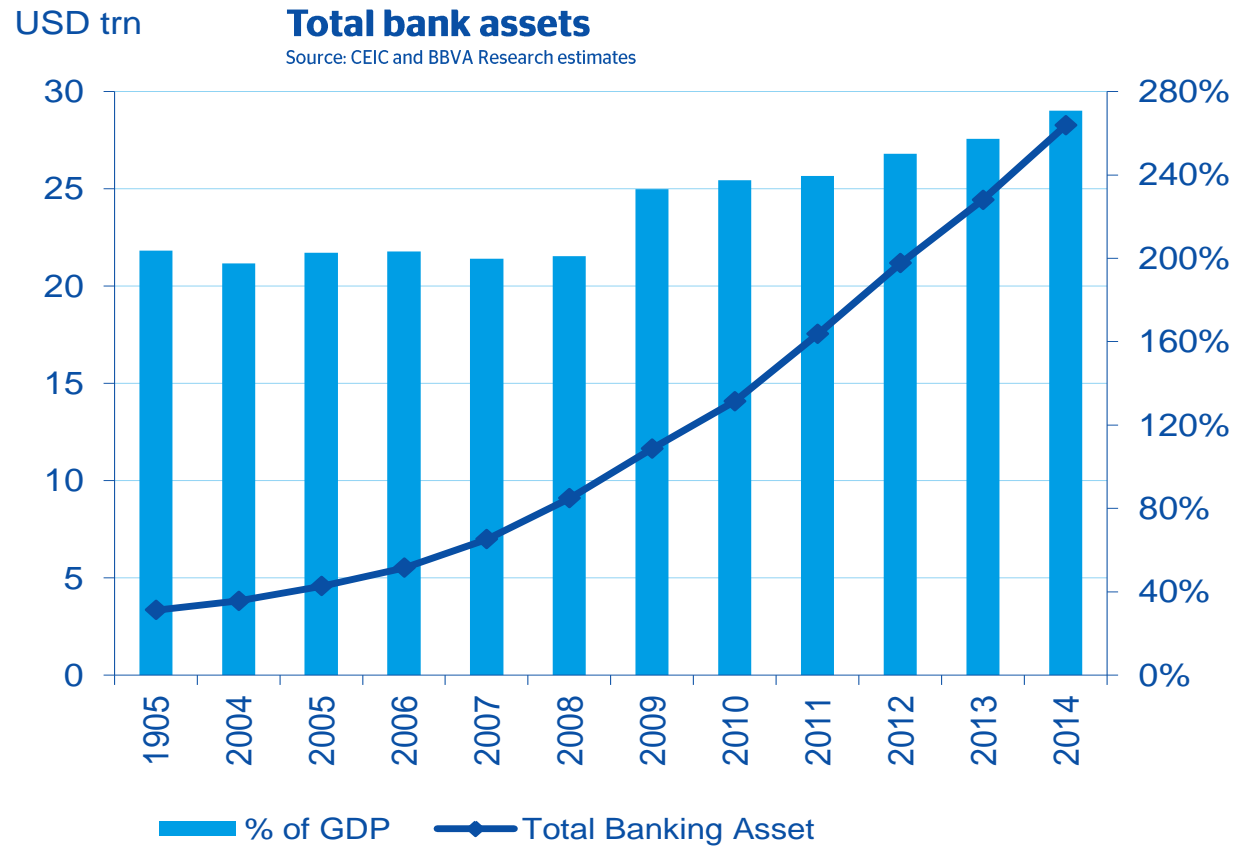
Chief Economist for Emerging Markets BBVA Research

Shanghai, March 1, 2015

# Outline

1. Current situation of China's banking sector since the reform
2. Key aspects of the financial reform
3. Outlook for China's banking system

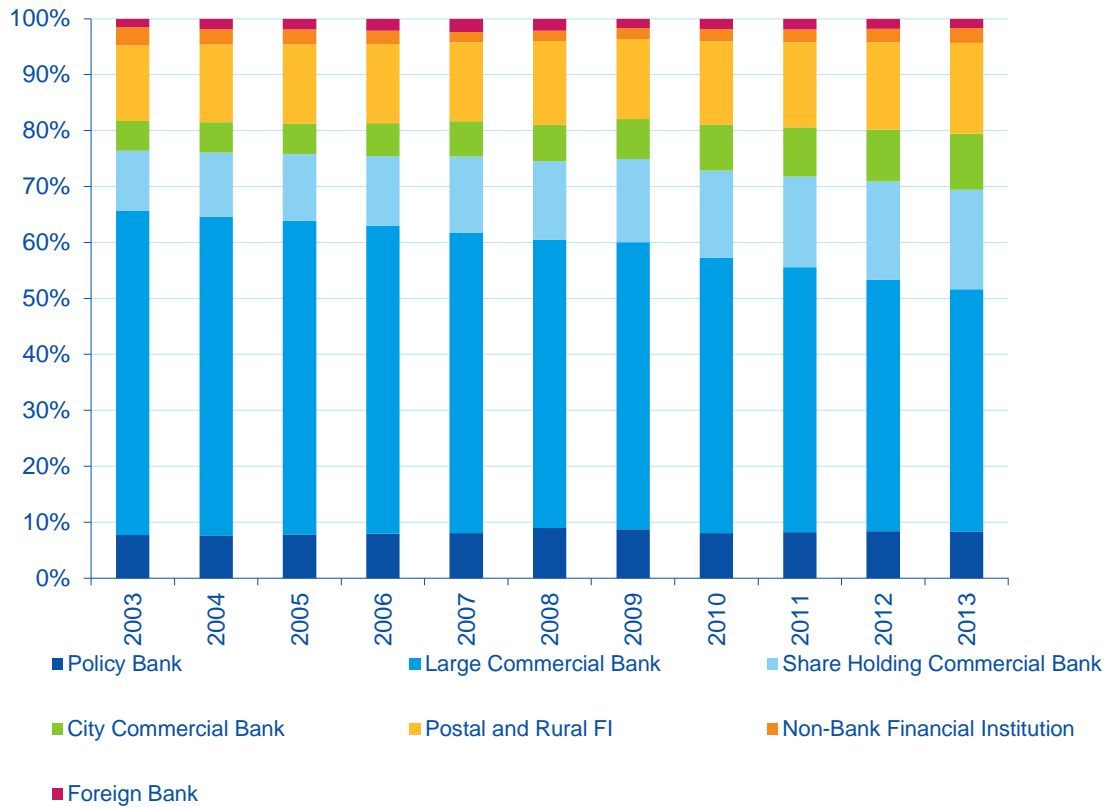
# Banking sector: giant but...



# Still mainly stated-owned

## Market share by type of bank

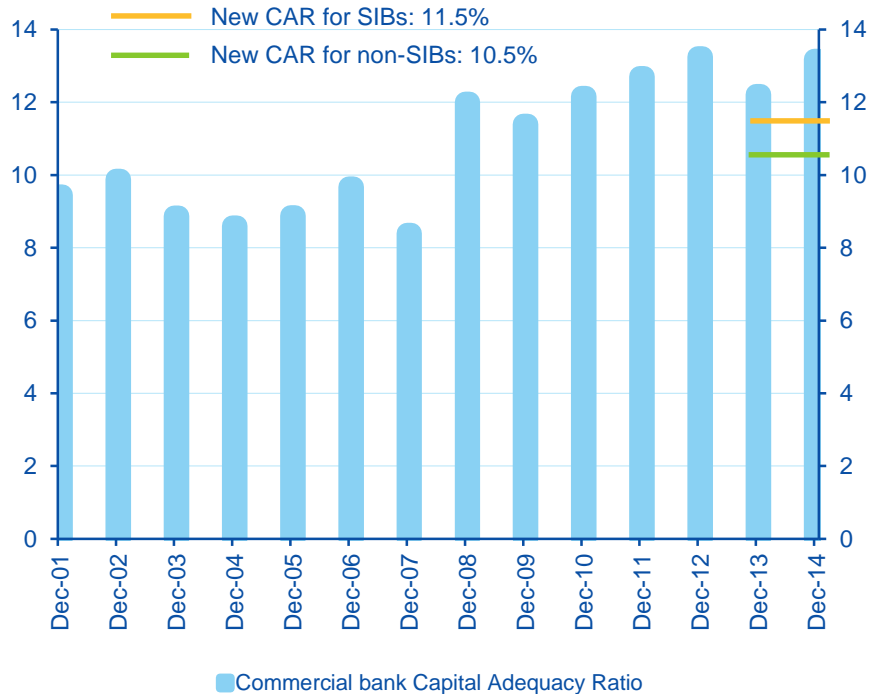
Source: CEIC and BBVA Research



# Aggregately, it looks healthy

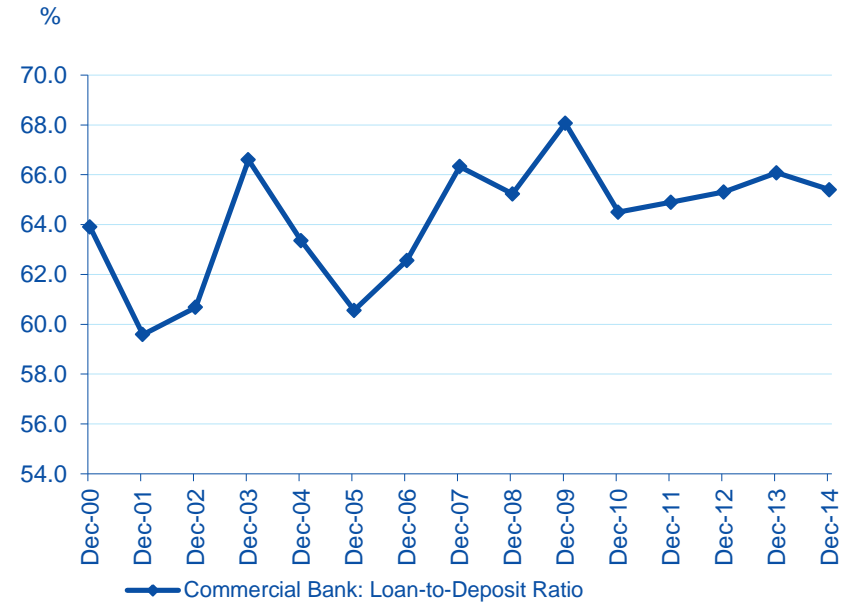
## Bank capital adequacy ratios remains healthy

Source: CEIC and BBVA Research



## Loan-to-deposit ratios are stable

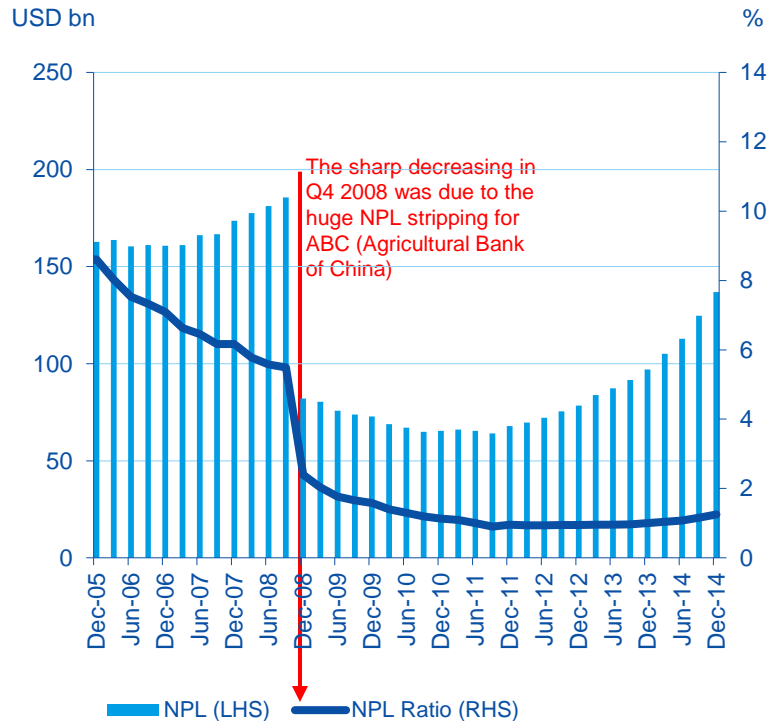
Source: PBoC and BBVA Research estimates



## Lower NPL ratio has helped boost profits ...

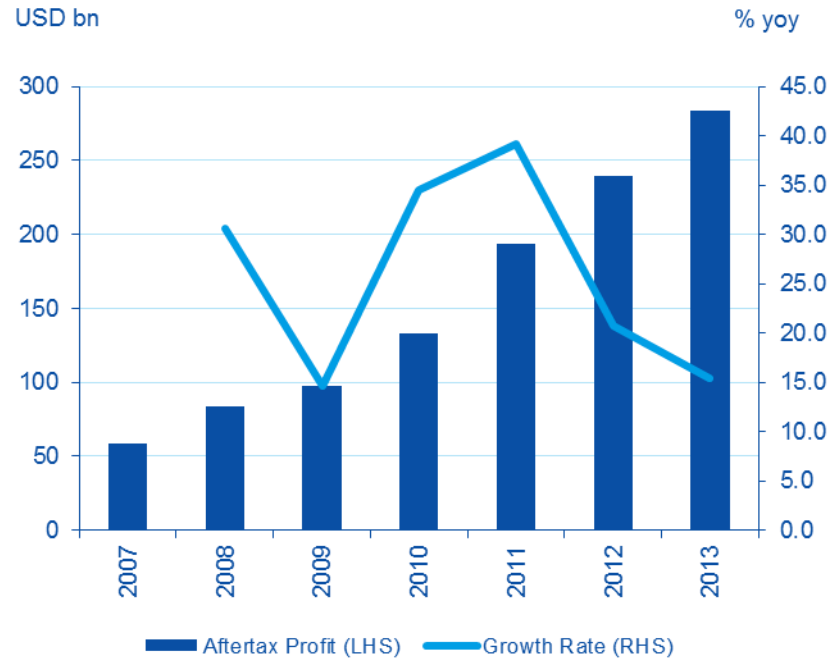
### NPL ratio

Source: CEIC and BBVA Research



### Total profit growth slowed from record high in 2011

Source: CEIC and BBVA Research



# ...but profits are slowing down

Credit growth slowing as economic growth moderates

NPL levels to increase because of increasing leverage

Interest liberalization to narrow interest margins

Tougher regulation

Shadow banking

# Financial openness limited

Entry into WTO led to some openness of China's banking system (20%-25% max foreign ownership) but never increased since.

Slow process to open branches and expensive

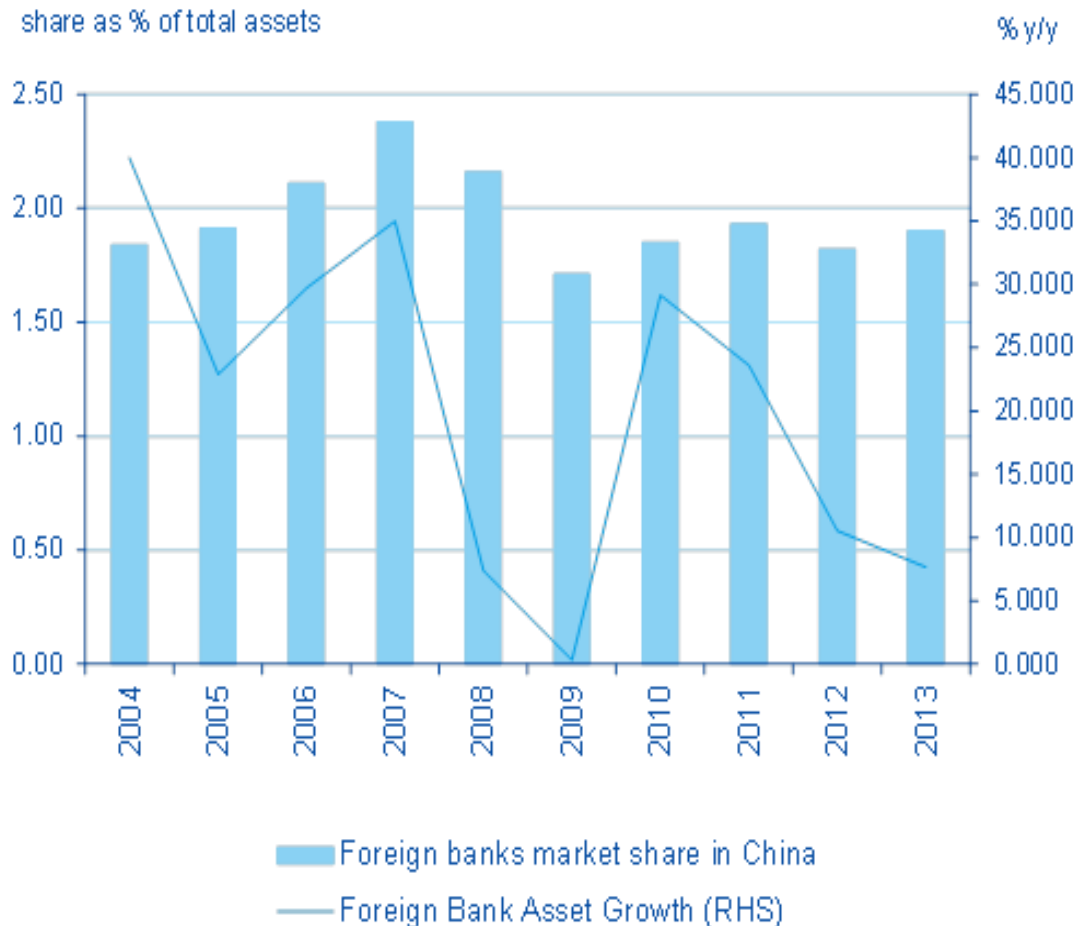
New development is outward expansion of Chinese banks but so far only through branches, no major acquisitions yet



# Fully owned foreign banks irrelevant

**Foreign bank asset growth has been decreasing since 2010**

Source: CBRC and BBVA Research



Market share of foreign banks below 2% of Chinese banks' total asset.

Foreign bank asset growth volatile

# Chinese banks going abroad through branches and minority stakes

Bank Name	Branches abroad	Date of establishment
<b>Bank of China (BOC)</b>	US (New York)	1981
	France (Paris)	1981
	Australia (Sydney)	1985
	Japan (Tokyo)	1986
	Macau	1987
	Germany (Frankfort)	1989
	Etc.	
<b>China Construction Bank (CCB)</b>	UK (London)	1991
	US (New York)	2009
	Australia (Sydney)	2010
	Taiwan(Tai Pei)	2011
	Russia (Moscow)	2011
	Etc.	2011
<b>Industrial and Commercial Bank of China (ICBC)</b>	France (Paris)	
	Switzerland (Amsterdam)	2011
	Belgium (Brussels)	
	Italy (Milan)	
	Spain (Madrid)	
	Etc.	
<b>Agricultural Bank of China (ABC)</b>	Singapore	1995
	Korea(Seoul)	2012
	UAE(Dubai)	2013
	Australia (Sydney)	2014
	Etc.	
<b>Bank of Communication (BOCOM)</b>	UK (London)	2011
	US (San Francisco)	2011
	Australia (Sydney)	2011
	Etc.	

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2. Key aspects of financial reform

- Bank Restructuring
- Financial liberalization
- Bank regulation

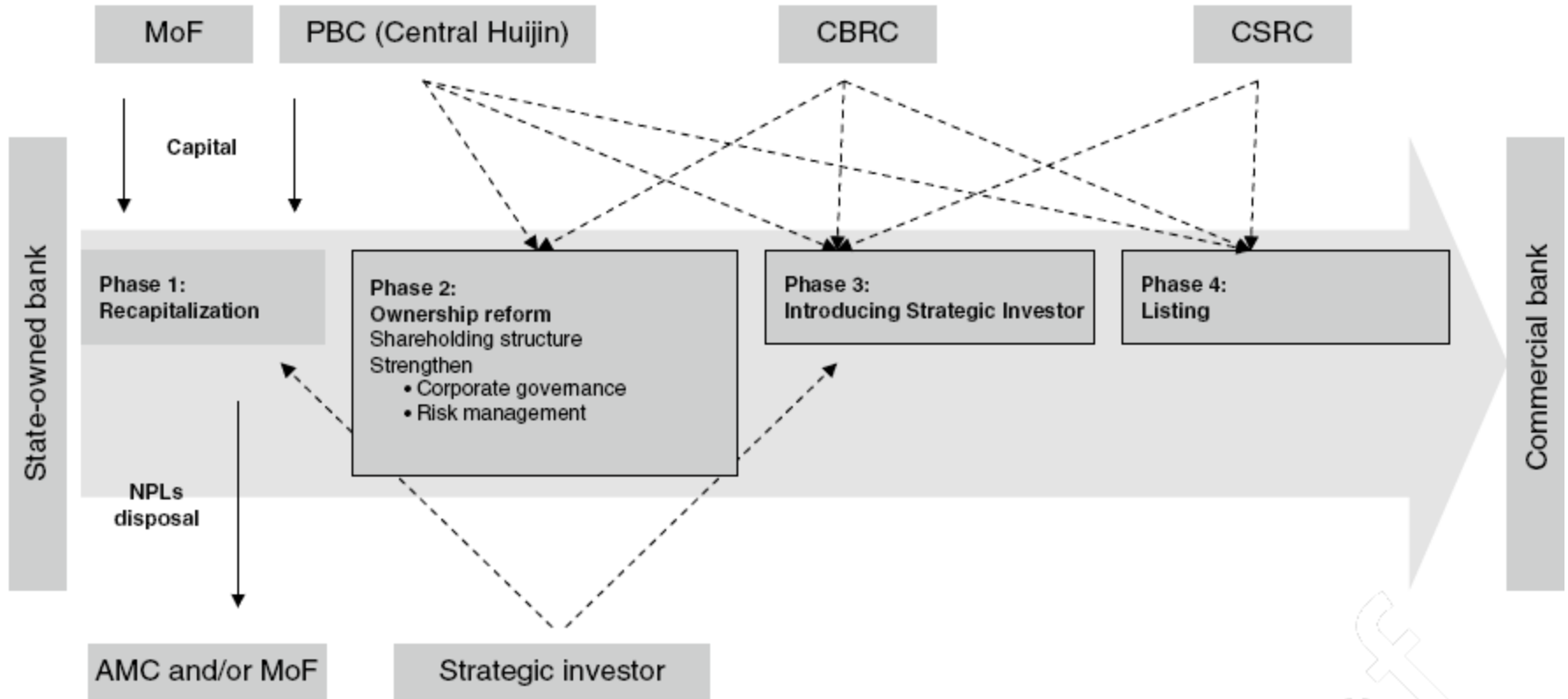
3. Outlook for China's banking system

# Outline

## 1. Key aspects of financial reform

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# One key pillar: Bank Restructuring



# Large public capital injections for restructuring

## Capital injected into SOCBs

Date	Bank	Amount			Financed by:	Currency
		RMB bn	USD bn	% GDP		
1998-1999	SOCBs	275	33	3.3	Ministry of Finance	RMB
2003-2004	CCB	186	22.5	1.4	PBC (Central Huijin)	USD (FX reserves)
	BoC	186	22.5	1.4		
2005	ICBC	124	15	0.7	PBC (Central Huijin)	USD (FX reserves)
2008	ABC	130	19	0.4	CIC (Central Huijin)	USD (FX reserves)

# Also private injections (IPOs and strategic investors)

Date	Bank Name	Financed by	Financing size
1998-1999	SOCBs	Injected by Ministry of Finance	Total RMB 275bn (USD 33.1bn)
2003-2004	CCB	Injected by PBC (Central Huijin)	Total RMB 186bn (USD 22.4bn)
	BoC		Total RMB 186bn (USD 22.4bn)
2005	ICBC	Injected by PBC (Central Huijin)	Total RMB 124bn (USD 151.2bn)
2008	ABC	Injected by PBC (Central Huijin)	Total RMB 130bn (USD 18.8bn)
2008	CCB, Everbright, etc.	A+H share Rights Issue Subordinated debt	Total RMB 134.4bn (USD 16.4bn)
2010	BoC, ICBC, ABC, etc.	A+H Share Rights Issue Subordinated debt	Total RMB 444.1bn (USD 65.3bn)
2011	CITIC, ABC, Ping An, Hua Xia, Beijing, Nanjing, etc.	Subordinated debt A+H Share Rights Issue	Total RMB 241.9bn (USD 37.2bn)
2012	Shanghai, Ningbo, BoC, CMB, Huaxia, etc.	Subordinated debt A+H Share Rights Issue	Total RMB 150.7bn (USD 23.9bn)
2013	Chongqing, Everbright, CMB, Huishang, etc.	Subordinated debt A+H Share Rights Issue	Total RMB 348.2bn (USD 56.2bn)

# Outline

## 1. Key aspects of financial reform

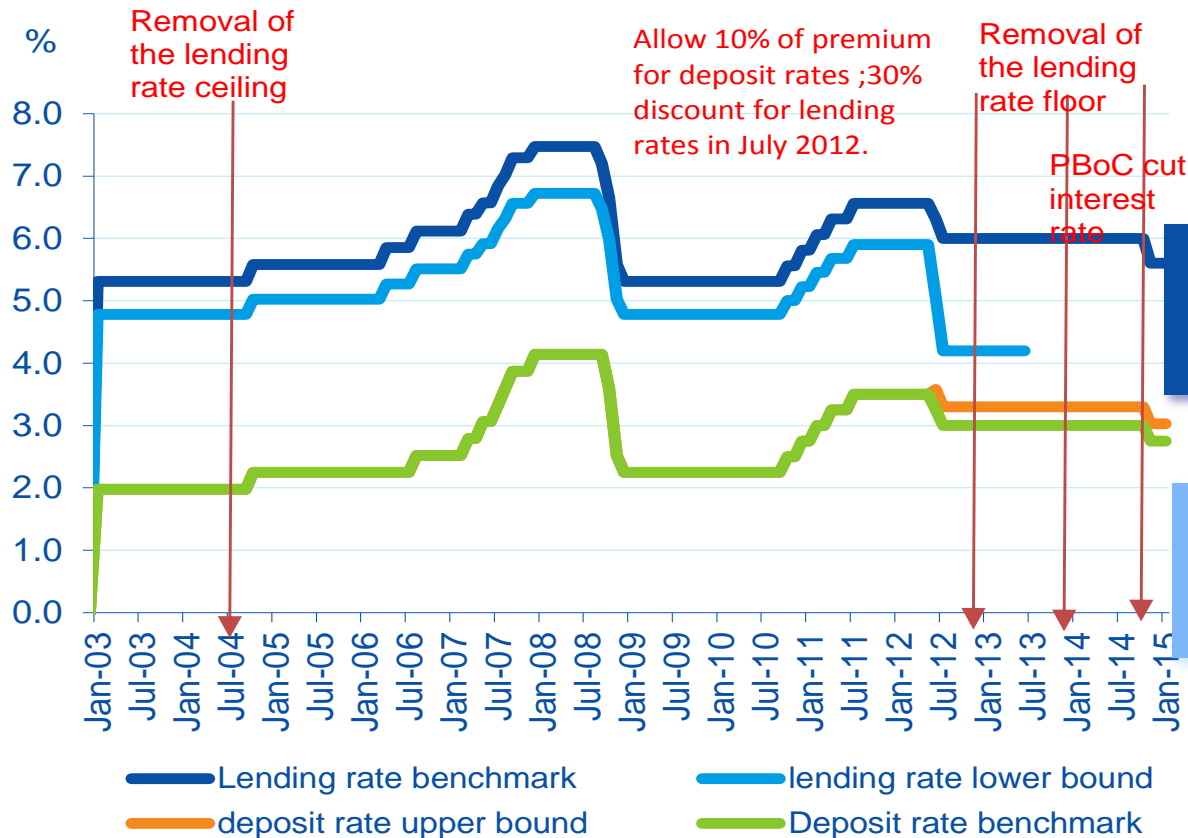
- Bank Restructuring
- Financial liberalization
- Bank regulation



# Ten years after interest rate liberalization started, we are not yet there!

## Lending and deposit rates

Recourses: BBVA research and CEIC



Lending rate started to be liberalized in 2004 and fully liberalized in 2013) but not deposit rate: key one for financial repression

Given that lending rates are not binding now, the removal of the lending rate floor can only benefit borrowers modestly.

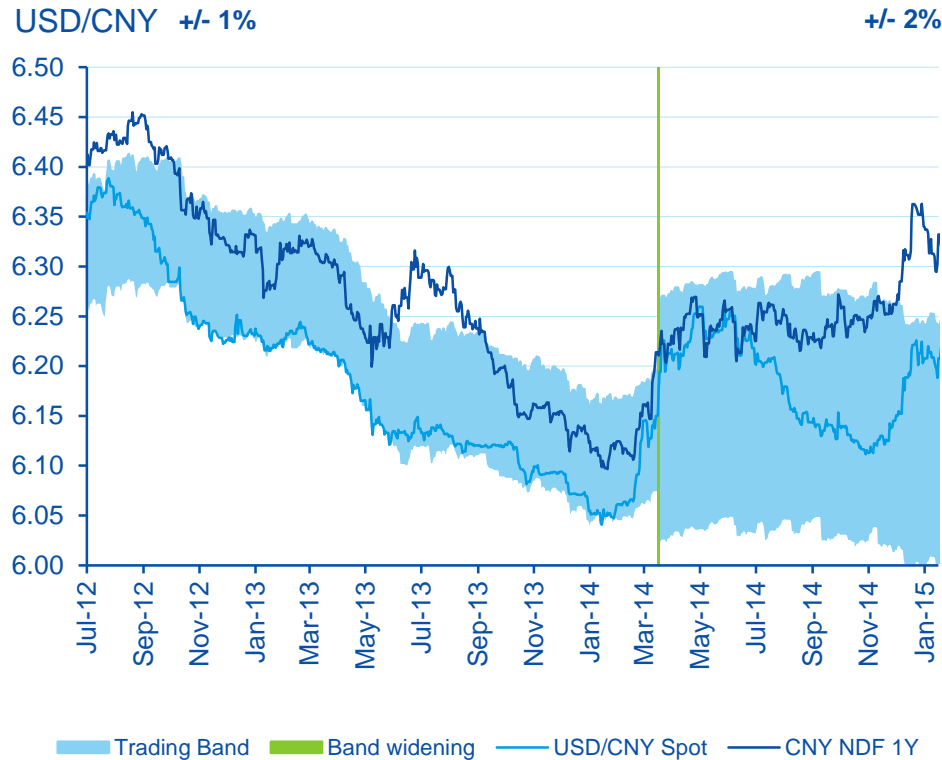
# Capital account liberalization: lots of measures but not much action, specially on the outflow side

Reform	Date	Regulator	Key Points
Enlargement of QFII Quota	April 2012	CSRC	Increased the quotas for qualified foreign institutional investors to \$80 billion from \$30 billion.
Enlargement of RMB-QFII Quota	November 2012	PBoC ,CSRC and SAFE	Increased the quotas for RMB qualified foreign institutional investors to RMB 270 billion from RMB 70 billion.
More access to the QFII investors	March 2013	PBoC	Qualified QFII institutions are allowed to investment in the inter-bank bond market. Previously, QFII investors were only allowed to invest in the A-share market and bonds listed in the Shanghai and Shenzhen exchanges.
Guidelines for the program of RMB Qualified Foreign Institutional Investors (RQFII)	May 2013	PBoC	Designated foreign institutional investors (mainly including banks, insurances companies, pension, and other financial institutions) are allowed to repatriate offshore RMB to the Mainland for investment use.
Cross-border stock investment between Shanghai and Hong Kong	April 2014	CSRC	The China Securities Regulatory Commission (CSRC) announced a pilot program to allow cross-border stock investment between Shanghai and Hong Kong stock exchanges.

# Exchange rate liberalization still far

## Depreciation risk is on the rise

Source: BBVA Research and Bloomberg



RMB daily trading band widened to +/-2% (from +/-1%) in March, 2014.

Previously, continuous RMB appreciation attracted large FX reserve accumulation, thereafter moderate depreciation

A more flexible RMB need for capital account liberalization to make sense

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## Banking Regulation strengthened on paper... but enforcement is an issue

### *Asset quality:*

- Five-tier credit classification system (2002)
- Banks required to classify their loans ( 2005);
- Provisioning coverage ratio 150% (2009).

### *Regulatory capital:*

- Internal Basel II risk models (2009);
  - New toolbox of **Basel III** CARs (2010)
- But full implementation delayed!**

Category	Status of Chinese version of Basel III
Capital Adequacy	<ul style="list-style-type: none"> <li>• 11.5% (8% minimum +2.5% extra +1% SIB) and 10.5%.</li> </ul>
Leverage Ratio	<ul style="list-style-type: none"> <li>• A minimum leverage ratio is 4%;</li> </ul>
Liquidity	<ul style="list-style-type: none"> <li>• Liquidity coverage ratio and net stable funding ratio</li> </ul>
Loan Provision	<ul style="list-style-type: none"> <li>• The minimum Provision/Total Loan ratio is set at 2.5%;</li> <li>• The minimum Provision coverage ratio is set at 150%;</li> </ul>
Source: CBRC and BBVA Research	

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# Quite gloomy: profitability to shrink

*Banks need additional RMB 1.5-2.0 trillion to replenish capital over next 5 years (1.5 % of Chinese GDP)*

*This is more than the aggregate capital of RMB 1.2 trillion raised since 2010.*

	2011	2012	2013	2014	2015	2016	2017
GDP growth	9.2%	7.7%	7.7%	7.4%	8.0%	7.6%	7.4%
CPI average	5.4%	2.6%	3.0%	2.0%	4.0%	4.0%	4.0%
Credit Growth	18.9%	17.9%	14.3%	10.0%	13.0%	12.5%	12.5%
Net Interest Margin	2.7%	2.6%	2.3%	2.6%	1.6%	1.6%	1.6%
% of fee and investment Income	33.8%	35.0%	36.5%	19.2%	40.0%	40.0%	40.0%
NPL Ratio	1.8%	1.6%	1.0%	1.3%	2.8%	3.1%	3.4%
Provision / NPL	278.1%	296.0%	282.7%	232.1%	155.0%	150.0%	150.0%
<b>Profit Growth</b>	<b>39.2%</b>	<b>18.9%</b>	<b>14.5%</b>	<b>9.7%</b>	<b>-7.7%</b>	<b>-13.9%</b>	<b>2.0%</b>

Note: Net Interest margin assumed to decline to 1.6% due to interest rate liberalization, close to average NIM for high-income countries

## This is just the baseline scenarios but huge risks

More recapitalization needs could come from:

1. **Taking part of the losses from the loans to local governments (LGFVs):**
  - *It could go all the way to 3 tn RMB more*
2. **Excessive leverage from corporations**
  - *1/3 of Chinese do not make enough EBIBTA to service debt*
3. **Shadow banking activities**
  - *Potential losses estimated at 1.5 tn RMB*



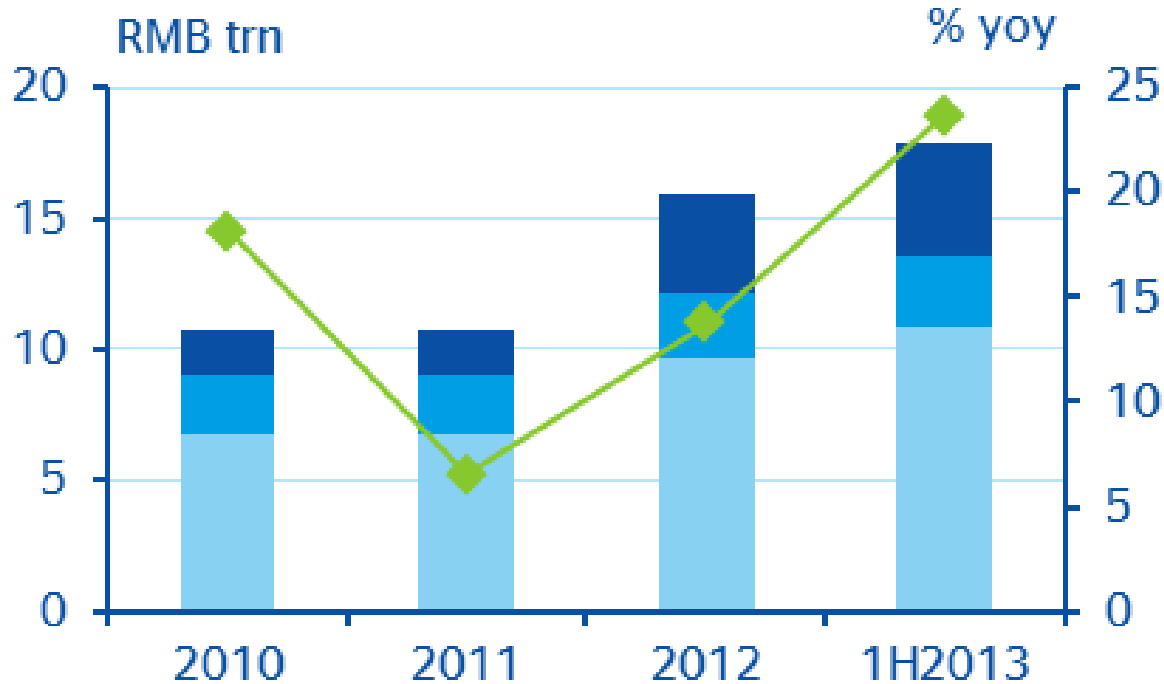
Banking crisis should not  
be the buzz word

**But problems are big  
and deserve attention and..  
Solutions!**

# Indebtedness of local governments adds pressure on asset quality

Local government debt has risen

Source: BBVA Research



- Contingent debt
- Guaranteed debt
- Ordinary debt
- Infrastructure investment growth (RHS)

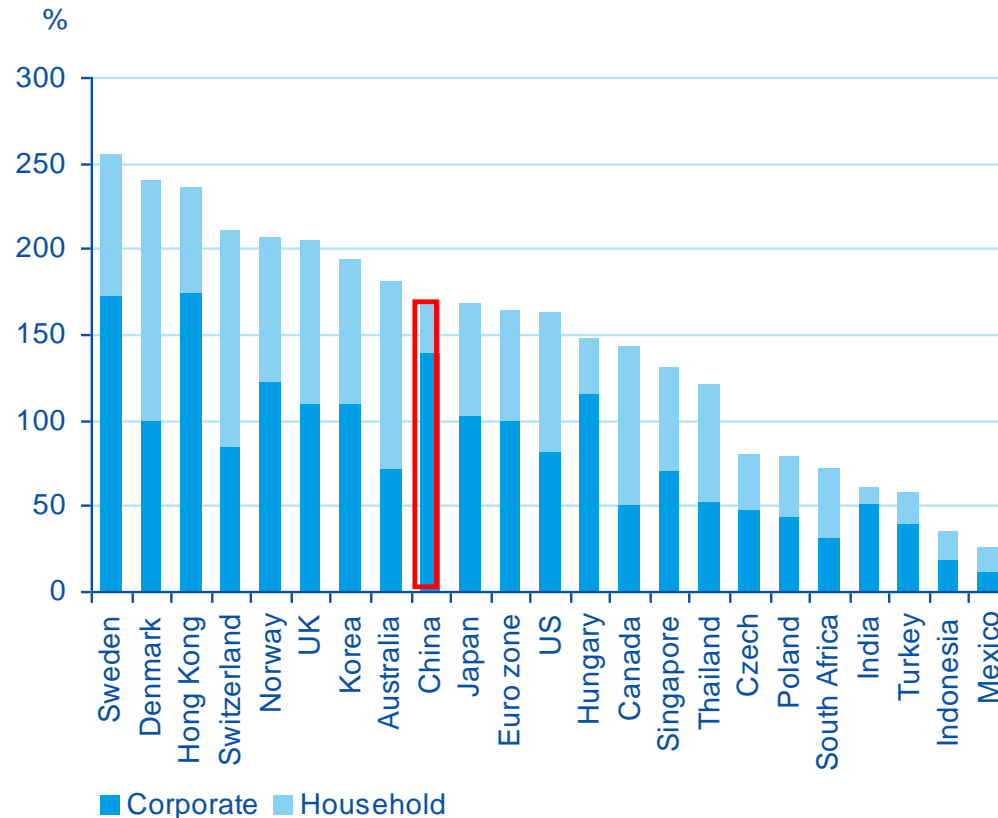
The latest audit of local government debt shows an increase to RMB 17.9 trillion at end-June

A clean-up of local government debt may require central government funds, and bank write-offs

# Corporate debt: Another drag for asset quality

**Corporate debt level is high by international standard, specially when compared to other EMEs and it is not only SOEs!**

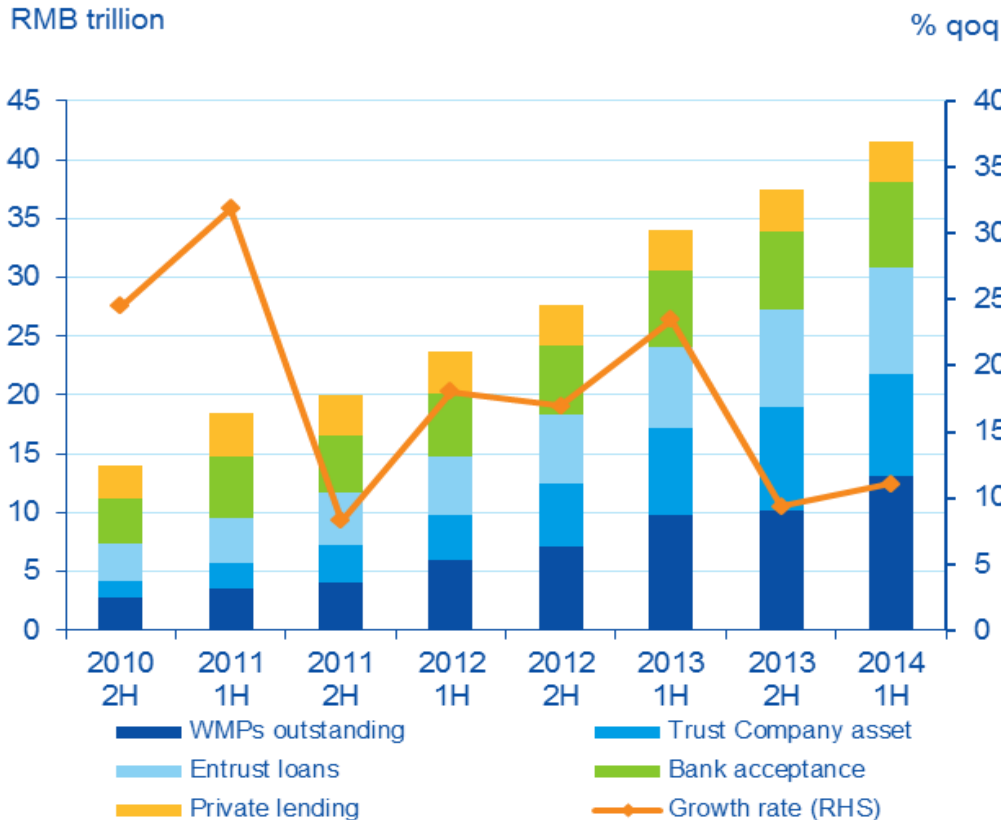
Source: BBVA Research



# Shadow banking also poses risks to banks

## Shadow banking activities have risen...

Source: Wind, CEIC, PBoC and BBVA Research estimates



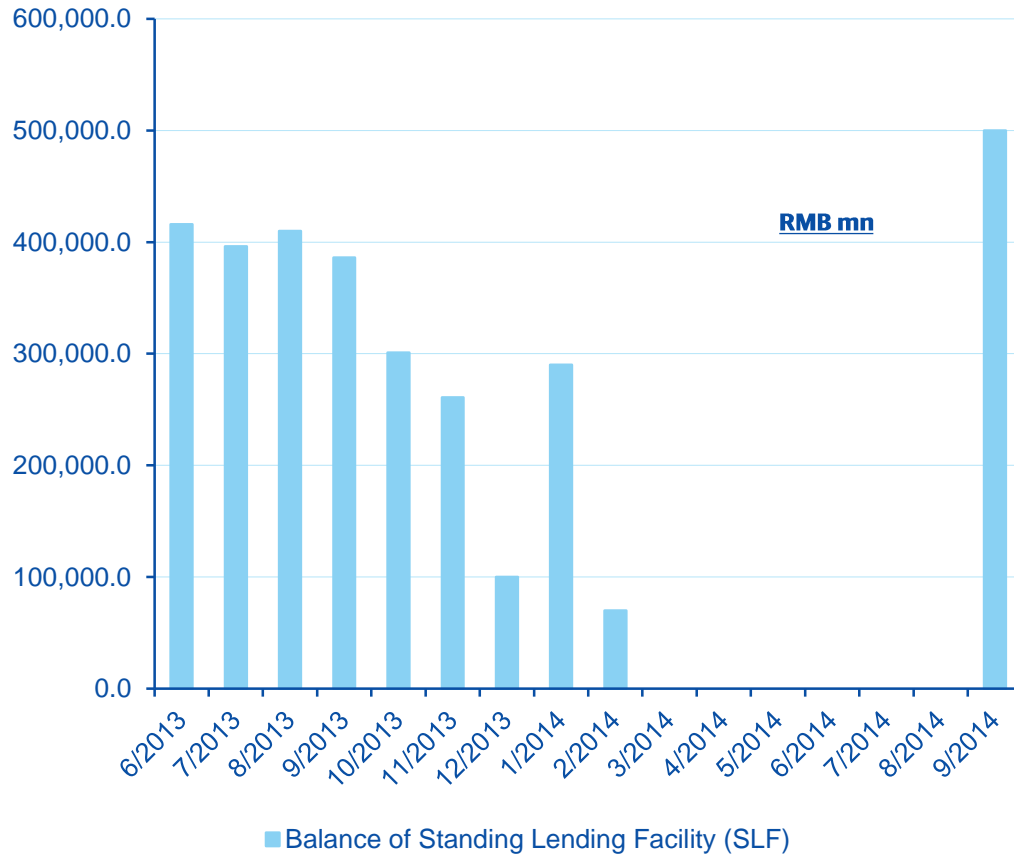
Half the credit is been created outside the banking system in China today

Involvement of banks in shadow banking activities could eventually impact their balance sheets.

# Bank liquidity is a problem too

## PBoC direct injections into banks: Standing Lending Facility (SLF)

Source: PBoC and BBVA Research



Growth of shadow banking and a more indebted economy, not fully accommodated by PBoC, has shot up interest rates and created some episodes of liquidity crunch (the most intense in May 2013)

Action taken in a selective basis by PBoC: Injection of 500 bn RMB (81 bn USD or 1.5% of the PBoC's balance sheet) to the top five big banks in China on Sep 17<sup>th</sup>.

Before that 1 trillion RMB to China Development Bank (CDB)

# Outlook looks gloomy but still options available

China's financial reform key but it faces enormous headwinds

**Interest rate liberalization**, will need to take place at a time when asset quality is set to worsen and regulation is toughened: **Hard choices will need to be made**

Episodes of liquidity shortage can bring asset quality issues to the surface: pressure on PBoC

• **Bank recapitalizations will be needed.**

- Most of it still born by the government but increasingly more role to the market through:
  - Additional IPOs (explains HK Stock exchange)
  - Asset securitization (called off during global crisis and back again)
  - Creation of new Local Asset Management companies to offload bad loans
  - Fully introduction of Basel III can be delayed further. World not really watching...

# All in all

- **Chinese system will be more of a problem than a solution for China's new economic future**
- **It needs a new wave of restructuring, which will be costly and, most importantly, time consuming**
- **It may be so time consuming that it may derail the badly needed reform process**

**WATCH IT OUT!**

**Thank you!**

**Alicia Garcia-Herrero**

Chief Economist Emerging Markets – BBVA Research

CEIBS Faculty