

Banking Monitor CHINA

May 8th

Main Takeways

- **Macro-environment: Growth rebounds while markets under stress**
 - The PBOC has raised short-term interest rates to steady Yuan value and rein in financial risks
 - Financial markets are under stress due to monetary prudence and regulatory tightening
- **Chinese banks performance: Still weak in 2016**
 - Assets and liabilities of banking system grew steadily
 - Mortgage loans contributed to a rising share of banking loans
 - The profitability indicators remained subdued although the fast rise of NPL ratio halted of late
- **Shadow banking system: Too big; too risky**
 - Shadow banks are increasingly exposed to China's property sector
 - Banks' aggregate exposure to shadow banking activities reached over 10% of total bank assets by the end of 2016
 - Capital market, household and corporate sectors all have large exposures to the shadow banking
- **Regulations outlook: Squeeze until you surrender**
 - Small-and-medium-sized banks demonstrate the greater interconnection with shadow banking sector.
 - City banks are under pressure based on the macro prudential assessment (MPA)
 - Some financial institutions could forcefully scale back their balance sheets



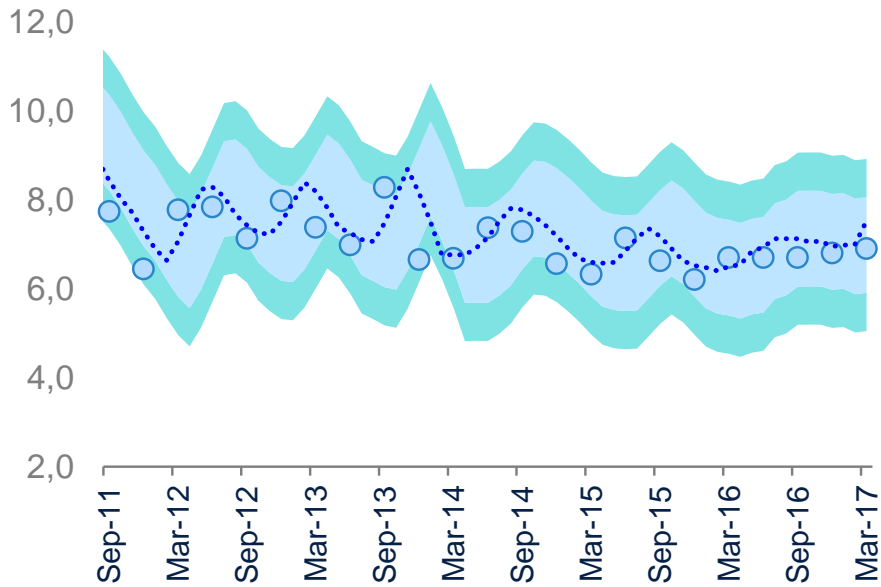
Economic conditions

Macro development, financial market and monetary policy



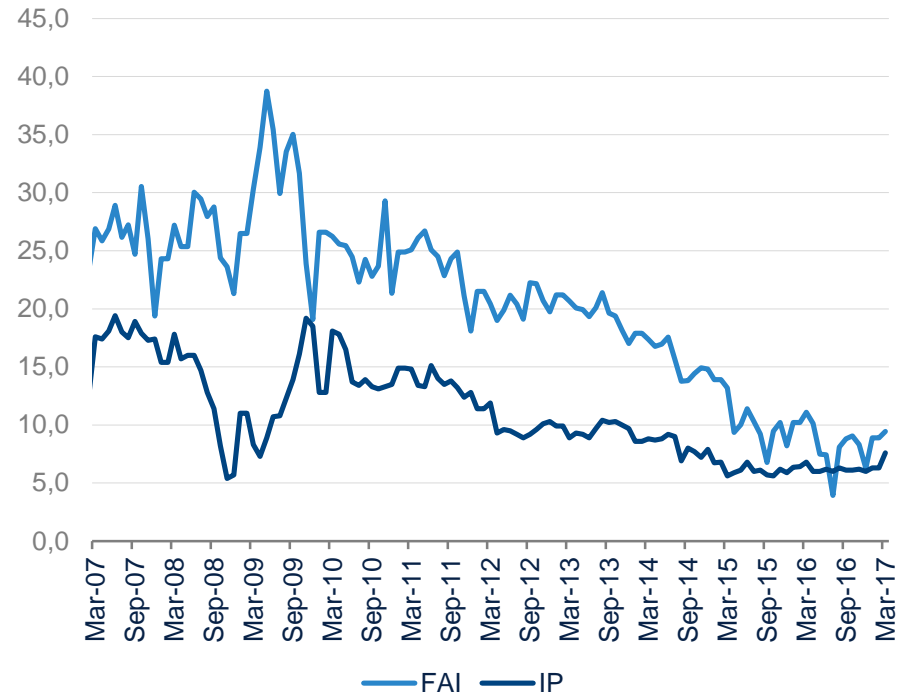
China's growth rebounded in Q1

BBVA MICA model for China's growth



Source: Wind and BBVA Research

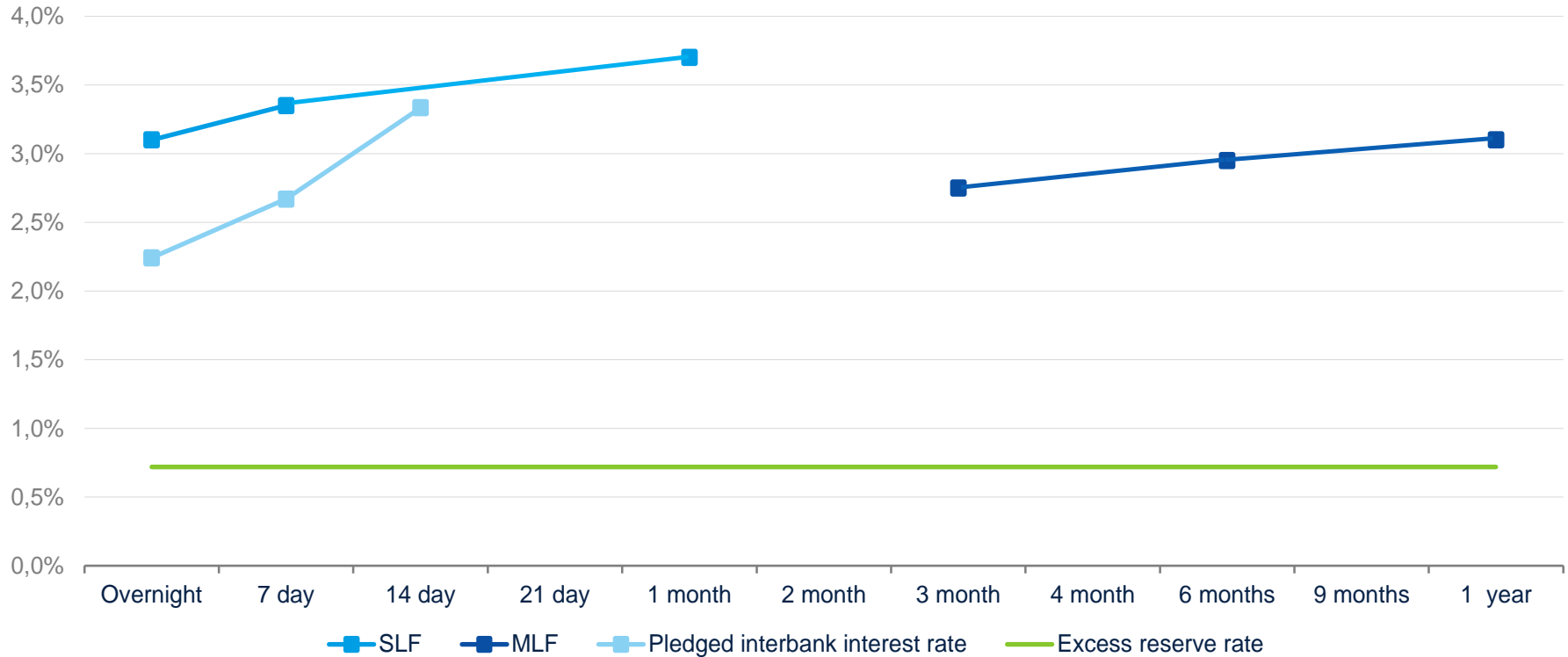
Fixed assets investment and Industrial Production



Source: Bloomberg and BBVA Research

China's economy gained momentum in Q1 2017 with a 6.9% GDP growth, the pickup was led by stronger industrial production and fixed asset investments.

New monetary policy framework takes shape

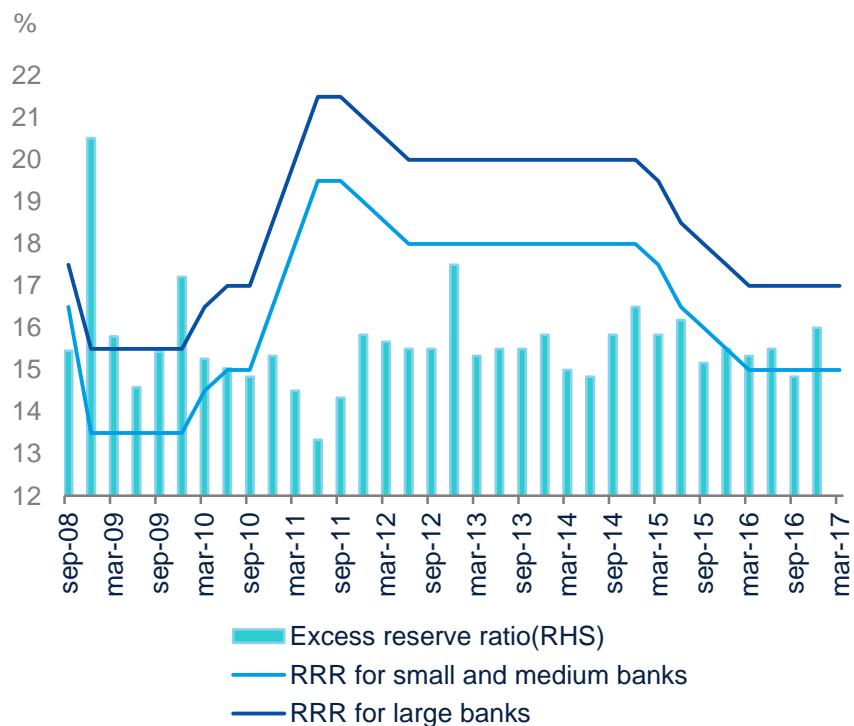


Source: CEIC and BBVA Research

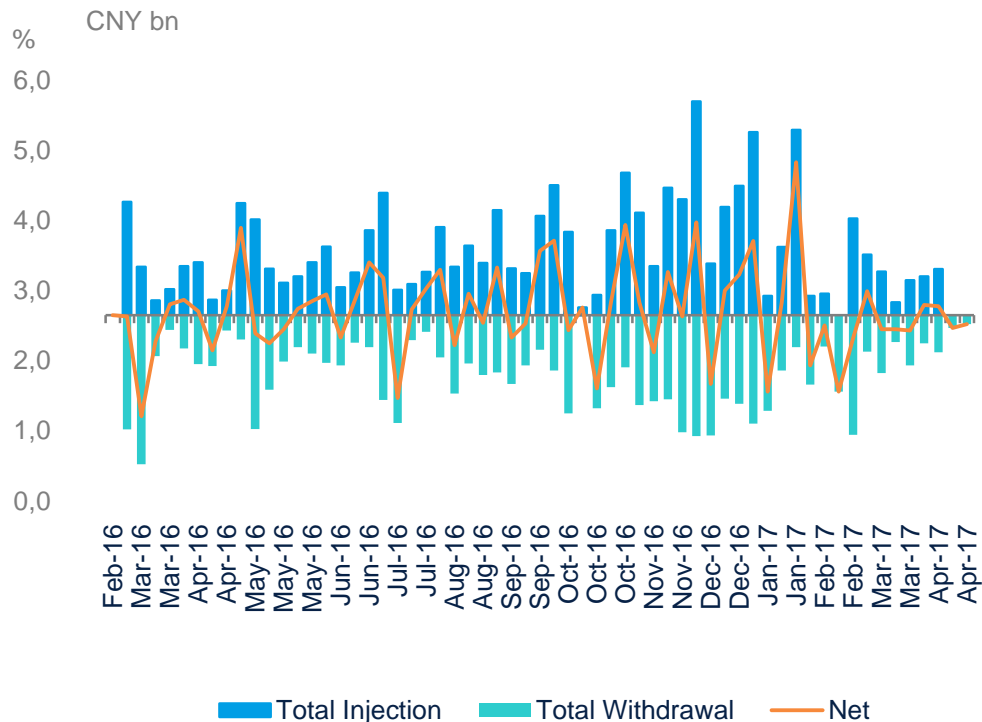
The PBOC is establishing a “corridor system” as its new monetary policy framework. The new policy target is the pledged 7-day interbank market rate while the rates of Standing Lending Facility (SLF) and excessive deposit reserves constitute the upper and lower bounds of the “corridor” respectively.

RRR is flat while OMO has been frequently used

Excess reserve ratio and RRR for banks



China PBoC Weekly Open Market Operations



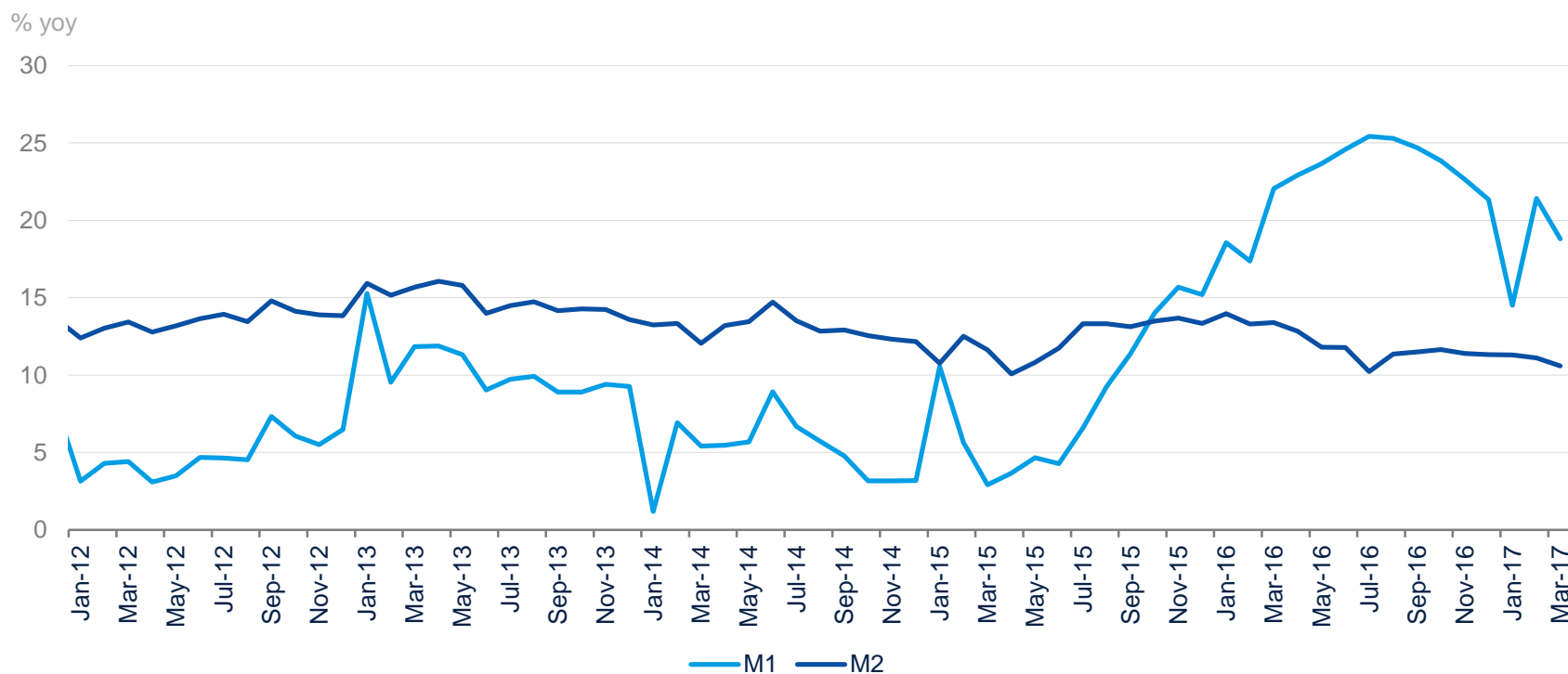
Source: CEIC and BBVA Research

Source: Bloomberg and BBVA Research

No traditional easing action after the RRR cut in 16Q1, the authorities used open monetary operation (OMO) to align the policy rate target with their desired level under the new monetary policy framework.

The gap between M1 and M2 has narrowed

Growth of M1 moderated in the last two quarters

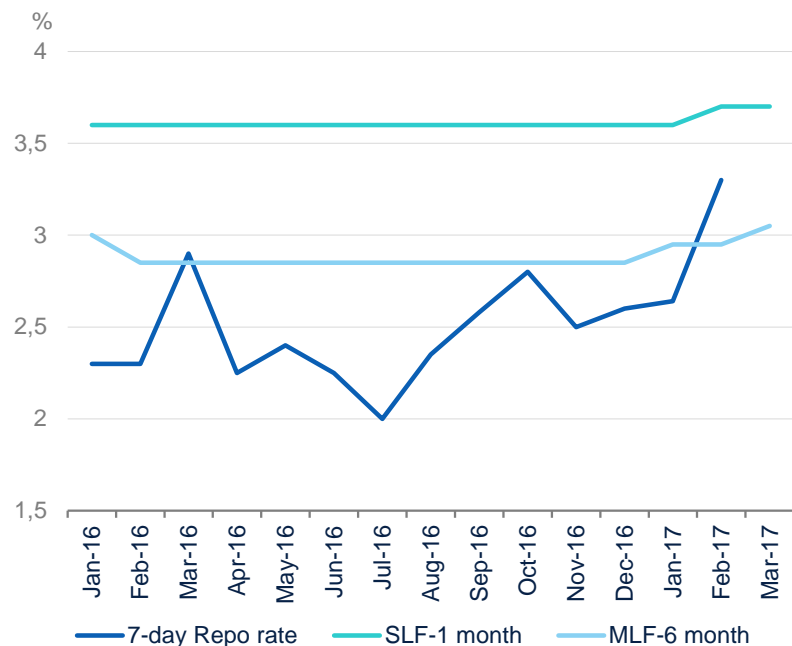


Source: CEIC and BBVA Research

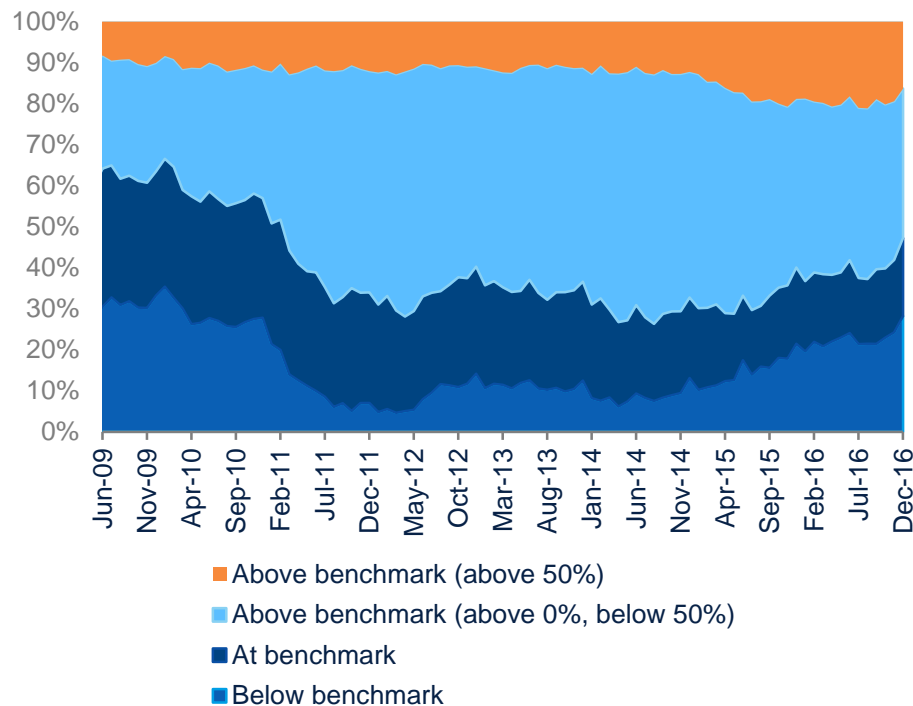
Growth of M1 and M2 crossed in the second half of 2015 as weak investment demand. M1 growth moderated at the end of 2016, reflecting combined impact of increasing regulatory scrutiny on the property market and WMPs as well as tighter liquidity conditions.

Financing costs modestly rise

Interbank Interest rate rocketed to a high level



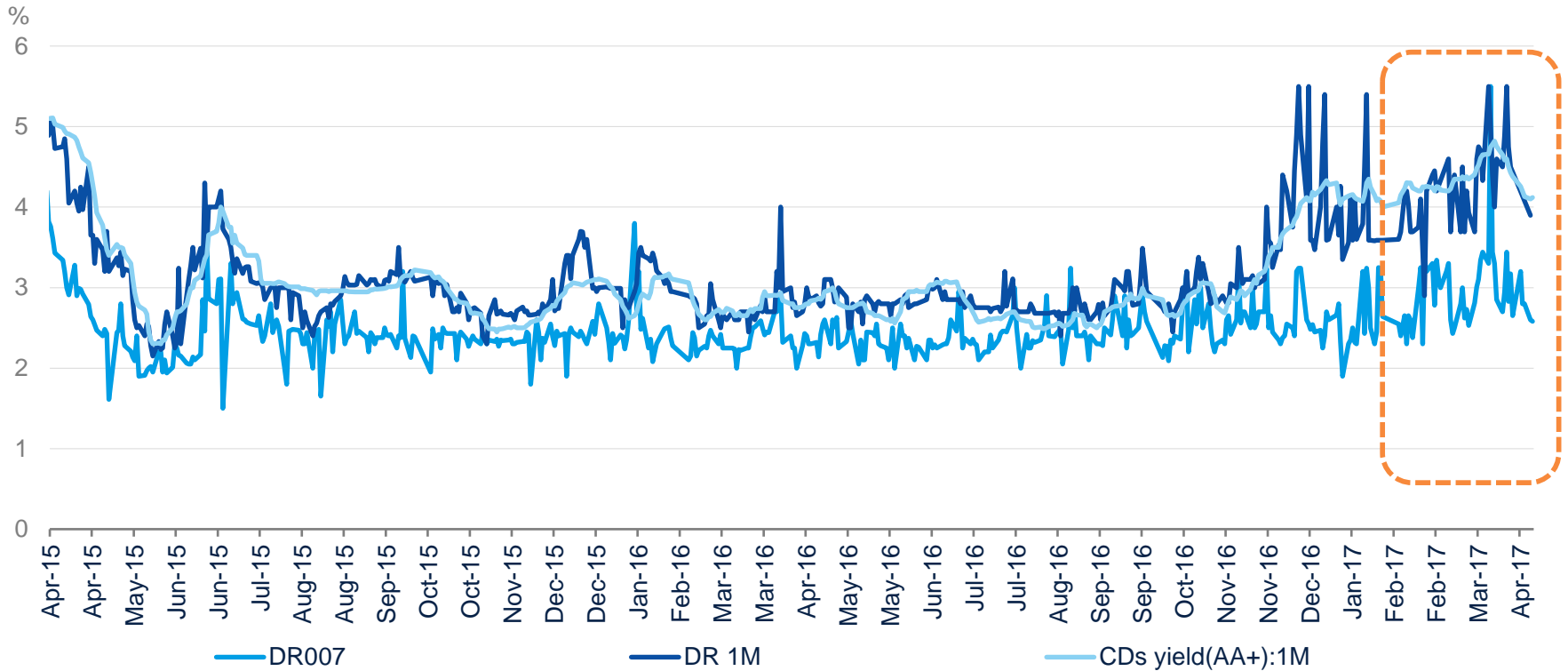
Bank Lending rates



Source: CEIC and BBVA Research

Since Q4 2016 the authorities have deliberately guided the interbank market rates to a higher level so as to stem capital outflows and curb shadow banking activities.

Liquidity squeeze is back in money market...

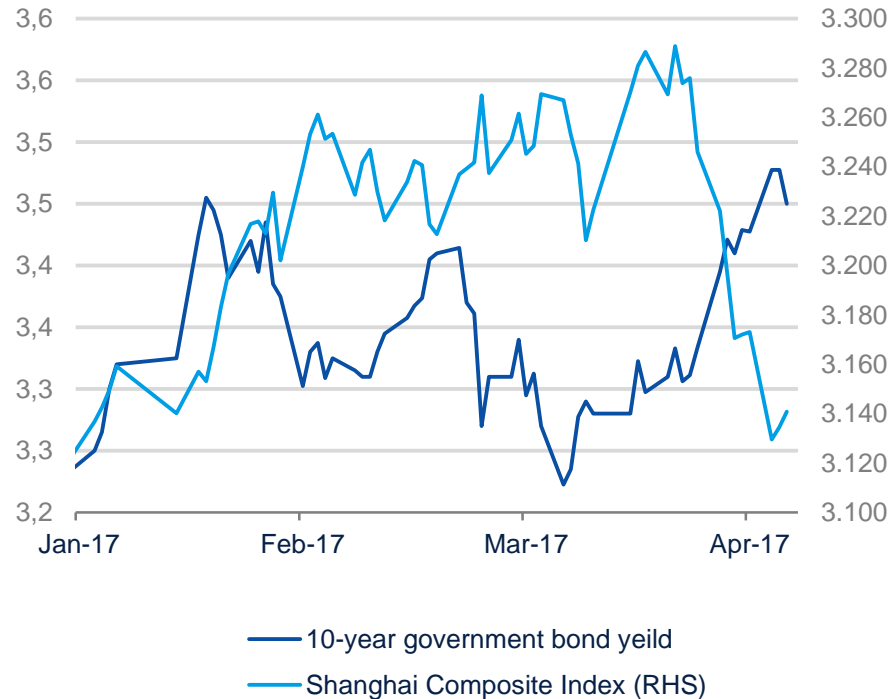


Source: Wind and BBVA Research

The combination of prudent monetary policy and tight regulations have sent interbank interest rates to high levels.

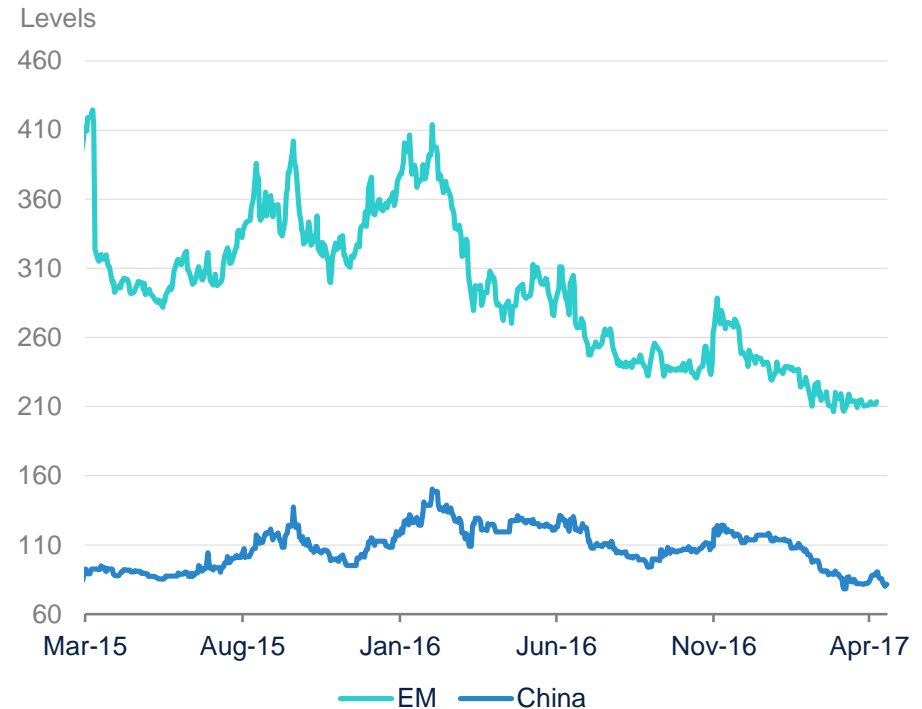
...while bond and stock market under stress

Financial tension rises



Source: CEIC and BBVA Research

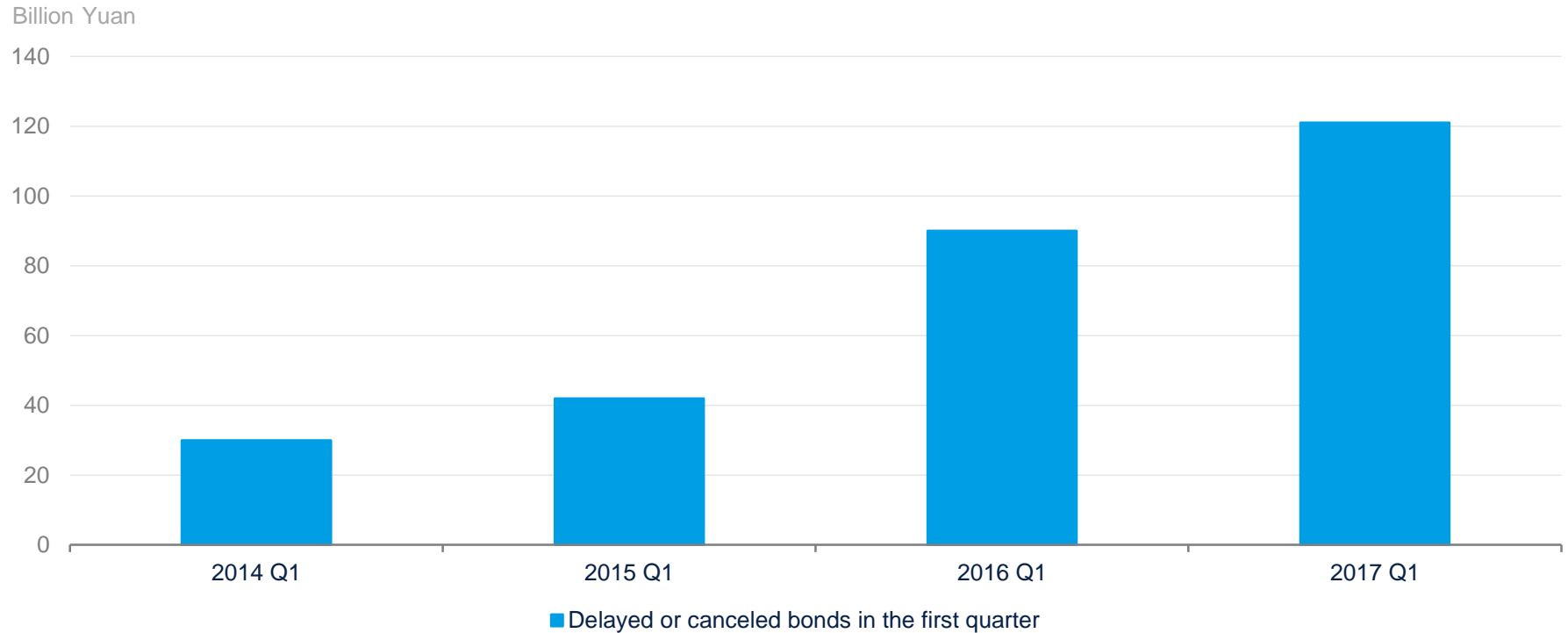
Sovereign CDS Indices



Source: Bloomberg and BBVA Research

China's bond and stock markets are under stress from stepped-up tightening regulations. Both China's CDS spread and Emerging market CDS has seen a downward trend since the start of this year.

Corporate bonds damped by rising funding costs

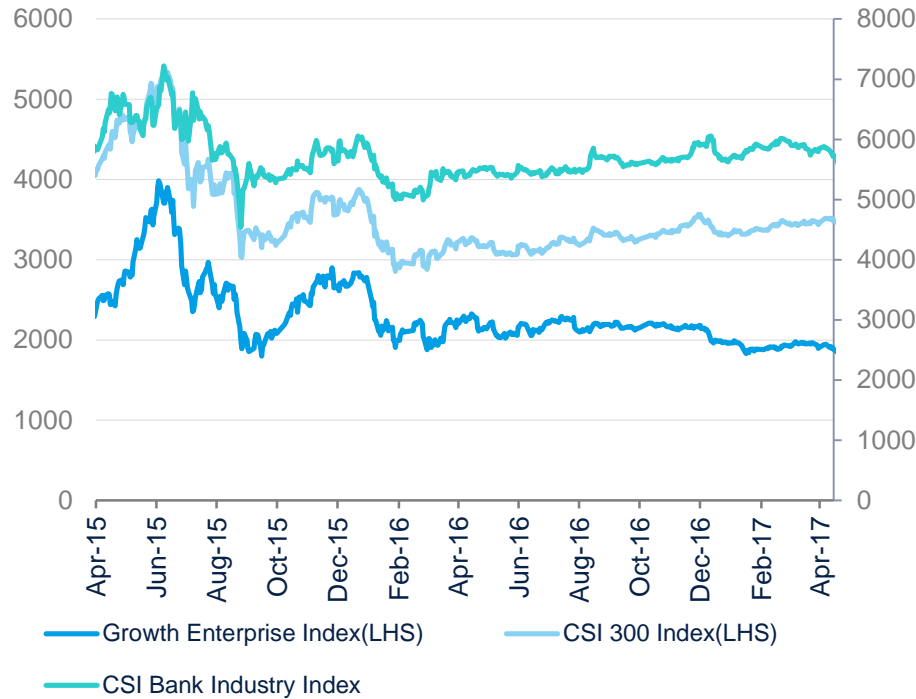


Source: Wind and BBVA Research

Banks which act as the biggest holders of Chinese bonds are trying to run down their their bondholding for liquidity, which has frozen corporate bond issuance in Q1.

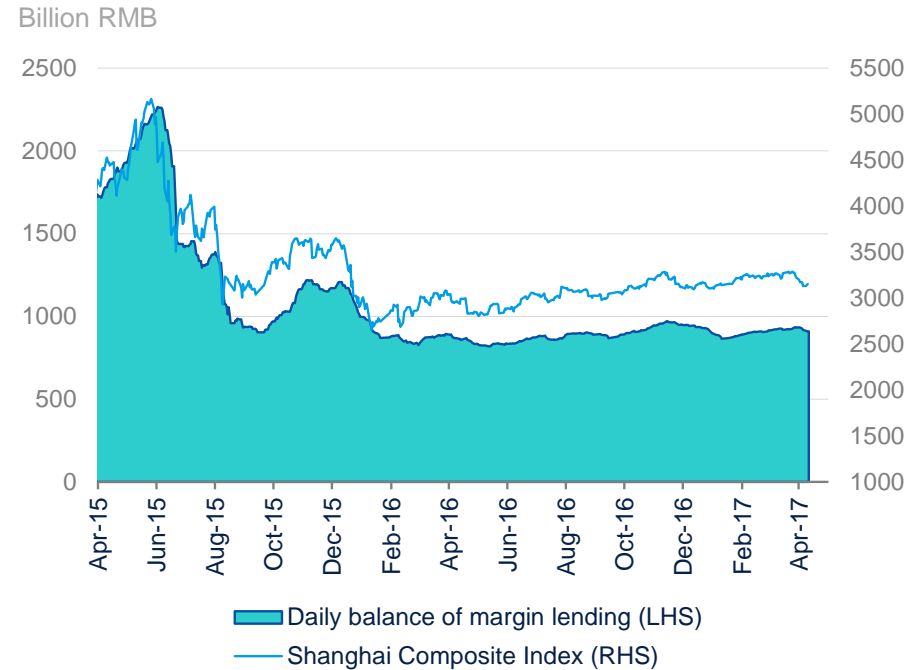
Stock market has been flat

CSI 300 and growth enterprise indexes



Source: Wind and BBVA Research

Margin lending in China

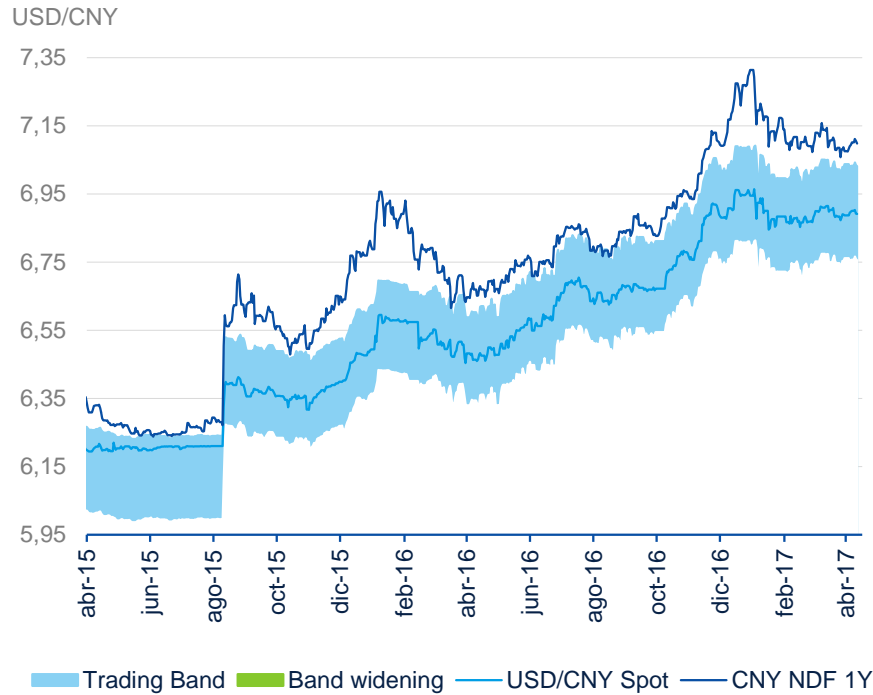


Source: Wind and BBVA Research

Stock market has seen a mild correction since the start of the year. Margin lending in the market remain flat.

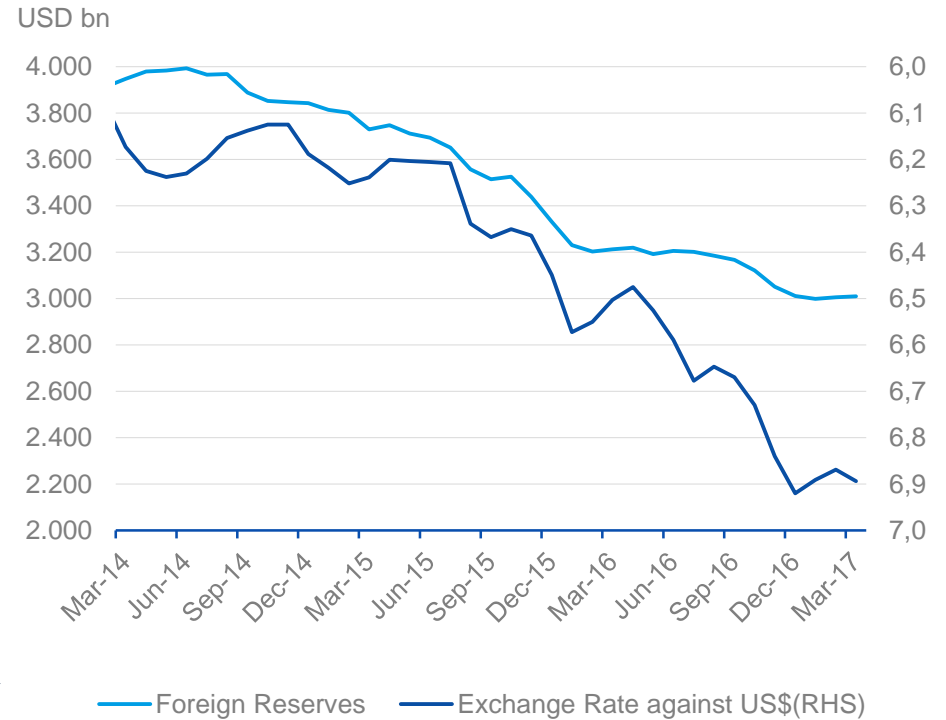
RMB stabilized but downward pressure remains

RMB exchange rate reached historical low



Source: CEIC and BBVA Research

Foreign reserves have been decreasing recently



Source: CEIC and BBVA Research

RMB exchange rate depreciated toward 7.0 at end-2016 but have rebounded somewhat thereafter due to the improved external environment. Foreign reserves have stabilized in February-March.

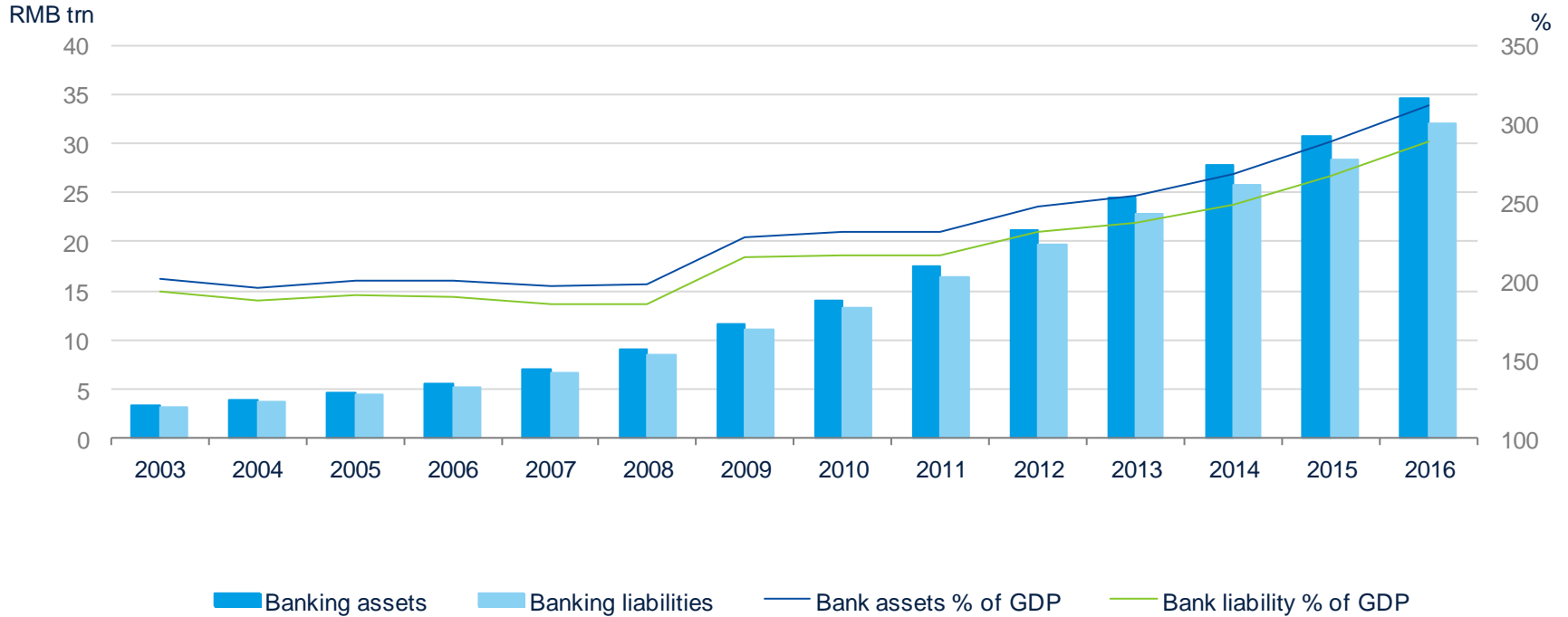
Banking Performance

Loan growth, asset quality,
profitability indicators



Banking assets grew steadily with increasing reliance on wholesale funding...

Total bank assets

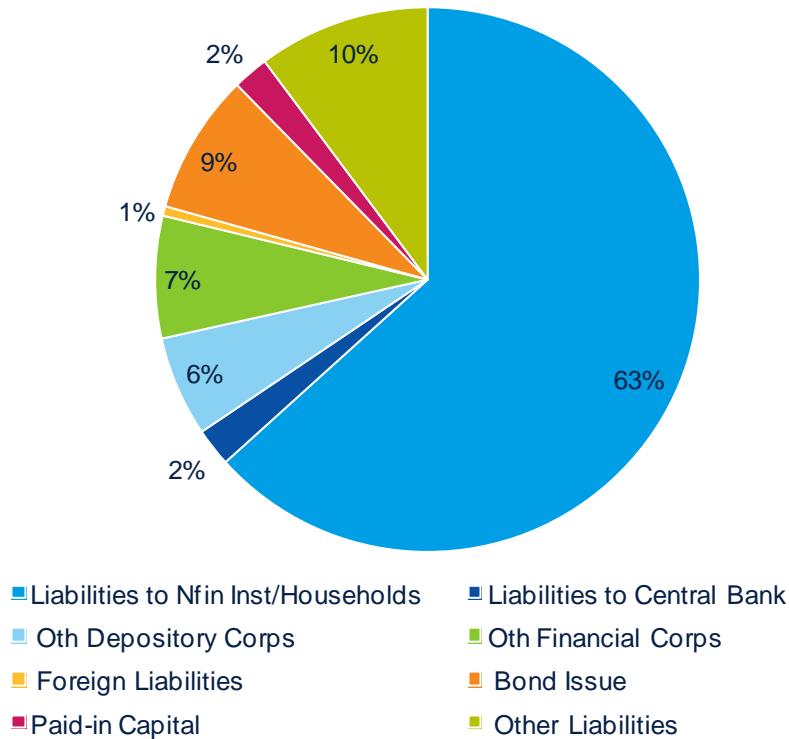


Source: CEIC and BBVA Research

Total assets of the banking sector grew steadily by the end of 2016. Banks' reliance on wholesale funding has increasing steadily.

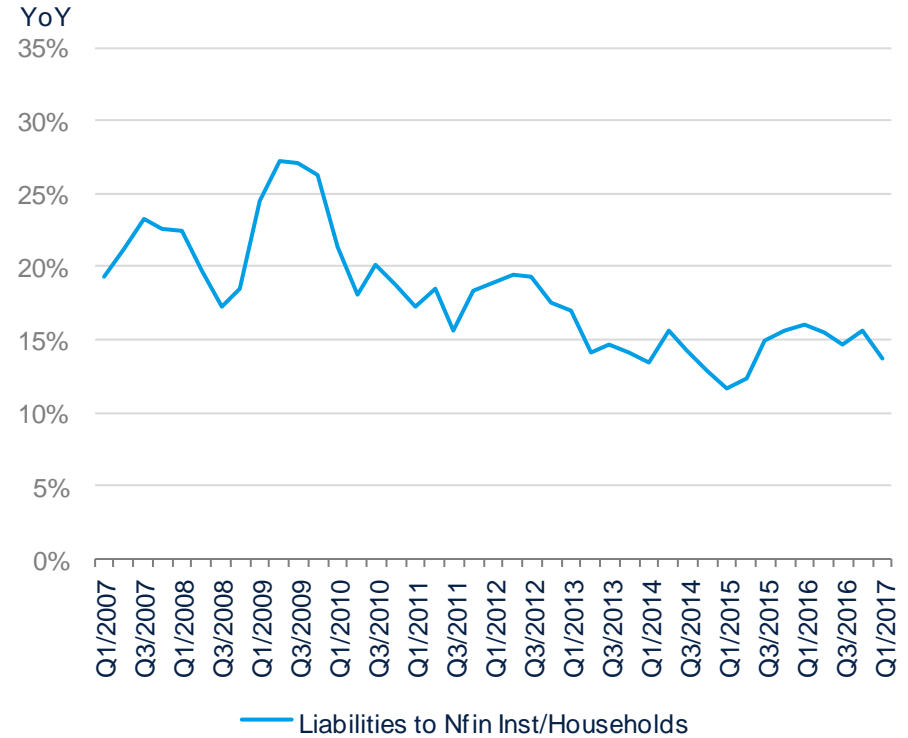
...but main fund sources remain to be deposits from households and firms

Breakdown of banks liabilities(16'Q3)



Source: Haver and BBVA Research

Growth rate of liabilities to Nfin Inst/households

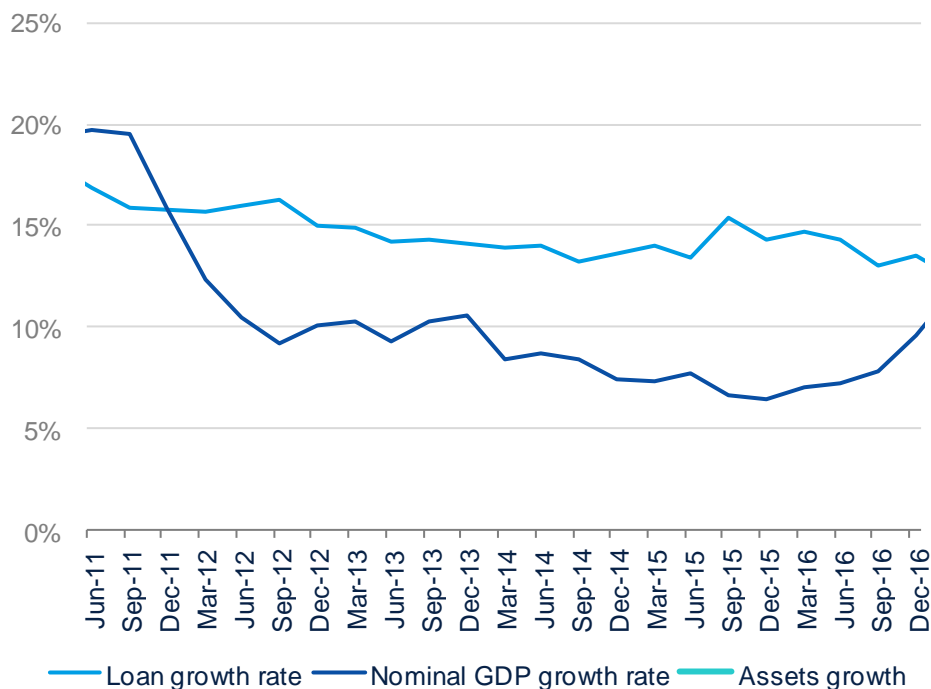


Source: CEIC and BBVA Research

The bulk of bank funding is nonfinancial institutions and households.

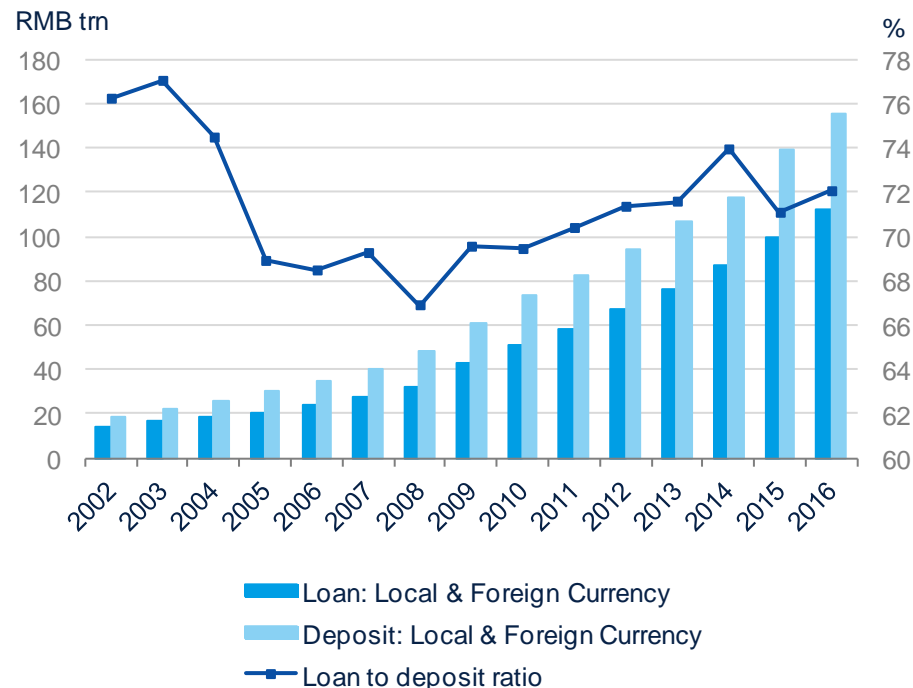
Loans grew faster than nominal GDP while below the pace of bank asset expansion

Loan growth still outpaces nominal GDP



Source: CEIC and BBVA Research

Loan to deposit ratio remains stable

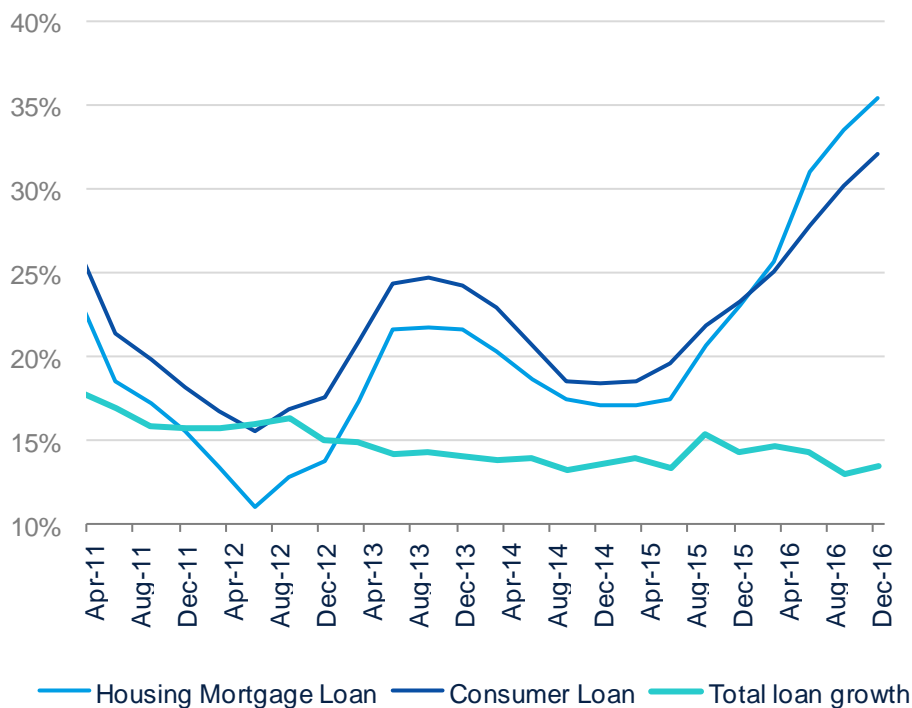


Source: CEIC and BBVA Research

Loan growth still outpaces nominal GDP while Loan-to-Deposit ratio remains stable. Moreover, loans growth rate has been below the pace of bank asset expansion, due to banks' active participation in off-balance-sheet businesses and shadow banking activities. *(More about shadow banking is in next section)*

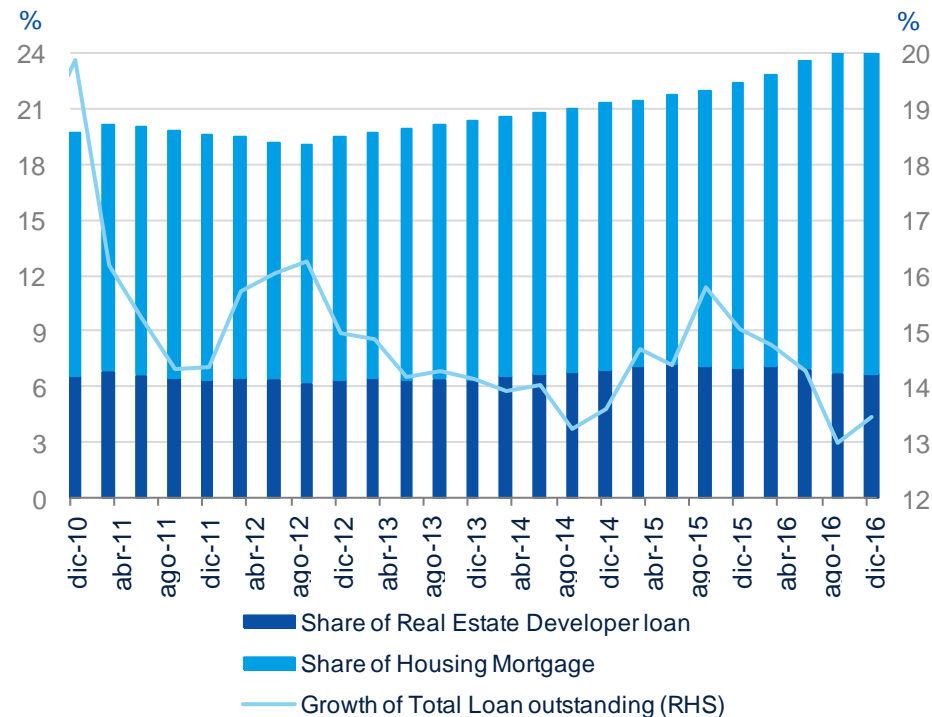
Loan growth underpinned by property-market related lendings

Growth of housing mortgage loan



Source: CEIC and BBVA Research

Total loans related to real estate sector

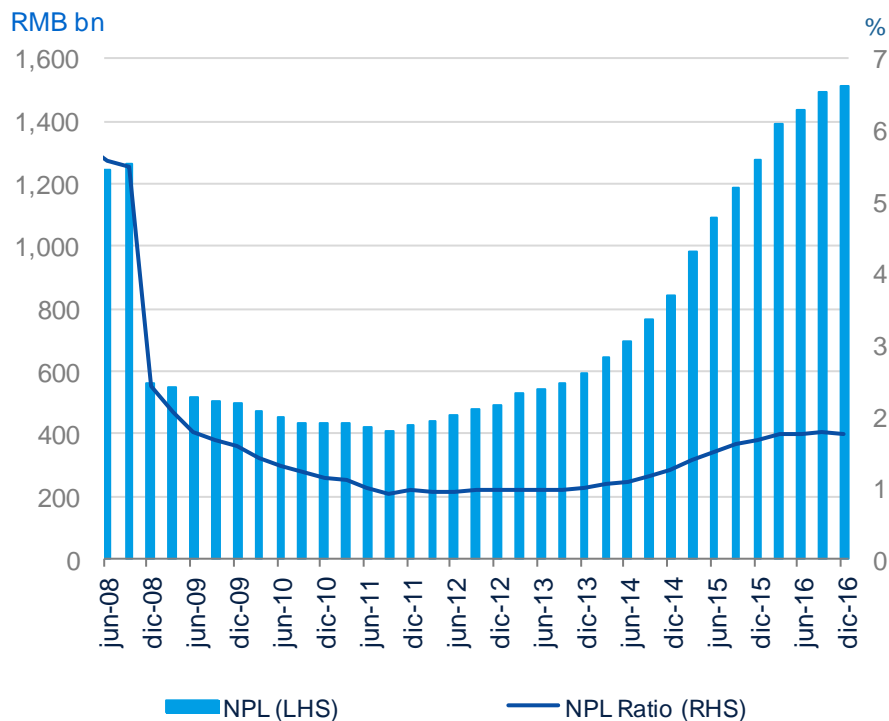


Source: CEIC and BBVA Research

Mortgage loans have continued to contribute a rising share of banking loan, by the end of 2016 mortgage loans hit RMB 19.57 tn, a yoy increase of 35.40%.

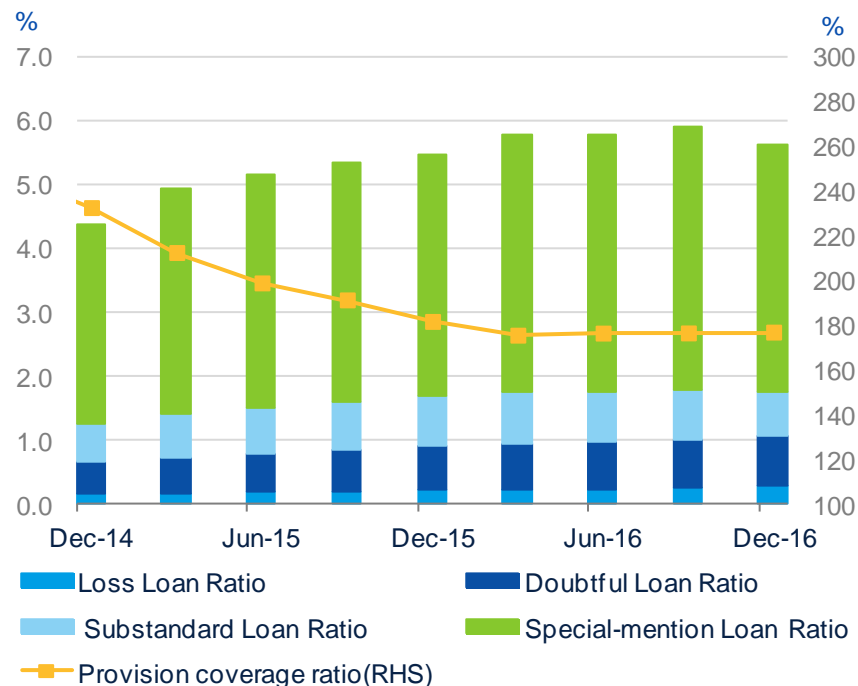
Deteriorating trend in asset quality comes to a halt...

NPLs value and ratio for banking industry



Source: CEIC and BBVA Research

NPL by classification and NPL provision

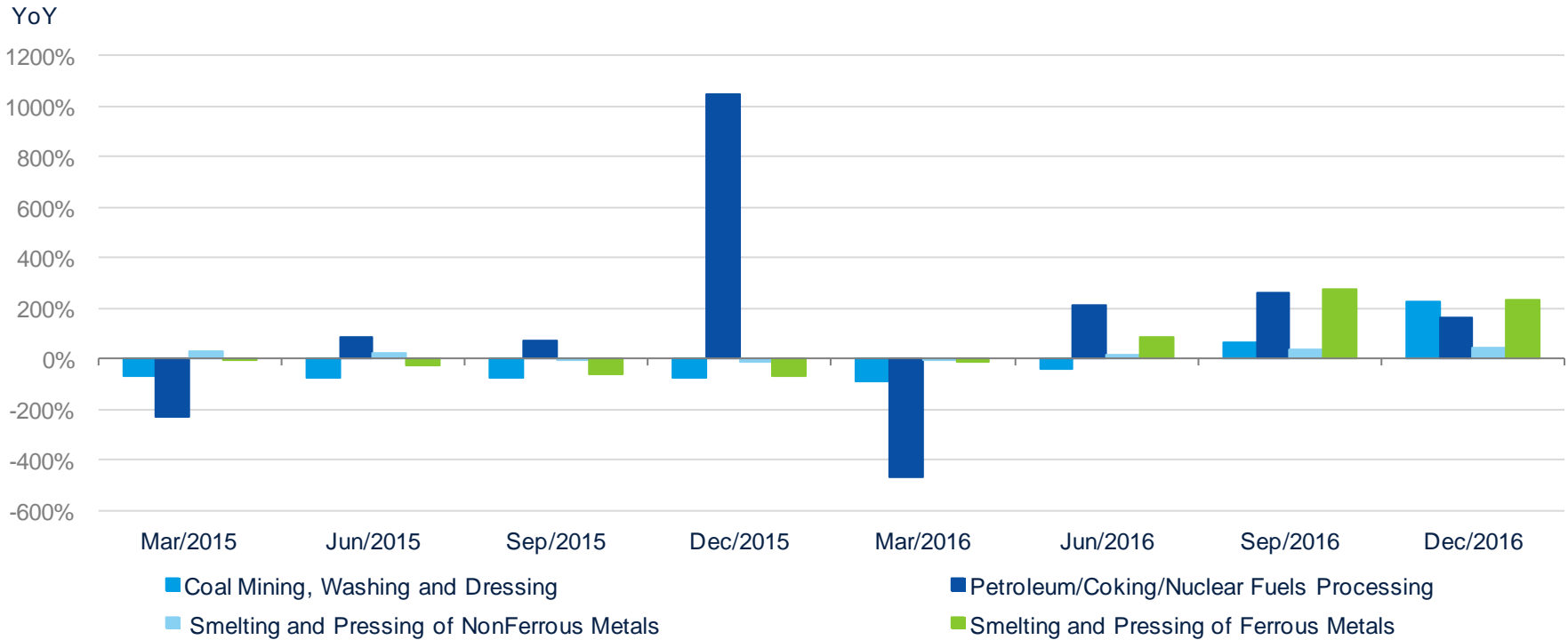


Source: CEIC and BBVA Research

NPLs continue to rise, totaling 1.51 trn RMB as end of 2016, an increase of 18.7% compared to end-2015. Both non-performing loans (NPLs) and a broad measure of NPLs including special mentioned loan ratio registered a quarter-on-quarter decline in Q4 2016, the first time since 2012.

...as profitability in certain upstream industries have improved significantly

Profit growth of some upstream industries

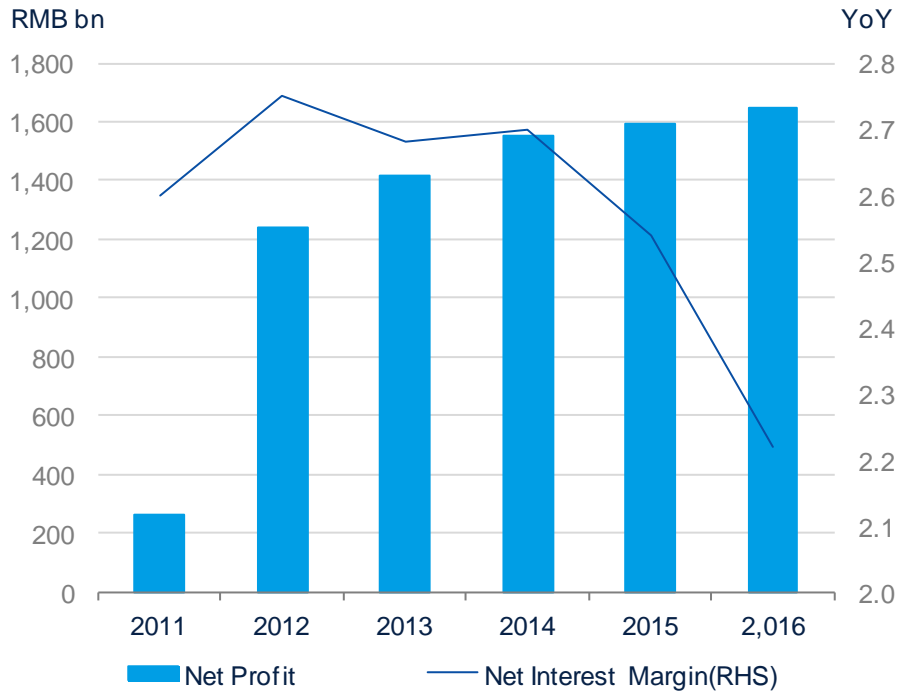


Source: Haver and BBVA Research

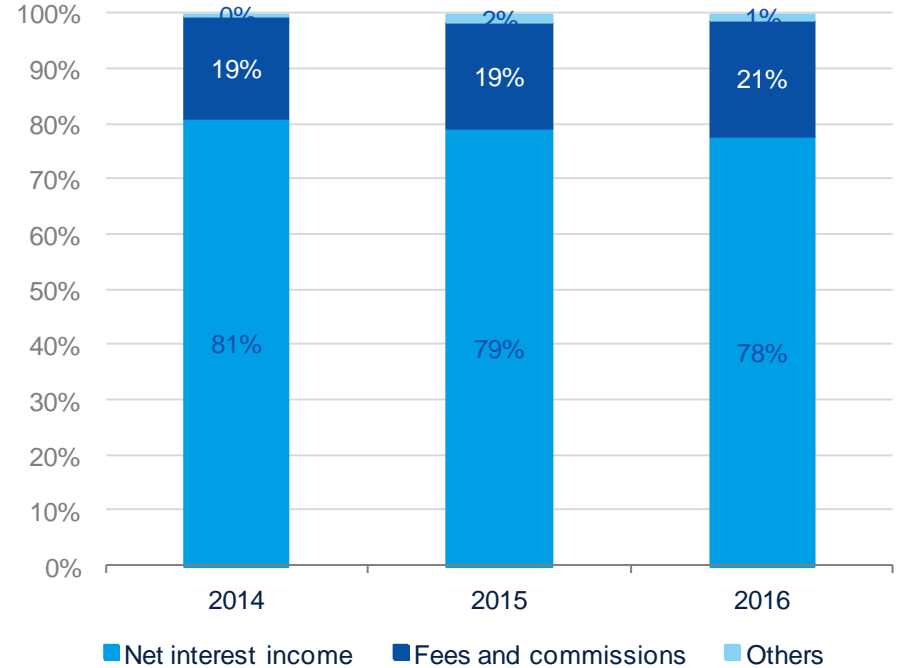
The improvement of NPL ratio is partially due to the recovery of upstream industries (e.g. coal mining, petroleum processing and smelting and pressing of ferrous/nonferrous metals) as well as the debt-equity swap and asset backed security scheme started last year.

Net profit growth remained weak

Net income and Net interest Margin (NIM)



Revenue composition



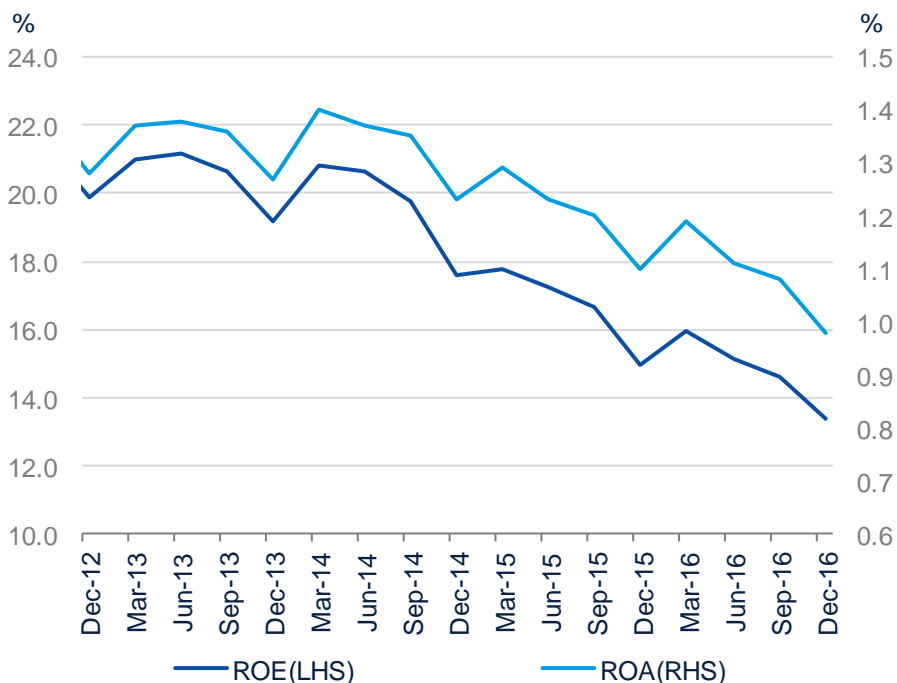
Source: CEIC and BBVA Research

*Others including investment income
Source: CBRC and BBVA Research

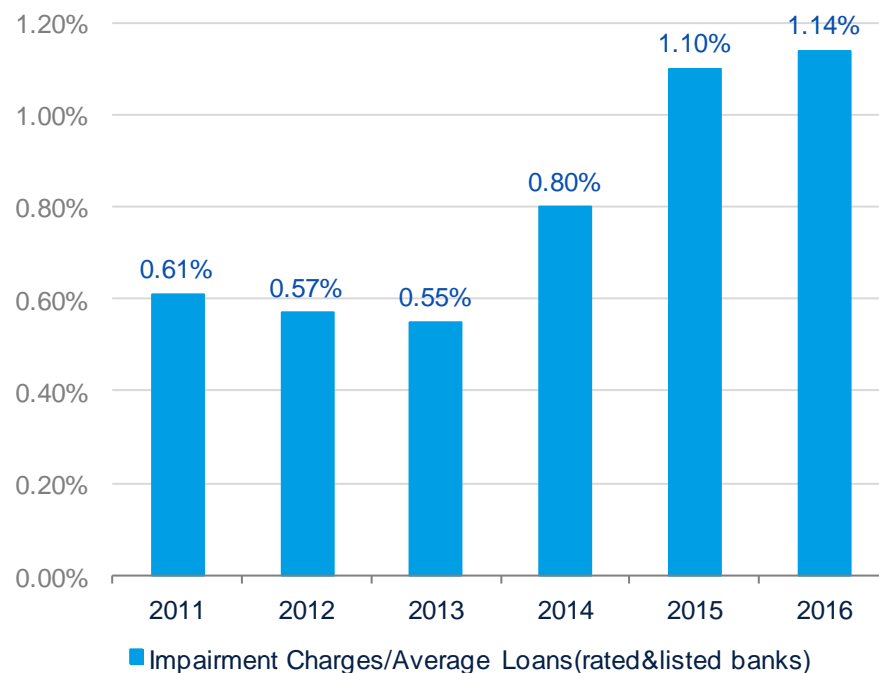
The persistently fast narrowing of NIMs weighed on net interest rate income, forcing banks to pursue investment income by participating in some shadow banking activities such as WMP.

Profitability indicators continued declining

ROE and ROA



Rising impairment charges



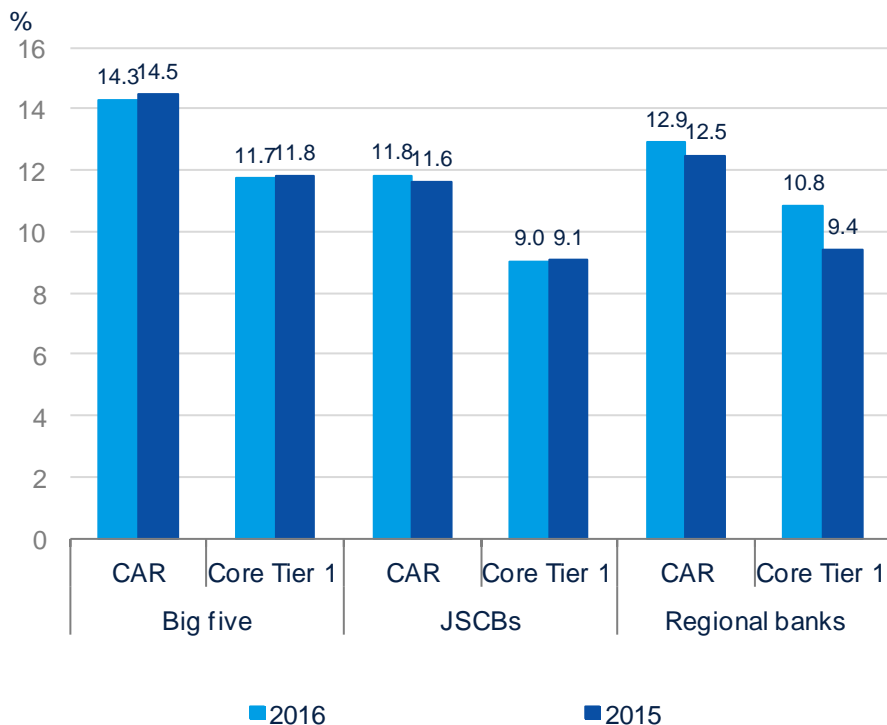
Source: CEIC and BBVA Research

Source: CBRC, Company data(12 rated and listed banks) and BBVA Research

Both the return on equity (ROE) and return on assets (ROA) continue decreasing in the end of 2016 due to the slowing net profit growth, further narrowing net interest margin and higher loan impairment charges.

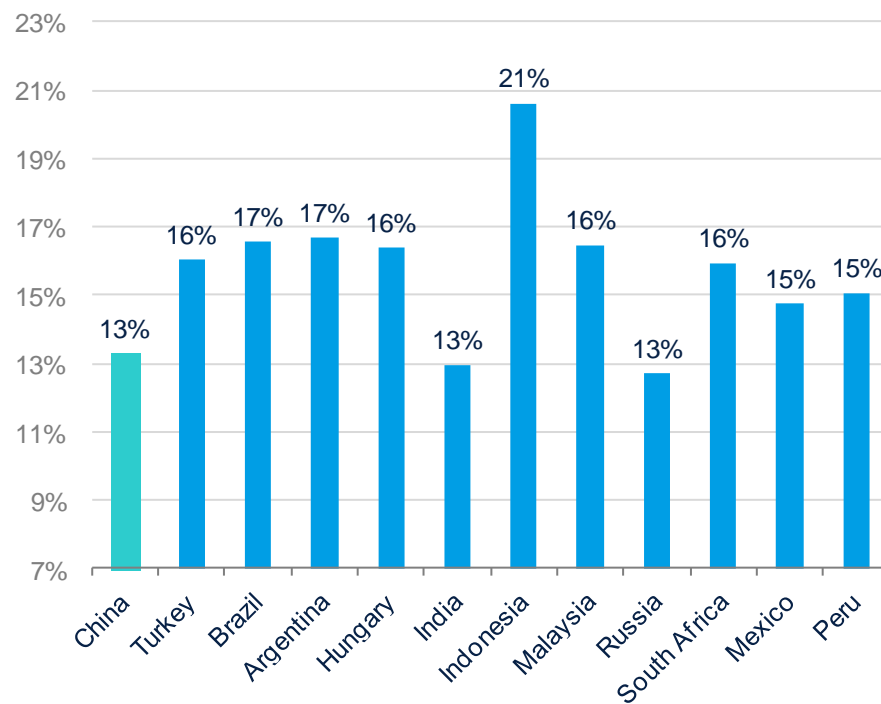
Capital buffers remain stable but still below the level of many emerging-market peers

CAR and Core Tier 1 Capital Ratio



Source: CEIC and BBVA Research

EM Capital Adequacy Ratios(Q4'16)



Source: Haver and BBVA Research
 Turkey, Brazil, Russia and Mexico are based on Q3 2016 data due to data available

Both CAR and core Tier 1 capital ratios are above the mandatory ratios, but is still on the lower side among their major EMs peers. Banks are under pressure to raise new capital if maintaining the current pace of balance sheet expansion.

Shadow banking

Total social financing, WMPs,
trust and peer to peer lending

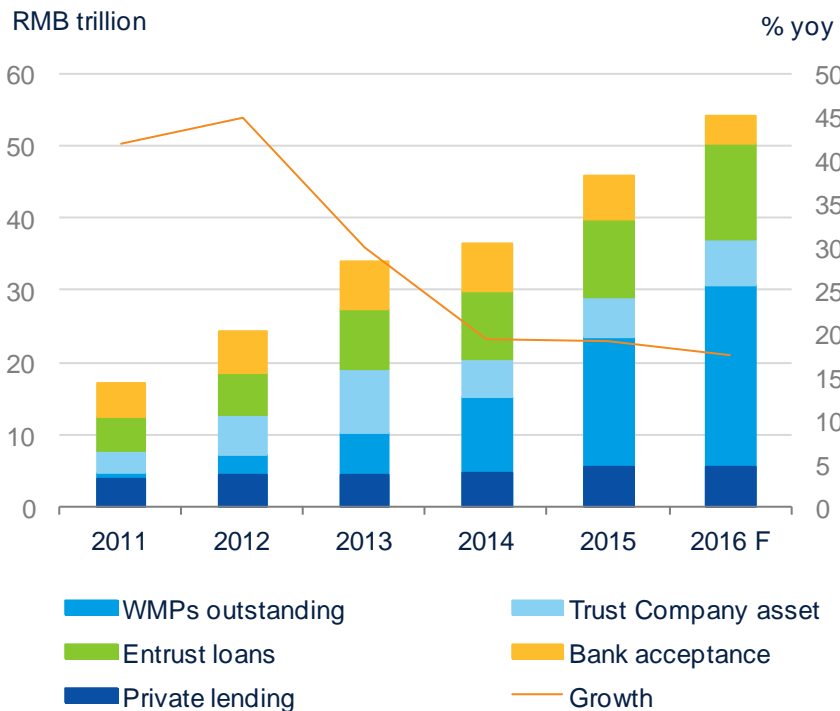


banking

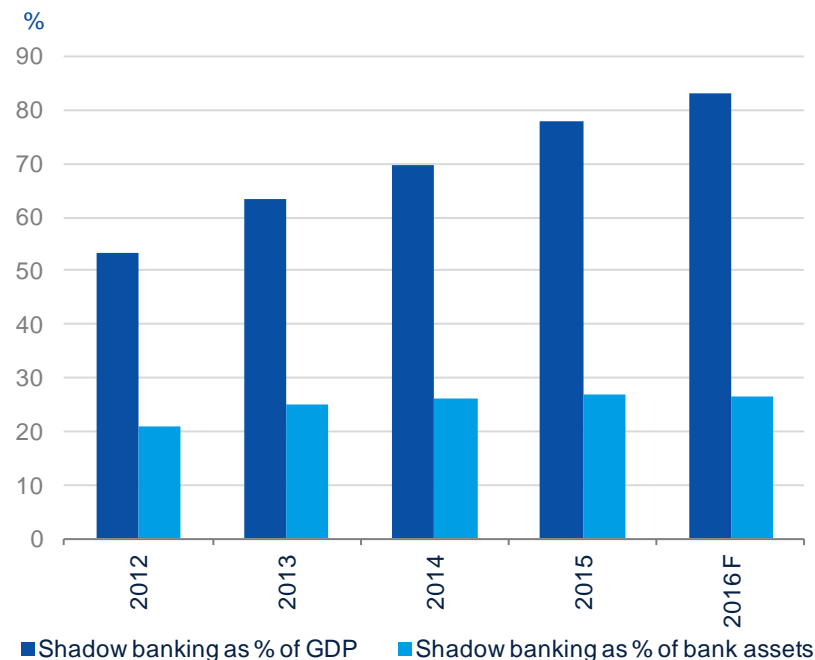
industry

Momentum of shadow banking growth continued in 2016...

Shadow banking activities have risen



Shadow banking account for GDP and banking assets



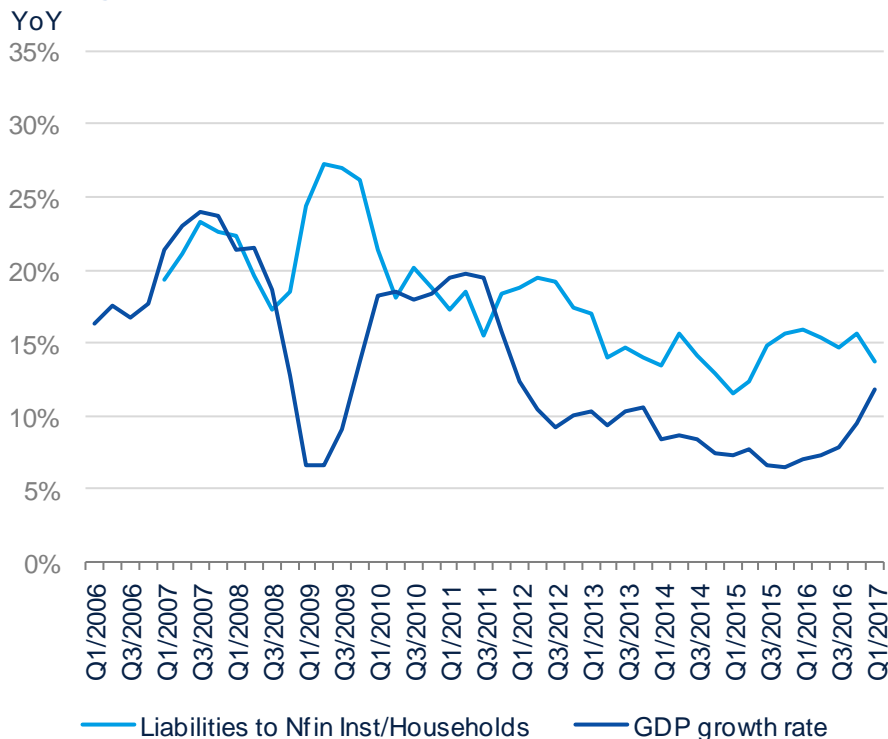
Source: CEIC, PBoC and BBVA Research

Source: CEIC, National Bureau of Statistics and BBVA Research

The size of shadow banking has grown rapidly in recent years, it is expected to reach 83% of GDP and 27% of total banking by the end of 2016. It amplifies spillover risks to the financial system given its interconnectedness with formal banking, which calls for a more prudential supervision.

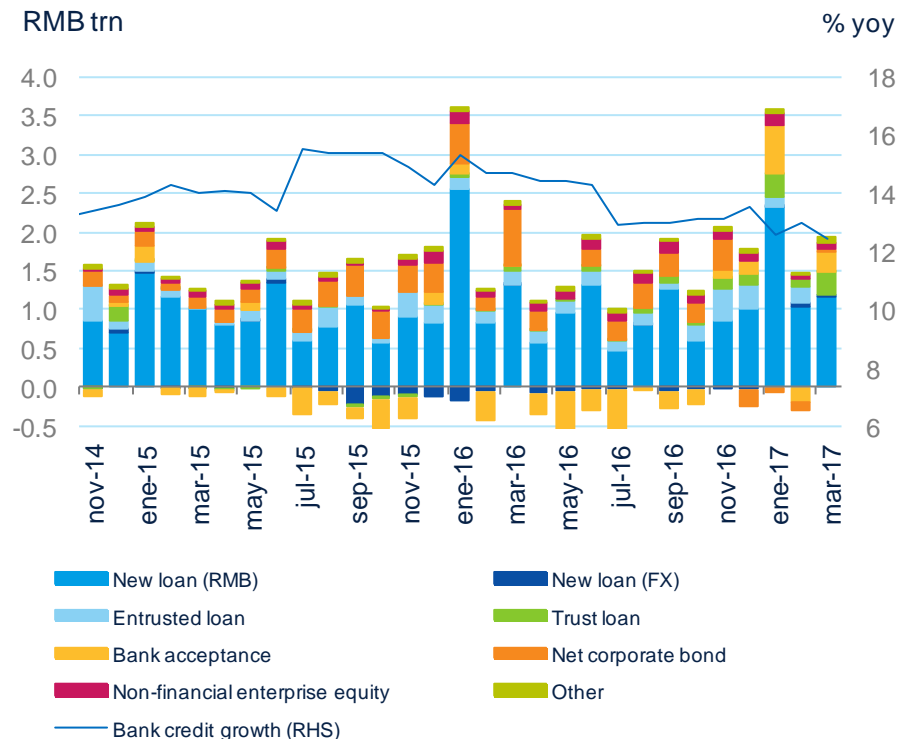
...although total social financing has slowed in Q1

Claims on nonfinancial institutions outpacing GDP growth rate



Source: CEIC, Haver and BBVA Research

Total social financing less relies on loans

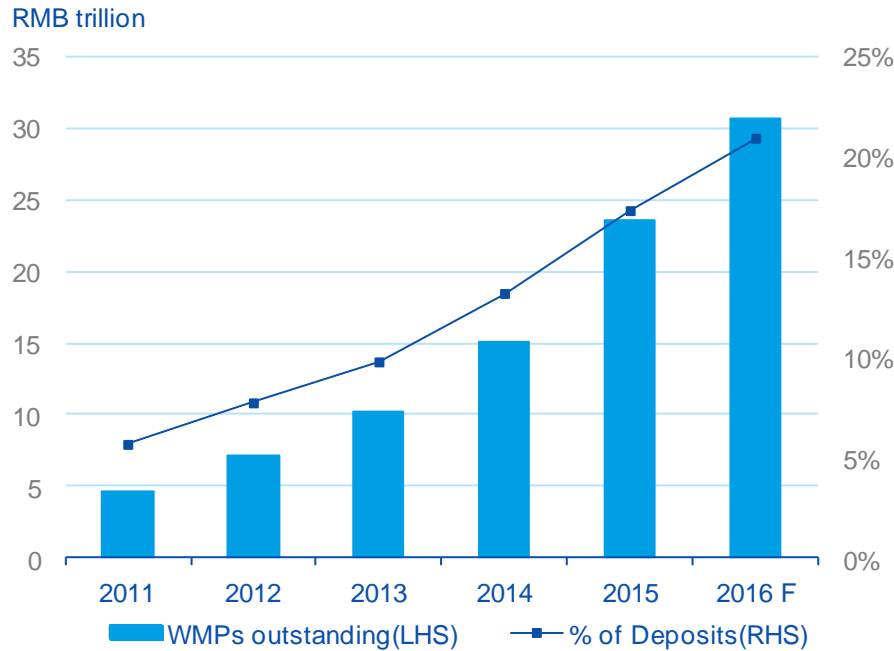


Source: CEIC and BBVA Research

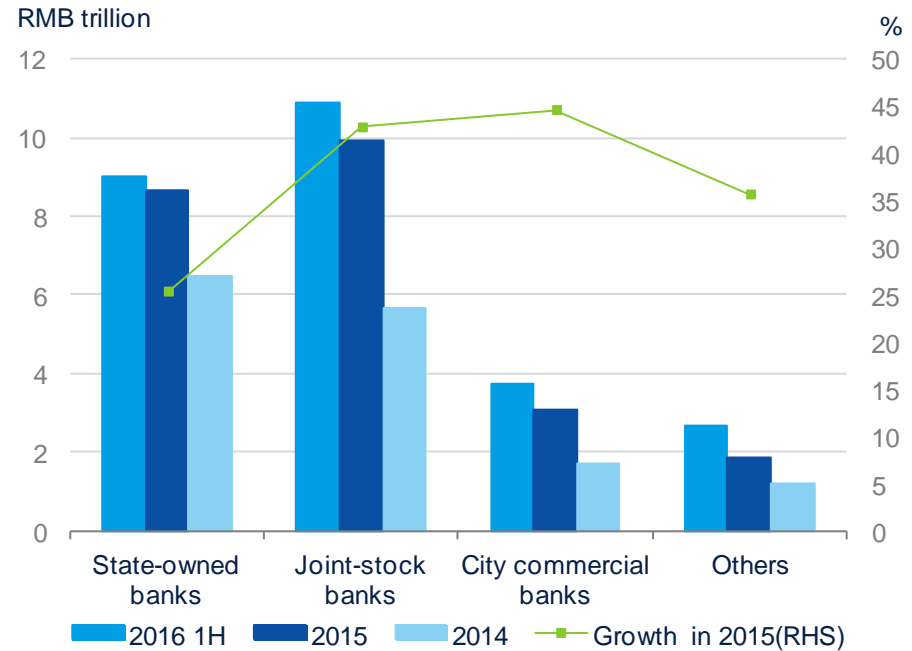
The authorities fine-tuned their monetary policy stance at end-2016 from accommodative to prudent. The effects of policy tuning started to emerge in the first quarter as both credit growth and money supply slowed significantly.

WMPs become the primary concern of the authorities and incurred strict regulations

WMP outstanding scale



WMPs issuing by commercial banks



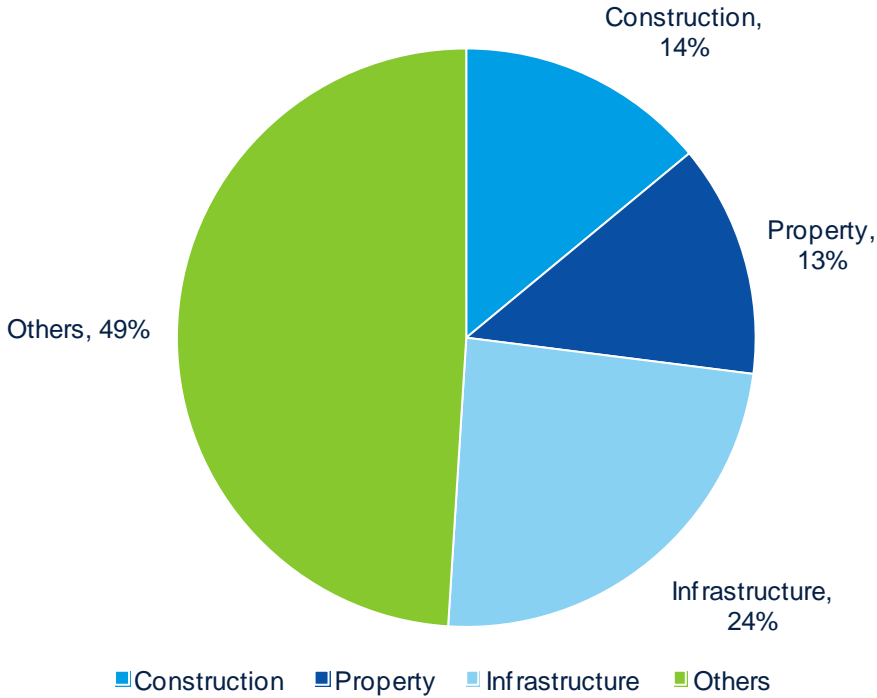
Source: WMP registration and custodian centre and BBVA Research

Source: China Banking Wealth Management Registration System and BBVA Research

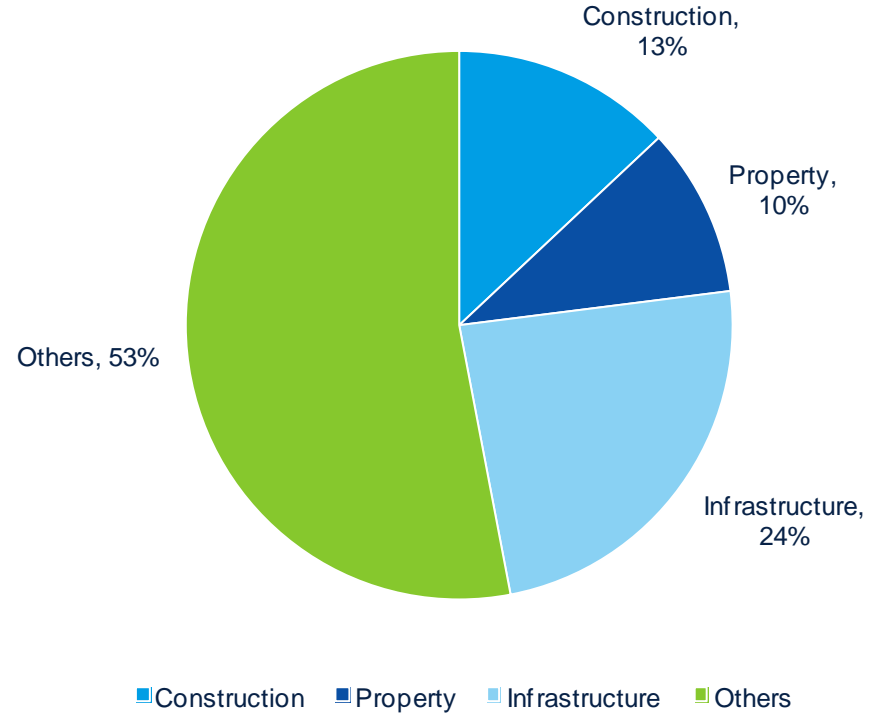
The issuance of wealth management products-WMPs are expected to reach 30.6 trillion in the end of 2016-equal to about 20% of deposit. Joint stock banks and city commercial banks are active in issuing WMPs.

WMPs' exposure to property and construction sector increased

WMPs by underlying assets-End of 1H 2016



WMPs by underlying assets-End of 2014



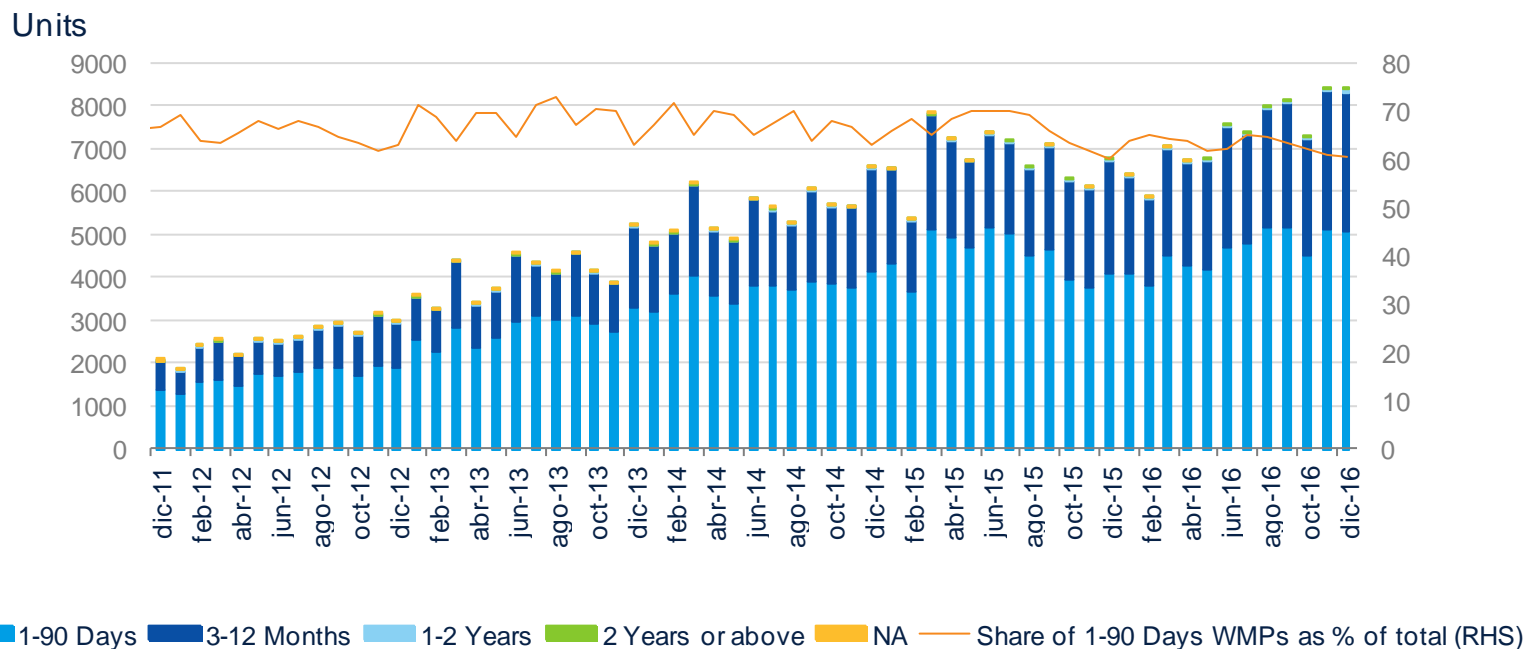
Source: China Banking Wealth Management Registration System and BBVA Research

Source: China Banking Wealth Management Registration System and BBVA Research

The share of WMP assets invested in the property and construction sectors increased in H1 2016, and we expect this trend to have continued during H2 2016.

Liquidity mismatch risk in WMPs remains high

Maturities of newly issued WMPs

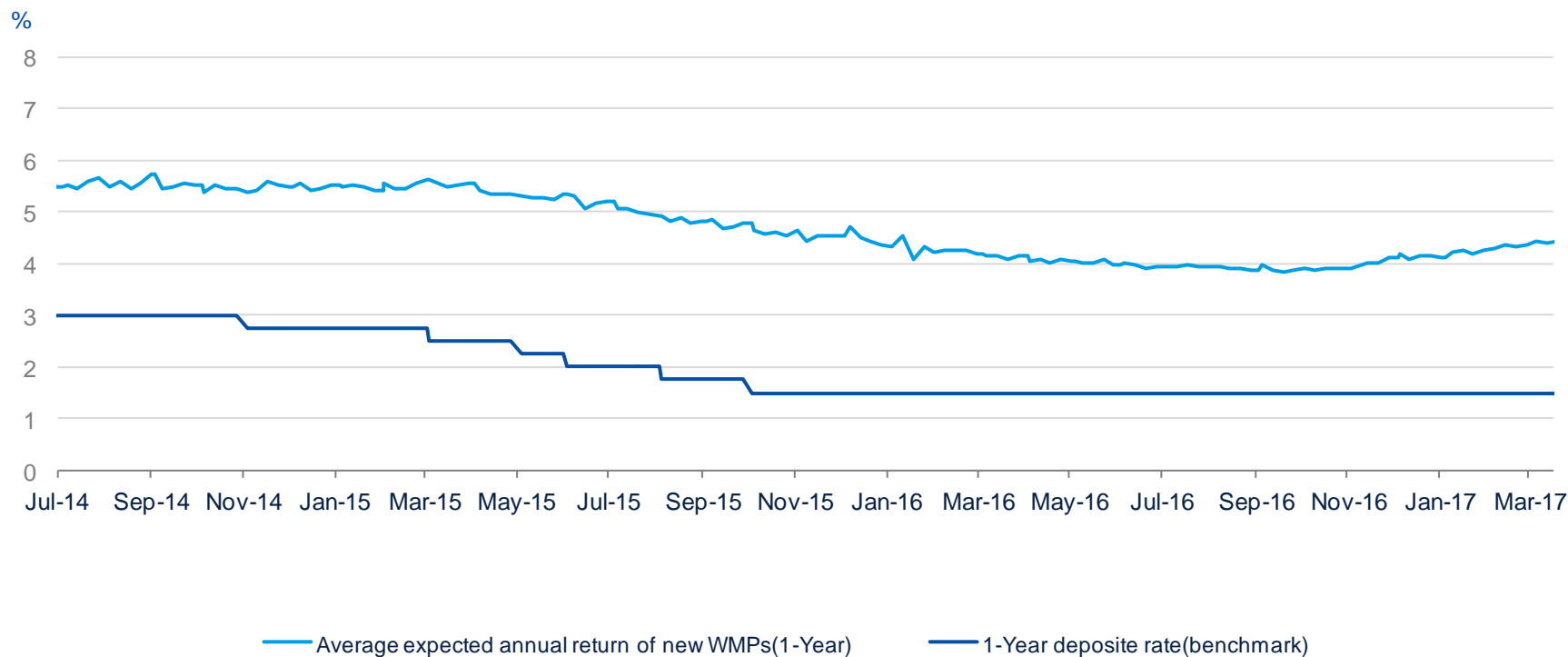


Source: Wind, and BBVA Research

The proportion of short maturity WMPs (1-3 months) issued remains the largest part, the maturity mismatch with their underlying assets may lead to potential liquidity risk.

Yields offered by WMPs recently picked up in step with other market interest rates

Annualized yield rate of newly issued WMPs



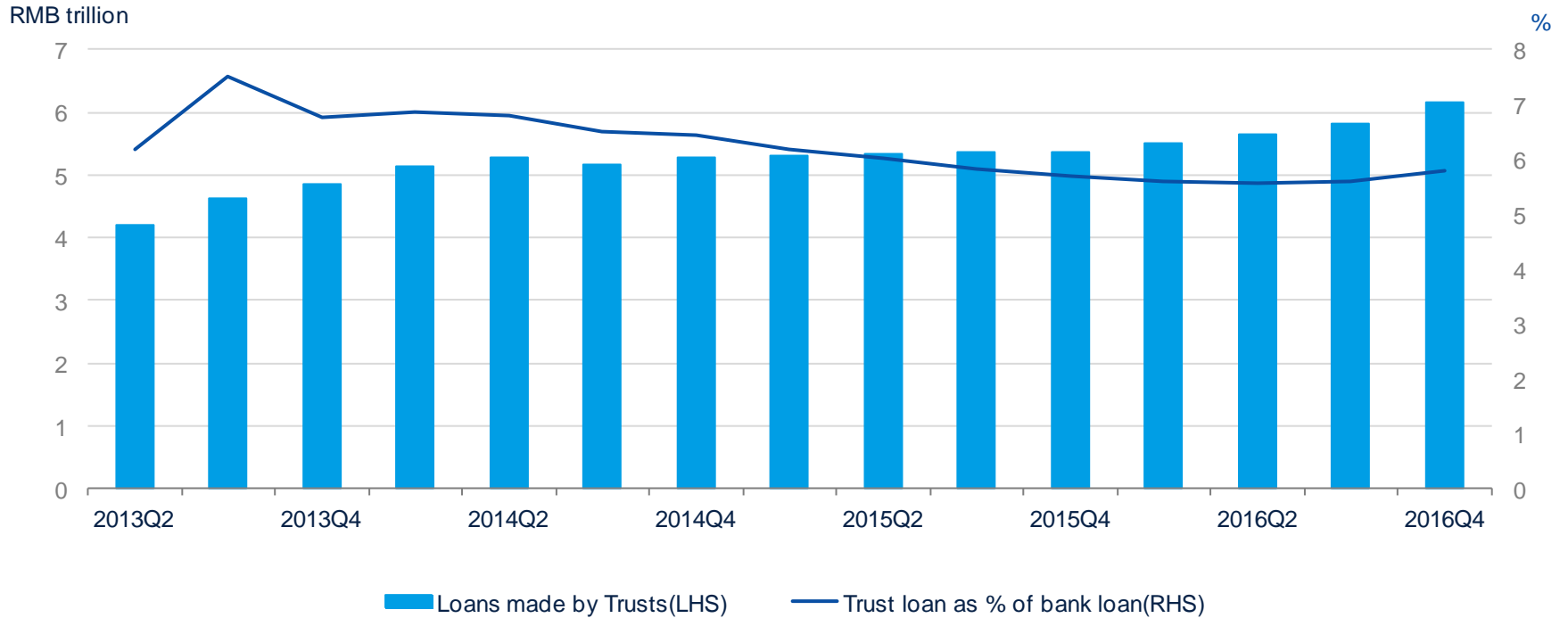
Source: Haver and BBVA Research

The gap between average annualized yield rate of newly issued WMPs and deposit rates widens again at the end of 2016, along with rising interbank certificate of deposit (CD) rates indicating a further tighter liquidity conditions.

Shadow Banking: Trust companies

A marked rebound since mid-2014

Growth in trust company loans



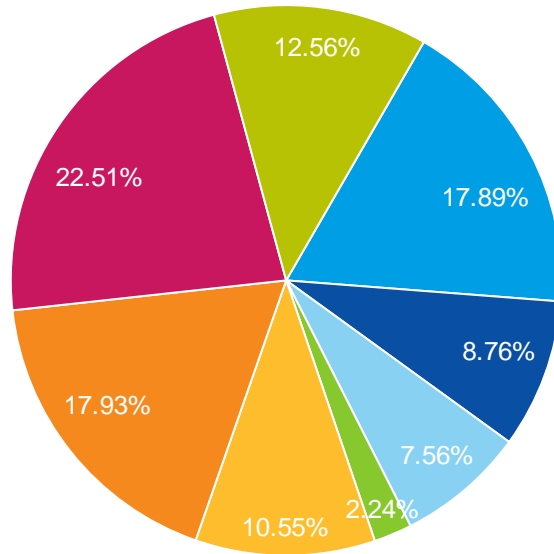
Source: China Trustee Association and BBVA Research

Trust loans registered its first significant increase since mid-2014 due to tighter regulation around WMPs and tighter financing conditions in the domestic bond market for some borrowers.

Shadow banking-Trust companies Investment in property market is up

Changing exposure of trust assets 2015

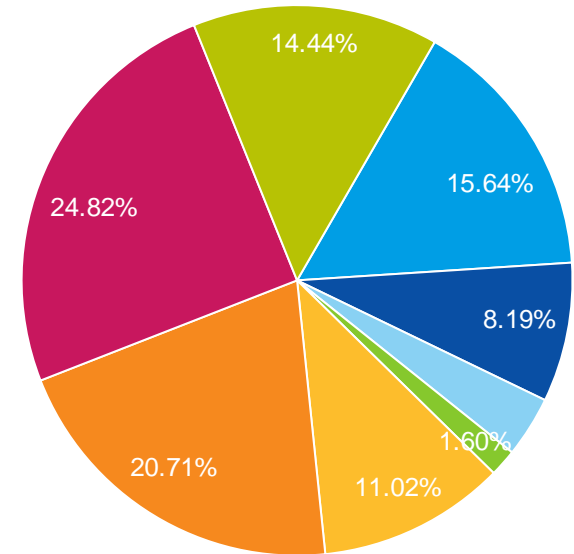
- Infrastructure
- Real estate
- Securities market (Stock)
- Securities market (Fund)
- Securities markets (Bond)
- Financial institutions
- Business enterprise
- Other



Source: China Trustee Association and BBVA Research

Changing exposure of trust assets 2016

- Infrastructure
- Real estate
- Securities market (Stock)
- Securities market (Fund)
- Securities markets (Bond)
- Financial institutions
- Business enterprise
- Other

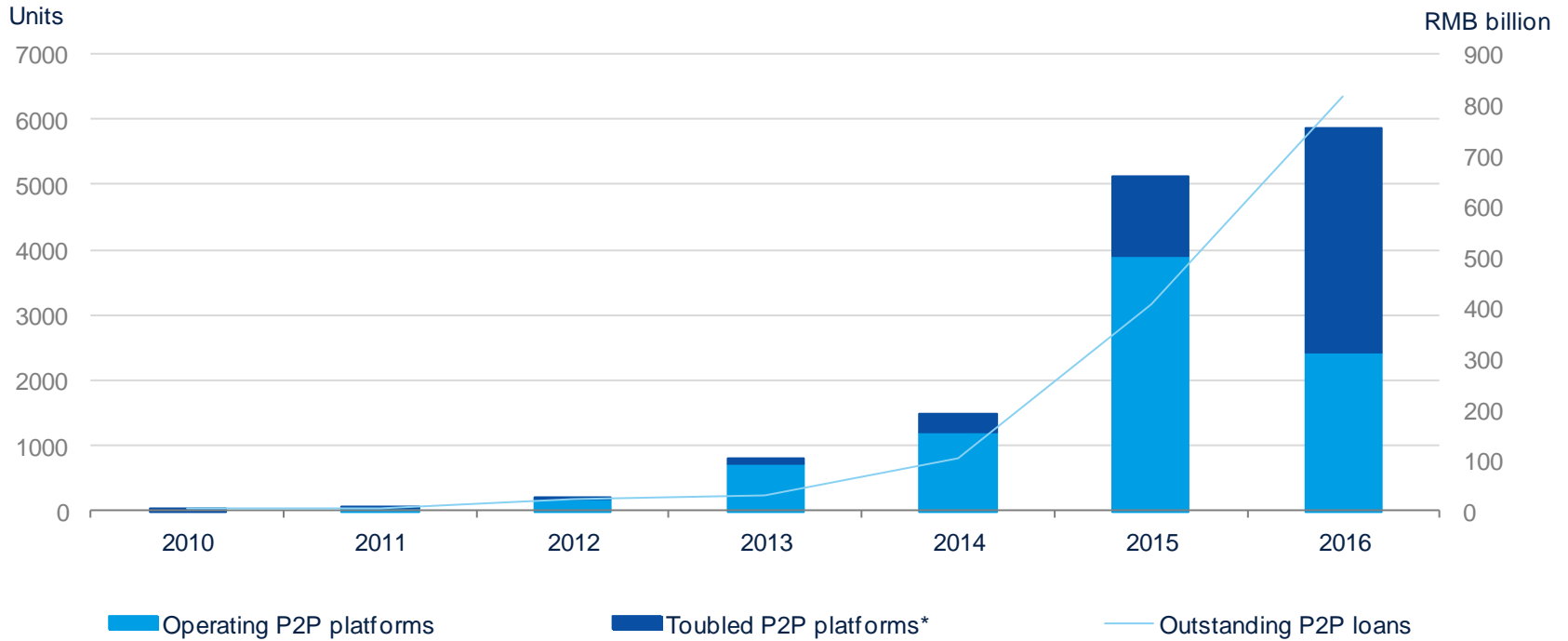


Source: China Trustee Association and BBVA Research

Trust assets further shift toward to business enterprise and financial institutions from securities market, the proportion invested in real estate market is increasing.

Shadow banking: Peer-to-Peer lending Still in trouble

Growth in P2P lending

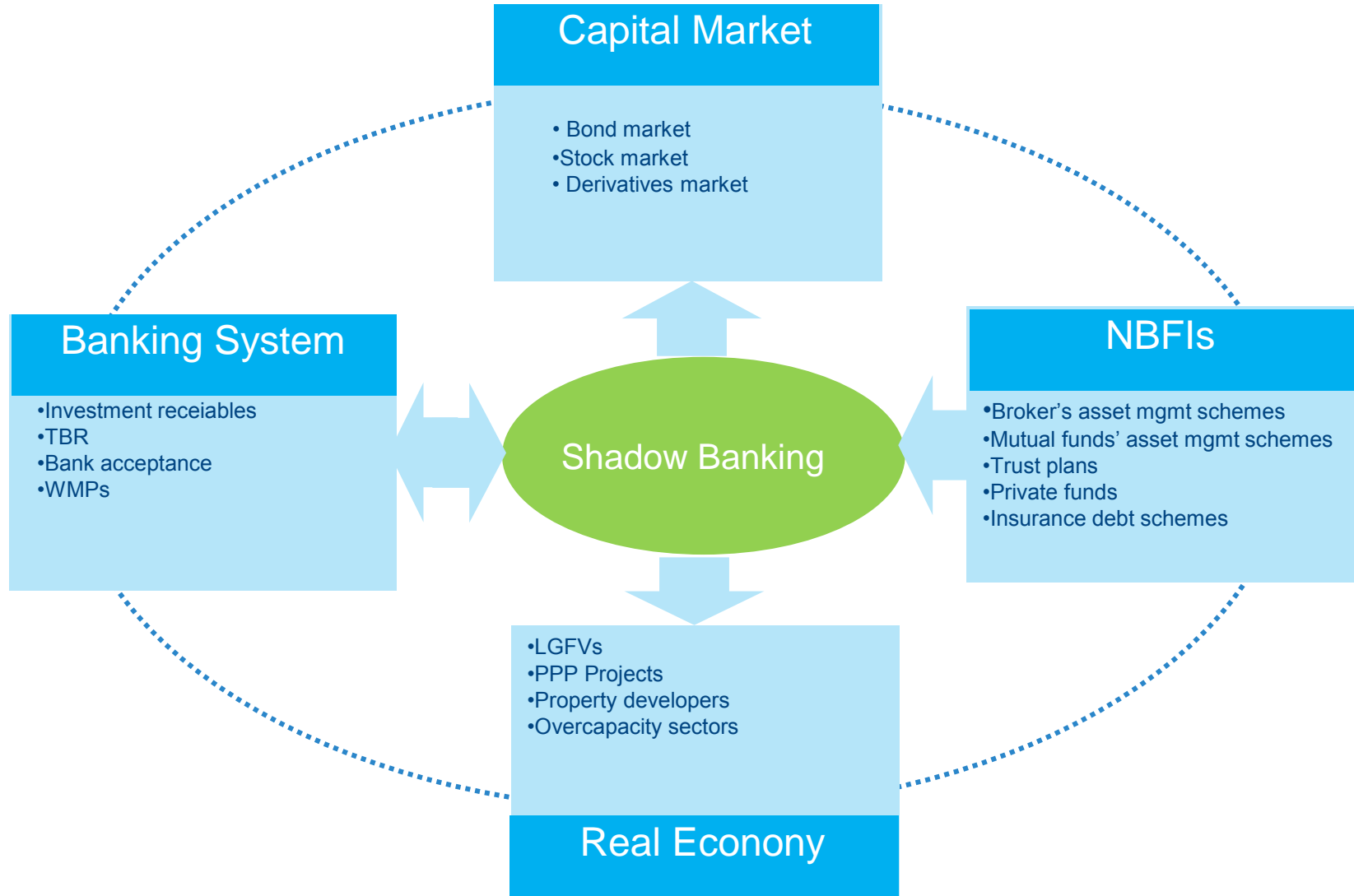


Source: China Trustee Association and BBVA Research

*Troubled “ refers to platforms that have encountered liquidity or insolvency problems, and are under investigation and/or have shut down Source: BBVA Research, CEIC

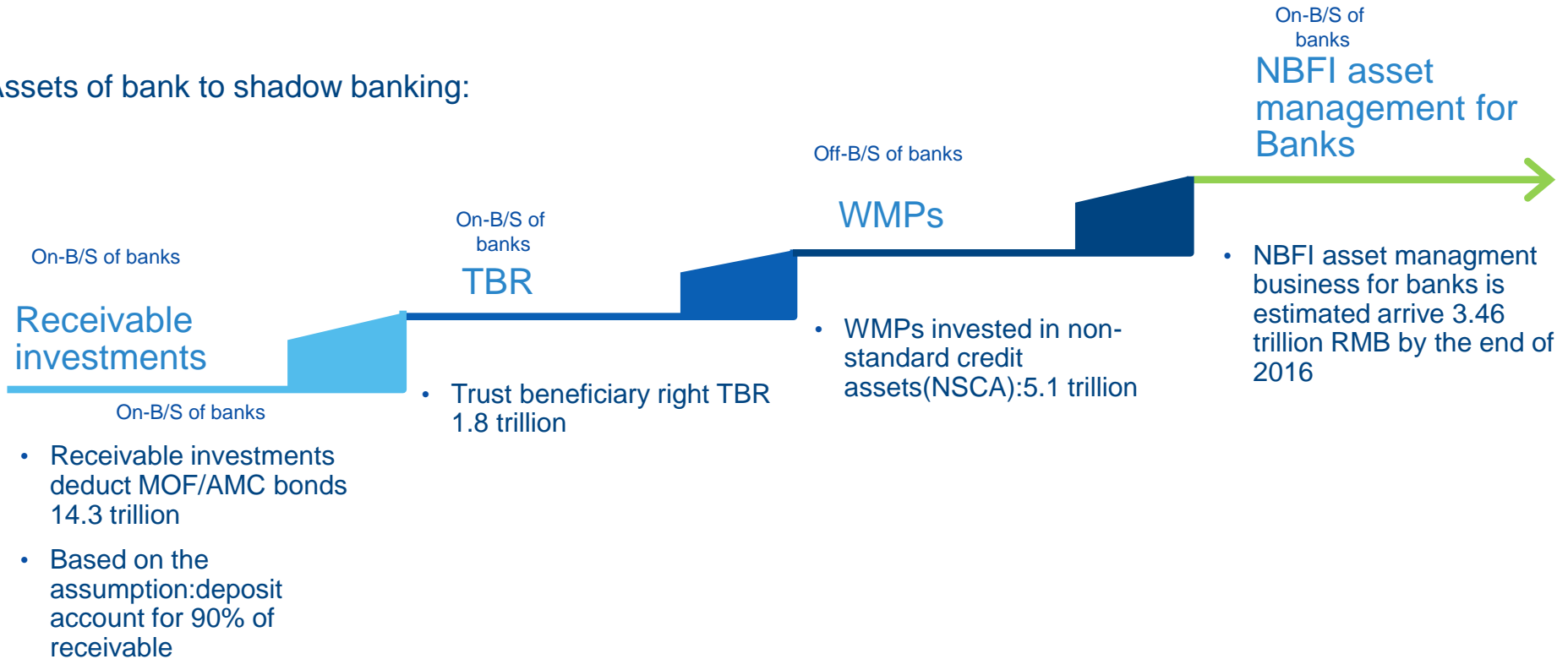
Although outstanding credit of P2P lending is still growing, the number of operating platform has declined by 30% in 2016 due to the CBRC’s new rules for the P2P lending industry circulated in the end of 2015 .

Shadow Banking system structure



Estimates of banks' exposure to shadow banking

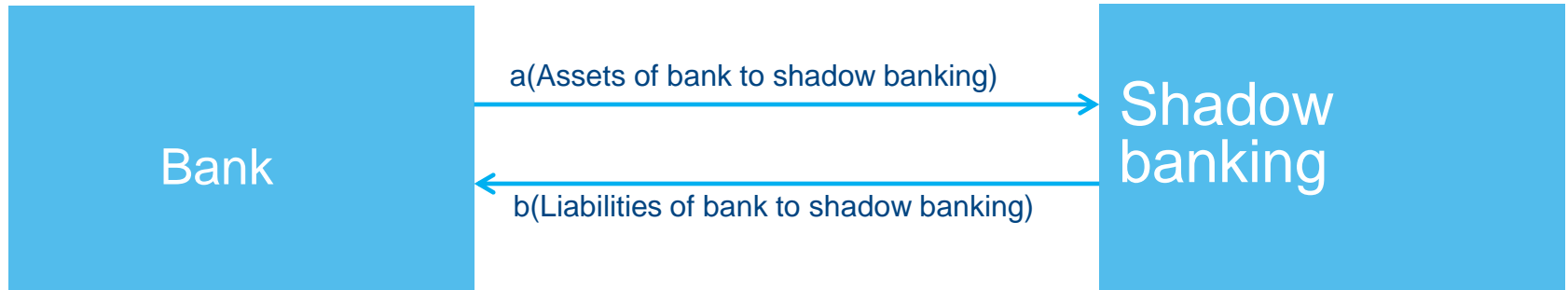
Assets of bank to shadow banking:



Liabilities of bank to shadow banking:



Two risk indicators for banks' exposure to shadow banking



High-level risk measures

$$\frac{a}{\textit{Banking assets}} = 11.3\%$$

Credit risk for bank

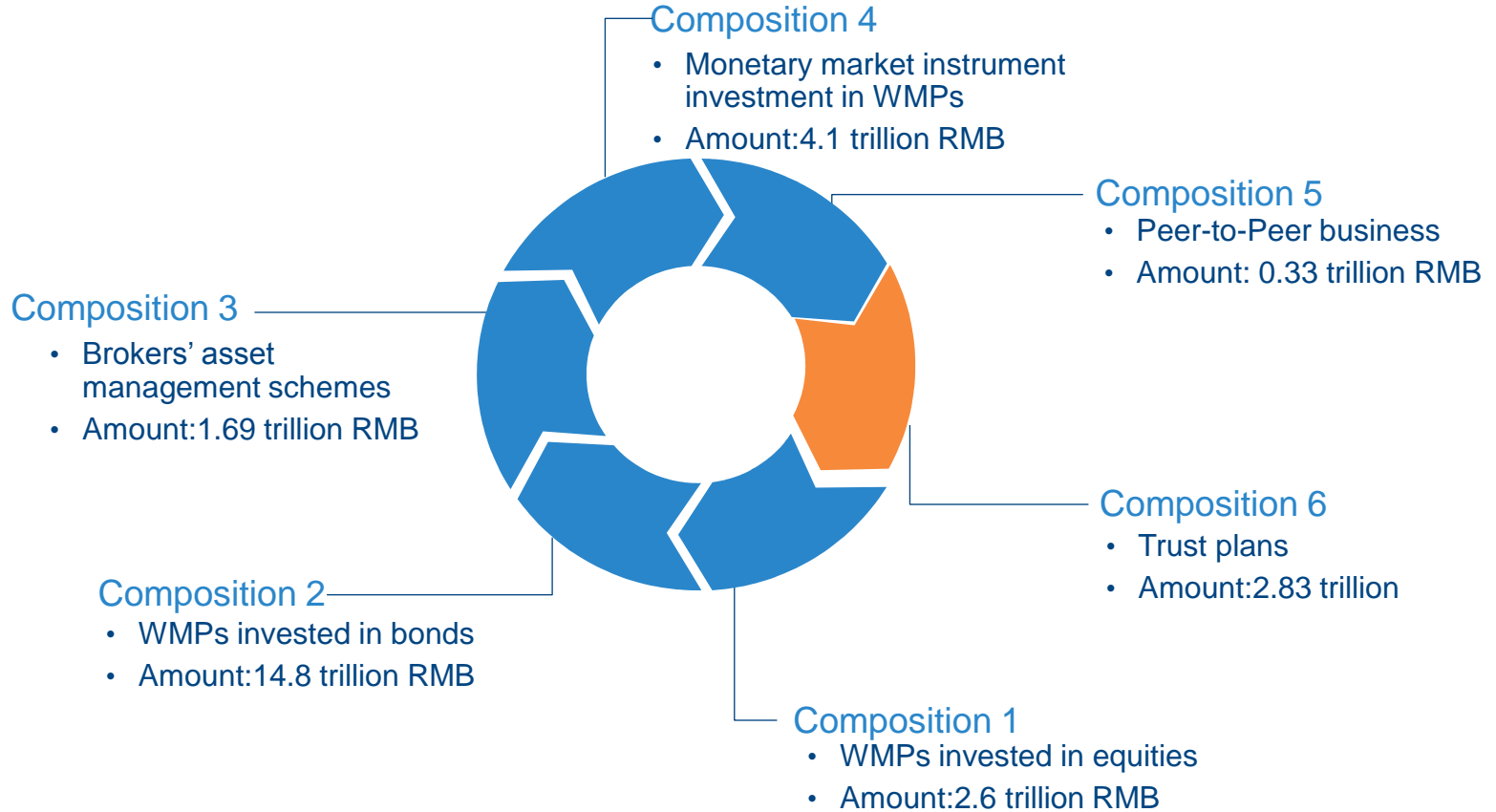
$$\frac{b}{\textit{Banking assets}} = 13.8\%$$

Funding risk for bank

Capital market's exposure to shadow banking

Shadow banking's exposure to capital market reached 22.74 trillion RMB

Account for 10.4% of banks' total assets



Household and corporate' exposure to shadow banking

Household exposure to shadow banking

Individuals invested in :

- WMPs, 12.71 trillion RMB
- Trust plan, 2.76 trillion RMB
- Account for 25.6% of banks' household deposits

Corporate exposure to shadow banking

Enterprises invested in:

- WMPs, 7.69 trillion RMB
- Private fund, 0.49 trillion RMB
- Trust plans, 3.8 trillion RMB
- Peer to Peer loans, 0.33 trillion RMB
- Account for 19.1% of banks' enterprise loans

Regulations

Measures to curtail shadow banking



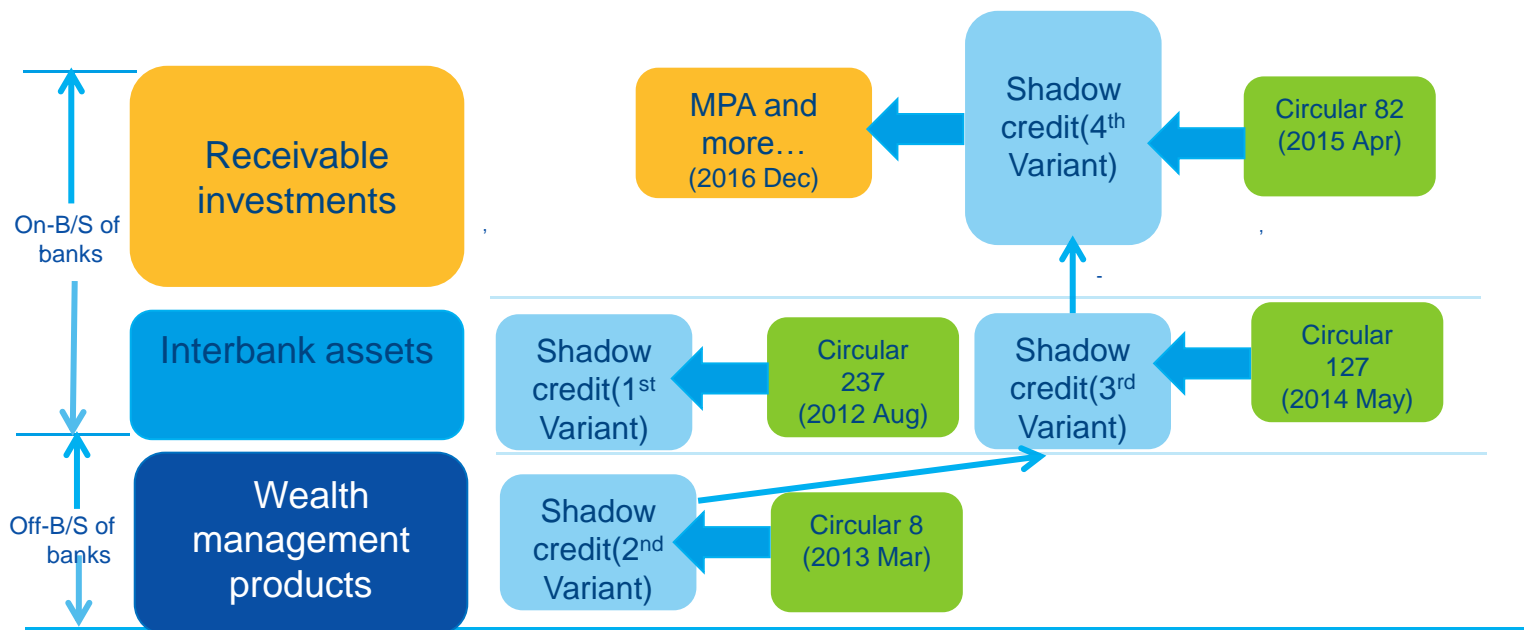
Regulations to curtail regulatory arbitrage

Circular 237 requires banks put the “inter-bank refinance for trade” business into the loan account and thus restricted by the loan amount limit.

Circular 8 requires the balance of the non-standardized creditor's rights assets (NSCA) is at the upper limit of the lower level between the 35% of the balance of the financial products and the 4% of the total assets disclosed by banks' previous annual audit report.

Circular 127 stipulates that only financial assets with high liquidity can be used as the target of buying back the sale of financial assets, and the CBRC also requires banks to make corresponding capital and provision according to the nature of the underlying assets.

Circular 82 aims to tighten the bank's transfer of non-standard credit assets (NSCA) to off-balance-sheet



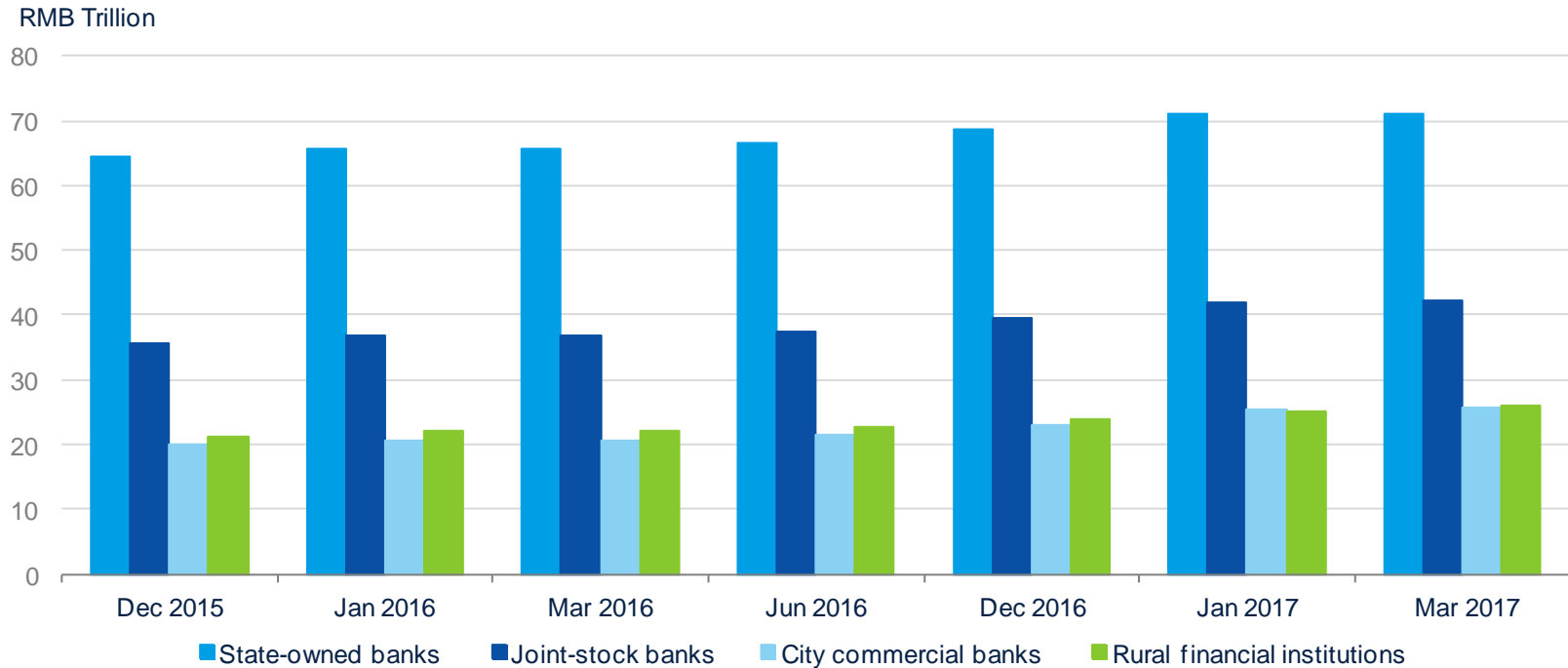
Macro Prudential Assessment(MPA)

7 Items	14 Indicators
1.Assets and leverage	Capital adequacy ratio (80 points),leverage ratio (20 points),total loss absorbing ratio
2.Assets and liabilities	M2 (60 points),entrusted loans (15 points),inter-bank liabilities (25 points)
3.Liquidity	Liquidity coverage ratio (40 points),net stable funding ratio (40 points),apply with deposit reserve policy (20 points)
4.Pricing	Interest rate pricing (100 points)
5.Asset quality	Non-performing loans (50 points),provision coverage ratio (50 points)
6.Cross-boarder financing risk	Balance of cross boarder financing risk weighted assets(100 points)
7.Credit policy implement	Credit policy evaluation result (40 points),credit policy execution sutiation (30 points),the usd of central bank fund (30 points)
Evaluation standard	
Classification A	Provide optimal incentive mechanism: If the score under every item excess 90 points
Classification B	Provide normal incentive mechanism: except classification A and C
Classification C	Provide certain constrains:Any one does not meet the standard between the 1 and 4 items,or any two do not meet 60 points between item of 2,3,5,6 and 7 .

Source: Institute of Financial Supervision and BBVA Research

China's central bank has adopted a Macro prudential Assessment (MPA) system in order to monitor banks' capital adequacy ratios, assets and liabilities, liquidity and risk. The new system will be more comprehensive and systematic than the previous system, and will focus on the "augmented credit" and "adjusted capital adequacy ratio".

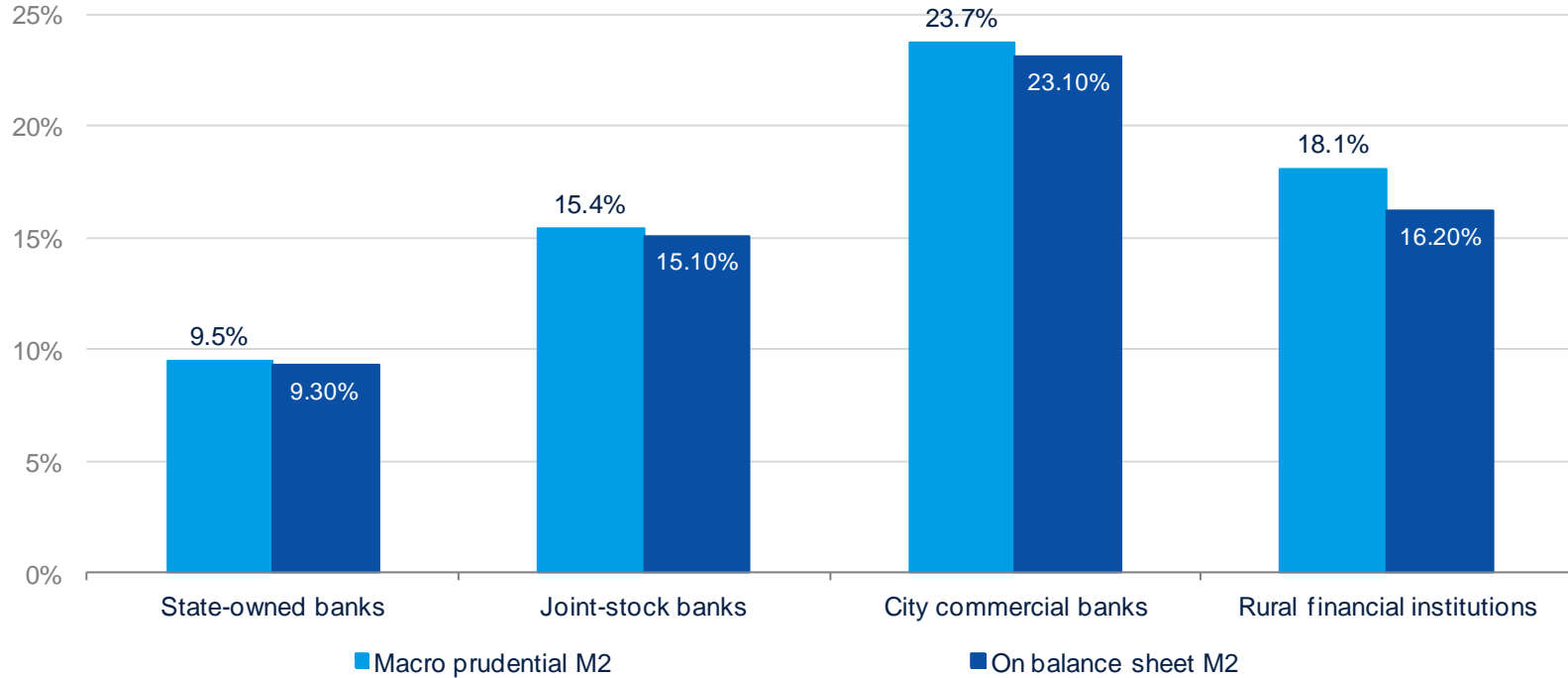
Assessment of banks' "augmented credit"



Source: Institute of Financial Supervision ,CBRC and BBVA Research

Based on the assumption that i)prudential credit assets equals to 80% of on balance sheet assets, ii)off balance sheet WMPs is equal to 90% of the total WMPs and iii) 20% of off balance sheet WMPs are cash and bank deposits. We can broadly gauge the "augmented credit" of different banks by volume above:

City commercial banks are under pressure

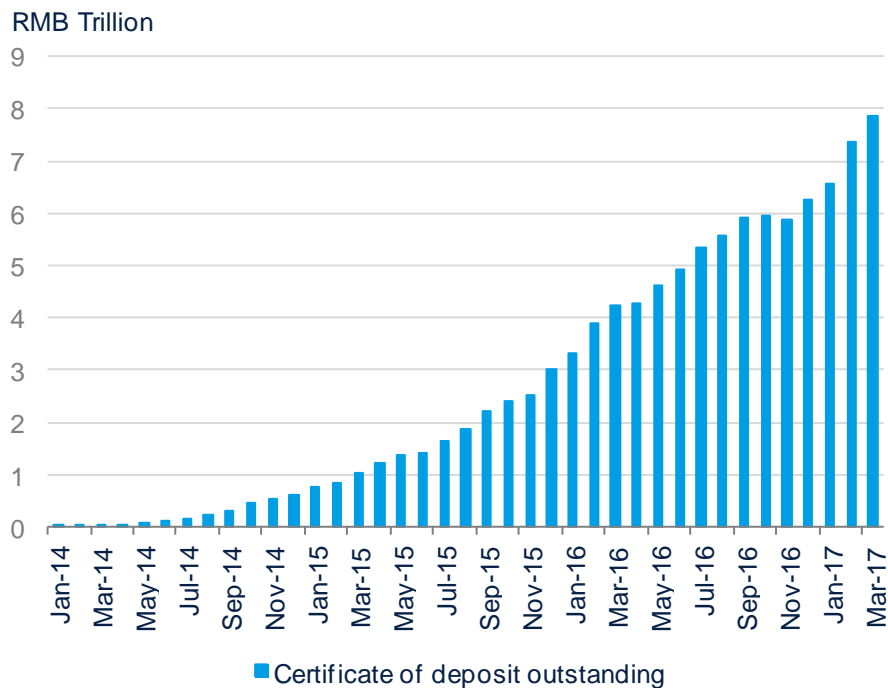


Source: Institute of Financial Supervision ,CBRC and BBVA Research

Currently the upper limit of highest macro prudential M2 growth rate supported by the capital adequacy ratio is in the range of 16%-25%. Thus We can conclude that city commercial banks are under pressure, while the state-owned banks suffered less pressure than rural financial institutions and joint-stock banks.

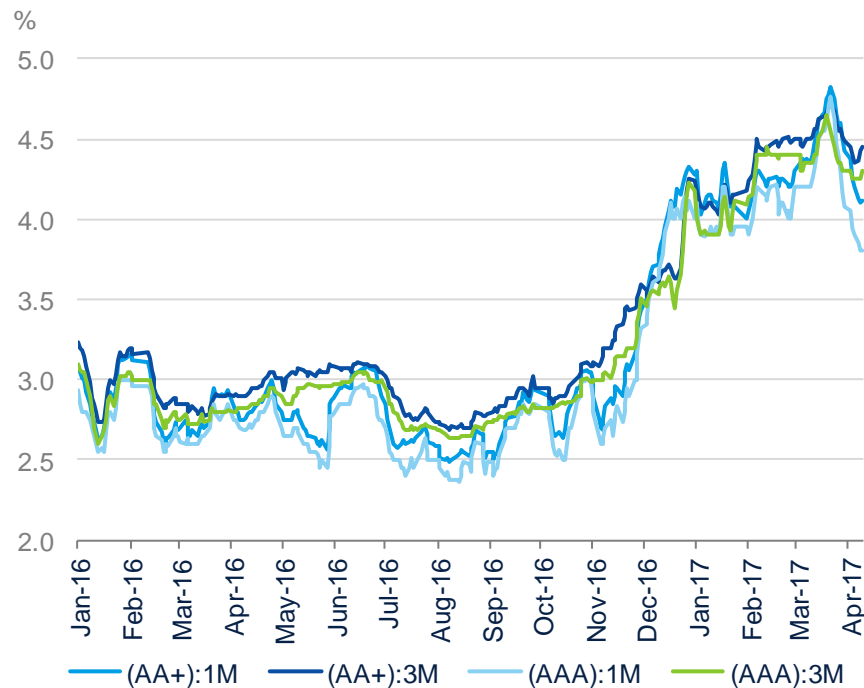
What's going on next?-CDs market

Outstanding of CDs



Source: Wind and BBVA Research

Asset price picked up followed by a decline



Source: Wind and BBVA Research

CDs market has experienced rapid expansion as it is included in the debt payable item instead of interbank deposit in the balance sheet, thus suffered less capital constrains. Total outstanding of CDs reached 7.85 trillion at the end of March.

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