

China Banking Monitor

1H 2019

June 2019

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- 01 Macroeconomic environment
- 02 Performance of banking sector
- 03 Shadow banking activities

Main takeaways

- Credit growth remained weak, which are mainly supplied through banks' balance sheet and dominated by consumer and residential mortgage loans.
- Bank assets growth moderated on government's efforts to curtail shadow banking and interbank activities.
- Although the headline NPL ratio remained stable, asset quality diverged among big and smaller banks as the regulators have enforced a stricter standard of NPL recognition policy.
- Banks' net profit managed to grow at a modest pace as banks shift to traditional lending from interbank activities. We expect banks' profitability remain subdued through the rest of the year.
- Capital adequacy ratio was supported by banks' issuance of capital instruments. Small banks are still subject to capital shortfall amid deteriorating asset quality and persistent regulations on shadow banking activities.
- Banks' liquidity remained adequate but is subject to challenges of credit event.
- Banks interconnectedness with shadow banking system has marginally decreased.

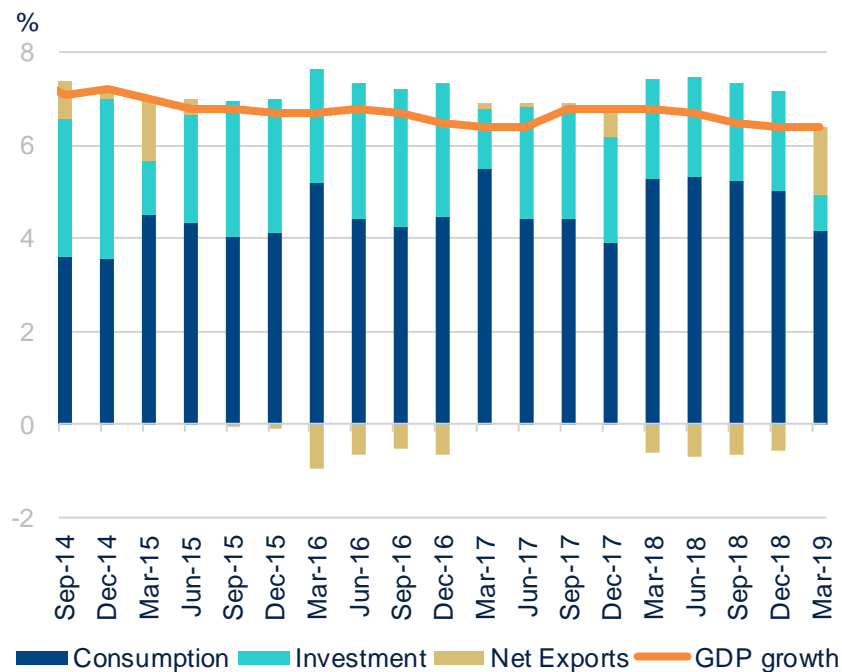
01

Macroeconomic environment

Credit growth remained weak
mainly supplied through banks'
balance sheet

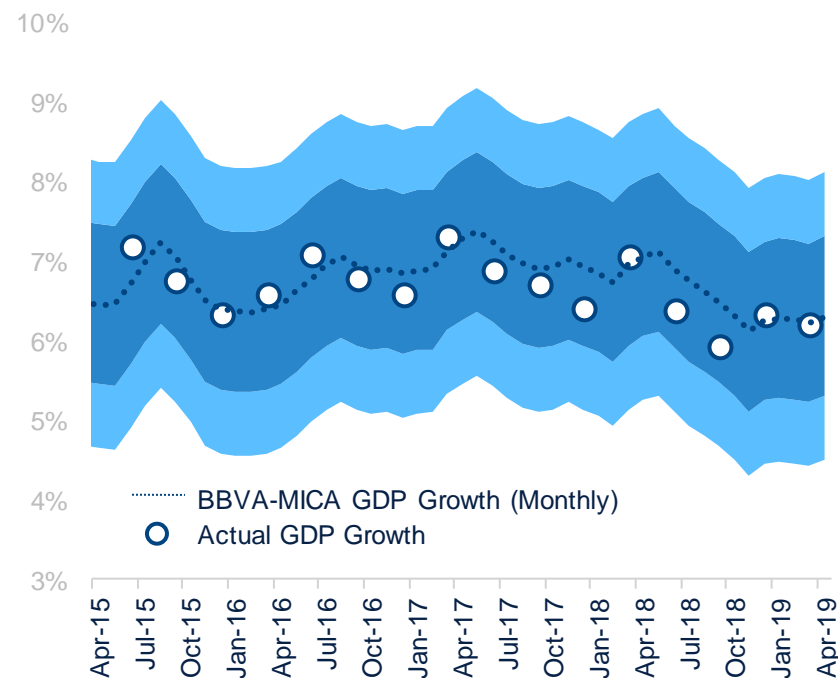
Renewed trade tensions pose a new threat to the stabilized growth

GROWTH STABILIZED IN Q1 2019, WITH CONSUMPTION THE MAIN CONTRIBUTOR



Source: CEIC & BBVA Research

BBVA MICA MODEL FOR MONTHLY GDP FORECASTING (% YOY)

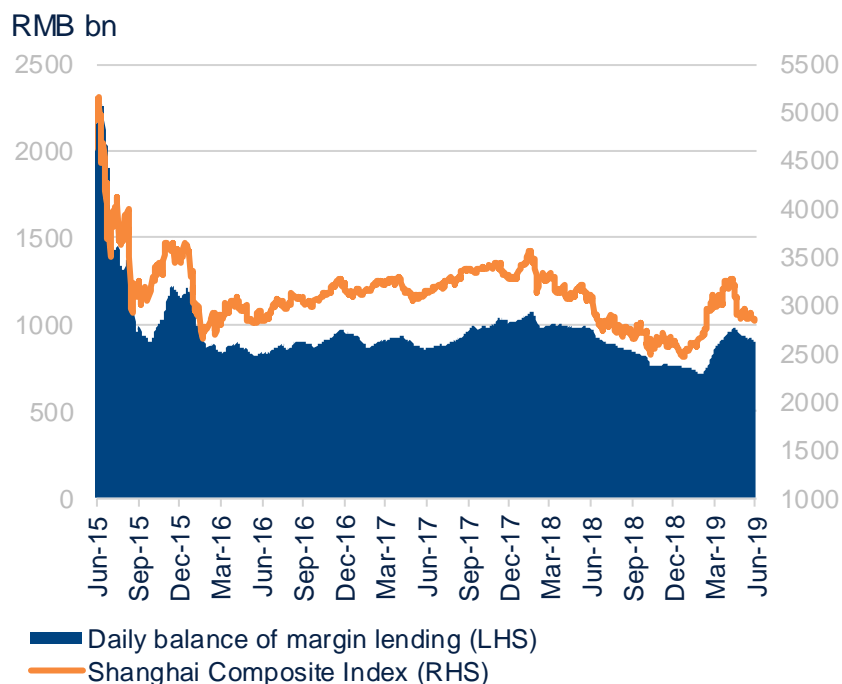


Source: CEIC, Haver & BBVA Research

On top of implemented stimulus measures, growth stabilization in Q1 benefited substantially from the improved sentiment as US-China trade negotiation went well then. But the situation deteriorated fast since early May

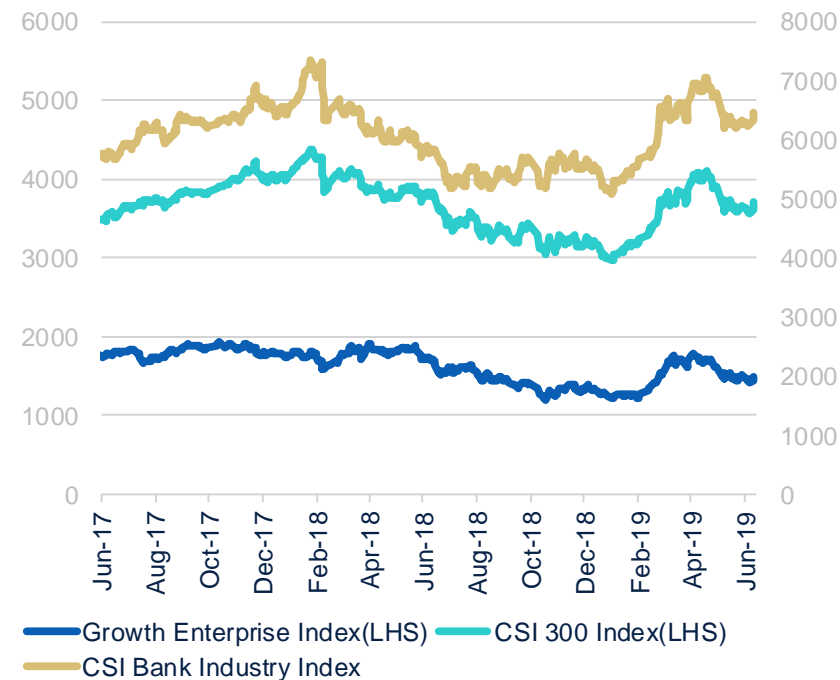
Escalating trade tensions weighed on stocks

SHANGHAI COMPOSITE INDEX



Source: Wind & BBVA Research

CSI 300 AND GROWTH ENTERPRISE INDEXES



Source: Wind & BBVA Research

Stock market was triggered a sell off weighed by the escalating trade tensions, potentially wiping out most of the market's year-to-date rallies. Margin lending to buy Chinese stocks is on the rise before slump

Prospect for a quick resolution to end the trade war has faded



U.S. accusation of China's backtracking

On 10th May, US government ratcheted up tariffs on \$200 bn of Chinese goods from 10% to 25%, and also signaled to impose duties on another \$300 bn of Chinese products so far unscathed.

China reiterated tariffs on US imports

On 13th May, China announced plans to increase duties on \$60 bn of US products to 20/25% from 10% start from 1st June.

On 14th May, China seen accusing US of using 'extreme pressure' in faltering trade talks and asking an 'unreasonable price' for a deal.

Trade war turn into a tech war

On 15th May, Trump signed an executive order declaring a national emergency barring on doing business with Chinese Huawei and China Mobile.

On 29th May, China accused US of violating a national security exception at the WTO by blacklisting Huawei. China to restrict exports of rare earths to US.

More tariff may come under the way

On 9th June, US Treasury Sectary Mnuchin met with China PBOC's Yi Gang, he tweeted that the talk was "candid" and "constructive".

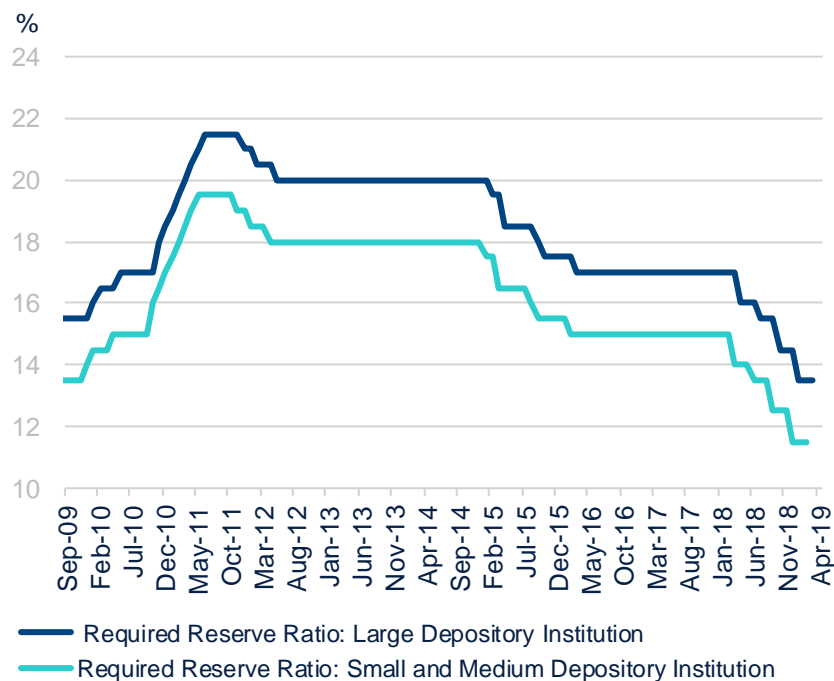
On 13th June, Trump has warned China a new round of tariffs would be levied if the two leaders failed to meet at the G20 summit in Osaka at the end of this month.

Source: BBVA Research

Although a trade deal between US and China is still in our baseline scenario, the probability of a full-blown trade war is increasing due to differences on both structural issues and enforcement measures

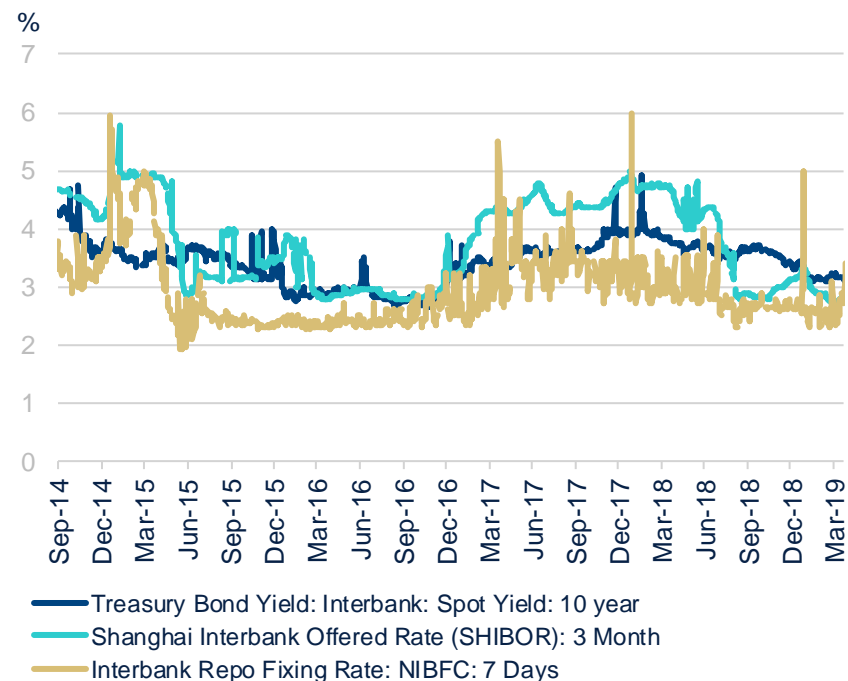
Supportive economic policies have been implemented to bolster the domestic economy

FURTHER EASING OF MONETARY POLICY IS EXPECTED...



Source: Haver & BBVA Research

INTEREST RATES ARE FALLING AS THE CENTRAL BANK EASES

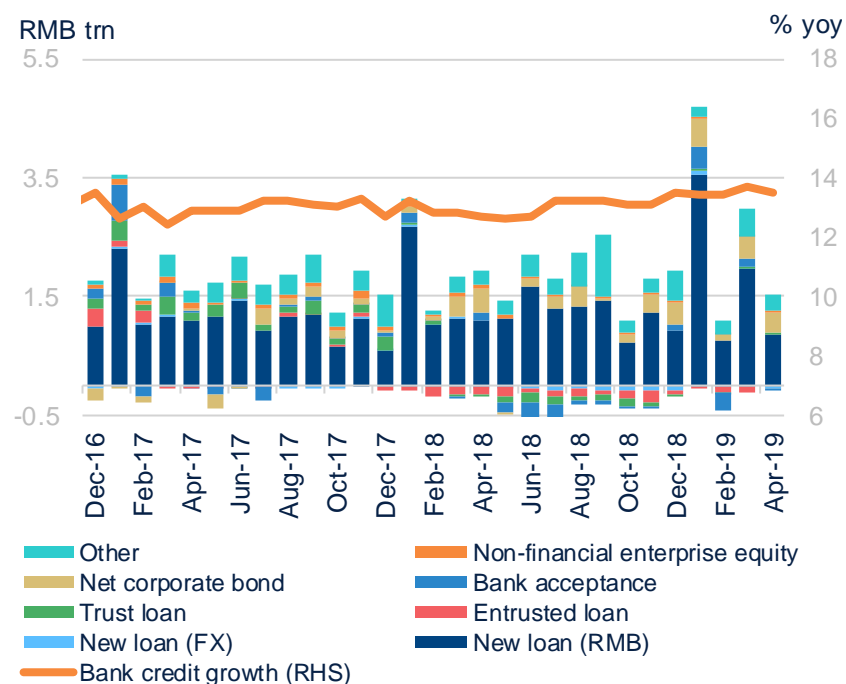


Source: CEIC & BBVA Research

The central bank has cut required reserve ratio 4 times in 2018, followed by another cut in January this year, injecting net liquidity of around RMB 800 bn. To facilitate the bank credit channel into the real economy, authorities introduced the targeted medium-term lending facility (TMLF) to provide long-term funding for banks to support the small and medium sized enterprises (SMEs)

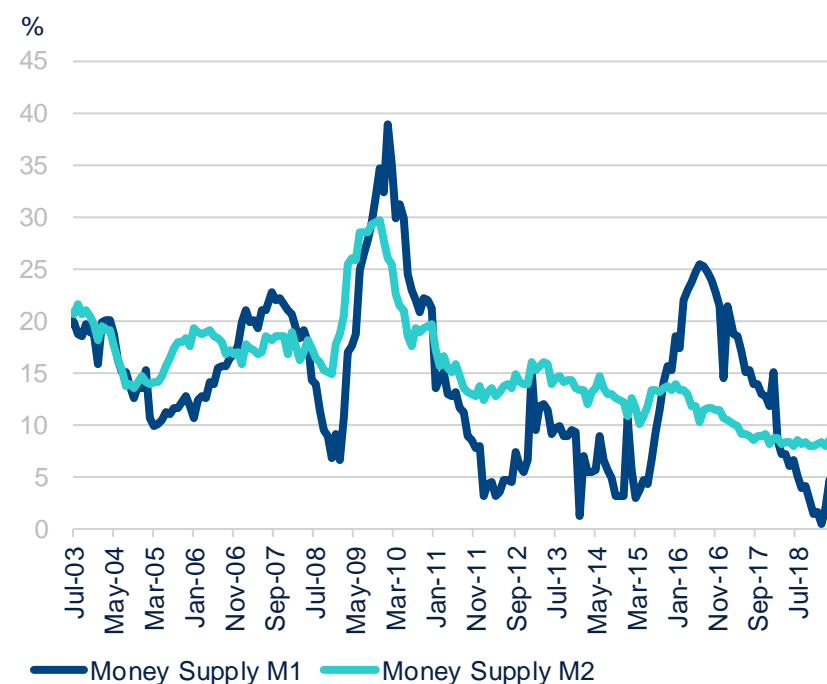
Credit growth slows more than expected in April

NEW CREDIT SUPPLY IS MAINLY THROUGH BANKS' BALANCE SHEET



Source: CEIC & BBVA Research

M2 INCREASED DUE TO THE EASING MONETARY MEASURES



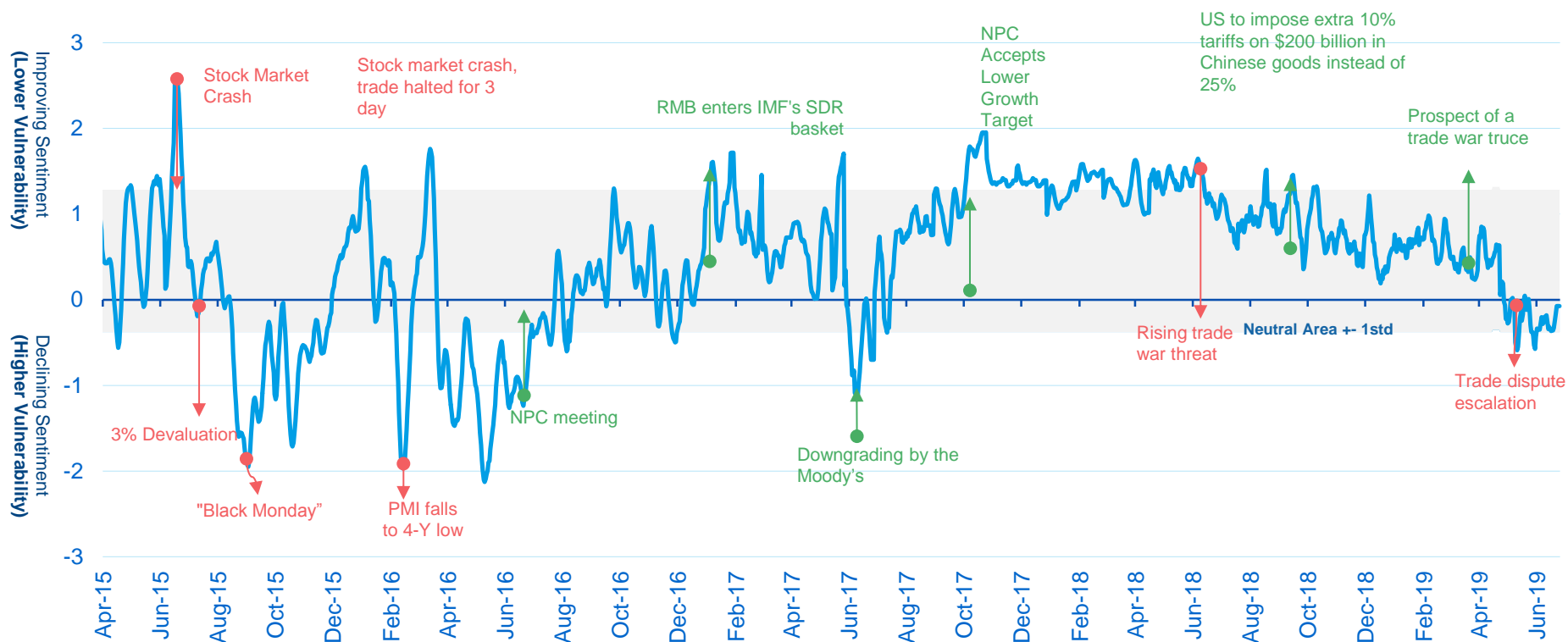
Source: Wind & BBVA Research

Both bank loans and Total Social Financing (a broader gauge of overall credit including shadow banking activities) remains weak, underlining the fragile nature of the recovery in the economy. New credit are mainly supplied from bank loans

Vulnerability sentiment index has shown a greater volatility to the downside amid the escalating trade war tensions

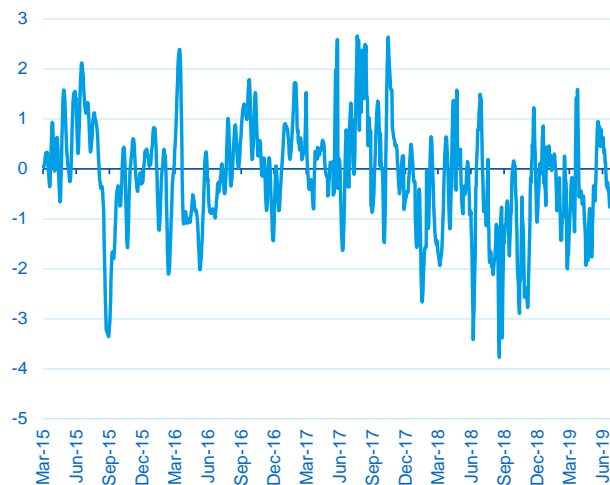
CHINESE VULNERABILITY SENTIMENT INDEX

(CVSI) (EVOLUTION OF THE "TONE" OF MAIN FOLLOWED THEMES ABOUT VULNERABILITY IN CHINA. LOWER VALUES INDICATE A DETERIORATION OF SENTIMENT AND HIGHER VULNERABILITY)

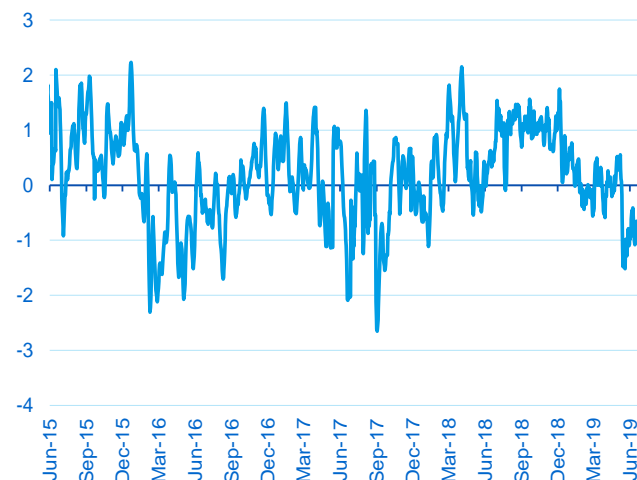


SOE and exchange rate sentiment index perform weakly

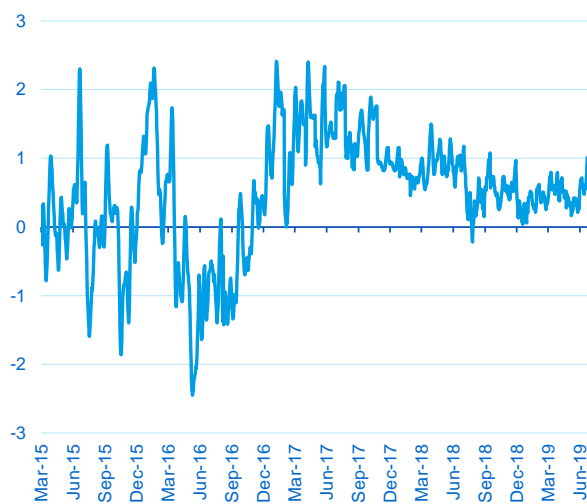
SOE VULNERABILITY INDEX



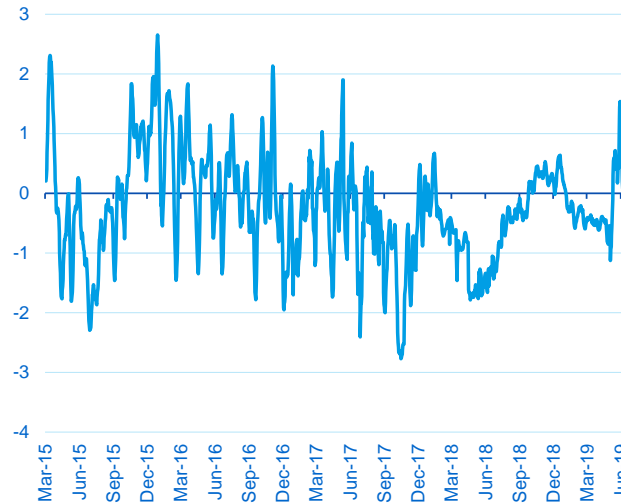
HOUSING BUBBLE VULNERABILITY INDEX



SHADOW BANKING VULNERABILITY INDEX



EXCHANGE RATE VULNERABILITY INDEX



02

Performance of banking Sector

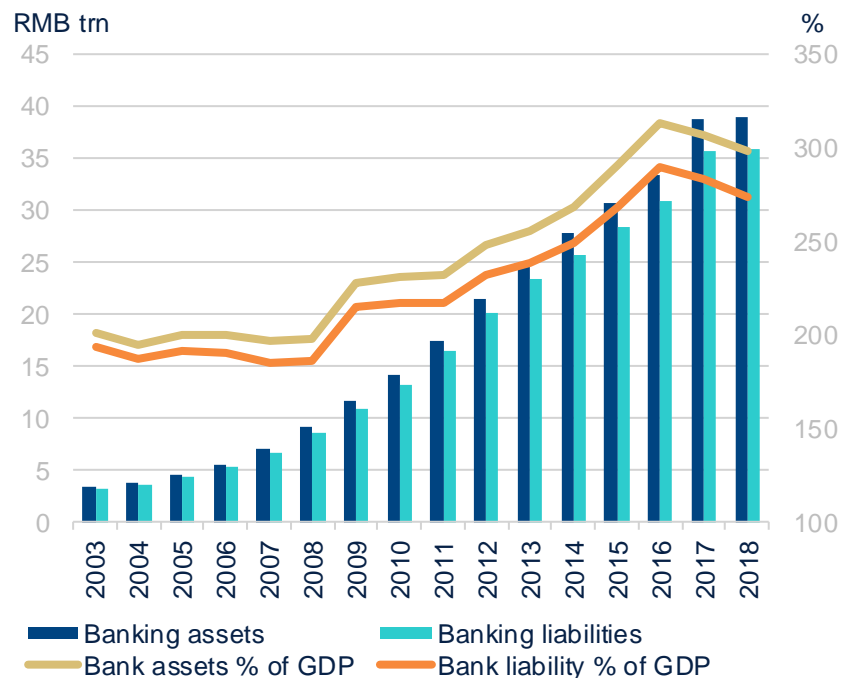
Bank's net profit managed to grow at a modest pace as banks shift to traditional lending

A snapshot of financial fundamentals

	2017 Q1	2017 Q2	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1
Asset quality and credit risk									
Loans/total assets	46.0%	47.0%	48.0%	48.0%	49.0%	50.0%	50.0%	51.0%	52.0%
NPL ratio	1.7%	1.7%	1.7%	1.7%	1.8%	1.9%	1.9%	1.8%	1.8%
(NPL+non-performing loan) ratio	5.5%	5.4%	5.3%	5.2%	5.2%	5.1%	5.1%	4.9%	4.8%
Coverage of above ratio	178.8%	177.2%	180.4%	181.4%	191.3%	178.7%	180.7%	186.3%	192.2%
Profitability & efficiency									
NIM	2.0%	2.1%	2.1%	2.1%	2.1%	2.1%	2.2%	2.2%	2.2%
Cost to income ratio	26.8%	27.6%	28.6%	31.6%	27.3%	27.4%	28.0%	30.8%	26.7%
ROE	14.8%	14.5%	13.9%	12.6%	14.0%	13.7%	13.2%	11.7%	13.2%
ROA	1.1%	1.0%	1.0%	0.9%	1.1%	1.0%	1.0%	0.9%	1.0%
Solvency									
Tier 1 ratio	11.3%	11.1%	11.2%	11.4%	11.3%	11.2%	11.3%	11.6%	11.5%
Leverage ratio	6.3%	6.3%	6.4%	6.5%	6.5%	6.5%	6.6%	6.7%	6.6%
NPLs/Capital	10.3%	10.6%	10.4%	10.2%	10.3%	11.2%	11.1%	10.7%	10.6%
Liquidity and funding									
Deposits/Total assets	65.3%	65.7%	65.7%	65.0%	66.1%	66.5%	66.6%	66.2%	66.6%
Non-deposits funding (Central bank, t	49.5%	49.3%	49.2%	49.9%	48.8%	49.0%	48.7%	49.2%	47.3%
Loan to deposit ratio	67.7%	69.1%	70.0%	70.6%	71.2%	72.3%	73.6%	74.3%	72.2%
Liquidity ratio	48.7%	49.5%	49.2%	50.0%	51.4%	52.4%	52.9%	55.3%	56.8%
Liquidity coverage ratio	119.1%	123.0%	120.2%	123.3%	125.3%	131.3%	127.8%	138.0%	141.1%

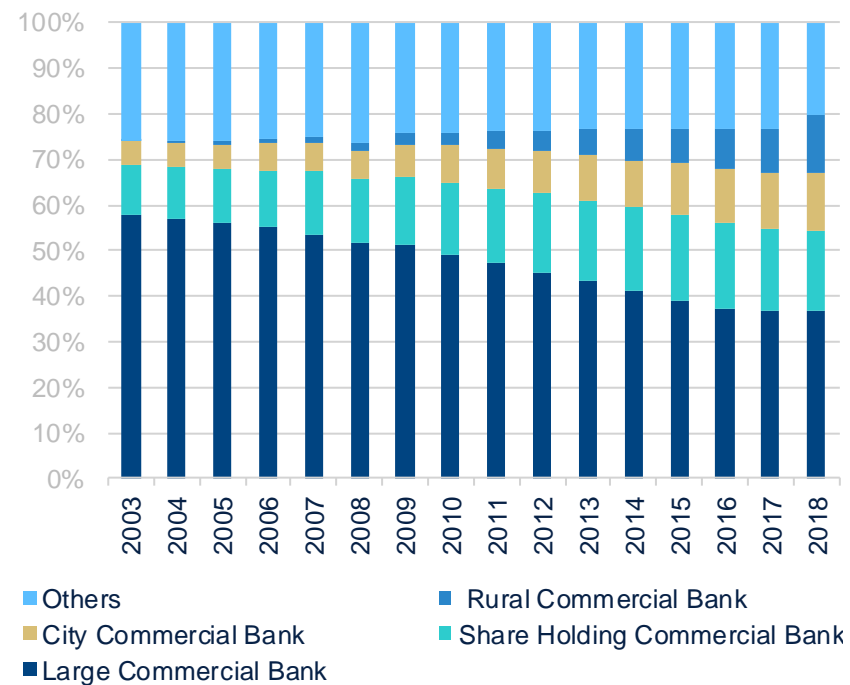
Bank assets growth moderated on government's efforts to curtail shadow banking and interbank activities

BANKING ASSETS HAS MODERATED ITS GROWTH RATE



Source: CBIRC & BBVA Research

LARGE AND SHAREHOLDING COMMERCIAL BANKS STILL DOMINATE

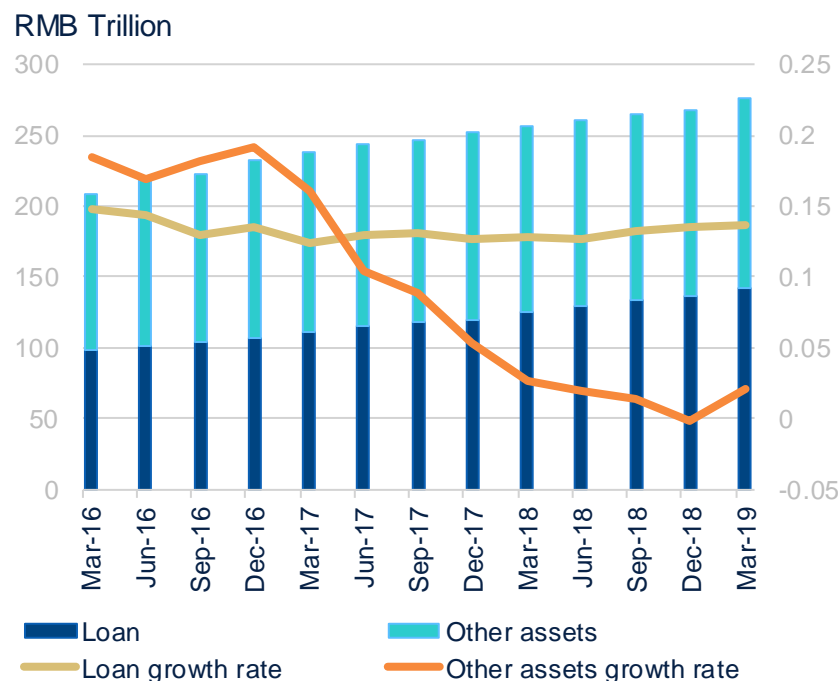


Source: CBRIC & BBVA Research

The expansion of China banking sector has slowed down its pace to 6.7% in 2018 from 8.3% a year earlier, resulting in a lower share of bank assets as a percentage of GDP. By category, large and shareholding commercial banks still dominate China's banking system

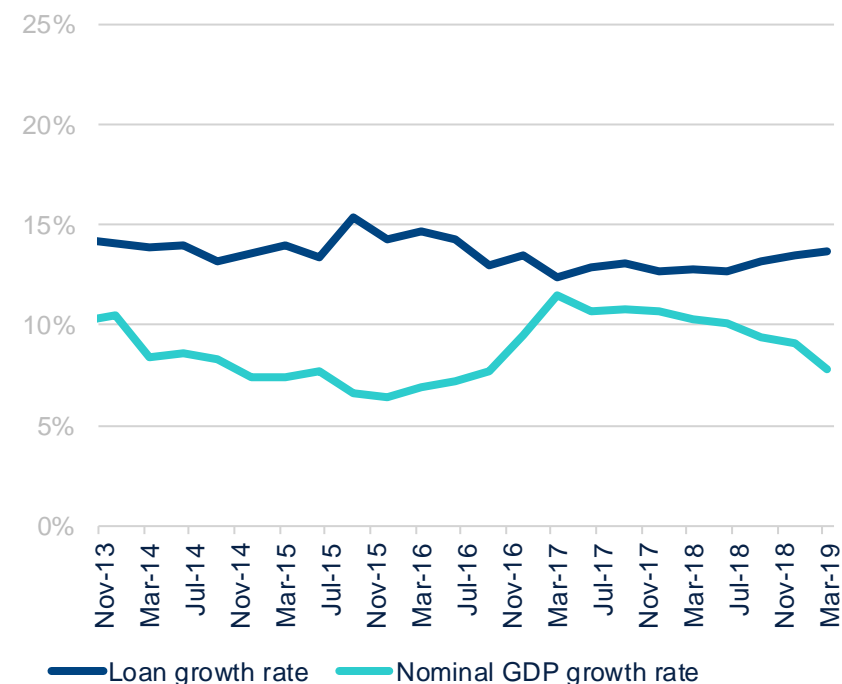
New credit are mainly supplied through banks' balance sheet

LOANS GREW MUCH FASTER THAN NON-LOAN ASSETS...



Source: CEIC & BBVA Research

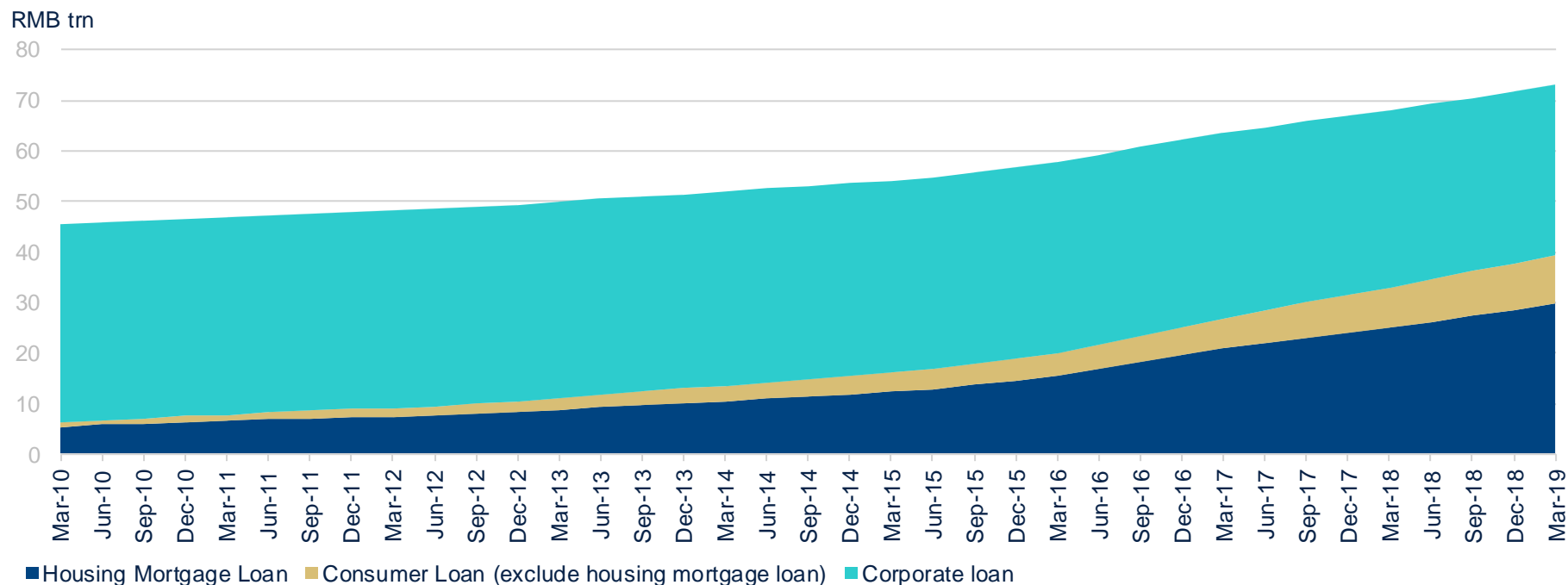
...AS WELL AS THE NOMINAL GDP



Source: CEIC & BBVA Research

Loans grew faster than non-loan assets which are believed to be associated with shadow banking activities, amid authorities called for more lending to the small and medium sized companies (SMEs)

New loans still dominated by consumer and residential mortgage loans

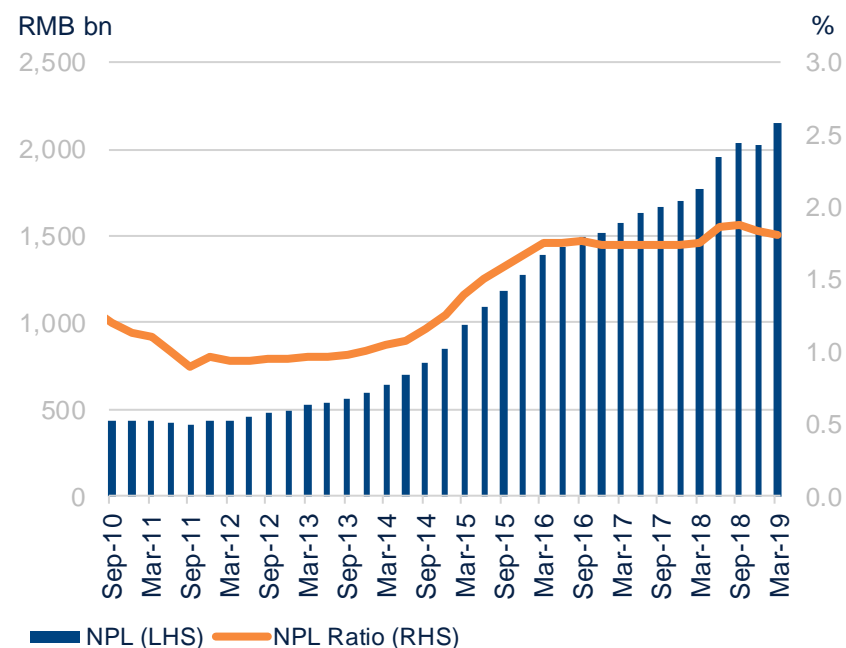


Source: CEIC & BBVA Research

New increased loan was mainly boosted by the home buyers. At the end of 2018, residential mortgage loans hit RMB28.5trillion, a yoy increase of 19%. Looking ahead, we expect corporate loans, in particular the ones to SMEs to increase as authorities beefed up their targeted stimulus efforts

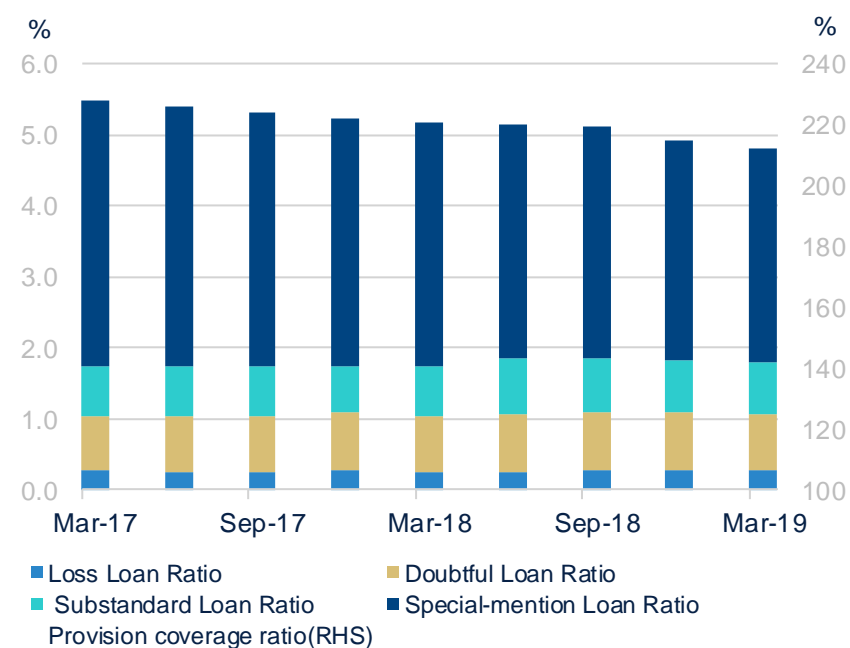
The headline NPL ratio remained stable...

NPLS VALUE AND RATIO FOR BANKING INDUSTRY LOOK EXCELLENT...



Source: CEIC & BBVA Research

...HOWEVER, THE REAL SITUATION IS NOT OPTIMISTIC IF TAKING INTO ACCOUNT SPECIAL-MENTIONED LOANS

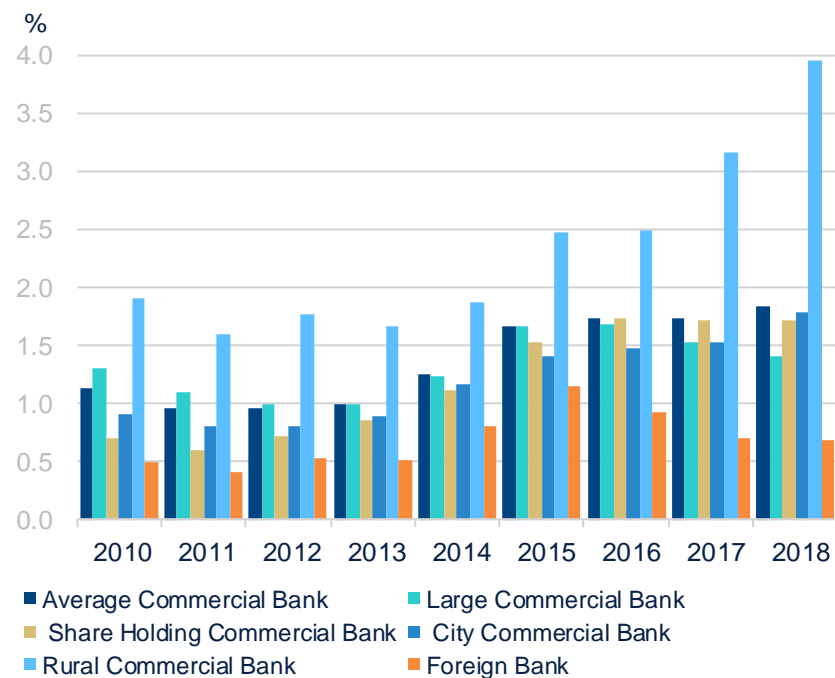


Source: CEIC & BBVA Research

Asset quality is the prime concern due in large part to its opaqueness. A broad measure of NPL ratio should include special-mention loans. Banks overall NPL ratio would reach approximately 5% if added the special-mention loan ratio

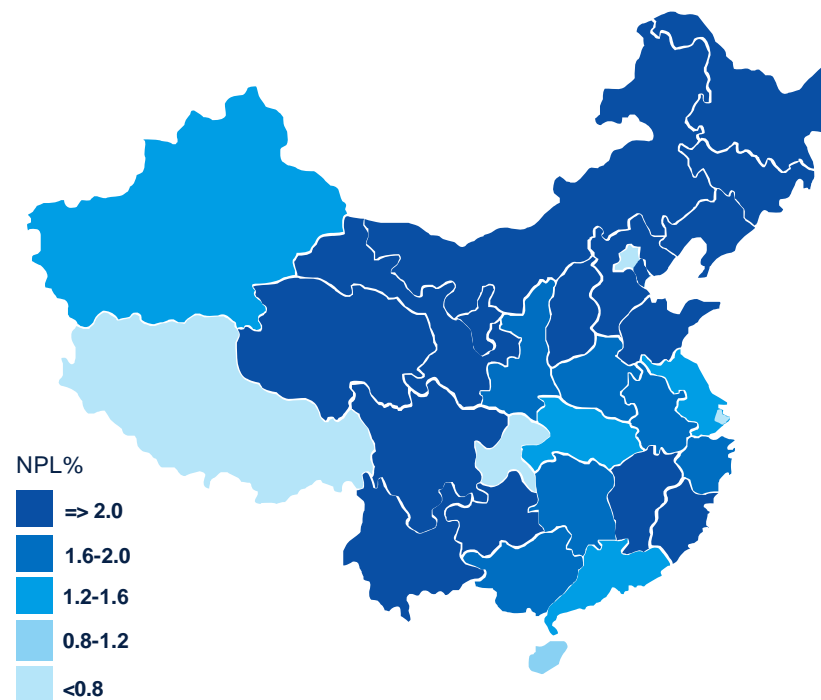
Pressure mainly concentrates on small banks

MARKED RISE IN RURAL COMMERCIAL BANK'S NPL RATIO



Source: CEIC & BBVA Research

NPL LANDSCAPE BY REGION

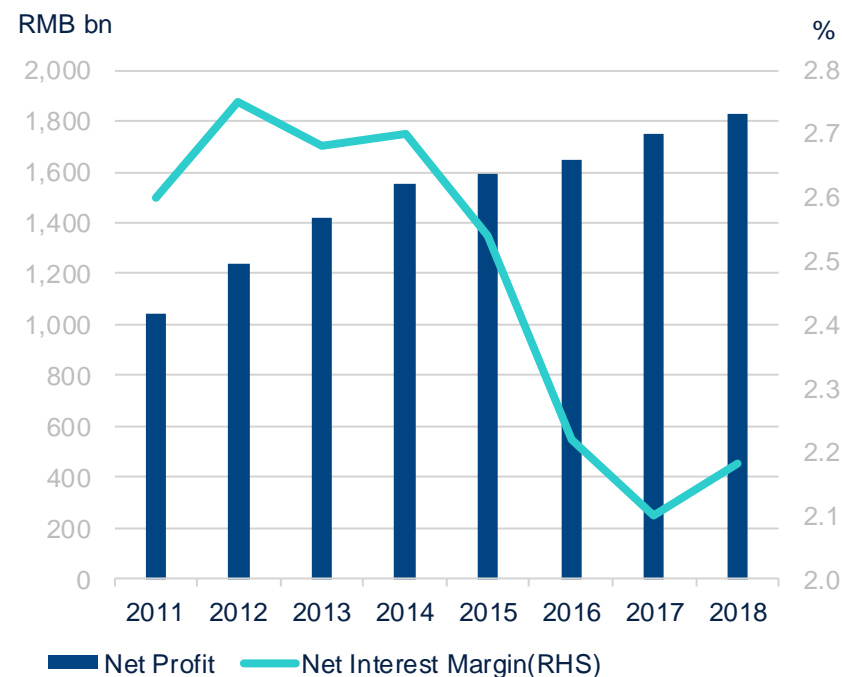


Source: CEIC & BBVA Research

As the regulators have enforced a stricter standard of NPL recognition policy since last year, rural and city commercial banks suffered a higher NPL ratio increases, with the NPL ratio for rural commercial banks reached approximately 4% at the end of 2018

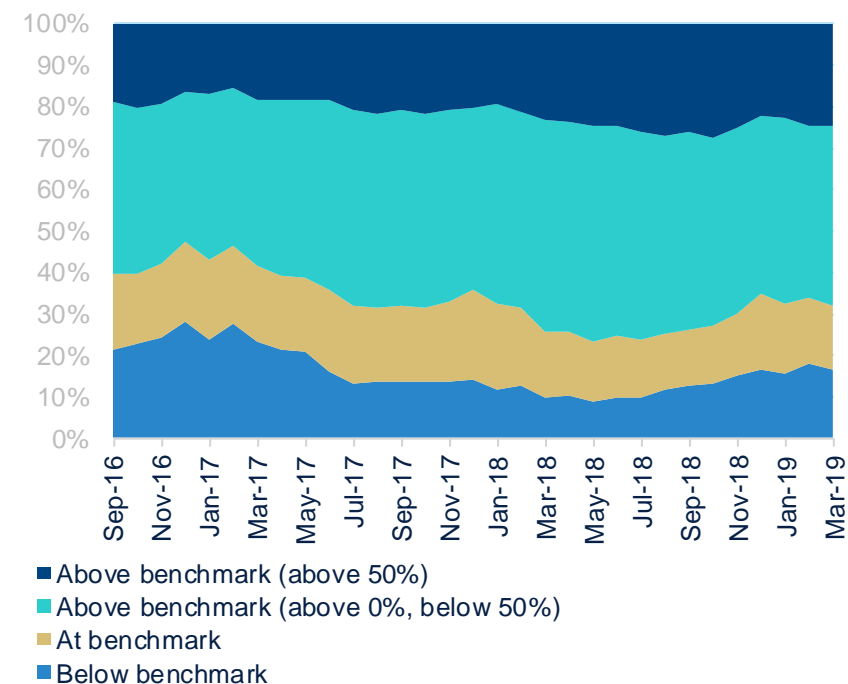
Banks' net profit managed to grow at a modest pace

NET INTEREST MARGIN (NIM) IMPROVED IN 2018



Source: CBRIC & BBVA Research

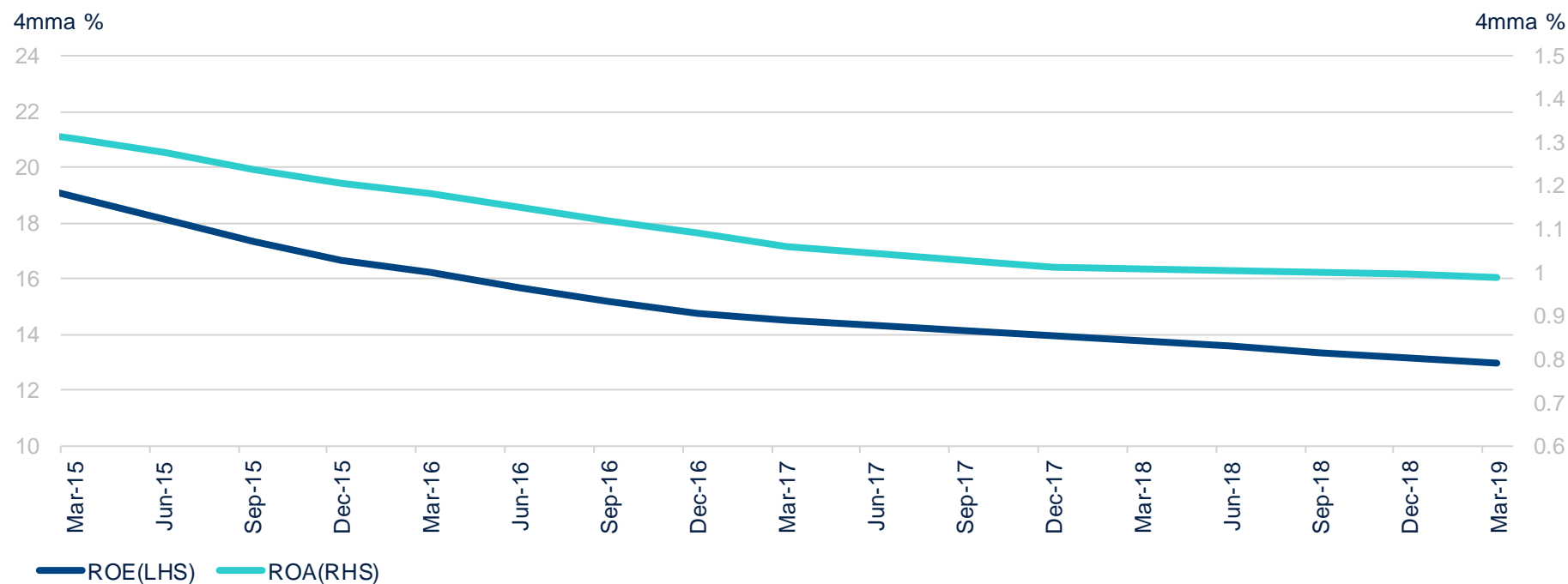
BANK'S LOAN PRICING CAPACITY IMPROVED



Source: CBRIC & BBVA Research

Banks net profit managed to grow at a modest pace as banks shift to traditional lending from interbank activities. Moreover, net interest margin (NIM) widened slightly in 2018 due to prudent monetary policy and financial deleveraging

However, ROA and ROE continue its weak performance

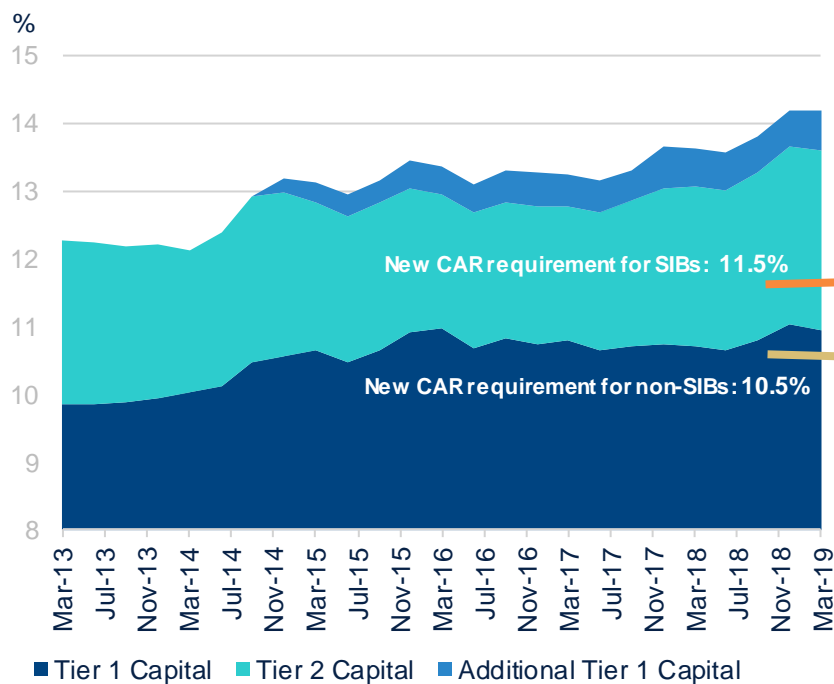


Source: CBRIC & BBVA Research

Although Net interest margin (NIM) maintained a small increase in 2018, both the return on equity (ROE) and return on assets (ROA) continue decreasing. It is related to the shrinkage of banks off-balance-sheet businesses (shadow banking), which used to contribute substantially to banks' profit growth with no change of balance sheet size

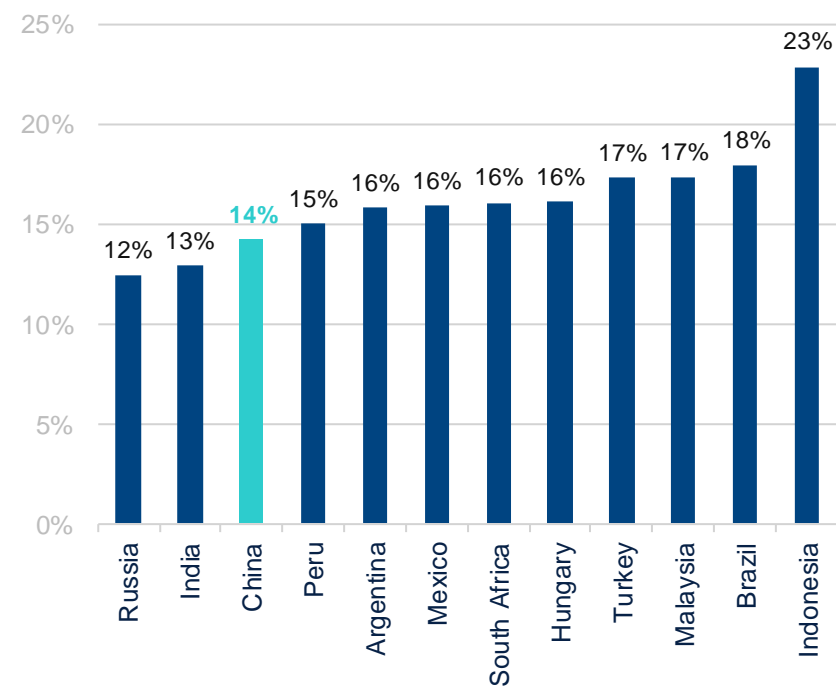
Capital buffers remained adequate

CAPITAL ADEQUACY RATIO INCREASED DUE TO THE ISSUANCE OF TIER 2 CAPITAL INSTRUMENT



Source: CBRIC & BBVA Research

HOWEVER, CHINESE BANKS' CAR STILL LAG BEHIND THEIR MAJOR EMS PEERS

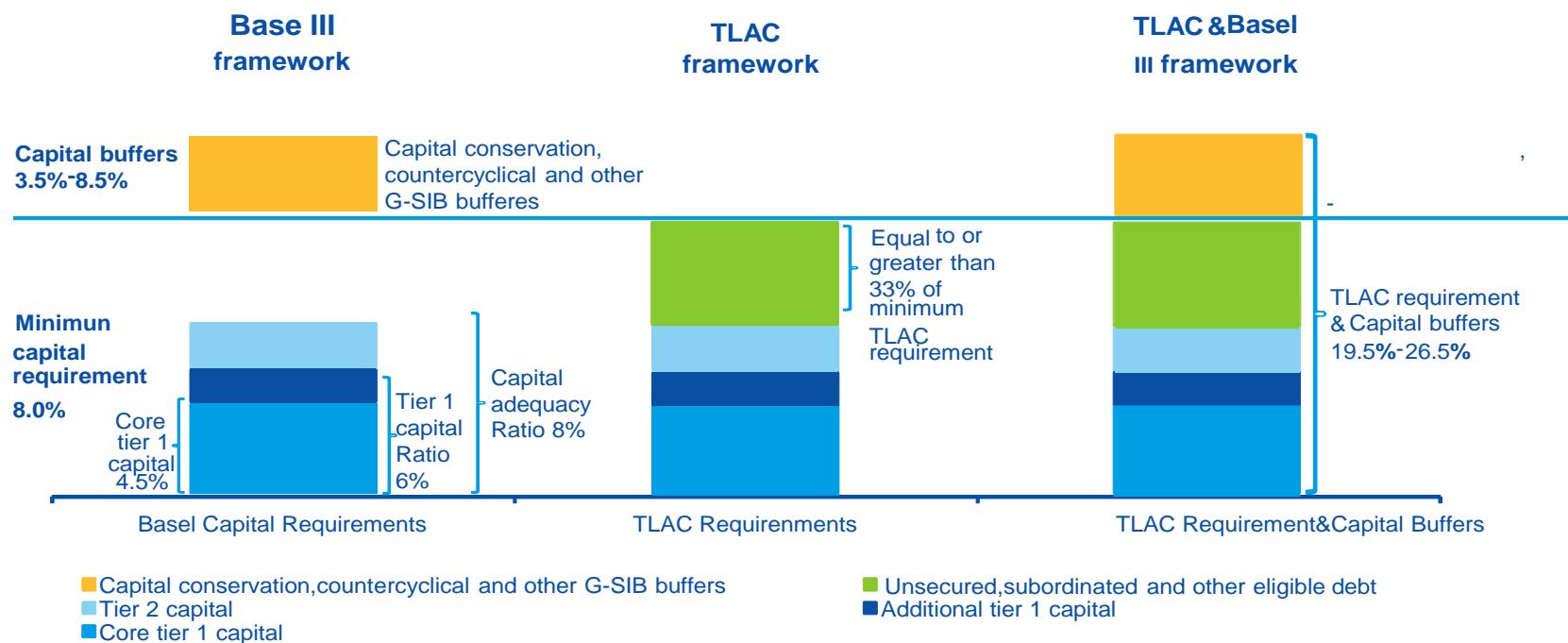


Source: CBRIC & BBVA Research

Both CAR and core Tier 1 capital ratios are above the mandatory ratios. However, banks are still subject to the pressure of raising more capital amid deteriorating asset quality and persistent regulations on shadow banking activities

China's global systemically important banks face TLAC shortfall

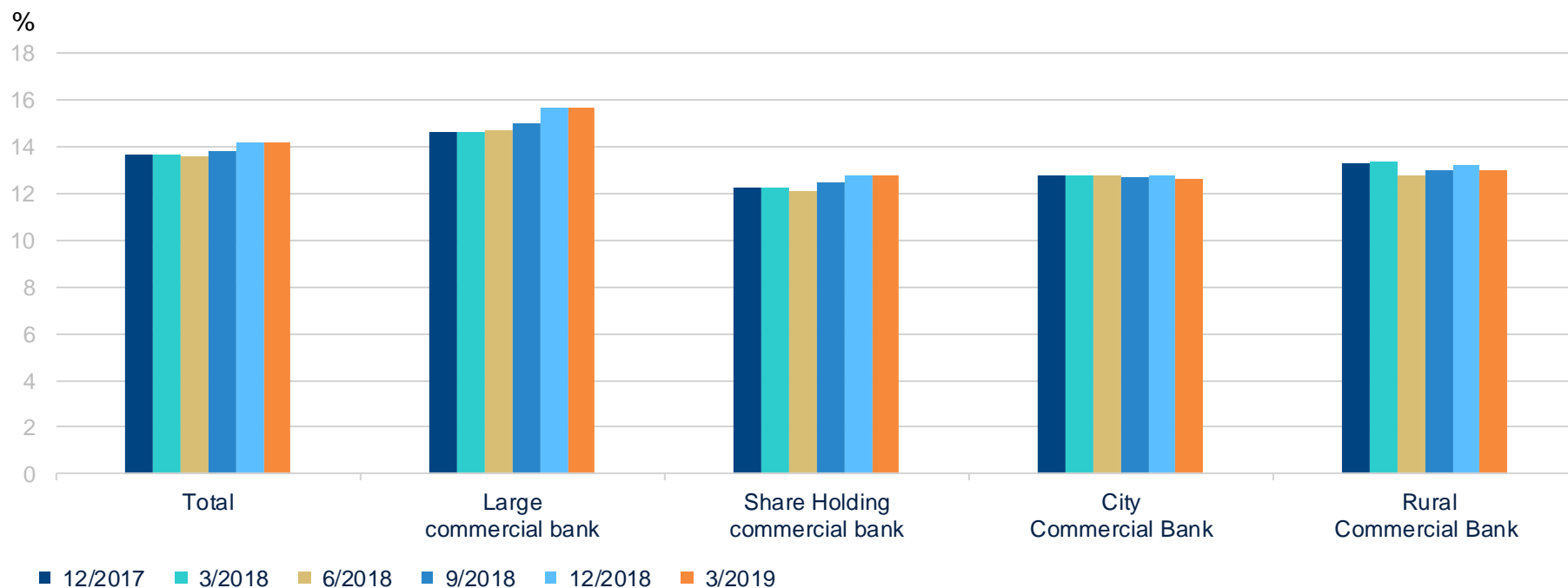
RELATIONSHIP BETWEEN TLAC AND BASEL III



Source: FSB & BBVA Research

The capital shortage major banks faced will be accelerated in the next few years to meet the TLAC rule, which will be implemented at the start in 2025, with a higher requirement taking effect in 2028. It is expected that the top 4 Chinese banks will need to raise RMB 2.8Tn in capital to meet the regulation needs

A diverged capital buffer distribution among big and smaller banks

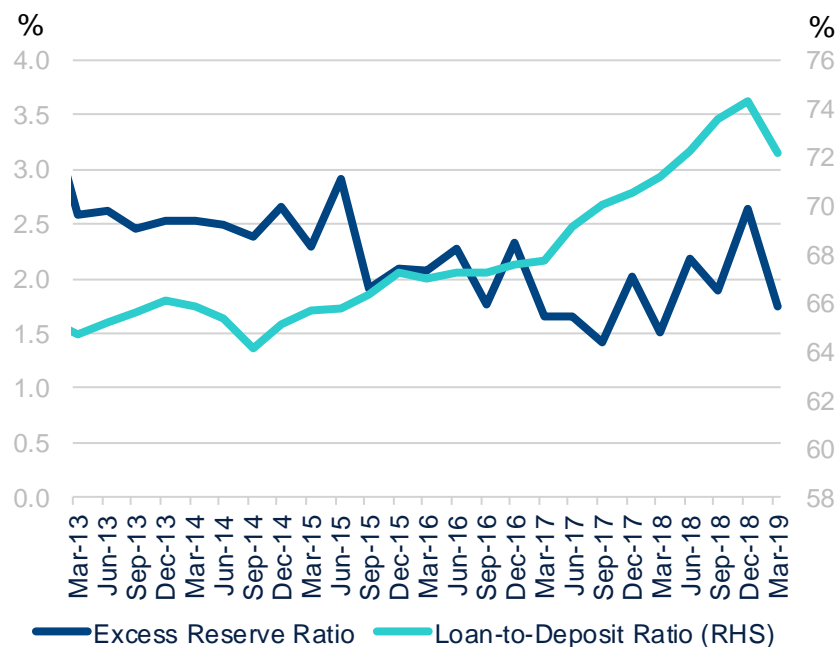


Source: CBRIC & BBVA Research

Although the total provision coverage ratio is rising for all banks, provisions for possible loan losses are seldom matching the aggressive expansion in the overdue loan book for some small city and rural banks, pointing to a potential capital shortfall

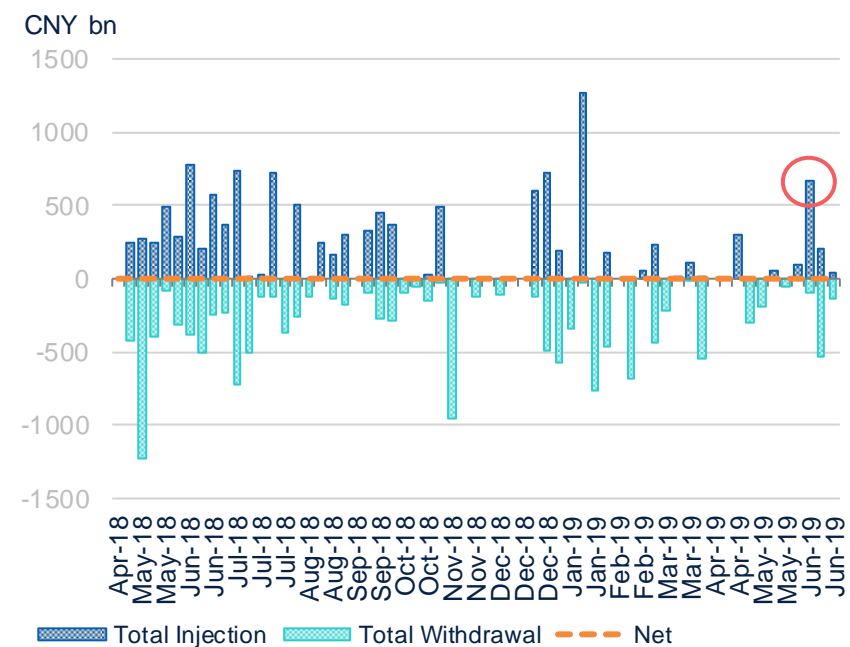
Banks' liquidity remained safe but is subject to challenges of credit event

RIISING LOAN-TO-DEPOSIT RATIO INDICATES THAT BANKS BECOME THE DOMINANT CHANNEL FOR CREDIT EXPANSION



Source: CBRIC & BBVA Research

CHINA PBOC WEEKLY OPEN MARKET OPERATIONS AND ITS REACTION TO BAOSHANG BANK EVENT

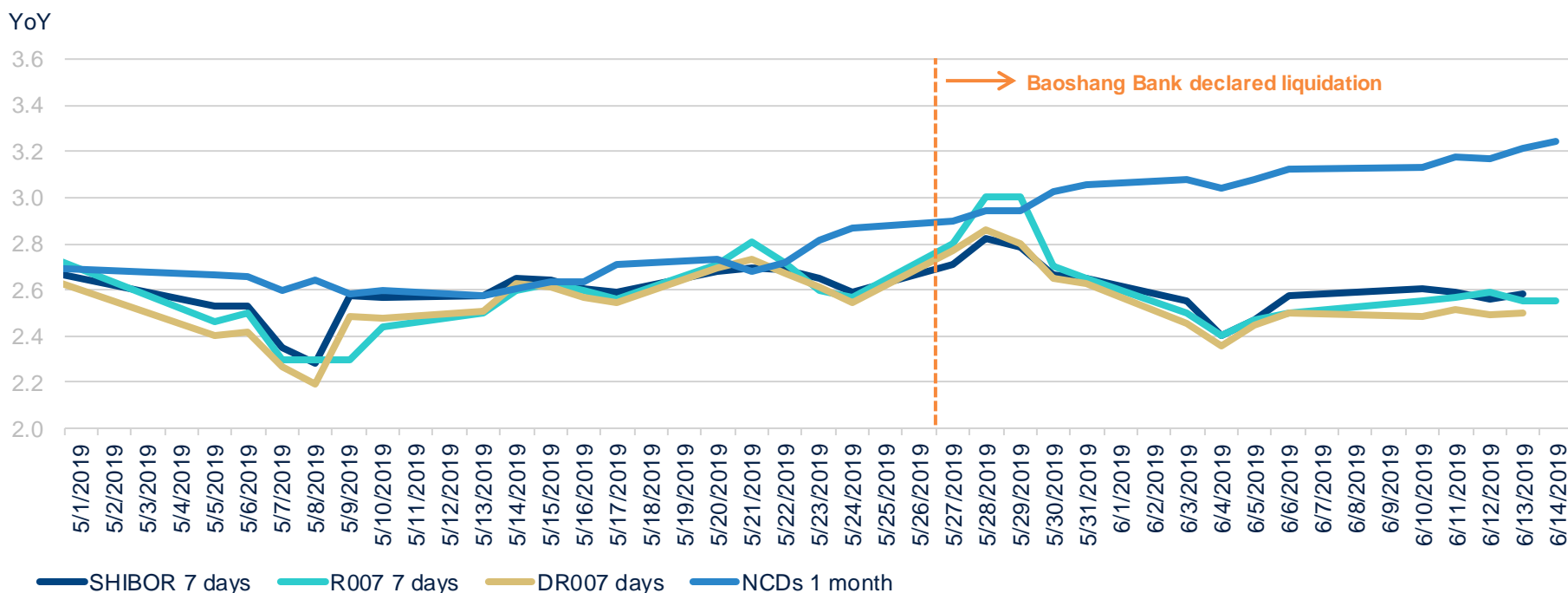


Source: Bloomberg & BBVA Research

The central bank injected Rmb 430 bn in short-term liquidity in the week following the Baoshang bank takeover

Liquidation case-Inner Mongolia based Baoshang Bank

SOLVENCY RISK IS RISING AMONG SOME SMALL CITY AND RURAL COMMERCIAL BANKS

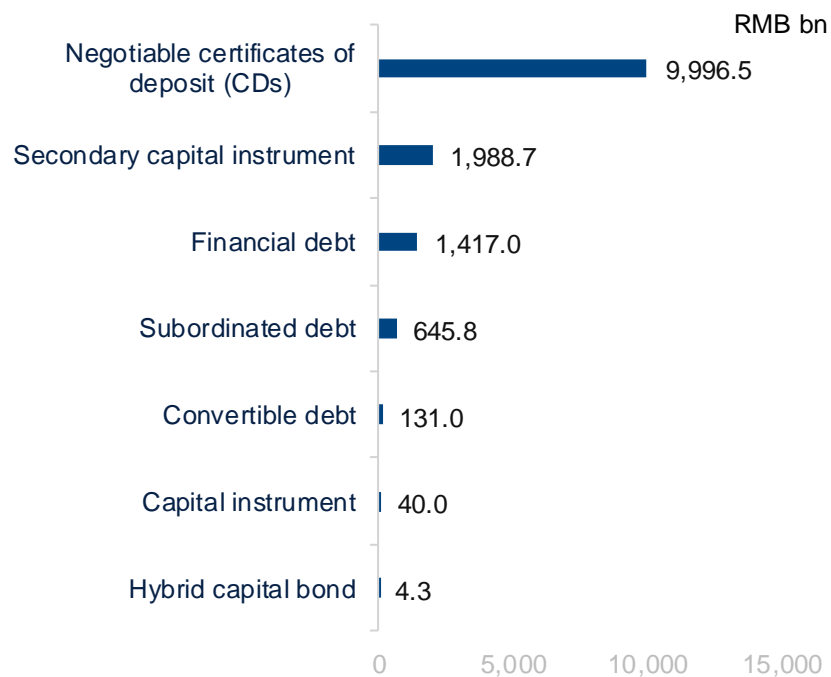


Source: Wind & BBVA Research

The outbreak of Baoshang Bank takeover sent a shock through the interbank market, it has caused jitters among investors about the health of China's banks, especially among the small banks. It is reported that 18 banks haven't report their up-to-date annual financial statement. As a result, Negotiable Certificate of Deposit (NCDs) market is now under great pressure

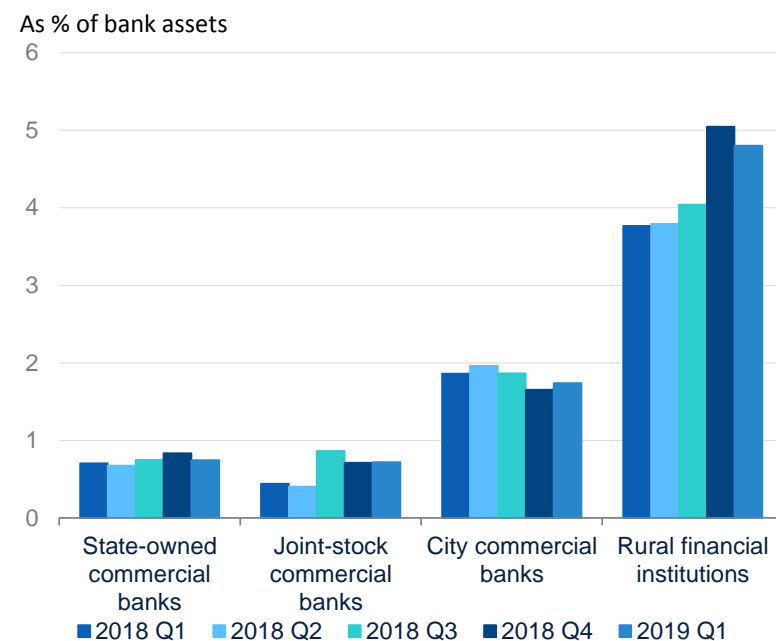
Small banks' increased reliance on negotiable certificates of deposits (NCDs) as fund sources

COMMERCIAL BANKS ISSUED DEBT-INSTRUMENT



Source: Shanghai Clearing House & BBVA Research

INTERCONNECTEDNESS THROUGH HOLDING OF NEGOTIABLE CERTIFICATES OF DEPOSITS (NCDs)

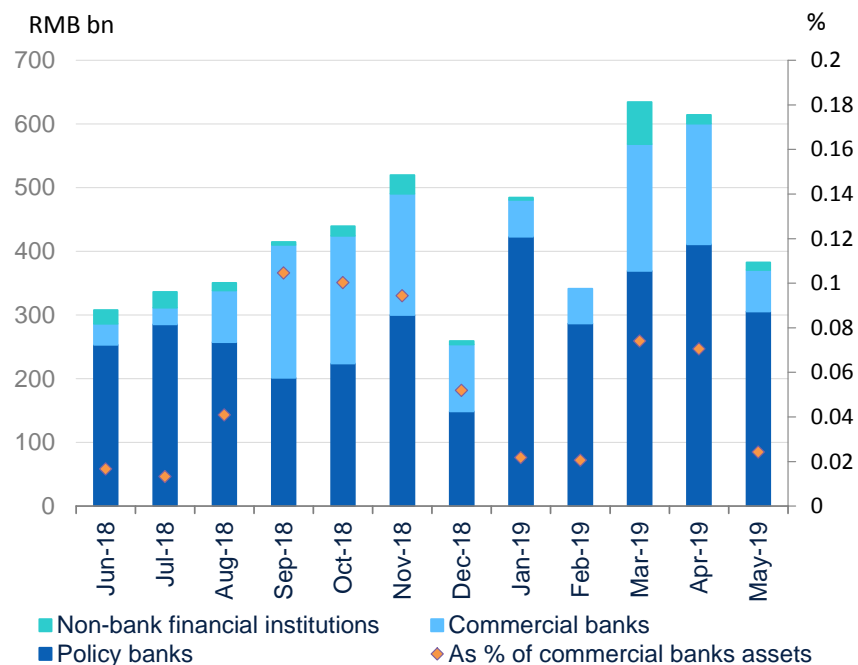


Source: Shanghai Clearing House & BBVA Research

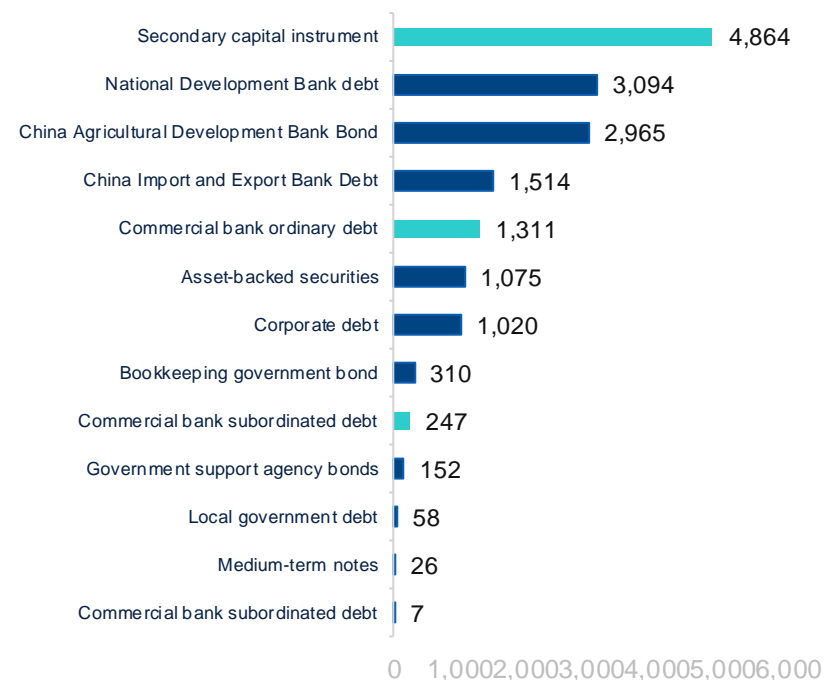
Rural commercial banks and City commercial banks have significantly increased their holding of NCDs issued by peers in the past couple of years, with NCDs as % of bank assets reaching 5.05% and 1.65% respectively at the end of 2018. The share held by state-owned banks and joint-stock commercial banks remained relatively stable.

Banks' increased reliance on bond market

BONDS ISSUANCE BY BANK TYPE



BOND DISTRIBUTION AMONG WEALTH MANAGEMENT PRODUCT HELD BY COMMERCIAL BANKS



Source: Shanghai Clearing House & BBVA Research

Source: China Central Depository and Clearing Co., Ltd & BBVA Research

Bonds issuance by commercial banks surged, driven by smaller bank's taking advantage of a lower market interest rates for funding. Also, wealth management product (WMP) held by commercial banks rely heavily on secondary capital instrument and commercial bank ordinary debt, exposing to credit risk

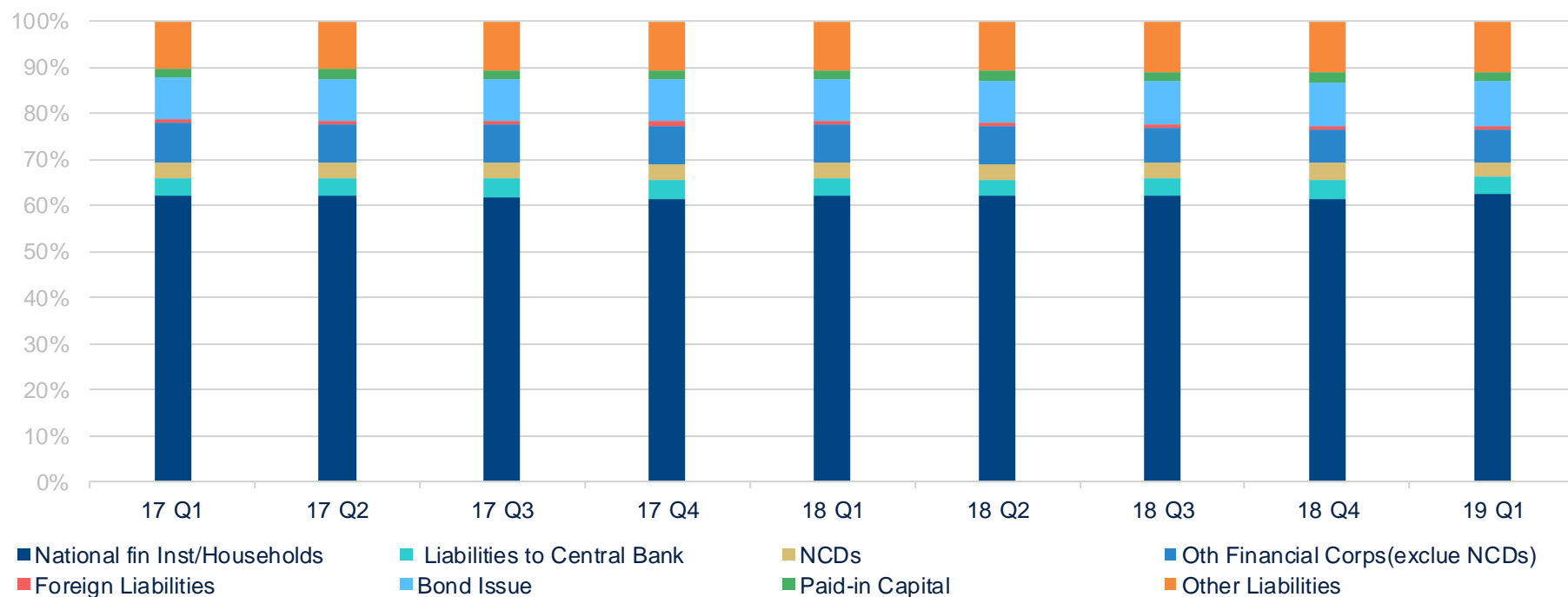
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Shadow banking activities

Banks interconnectedness
with shadow banking system
has marginally decreased

Banks' fund dependence of shadow banking system has marginally decreased

BREAKDOWN OF BANKS LIABILITIES

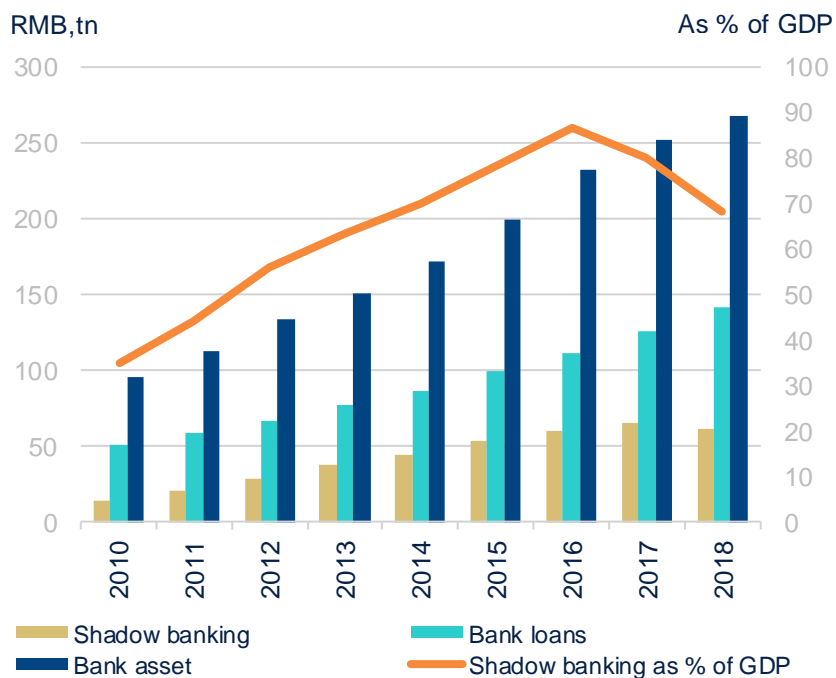


Source: Haver & BBVA Research

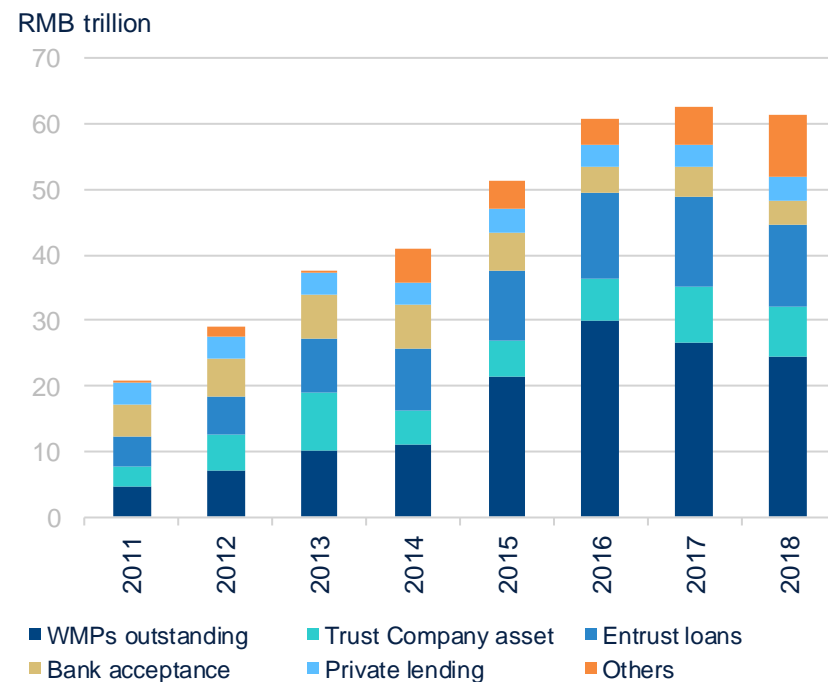
PBOC's direct lending to banks grows amid the financial deleveraging, and banks' interconnectedness with other financial institutions has marginally decreased. However, bank's liabilities to bond issuance and other liabilities increased

Financial deleveraging has seen good progress

SHADOW BANKING ASSETS AS % OF GDP DECLINED FURTHER AT THE END OF 2018



INTENSIFIED REGULATIONS HAVE A GROWING IMPACT ACROSS SHADOW BANKING SECTOR



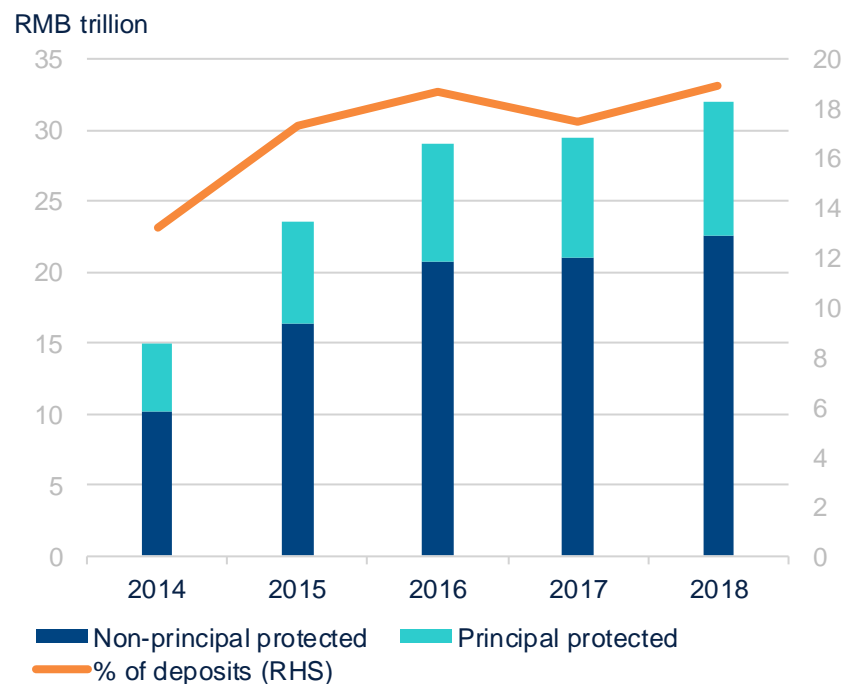
Source: CBIRC & BBVA Research

Source: CBIRC, China Banking Wealth Management Product Registration & Depository Center & BBVA Research

The broad shadow banking assets declined at RMB 61.3 trillion in 2018. Major components of shadow banking including WMPs, trust loans, entrusted loan and bank acceptance all dipped to their slowest pace over the past five quarters

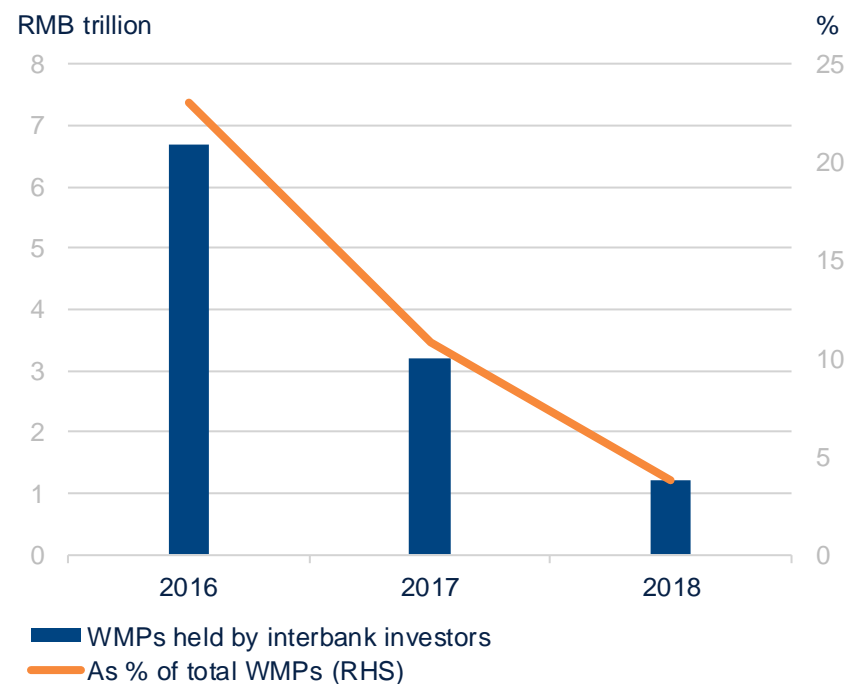
Coordinated regulatory actions help to curb WMPs growth

WMPs OUTSTANDING SLIGHTLY INCREASED END OF 2018



Source: Wind & BBVA Research

INTERBANK INVESTORS' EXPOSURE TO SHADOW BANKING HAS SHRUNK FURTHER

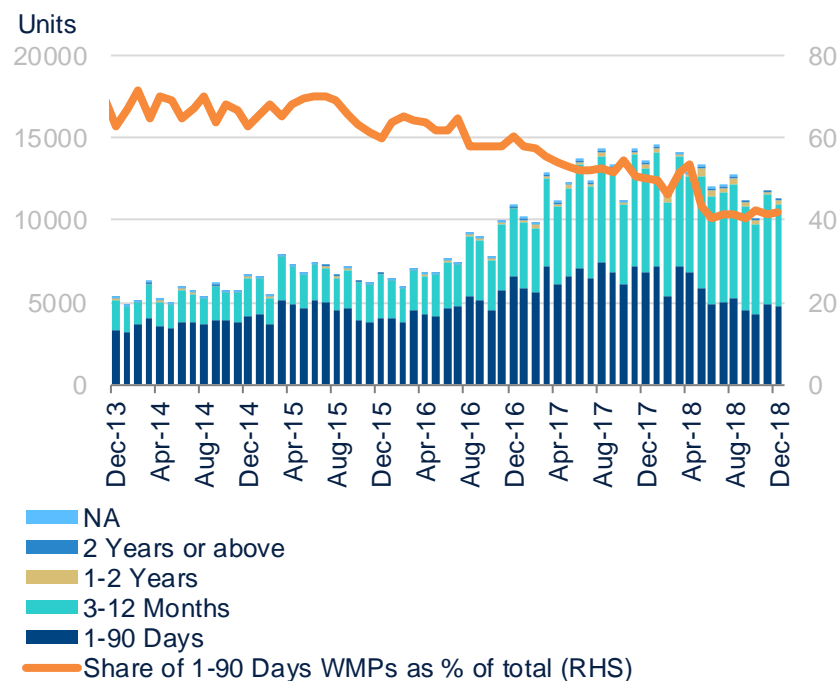


Source: Wind & BBVA Research

Non-principal protected WMPs distributed by banks have shrunk to RMB24.4 trillion at the end of 2018. We expect a marginal relaxation in the implementation of the asset management regulation this year as policy priorities are shifting away from combating leverage towards sustaining growth

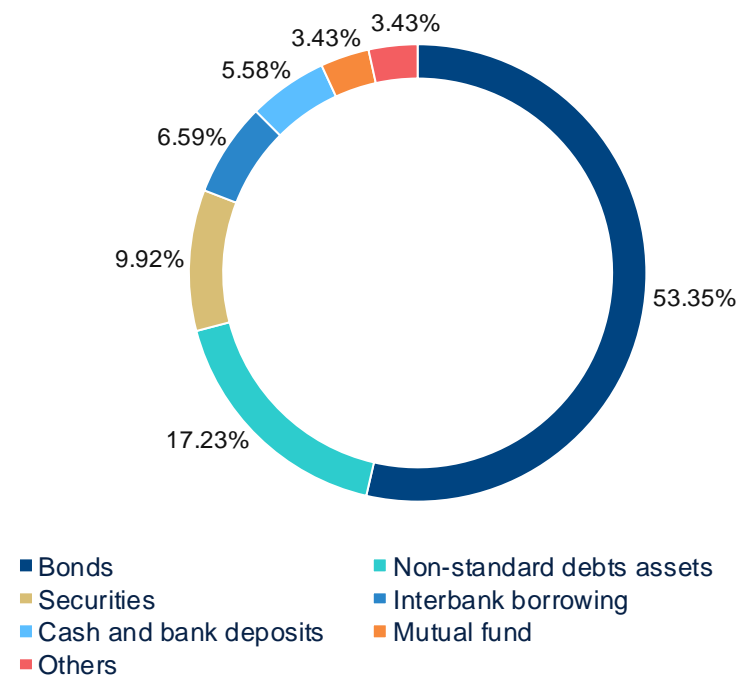
Maturity mismatch between WMPs and underlying assets has lessened

THE SHARE OF SHORT TERM WMPs REMAINED STABLE



Source: CEIC & BBVA Research

WMPs SHIFTED TO EQUITY-LINKED PRODUCTS

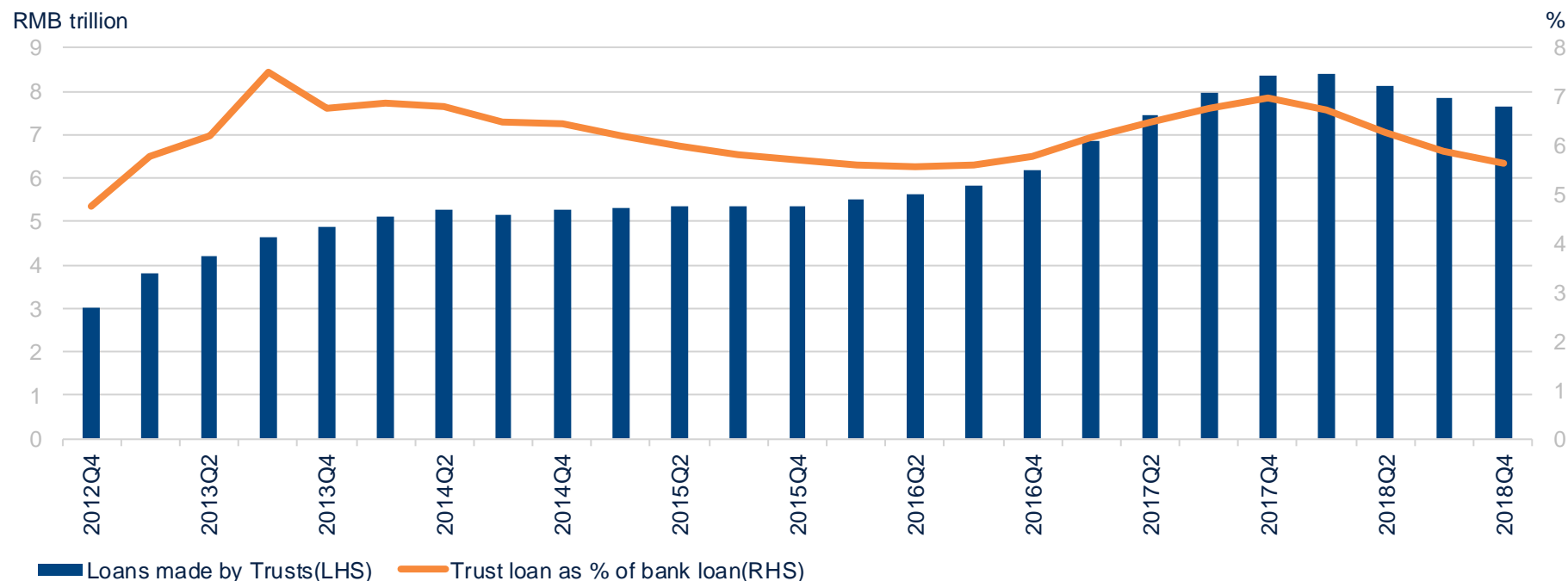


Source: CEIC, Haver & BBVA Research

WMPs with short maturities (below 3 months) are decreasing steadily, with their share having been stable during the second half of last year, helping reduce liquidity risk from a maturity mismatch between WMPs and underlying assets

Trust loans resume to grow in Q1 2019 amid a cooling economy

GROWTH IN TRUST COMPANY LOANS

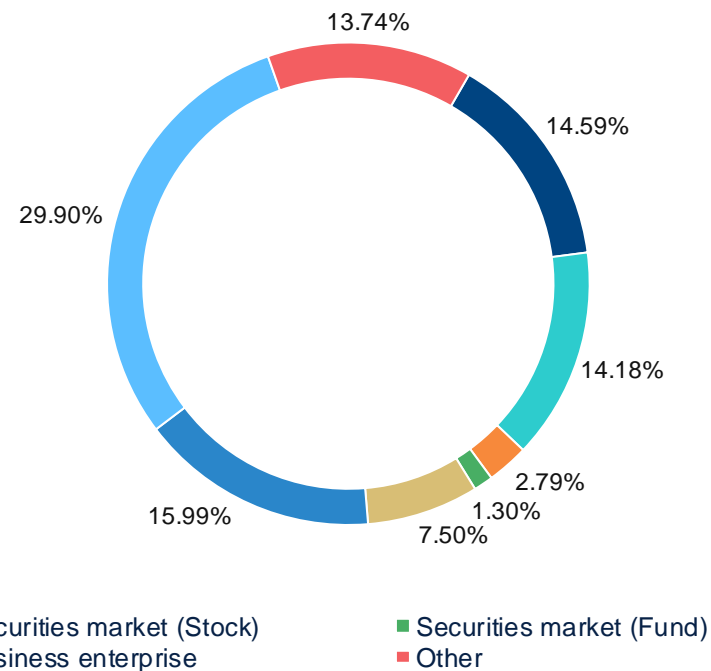
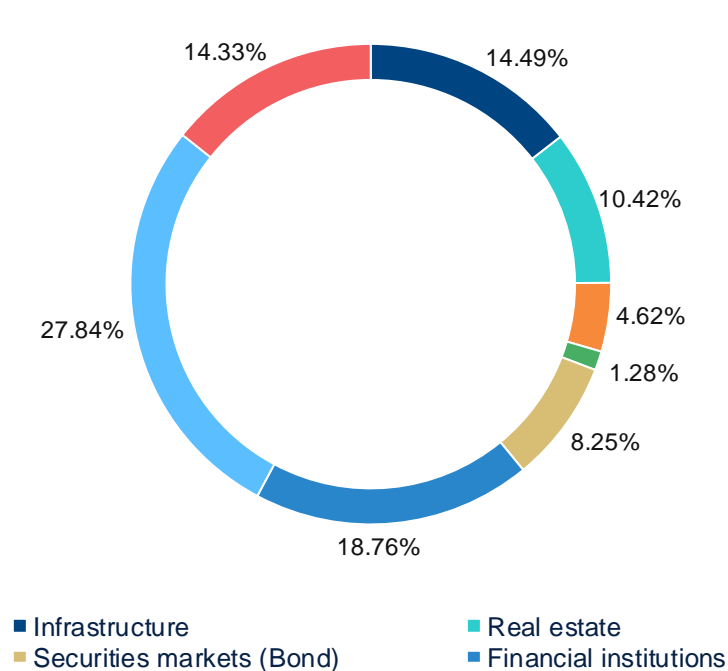


Source: China Trustee Association & BBVA Research

Growth of outstanding trusts loans picked up in Q1 2019 amid a cooling economy, which also reflected the recent relaxation of regulation. We expect this trend will continue in the rest of the year

Trust assets continue to shift toward property sector and business enterprises

PROPERTY SECTORS AND BUSINESS ENTERPRISES SEEK TO TRUST ASSETS FOR FINANCING

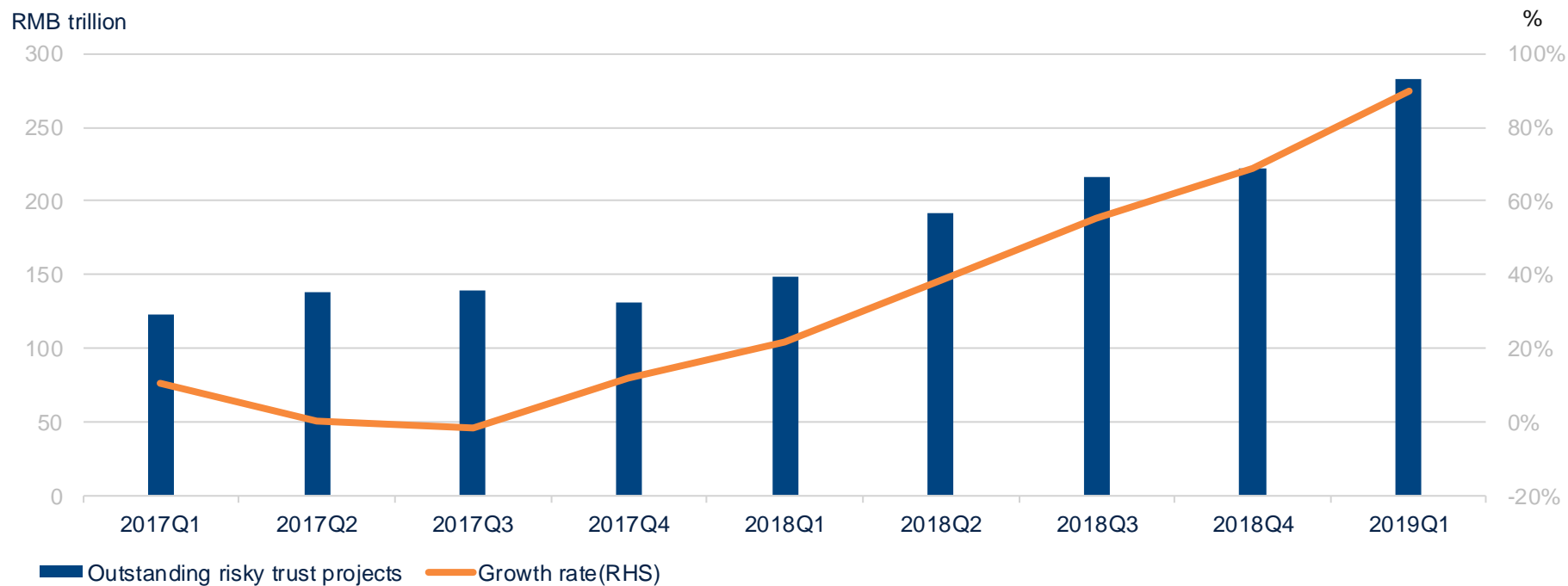


Source: China Trustee Association & BBVA Research

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Although the authorities have pushed for enhanced financial support for POEs, the effect is still limited. Many investors in property sectors and business enterprises seek financing through trust assets

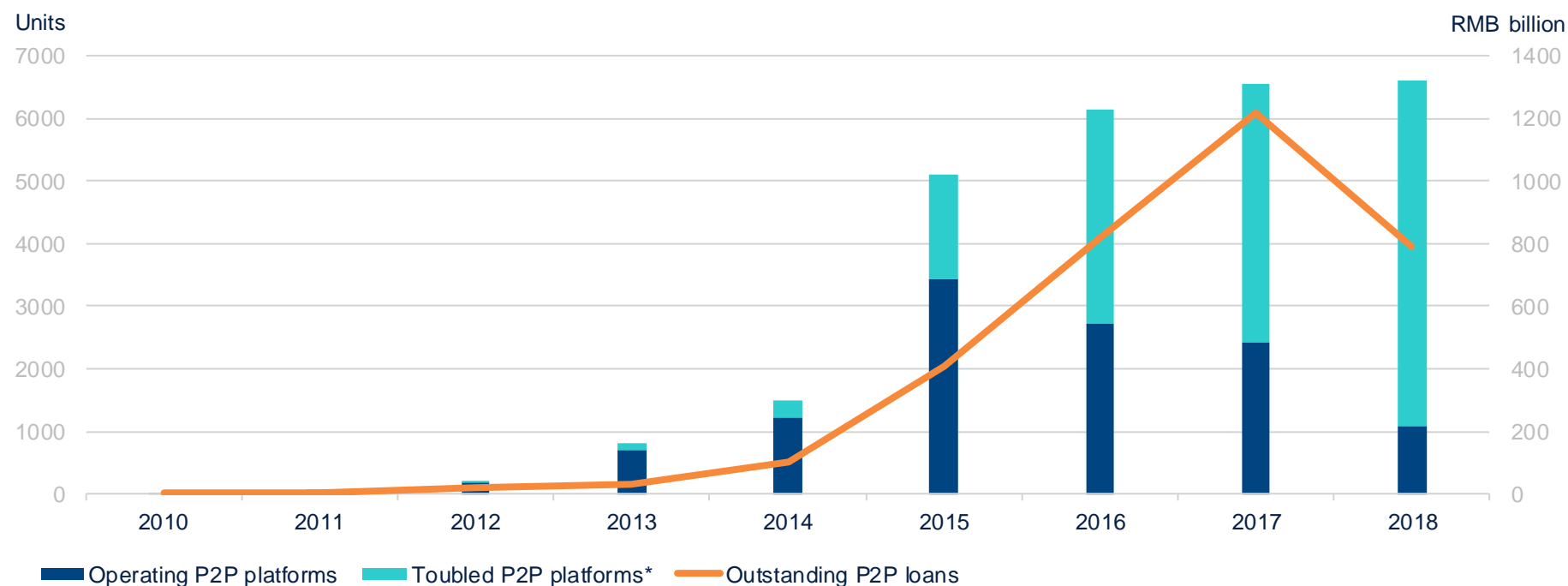
Trust asset quality deteriorated rapidly amid a cooling economy



Source: China Trustee Association & BBVA Research

Default risks are rising for trust projects at the end of 2018 (RMB 222 billion), with the yoy growth reaching almost 70% in Q4. This will accelerate amid a cooling economy as most of its borrowers are highly leveraged. But the risks are still manageable given their small size, which only account for less than 1% of total trust assets

P2P lending growth halved with declining number of operating platforms



Source: Wind & BBVA Research

P2P lending has attracted more stringent regulatory oversight for its high default rates due to weak risk management and fraud. However, the continuous increase in “troubled” P2P platforms has not posed as a significant systemic risk given the industry’s relatively smaller size (around 2% of broad shadow banking assets)

Regulatory measures to curb shadow banking activities

Date	Key Regulatory Developments
Mar-17	Combating market chaos, focusing on strict supervision of inter-bank arbitrage activities, e.g. interbank financing, interbank deposits and outsourcing
Apr-17	Improve the ability and level of the banking system to serve the real economy and avoid idling funds
Apr-17	Strengthen the requirements for risk prevention and risk control in the banking industry, clarify the key areas of risk supervision; limit the scale of inter-bank financing, and intergrate inter-bank businesses into liquidity regulation
Dec-17	Clearly define the bond holding business, the level of bond leverage, etc., implement unified supervision of the bond market business, and gradually de-leverag
Jan-18	Clarify the regulatory standards for large-scale risk exposure of commercial banks, further standardize interbank business, guide banks to focus on their main business
Jan-18	It is make clear that commercial banks, as trustees, may not participate in loan decisions, prohibit the use of funds raised from asset management products to issue entrusted loans, and restrict channels for non-standard investment in asset management products.
Apr-18	Fully standardize the asset management business of financial institutions: clarify the classification standards for asset management products; distinguish the on- and off-balance sheet, break the rigid redemption; control the leverage level; suppress multi-layer nested and non-standard business, etc.
Jun-18	PBOC and CSRC jointly publish rules to limit same-day withdrawal amount from one single MMF at RMB 10,000 per investor with a one-month transition period before full implementation. Only qualified commercial banks are allowed to provide advances for the instant redemption of withdrawals.
Jul-18	CBIRC releases new draft rules to strengthen supervision of commercial banks' WMP business. The draft rules allow product valuation on an amortized cost basis for qualified closed-end WMPs, and lower the minimum subscription amount for single publicly offered WMP to RMB 10,000 from previous RMB50,000. The transition period will last until the end of 2020, in line with the finalized regulation for banks' and NBFIs' asset management businesses released in April. PBOC issues asset management implementation guidelines. The regulator will adjust related MPS parameters and encourage banks to raise tier 2 capital to facilitate the transfer of qualified non-standard debt assets back to banks' balance sheets.

Regulatory measures to curb shadow banking activities

Date	Key Regulatory Developments
Aug-18	CBIRC issues a statement (Document 76) to ask banks and insurers to meet reasonable demand for financing from LGFVs and avoid disruption to ongoing infrastructure projects, as long as it will not increase local government debt. CBIRC issues a statement (Document 37) and clarifies that trust companies can carry out qualified channel business to support the real economy. The financial regulators announce 10 measures to address risks related to P2P lending platforms. The measures clarify the responsibilities of P2P platforms and their shareholders, stipulate the conditions for orderly liquidation of failed platforms, outline penalties for borrowers that escape their debt obligations and prohibit registration of new platforms.
Sep-18	CBIRC publishes the finalized regulation on commercial banks' WMP business after a two-month public consultation. The finalized regulations maintain a minimum 90-day tenor requirement for all closed-end WMPs as proposed in the draft rules, and also allow WMPs to indirectly invest in the stock market through mutual funds
Oct-18	CBIRC publishes the draft regulations on commercial banks' wealth management business unit for public comment. The regulations will split off wealth management units from the parent banks, and allow those units to sell publicly-offered wealth management products without a minimum subscription amount. Wealth management business unit allows a wider scope of products to be developed and to suit the needs of customers. A "fire-wall" will be developed between the bank and the wealth management unit. It will also facilitate to break implicit guarantees of banks' wealth management business.
Dec-18	CBIRC publishes the finalized regulations on commercial banks' wealth management business unit. The finalized regulation requires that wealth management business units cannot invest more than 20% of their own funds into wealth management products issued by the parent banks.
Jan-19	The Office of the Leading Group for the Special Campaign against Internet Financial Risks and the Office of the Leading Group for the Special Campaign against Peer-to-peer Lending Risks jointly release new guideline to facilitate an orderly liquidation of failed platforms in the P2P industry.
Feb-19	PBOC launches the first time issuance of central bank bills swap (CBS), which aims to support eligible banks' issuance of perpetual bonds.

Source: Moody & BBVA Research

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