

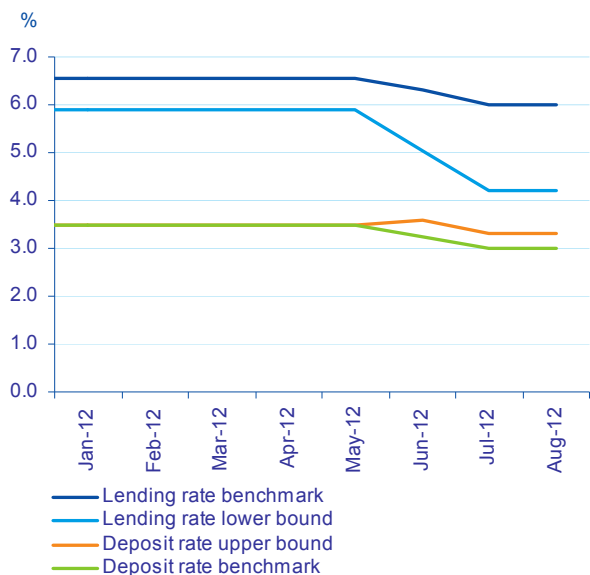
China Flash

First half annual bank financial reports reveal a healthy sector, but with further profit declines ahead

First-half 2012 financial results released over the past two weeks by the 16 listed banks (covering 69% of outstanding bank credit in China) show slower, but still strong profit growth. Liquidity remains adequate and capital increased slightly on capital raising efforts through bond placements. Nevertheless, there was deterioration in asset quality, in line with a trend that we expect to continue in the next 1-2 years due to slowing economic growth and the legacy of high local government debt. Moreover, profit growth is expected to decline further from narrowing interest margins, rising provisions, and implementation of Basel III regulatory requirements (Basel III). See our latest [Banking Watch](#) for further details on the outlook.

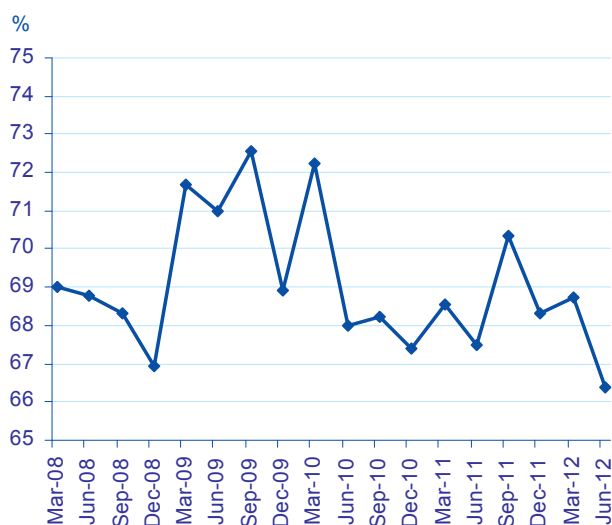
- **H1 profits moderate on weaker loan growth and narrower net interest margins (NIM).** Aggregate net profits of listed banks registered year-on-year growth of 18.1% in H1 2012, down from 23.4% in H2 2011. The moderation in profits was mainly attributable to lower loan growth as the economy slowed down. Narrowing NIMs were also a factor as several banks faced higher funding costs due to tighter liquidity conditions. We expect NIMs to decline further in H2, following asymmetric interest rate cuts by the PBoC in June and July (Chart 1) in which lending rates were effectively lowered by more than deposit rates as greater flexibility in interest rate setting was introduced (by increasing the permissible discount and premium for lending and deposit rates, respectively, from the benchmark).
- **Loan-to-deposit ratios and capital levels remain healthy.** The average loan-to-deposit ratio fell to 66.4% at end-June, from 68.3% at end-2011 (Chart 2). More generally, banking liquidity remains adequate as the PBoC offset tighter financial conditions arising from capital outflows through cuts in the RRR and open market operations. Meanwhile, bank capital adequacy ratios rose slightly to 12.49% from 12.42% during the same period (Chart 3), on the successful implementation of capital replenishment plans of a handful of banks (namely, by ICBC and CITIC through subordinated bond issues and by Beijing Bank through new equity issuance). The five large listed banks also reduced their dividend payout ratios to retain more capital to support their organic growth.
- **However, asset quality declined.** Non-performing loans increased for 14 of 16 the listed banks during H1. In 7 of these banks, the NPL ratio (as a percentage of outstanding total loans) rose as well (Chart 4), although the aggregate NPL ratio remains low at 0.9%. Of greater concern is a significant rise in overdue loans (of less than 90 days, and not yet classified as NPLs) as they signal a further deterioration in credit quality in the coming months. In particular, outstanding overdue loans increased to RMB 528 billion as of end-June 2012 from RMB 402 billion at end-2011, an increase of over 30%.
- **Bank profits are likely to decline further over the coming year.** NIMs are likely to narrow further as interest rate liberalization continues and as greater competition in the banking industry is fostered. Although financial sector liberalization and increased competition should improve bank efficiency in the longer term, the immediate effect is likely to suppress profits due to narrower NIMs. Further monetary easing, as we expect during the remainder of the year, can also be expected to lead to narrower NIMs. At the same time, the rise in NPLs is likely to continue due to the economic slowdown and uncertain global environment. We maintain our projection of bank profit growth slipping into single-digit territory over the next five years.

Chart 1
Interest rate cuts are causing NIMs to narrow



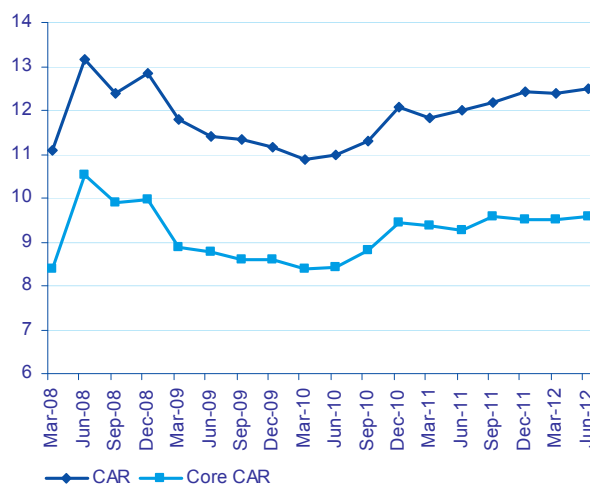
Source: CEIC and BBVA Research

Chart 2
Loan-to-deposit ratios declined in H1 2012



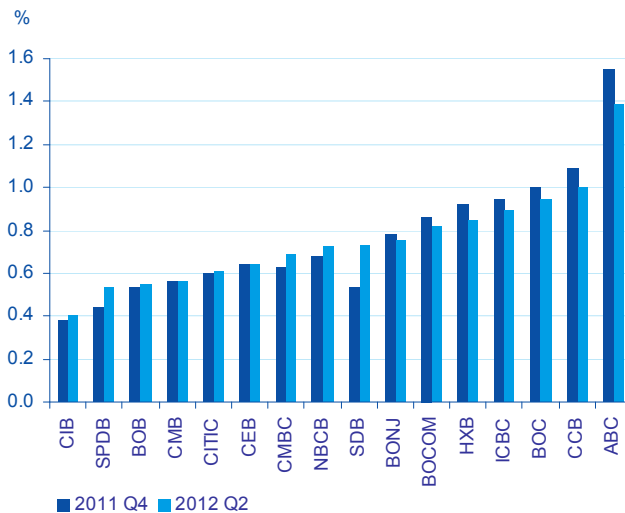
Source: Bank Reports, Wind and BBVA Research

Chart 3
CARs increased slightly in H1 2012



Source: Bank Reports, Wind and BBVA Research

Chart 4
NPL ratios rose for a number of banks in H1 2012



Source: Bank Reports, Wind and BBVA Research



Before you print this message please consider if it is really necessary.

This email and its attachments are subject to the confidentiality terms established in the corresponding regulations and are intended for the sole use of the person or persons indicated in the header. They are for internal use only and cannot be distributed, copied, conveyed or furnished to third parties without prior written consent from BBVA. If this message has been received erroneously, it is forbidden to read, use or copy any of the contents and you are asked to inform BBVA immediately by forwarding the email to the sender and eliminating it thereafter.