

# China's Financial Reform: Moving Against Headwinds

Alicia Garcia-Herrero

Chief Economist Emerging Markets – BBVA Research

# Outline

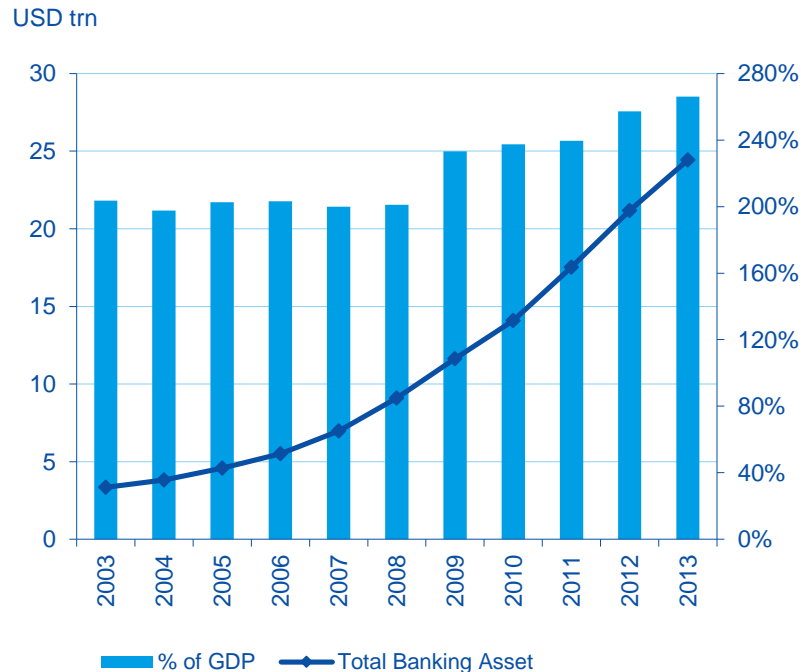
1. Current situation of China's banking sector since the reform
2. Key aspects of the financial reform
3. Outlook for China's banking system

# Development of China's banking sector

- Fast expansion over the past decade
- Still dominated by the state, accounting for over 70% of the system by assets but declining share (policy banks, the 'big five' large commercial banks and shareholding banks)
- Subject to financial repression through regulated interest rate and lending quotas .

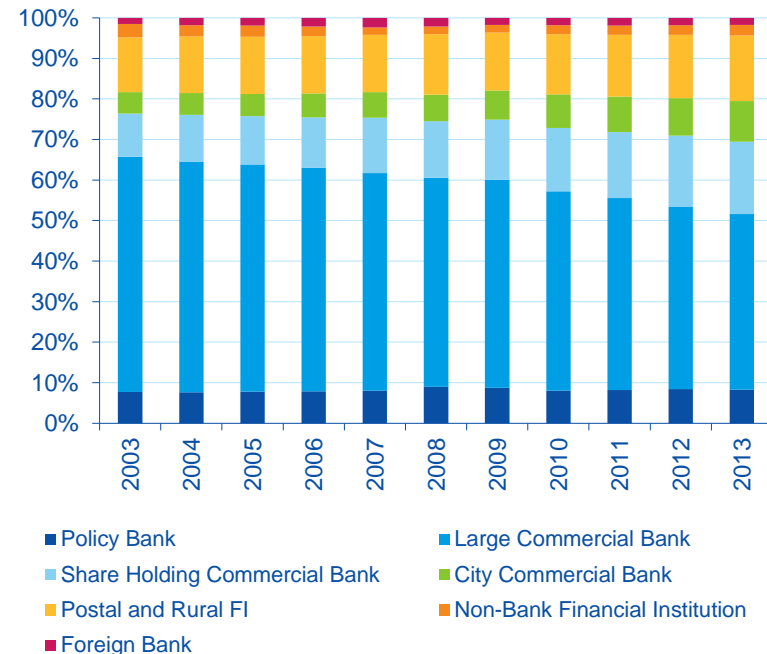
## Total bank assets

Source: CEIC and BBVA Research estimates



## State-owned banks still dominate the market

Source: CEIC and BBVA Research

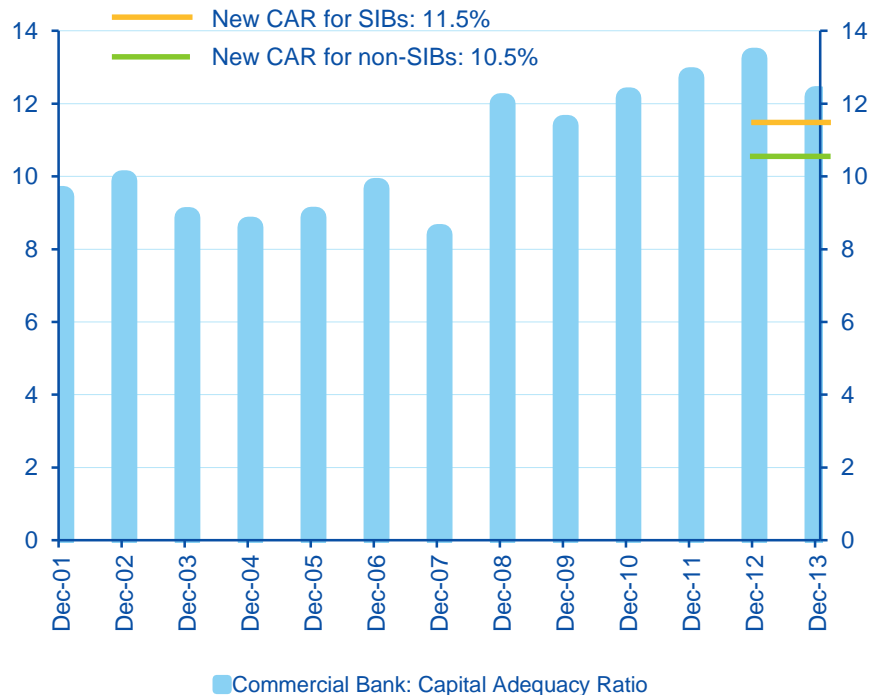


# Banking looks healthy

- After a very difficult situation, solvency wise, system was recapitalized from 2005 onwards.
- Now both capital adequacy ratio and loan-to-deposit ratio look healthy but problems looming

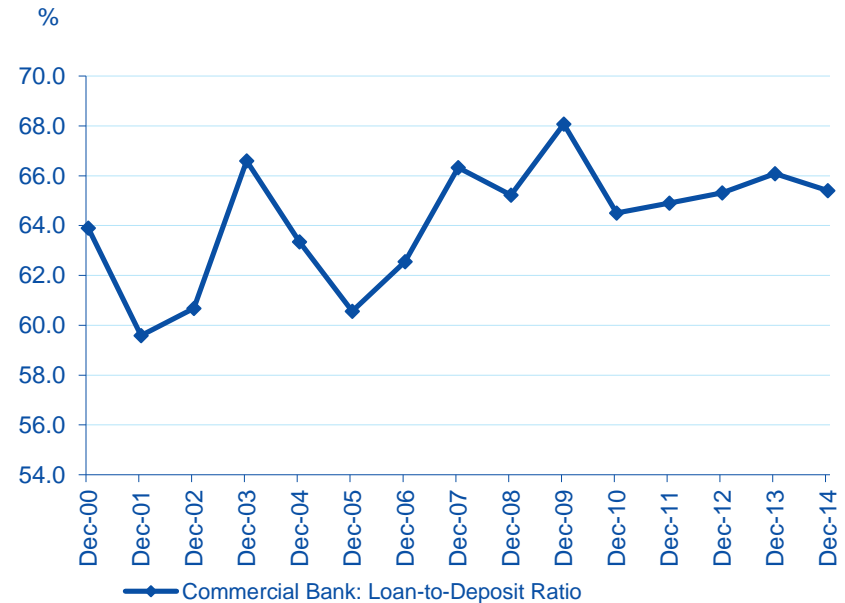
## Bank capital adequacy ratios remains healthy

Source: CEIC and BBVA Research



## Loan-to-deposit ratios are stable

Source: PBoC and BBVA Research estimates

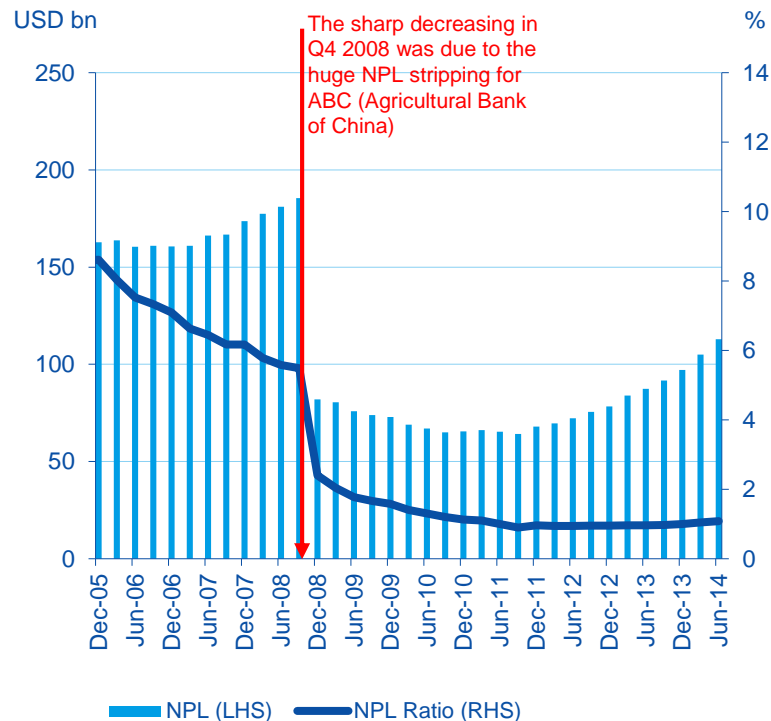


# High profitability so far...

- Drivers:
  - Cyclical factors: fast credit growth (fiscal stimulus since 2008 intermediated by bank lending) and low NPL level (old NPLs transferred, economy still growing and losses not recognized)
  - Structural factors: high interest margins from regulated interest rates

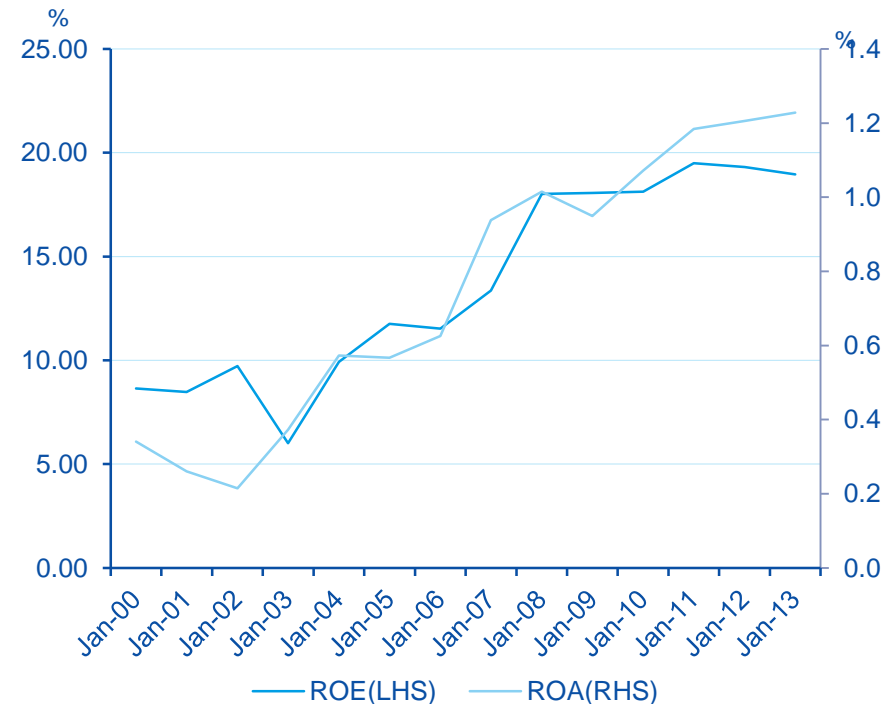
## NPL ratio

Source: CEIC and BBVA Research



## ROA and ROE

Source: Wind, CEIC, PBoC and BBVA Research estimates

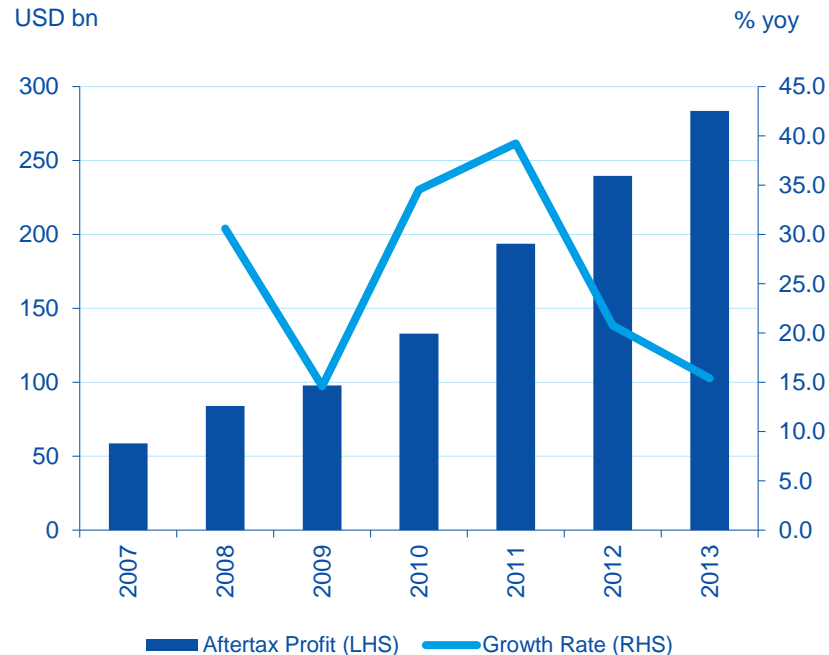


# But profits likely to slow

- We project profit growth to decline to single-digits over the next five years.
- Projection is sensitive to pace of interest rate liberalization and rise in NPLs.
- Falling profit growth is causing banks to cut their dividend payouts to meet the capital requirements and more capital will need to be raised

## Total profit growth slowed from record high in 2011

Source: CEIC and BBVA Research



Credit growth slowing as economic growth moderates

NPL levels to increase as local governments' project become non-performing and corporates start having difficulties to pay (too leveraged)

Interest liberalization to narrow interest margins

Tougher regulation (delayed implementation of Basel III)

Interaction with shadow banking key for profitability outlook

# 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

# Foreign banks invested in China but many left

## Agreements between foreign banks and Chinese banks

Chinese bank	Foreign acquirer	Date <sup>1</sup>	Stake (%)	Price (mn USD)	Strategic investment	Agreement terms of interest
Bank of China (BOC)	Royal Bank of Scotland and coinvestors (Merrill Lynch and others)	Aug-05	10.0	3100	Yes	The consortium assists BOC in credit cards, wealth management, corporate banking and personal life insurance. One seat on the board of directors
	UBS	Sep-05	1.6	500		UBS assists in investment banking
	ADB	Oct-05	0.2	75		ADB aim is to streamline corporate governance. It also provides technical assistance for internal control and anti-money laundering
	Temasek	Dec-05	5.0	1500		A 10% stake was proposed, but only a 5% was approved. Temasek assists BoC in improving corporate governance. Right to nominate candidates for board of directors. Temasek decided to cut its stake
		Nov-07	-0.5			
Bohai Bank	Standard Chartered	Sep-05	19.9	123	Yes	Standard Chartered advises in product development, risk management and governance. Right to nominate vice chairman and deputy CEO
Huaxia Bank	Deutsche Bank	Oct-05	9.9	233	Yes	Launching co-branded credit cards. Cooperation in high-end customer business, distribution of investment products and cash management services. Provide technical support for risk management, retail and corporate banking and governance. Initially, one seat on board of directors
	Sal Oppenheim	Oct-05	4.1	96		
Hangzhou City Commercial Bank	Commonwealth Bank of Australia	Apr-05	19.9	77	Yes	Advice in credit management, marketing, IT technology, financial management and risk management. One seat on board of directors
	ADB	Nov-06	5.0	30		ADB helps to promote corporate governance and internal control procedures
ICBC	Goldman Sachs, Allianz and America Express	Mar-06	8.5	3800	Yes	Goldman Sachs assists ICBC to enhance corporate governance, risk management and internal controls. The former also provides expertise in treasury, asset management, corporate and investment banking, non-performing loans disposal and product innovation. Allianz Group cooperates with ICBC to provide insurance products and services to ICBC's clients. American Express and ICBC develops their existing strategic cooperation in the credit card business. One board seat.
						This sovereign wealth fund is in talks to expand its stake to 10%
	Kuwait Investment Authority	Apr-06	1.0	719		
Ningbo Commercial Bank	OCBC	May-06	12.2	70	Yes	
Tianjin City Commercial Bank	ANZ Banking Group	Jul-06	19.9	112	Yes	ANZ advises on risk management, retail banking and trade finance. Two seats on board of directors
Hangzhou United Rural Cooperative Bank	Rabobank	Jul-06	10.0	31	Yes	First overseas investor in a Chinese rural cooperative bank. Rabobank provides management expertise and technical assistance in business development, distribution policy, product marketing, credit control, risk management and IT. Rabobank will send a senior staff member
	IFC	Aug-06	4.9	NA		Rabobank and IFC advise Chinese authorities on rural cooperative reforms in Zhejiang province
Nan Tung Bank	Morgan Stanley	Sep-06	100			Full acquisition. Foreign bank status
Shanghai Rural Commercial Bank	ANZ Banking Group Ltd	Sep-06	19.9	252	Yes	Two seats on board of directors
CITIC Bank	BBVA	Nov-06	5.0	648	Yes	BBVA advises on retail banking, wholesale banking, international markets, treasury, risk management and human resources
	BBVA	Jun-08	5.1		Yes	BBVA has an option to increase its stake to 15 percent until 2010
Chongqing Commercial Bank	Dah Sing Bank	Apr-07	17	89	Yes	
Qindao City Commercial Bank	Intesa Sanpaolo	Jul-07	19.9	135	Yes	
	Rothschild	Jul-07	5	33		

Source: Own elaboration based on companies reports and news

1) Agreement or publication date



## Agreements between foreign banks and Chinese banks (cont'd)

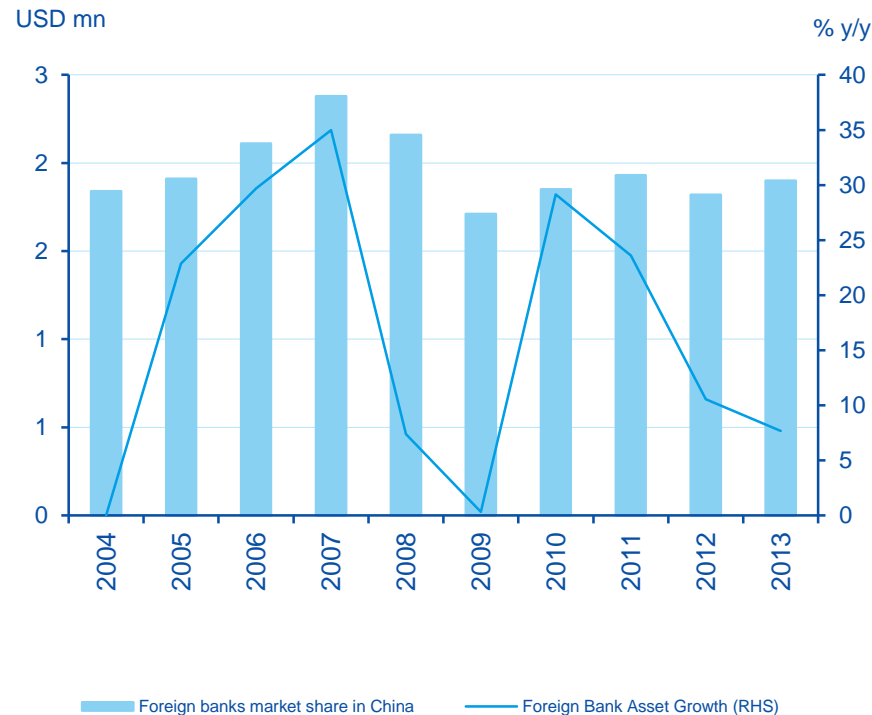
Chinese bank	Foreign acquirer	Date	Date	Stake change%	Stake(%)	Price(mn USD)	Strategic investment	Agreement terms of interest
CITIC Bank	BBVA	Nov-06	Nov-06	5.0	5.0	648	Yes	BBVA advises on retail banking, wholesale banking, international markets, treasury, risk management and human resources
	BBVA	Jun-08	Jun-08	5.1	10.1		Yes	BBVA has an option to increase its stake to 15 percent until 2010
	BBVA	Jun-10	Jun-10	4.9	15.0			
		Oct-13	Oct-13	-5.1	9.9			BBVA cut its stake in order to meet BASEL III standard
Bank of Qingdao	Intesa Sanpaolo	Jul-07	Jul-07	19.9	19.9	135	Yes	Intesa Sanpaolo will provide support in information technology, product development, strategic planning, risk management and credit audit process reform, human resource management, and other core business areas in order to provide technology transfer and support to the bank. At the same time, the two sides will also enhance staff communication training.
	Rothschild	Jul-07	Jul-07	5.0	5.0	33		
		Year 2011	Dec-11	-1.1	3.9			Diluted by non-public offering (0.6 billion shares)
Tianjin binhai rural commercial bank	IFC	Dec-07	Dec-07	10.0	10.0			
Yantai Commercial Bank	HSBC	Jan-08	Jan-08	20.0	20.0	103		
	Wing Lung Bank	Jan-08	Jan-08	5.0	5.0	26		
Bank of Yingkou	Cimb securities and banking group	Mar-08	Mar-08	20.0	20.0	49	Yes	The group will help bank of yingkou to provide technical and management, and aid \$2 million for related training
Xiamen Commercial Bank	Fubon Bank	Jun-08	Jun-08	20.0	20.0	33		
Evergrowing Bank	United Overseas Bank	Jun-08	Jun-08	15.4	15.4	115		
		Year 2009	Dec-09	-7.1	8.3			Diluted by stock dividend payout (3 per 10 shares)
		Jul-10	Jul-10	3.7	12.1	202		UoB increased its stake
		Year 2011	Dec-11	2.2	14.3			Diluted by stock dividend payout (0.8 per 10 shares)
Bank of Jilin	Hana Bank	May-10	May-10	18.3	18.3	316	Yes	Two seats on board of directors, including an executive director
		Year 2011	Dec-11	-1.3	17.0			Diluted by non-public offering (500 million shares)
Bank of Deyang	IFC	Oct-09	Oct-09	15.0	15.0	211		
Merchant Bank	JPMorgan Chase & Co.	Dec-06	Dec-06	1.5	1.5	287		Short term operation
		Jun-07	Jun-07	-0.2	1.3			Short term operation
		Dec-07	Dec-07	0.6	1.8			Short term operation
		Jun-08	Jun-08	1.3	3.1			Short term operation
		Dec-08	Dec-08	0.4	3.6			Short term operation
		Dec-11	Dec-11	7.5	11.0			Short term operation
		Sep-13	Sep-13	-3.2	7.8			JP Morgan reduced stake in China Merchant Bank
	UBS AG	Jun-07	Jun-07	1.0	1.0	571		Short term operation
		Dec-07	Dec-07	0.4	1.4			Short term operation
		Jun-08	Jun-08	0.2	1.6			Short term operation
		Dec-08	Dec-08	-0.5	1.1			Short term operation
	Deutsche Bank Aktiengesellschaft	Dec-11	Dec-11	5.6	5.6	412		Short term operation
		Dec-08	Dec-08	5.6	1.3	233		Short term operation
	Barclays Global Investors UK Holdings Limited	Dec-08	Dec-08					

# Fully owned foreign banks irrelevant

- Total number of foreign banks in China include only 42 locally incorporated foreign banks and 95 branches (Source: CBRC annual report); their business are highly restricted by Chinese regulators;
- The market share of foreign banks dropped recently and is below 2% of Chinese banks' total asset.
- Foreign bank asset growth has been volatile since 20014.

## Foreign bank asset growth has been decreasing since 2010

Source: CBRC and BBVA Research



# Reverse trend: Chinese banks going abroad

- Only largest (state-owned banks) going abroad so far, mostly with branches.
- BOC the king with 613 overseas branches (global SIFI)
- CCB has 13, ICBC has 329, ABC has 10 and BOCOM has 12. Hong Kong key destination

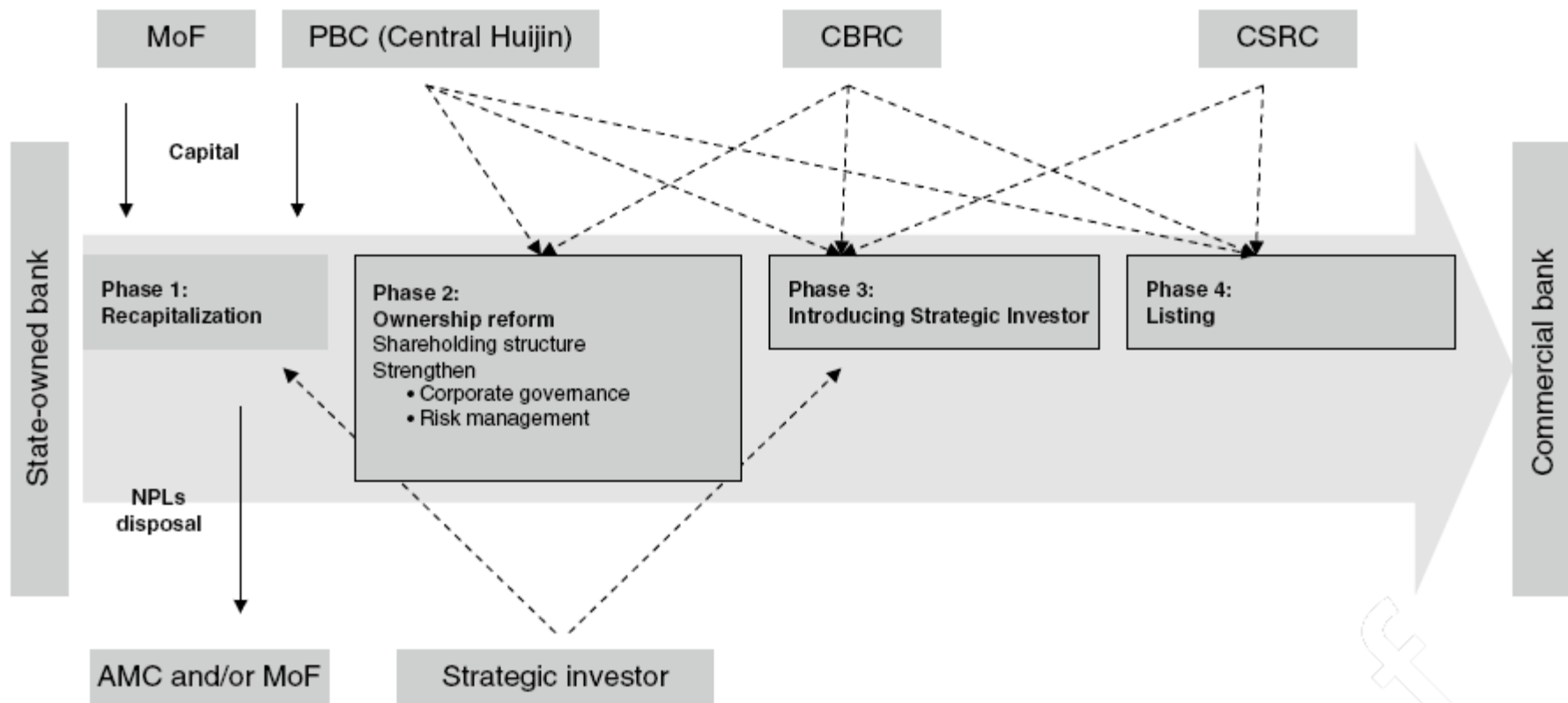
Bank Name	Branches abroad	Date of establishment
<b>Bank of China (BOC)</b>	US (New York)	1981
	France (Paris)	1981
	Australia (Sydney)	1985
	Japan (Tokyo)	1986
	Macau	1987
	Germany (Frankfort)	1989
	Etc.	
<b>China Construction Bank (CCB)</b>	UK (London)	1991
	US (New York)	2009
	Australia (Sydney)	2010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

# Outline

1. Current situation of China's banking sector since the reform
2. Key aspects of financial reform
  - Bank Restructuring
  - Financial liberalization
  - Bank regulation
3. Outlook for China's banking system

# One key pillar: Bank Restructuring

- Since the 1980s, financial sector in China is a central element but trapped in stimuli-NPLs-restructuring cycles.
- In 1998, the PBC began what was meant to be a multi-year restructuring process. The SOCB restructuring was carried out in four waves, each with four sequential phases:



# Large public capital injections for restructuring

- During the banking reform, the authorities have injected (mainly FX reserves) into major commercial banks around 7% of GDP in terms of capital.

## 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)

- Before 2008, bank financing was mainly by the Central Bank injection (with international reserves) through Huijin or Ministry of Finance.
- After 2008, source of capitalization has diversified: A+H Share Rights Issue and Subordinated bond

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)

# NPLs transferred to AMCs

- In terms of NPLs transferred to Asset Management Companies (AMCs) or the MoF, cost was around 20% of GDP (after recoveries 25%), excluding latest – and largest case - ABC

## China's NPLs transfered to AMCs

(figures in RMB bn)

Date	Source bank	Destination AMC	NPLs		Financed by:			Notes
			(RMB bn)	(% of GDP)	AMC bonds	PBC loans	Other	
1999-2000	ICBC	Huarong	408	4.5	313	95		NPLs purchased at 100% of book value, bond maturity 10 years
	ABC	Great Wall	346	3.9		346		
	CCB	Cinda	250	2.8	247	3		
	China Development Bank	Cinda	100	1.1	100			
	BoC	Oriental	267	3.0	151	116		
2000-2001	CCB and China Development Bank		45	0.5				
		Cinda						
2004	BoComm	Cinda	64	0.4				Purchased at 47% of book value, PBC loans to 5 years
	CCB	Cinda	129	0.8		161		
	BoC	Cinda	150	0.9				
	CCB	Cinda	57	0.4				Transferred at 0% of book value
	BoC	Oriental	142	0.9				
2005	ICBC	Great Wall	257	1.4				Purchased at 38% of book value, PBC loans to 5 years
	ICBC	Oriental	121	0.7		176		
	ICBC	Cinda	58	0.3				
	ICBC	Huarong	23	0.1				
	ICBC		246	1.3			246	RMB 246bn represents a debt recognition by the MoF
	Shanghai Bank	Cinda	3	0.0		3		Transferred at 0% of book value
2007	Various banks	Oriental	5	0.0		5		
	Shenzhen Comm. Bank	Cinda	4	0.0		4		
2008	ABC		816	2.6		151	665	RMB 665bn represents a debt recognition by the MoF

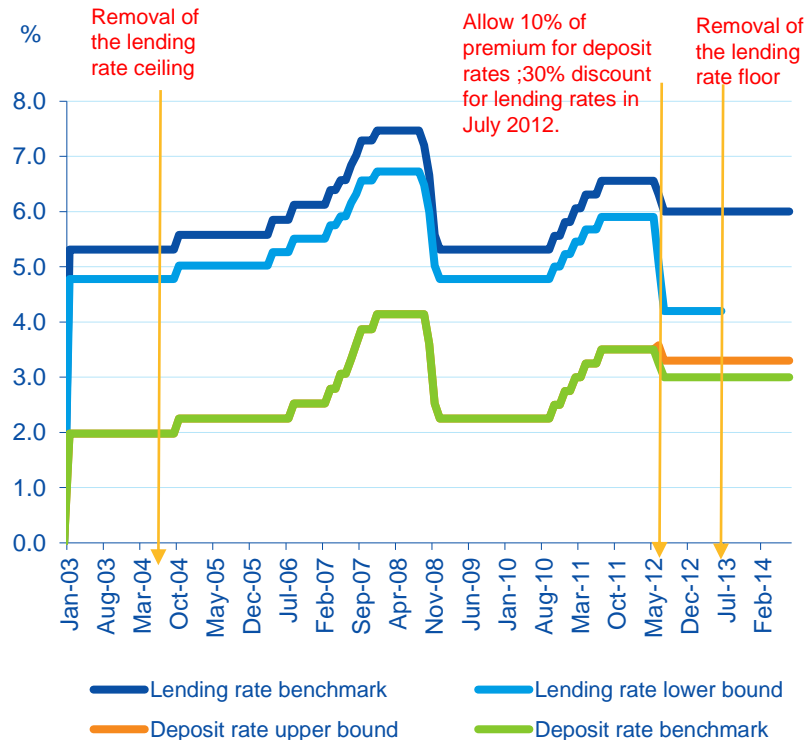
Source: Authors' calculations based on AMC reports and Dragonomics (2011)



# Financial Liberalization

- Lending rate fully liberalized (final step in June 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.

Lending and deposit rates



Details of interest rate liberalization process:

**Fully liberalized the money market**  
June 1996

Allow the interbank rates determined fully by the market force

**Interest Rate Benchmark Band Widening**  
June/July 2012

Allow 10% of premium for deposit rates and 30% discount for lending rates.

**Removal of lending rate floor**  
July 2013

Removed: (i) the lending rate floor on bank loans (before set at 70% of the benchmark lending rate); (ii) controls on the price setting of banks' bill discounting; and (iii) lending rate caps (previously set at 2.3x the benchmark lending rate) on rural credit unions

**Creation of New Prime Lending Rate**  
October 2013

The new prime lending rate will be calculated daily as a weighted average of nine banks' actual lending rates, and is meant to assist banks in pricing their loans.

# Capital account liberalization

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

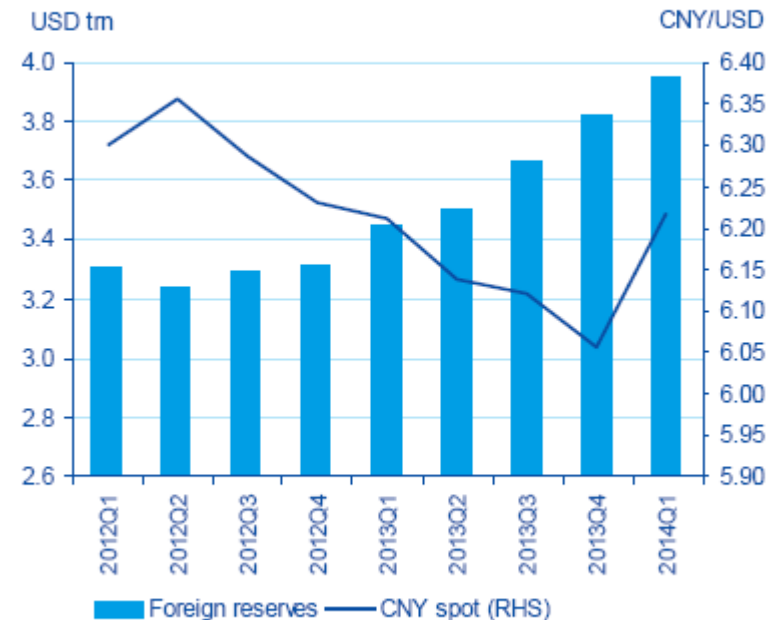
- Increased exchange rate flexibility by widening the RMB daily trading band to  $\pm 2\%$  (from  $\pm 1\%$ ) in March, 2014.
- Previously, continuous RMB appreciation attracted large FX reserve accumulation, thereafter moderate depreciation
- A more flexible RMB should help to hamper strong capital influx (particularly “hot money”) and strengthen the independence of China’s monetary policy in the long run.

The daily trading band is expanded to allow for a larger extent of exchange rate flexibility



Source: Bloomberg and BBVA Research

Continuous appreciation of the RMB contributes to China's FX reserve accumulation



Source: Bloomberg and BBVA Research

# Strengthening Banking Regulation

- With the creation of the CBRC in 2003, banking regulation during the reform was accelerated in several areas:
- ***Asset quality:***
  - Five-tier credit classification system established in 2002 according to the probability of default, and similar to that used internationally
  - Banks required to classify their loans according to the standard classification system in 2005 and banks finally required to completely provision their impaired loans in 2009
  - Provisioning coverage ratio increased to 150% of impaired loans in 2009
- ***Regulatory capital:***
  - A similar framework to Basel I I introduced in 2003
  - Internal models for risk within Basel II framework adopted in 2009
  - New toolbox of capital requirements drawing from the new Basel III announced in 2010, including strengthened capital adequacy requirements, leverage ratios, dynamic provisioning and new liquidity measures.

# Status of Chinese version of Basel III

Category	Rules and compliance timeline
Capital Adequacy	<ul style="list-style-type: none"> <li>Minimum capital adequacy ratio (CAR) for core tier I capital, tier I capital and total capital are set as 5%, 6% and 8%, respectively;</li> <li>On top of the minimum CAR, SIBs are also required to set aside <b>2.5% extra capital</b>;</li> <li><b>A countercyclical capital buffer</b> (0-2.5%) will be required when necessary;</li> <li>SIBs are required to maintain CARs of 1% higher than non-SIBs, which means that under normal circumstance (i.e., when no countercyclical capital is imposed) the CARs of SIB and non-SIB would be at least <b>11.5% (8% minimum +2.5% extra +1% SIB) and 10.5%</b></li> <li>Compliance timeline: start implementation from January 2013 and <b>full compliance by end-2018</b>.</li> </ul>
Leverage Ratio	<ul style="list-style-type: none"> <li>A <b>minimum leverage ratio</b>, defined as the ratio of core tier I capital to adjusted total asset, is set at 4%;</li> <li>Compliance timeline: start implementation from January 2012, full compliance by end-2013 for SIBs and by end-2016 for non-SIBs.</li> </ul>
Liquidity	<ul style="list-style-type: none"> <li><b>Liquidity coverage ratio and net stable funding ratio</b> are introduced into the current liquidity supervisory framework;</li> <li>Compliance timeline: start implementation from March 2014 and <b>full compliance by end-2018</b> (for both SIBs and non-SIBs),</li> </ul>
Loan Provision	<ul style="list-style-type: none"> <li>The <b>minimum Provision/Total Loan ratio</b> is set at 2.5%;</li> <li>The <b>minimum Provision coverage ratio</b> (the ratio of provision to non-performance loans) is set at 150%;</li> <li>The authorities will dynamically adjust the provision requirement;</li> <li>Compliance timeline: SIBs by end-2013 and non-SIBs by end-2016..</li> </ul>
Source: CBRC and BBVA Research	

# Outline

1. Current situation of China's banking sector since the reform
2. Three key aspects of the financial reform
3. The outlook for China's banking system

# Gloomy outlook for medium-term profitability

- Even in our baseline scenario, banks' profit is likely to slide into a multi-year decline
- We estimate that banks need additional RMB 1.5-2.0 trillion to replenish capital over the next five years in our base scenario, which is higher than the aggregate capital of RMB 1.2 trillion raised since 2010.

	2011	2012	2013	2014	2015	2016	2017	2018
GDP growth	9.2%	7.8%	7.7%	7.2%	7.0%	7.0%	6.8%	6.5%
CPI average	5.4%	2.6%	3.0%	4.0%	4.0%	4.0%	4.0%	4.0%
Credit growth	19.2%	17.9%	14.3%	13.5%	13.0%	12.5%	12.0%	11.0%
Net interest margin	2.7%	2.6%	2.3%	2.0%	1.9%	1.8%	1.7%	1.6%
% of fee and investment income	33.8%	35.0%	36.5%	38.0%	40.0%	40.0%	40.0%	40.0%
NPL ratio	1.0%	1.0%	1.0%	1.3%	1.8%	2.3%	2.7%	3.0%
Provision / NPL	278.1%	296.0%	282.7%	220.0%	170.0%	150.0%	150.0%	150.0%
<b>Profit growth</b>	<b>36.3%</b>	<b>19.0%</b>	<b>14.5%</b>	<b>9.3%</b>	<b>-14.7%</b>	<b>-7.7%</b>	<b>-8.7%</b>	<b>4.5%</b>

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

- But, if banks need to take up part of bad debt resulting from LGFVs (RMB 4 trn) and WMPs (RMB 1.3 trn), NPL ratio will increase substantially.

# Indebtedness of local governments adds pressure on asset quality

- The latest audit of local government debt shows an increase to RMB 17.9 trillion at end-June 2013
- A clean-up of local government debt may require central government funds, and bank write-offs

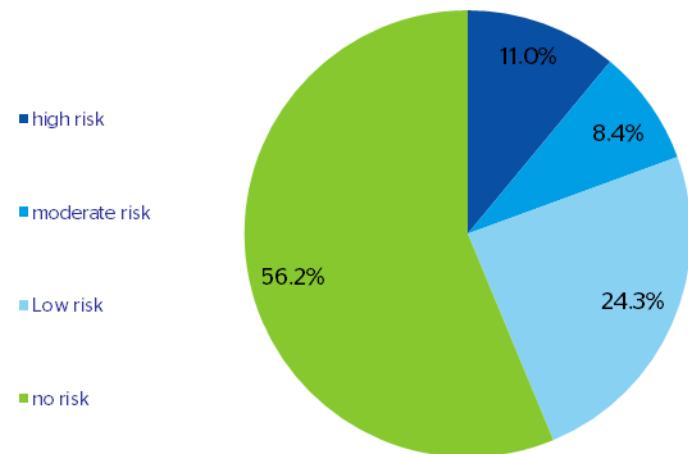
Local government debt has risen

Source: BBVA Research



The government estimated around 20% of LGFVs debt at risk

Source: BBVA Research



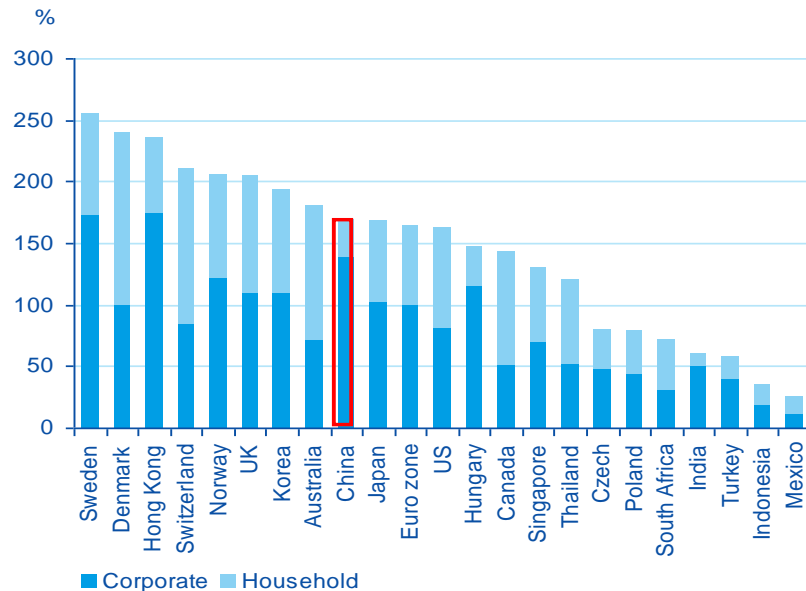


# Corporate debt: another drag for asset quality

- As a share of GDP, China's corporate debt is high by international standards.
- High corporate debt may constrain growth and weigh on bank asset quality

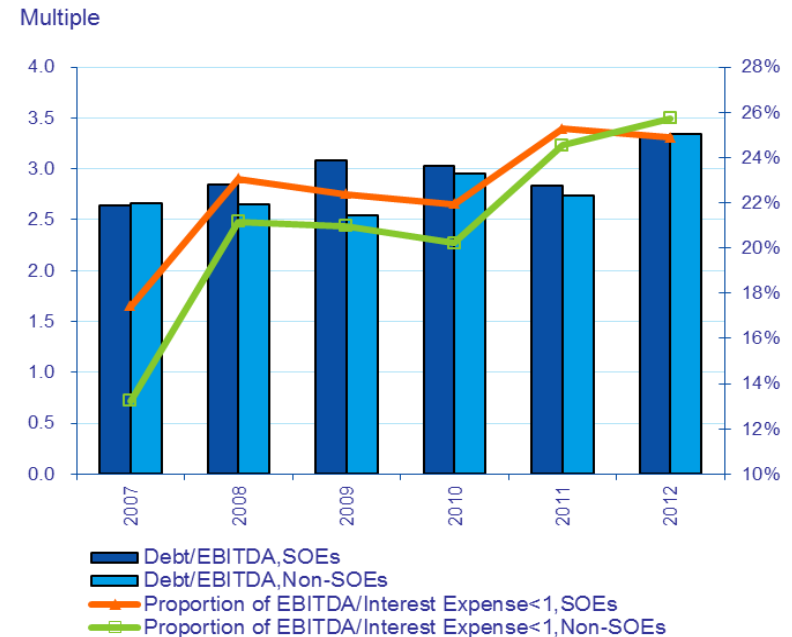
## corporate debt level is high by international standard

Source: BBVA Research



## Corporate debt stress ratio rose to new high

Source: BBVA Research

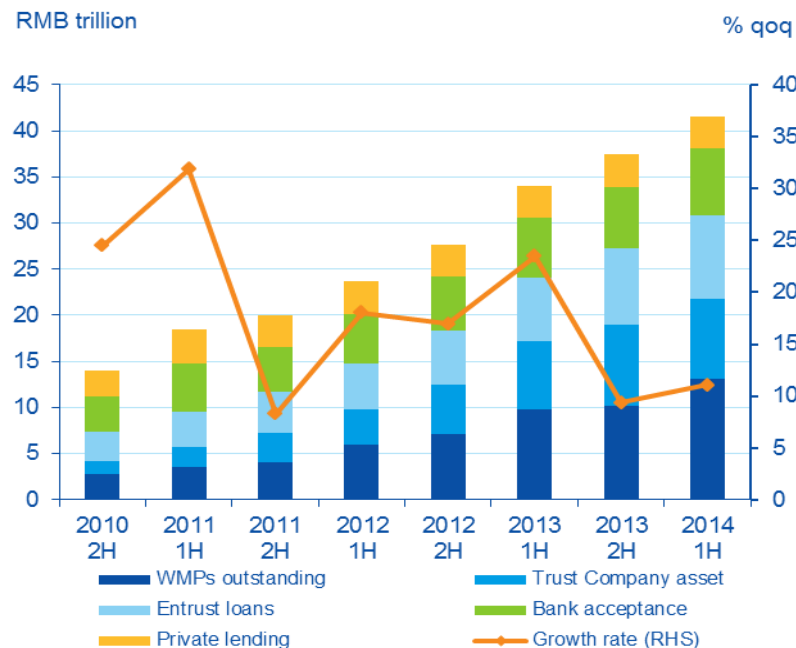


# Shadow banking also poses risks to banks

- Its size has grown rapidly in recent years as banks circumvent tightening regulations
- Involvement of banks in shadow banking activities could eventually impact their balance sheets.

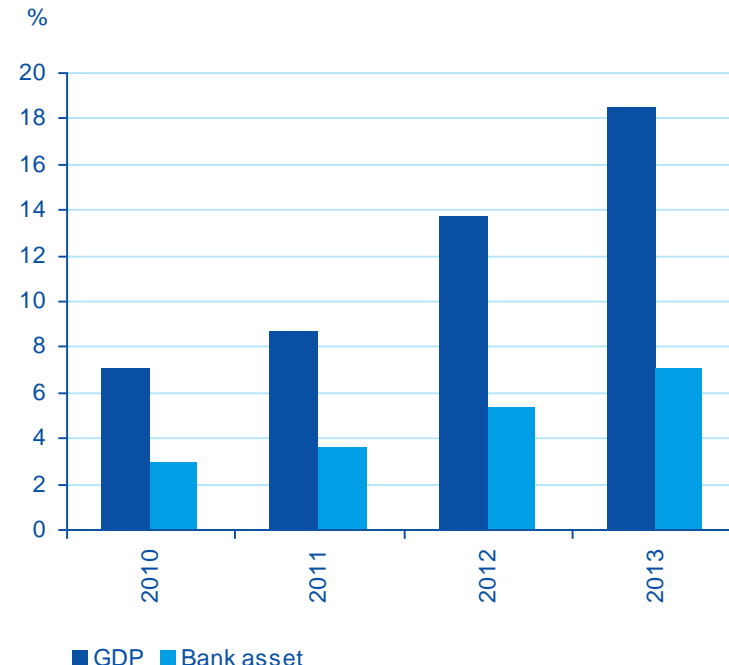
## Shadow banking activities have risen...

Source: Wind, CEIC, PBoC and BBVA Research estimates



## ...leading to an increase in the size of the shadow banking sector in the economy

Source: PBoC and BBVA Research



# Worse scenarios analysis: LGFVs and shadow banking

- Under Scenario A and B, banks' profit will fall below zero from 2016 onwards and recapitalization needs will be much bigger than previously assumed

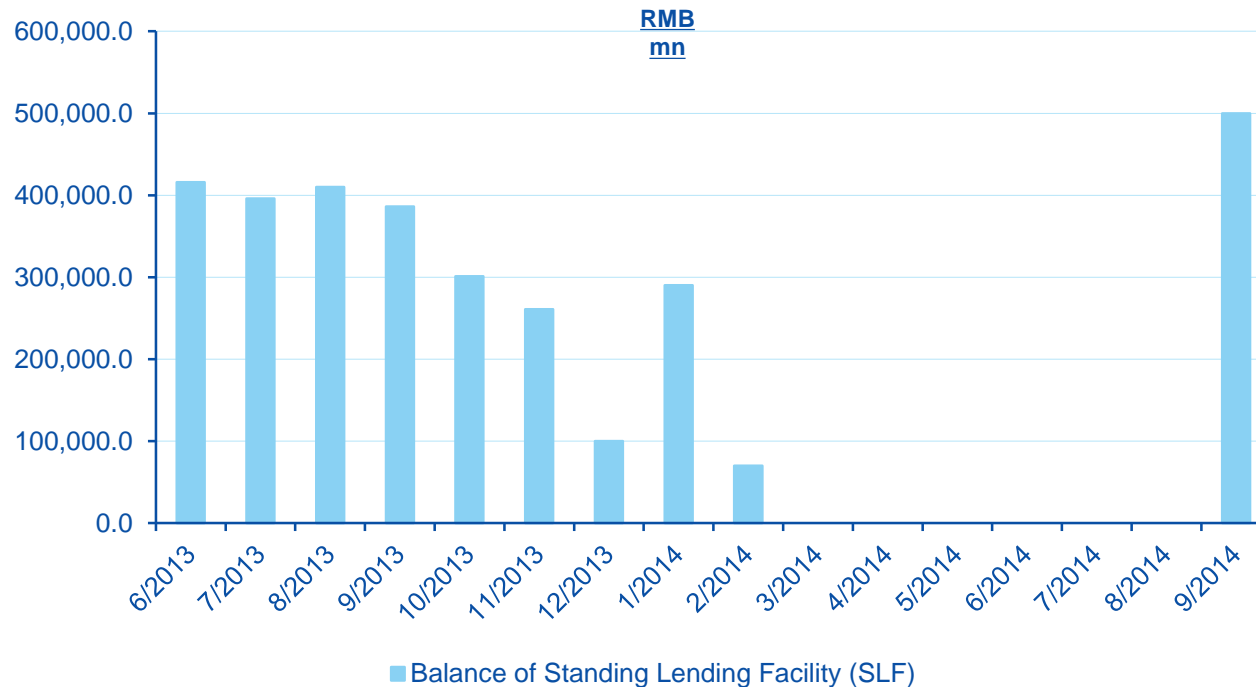
NPL ratio	2011	2012	2013	2014	2015	2016	2017	2018
Base Scenario	1.0%	1.0%	1.0%	1.3%	1.8%	2.3%	2.7%	3.0%
Scenario A (Baseline +LGFV loans)	1.0%	1.0%	1.0%	2.4%	3.9%	5.1%	6.0%	6.7%
Scenario B(Baseline+LGFV loans+WMPs)	1.0%	1.0%	1.0%	2.8%	4.6%	6.0%	7.1%	8.0%

# Liquidity is a problem too: Recent liquidity injections by PBoC

- 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)

## Balance of Standing Lending Facility (SLF)

Source: PBoC and BBVA Research



# Potential additional steps on restructuring

## 1. Further IPOs

- A fundamental benefit of public ownership is increased exposure to competition, as capital markets force companies to accept market supervision.
- The IPO process enforces greater transparency and more stringent reporting standards, and public companies can typically raise capital to support long-term growth more economically than private companies.

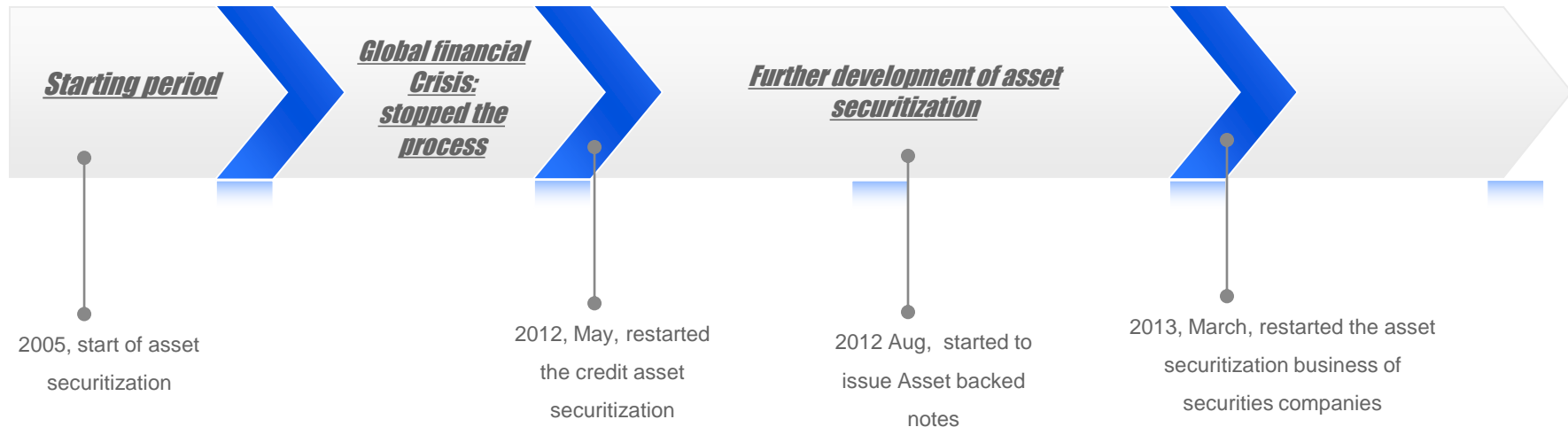
### Commercial Banks that finished IPO and are waiting for IPO

Commercial Banks that finished IPO (16) and the amount raised through IPO	Commercial Banks waiting for IPO (11)
Industrial and Commercial Bank of China(ICBC): 19.1 bn USD	Bank of Shanghai
Agricultural Bank of China (ABC): 22.1 bn USD	Bank of Jiangsu
Bank of China (BOC): 31.2 bn USD	Shengjing Bank
CCB (China Construction Bank): 9.2 bn USD	Bank of Hangzhou
BOCOM (Bank of Communication): 2.2 bn USD	Bank of Chengdu
China Merchant Bank (CMB): 10.9 bn USD	Bank of Guiyang
Industrial Bank: 15 bn USD	Changshu Rural Commercial Bank
CITIC Bank: 5.4 bn USD	Wuxi Rural Commercial Bank
Shanghai Pudong Development Bank (SPD): 5.0 bn USD	Jiangyin Rural Commercial Bank
Minsheng Bank: 3.9 bn USD	Zhangjiagang Rural Commercial Bank
Huaxia Bank: 0.7 bn USD	Wujiang Rural Commercial Bank
Pingan Bank (former name: Shenzhen Development Bank): 0.5 bn USD	
Everbright Bank: 2.6 bn USD	
Bank of Beijing: 4.1 bn USD	
Bank of Nanjing: 1.0 bn USD	
Bank of Ningbo: 0.48 bn USD	

# Potential additional steps on restructuring

## 2. Asset securitization

- Historical development of China's asset securitization process



- The scale of asset securitization in 2014 is around 120 bn RMB (19.4 bn USD), which is equivalent to the total amount of issuing of the previous 8 years (from 2005 to 2012).
- However, the size of asset securitization is only 1.75% of China's bond market, which is 7.58 trn RMB (1.22 trn USD).
- Asset securitization reduces banks' capital pressure and improves their financial structure.
- However, based on the U.S. experience, the risk of asset securitization should be monitored.

# Potential additional steps on restructuring

## 3. Transfer of bad assets to national AMCs and newly created local AMCs

- **National AMCs may create more room to absorb losses through different capital recapitalization.**
  - ✓ Good example is the IPO of one of the largest national ACMS in Hong Kong, Cinda (raised 2.5 bn USD in 2013).
  - ✓ Following Cinda's IPO, Huarong is currently planning to go public in HK H-share market at the end of 2014, after its restructuring in 2012.
- **Five local AMCs set up** by CBRC in July 2014 in Guangdong, Zhejiang, Jiangsu, Anhui and Shanghai.
  - ✓ These mini-AMCs should help transfer the loans from LGFVs and property developers
  - ✓ The companies will buy up bad debt from banks, trust companies, financial corporations, and financial leasing companies, in an attempt to clean up the balance sheets of banks.

# Outlook for bank profitability once interest rates are fully liberalized

- It is predicted that both deposit and lending rates will increase further after full liberalization at about 7% (He, Wang and Yu, 2013)
- But interest rate margin will also be reduced (as already considered in our baseline scenario for profitability)
- However, because of this, banks will be in a better position to compete with shadow banking sector attracting more deposits.
  - Positive development liquidity wise but still at low interest rate margin



# All in all, outlook for China's banking system looks gloomy

- China's financial reform is key within the government's reform process but it faces enormous headwinds
- Interest rate liberalization, and the related reduction in the net interest margin, will need to take place at a time when asset quality is set to worsen and regulation is toughened
- Increasingly frequent 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 IPOs and securitization
  - Fully introduction of Basel III may need to be delayed further

# Thank you!

Alicia Garcia-Herrero  
Chief Economist Emerging Markets – BBVA Research