CHINA HOT TOPICS

ECONOMIC RESEARCH

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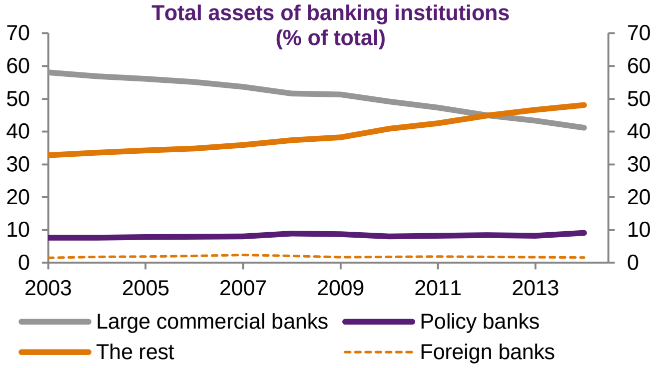
Chinese banks: Quo vadis?

Where is the Chinese banking sector coming from?

China's banking system was deemed monolithic until the early 80s when the government started opening up the banking system and allowed four state-owned banks[1] to take deposits and conduct banking business. As the economy skyrocketed in the past few decades, China's financial system has thrived. However, the key role that banks played to combat the impact of the global financial crisis on China resulted in a massive credit boom that has weighed on the quality of bank assets. Official bad loans have reached 1.27 trillion yuan at the end of 2015 - the highest since the global financial crisis - on the back of an economic slowdown and a ballooning corporate debt.

One can argue that the banking sector is becoming the Achilles' heel of the Chinese economy once again, as happened in the past. This is particularly true for Chinese state owned banks as competition with other banks and non-bank financial institutions increases. In fact, **Chart 1** shows that the assets managed by large commercial banks[2] have been dropping over years from nearly 60% of total assets in system in 2003 to about 40% in 2014, while the share of policy banks[3] remains flat at roughly 10%.

Chart 1
Total assets of banking institutions
(% of total)



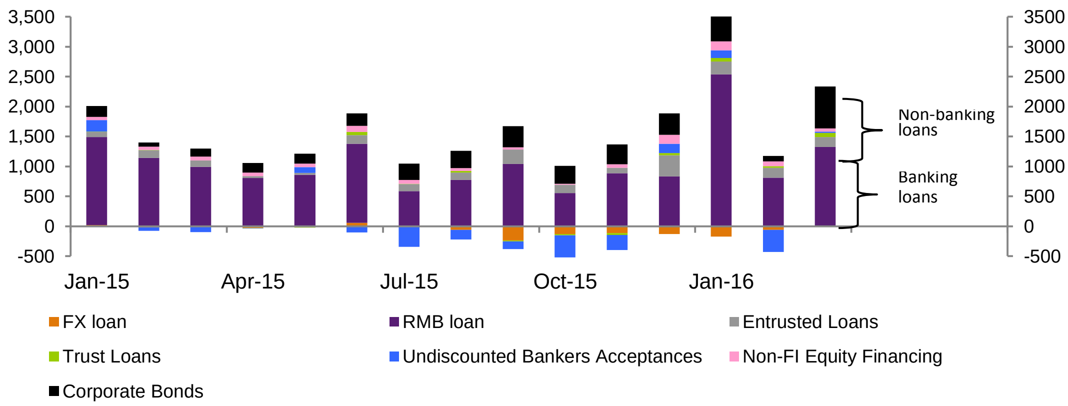
Source: CBRC, Natixis

Where is bank credit heading?

Notwithstanding the slowdown of the Chinese economy, bank credit has continued to expand quite rapidly. This includes both official bank credit but also the shadow banking. Only in the first three months of 2016, new RMB bank credit rose a significant 29% to RMB 4670 billion compared with the same period in 2015. When adding corporate bond issuance and shadow banking, credit expansion in the economy totaled RMB 6540 billion in Q1, a 41% increase from the same period in 2015 (**Chart 2**). Such growth is clearly much higher than nominal GDP growth, which remained below 6% in 2015. In particular, net issuance of corporate bonds skyrocketed (up 225% from 2015) but its size is still limited compared to bank financing. This signals a very high demand for credit in the whole financial system of China and, unavoidably, also additional leveraging. The figures show that the bulk of the borrowing is by Chinese corporate sectors.

1 Include Industrial & Commercial Bank of China (ICBC), China Construction Bank (CCB), Bank of China (BOC) and Agricultural Bank of China (ABC)
2 Also known as the big 5 banks which include four banks mentioned in 1 and also Bank of Communication
3 Policy banks include the Export-Import Bank of China, China Agricultural Development Bank and China Development Bank

Chart 2
New Total Social Financing (RMB bn)



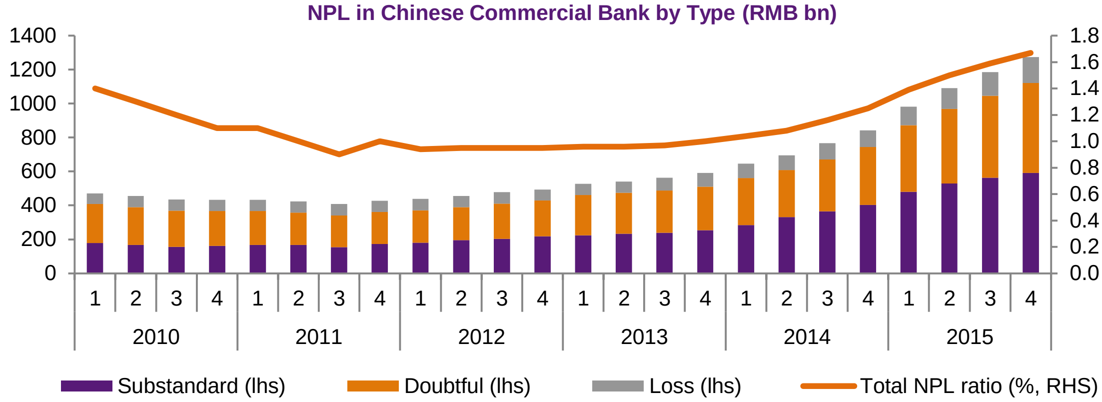
Source: Bloomberg, NATIXIS

Looser monetary policy is of course helping towards such rapid credit growth. Beyond the 50 bps cut in the required reserve ratio (RRR) effective from March 1st, 2016, open market operations have been used massively to inject as much as 1 trillion RMB in Q1 and push banks to lend. While effective in terms of credit growth, the ultimate destination of the credit binge seems much harder to control. In fact, monetary policy itself does not have the tools to direct the lending into the productive sectors and avoid overcapacity to continue to build. This ultimately has a bearing on the quality of banks' balance sheets as the repayment capacity in these sectors is limited.

How much are Chinese banks being hurt by the slowdown?

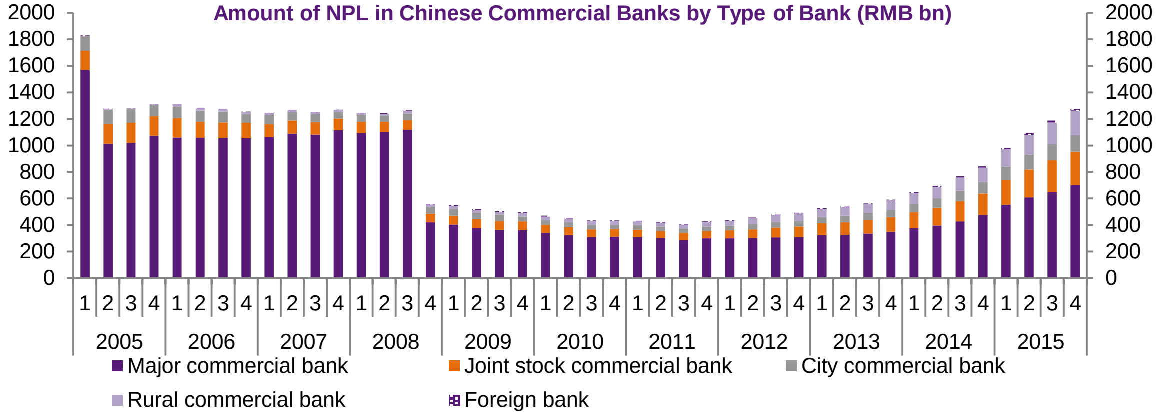
The extensive credit expansion in first three months, especially from the banking sector, has several implications. First, it masks the growth of the non-performing loan ratio as the denominator has experienced such a big increase (**Chart 3,4**). Second, such surge in credit granted must have had a surge in demand as well. Whether that new demand reflects an improvement in the economy or simply more financing needs is the key question. If it is the latter then it reflects an increasing demand for new funds to repay outstanding loans.

Chart 3
NPL in Chinese Commercial Bank by Type (RMB bn)



Source: Bloomberg, Natixis

Chart 4
Amount of NPL in Chinese Commercial Banks by Type of Bank (RMB bn)



Source: Bloomberg, Natixis

Having said that, China had a bad-loan coverage ratio of 150%, which is considered high for international standards. However, there is rumor that this will be lowered to 120%. In any event, credit risk is rapidly rising in China as the economy slows down and financial conditions are loose enough for corporates to continue to leverage. The question, thus, is how weak are Chinese banks in the current circumstances.

The five major commercial banks in the Mainland have been the major contributors of non-performing loan (NPL), not only because these banks have a large loan base but also a higher NPL ratio of 1.68% than industry average (**Table 1**). Looking only at NPL does not give us the full picture because it is well known that Mainland banks tend to write off loans turning bad in advance. Taking a glimpse of the net advance written-off shows that the situation in major banks may be more severe than NPL figures suggest as the amount written off nearly doubled that of the industry average.

Table 1. NPL of banks in China

	NPL ratio (%)	NPL (RMB bn)	Net advance written-off (RMB bn)*
5 largest commercial banks average	1.68	149.1	38.3
Industry average in China	1.44	62.1	20.0

* Data from latest disclosure

Having that said, the big 5 Mainland banks still have an average tier-1 capital ratio of 12.3% (versus 10.4% of the industry average in China, **Table 2**), suggesting they have room to take on more write-offs. Stronger tier-one capital ratios of China's 5 largest commercial banks also offer space to shoulder the new game of debt-to-equity swap to save overcapacity companies. Nevertheless such debt-to-equity swaps will not help solve the overcapacity problems unless these banks, by becoming major shareholders, force the restructuring of these companies. This looks really far off what a bank is supposed to do. In any event, what is clear is that the profitability of Mainland banks is really at risk, let alone their relatively good solvency ratios. Some banks' ROA were still marginally above 1% in 2015 but it cannot but go south in 2016.

On solvency, under the backdrop of higher NPL, coupled with more frequent write-offs and debt-to-equity activities, Chinese banks will need to raise their tier-1 and tier-2 capital to fulfil the existing Basel requirements. On top of this, the recently approved additional capital requirement, namely total loss-absorbing capital (TLAC), will require big Chinese banks to raise an extra RMB3,900 trillion (US$600 billion) by 2025.

Table 2. Other financial indicators of Chinese banks

	Loan size (RMB tr)	Loan-to-deposit loan (%)	NIM (%)	ROA (%)	Tier 1 capital ratio(%)
Average of 5 largest commercial banks	8.8	74.6	2.85	1.14	12.3
Industry average	4.0	73.0	3.51	1.06	10.4

While the outlook for the big five is gloomy, that of smaller Chinese banks is actually worse as they cannot count on the state supporting their recapitalization while their portfolios in terms of exposure to Chinese corporates (in particular excess capacity ones) is not necessarily better.

The more important factor to assess future profitability of Mainland banks would be the net interest margin (NIM). The reality is that NIM has already dropped quite aggressively in the last few years. It was only 2.54% at the end of 2015 from 2.70 in 2014. However, as the central bank tries to help banks through lower funding costs via open market operations, the NIM in 2016 may actually not be as thin as expected.

Beyond bank the credit quality from bank loans and profitability from NIM, Chinese banks could also be hurt by defaults on wealth management products (WMPs) given the banks' relation with the shadow banking (through referral commissions among others).

In addition to these risks, the internationalization of Chinese largest banks, is being complicated lately as their lending activities with Mainland companies through their subsidiaries (especially in Hong Kong) are being reduced as corporates reduce their offshore exposure.

New threats to Chinese banks: New players

Mainland banks have put their business focus on corporates for many years. Until 2014, lending to households was virtually limited to mortgages. The space to lend to SMEs was also limited as large corporates had enough appetite to drive a very rapid loan growth anyway. Meanwhile, part of the households' and SME's needs have been filled by fintech companies. Leveraging on their big data capabilities, as well as loose regulation, they are providing flexible personal finance products to the younger generation in the Mainland. Still, fintech is still only a complement to banking services but the competition for banks is clearly increasing. In response, some commercial banks have developed their own fintech subsidiaries. The most renowned representative is Ping An's P2P lender Lu.com (previously known as Lufax) which recently raised US$1.2 billion by selling about 5 percent of stake, making it one of the world's most valuable financial technology startups. This is certainly a big threat for Chinese banks as they might not be able to enjoy their bit of the New China, i.e., Chinese household increasingly leveraged consumption boom.

All in all, it seems clear that the Chinese banking sector, which has become massive – even for China's huge economic size – will have to navigate difficult waters in the next few years. The key risk is coming from corporate borrowing, which will not only continue to push down profitability but will also force Chinese banks to seek additional capital, over and above those stemming from global regulatory pressure, namely TLAC. Another key challenge for future profitability stems from the continuous reduction in the net interest margin due to financial liberalization and heightened competition. As Chinese banks' linkages with the rest of the world have grown enormously in the last few years, it seems clear that the health of the Chinese banking sector will remain a topic of global relevance for years to come.

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