China

Banking Watch

November 19, 2010
Hong Kong

Economic Analysis

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Success in capital-raising contains risks

- Third quarter bank results released in early November show further strong performance, with rising profits and declining NPLs.
- While profitability and capital adequacy ratios in 2011 are expected to decline from the high levels of 2010, they should nevertheless remain healthy under our baseline assumptions, even with the imposition of a possible new regulation to establish a minimum provision-to-total loan ratio.
- Under adverse scenarios of rapid credit growth or rising NPLs, some Chinese banks would experience modest capital shortfalls, but they should be able to meet minimum capital adequacy ratios through issuance of relatively low-cost and non-diluting Tier II capital instruments.

Recent indicators continue to show strong growth momentum in China, but with rising inflation. This has, appropriately, prompted an increasingly aggressive approach to monetary tightening, including hikes in interest rates and required reserve ratios (see our recent China Economic Outlook). Meanwhile, bank lending has continued to be brisk, even as the authorities seek to restrain new loans to within their RMB 7.5 trillion target for the year. (An amount of RMB 6.9 trillion has been lent out by the end of October.) As a result, third quarter banking results continued to show strong performance, with a further rise in profitability. Also, banks have continued to make good progress in their capital raising efforts, increasing the likelihood that capital adequacy ratios will remain above regulatory minimums through 2011.

This note is a follow-up to our recent China Banking Watch, in which we reported on the banking sector's strong first-half 2010 results, the "healthy, though weakening" profit outlook for 2011, and the status of banks' capital raising efforts. In that report we presented a favorable outlook for bank profitability and capital adequacy based on their progress in raising funds to date. In particular, we noted that banks should be able to meet or exceed their minimum capital adequacy ratios (CARs) through 2011 without the need for additional capital.

The current note updates this assessment based on recent policy initiatives and banks' Q3 performance results. In addition, we assess the impact on projected capital adequacy of changes in assumptions on credit growth and loan quality. Under our baseline assumptions, which include the possible implementation of new provisioning requirements, we find that Chinese banks should continue to be well positioned to meet minimum CARs (the expected new requirements would establish a provision-to-total loans ratio of 2.5 percent).

Using our model of individual bank balance sheets, we also assess the impact of banks' capital needs of adverse alternative scenarios, in which credit growth is more rapid than expected or loan quality is weaker than expected (due in particular to banks' exposure to local government financing vehicles). Our analysis indicates that, even under these adverse scenarios, only a handful of banks would fall below the minimum CAR ratio, and that given their high levels of Common Equity Tier I capital, they could rely if necessary on the issuance of Tier II capital instruments to bring capital back up to within the required minimum.

Recent Policy Initiatives and Q3 performance

In response to strong economic indicators and rising inflation, the People's Bank of China (PBoC) has been taking an increasingly aggressive approach to monetary tightening. Following a 25bp hike in its benchmark lending and deposit rates in October, more recently in November the PBOC raised the required reserve ratio (RRR) by 50bp, marking the fifth hike this year (including a temporary RRR hike for six large commercial banks in October). In contrast to the previous four hikes in the RRR, the latest move applied to all banks (not just the large ones).

The most recent results show that banks' strong performance continued in the third quarter. (Table 1) Average net interest income and fee & commission income registered increases of 28% y/y and 27% y/y respectively. Average net profit for Q3 grew by 33% y/y (our previous full-year profit projection for 2010 of 27% now appears conservative).

Table 1

	Q3 2009 RMB, bn	Q3 2010 RMB, bn	y/y increase RMB, bn	y/y Growth %
Net Interest Income	270	346	76	28%
Fee & Commission income	55	70	15	27%
Operating Profit	161	227	66	41%
Net Income	133	177	44	33%
NPL Ratio	1.42%	1.03%	-0.39%	

Outlook of Banks Capital Adequacy

Based on recent reports, we anticipate that the China Banking Regulation Commission (CBRC) may impose a new regulation, possibly as early as the end of this year, requiring banks to maintain a provision-to-total loan ratio of 2.5%. Once implemented, the new regulation would reduce banks' profits in near term, although it would strengthen banks' financial health in the long run.

We do not anticipate a significant impact on bank profitability of the monetary tightening measures so far, given banks' ability to maintain their net interest margins; however, further hikes in the RRR and efforts to restrain credit growth could diminish banks' still-healthy profit outlook for 2011, as discussed in our previous Banking Watch.

To assess the outlook for bank capital adequacy we apply our financial model based on a simplified version of the balance sheets of 8 banks, covering 60% of the total assets of the banking system. Our model can be used to simulate the impact of changes in various assumptions on banks' capital adequacy ratios. We apply three scenarios, a baseline and two "adverse" alternatives as described below.

Our baseline scenario incorporates the following assumptions:

- Annual loan growth of 19% in 2010 and 15% for 2011, consistent with the authorities' target for new loans of RMB 7.5 trillion this year, and an assumed target of RMB 7 trillion in 2011. The actual target of 2011, which is to be determined in the early of next year, may be lowered than our assumed figure given the authorities' increasing efforts to restrain credit growth to prevent overheating;
- Deposit growth of 17% in 2010 and 15% in 2011, in line with the official M2 growth target in 2010 and our projected M2 growth in 2011;
- Banks' Provision/Total Loans ratio increases to 2.5% at end-2010, in line with an expected new CBRC regulation;
- No interest rate hike during the remainder of 2010 and two symmetric interest rate hikes in Q1 2011 and Q3 2011 respectively (25bp each);
- CAR requirement for the five largest banks remains 11.5% and 10% for other banks;

- Bank dividend payout ratios in 2010 and 2011 remain the same as the levels in 2009;
- CCB, BOC and ICBC complete their rights issues as scheduled before the end of 2010, while other listed banks with future capital raising plans will implement them during the course of 2011 (Table 2);

Table 2

Ongoing and forthcoming Capital-raising Plans

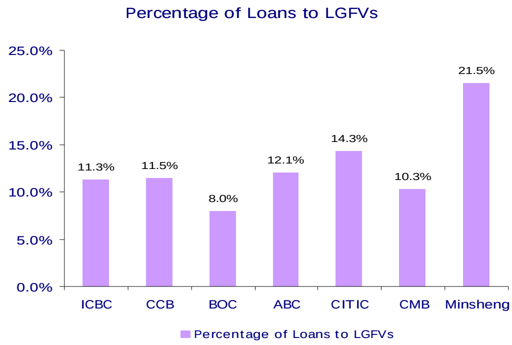
Bank Name	Financing Plan	Financing size	Progress
China Construction Bank	A+H share Rights Issue	Total RMB 62bn	Ongoing
Bank of China	A+H Share Rights Issue	Total RMB 60bn	Ongoing
ICBC	A+H Share Rights Issue	Total RMB 45bn	To be implemented in November 2010
CITIC	Subordinated debt A+H Share Rights Issue	Total RMB 42.5bn SD: RMB 16.5bn, A+H: RMB 26bn	Plan announced, to be implemented in 2011Q1.
Minsheng	Subordinated debt	Total RMB 15bn	Plan announced.

We further assume two adverse scenarios (Table 3): (i) to reflect the possibility of even more credit growth if the authorities' measures prove insufficient to restrain lending (Scenario A); and (ii) a deterioration in loan quality from banks' exposure to LGFVs (Chart 2), if the full 23% of loans at risk (as identified by the CBRC) were to become NPLs (equivalent to RMB 1.76 trillion), requiring correspondingly higher provisions (Scenario B). Regarding the latter, bank exposure to LGFVs amounted to 17.2% of total outstanding bank credit as of end-June 2010.

Table 3
Key Assumptions of Scenarios

2011	Baseline	Scenario A	Scenario B
Loan Growth	15%	20%	15%
Deposit Growth	15%	18%	15%
NPL of LGFVs	0%	0%	23%

Chart 2
Loans to LGFVs



Source: Wind and BBVA Research

Table 4
Projections of Banks' CARs

	Baseline				Scenario A			Scenario B		
	2010		2011		2011			2011		
Bank	CAR	Common Equity Tier I	CAR	Common Equity Tier I	CAR	Common Equity Tier I	Capital Need to meet minimum requirement	CAR	Common Equity Tier I	Capital Need to meet minimum requirement
ICBC	12.3%	10.5%	12.9%	10.8%	11.7%	10.1%	-	11.5%	9.8%	2.2
CCB	12.6%	10.4%	13.6%	10.5%	12.0%	10.0%	-	11.6%	9.6%	-
BOC	11.9%	9.6%	11.5%	9.4%	11.1%	9.0%	26.4	11.0%	8.8%	37.5
ABC	12.0%	10.3%	11.8%	10.1%	11.2%	9.5%	20.6	10.8%	9.1%	44.4
BOCom	12.0%	9.6%	12.1%	9.9%	11.5%	9.4%	-	10.3%	8.2%	30.2
CITIC	10.3%	8.2%	11.6%	9.7%	11.6%	9.7%	-	10.6%	8.6%	-
CMB	11.3%	8.6%	11.2%	8.7%	10.6%	8.1%	-	10.3%	7.8%	-
Minsheng	10.2%	8.4%	11.4%	8.6%	10.8%	8.1%	-	9.2%	6.4%	11.1
Average	**11.6%**		**12.0%**		**11.3%**		**47.0**	**10.6%**		**125.4**

Source: Wind and BBVA Research

Under our baseline scenario, the eight largest commercial banks are expected to maintain their CARs above the minimum statutory requirements, of 11.5% for the five largest banks and 10% for other banks, through 2011. (Table 4)

Under Scenario A (rapid lending growth), only BOC and ABC would have capital shortfalls, with the total capital gap amounting to RMB 47 billion. But they can still maintain high levels of Common Equity Tier I CAR above 9%, which means they can raise Tier II capital to meet the minimum CAR requirement.

In Scenario B (23% of loans to LGFVs become NPLs), five of the eight largest banks would have capital shortfalls, collectively requiring an additional RMB 125 billion to meet their minimum requirements. Since Chinese banks generally have high levels of Common Equity Tier I capital ratios, defined as the ratio of a bank's common equity to its total risk weighted asset, they could resort to more easily-financed and inexpensive Tier II capital (including subordinated debt and convertible bonds) to fill the shortfall. (The newly released global Basel III proposals highlight the common equity Tier I ratio, and set a target of 7% by the year-end of 2014, with which China is expected to comply or even exceed.)

Conclusions

Based on our estimates, under plausible assumptions Chinese banks should be able to maintain their capital adequacy ratios above minimum required levels through 2011, even with the likely implementation of a regulatory increase in the provision/total loans ratio. Under adverse scenarios of rapid lending growth or a sharp rise in NPLs due to loan quality deterioration, some banks may need to raise additional capital. However, most of them would be able to replenish their capital via tier II capital instrument issuance given their relatively higher common equity tier I capital ratios.

There are upside and downside risks to the scenarios presented above. First, under the baseline, if the expected regulatory change on provision/total loans is not implemented, capital adequacy would be correspondingly higher. On the other hand, the problems reflected in two risk scenarios may appear simultaneously. For example, the stronger-than-expected credit growth may eventually lead to the deterioration of loan qualities and the surge of NPLs. Although the likelihood of such a worst case is low in near term, it could develop over the long run.

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