China Flash

Strong 2012 banking indicators, but profits are set to decline

The China Banking Regulatory Commission (CBRC) released its annual set of banking indicators last Friday, showing overall profit growth of 19% (Chart 1) for the banking system, notwithstanding headwinds from the economic slowdown and narrowing interest margins. The indicators are for the overall banking system, consisting of both listed and non-listed banks; full-year financial results for the listed banks will be released at end-March. While the profit growth was down from a record 39% in the previous year, it still exceeded our expectations (about 9%) by a wide margin due to better-than-expected NPLs. The indicators also show that liquidity remained adequate and that capital increased slightly following the implementation of capital replenishment plans by several banks. Asset quality deteriorated somewhat (albeit less than expected), a trend that is likely to continue over the next couple of years due to the recent rapid pace of credit growth and ongoing downshift in GDP growth. Given an expected further tightening of interest margins and regulations, we maintain our projection of slowing profit growth in the coming years.

- **Strong lending growth supports profits in 2012.** Banking sector net profits rose by 19% in 2012, from a record 39% in 2011. The results were impressive given the headwinds during the course of the year from an economic slowdown (GDP growth was 7.8% in 2012, down from 9.3% in 2011) and asymmetric interest cuts in June and July that resulted in narrower net interest margins. The strong results were due to a low NPL ratio (0.95%) and rapid asset growth of 18% in 2012, fueled in part by the authorities' effort to encourage banking lending to stimulate economic growth.
- **Liquidity and capital ratios remain healthy.** The overall loan-to-deposit ratio edged up to 65.3% at end-2012, from 64.8% the previous year (Chart 2). Banking liquidity remained adequate as the PBoC offset tighter financial conditions from capital outflows through cuts in the RRR and expansionary open market operations. Meanwhile, the overall capital adequacy ratio increased to 10.6% from 10.2% during the same period (Chart 3), on the successful implementation of capital replenishment plans, as well as reductions in dividend payout ratios of a few banks.
- **However, asset quality has deteriorated.** Non-performing loans (NPLs) increased to RMB 493 billion in 2012 from RMB 428 billion in the previous year, a rise of 15%. However, given the rapid increase in outstanding loans, the overall NPL ratio remained flat at around 1%.
- **Despite the strong performance, profits and asset quality are likely to decline.** Looking ahead, a number of factors will weigh on bank profits in the coming years: (i) narrowing net interest margins (NIMs) as interest rate liberalization proceeds and competition in the banking industry increases; (ii) a slowdown in growth compared to the double-digit levels of recent years (to around 8% in 2013-14); (iii) financial loses appearing on bank balance sheets from shadow bank lending (including to local government financing vehicles). In addition regulations are likely to tighten as Basel III is implemented and as the authorities seek to contain risks from rapid credit growth, all of which may raise costs in the banking sector. In view of these factors, we maintain our projection of bank profit growth slipping to single-digit levels over the next five years (see *Banking Watch, May 2012*).

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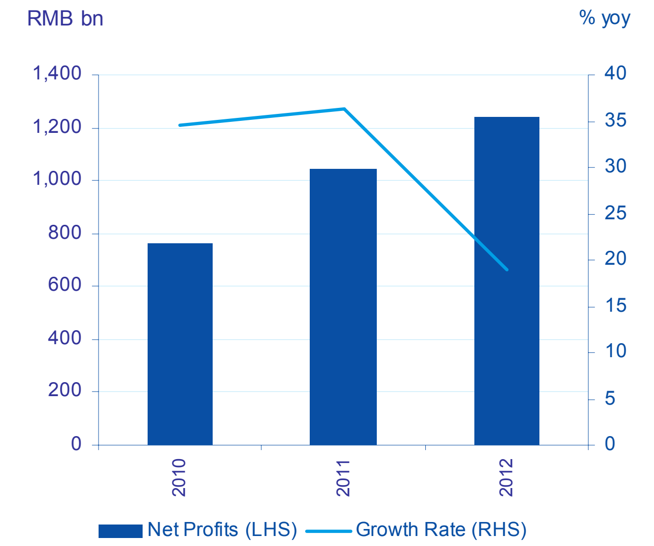
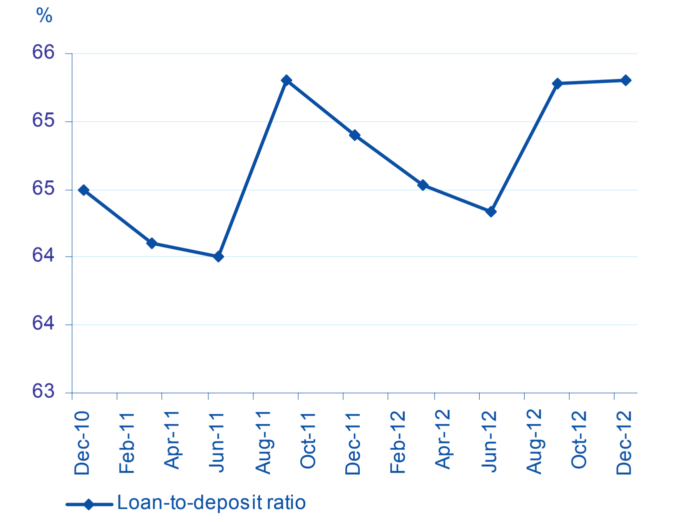
Chart 1
Profit growth in 2012 moderated but was still strong



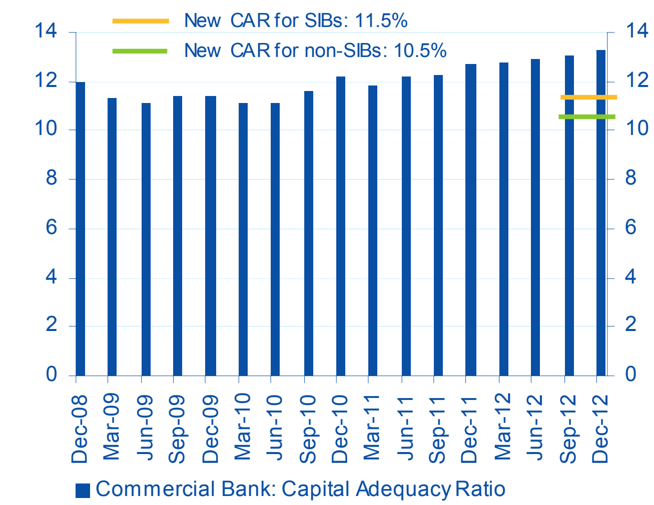
Source: CBRC, CEIC and BBVA Research

Chart 2
Loan-to-deposit ratio were stable



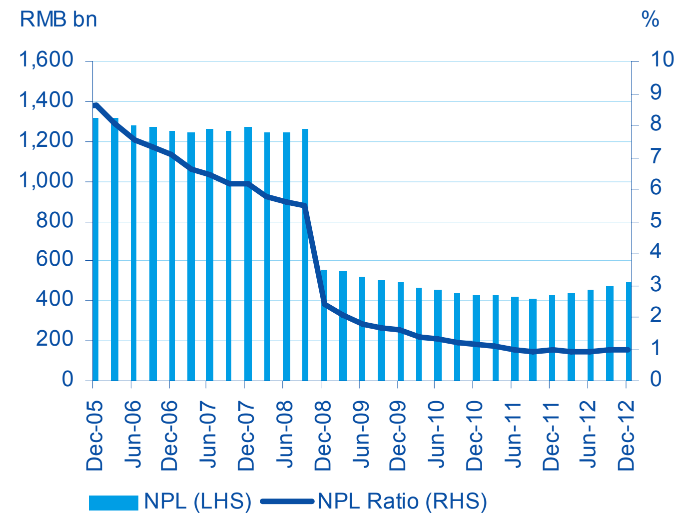
Source: CBRC, CEIC and BBVA Research

Chart 3
CARs increased due to banks' capital replenishment



Source: CBRC, Wind and BBVA Research

Chart 4
NPL amount increased but NPL ratio remained flat



Source: CBRC, Wind and BBVA Research

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