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# Banking Watch

## China


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Economic Analysis

Emerging Economies

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# Bank profits expected to stall

- **After better-than-expected results in 2012, we expect profit growth to slow sharply in 2013, and even to turn negative in 2014-15**

  We have long expected profit growth to decline in the coming years due to a slowdown in economic growth, rising NPLs, gradual interest rate liberalization, and a tougher regulatory environment. Since our last estimates of Chinese banks' profitability in May 2012 we have revised down the outlook due to slower expected credit growth and narrower interest margins (NIMs). The former is due to slower GDP growth and tighter credit policies. At the same time, China's new policy makers seem committed to faster interest rate liberalization (below), which is likely to accelerate the trend of narrowing NIMs. As such, after last year's 19% growth, we expect profits to grow by only 2% this year, and to turn negative thereafter (-8% and -10% in 2014 and 2015).

- **Financial liberalization will lead to narrower net interest margins, and weigh on bank profitability in the near term**

  Interest rate liberalization has already begun with the implementation last year of wider permissible interest rate ranges for banks in the pricing of their loans and deposits. These liberalization measures are resulting in higher deposit rates and lower lending rates. We expect this trend to continue as interest rates are fully liberalized by end-2015 under our baseline.

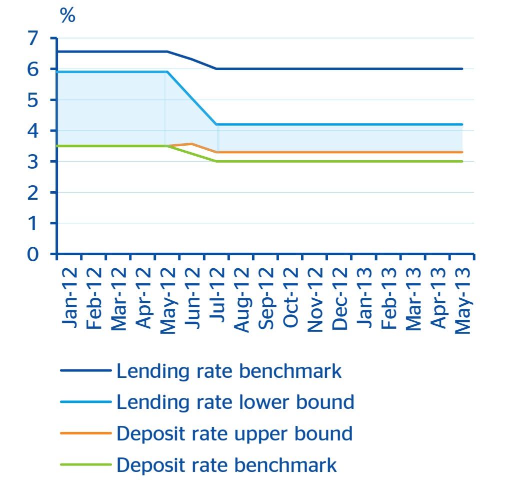
- **There are additional factors that could weigh further on profit growth, especially an increase in non-performing loans**

  Adverse cyclical factors consisting of somewhat slower GDP growth and, more importantly, lower credit growth, should push up the non-performing loan ratio from the current level of 1.6% to double as much by 2017. In addition, there are other potential sources of higher NPLs which are excluded in our baseline scenario but which are nevertheless important to consider. First, if problem loans extended to local governments are not fiscalized (i.e., there is no bailout), NPLs could rise to 6.1% in 2017. Second, if banks need to subsidize losses from shadow banking activities in which they are involved (i.e., bail out trust companies and the like belonging to their same financial group), the NPL ratio would rise by an additional one percentage point. All in all, in a worst case in which these two scenarios come to pass at the same time, NPLs could be 2-3 times higher than in our baseline.

## A review of the strong 2012 profit results

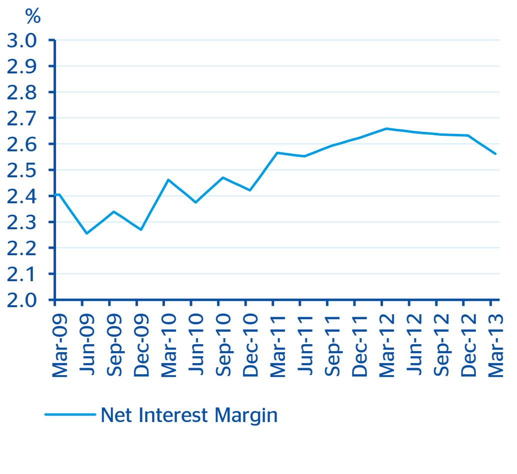
Chinese bank profit growth slowed to 19% in 2012 from a record high 39% in 2011. Nevertheless, the 2012 results exceeded our expectations (of 11%, projected in May 2012). The are two main reasons for this better than expected result: first, faster-than-expected credit growth of 16.1% in 2012, as the authorities eased policies to counter the impact of external headwinds to GDP growth; second, a smaller reduction in the net interest margin than we had expected, notwithstanding two interest rate cuts in June and July (Chart 1) and accompanying liberalization steps that narrowed lending spreads, possibly due to the typical front-loading of lending that occurs early in the year (prior to the measures that took place to enhance interest rate flexibility); indeed, the effect of the narrower lending spreads on bank NIMs is more apparent in the current year (Chart 2). By category, both net interest and non-interest income performed well in 2012, rising by 17.9% and 21.8%, respectively (Chart 3). Rapid credit growth kept the non-performing loan ratio on a declining trajectory, down to 1.6% in 2012 from 1.8% the previous year, even as the outstanding level of NPLs rose (Chart 4).

Chart 1
**The authorities took steps to liberalize interest rates**



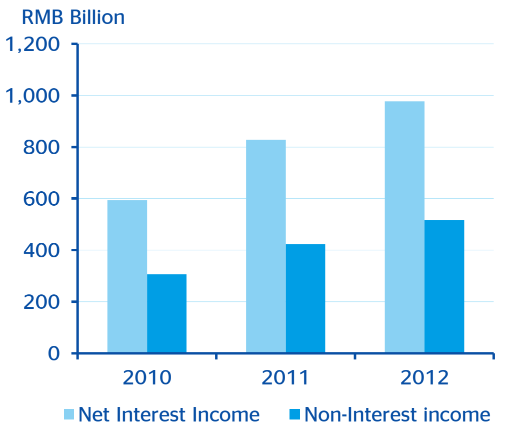

Source: Banks reports, Wind and BBVA Research

Chart 2
**Net interest margins have fallen this year**



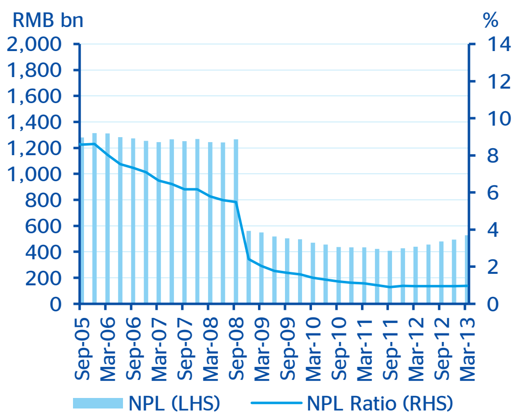

Source: Banks reports, Wind and BBVA Research

Chart 3
**Profit growth rose by 19% in 2012**




Source: Banks reports, Wind and BBVA Research

Chart 4
**Though NPLs are rising, the ratio has been stable**




Source: Banks reports, Wind and BBVA Research

## Bank profit growth expected to stall in 2013

We have long expected profit growth to decline in the coming years due to a slowdown in economic growth, rising NPLs, gradual interest liberalization, and a tougher regulatory environment associated with Basel III implementation (see *Get Ready For a Hard Landing in Profits*, May 2012). Despite the better-than-expected outturn of last year, we have revised our profit outlook down for 2013-17 due to: (i) changes in our baseline macro assumptions (Table 1) which imply slower credit growth; and (ii) a faster pace of interest rate liberalization than previously anticipated (full interest rate liberalization by end-2015), which will lead to a more significant decline in net interest margins. We project that profit growth will be barely positive in 2013, and turn negative in 2014-15 before picking up again in 2016 after interest rate liberalization is complete. Note that the macro outlook is deteriorating, and any further downgrades to GDP growth, which appear likely for 2013-14, would further erode bank profits.

Table 1
Profit Outlook and Underlying Assumptions and Ratios

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|---|---|
| GDP growth | 9.2% | 7.8% | 8.0% | 8.0% | 8.0% | 7.6% | 7.4% |
| CPI average | 5.4% | 2.6% | 3.0% | 4.0% | 4.0% | 4.0% | 4.0% |
| Credit growth | 18.9% | 17.9% | 13.5% | 13.0% | 13.0% | 12.5% | 12.5% |
| Net interest margin | 2.7% | 2.6% | 2.3% | 2.0% | 1.6% | 1.6% | 1.6% |
| Share of fee & investment income | 33.8% | 35.0% | 36.5% | 38.0% | 40.0% | 40.0% | 40.0% |
| NPL ratio | 1.8% | 1.6% | 2.0% | 2.4% | 2.8% | 3.1% | 3.4% |
| Provision / NPL | 278.1% | 296.0% | 220.0% | 175.0% | 155.0% | 150.0% | 150.0% |
| Profit growth | 39.2% | 18.9% | 2.0% | -10.4% | -7.7% | 9.1% | 11.7% |

Source: BBVA Research

Our projections, however, should be viewed as suggestive as the calculations are highly sensitive to key assumptions, including the pace of interest rate liberalization and the rise in NPLs and associated provisioning. That said, the bottom line is that it will be difficult for profits to grow, even with resilient GDP growth and stable inflation. The assumptions are described more fully below. At the outset, our baseline scenario for profits during 2013-17 incorporates the following:

- Annual credit growth of the banking sector slows from 15.4% in 2012 to 13.0% in 2017, reflecting the macro outlook and the authorities' efforts to keep credit growth broadly in line with nominal GDP growth in order to contain financial fragilities;
- Interest margins gradually decline to 60% of their current level by end-2015, driven by interest rate liberalization and enhanced competition (this would bring NIMs from 2.6% in 2012 to 1.6% by 2015, in line with average NIMs in high income economies[1];
- Under our benign baseline scenario, the NPL ratio would pick up over the next few years to from 1.6% at present to 3.4% at end-2017, assuming the credit growth rates described above and an average annual increase in NPLs of 30% over the period 2013-17, the same pace as in the year from September 2011, after NPLs bottomed out (see below for a discussion of additional factors that could bring NPLs even higher and further reduce profits). The provision/NPL ratio is projected to gradually decrease from 296% in 2012 to the regulatory minimum of 150% in 2017 as banks utilize some of their existing provisions against rising NPLs, thereby mitigating the impact on profitability;

1: See "Financial Institutions and Markets across Countries and over Time -- Data and Analysis," Thorsetn Beck and Asli Demiguc-Kunt, World Bank Working Paper, 2009.

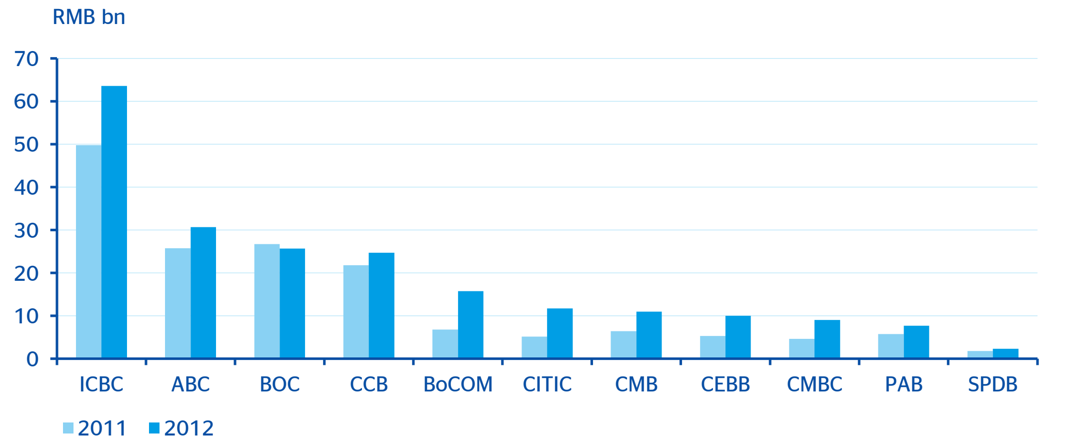
- We assume fee and investment income rise as a share of total income, to 40% in 2017 from 35% in 2012, but it is unlikely to go beyond this level as it is already relatively high compared to other emerging economies;
- The implementation of Basel III, which the authorities have confirmed for 2016, will probably have a negative impact on profitability. Given the difficulties in measuring it, however, we assume this negative impact to be fully offset by efficiency gains.

Regarding financial liberalization, it appears that the authorities are accelerating the pace of reforms relative to previous expectations, with a view to achieving full interest rate liberalization by end-2015 (see *Taking Stock of Financial Liberalization*, December 2012). Although the deepening of financial reforms should benefit the financial sector in the long run, it the near term it will lead to higher deposit rates and thereby squeeze bank NIMs. The establishment of a deposit insurance scheme, widely considered to be a necessary step for further interest rate liberalization, will probably add costs to banks in the form of contributions to the deposit guarantee scheme.

## NPLs are likely to increase in the coming years

One of the reasons for declining profit growth during our projection horizon is an expected increase in non-performing loans (NPLs). As shown in Chart 2 above, the absolute level of NPLs has been rising since early 2012, although the NPL ratio has been stable because of an offsetting increase in outstanding credit. Going forward, it will become more difficult for banks to keep NPL ratios from rising by simply expanding credit, as was done last year. In addition, a number of early indicators point to a rise in NPLs, such as the increasing level of overdue loans, not counted in NPLs according the bank accounting rules (Chart 5).

Chart 5
A rise in overdue loans is  a sign of higher NPLs ahead




Source: Banks reports, Wind and BBVA Research

Beyond the GDP growth and credit cycle, there a couple of potential sources of NPLs to consider beyond our baseline in which the NPL ratio rises from the present level of 1.6% to 3.4% by 2017 (Table 2). To do so, we construct two additional scenarios.

The first additional source of NPLs, evaluated in Scenario A, is potentially bad loans that were extended in order to finance local-government projects under the stimulus package of 2008-2009. Some 50-60% of total principal payments associated with these loans are coming due over the next few years. We continue to expect that a resolution to the debt overhang of local governments will include a combination of central government funds and write-offs by banks, of which the latter will contribute to a rise in NPLs. Under the methodology discussed in our report *Who will pay the bill for local governments' fiscal stimulus?* (July 2011), we now estimate that RMB 3.5 trillion of total LGFV loans (RMB 10.0 trillion) that is expected to encounter repayment difficulties, will need to be absorbed as losses by the banks, with the central government under our scenario absorbing the remaining losses associated with loans made directly to local government agencies (according to our estimates, total outstanding loans to local agencies is RMB 6.5 trillion).

Another potential source for higher NPLs has to do with banks' involvement in shadow banking activities (see *An update on China's shadow banking activity: have the risks increased?* March 2013). In particular banks have been active in marketing various wealth management products (WPMs) as a way of increasing their fee & commission income. These activities expose the banks to financial risks and losses, for example if they are pressured by the government to bail out loss-making Wealth Management Products (WMPs). This is especially so for banks that are affiliated (by belonging to the same financial group) with trust companies offering WMPs. It is also possible that banks may need to transfer funds to their affiliated trust companies or other related non-bank financial institutions if and when they suffer losses. In Scenario B, we further add the impact on NPLs of banks having to absorb losses on projects financed through WMPs. For this purpose we assume that 10% of total projects financed by WMPs (RMB 13.0 trillion) encounter repayment difficulties and end up as NPLs on bank balance sheets. This would bring the NPL ratio up to 7.1% by 2017.

Table 2
NPL ratio

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|---|---|
| Base Scenario | 1.8% | 1.6% | 2.0% | 2.4% | 2.8% | 3.1% | 3.4% |
| Scenario A (Baseline +LGFV loans) | 1.8% | 1.6% | 2.8% | 4.0% | 4.8% | 5.5% | 6.1% |
| Scenario B (Baseline+LGFV loans +WMPs) | 1.8% | 1.6% | 3.1% | 4.6% | 5.6% | 6.5% | 7.1% |

Source: BBVA Research

Under these two scenarios of higher NPLs, bank profits would be significantly lower. In particular, average annual profits of the banking sector would be 63% and 86%, respectively, lower than the level in the baseline scenario.

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