China Flash

Bank profit results for H1 look good on the surface, but a closer look underscores challenges that lie ahead

First-half 2013 financial results of the listed banks (covering about two-thirds of total banking assets) released in recent days were generally better than expected, with aggregate profit growth of 13.6% y/y compared to 18.9% for full-year 2012 (Chart 1). The results reflect faster-than-expected lending growth in H1, as well as strong fee & commission income that helped to offset a decline in net interest rate margins since early 2013 (NIMs) (Chart 2), as anticipated, following last year's official steps to enhance interest rate flexibility. Given the results, profit growth for 2013 is likely to exceed our previous 2% projection (see *Banking Watch*, June 2013) by a considerable margin. However, despite the positive outturn, overdue loans rose sharply (Chart 3), suggesting that underlying financial trends may not be as strong as indicated by the profit results alone. While we expect profits, capital adequacy, and non-performing loans to remain within healthy ranges, we continue to project overall profit growth to slow in the coming quarters on a further narrowing of net interest margins, deteriorating asset quality, and lower credit growth.

- **NIMs have continued to decline as the authorities enhance interest rate flexibility.** The impact of measures taken in mid-2012 to enhance interest rate flexibility is finally being seen in bank financial results. In June and July 2012, the permissible range for lending and deposit rates beyond the benchmark was widened, resulting in an effective narrowing of interest rate margins. While the more recent measure in July 2013 to remove the lending rate floor may have a further small adverse impact on net margins going forward (the lending floor was not really binding), it came after the end of H1 and therefore did not affect the results. The largest listed banks (ABC, BOC, ICBC, CCB and BoCOM) were able to protect their H1 net interest margins in H1 better than the smaller banks (Chart 4) as they have not needed to raise deposit rates to attract liquidity (in contrast, the smaller banks have taken advantage of the upward flexibility on the deposit rate cap).
- **Profit growth held up due to fast credit growth and strong fee & commission income.** Despite the economic slowdown, credit growth of the listed banks continued to expand rapidly in 1H13 (15.0% y/y vs. 15.6% in 2012). Also, fee & commission income grew rapidly in 1H13, associated with an expansion of credit card business, as well as an increase in issuance of Wealth Management Products (WMPs) and entrust loan activities (the latter two coincide with an expansion of "total social financing" and shadow banking activities).
- **There are signs of deteriorating asset quality.** Although headline non-performing loans (NPLs) for listed banks rose only slightly, from 0.8% of total loans at end-2012 to 0.9% at present (Chart 5), "overdue loans" rose by 21.4% from end-2012, especially for medium-size banks that have a relatively higher exposure to smaller firms that are more susceptible to the economic slowdown. Capital adequacy ratios also declined to 12.2% from 12.9% at end-2012 (Chart 6) due to the rapid growth of lending.
- **Profit growth is expected to decline in the coming quarters.** While profit growth for 2013 is now likely to exceed our previous projections, we still expect profits to decline in the coming quarters. In particular, to the extent that fee & commission income has been associated with the pickup in shadow banking activities, which the authorities are seeking to slow, this source of income may not be sustainable. Also, further steps to enhance interest rate flexibility, especially by freeing up the deposit rate cap, though highly desirable for the financial system, may lead to a further narrowing of net interest margins. And finally, as evident in the rise in overdue loans, deteriorating asset quality will further weigh on profit growth in the period ahead.

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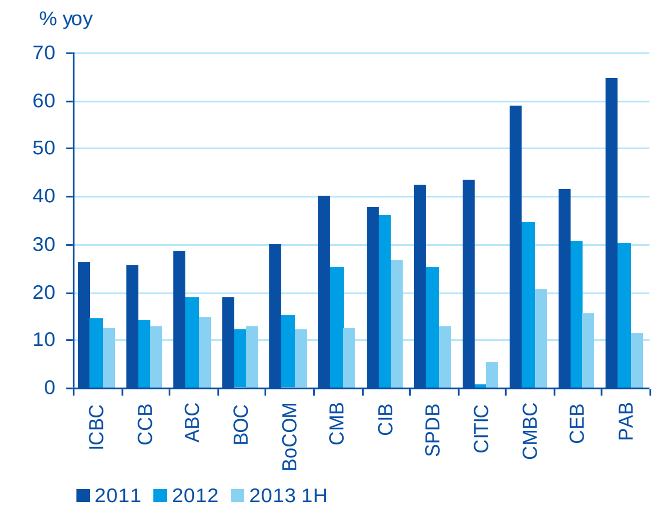
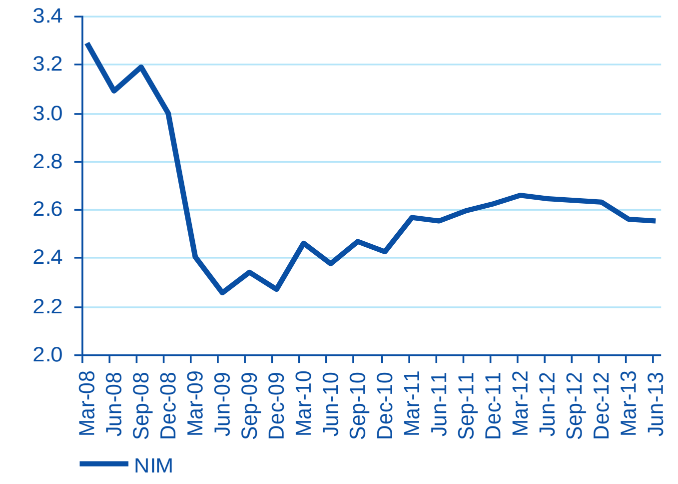
Chart 1
Profit growth for of the listed banks is slowing…



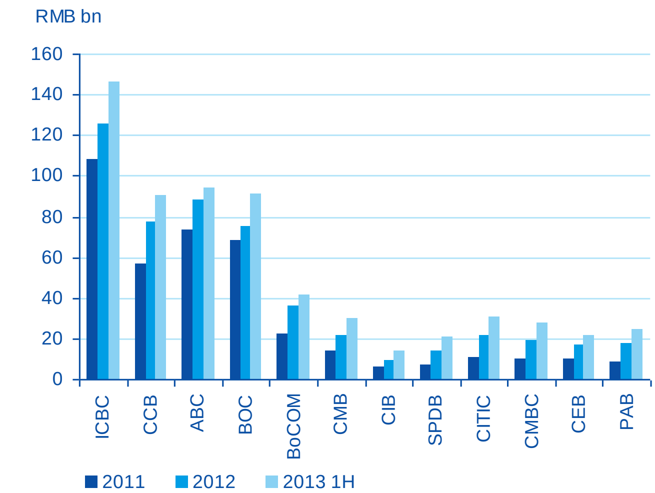
Source: Bank reports, Wind and BBVA Research

Chart 2
…as NIMs have narrowed with great interest rate flexibility



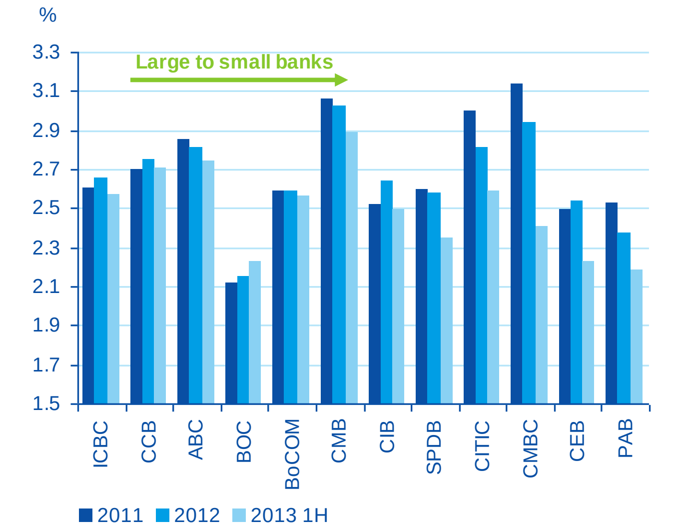
Source: Bank reports, Wind and BBVA Research

Chart 3
Overdue loans of listed banks have risen rapidly



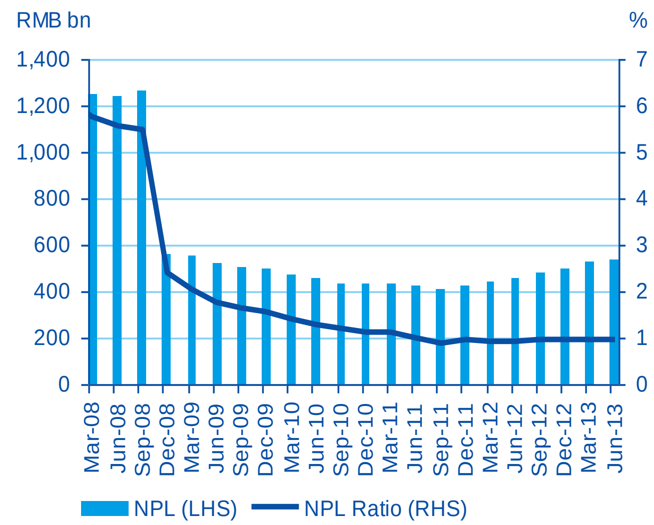
Source: Bank reports, Wind and BBVA Research

Chart 4
Larger banks have been able to protect their NIMs



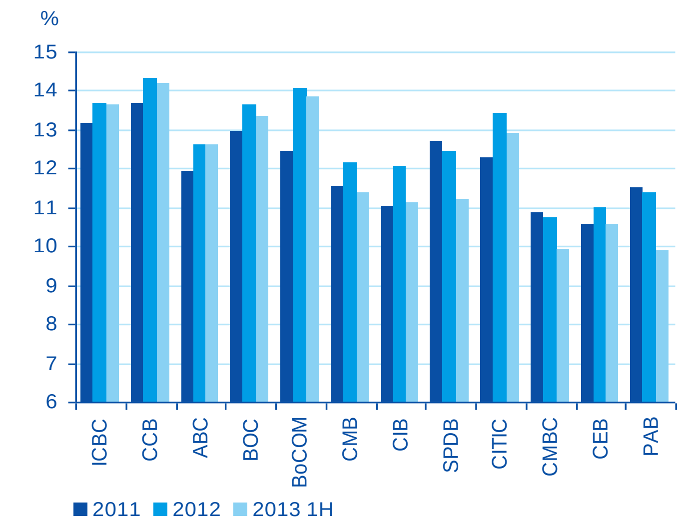
Source: Bank reports, Wind and BBVA Research

Chart 5
NPLs of the banking system are also rising



Source: CEIC and BBVA Research

Chart 6
Fast credit growth is putting downward pressure on listed banks' capital adequacy ratios



Source: Bank reports, Wind and BBVA Research

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