

China

# Banking Watch

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Hong Kong

**Economic Analysis**

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## An overall healthy, though weakening, outlook

- Profitability in the Chinese banking sector remained high during the first half of 2010 despite tighter monetary and credit policies
- Going forward, profits should remain healthy into next year, but will decline on slower credit growth, and with risks beyond 2011 from a possible deterioration in asset quality
- Completion of announced capital raising plans should leave the banks in a reasonable position to weather shocks in the near term
- Given Chinese banks high capital adequacy ratios, the new proposed Basel III capital rules are unlikely to have a significant impact on Chinese banks

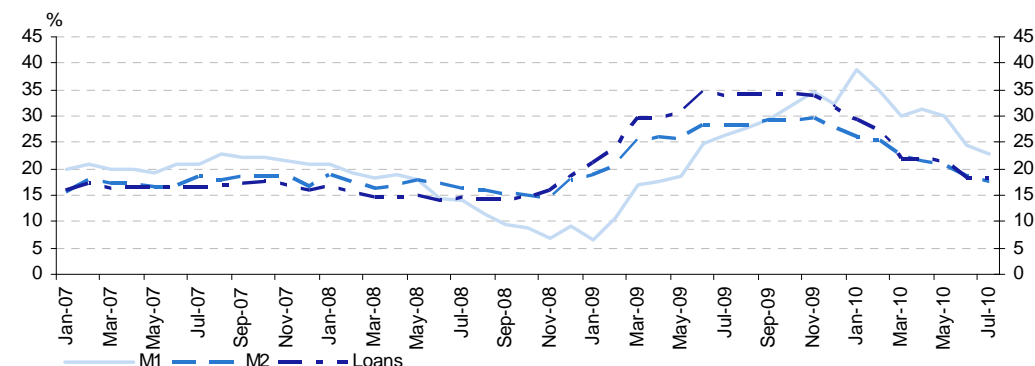
### A gradual tightening of monetary and credit policies

As part of its stimulus measures to counter the effects of the global financial tsunami, the Chinese authorities adopted a lax monetary stance that resulted in a record RMB 9.6 trillion of new loans in 2009, equivalent to an overall growth of credit of 31.7% (Chart 1). Rapid credit growth helped to bolster Chinese economy, although it had inevitable side effects such as a run-up of housing prices and overcapacity in some industrial sectors (for more on these policies, see the [China Real Estate Outlook](#) and [China Outlook](#)).

Since the beginning of 2010, the Chinese authorities have been adjusting their policy stance to prevent the buildup of housing price bubbles, and to achieve an overall soft-landing of the economy. In particular, the People’s Bank of China (PBOC) hiked the required reserve ratio (RRR) three times during the first half of 2010 to rein in liquidity. The target for new loans in 2010 was also set at a reduced level of RMB 7.5 trillion, or 18.8% annual credit growth. Moreover, the authorities raised down payment requirements and used other direct measures to restrain bank lending to the property market and sectors with overcapacity such as steel, cement, plate glass among others.

Chart 1

### Credit Growth and Money Supply



Source: CEIC

## Review of banks' 2010 interim results

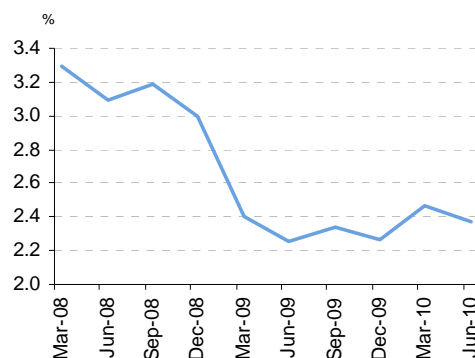
Despite the tightening of monetary and credit policies, Chinese banks' profitability remained high in the first half of 2010 (Table 1). Both net interest income (78% of total operating income), and fee and commission income saw high rates of year-on-year growth. Net interest income was up by 27% y/y due to both a slight improvement in net interest margins (NIM) and an increase in outstanding loan volumes (Chart 2). Fee and commission income grew by 35% y/y on strong demand for financial services beyond traditional loan-and-deposit transactions.

Table 1  
**H1 2010 Results of Chinese Banks**

	2009H1	2010H1	y/y	y/y
	RMB, bn	RMB, bn	Increase	Growth
			RMB, bn	%
Loans Issued	21278	25266	3988	19%
Total Asset	41747	48559	6812	16%
Total Liabilities	39518	45881	6364	16%
Operating Income	542	678	136	25%
Net Interest Income	418	530	112	27%
Fee and Commission income	92	125	33	36%
Administrative Expense	166	202	36	22%
Asset Impairment Loss	50	47	-3	-5%
Net Income	225	294	68	30%

Source: Banks Financial Reports and BBVA Research

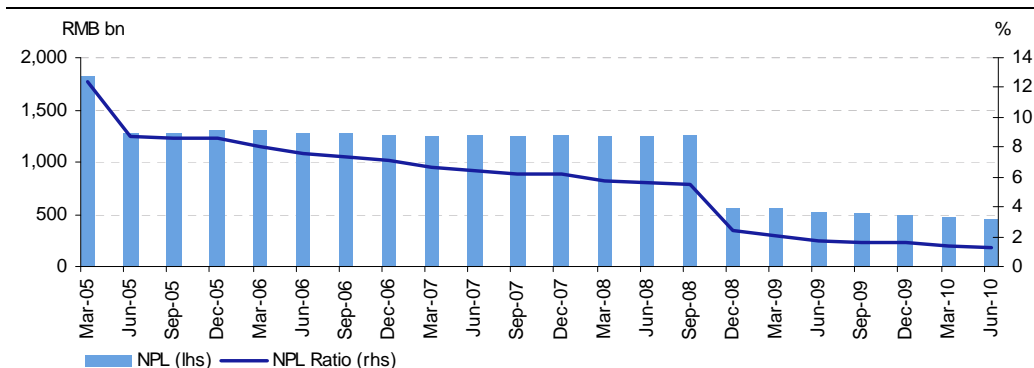
Chart 2  
**Net interest margin of Chinese Banks**



Source: Banks Financial Reports and BBVA Research

Chinese banks did a good job in limiting year-on-year growth of administrative expenses at 22%, which is lower than the operating income growth rate of 25%. The asset impairment loss in the first half of the year also declined from a year earlier, and the NPL ratio of the banking sector continued to fall to 1.3% as of June 2010. (Chart 3)

Chart 3  
**NPLs of Chinese Banks**



Source: CEIC and BBVA Research

## Outlook for further growth of bank profitability

Given the predominance of interest income in the total operating income, the projection of bank profits is dependent on changes in the volume of outstanding loans and NIMs. Interest rates on loans and deposits in China are still subject to regulation. Ceilings on deposit rates are relatively more binding, as banks are forbidden from offering a deposit rate above the PBOC's benchmark rate. The evolution of NIMs depends on the setting of the deposit and lending rates, and asymmetric changes in rates could have different impacts on NIMs. A symmetric increase in lending and deposit rates could result in an increase in NIMs, as banks have room to raise lending rates with a specified margin around the PBOC's benchmark lending rate.

Under our baseline macro scenario, we anticipate up to one symmetric 27bp interest hike in the fourth quarter of 2010, and another two hikes in 2011 as monetary policy is progressively tightened. Under this scenario, we would expect the average NIM for banks to remain the same, or even

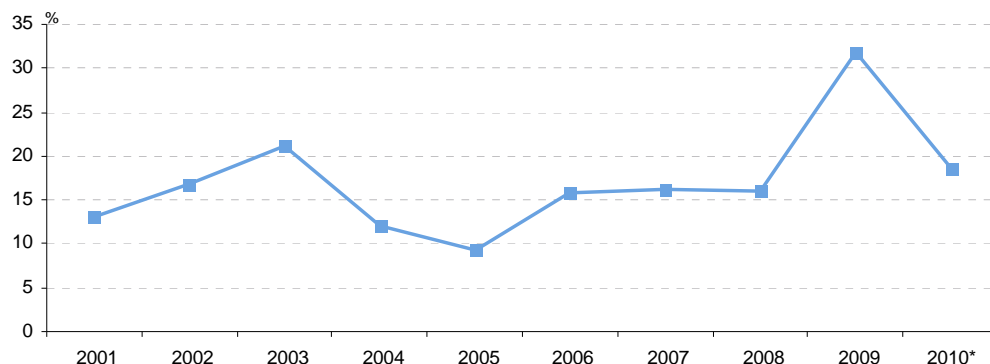
improve slightly. Note that an asymmetric rate hike, in which lending rates are raised by more than deposit rates would increase NIMs even further.

We project the net increase of outstanding loans toward 2010 in line with the authorities' full-year target of RMB 7.5 trillion (new loans through August amounted to RMB 5.7 trillion).

For 2011, the authorities' target for new loans has not yet been announced. That said, we project the net growth of loans in 2011 to be in line with the average level of the past decade at around 17% (Chart 4). This would also be in line with our macro projections of 9.2% GDP growth in 2011 and 3.3% average inflation. Overall, the expanded balance of outstanding loans and stable NIM should continue to support bank profitability during the remainder of 2010 and in 2011.

A couple of risk factors, however, could undermine the outlook for profitability. First is the exposure of banks to local government financial vehicles (LGFVs). The official estimate of such exposure is RMB 7.66 trillion as of end-June 2010, equivalent to 17.2% of total outstanding bank credit. CBRC estimate that up to 23% of LGFVs, or equivalently RMB 1.76 trillion could be at risk of becoming NPLs. More generally, a rise in NPLs following the very rapid extension of bank credit over the past year, including prospects for a decline in the property sector, could add to the NPL burden. We view these as medium-term risks to the profitability outlook.

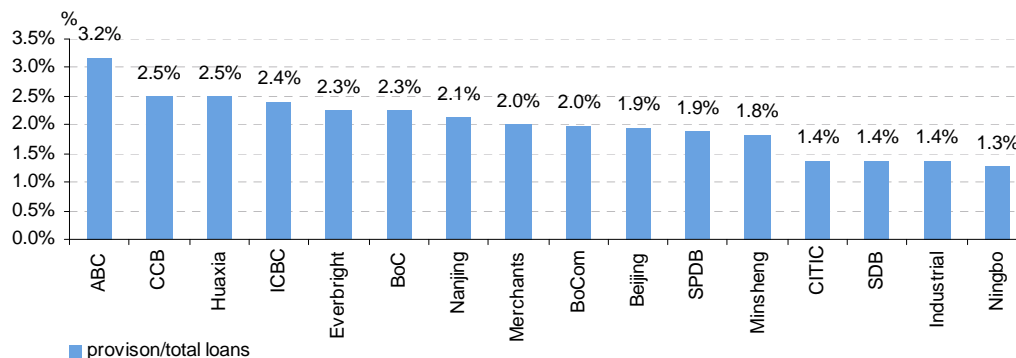
Chart 4  
**Growth of Net New Loans (2001-2010)**



Source: CEIC and BBVA Research

A second factor that could bear negatively on bank profitability are reports of a further tightening of prudential regulations. In particular, there are as yet unconfirmed reports that the Chinese authorities may raise the provision/total loans ratio up to 2.5% at the end of 2010. Although such a measure would improve the soundness of the banking system over the medium-term, in the near term, it would undermine bank profitability, as most banks are currently below such a threshold (Chart 5).

Chart 5  
**Provision/ Total Loans Ratio**



Source: Wind and BBVA Research

Given the above, we hold a cautiously optimistic view of the profitability outlook for Chinese banks, with a assumed growth of profits of 27% in 2010 and 15% in 2011. This implies that the outlook for the banking sector is still quite good, although profitability is expected to decline due to slower

lending growth and provisioning to cover a slight rise in NPLs. Our baseline does not take into account the possibility of a 2.5% requirement of provision/total loans ratio, which, if implemented, would lower profits growth to 11% in 2010 according to our calculations.

## Capital replenishment of Chinese banks and the outlook

In its efforts to strengthen the banking system, over the past several years the CBRC has been increasing minimum required capital levels. In early 2009, the minimum CAR was raised from 8% to 11% for large banks and to 10% for the other banks. More recently, early this year as noted above, the minimum CAR ratio for large banks was raised to 11.5%.

According to CBRC data, all Chinese banks met the then-existing minimum CAR requirements at the end of 2009 (11% for large banks and 10% for other commercial banks). At the aggregate level, the average and core CARs of Chinese banks amounted to 11.4% and 9.2% respectively. However, the rapid rise in credit growth and an increase in the minimum CAR ratio to 11.5% for large banks in the first half of 2010 have necessitated capital raising efforts by a number of banks (Table 2).

Table 2

### Announced Capital Replenishment Plans

Bank Name	Financing Plan	Financing size	Progress
Agricultural Bank of China	A+H listing	Total RMB 150bn	Finished in early July10
China Construction Bank	A+H share Rights Issue	Total RMB 75bn	Approved by shareholders, probably to be implemented within 2010.
Bank of China	Convertible bonds A+H Share Rights Issue	Total RMB 100bn CB: RMB 40bn, A+H: RMB 60bn	-CB: issued in early June10; -A+H: approved by shareholders, probably to be implemented within 2010.
Industrial and Commercial Bank of China	Convertible bonds A+H Share Rights Issue	Total RMB 70bn CB: RMB 25bn, A+H: RMB 45bn	-CB: issued in Aug 31, 2010; -A+H: plan announced, waiting for approval from shareholders.
Bank of Communications	A+H share Rights Issue	Total RMB 33bn	Finished in early June10
CITIC	Subordinated debt A+H Share Rights Issue	Total RMB 42.5bn SD: RMB 16.5bn, A+H: RMB 26bn	-SD: Issued in early June10; -A+H: plan announced, probably to be implemented in 2011Q1.
China Merchants Bank	A+H Share Rights Issue	Total RMB 220bn	Finished in 1Q10
China Industrial Bank	A Share Rights Issue	Total RMB 17.8bn	Finished in 2Q10
Shenzhen Development Bank	Private placement	Total RMB 6.93bn	-Finished in the early of July; -Another round of capital raising to be announced.
Nanjing Bank	A Share Right Issue	Total RMB 5bn	-Approved by shareholders, to be issued in 2H10.
Ningbo Bank	Private placement	Total RMB 5bn	Approved by SFC.
Huaxia Bank	Private placement	Total RMB 20.8bn	Approved by shareholder.
Minseng Bank	Subordinated debt	Total RMB 15bn	Plan announced.
Everbright Bank	A share listing	Total RMB 18.9bn	Finished on Aug 18th, 2010
Shanghai Pudong Development Bank	Private placement	Total RMB 51.7bn	Approved by SFC.

Source: Wind and BBVA Research

To date, listed banks have raised RMB 330 billion in new capital during the first eight months of 2010. This includes two large IPOs of ABC (Agricultural Bank of China) and Everbright bank, of RMB 150 billion and 18.9 billion respectively.

During the fourth quarter of 2010, three of the largest state-owned commercial banks, CCB, ICBC and BOC, are expected to launch their capital replenishment plans via rights issues. Other joint-stock commercial banks including CITIC, Huaxia, Minsheng, SDB and SPDB are on their way to implementing capital raising plans that will be completed in 2011.

Large shareholders of the listed banks, particularly the controlling ones with government-links, have shown support for their banks' capital replenishments. The Chinese Ministry of Finance fully took up the allotted shares when Bank of Communication raised capital by rights issue. Regarding the incoming capital issuances of CCB, BOC and ICBC, Central Huijin, the investment arm of China's

sovereign wealth fund and the controlling shareholder of these three largest state-owned banks, committed to fully subscribe the allotted shares. Given the above, we anticipate that the incoming capital raising plans of banks will be implemented smoothly.

Once completed, banks' capital replenishment efforts should enhance their core capital since many of them have adopted rights issues. According to the CBRC statements, the new proposed Basel III rules are unlikely to have a significant impact on Chinese banks since the core capital of banks accounts for around 80% of total capitals. Moreover, the authorities' minimum CAR requirements are already quite high, at 11.5% for large banks, and 10.0% for the others.

Under our baseline assumptions, once banks complete their planned capital raising efforts, we anticipate that all major banks should be able to meet or exceed their minimum CAR ratios through 2011 without the need for additional capital. We will explore the impact on bank capital of adverse scenarios in a future note.

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