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Banking Watch

China

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Economic Analysis

Asia
Chief Economist of Emerging Markets
Alicia Garcia Herrero
alicia.garcia-herrero@bbva.com.hk

Asia Chief Economist
Stephen Schwartz
stephen.schwartz@bbva.com.hk

Senior Economist
Le Xia
xia.le@bbva.com.hk

Assessing the financial sector implications of China's new Five-Year Development Plan

- **As with its predecessor, the new 5-year Development Plan attaches importance to continuing reforms in the financial sector, although specifics are lacking in a number of areas.**
The Plan emphasizes a deepening of financial sector reforms in four areas: (i) a strengthening of financial institutions, (ii) development of financial markets, (iii) improvements to monetary policy instruments, and (iv) enhancements to the supervisory framework. That said, the financial sector components of the Plan are rather general and lack specifics such as on the role of foreign banks and reform timetables.

- **From the Plan, one can envisage two major breakthroughs in financial reforms during the next few years.**
These two major breakthroughs are interest rate liberalization and further opening of the capital account. In addition, the proportion of "direct" (non-bank) financing is expected to increase, and the supervisory framework should continue to be strengthened in line with international standards.

- **The Plan will have implications for the financial sector landscape, with a possible intensification of competition and a likely decline in profitability.**
The liberalization of interest rates, move toward further capital account opening, and further financial disintermediation should intensify competition in the domestic banking market and could squeeze banks' margins.

- **At the same time, the Plan should create new business opportunities in the financial sector.**
Given the Plan's emphasis on raising consumer income and purchasing power, the retail banking businesses in China, especially in consumer finance and wealth management, could enter an even faster growth path in the next few years.

- **The role of foreign banks in China's financial sector development could well increase, but as there are no specific references in the plan, uncertainties remain.**
In theory, liberalization of interest rates, capital account opening, and greater competition should create opportunities for foreign banks. That said, the new 5-year Plan is silent on the role of foreign institutions, and more generally on opening the domestic financial sector to greater competition. Careful monitoring will be needed over time to assess the authorities' willingness to allow greater competition in the domestic market.

12th Five-Year Development Plan: deepening reform of the financial system

This past March, China's National People's Congress (NPC) passed the 12th five-year development plan covering 2011-2015. Among the areas of emphasis are a rebalancing of the economy toward higher private consumption levels, boosting certain new strategic industries, improving people's livelihood and promoting social harmony (a euphemism for reducing income inequality). The Plan also sets out 24 main targets on various aspects of economic and social development (see *Economic Watch: New 5-Year Plan*).

As was the case with the 11th Five-Year Plan of 2006-2010, the new Plan devotes a chapter (Chapter 48) to the development of the domestic financial sector over the coming five years, and elaborates on deepening financial sector reforms in four key areas: restructuring of financial institutions, development of financial markets, improvements to monetary policy instruments, and enhancements to the supervisory framework. In addition to the general development of the financial sector, the Plan also devotes a chapter (Chapter 57) to the evolution of Hong Kong's and Macao's financial sectors. Below is a relevant summary:

- **Restructuring of financial institutions**
  Continue to reform major state-owned financial institutions, improve the modern financial enterprise system, strengthen internal governance and risk management, enhance innovation and develop capacity for international competitiveness.
- **Development of financial markets**
  Develop the multi-layer financial market, continue to encourage financial innovation, and significantly improve the proportion of "direct" (non-bank) financing. Expand the money market to enhance liquidity management functions. Deepen reform of the stock listing approval system, regulate the development of the main board and stock market for small - and medium-sized enterprises, promote the development of the GEM market, and accelerate the development of the OTC market.
- **Improvements to the instruments and conduct of monetary policy**
  Optimize monetary policy objectives, and improve monetary policy decision-making mechanisms. Improve the transmission mechanism of monetary policy. Establish a counter-cyclical framework for a macro-prudential financial management system, establish a sound early warning system to prevent systemic financial risk, and establish assessment systems and disposal mechanisms.
- **Strengthening the supervisory framework**
  Improve supervision of the financial sector and improve financial regulatory agencies and coordination between different departments. Improve financial management of local governments, and increase local governments' responsibility for small - and medium-sized institutions. Develop cross-sector and cross-market financial regulatory rules, and strengthen the supervision of systemically important financial institutions. Improve financial laws and regulations. Accelerate the construction of a credit system and regulate the development of credit rating agencies. Strengthen cooperation with international organizations and foreign regulatory bodies.
- **Development of Hong Kong's financial sector**
  Continue to support Hong Kong in developing its financial services, and enhance its status as an international financial center. Support the development of Hong Kong as an offshore Renminbi business center and an international asset management center.

Old wine in new bottles?

A comparison of the previous Five-Year Plan with the current one reveals a number of similarities. Although there have been advances in the financial sector agenda over the past five years (Table 1), the pace of reform appears to have fallen short of the ambitious targets set out in the last Plan, especially on interest rate liberalization and capital account convertibility, and the consequent opening-up of the domestic financial market. To some extent, shortfalls in the agenda are due to weaknesses in the banking system, which in the first half of the 2000s, was viewed as the "Achilles' heel" of the Chinese economy, given the high NPL ratio that prevailed at that time.

Reasons for optimism on reforms

Looking forward, however, prospects are good for an acceleration of reforms in line with the new targets, albeit along the authorities' preferred gradual approach. The banking system appears stronger and better placed to undergo reform than it was five years ago, especially given its improved asset quality, higher capital adequacy, and having now successfully weathered the global financial crisis (Charts 1 & 2). Reflecting the strength of the sector, the Plan envisages the financial sector serving a core function in promoting the sought-after economic rebalancing toward private consumption.

A healthy banking system is also viewed by the authorities as a prerequisite for the further opening-up of the capital account. Although no clear timetable has been established, on a number of occasions PBoC officials have indicated that the pace of liberalization steps will be stepped up. The promotion of the use of RMB in cross-border trade and investment settlement is an example (see *Economic Watch: RMB Internationalization*).

- Regarding **interest rate liberalization**, the remaining breakthrough needs to be on the deposit side. Currently, the PBoC maintains a ceiling on deposit rates for all tenors, and a floor on lending rates expressed as a fraction of 0.9 of the benchmark rate (in 2004 the ceiling on lending rates was removed). It is anticipated that the deposit rate will be allowed to fluctuate (upward) within a certain range in the future, which should increase competition. As for the lending rate, while competition should already exist today (there is no ceiling on the lending rate), evidence shows that bank borrowers are generally charged the minimum lending rate. If that minimum lending rate were to disappear as well, price competition would increase, perhaps resulting in a decline in real interest rates.
- With regard to the **development of capital markets,** the authorities aim to increase the proportion of non-bank financing. (Corporate bond issuance and IPOs are the two most common forms of non-bank financing, and account for around 22% of total banks loans at present).
- The authorities will continue to **strengthen the supervisory framework** and implement regulatory standards in line with Basle II and III. On May 3, the CBRC announced plans to step up efforts to strengthen supervision by implementing new and stricter regulations based on Basel III principles. In particular, the CBRC plans to impose differing criteria for systemically important banks (SIB) and non-SIBs although it has yet to specify banks' classification into the two groups. The new rules are to include counter-cyclical capital adequacy ratios (up to 2.5% on top of the normal capital ratio requirement, 11.5% for SIBs, and 10.5% for non-SIBs), a leverage ratio (4% as minimum requirement), provision/total loans ratio (2.5% as a minimum) and liquidity ratio (liquidity coverage ratio and net stable funding ratio set at 100%). The compliance deadline is end-2013 for SIBs and end-2016 for non-SIBs. (Table 2).

Competition in the banking sector may increase

Liberalization of interest rates and a further opening of the capital account should increase competition in the domestic financial market. As described above, the ceiling on deposit rates is currently binding, so that further liberalization would lead to a relatively large rise in deposit rates and a narrowing of banks' net interest margins (NIMs) (Chart 3). It is important to note that this would likely squeeze profitability as two-thirds of bank profits last year were derived from net interest income.

A further liberalization of the capital account would increase the range of financial service options available to domestic enterprises and residents, thereby opening domestic banks to greater international competition. Likewise, further development of the capital market would lead to some disintermediation, adding to competition among banks for good borrowers.

New business opportunities for banks

Despite more intense competition going forward, China's rapid economic growth combined with the Plan's emphasis on economic rebalancing toward higher levels of private consumption—with the financial sector playing a key role under the Plan—present opportunities for banks. The Plan establishes explicit targets on household income growth for the next few years (>7% annual), which should foster increasing levels of private consumption. This, in turn, should create expanding opportunities for consumer finance, wealth management, and pensions. Accompanying these trends are targets in the Plan to increase the size of the service sector (by 4 percentage points to 47% of GDP). The Plan specifically notes the role of the financial sector in promoting the growth of service sector industries, especially for small and medium size enterprises.

Internationalization of the RMB

Another set of business opportunities derives from the internationalization of the RMB. Toward this end, the authorities have been promoting Hong Kong as the key offshore RMB center, which is affirmed in the Plan. To date, Hong Kong has already exhibited its strength in RMB cross-border trade settlements business, and opportunities for foreign banks have grown. This is a trend that can be expected to continue.

Role of foreign banks

While the Plan is silent on the role of foreign financial institutions, liberalization of interest rates and opening of the capital account could present opportunities for them to expand their market share (Chart 4). In this regard, foreign banks can use their expertise to serve strategic industries supported under the Plan including new energy, logistics and other 'green industries'. Foreign banks might also be able to play a role in supporting business activities of small-and-medium size enterprises (SME) as well as those in rural regions, which are currently underserved by domestic banks. Given the authorities' positive attitude toward financial innovation, emphasized in the Plan, foreign banks may be able to expand their market share in related businesses by introducing new and competitive products. However, given the lack of substance in the Plan on the role of foreign banks, it is difficult at this juncture to foresee specific opportunities. On the negative side, it should also be noted that no mention is made of lifting existing restrictions on foreign ownership for Chinese banks (20% limit for single investor and 25% for joint foreign ownership). Indeed, careful monitoring will be needed over time by foreign players to assess the authorities' willingness to allow greater competition in traditional business segments.

Table 1

Development of the financial sector during 2006-2010

Objectives in 11th Five-Year Development Plan	Important Progress
Reforms of financial institutions	• Five largest commercial banks (ICBC, CCB, BOC, ABC and BoCom) completed restructuring (capital injection and spin-off of NPLs) and listed in Hong Kong and Shanghai stock markets
Development of financial markets	• The majority of domestically listed firms completed the reform of Non-tradable Shareses (NTS), entitling trading rights to more than 60% of outstanding shares which were previously prohibited from being freely traded in stock exchanges
Improvement of monetary policy	• The RMB/USD peg has been reformed to increase the flexibility of RMB exchange rate (now RMB is pegging to a basket of currencies); • SHIBOR has introduced as a market-based interest rate benchmark and banks are endowed with greater discretion to determine their own lending rates although the ceiling for deposit rates still applies; • Qualified Domestic Investor Institutions (QDII) and Qualified Foreign Investor Institutions (QFII) programs are launched to relax the regulation of capital account; • Pilot programs of RMB cross-border settlement for trade and investment are implemented to boost internationalization of RMB
Strengthening of supervisory framework	• The CBRC has been endeavouring to improve asset quality of the banking system by applying stricter regulation; • CBRC has laid out clear roadmaps for the concurrent implementation of Basel II and Basel III; • CBRC has made efforts to improve banks' corporate governance and increase their transparency.

Source: BBVA Research

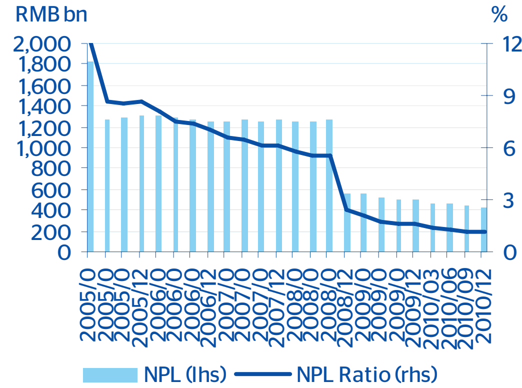
Table 2

New Regulations announced by the CBRC on May 3

Category	Rules and compliance timeline
Capital Adequacy	• Minimum capital adequacy ratio (CAR) for core tier I capital, tier I capital and total capital are set as 5%, 6% and 8%, respectively; • On top of the minimum CAR, banks are also required to set aside 2.5% extra capital; • A countercyclical capital buffer (0-2.5%) will be required when necessary; • SIBs are required to maintain CARs of 1% higher than non-SIBs, which means that under normal circumstance (i.e., when no countercyclical capital is imposed) the CARs of SIB and non-SIB would be at least 11.5% (8% minimum +2.5% extra +1% SIB) and 10.5% (more or less what they are now for large and small banks, respectively). • Compliance timeline: SIB by end-2013 and non-SIB by end-2016.
Leverage Ratio	• A minimum leverage ratio, defined as the ratio of core tier I capital to adjusted total asset, is set at 4%; • Compliance timeline: SIBs by end-2013 and non-SIBs by end-2016.
Liquidity	• Liquidity coverage ratio and net stable funding ratio are introduced into the current liquidity supervisory framework; • The minimum regulatory levels of both new indicators are set at 100%; • Compliance timeline: liquidity coverage ratio by end-2013 (for both SIBs and non-SIBs), and net stable funding ratio by end-2016 (for both SIBs and non-SIBs);
Loan Provision	• The minimum Provision/Total Loan ratio is set at 2.5% (as expected); • The minimum Provision coverage ratio (the ratio of provision to non-performance loans) is set at 150%; • The authorities will dynamically adjust the provision requirement; • Compliance timeline: SIB by end-2013 and non-SIB by end-2016..

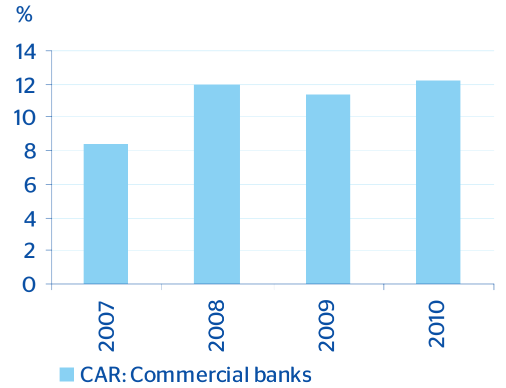
Source: CBRC and BBVA Research

Chart 1
NPLs have declined sharply in recent years



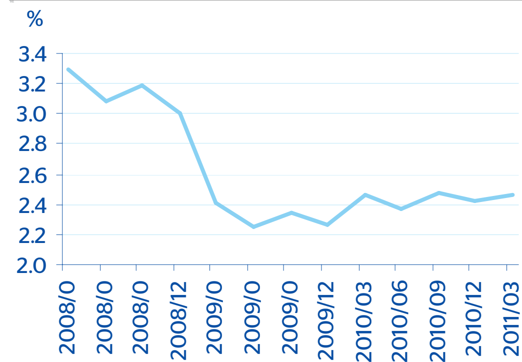
Source: CEIC and BBVA Research

Chart 2
Capital adequacy ratios have improved



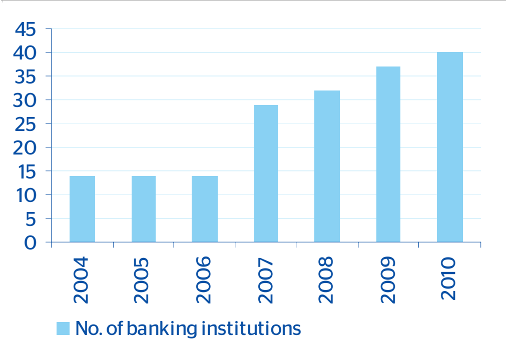
Source: BBVA Research

Chart 3
Net interest margins are still high, but are likely to fall further



Source: CEIC and BBVA Research

Chart 4
The market is luring more foreign banks



Source: BBVA Research

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