

Banking Watch

China

Hong Kong, May 18, 2011
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	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> The majority of domestically listed firms completed the reform of Non-tradable Shares (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	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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

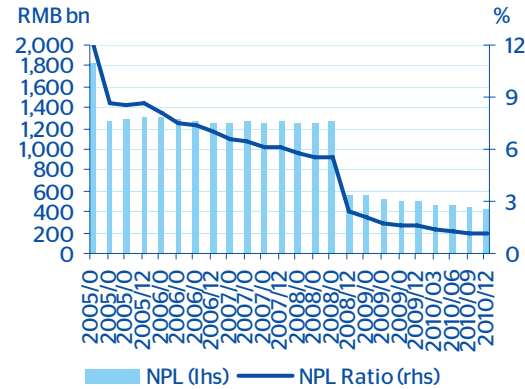
Table 2

New Regulations announced by the CBRC on May 3

Category	Rules and compliance timeline
Capital Adequacy	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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.

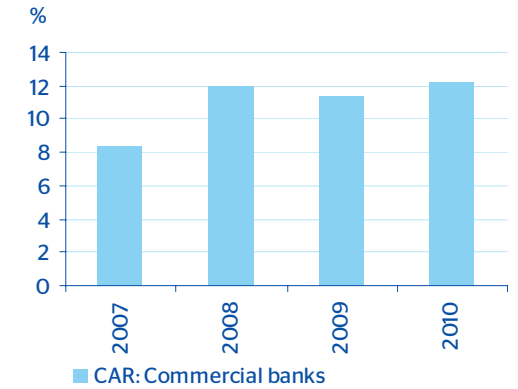
Source: CBRC and BBVA Research

Chart 1
NPLs have declined sharply in recent years



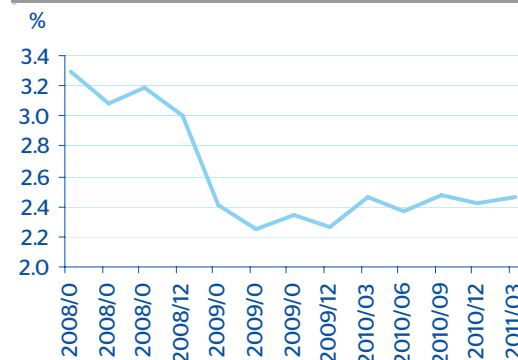
Source: CEIC and BBVA Research

Chart 2
Capital adequacy ratios have improved



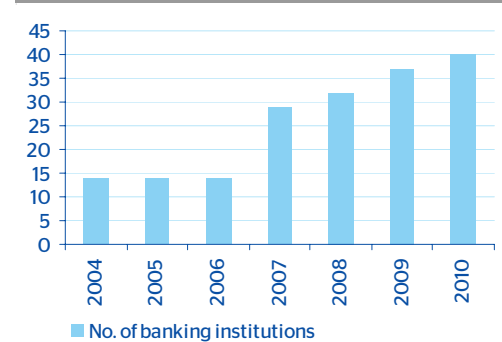
Source: BBVA Research

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

DISCLAIMER

This document and the information, opinions, estimates and recommendations expressed herein, have been prepared by Banco Bilbao Vizcaya Argentaria, S.A. (hereinafter called "BBVA") to provide its customers with general information regarding the date of issue of the report and are subject to changes without prior notice. BBVA is not liable for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, or to undertake or divest investments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. The contents of this document are based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. BBVA accepts no liability of any type for any direct or indirect losses arising from the use of the document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, options and securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances, investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying stocks. Investors should also be aware that secondary markets for the said instruments may be limited or even not exist.

BBVA or any of its affiliates, as well as their respective executives and employees, may have a position in any of the securities or instruments referred to, directly or indirectly, in this document, or in any other related thereto; they may trade for their own account or for third-party account in those securities, provide consulting or other services to the issuer of the aforementioned securities or instruments or to companies related thereto or to their shareholders, executives or employees, or may have interests or perform transactions in those securities or instruments or related investments before or after the publication of this report, to the extent permitted by the applicable law.

BBVA or any of its affiliates' salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates' proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

In the United Kingdom, this document is directed only at persons who (i) have professional experience in matters relating to investments falling within article 19(5) of the financial services and markets act 2000 (financial promotion) order 2005 (as amended, the "financial promotion order"), (ii) are persons falling within article 49(2) (a) to (d) ("high net worth companies, unincorporated associations, etc.") Of the financial promotion order, or (iii) are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the financial services and markets act 2000) may otherwise lawfully be communicated (all such persons together being referred to as "relevant persons"). This document is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is available only to relevant persons and will be engaged in only with relevant persons. The remuneration system concerning the analyst/s author/s of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

BBVA is not a member of the FINRA and is not subject to the rules of disclosure affecting such members.

"BBVA is subject to the BBVA Group Code of Conduct for Security Market Operations which, among other regulations, includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. The BBVA Group Code of Conduct for Security Market Operations is available for reference at the following web site: www.bbva.com / Corporate Governance".

BBVA is a bank supervised by the Bank of Spain and by Spain's Stock Exchange Commission (CNMV), registered with the Bank of Spain with number 0182.