Banking Watch
China

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Asia

Senior Economist
Le Xia
le.xia@bbva.com

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

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

Relaxation of banking regulations in support of growth

This note takes stock of relevant regulatory changes over the past year and highlights forthcoming initiatives in 2012. We find that recent initiatives contain modest forbearance as part of a broader shift in the policy stance to support for growth.

- **Regulatory initiatives in 2011 were aimed at averting overheating and mitigating risks in the banking sector.**

  Regulations in 2011 were aimed at reducing three major risks by slowing: (i) rapid credit growth in the residential property market; (ii) bank lending to local governments, in particular to local government financing vehicles (LGFVs); and (iii) growth of shadow banking activities.

- **In contrast, more recent initiatives reflect a shift in policies to support growth.**

  One of the most significant signs of a policy shift is the likelihood of a postponement in Basel III implementation. The CBRC had previously planned to implement Basel III on an accelerated timetable, but recent reports suggest a delay of around 6-12 months in order to: (i) encourage bank lending in response to headwinds to growth; and/or (ii) prevent the need for banks to raise capital in a difficult market environment. Such a delay would have positive effects on bank profitability in the near term, at the cost of a modest increase in financial sector risks.

- **Regulatory forbearance will be used to address pressures from local government debt.**

  The authorities are loosening restrictions on banks' ability to roll over loans to local governments in order to avoid a disruption to locally-financed projects under construction. The relaxation is meant to apply only to viable projects, although there is a risk that, if banks apply lax conditions, it could cover any kind of project and credit quality could be compromised.

- **We believe these forbearance policies, if applied cautiously, are warranted to support growth in the current challenging environment.**

  However, care will need to be taken to avoid the emergence of new financial sector risks by limiting the duration and scope of such measures.

- **Recent and prospective regulatory initiatives have mixed implications for business opportunities of foreign banks.**

  We expect restrictions on shadow banking activities and curbs in the property sector to remain in place for the near term. The former may tend to dampen business in Wealth Management Products (WMPs). At the same time, official efforts to encourage the financial sector to better serve the real economy could lead to opportunities for foreign banks in the coming years to gain a foothold in areas such as consumer finance, SME finance and Village-and-Township Bank (VTB) business.

Regulations aimed at mitigating risks in 2011

Through much of 2011, policy initiatives sought to contain some of the negative legacies of the massive stimulus package of 2008-2009 that was implemented in response to the global financial crisis. While the stimulus package helped the economy to weather the external shock, adverse side effects included rapid credit growth, property price increases, unsustainably high levels of local government debt, and an expansion of the shadow bank lending market. In addition to posing risks to the soundness of the banking sector, these side effects also fuelled economic overheating and inflation pressures.

Monetary policy tightening was accompanied by macro-prudential measures, mainly through strengthened banking regulations (Table 1). In general, these regulations focused on three areas: (i) slowing rapid credit growth in the residential property market; (ii) controlling the risk of bank loans to local governments, in particular to local government financing vehicles (LGFVs); and (iii) clamping down on shadow banking activities.

The new regulations have been broadly effective in moderating banking sector risks. Real estate loans as a share of total new loans slowed significantly, to 15% y/y in Q4 2011 from 33% y/y in Q1 2010, and the ratio of shadow banking activities to loans of the formal banking sector decreased to 46% in 2011 from 56% in 2010. Moreover, while detailed data is still lacking, anecdotal evidence points to a slowdown in the growth of LGFV loans.

While the measures have worked on a flow basis, they have done little to clean up the 'stock' problem. As a result, the legacy of rapid growth continues to pose risks to the financial sector.

Table 1: Selective banking regulations in 2011

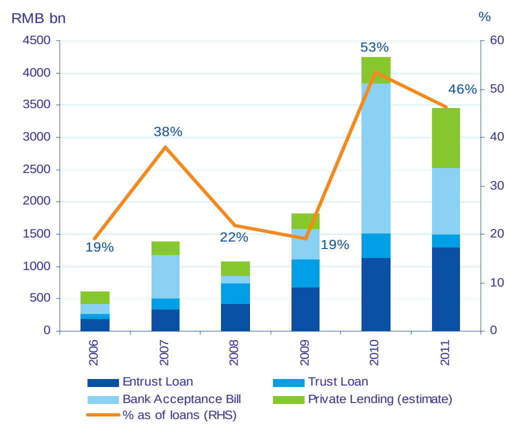
Unveiled regulations	Time	Detail
Property market	January 26, 2011	The State Council unveils another package of tightening measures in the property market, including an increase in minimum down payment ratios for second-home purchase from 50% to 60%.
	March 10, 2011	The CBRC strengthens enforcement of existing regulations on the discount banks are permitted to offer on housing loans, and orders banks to screen lending applications more carefully through stricter risk management practices. These are all in an effort to slow the growth of property sector lending.
	April 19, 2011	The CBRC releases a statement to order banks to launch a new round of stress tests on property loans and increase their efforts to prevent loan risks
Local government debt	March 7, 2011	The CBRC forbids banks from extending new loans to local government financing vehicles (LGFVs) unless they are for affordable housing development.
Shadow banking	January 20, 2011	The CBRC issues a new rule requiring commercial banks to transfer off-balance sheet trust assets to on-balance sheet by end-year, and at a pace of no less than 25% per quarter.
	August 16, 2011	China's SAFE announces plans to lower its 2011 annual quota for the 'financing' of overseas guarantees provided by domestic banks. This move is aimed at maintaining the effectiveness of ongoing tightening measures against domestic credit.
	August 26, 2011	PBoC broadens the base for calculating banks' required reserve ratios by including banks' margin deposits. The six largest banks are required to set aside 21.5% of deposits as of September 5, 2011. Medium and small banks are to set aside 19.5% of deposits.
	October 25, 2011	The CBRC allows commercial banks to issue special financial bonds to grant loans to small and micro-sized enterprises and lower the capital requirement on banks exposure to small and micro-sized enterprises. The measure is a step toward enhancing the flow of credit to SMEs, as regulations are tightened on shadow bank financing.

Source: The State Council, CBRC, PBoC, SAFE and BBVA Research

Chart 1
Growth of property sector loans has slowed

Source: Banks reports, Wind and BBVA Research

Chart 2
Shadow banking activities have moderated



Source: Banks reports, Wind and BBVA Research

A postponement of Basel III implementation

Although still unconfirmed, it has been widely reported in recent months that the CBRC will postpone implementation of an advanced Basel III timetable. The CBRC set out an accelerated roadmap last May to implement new regulations on bank capital, liquidity, leverage ratios and bad loan provisions. The timetable applied differently to systemically important financial institutions (SIFIs) and non-SIFIs[1] (Table 2). On the original timetable, implementation was to have begun at the beginning of 2012, but this is now likely to be pushed back by 6 to 12 months.

Such a postponement, if implemented, would reflect regulators' awareness of the increasing challenges for banks to satisfy the new regulatory rules. In the first place, intensified external uncertainties, in particular from the European sovereign debt crisis, have resulted in lower capital inflows and tighter liquidity conditions in the banking sector. While the central bank can continue to implement supportive measures, such as further cuts in required reserve ratios (RRR), these may not be sufficient to offset fully the tighter liquidity conditions in the banking sector (Chart 3). Additionally, the growth of shadow banking activities has further drained liquidity from the formal banking system (see our November 2011 report *China's shadow banking lending*). Finally, a postponement may reflect concern about imposing more stringent capital requirements on banks at a time when they may have difficulty raising new capital, or that current capital levels could become a constraint on their lending activities at a time of slowing economic growth.

A postponement in implementing new regulations could signal the authorities' increasing concern of growth outlook. Although a delay would not look good from a credibility point of view, any negative assessments should be tempered by the fact that the timetable for implementation of the new regulations (full implementation by end-2016) was already well ahead of Basel III requirements (full implementation no later than 2019).

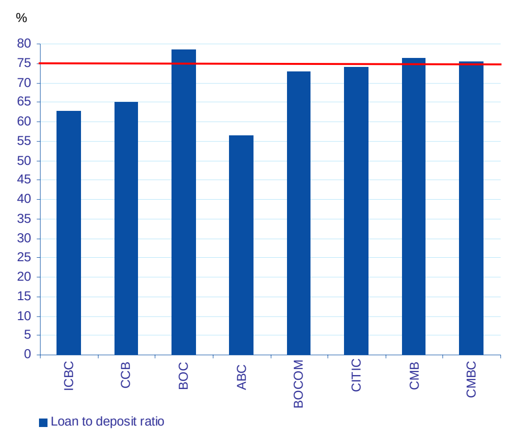
[1] In this respect, the CBRC's assessment methodology for SIFIs is based on an indicator-based approach comprising four broad categories: size, interconnectedness, lack of substitutability (financial infrastructure) and complexity, although the final results have not been revealed. It is widely believed that the five largest state-owned commercial banks (ICBC, CCB, BOC, ABC and BOCOM) will be classified as SIFIs, among which BOC has already been classified as one of 29 globally systemic important financial institutions (SIFI) by the Basel Committee on Banking Supervision in July 2011.

Table 2 :Basel III Rules announced and compliance timeline in China

Category	Basel III rules announced by China	Proposed 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. • SIFIs are required to maintain CARs of 1% higher than non-SIFIs, which means that under normal circumstance (i.e., when no countercyclical capital is imposed) the CARs of SIFI and non-SIFI would be at least 11.5% (8% minimum +2.5% extra +1% SIFI) and 10.5% (more or less what they are now for large and small banks, respectively).	SIFIs by end-2013 and non-SIFIs 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%.	SIFIs by end-2013 and non-SIFIs by end-2016.
Liquidity	• Liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) are introduced into the current liquidity supervisory framework. • The minimum regulatory levels of both new indicators are set at 100%.	All banks: LCR by end-2013 NSFR by end-2016 a
Other	• The minimum Provision/Total Loan ratio is set at 2.5%. • 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.	SIFIs by end-2013 and non-SIFIs by end-2016, individual banks by end-2018

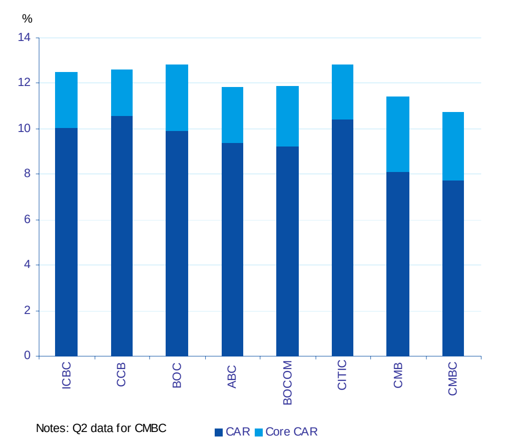
Source: CBRC, Central Bank of Brazil, and BBVA Research.

Chart 3
High loan-to-deposit ratio as liquidity drained



Source: Banks reports, Wind and BBVA Research

Chart 4
Capital Adequacy Ratios (CARs) at safe levels



Source: Banks reports, Wind and BBVA Research

Regulatory outlook: shift to forbearance

With economic growth slowing, in early 2012 the CBRC signaled that forthcoming regulations would aim to encourage banks to support growth, while containing potential risks. This dual and somewhat conflicting mandate reflects a rising priority of the authorities to sustain growth, over previous worries about overheating and inflation. In this regard, a certain degree of regulatory forbearance can be anticipated as a complement to the ongoing easing of monetary policy. In addition to cuts in the RRR, the authorities have already allowed a few large banks to increase their internal loan-to-deposit (LTD) targets in a bid to support more credit extension. These new targets are still below the limit of 75% stipulated by Chinese commercial banking laws.

The regulatory forbearance comes despite ongoing risks related to outstanding credit in the property sector and to local governments. A full resolution of these risks would require longer term measures, including sorting out fiscal relationships between the central and local governments. In view of the lingering risks, it will be important for regulatory forbearance in the near term to be applied cautiously. It would be helpful in this regard for the authorities to clarify that Basel III implementation delays are temporary and announce a new timetable of implementing these rules as soon as possible, which could be more flexible on the compliance agenda.

One form of regulatory forbearance is appearing in the authorities' willingness to set aside their previous hard stance on forbidding banks to extend or renew credits to local governments. According to the authorities' estimate, about RMB 1.84 trillion (USD 292 billion) of local government debt is to be repaid by local governments this year, accounting for 17.2% of total outstanding local government debt pronounced by the authorities. Moreover, a considerable amount of these local government debts, especially loans to LGFVs, are used to finance long-term projects. Disallowing rollovers of these debts could result in a disruption to projects under construction, and could have a contractionary economic effect.

In view of this, the authorities have announced that they will encourage banks and local governments to renegotiate the terms of government-related loans, including repayment schedules, qualified collateral, and even interest rates, so that the loans can be rolled over to support the projects under construction as well as reduce the mismatch of loan repayment and cash flow generated from the projects. However, such a type of regulatory forbearance could also generate risks. If the banks apply too lax conditions on the extension and renewing of local government debt, it may aggravate existing problems rather than mitigate them. Therefore, the rollover policy, even if beneficial to some degree, would be only a temporary and partial solution. A more permanent solution would still need to be found, which we believe would most likely consist of a combination of bank write-offs and central government bailouts. (*Who will pay the bill for local governments' fiscal stimulus?*)

It appears unlikely at this stage that curbs in the property sector will be lifted, given the authorities' determination to engineer a further decline in prices. It also appears unlikely that tighter regulations on shadow banking activities will be relaxed, with the exception of "private lending" in pilot schemes, such as the one recently announced for the city of Wenzhou. A key element of the pilot program is to allow private lenders to operate as investment companies to augment financing to SMEs. Effectively, this legalizes private lending, but within a regulated market. The authorities have indicated that if the pilot program in Wenzhou is successful it may be expanded to other cities and regions.

Conclusions and implications

With the growth outlook having become less robust, the policy stance is shifting to become more growth supportive. As a complement to macro policies, the authorities are resorting to financial sector regulatory forbearance. In addition to a temporary postponement in implementation of Basel III, the most notable area of forbearance is in the area of allowing rollover of local government debt (and credit extension for social housing construction). We believe these policies, if applied cautiously, are warranted to support growth in the current challenging environment. However, care will need to be taken to avoid the emergence of new financial sector risks by limiting the duration and scope of such measures.

The implications for banking business, particularly as it relates to foreign players, are not straightforward. On the one hand, efforts to clamp down on shadow bank lending may reduce the advantage for foreign banks in the area of financial innovation, such as in wealth management products. On the other hand, the authorities may become more willing to welcome new foreign entrants whose operations are growth-supportive, in the areas of consumer finance, SMEs, and village and township bank (VTB) business.

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