Banking Watch

China

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Asia

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Get ready for a hard landing in profits

- **China's banks have been recording double-digit profit growth for much of the past decade. We believe this is about to change, even under our baseline scenario of a soft landing in economic activity.**

  Profit growth averaged 27% from 2007 to 2010, reaching a record 39% in 2011. However, we believe that such a high growth rate is unsustainable. We expect it to slow to around 8% per year on average over the next few years.

- **The projected hardlanding in profit growth is due to a slowdown in economic growth, rising non performing loans (NPLs), gradual interest rate liberalization and a tougher regulatory environment.**

  Our profit growth projections are consistent with our baseline macro scenario, which projects a soft-landing for China's economy. We also include further liberalization of interest rates although in a gradual way. We also forecast a rise in NPLs from their currently exceptionally low level due to weak asset quality at the local government level, the much weaker real state market as well as poorer economic activity in more general terms. The time for deeper financial sector reform seems now ripe with the government introducing several measures. which should result in more heightened competition and a narrowing of interest margins. Finally, implementation of Basel III regulatory framework will imply higher additional capital requirements for banks limiting further their profitability.

- **Slower profit growth will constrain banks' ability to raise capital through retained earnings. We should soon be seeing a new wave of efforts to raise capital by Chinese banks.**

  Under our baseline scenario for economic growth, inflation, bank asset growth and other relevant variables, we estimate that banks would need to raise up to RMB 1.4 trillion in new capital during 2014-16 (about one-third higher than the capital raising efforts during 2010-11). The calculations are, however, highly sensitive to assumptions of NPLs, and the pace of interest rate liberalization. Capital raising needs of the large listed banks with higher dividend payout ratios would make them move proactively.

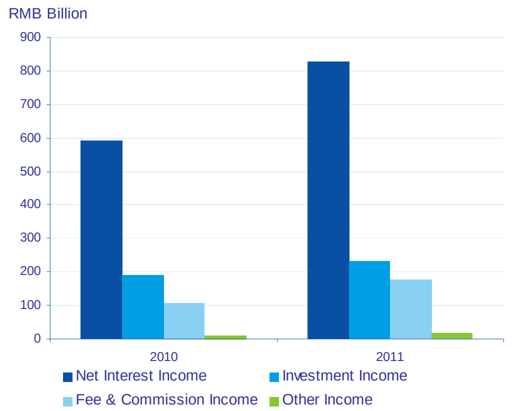
Introduction

After a surge in China's bank profitability in 2011, we expect profit growth to moderate over the next few years even as the economy manages to engineer a soft-landing. In particular, profits will come under pressure from the following four sources: (i) slowing asset growth; (ii) rising NPLs; iii) narrowing net interest margins; and iv) higher costs from Basel III implementation. The moderation in profits is likely to weigh on retained earnings and the organic growth of capital, leading some banks to cut dividend payout ratios.

A look back at banks' higher-than-expected profitability

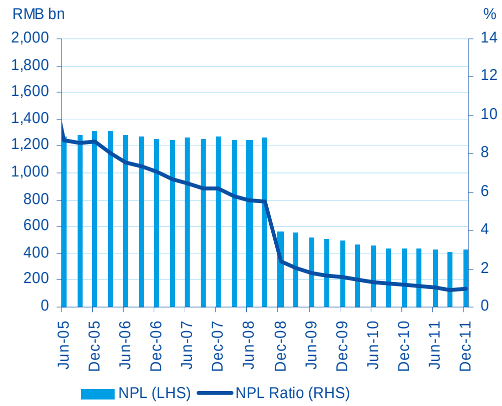
Profit growth of Chinese banks climbed to 39% in 2011, a new high over the past decade. By category, both net interest income and fee & commission income performed well. Net interest income rose by 40% as interest margins widened (Chart 1), and fee & commission income was up by 62%. On the other hand, investment income increased by only 23% in 2011, mainly due to the subdued stock and bond market. Overall, net interest income continued to account for the lion's share of the total income, at about two-thirds.

Chart 1
Total profit grew by 39% in 2011



Source: Banks reports, Wind and BBVA Research

Chart 2
The NPL ratio declined to a new low

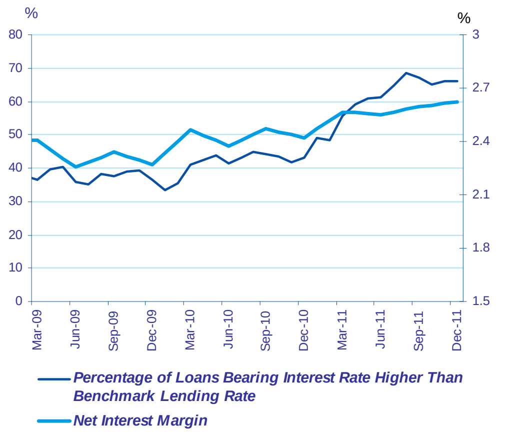


Source: Banks reports, Wind and BBVA Research

We view the main drivers of high growth in bank profitability to be both cyclical and structural in nature. Regarding the former, during 2010-2011, the economy grew rapidly on the heels of the massive stimulus package in previous years. As a result, cash flows of borrowers, including both enterprises and local governments, remained solid through 2010-2011, helping to keep bank NPL ratios at a low and stable level.

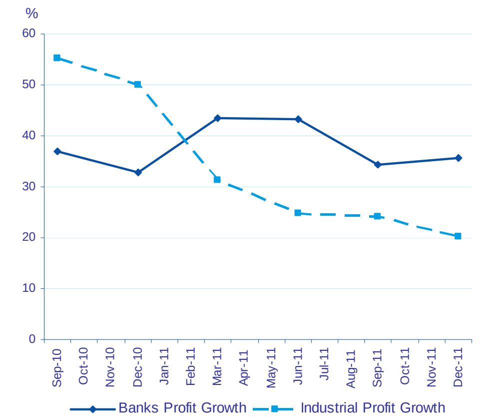
Meanwhile, the main structural factor for high profit growth has been continued regulated interest rates, with deposit interest rates subject to a ceiling and lending rates subject to a floor. As such, the regulated interest rate environment has effectively protected net interest margins. The central bank's preferred use of quantitative tools (i.e., credit quotas and RRR adjustments) in its monetary policy conduct have further ensured banks' high profit in both easing and tightening cycles. During easing periods, when liquidity is abundant, banks can profit from the large-scale credit extension; and during tightening cycles, enforcement of credit quotas infers stronger pricing power for banks (Charts 3 and 4).

Chart 3
Strengthened pricing power bolstered up net income margin (NIM)



Source: Banks reports, Wind and BBVA Research

Chart 4
Enabliing banks to maintain high profit growth even as industrial profit slowed



Source: Banks reports, Wind and BBVA Research

Why high bank profit growth is not sustainable

We expect the cyclical and structural factors that drove high profit growth during 2010-2011 to reverse over the next few years. The deepening of financial sector reforms and the strengthening of banking regulations, in particular the implementation of Basel III, are expected to impose additional costs on banks.

In the first place, NPL ratios are likely to rise from the current record lows as the economic growth slows and on weakening asset quality from the rapid loan growth of 2008-09. Regarding the latter, local government borrowing through LGFVs will mature in the next three years. Although the authorities have already allowed banks to roll over part of qualified LGFV loans, many LGFVs will face financial difficulty projected in our previous thematic report (*China Banking Watch: Who will pay the bill for local governments' fiscal stimulus?*). In addition, tightening measures in the property market, combined with efforts to slow shadow banking activities, will squeeze funding sources of real estate developers. And finally, the ongoing gradual decline of housing prices will impact collateral valuations.

Further weighing on the profit outlook is that supportive structural factors are unlikely to remain intact over the coming years. In particular, the authorities are likely to liberalize interest rates in order to remove the distortions they create by impeding an efficient allocation of capital. Although the authorities are likely to undertake liberalization only gradually, bank interest margins will nevertheless come under pressure. Another important move in this direction is a pilot program of financial reform in Wenzhou, announced in April. The thrust of this pilot program includes: (i) reduced entry thresholds for new private banks in order to enhance banking competition; and (ii) to allow individuals to engage in outward portfolio investment. The first point is expected to enhance banks competition and have negative impact on the incumbent banks. If successful, the authorities plan to broaden the program to other cities over time.

Lastly, implementation of Basel III regulations will impose additional costs on banks. Like many other countries, China has already set out a roadmap to implement new regulations on bank capital, liquidity, leverage ratios and bad loan provisions to comply with the requirement of Basel III framework (*China Banking Watch: Relaxation of banking regulations in support of growth*)

Hard landing in bank profits to be expected

The factors discussed above suggest that the surge in bank profitability seen in the past couple of years is unlikely to be sustained. That said, bank profits are expected to remain healthy, albeit at single digit growth levels. We also expect the authorities to manage the pace of reforms and regulatory implementation in a manner so as to avoid adverse shocks to bank profitability and stability.

Our scenario for banking profit projections is based on our baseline macro outlook (*China Outlook Second Quarter 2012*), under which the economy manages to achieve a soft-landing in the next few years. China's real GDP growth is still expected to remain robust, with stable inflation (Table 1).

Table 1

	2011	2012	2013	2014	2015	2016
GDP growth	9.2%	8.3%	8.7%	8.6%	8.6%	8.5%
CPI average	5.4%	3.5%	3.8%	4.0%	4.0%	4.0%

In addition, our baseline scenario in projecting banks profits during 2012-16 incorporates the following assumptions:

- Annual asset growth of the banking sector slows from 19% in 2011 down to 16% in 2016, in line with our projected soft-landing for real GDP and inflation;
- Interest margins gradually decline to 60% of the current level by end-2016, driven by both enhanced competition and interest rate liberalization;
- NPLs are assumed to pick up over the next few years to 3.4% as of end-2016 from current 1.8%, implying an average 30% annual growth in NPLs over the period of 2012-2016;
- The ratio of provision/NPL is projected to gradually decrease to 150% in 2016 from 278% in 2011 as the banks mitigate the negative impact of the rising NPLs on their profitability;
- The income structure of banks is expected to be further balanced as the share of fee and investment income to the total income increase to 40% in 2016 from 34% in 2011;
- The additional costs incurred by the implementation of new regulations, which are difficult to be quantified, are assumed to be offset by the continuing efficiency gain of banks.

An assumed 40% cut in net interest margin (NIM) is particularly aggressive; as it implies a decline to 1.6% from the current level of 2.7% (market expectations are often as much as a halving of net interest margins). This is slightly lower than the average NIM among high income countries (which over the period of 1995-2007estimates[1] but it is probably close to their NIM today.

Table 2

	2011	2012	2013	2014	2015	2016
Asset Growth	18.9%	17.8%	17.0%	16.5%	16.0%	15.0%
Net Interest Margin	2.7%	2.5%	2.3%	2.0%	1.8%	1.6%
% of fee and investment Income	33.8%	35.0%	36.5%	38.0%	40.0%	40.0%
NPL Ratio	1.8%	2.1%	2.4%	2.8%	3.2%	3.4%
Provision / NPL	278.1%	240.0%	210.0%	180.0%	160.0%	150.0%
Profit Growth	**39.2%**	**10.5%**	**9.4%**	**8.0%**	**6.8%**	**5.2%**

[1] "Financial Institutions and Markets across Countries and over Time – Data and Analysis". By Thorsten Beck and Asli Demirgüç-Kunt, World Bank Working Paper, 2009

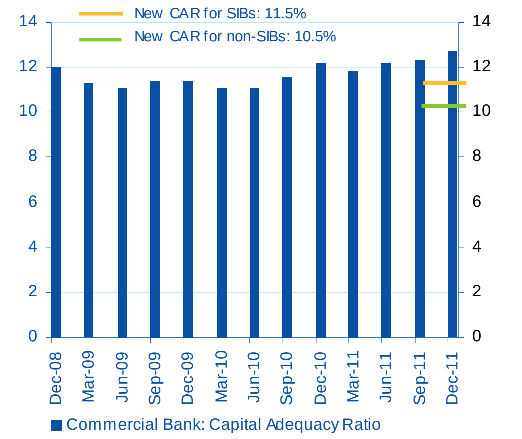
Based on the set of assumptions above, we project that the profitability of the entire banking sector will enter a period of single digit growth as reported in Table 2. However, the results are suggestive because the calculations are highly sensitive to the pace of interest rate liberalization and the rise in NPLs. Our bottom line is that the profit growth of China's banks is expected to fall sharply over the next few years even when real GDP still maintain a relatively rapid growth and the inflation is stable.

Chinese banks to raise capital again

The moderated profit growth is set to bring new challenges to the organic growth of capital through retained earnings. This could force banks to cut their dividend payout ratios.

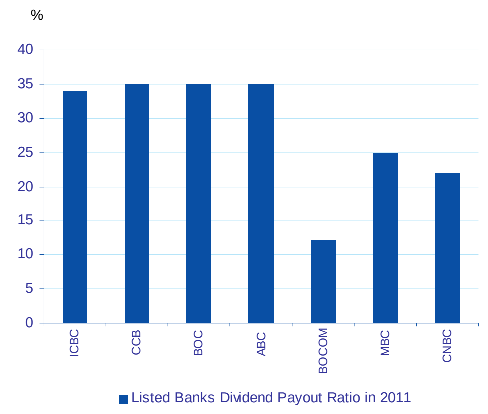
According to 2011 annual financial reports, bank capital remained solid in 2011 (Chart 5). This was mainly due to capital replenishments totaling RMB 380 billion, compared to RMB 500 billion in 2010. Based on our economic growth and balance sheet scenarios, among other variables, we estimate that Chinese banks will face a capital gap of around RMB 1.8 trillion over 2012-2016 if they target to keep the Capital Adequacy Ratio (CAR) above 11.5% and maintain a dividend payout ratio of 22%. Even if banks halve their dividend payout ratios, capital would contract to RMB 1.3trillion. Pressures on dividend payout ratios would be higher for large commercial banks, which have typically had higher-than-average dividend payouts. (Chart 6)

Chart 5
Banks' capital level is still robust



Source: Banks reports, Wind and BBVA Research

Chart 6
Banks with higher dividend payout ratio are facing larger pressure on capital



Source: Banks reports, Wind and BBVA Research

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