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# Where is the Chinese Banking System heading? Some take-aways for Europe

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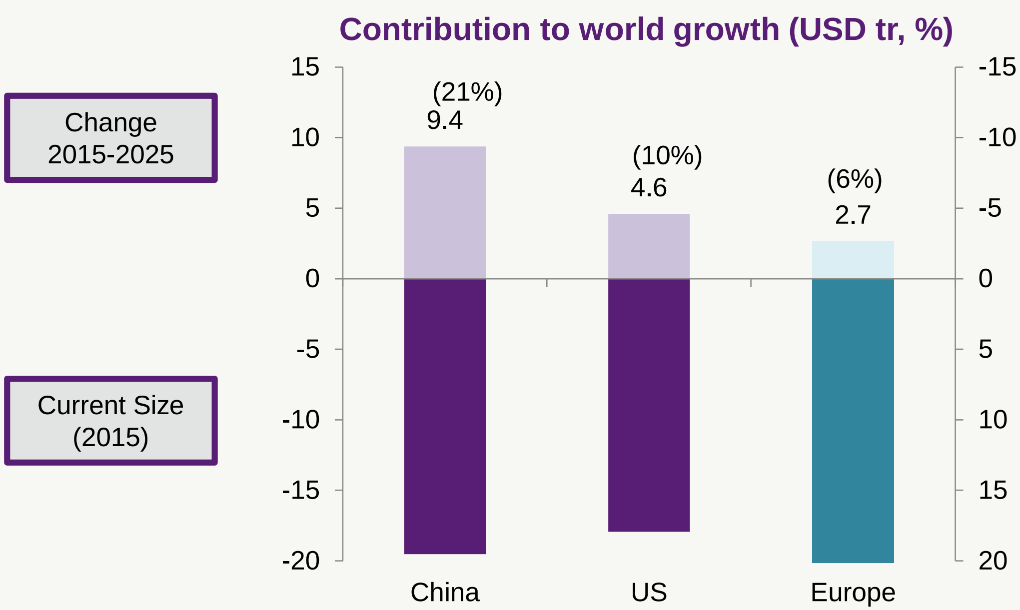
# Key issues

1. China's financial sector in context
2. China's first wave of bank reform
3. Banks to China's rescue in the wake of the global financial crisis
4. Hitting the wall again and the new restructuring wave
5. The way forward and consequences for Europe

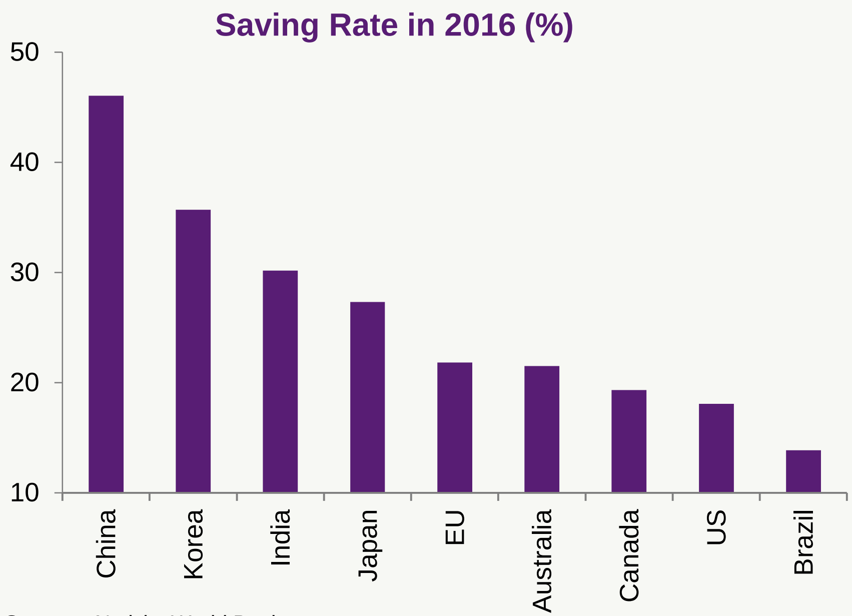
# 1. China's financial sector in context

# China’s economy is not only huge already but will continue to contribute much more than any other large economy to global growth: Increasingly large spillovers on rest of the world

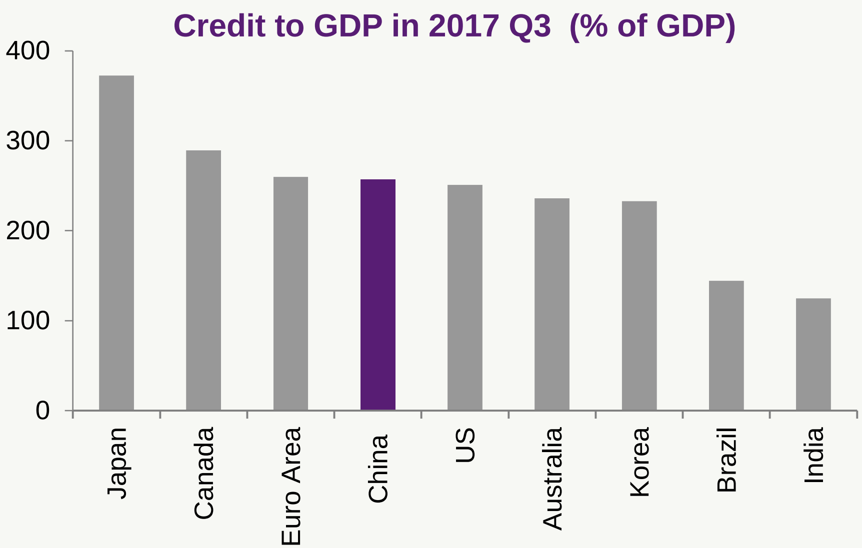



Source: Natixis

# Supported by massive (and captive) savings, China's financial deepening has been even faster than the growth miracle but less attention is paid as to how it has happened

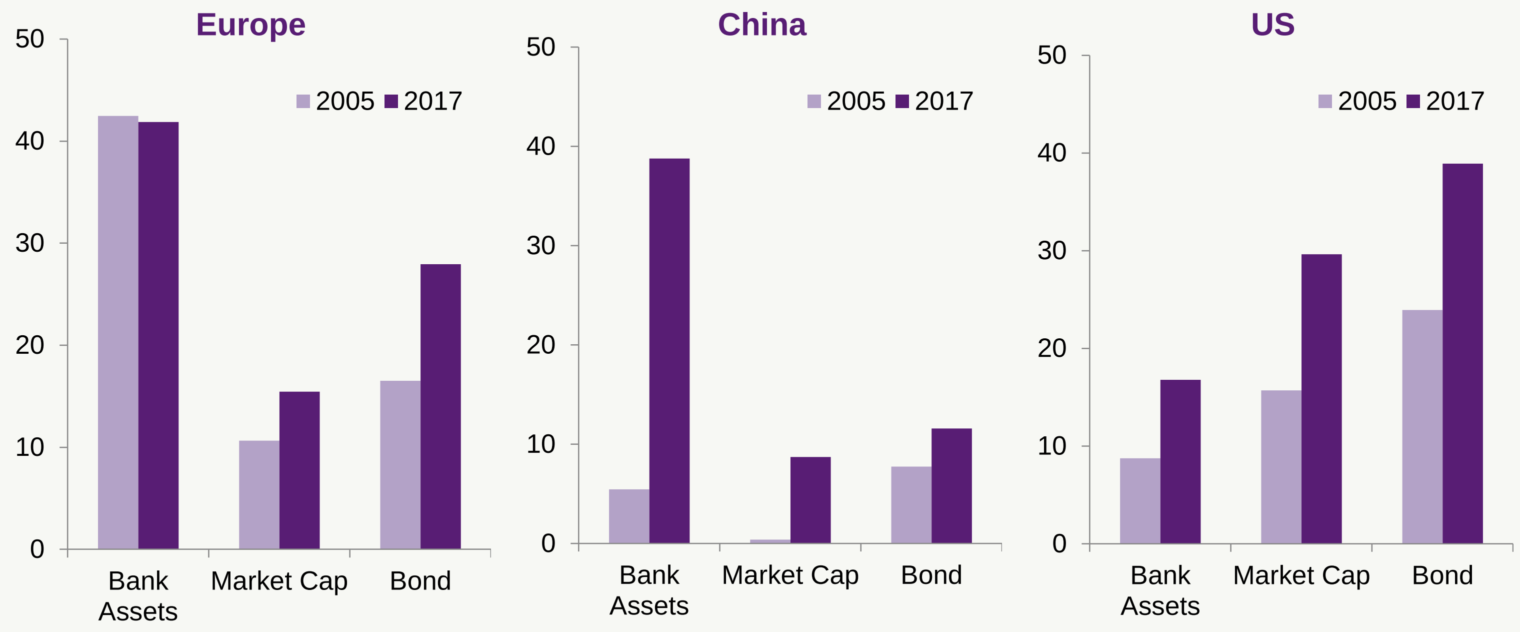



Sources: Natixis, World Bank




*Credit to GDP is calculated as sum of credit to general government, household, corporate to GDP
Sources: Natixis, BIS

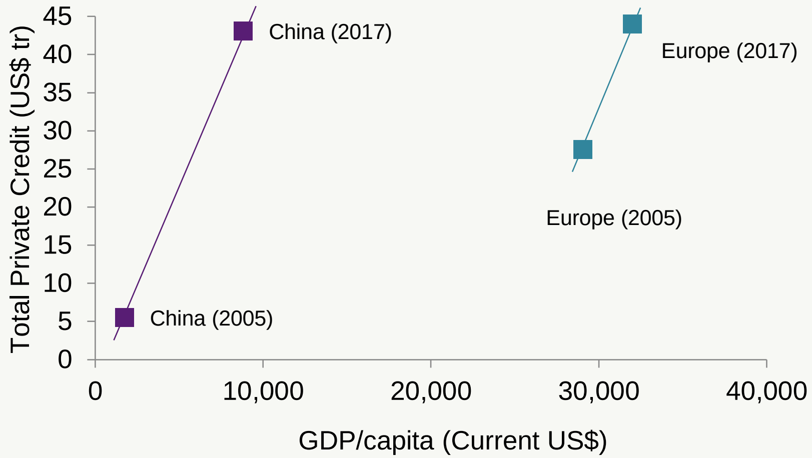
# The backbone of China's financial system is the banking sector with assets as large as those of EU banks already but coming from a very small base in 2005




N.B. Unit is USD tn. Bonds is till of 2017 Q3
Europe included euro area, UK, Sweden, Switzerland, Norway, Denmark
Source: Natixis, BIS, Bloomberg

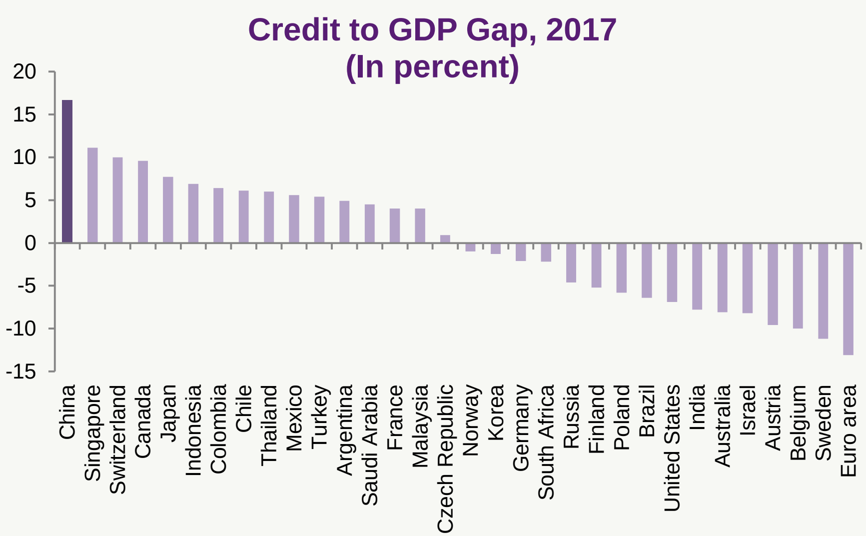
# However, China's GDP per capita is still only one third of that of Europe so financial deepening set to continue with a multiplying effect on the absolute size of China's financial assets

**Total private credit and GDP per capita**

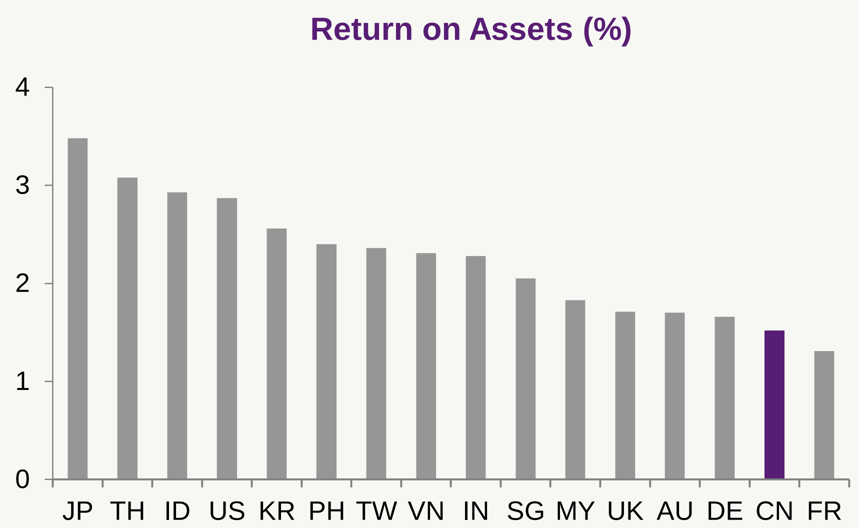



N.B. GDP per capita of Europe is in 2016
Source: Natixis, BIS, CEIC, Datastream

# The problem, though, is that China's financial sector is already stretched due to China's investment led growth model leading to very low return on assets and a very high credit gap

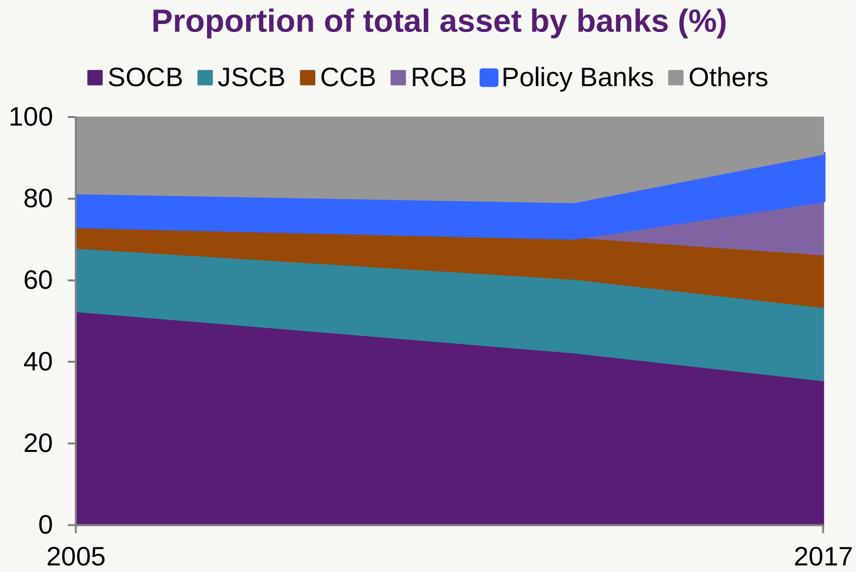



N.B. Credit-to-GDP gaps is based on total credit to the private non-financial sector, as % of GDP
Source: Natixis, BIS (2017 Q3)




*Estimated from stock indexes as of Q1 2018
Sources: Natixis, Bloomberg

# Most importantly, the use of bank credit to support an investment-led growth model has been government driven as the intermediaries (i.e., the banks) continue to be generally state-owned




*RCB is included to others until 2013. Since 2014, RCB is counted separately from others. Others include foreign banks, postal savings banks, non-bank financial institutions. We estimated the value of asset value of policy banks
Source: Natixis, CBRC

# 2. China’s first wave of bank reform

# The banking sector was instrumental in Zhu Rongji's SOE restructuring but at the cost of a massive clean-up in the early 2000s

After **institutional shake-up**:
- From mono bank to sectoral banks
- To the separation of commercial and policy banks (1995)
- To reinforcement of the PBoC charter (with bank supervision/ payment functions)

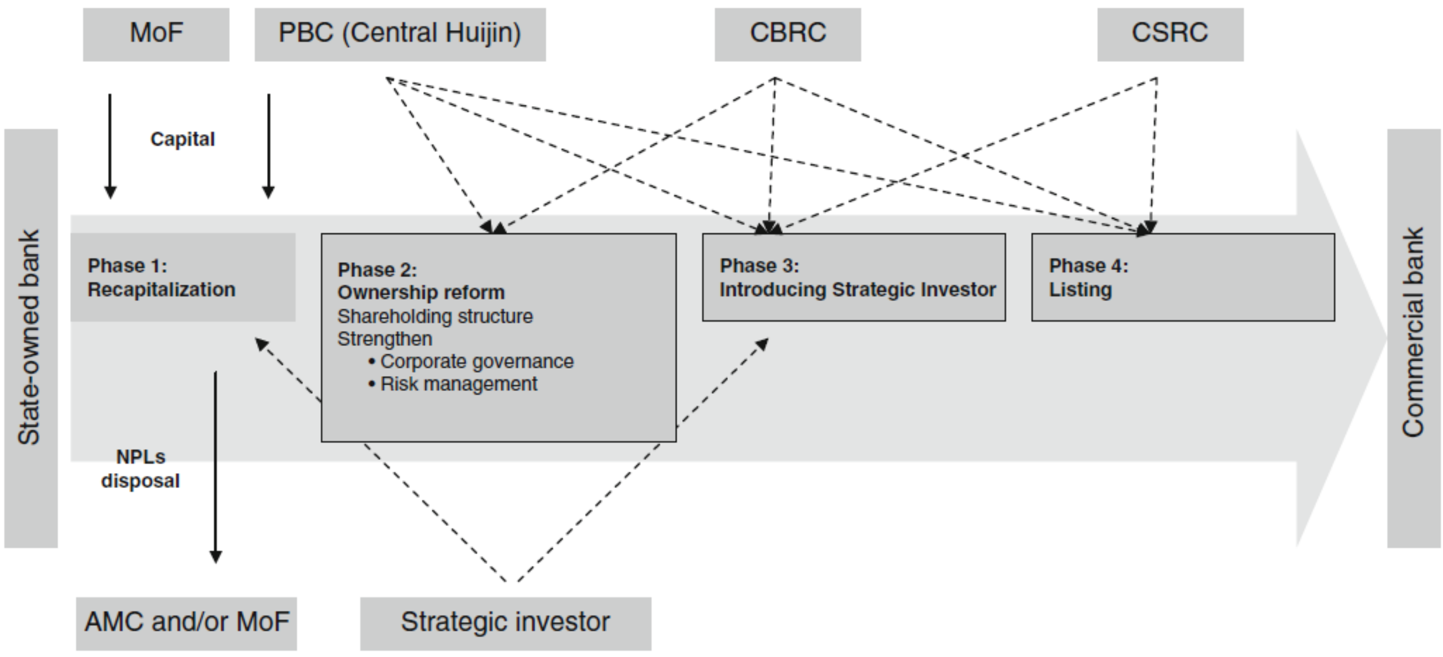
**Bank restructuring** starts:
- Public funds injected to recapitalize state-owned commercial banks (SOCBs)
- Non-performing loans (NPLs) divested into newly created Asset management companies (AMCs)
- But also private funds (first strategic investors and then IPPs in Hong Kong and, alter also Shanghai

**Government control** of banking sector remains intact:
- private funding to reduce cost of restructuring and import best practices but never to divest control

To support the restructuring efforts, the process of **financial liberalization slows downs** (relative to rest of economy) and **financial regulation remains accommodative**

# Several government agencies involved in restructuring process but still centralized

**Fig. 5** Commercial bank reform strategy: participants and phases



# Estimated total cost of first waves around 24% of 2004 GDP with a very large reduction in banks' NPL ratio. But a good part of the cost hidden in AMCs which only managed to recover around 10% of transferred NPLs with a latent loss

Fig. 6 NPL ratio (% of outstanding loans).

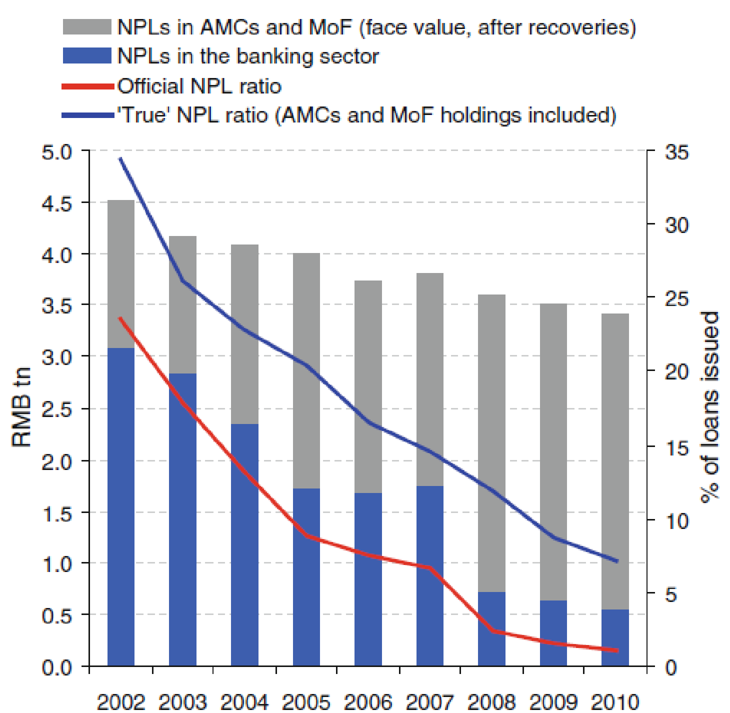
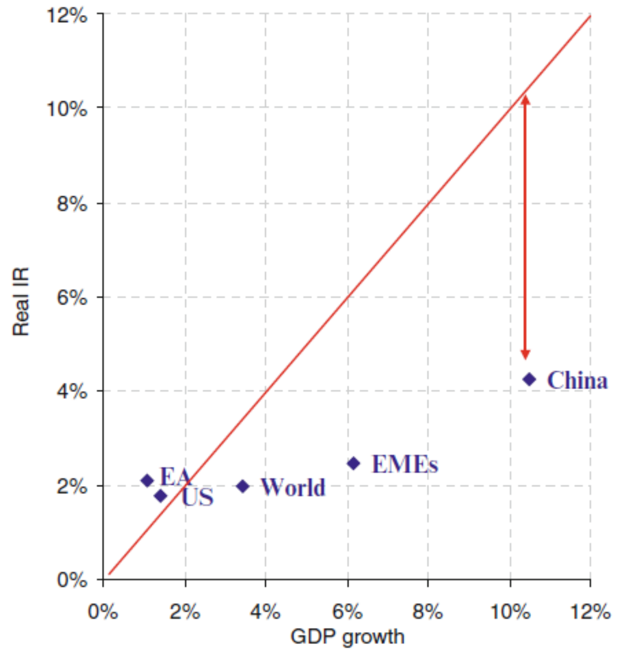



**Fig. 6** NPL ratio (% of outstanding loans). Source: Authors calculations based on Dragonomics (2009) and CEIC

# A way to reduce the cost of restructuring was to keep financial representation and regulatory forbearance. Very low interest rates are the best example of the former

**Fig. 7** Real GDP growth and real long-term interest rates, average 2001–2009 (%).




Sources: Haver Analytics

# 3. Banks to China's rescue in the wake of the global financial crisis

# The largest credit binge in recent history

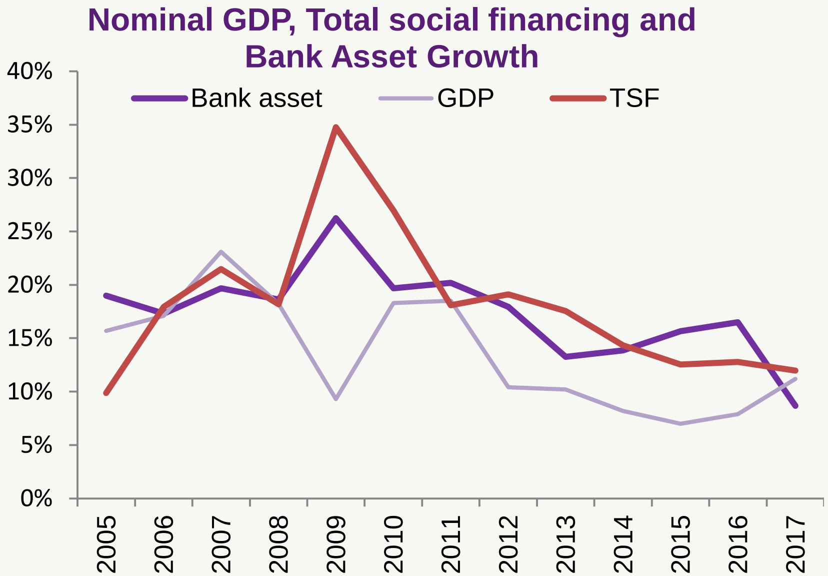
- The global financial crisis, with a massive immediate effect on China’s export orders and, thus, manufacturing unemployment,  was a clear wake-up call for China to shift its growth model to domestic demand.

- The urgency of the response needed shifted the model to investment (consumption being slower to react).

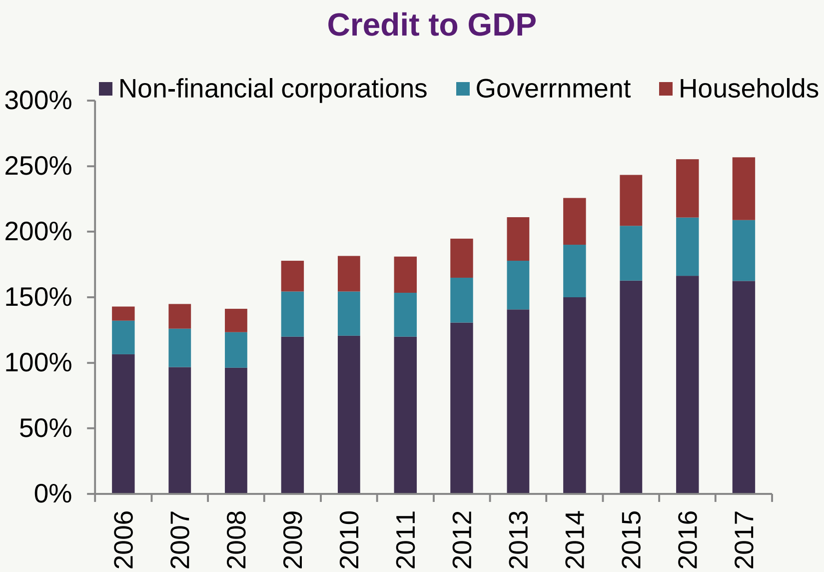
- Banks were instrumental in carrying out the government massive stimulus package though credit targets to be achieved on lending to local governments for infrastructure projects as well as SOEs for their investment plans.

- This led to an extraordinary expansion of banks’ balance sheets and ballooning credit growth

# Beyond PBoC window guidance to boost credit and very lax monetary policy, China attracted massive capital inflows which added to the credit binge. This was not only reflected in bank asset growth but, even more so, in the shadow banking. Most of the credit went to corporations but also local governments

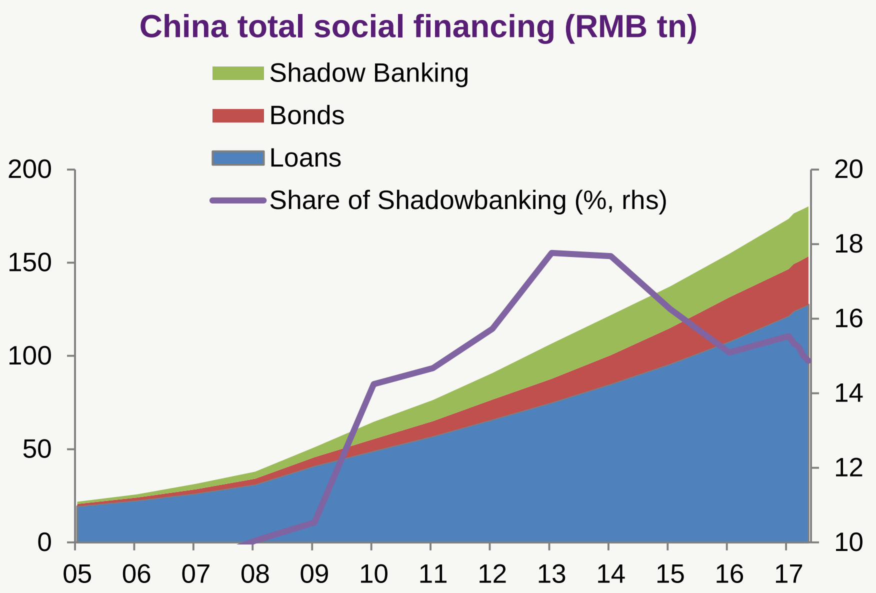



N.B. Total social financing is comprised of a total of loans, shadow banking, equity and bonds, which is provided by PBoC
Source: Natixis, Bloomberg

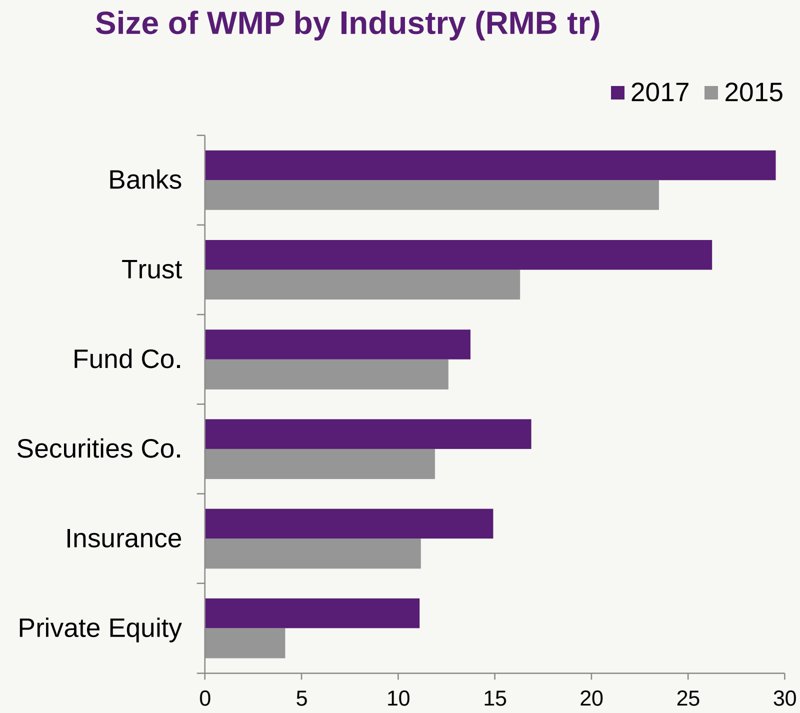



Source: Natixis, BIS
* Year 2017 end day: 9/30/2017

# Beyond bank assets, both bond issuance and shadow banking have surged since GFC but both closely intervened with banking sector: Banks have long been largest issuers of wealth management products (part of shadow banking)



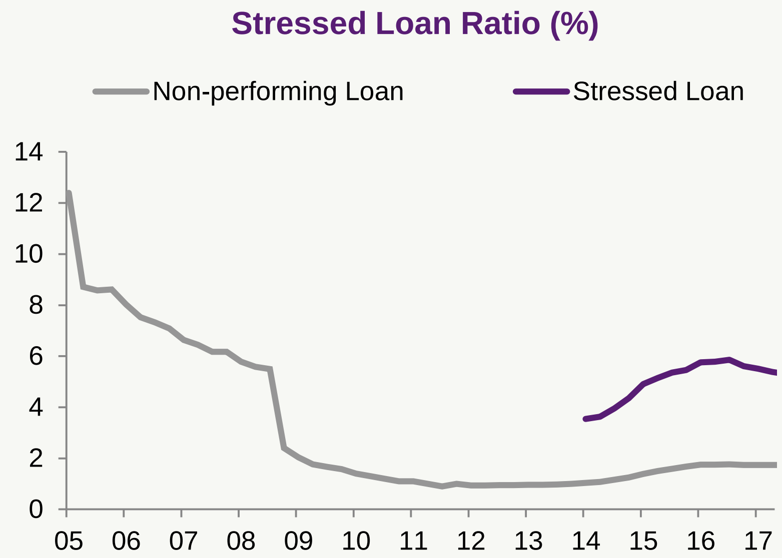

Sources: Natixis, CEIC




Source: Natixis, CEIC

# Corporates' leverage facilitated by China's very fast growth as a consequence of lax financial conditions after GFC, leading to a rapid increase in profits. Also banks' asset quality improved on the back of massive credit growth

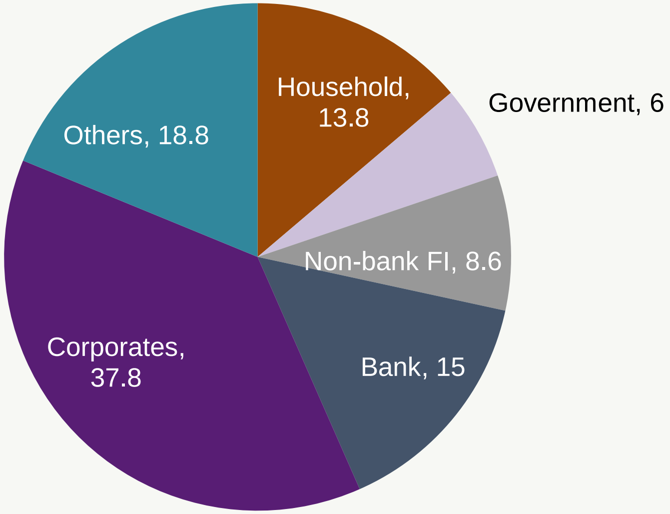

Sources: Natixis, CEIC




Stressed loan is the sum of non-performing loan and special mention loan
Source: Natixis, WIND

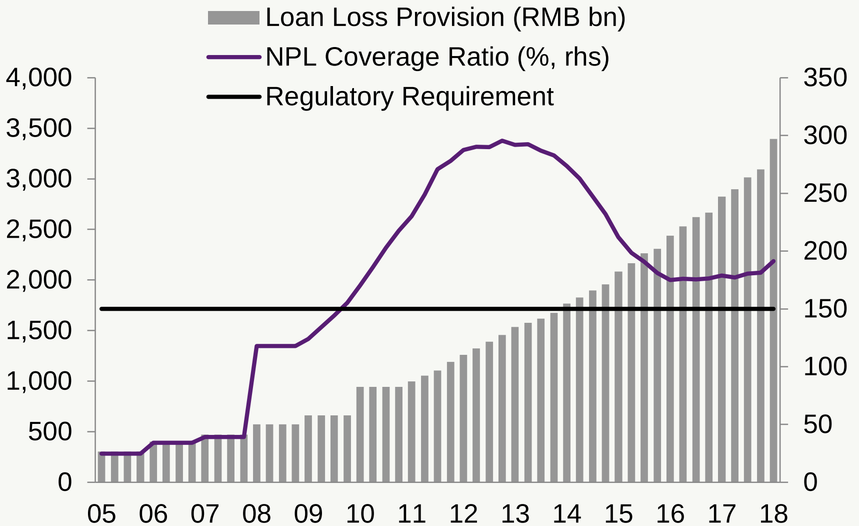
# Banks remained largely exposed to the corporate sector (also to local governments) but their compliance with seemingly tight regulation of 150% minimum coverage ratio seemed enough to avoid solvency problems down the road

**Asset by Sector of Average from 2013-2017 (%)**




Sources: Natixis, CEIC

**NPL Coverage Ratio and Provision**




Source: Natixis, WIND

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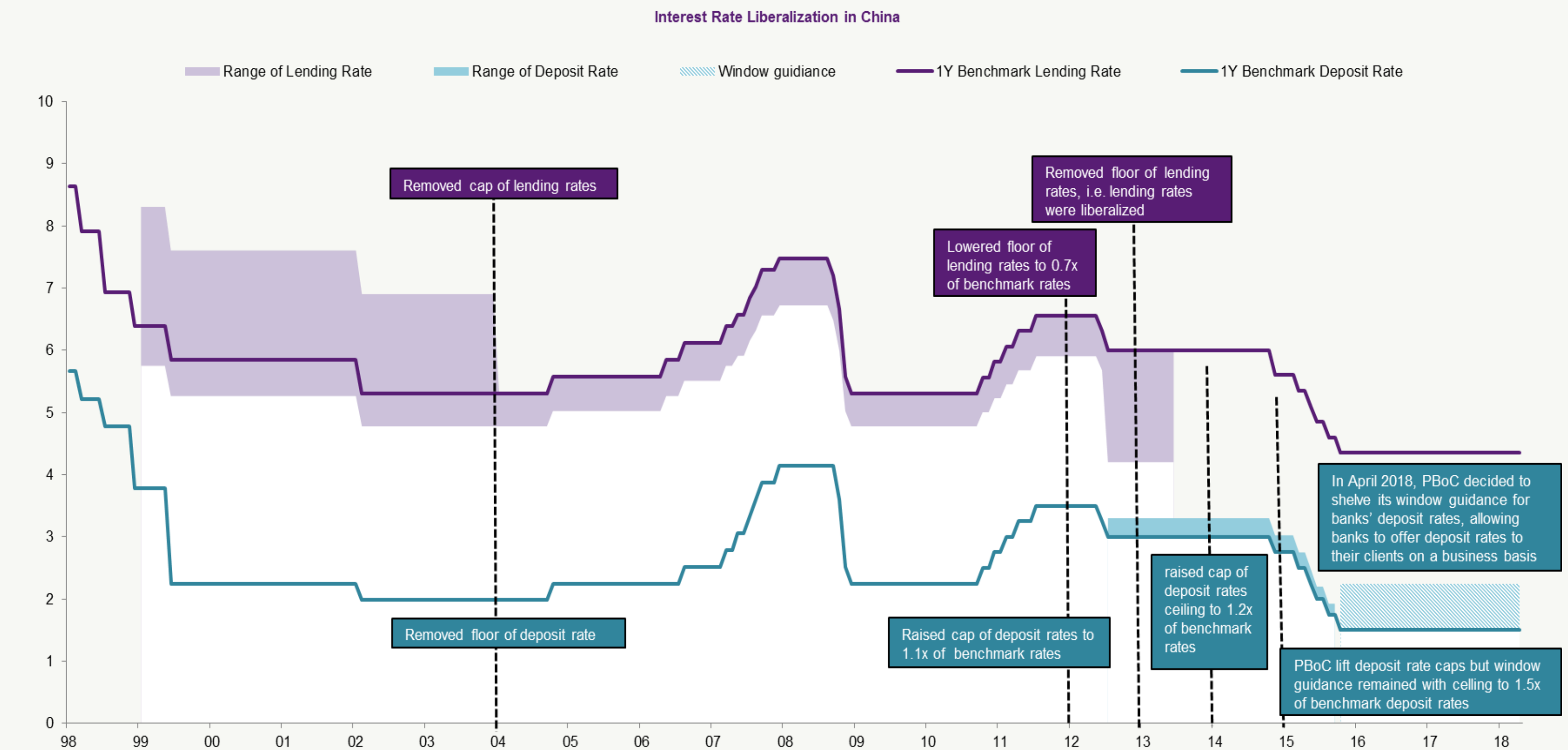
# 4. Hitting the wall again and the new restructuring wave

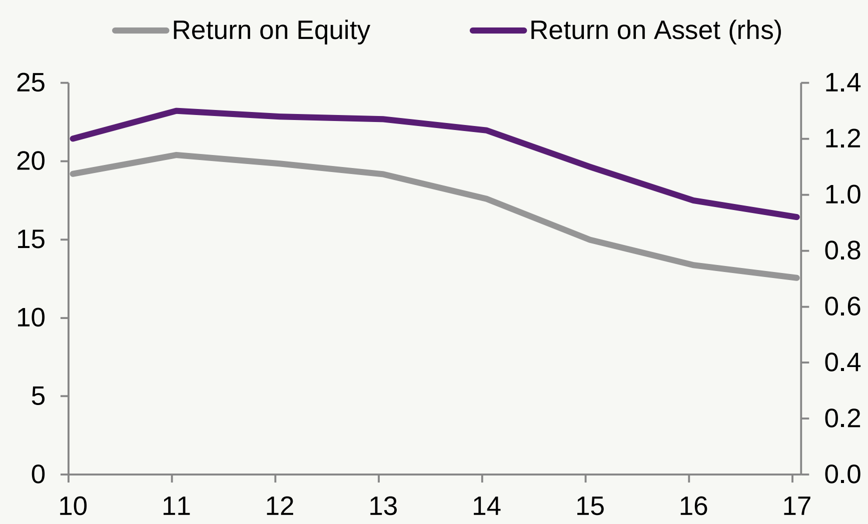
# After being freezed during GFC, financial liberalization accelerated between 2013-15




Source: Natixis, Bloomberg

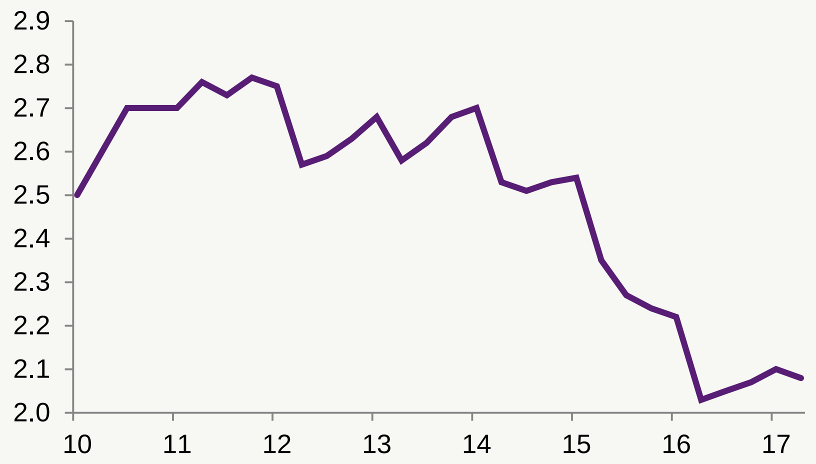
# Interest rate liberalization and heightened competition from more private banks, led to a reduction in the interest margin, pushing return on assets/equity down the road

**Return on equity and return on asset (%)**



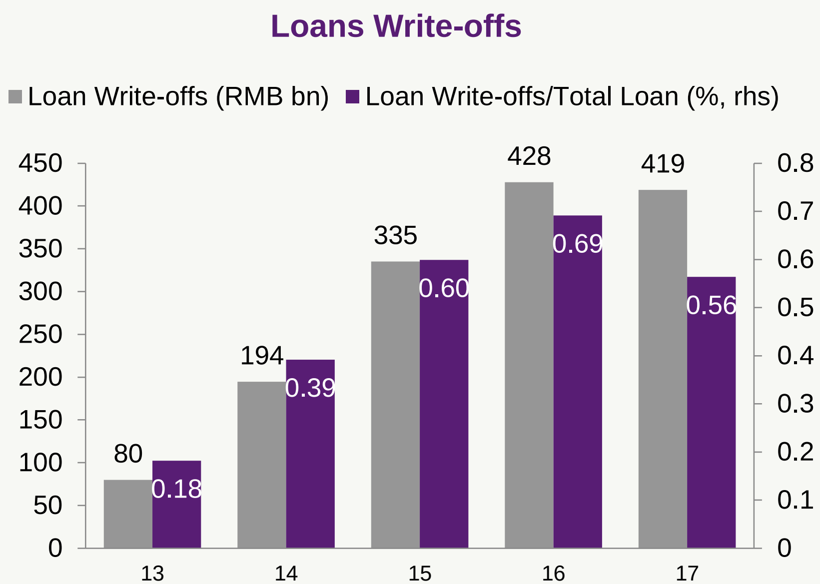

Source: Natixis, WIND

**Net Interest Margin (%)**

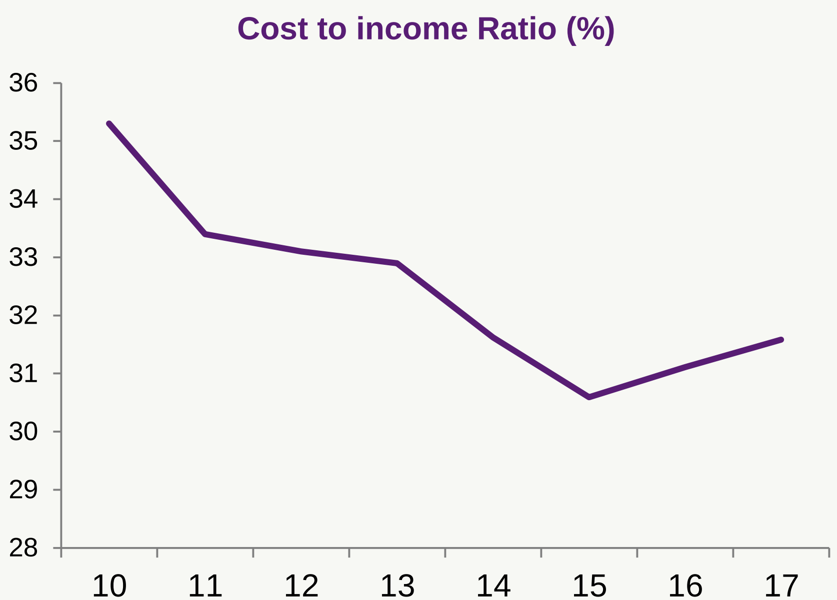



Source: Natixis, WIND

# Collapse in industrial profits since 2012 and worsened environment and asset quality, pushing ROE even lower. Bank efforts to cut costs were not enough to offset impact of worsening asset quality

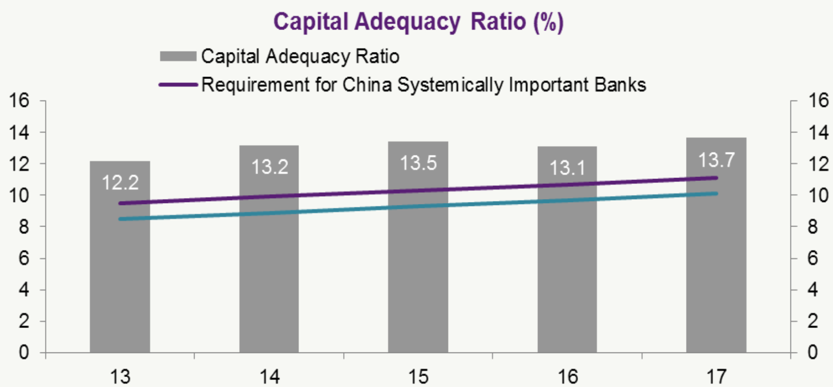


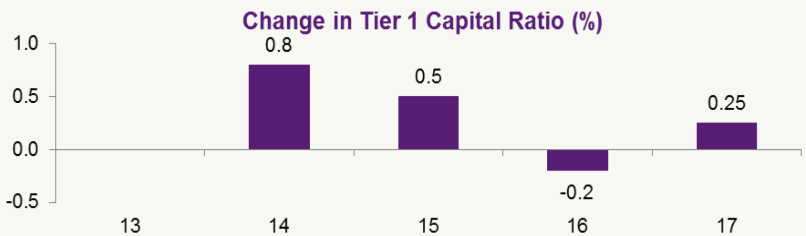

Source: Natixis, Bloomberg N.B. Data of listed banks used



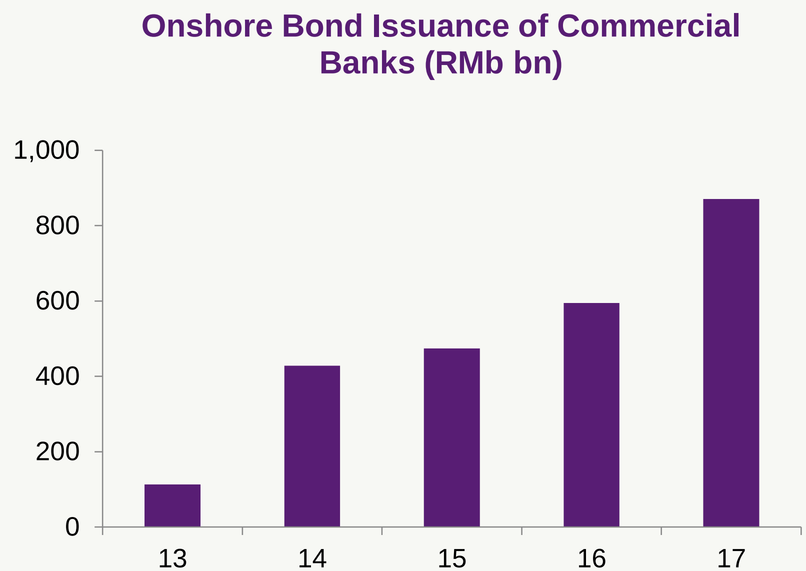

Sources: Natixis, WIND

# Bank solvency was not severely affected thanks to an easier access to market (from booming onshore bond market in China)



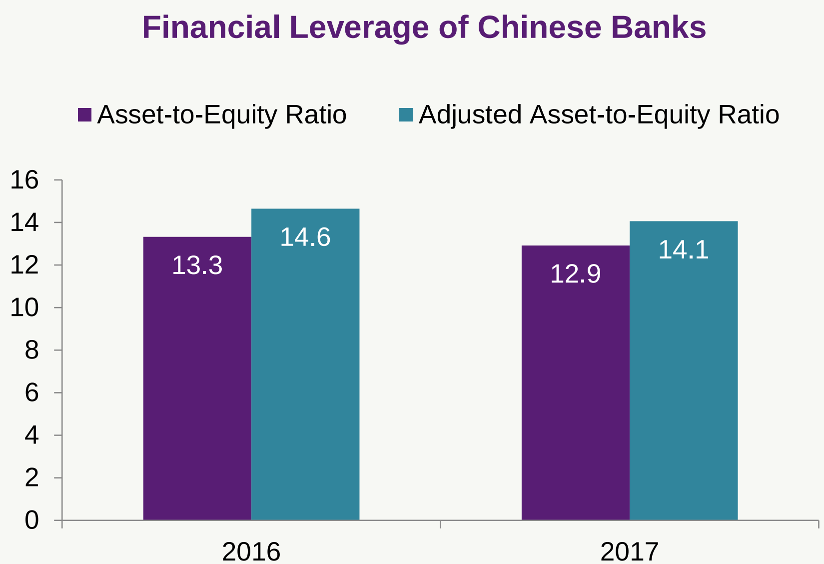




Source: Natixis, WIND

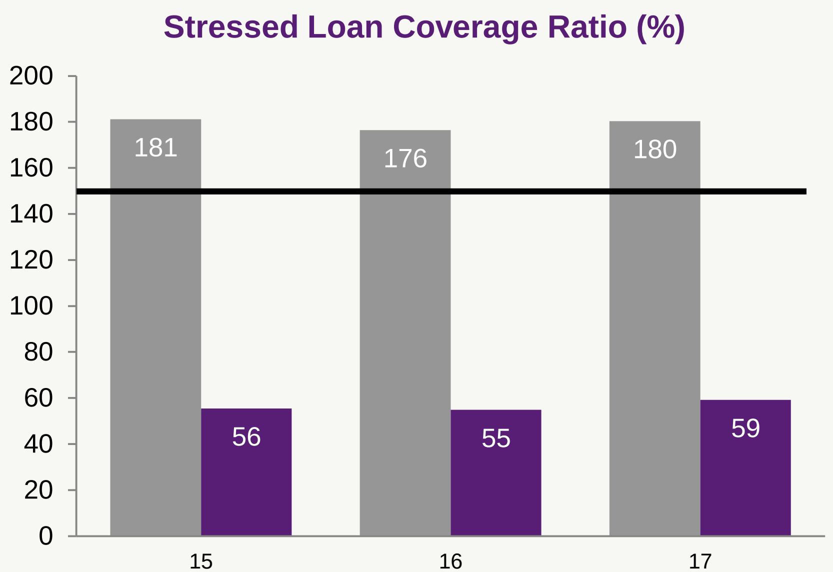



Source: Natixis, WIND

# But, seemingly ample capital casts worse asset quality that recognized in NPL ratio as well as large (non-consolidated) off-balance sheet assets




Adjusted ratio calculated by using the sum of asset and wealkth management products divided by equity  Source: Natixis, CEIC

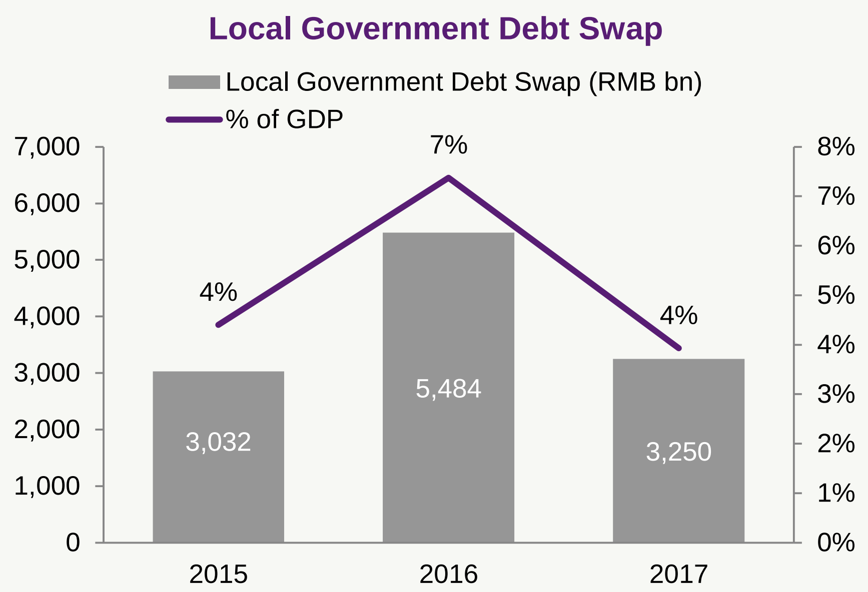



Source: Natixis, WIND

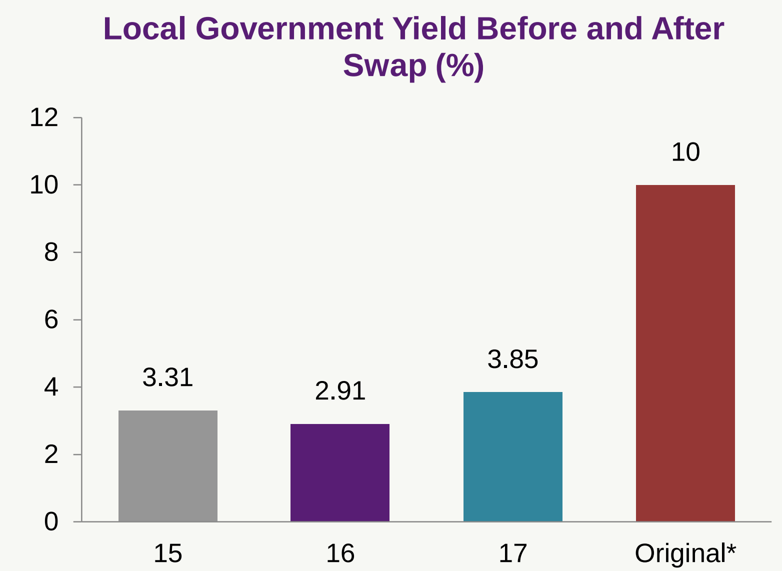
# The new wave of restructuring after GFC has had to main components to address the two key sources of bad assets

- Focused on two key problems generated by 2008-2012 credit boom:
  - Bank loans granted to local governments (directly or through special vehicles)
  - Bank loans to corporates with overcapacity (mainly in the industrial, up stream, sector)

# The clean-up of local governments seems to have come to an end, which has improved bank solvency but has also reduced profitability



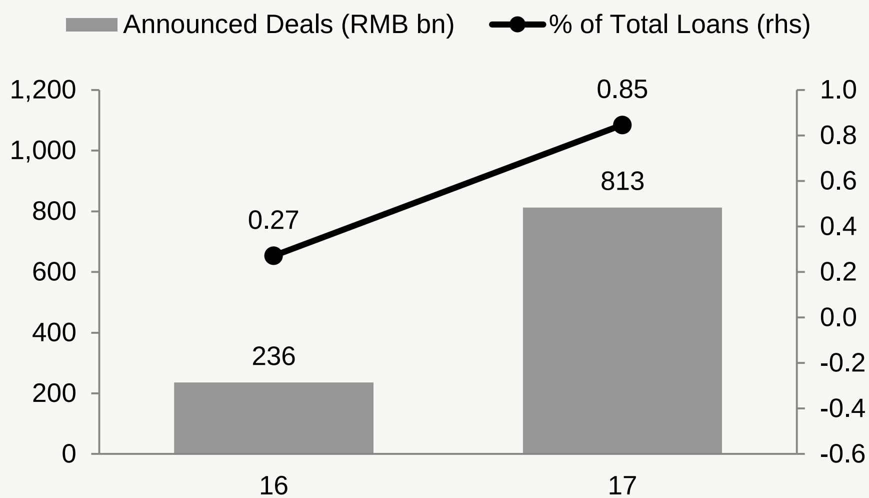

Source: Natixis, WIND




*Average loan interest rate before debt swap mentioned by government officials
Source: Natixis, WIND

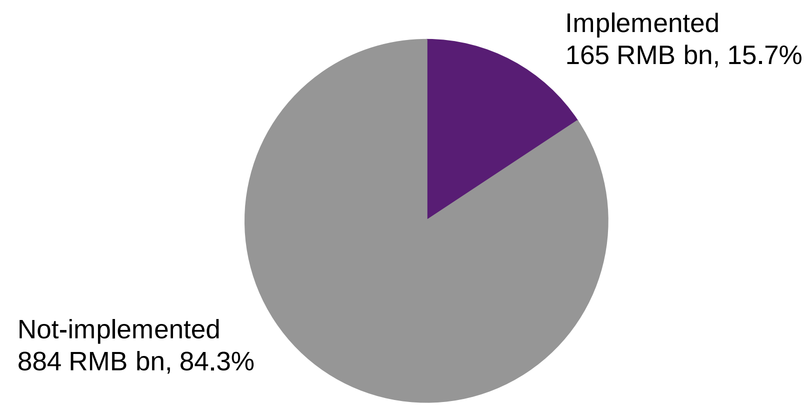
# Moving to corporate problem loans, the clean-up started with the use of debt-to-equity swaps but there is still a long way to go to clean up all of the problem assets (between 15-20% achieved) and so far only target over-capacity SOEs

**Announced Debt to Equity Swap (RMB bn)**




Source: Natixis NB Based on swap announced date

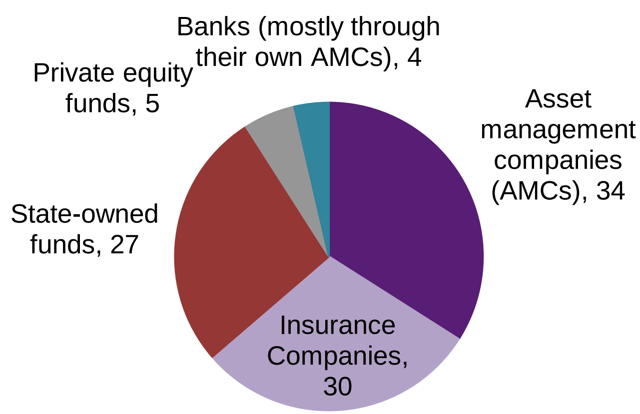
**Implemented D/E swaps remain limited (Value, % of Total Announced Deals)**




Data as of 5th Feb 2018
Source: Natixis

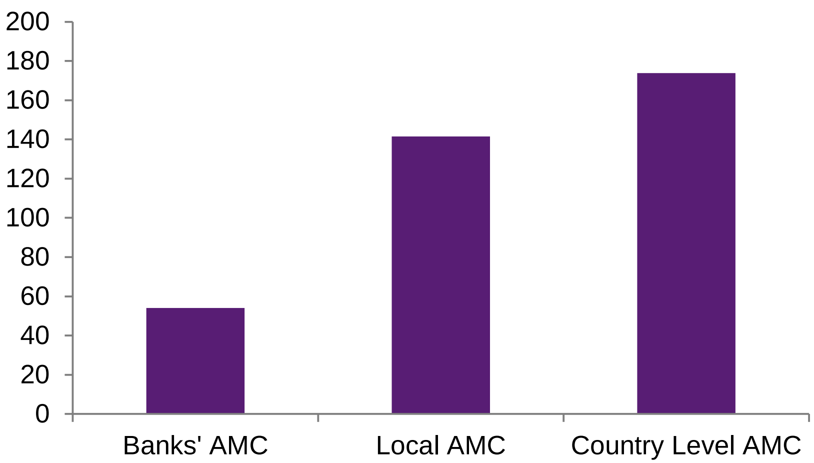
# From the first (naive) approach to keep the equity in the banks, divestment of both loans and equity from banks to rest of financial system was preferred: Banks as big winners (but only SOCBs)； Potential risks for insurance and asset management companies (AMCs)； Another venue for disposal of assets is AMCs, more recently also created by banks

**Debt-to-equity Swaps by Investor (%)**




Aluminum Corporation of China, China State Shipbuilding Corporation and China Shipbuilding Industry Company included
Source: Natixis

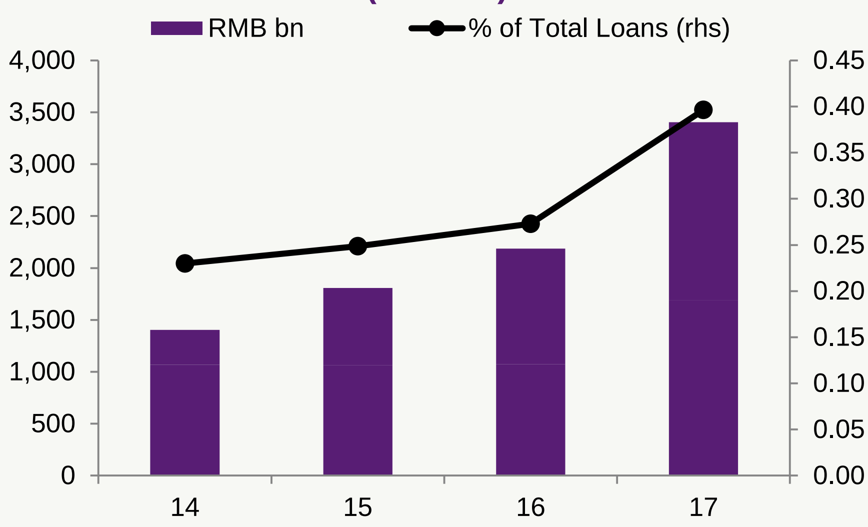
**Registered capital of Asset Management Companies by Group (RMb bn)**




Source: Natixis

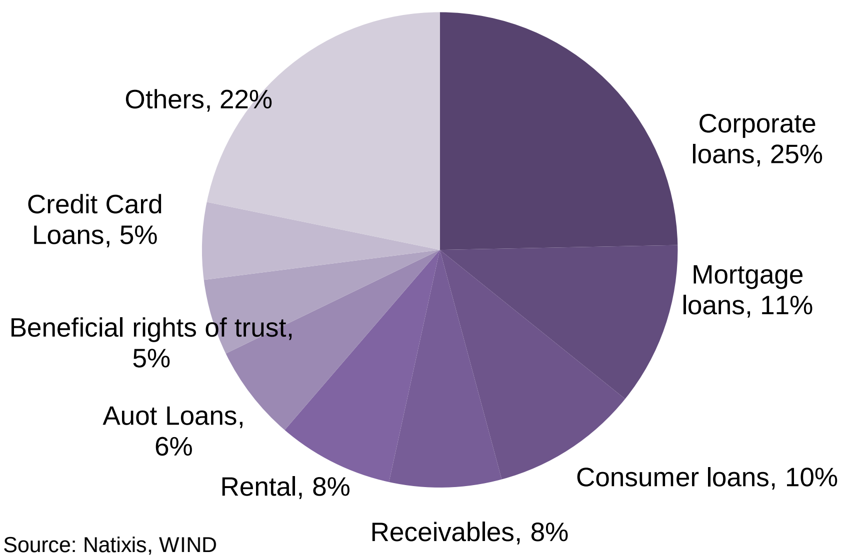
# In addition, more market driven securitization of loans also in full swing, to create more lending space in banks' balance sheets

**Outstanding Asset Backed Securities (RMB bn)**




Source: Natixis, WIND

**Outstanding ABS by underlying asset (2017)**




Source: Natixis, WIND

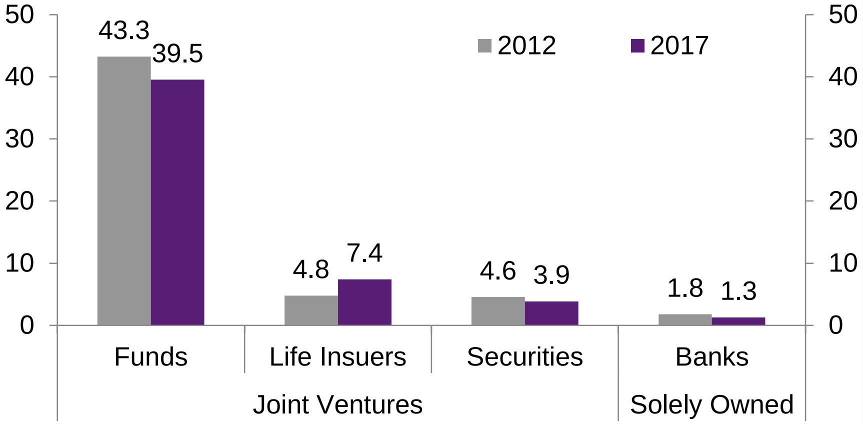
# In a nutshell, the ongoing bank restructuring uses quite different tools but also state-owned driven

| | First Round (1999 - 2010) | Second Round (2015 - Now) |
|---|---|---|
| Key Methods | Capital injection | Debt-to-equity swaps |
| | Disposal of assets | Securitization |
| | IPOs | Onshore and offshore bond funding |
| Capital from government | Yes | No |
| Centralized approach | Yes | No |
| Market force | No | Semi |

# 5. The way forward and potential implications for Europe

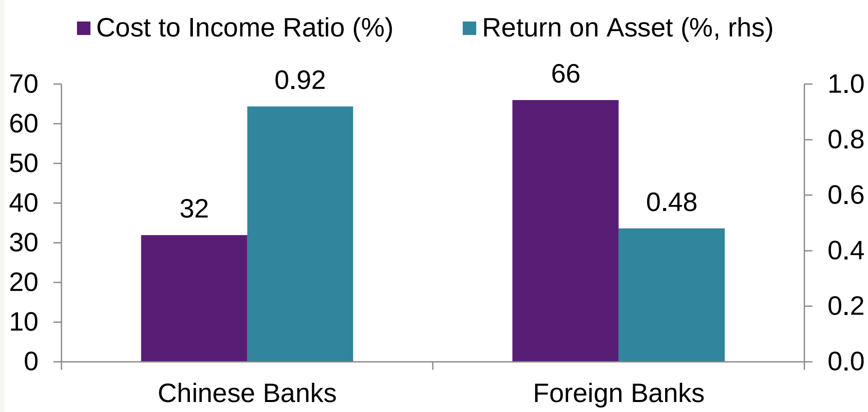
# Opening to financial institutions?: to share the burden? Foreign institutions might not be so interested

**Market Share of Foreign Capitals in China (%)**



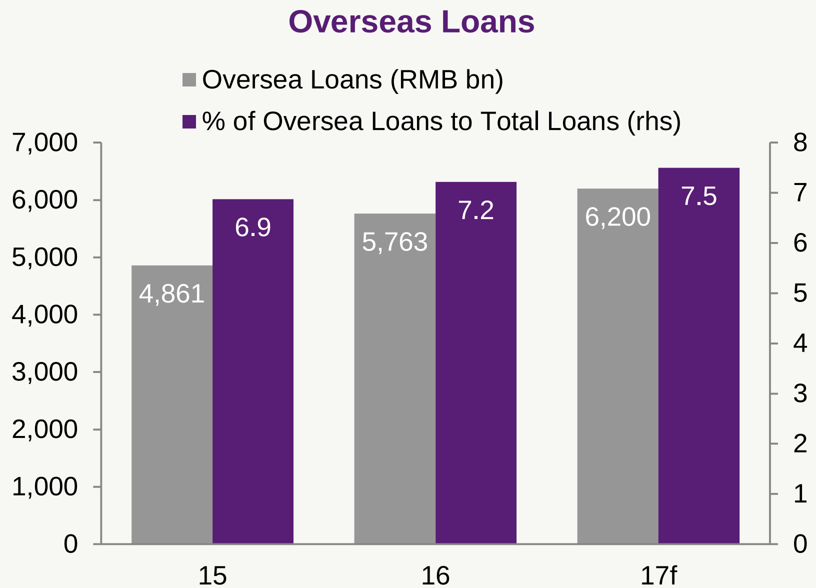

N.B. Data as of 2017 except for fund which is based on 2016. Asset size used for banks. Operating income used for securities. Premium used for life insurance. Net Income used for fund. Source: Natixis, Company Data, CEIC, WIND

**Cost and Income of Chinese and Foreign Banks in China**




N.B. Data as of 2017 except for cost to income ratio for foreign banks, which is estimated by the median value of avaiable disclosure as of 2016.
Source: Natixis, CEIC, Company Data

# Chinese banks have also expanded their overseas strategy as a way to diversify



Source: Natixis, Company Data

# Regulatory forbearance being reduced but still helping and no reduction in pervasive role of state

- Chinese regulator dragging its feet to introduce TLAC
- Single regulator for asset management industry announced but with implementation delayed again to 2020
- Monetary policy laxer again
- No intention to reduce the size of the state in the financial system

# What is it in for Europe

- Chinese banks, especially state-owned banks, will be reinforced from current clean-up
- Do not expect a financial crisis in China soon
- If anything, they will become even bigger from consolidation efforts to address problems in smaller banks
- Their going-on strategy increasingly relevant for China’s Belt and Road Initiative
- European banks to face increasing competition in third markets and, for Chinese corporates, also in Europe

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# Thank you!