



## Global Banking Industry Outlook

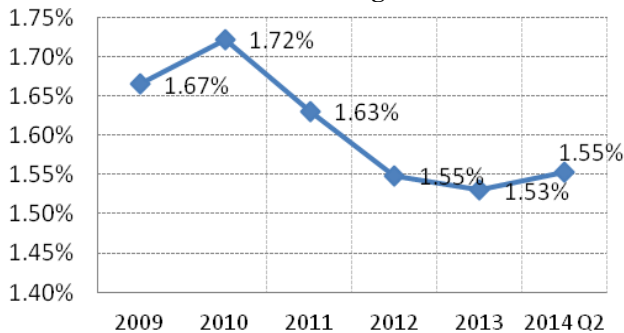
2015 Annual Report (Issue 2)

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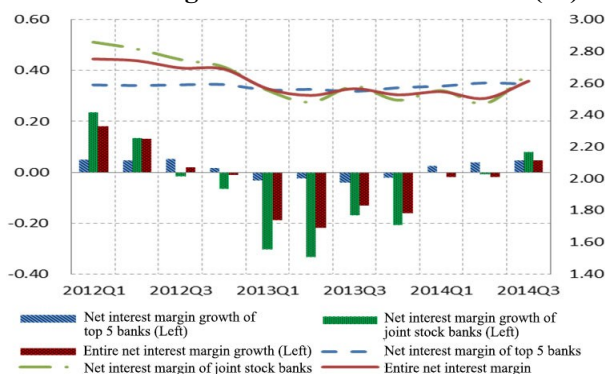
### Highlights

- In 2014, the global economy entered a period of adjustment, leading to differentiated bank performance results. The banking industry in the US and the UK saw an upturn, while that in Japan and Euro Zone remained sluggish and facing challenges. Against the backdrop of the “New Normal” economic pattern in China, the assets and liabilities and net profit growth of China’s banking industry slowed down, and credit risk pressure increased but was controllable on the whole.
- In 2015, the global banking industry will face large and challenging operating pressure, and difficulties and differentiated performances will become the key words.

G-SIBs Net Interest Margin Movement



Net Interest Margin of Listed Banks in China (%)



Source: Bankscope, Wind

### BOC Institute of International Finance Global Banking Industry Research Team

Team leader: Chen Weidong

Deputy leaders: Cao Yuanzheng

Zong Liang

Zhong Hong

Team members: Zhang Xingrong

Shao Ke

Xiong Qiyue

Zhao Xue

Huang Xiaojun  
(New York)

Qu Kang (London)

Yang Bo (Frankfurt)

Zhang Nan (Tokyo)

Wang Zhe (Tokyo)

Contact: Zhang Xingrong

Telephone: 010-66594076

Email: zhangxingrong@bankofchina.com

## Brave Hardships and Differentiation in Transition

### -- Global Banking Industry Outlook of BOC (2015)

In 2014, the banking industry was confronted with huge operating pressure as a result of the weak recovery of the world economy, and the operating results varied in different countries. The banking industry in the US, UK and China performed well, while that in the Euro Zone and Japan remained sluggish. In 2015, the banking industry in the US, the UK and China is expected to maintain smooth growth, and that in the Euro Zone and Japan will still face huge growth pressure.

#### I. G-SIBs Operation Review and Outlook

Global systemic important banks (G-SIBs) are the financial institutions released by the Financial Stability Board (FSB), which assume key functions in the financial market and have a global presence. G-SIBs are recognized as the “stabilizers” of the global banking industry. G-SIBs assessment and selection, dating back to 2011, is carried out once a year. In November 2014, FSB released the fourth-phase list of G-SIBs (Table 1), in which the Agricultural Bank of China was enrolled, increasing the total number of G-SIBs to 30.

**Table 1: List of G-SIBs in 2014**

<b>Place of head office</b>	<b>List of banks (enrollment time)</b>
China (3)	Bank of China (2011), Industrial and Commercial Bank of China Limited (2013), Agricultural Bank of China (2014)
UK (4)	HSBC (2011), Barclays (2011), RBS (2011), Standard Chartered (2012)
Italy (1)	Unicredit Group (2011)
Spain (2)	Santander (2011), BBVA (2012)
Switzerland (2)	Credit Suisse(2011), UBS (2011)
Sweden (1)	Nordea (2011)
Japan (3)	Mitsubishi UFJ FG (2011), Mizuho FG (2011), Sumitomo Mitsui FG (2011)
The US (8)	JPMorgan Chase (2011), Citigroup (2011), Bank of America (2011), Wells Fargo (2011), Goldman Sachs (2011), Morgan Stanley (2011), Bank of New York Mellon (2011), State Street (2011)
Netherlands (1)	ING Bank (2011)
France (4)	BNP Paribas (2011), Group BPCE (2011), Group Credit Agricole (2011), Societe Generale (2011)
Germany (1)	Deutsche Bank (2011)

Source: Financial Stability Board, Institute of International Finance BOC

G-SIBs provide an important window to learn about and grasp the operation and development trend of the global banking industry. In order to provide more insights into the study of global banking industry, the Global Banking Industry Outlook launches the part of G-SIBs operating situation review and outlook from this issue.

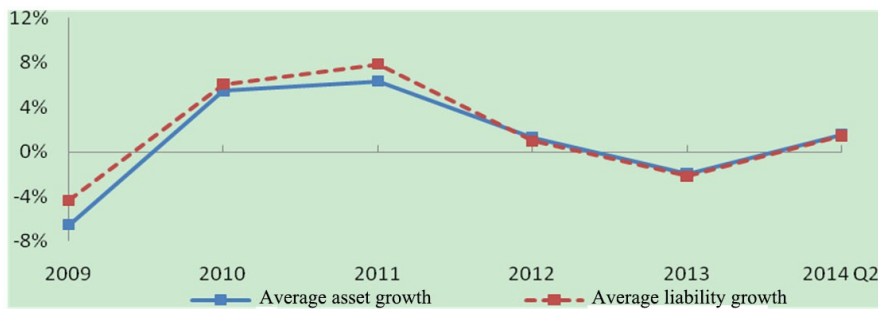
## I.1 Operating situation review

In 2014, G-SIBs maintained overall sound operations with the following features: (1) assets and liabilities scaled up steadily, while the proportions of deposits and loans in liabilities and assets decreased slightly; (2) net interest margin narrowed, and the proportion of net interest income slid down; (3) profitability improved through cost control; (4) non-performing loan (NPL) ratio and allowance to loans both tended to decline; (5) capital adequacy ratio (CAR) and capital quality continued improving.

### I.1.1 Stabilization and rebound of asset and liability growth

After the global financial crisis in 2008, the US, Euro Zone and Japan successively launched the quantitative easing policy, resulting in an abrupt expansion of the asset size of G-SIBs (Figure 1). At the end of 2011, G-SIBs' assets grew by 6.33%<sup>1</sup>, an increase of 12.88 percentage points over 2009. G-SIBs' asset expansion speed slowed down after 2011, but rebounded in the first half of 2014. In the second quarter of 2014, assets and liabilities grew by 1.58% and 1.44% respectively over the same period of last year, 3.52 and 3.62 percentage points higher respectively over the end of last year.

Figure 1: Average Growth of Assets and Liabilities of G-SIBs



Source: Bankscope, Institute of International Finance BOC (the same below)

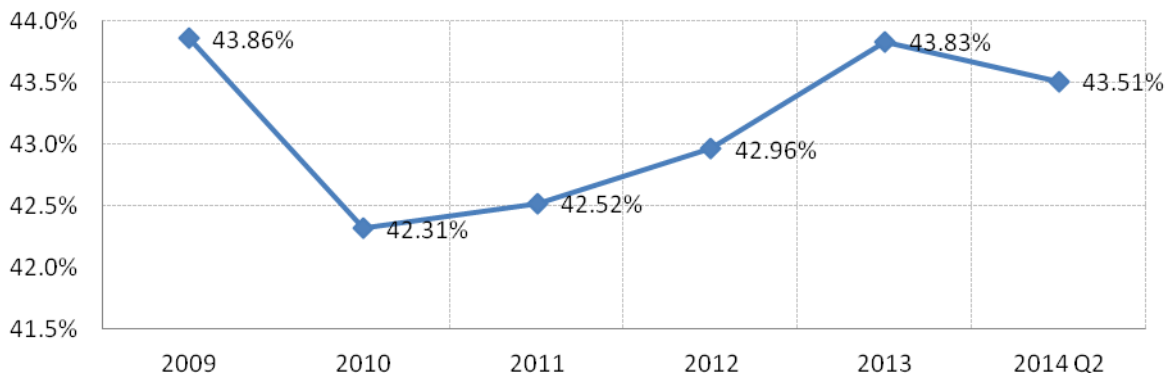
### I.1.2 Proportions of deposits and loans decreased slightly

In the wake of the financial crisis, banks has attached greater importance to the traditional asset and liability business models since 2010, due to tightened supervision worldwide and commercial banks' change of risk appetite. At the end of 2013, the average ratio of outstanding loans to total assets was 43.83%, up 1.52 percentage points over the end of 2011.

Entering 2014, however, the ratio dipped slightly. At the end of the second quarter, the average ratio of G-SIBs was 43.51%, a decrease of 0.32 percentage point from the end of 2013.

1. The arithmetic average, the same below.

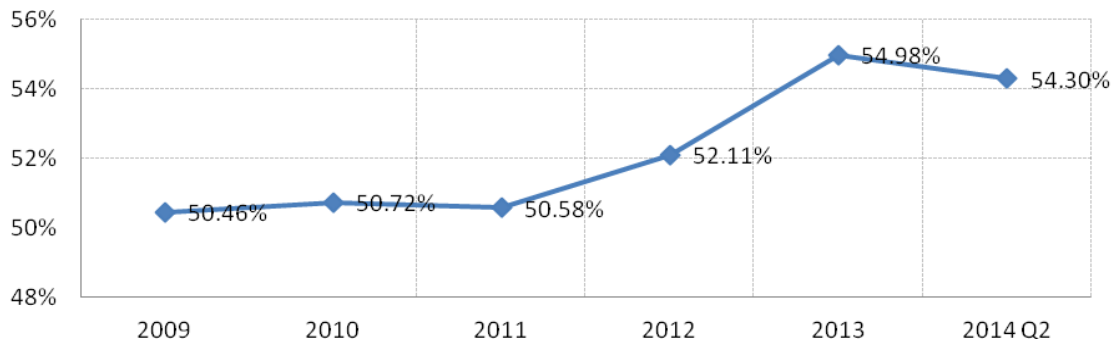
**Figure 2: Outstanding Loans/Total Assets of G-SIBs**



Note: This figure does not include the institutions with a ratio of loans to total assets of less than 20%, such as Goldman Sachs Group, Morgan Stanley, JPMorgan Chase, Bank of New York Mellon and State Street.

At the end of the second quarter of 2014, the average ratio of deposit balance to total liabilities of G-SIBs was 54.30%, an increase of 3.84 percentage points over 2010 but down 0.68 percentage points from the end of 2013.

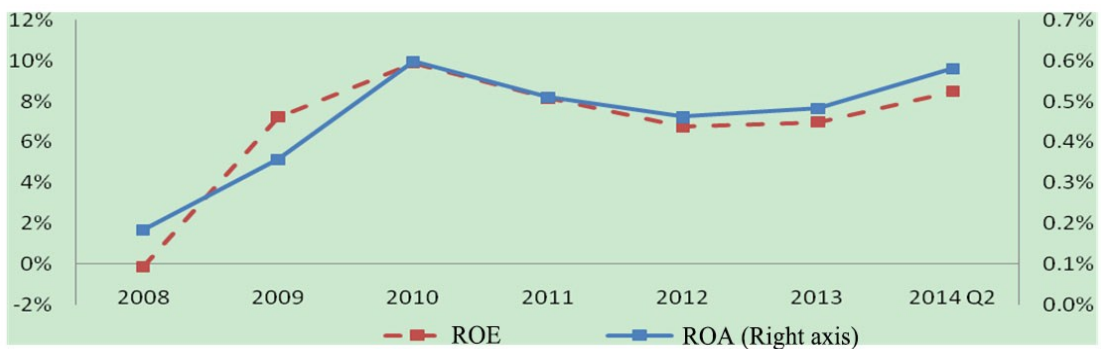
**Figure 3: Deposit Balance/Total Liabilities of G-SIBs**



### I.1.3 Profitability improved steadily and remarkable progress was achieved in cost control

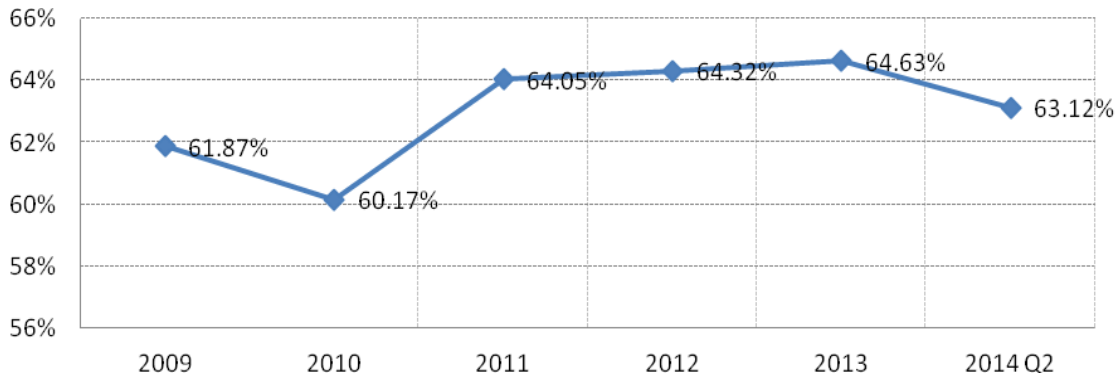
In the first half of 2014, the average return on assets (ROA) and the return on equity (ROE) of G-SIBs were 0.58% and 8.49% (both annualized) respectively, up 0.37 and 8.59 percentage points over the end of 2008, and 0.10 and 1.49 percentage points over the end of 2013.

**Figure 4: ROA and ROE of G-SIBs**



G-SIBs' cost control capability was enhanced slightly. In the same period, the average cost-to-income ratio of G-SIBs was 63.12%, 2.95 percentage points higher than the end of 2010 but 1.51 percentage points lower than the end of 2013.

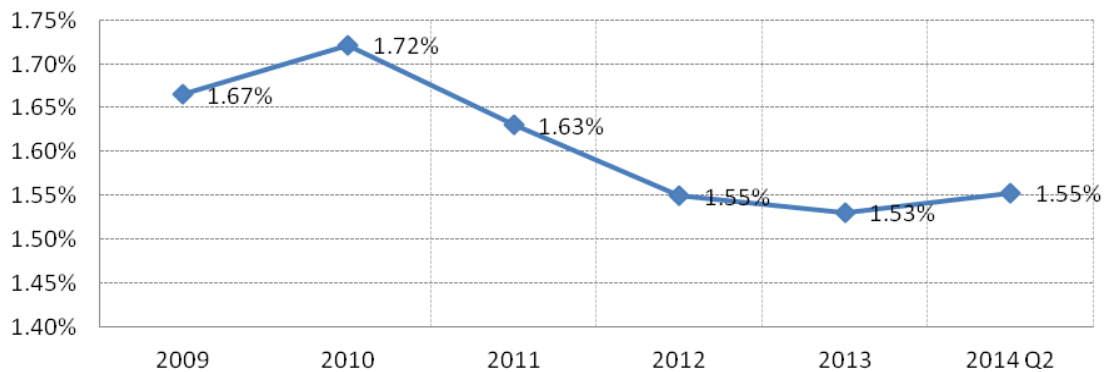
**Figure 5: Cost-to-income Ratio of G-SIBs**



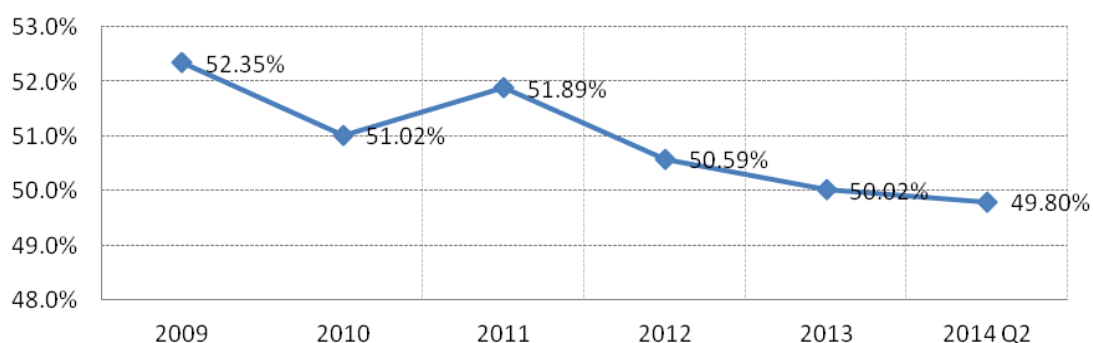
#### I.1.4 Net interest margin narrowed and proportion of interest income declined

After the global financial crisis, developed economies, including the US, Japan and Europe, successively launched a low-interest rate policy, leading to the continuous narrowing of net interest margin of G-SIBs. In the first half of 2014, the average interest margin of G-SIBs was 1.55%, decreasing by 0.17 percentage points from 2010 but slightly increasing by 0.02 percentage points over the end of 2013.

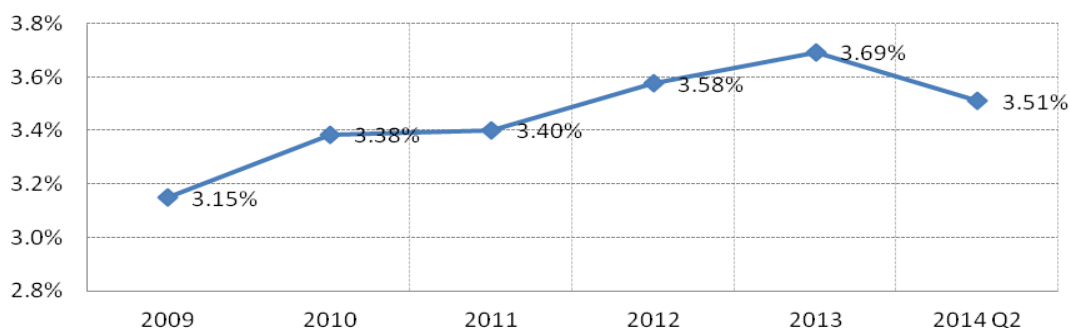
**Figure 6: Changes in Net Interest Margin of G-SIBs**



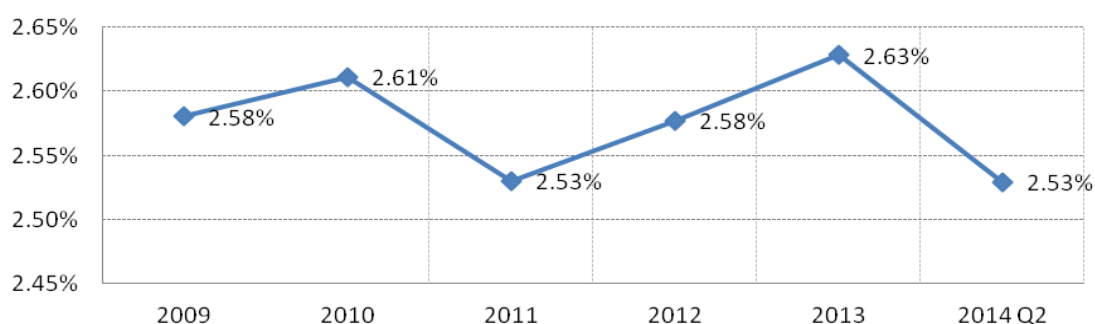
With the narrowing of the net interest margin, the proportion of interest income in the total income of G-SIBs also showed a tendency of decrease. In the first half of 2014, the ratio of net interest income to the total income of G-SIBs was 49.80%, down 2.45 percentage points from 2009 and 0.22 percentage points from the end of 2013.

**Figure 7: Proportion of Interest Income of G-SIBs****I.1.5 NPL ratio and ratio of allowance to loans both declined**

NPL ratio of G-SIBs increased notably after the breakout of the financial crisis. In the second quarter of 2014, NPL ratio of G-SIBs was 3.51%, an increase of 0.36 percentage points over 2009 but down 0.18 percentage points from the end of 2013.

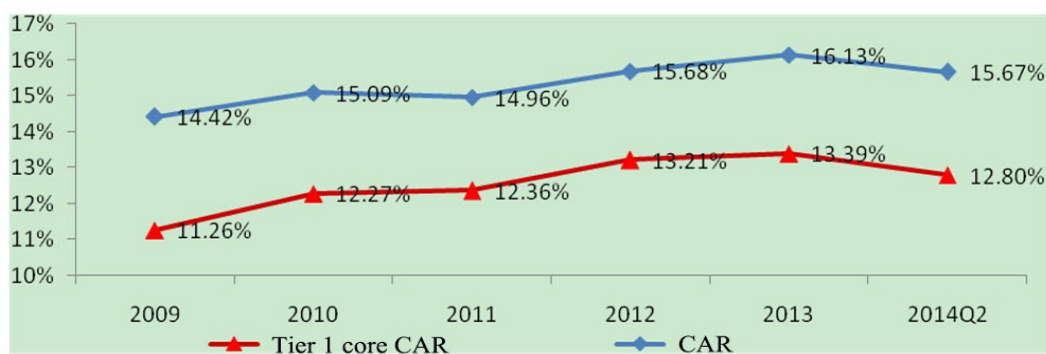
**Figure 8: NPL Ratio of G-SIBs (%)**

In the second quarter of 2014, the ratio of allowance to loans of G-SIBs was 2.53%, the lowest level after 2008 and down 0.1 percentage points from the end of 2013.

**Figure 9: Ratio of Allowance to Loans of G-SIBs (%)****I.1.6 CAR increased steadily and capital quality improved notably**

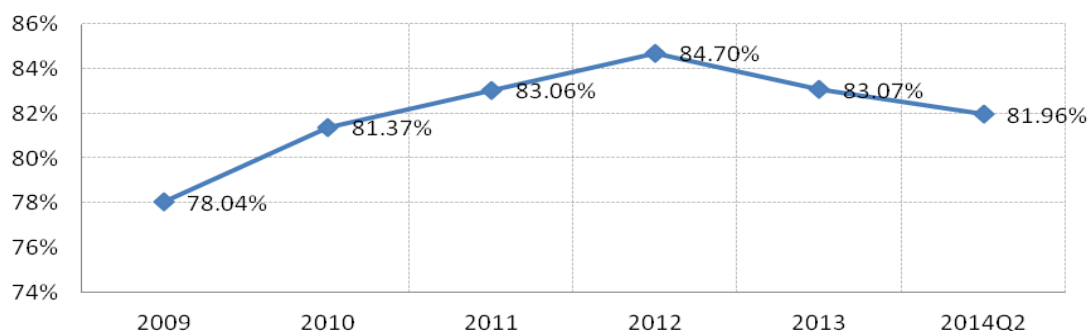
After the global financial crisis in 2008, the Basel Committee issued the Basel III worldwide. With its implementation, G-SIBs' CAR increased quickly. In the second quarter of 2014, average CAR and tier 1 CAR of G-SIBs were 15.67% and 12.80%, an increase of 1.25 and 1.54 percentage points over 2009 but down 0.46 and 0.59 percentage points from the end of 2013 respectively.

Figure 10: CAR and Tier 1 CAR of G-SIBs



In the second quarter of 2014, tier 1 capital made up 81.66% of aggregate capital of G-SIBs, an increase of 4.59 percentage points over 2009 but down 1.31 percentage points from the end of 2013.

Figure 11: Ratio of Tier 1 Capital/Aggregate Capital of G-SIBs



## I.2 Outlook

In 2015, global economic recovery prospect is not optimistic, posing challenges to G-SIBs.

First, macro-economic fundamentals will develop towards different directions. G-SIBs mainly come from five economic areas, namely the US, China, Euro Zone, Japan and UK. After the financial crisis in 2008, except for the banking industry in China, most G-SIBs slowed their transnational expansion, making them more sensitive to the changes in the economic situation of host countries. In 2015, it is forecast that the US, UK and China will maintain a relatively strong momentum of economic growth, which will help promote the operation and development of their G-SIBs; however, economic recovery will be still weak in Japan and Euro Zone, and banks in the two economies will face big challenges.

Second, monetary policy will be differentiated. The different economic trends will cause the central bank of each country to have different stances on monetary policy. The US and UK are expected to raise interest rates, while China is expected to cut interest rates and reserve requirement ratio. Euro Zone will possibly kick off a new round of quantitative easing policy, and Japan may continue its current easing policy. With different stances on monetary policy, interest margins of the banking industry in the US and UK is expected to increase next year, while that of G-SIBs in China will face the narrowing pressure. In Japan and Euro Zone, G-SIBs will continue to have a relatively low interest margin.

Third, regulatory policies will be implemented. Regulatory policy will be an important factor

affecting the operating results of G-SIBs. With the Basel III implementation worldwide, G-SIBs will steadily increase CAR, and further improve capital structure and liquidity.

## II. Banking Industry Operation and Outlook of Major Economies

### II. 1 US banking industry

#### II.1.1 Operating profile

Operating scale grew smoothly, and profits fluctuated. As at the third quarter of 2014, US banking industry had total assets of USD15.35 trillion, a year-on-year increase of 5.11% and a quarter-on-quarter increase of 1.16%; total liabilities were USD13.62 trillion, a year-on-year increase of 5.05% and a quarter-on-quarter increase of 1.22%; capital was USD1.64 trillion, a year-on-year increase of 5.55% and a quarter-on-quarter increase of 0.70%. As affected by set-aside of allowance and regulatory fines, the net profit of the US banking industry was lumpy, reaching USD39 billion in the third quarter of 2014, a year-on-year increase of 8.04% and a quarter-on-quarter decrease of 3.14%; in the same period, ROA and ROE of the US banking industry were 1.02% and 9.10% respectively, down 0.05 percentage point and 0.44 percentage point from the second quarter.

**Table 2 Indicators of the US Banking Industry (Unit: USD100 million)**

	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	Q-o-q change	Y-o-y change
Assets	146036	147313	149104	151725	153492	1.16%	5.11%
Liabilities	129663	130765	132284	134564	136212	1.22%	5.05%
Capital	16372	16547	16820	17161	17281	0.70%	5.55%
Net profit	361	399	373	402	390	-3.14%	8.04%
ROA	1.00%	1.09%	1.01%	1.07%	1.02%	-0.05%	0.02%
ROE	8.94%	9.78%	9.00%	9.54%	9.10%	-0.44%	0.16%

Source: FDIC, Institute of International Finance BOC

Operating income increased steadily, and the proportion of non-interest income increased. In the first three quarters of 2014, the banking industry's operating income (sum of net interest income and non-interest income) rose modestly, reaching USD171.4 billion in the third quarter, up 4.8% over the same period of last year and 1.4% over the second quarter. Net interest income was USD107 billion, a year-on-year increase of 1.43% and a quarter-on-quarter increase of 2.33%; non-interest income was USD64.4 billion, a year-on-year increase of 9.22% and a quarter-on-quarter increase of 1.24%. In the third quarter of 2014, non-interest income accounted for 37.57% of total, up 1.59 percentage points over the third quarter of 2013.

**Table 3 Income of the US Banking Industry (Unit: USD100 million)**

	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	Q-o-Q change	Y-o-Y change
Operating income	1635	1665	1638	1691	1714	1.36%	4.82%
Net interest income	1046	1067	1042	1055	1070	1.43%	2.33%
Non-interest income	589	599	596	636	644	1.24%	9.22%

Source: FDIC, Institute of International Finance BOC

NPL ratio decreased while CAR climbed steadily. In the third quarter of 2014, the banking industry

of the US recorded NPLs of USD171.9 billion, a year-on-year decrease of 22.27% and a quarter-on-quarter decrease of 5.38%; NPL ratio in the same period was 2.11%, down 0.73 percentage points from the same period of last year. Tier 1 CAR of the US banking industry was 13.27% in the third quarter of 2014, up 0.02 percentage points over the second quarter of 2014 and 0.21 percentage points over the same period of last year.

**Table 4 NPLs and CAR of the US Banking Industry (Unit: USD100 million)**

	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	Q-o-Q change	Y-o-Y change
NPLs	2212	2072	1952	1817	1719	-5.38%	-22.27%
Tier 1 capital	13.06%	13.10%	13.30%	13.25%	13.27%	0.02%	0.21%
NPL ratio	2.84%	2.63%	2.46%	2.24%	2.11%	-0.13%	-0.73%

Source: FDIC, Institute of International Finance BOC

### II.1.2 Regulatory environment

In the US, regulatory laws and rules were promulgated one after another. In 2014, the financial regulator of the US continuously released the implementation rules in relation to the Dodd-Frank Wall Street Reform and Consumer Protection Act, mainly including the Volcker Rule, implementation of the regulatory indicator of liquidity coverage rate, raising of the prudential supervision criteria by the US Fed and the requirements of “strengthening regulatory expectation” raised by the Office of the Comptroller of the Currency.

Large banks and small banks are supervised in a differentiated way. In the implementation of such regulatory laws and rules as the Dodd-Frank Wall Street Reform and Consumer Protection Act (including capital standards and liquidity regulations), the regulators further enhanced the supervision of large banks, but intended to reduce regulatory burden for small and medium banks. In respect of anti-money laundering compliance, the Office of the Comptroller of the Currency will continue strengthen inspection and monitoring of anti-money laundering in the industry, since money laundering activities were spreading from regional banks to community banks.

### II.1.3 Outlook

In the next step, the US banking industry is expected to maintain smooth development. The following factors will bring about new changes in the industry:

Firstly, there is an upturn of the macro environment. The banking industry, as a pro-cyclical industry, is relatively sensitive to the changes in the macro-economic environment. In 2015, the US economy will develop towards a favorable direction for the banking operation.

Secondly, the expectation for interest rate rise is continuously intensified. As the US Fed has formally exited its quantitative easing policy in October 2014, the market has a strong expectation for an interest rate increase next year. Once the US Fed raises the interest rate, it will have a substantial impact on commercial banks’ return on assets and liability costs. The interest rate increase decision of the US Fed will be an important factor affecting the operation of the US banking industry next year.

Thirdly, regulatory policies are increasingly rigorous. Various supervision policies implemented by the banking regulator of the US, including Volcker Rule, capital and liquidity management framework, and strengthening of regulatory expectation, will pose severe challenges to the operation and development of the banking industry, particularly large systemic important banks, in the US.

## II.2. Banking industry in the Euro Zone

### II.2.1 Operating profile

Deposits and loans remained stable as a whole but had different performance in each country. As at the third quarter of 2014, the banking industry in the Euro Zone recorded total deposits of EUR16.65 trillion, a year-on-year increase of 0.03%. Deposits increased year on year in nine countries, of which the deposit growth in Germany, Luxembourg and Belgium was considerable, reaching EUR47.2 billion, EUR29.7 billion and EUR22.3 billion; deposits decreased in nine countries, especially Spain, Ireland and Greece where deposits dropped by EUR41 billion, EUR32 billion and EUR28.1 billion.

As at the third quarter of 2014, the banking industry in the Euro Zone recorded total outstanding loans of EUR16.82 trillion, a year-on-year decrease of 0.93%. Loans increased year on year in only five countries in the Euro Zone, of which the loan growth in Belgium, Italy and Finland was considerable, reaching EUR24.8 billion, EUR7 billion and EUR4.3 billion; loans decreased in the other 13 Euro Zone countries, especially Spain, the Netherlands and Ireland where loans dropped by EUR104.6 billion, EUR31.3 billion and EUR23.7 billion.

**Table 5 Deposit and Loan Information of the Euro Zone and Major Countries (Unit: EUR billion)**

Item		Euro Zone	Germany	France	Italy	Spain	Netherlands
<b>2013Q3</b>	Deposits	16646.2	4482.6	3908.2	2301.3	2045.8	1040.9
	Loans	16981.2	4429.3	4334.8	2382.1	1828.5	1266.6
<b>2014Q3</b>	Deposits	16651.8	4529.8	3897	2297	2004.8	1062
	Loans	16822.6	4425	4314.4	2389.1	1723.9	1235.3
<b>Year-on-year change</b>	Deposits	5.60	47.20	-11.20	-4.30	-41.00	21.10
	Loans	-158.60	-4.30	-20.40	7.00	-104.60	-31.30
<b>Year-on-year growth</b>	Deposits	0.03%	1.05%	-0.29%	-0.19%	-2.00%	2.03%
	Loans	-0.93%	-0.10%	-0.47%	0.29%	-5.72%	-2.47%

Source: ECB, Institute of International Finance BOC

Capital strength steadily increased but related problems were outstanding in some countries. As at the third quarter of 2014, capital of the banking industry in the Euro Zone totaled EUR2.49 trillion, EUR97.9 billion or 4.09% higher than a year earlier and EUR67.1 billion or 2.77% higher than the end of the previous year. Compared with the same period of last year, the banking industry of only three countries in the Euro Zone, namely Ireland, Malta and Spain, saw a decline in capital, reaching EUR16.5 billion, EUR5 billion and EUR3.6 billion respectively; capital of the banking industry increased in all the other 15 Euro Zone countries, of which Italy, Germany and France kept atop with a capital growth of EUR33.3 billion, EUR28.3 billion and EUR12.9 billion.

**Table 6 Capital Information of the Euro Zone and Major Countries (Unit: EUR billion)**

Item	Euro Zone	Germany	France	Italy	Spain	Netherlands
<b>2013Q3</b>	2392.8	436.6	505.1	386.1	426.3	117.1
<b>2013Q4</b>	2423.6	437.5	511.1	399.7	432.9	115.2
<b>2014Q3</b>	2490.7	464.9	518	419.4	422.7	118.3
<b>Year-on-year change</b>	97.90	28.30	12.90	33.30	-3.60	1.20
<b>Change from the end of the previous year</b>	67.10	27.40	6.90	19.70	-10.20	3.10

Source: ECB, Institute of International Finance BOC

As of June 2014, local banks' tier 1 CAR was 13.13%, a year-on-year increase of 0.55 percentage point. Large local banks had the lowest tier 1 CAR of 12.66%, up merely 0.19 percentage points over the same period of last year; foreign-invested banks had the highest tier 1 CAR of 15.77%.

**Table 7 Tier 1 CAR of Various Banks (%)**

	Local banks	Large local banks	Medium local banks	Small local banks	Foreign banks
At the end of June 2014	13.13	12.66	13.67	14.97	15.77
As at the end of June 2013	12.58	12.47	12.51	14.14	15.91
Year-on-year increase/decrease	0.55	0.19	1.16	0.83	-0.14

Source: ECB, Institute of International Finance BOC

Large and medium local banks saw a notable decline in profits, but small and foreign-invested banks had outstanding performance. In the first half of 2014, local banks in the Euro Zone recorded an operating income and net profits of EUR235 billion and EUR21.9 billion respectively, a year-on-year decrease of EUR500 million and EUR12.4 billion. Net profits of large, medium and small banks were EUR29.1 billion, EUR4.6 billion and EUR530 million, a year-on-year change of -33.83, -58.57 and 33.96 percentage points. It should be noted that foreign-invested banks stood out in the operation in the Euro Zone, with net profits of EUR7.5 billion in the period, a year-on-year increase of 52.44%.

NPL ratio continued to climb, especially in large and medium banks. As at the end of June 2014, local banks in the Euro Zone recorded an average NPL ratio of 5.78%, a year-on-year increase of 0.39 percentage points; medium banks had the highest NPL ratio of 7.77%, up 0.52 percentage points; large banks' NPL ratio increased by 0.27 percentage points to 4.91%; small banks had the lowest NPL ratio of 2.36%, down 0.04 percentage points. Foreign-invested banks' NPL ratio was 4.13%, higher than the average level of local banks.

**Table 8 NPL Ratios of Various Banks (%)**

Time	Average of local banks	Large local banks	Medium local banks	Small local banks	Foreign-invest ed banks
2014Q2	5.78	4.91	7.77	2.36	4.13
2013Q2	5.39	4.64	7.25	2.4	3.79
Year-on-year growth	7.24	5.82	7.71	-1.67	8.97

Source: ECB, Institute of International Finance BOC

## II.2.2 Outlook

The prolonged slowdown of the economic recovery in the Euro Zone has cast a shadow on banking development. In 2015, it is forecast that the banking scale in Euro Zone will remain stable, non-performing asset pressure is likely to increase, and banking risks in certain countries will be more obvious.

## II.3 British banking industry

### II.3.1 Operating profile

In the UK, monetary credit growth tended to slow down, and wholesale loans and retail loans had different performances. As at the third quarter of 2014, M4<sup>1</sup> of the UK reached GBP1.84 trillion, up 0.7% over a year earlier and the same as the previous quarter. The balance of wholesale loans<sup>2</sup> of non-financial institutions was GBP442.4 billion, down 3.1% year on year and 0.7% quarter on quarter. The balance of personal credits was GBP1.5 trillion, up 2.2% year on year and 2.6% quarter on quarter. Real estate mortgage loans totaled GBP1.3 trillion, accounting for 87% of total. Real estate mortgage loans and consumer credits increased by 1.5% and 3.8% respectively over the year beginning.

Mortgage loans and consumer loans had different growth rates. In 2014, the growth rates of mortgage loan quantity and amount, showed a trend of irregular decline, sharply contrasting with the rise in 2012 and 2013. The number of new mortgage loans dropped by more than 8% every month in the second half of this year, and the amount of new mortgage loans fell by 7.8%. In 2014, consumer credits grew quickly in UK, with the balance increasing steadily by 6.1% year on year to GBP165.1 billion.

The costs of retail and other liabilities declined, while deposits of families and non-financial enterprises increased. In the third quarter of 2014, the costs of retail and other liabilities declined, while deposits of families and non-financial enterprises increased. Due to the influence of market share objective and non-price clauses, UK banks had a growing demand for deposits, especially corporate deposits, thereby pushing up deposit rate and deposit supply, and narrowing the interest spread of banks.

Capital increased notably and asset quality improved to some extent. In the third quarter of 2014, the aggregate capital of the British banking industry increased notably, and is expected to continue rising in the fourth quarter; capital costs basically remained unchanged and is expected to decrease slightly in the fourth quarter. Capital increase was mainly attributed to the regulatory requirements, coupled with changes in economic environment and credit strategies of banks. In respect of NPLs, the default rate and default losses of secured household loans declined notably in the third quarter of 2014; the default rates of credit cards and other unsecured personal credits basically remained unchanged; the default loss on credit cards decreased slightly, while that on other unsecured personal credits remained unchanged.

### II.3.2 News from Regulators

The stress test results of European banking industry have been made public. In October 2014, European Banking Authority (EBA) released the 2014 European Banking Stress Test Report. In the extreme scenarios, 24 out of the 123 tested banks were not able to meet the minimum capital requirements (none of them are UK banks), with a capital shortfall of EUR24.2 billion.

British banking industry is about to embark on a stress test. Though British commercial banks have participated in EBA stress test, the results of such test is only used as a reference for assessing the soundness of these banks. Such test cannot replace local stress test of UK because different methods are adopted. The Bank of England is conducting a more comprehensive and rigorous stress test for the local banking industry. The test results will be released in December 2014.

### II.3.3 Outlook

With the continuous economic recovery in the UK, credit growth of non-financial enterprises in the country is expected to pick up, and asset quality will improve accordingly. It is forecast that the British banking industry will maintain smooth development in 2015, but its operation and

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1. Asset securitization and credit transfer were not counted in.

2. Exclude credits between financial institutions.

development will be subject to the expectations for the monetary policy of interest rate increase and changes in the regulatory policy.

## **II.4 Japanese banking industry**

### **II.4.1 Operating profile**

The operating results of the banking industry in Japan dropped slightly, but still remained high. In the second quarter of 2014, Japan raised its consumption tax rate, with a far-than-expected negative impact on its economy. Personal consumption and mine production were still depressed. Furthermore, due to yen depreciation, large enterprises' operating results improved and stock prices went up, which will increase individual income and drive demand. In April-September 2014, the operating results of Japanese banking industry declined but still remained high. After-tax profit of Bank of Tokyo-Mitsubishi UFJ increased by 9% year on year, while that of Mizuho Bank decreased by 17%. The total after-tax profits of the five major financial groups found in Japan, dropped by 2%.

The higher deposit rate than loan rate has affected interest spread income. Japan's domestic interest rate continuously declined as domestic banks implemented a large-scale quantitative easing policy. The yield of 10-year treasury bonds has dropped to around 0.47%, drawing down the loan rate. Loan rate was lower than the deposit rate for the first time in the Bank of Tokyo-Mitsubishi UFJ and Mizuho Bank, and some banks in Japan suffered losses on deposit and loan business. As for the Japanese banking industry, domestic interest spread income accounted for about 40% of its total income. If the lower loan rate continues, it will have a considerable negative impact on the whole banking industry.

The industry pattern will be adjusted. Due to the influence of change in monetary policy and economic situation, Japan's domestic banking industry will be reshuffled. Large banks have obvious advantages in diversified and internationalized operations, which can offset the impact caused by the domestic economic situation worsening. However, Japan's domestic small and medium banks will face big challenges, and these banks have taken measures such as acquisition and restructuring to counteract the impact of the economic environment. Following the merger of the Bank of Yokohama and Higashi-Nippon Bank, Higo Bank and Kagoshima Bank also announced a merger plan; besides, the moves taken by three major financial groups in Japan to actively acquire overseas banks should also draw our attention. Sumitomo Mitsui Banking Corporation has acquired a controlling stake in Hong Kong-based Bank of East Asia and Cambodia-based Aceda Bank; the Bank of Tokyo-Mitsubishi UFJ has acquired the Bank of Ayudhya in Thailand.

### **II.4.2 Outlook**

In 2015, Japan's banking industry will face intense challenges to its operation and development. First, Japan's economic recovery is weak. The country's GDP decreased by 0.4% in the third quarter of 2014, far below than market expectations, and the economic downturn will have a substantial adverse influence on banking operations; meanwhile, the lower loan rate than deposit rate caused by the quantitative easing policy will pose a huge impact on Japan's banking industry in which interest income makes up the majority of total income. Japan's banking industry will face the transition pressure. In the future, with a rapidly aging population gathering momentum, wealth management that meets diversified demands will be the future development direction for the industry.

## **III. China's Banking Industry Review and Outlook**

### **III.1 Banking operation review for 2014**

China's banking industry continued smooth operation in the third quarter of 2014. As at the end of September 2014, commercial banks' assets and liabilities were RMB131.10 trillion and RMB122.03 trillion respectively, a year-on-year increase of 13.89% and 13.55%; net profits grew by RMB142.9 billion or 12.74% to RMB1.26 trillion; the balance of NPLs was RMB766.9 billion, with a NPL ratio of 1.16%; weighted average tier 1 CAR was 10.47%, and weighted average CAR was 12.93%.

In 2014, 16 listed banks<sup>1</sup> of China mainly had the following operating features: asset and liability growth slowed down and entered the medium-speed growth phase of around 10%; profitability remained stable, net profit margin was about 9.6%, and interest margin improvement and cost control contributed greatly to profits; asset and liability structure changed, and deposit to liability ratio dropped to around 77%, leading to a loan-to-deposit of nearly 70% and increasing the supervision pressure; income structure continued to improve, with non-interest income expected to account for about 23% of total; NPL balance and ratio continue increasing, with a NPL ratio of nearly 1.1%; as for the two allowance indicators, one increased while another decreased, and risks were basically controllable; CAR steadily went up to around 12.3%, showing a sound capital status.

### III.1.1 Asset and liability growth slowed down while scale steadily expanded

Entering 2014, China's banking industry continued scaling up steadily. As at the end of September 2014, commercial banks' total assets reached RMB131.10 trillion, an increase of RMB12.31 trillion or 13.89% over the end of last year. Assets and liabilities of listed banks amounted to RMB104.06 trillion and RMB97.13 trillion respectively, a year-on-year increase of 11.26% and 10.93% respectively, 0.67 percentage point and 0.77 percentage point lower than the growth rates in the same period of last year. The top five banks recorded total assets and liabilities of RMB74.49 trillion and RMB69.38 trillion, up 9.98% and 9.64%, 0.11 percentage point and 0.03 percentage point higher than the growth in the same period of last year; assets and liabilities of joint stock banks were RMB27.00 trillion and RMB25.33 trillion respectively, up 13.88% and 13.45%, 3.99 percentage points and 4.11 percentage points lower than the growth in the same period of last year.

Chart 12 Y-o-Y Asset Growth of Listed Banks

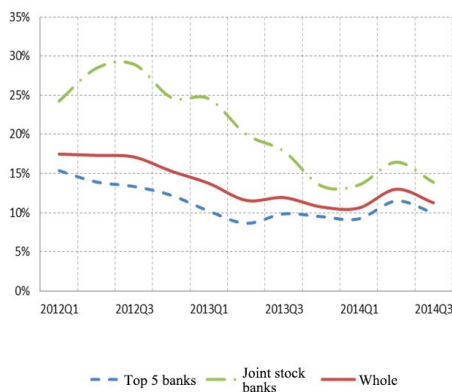
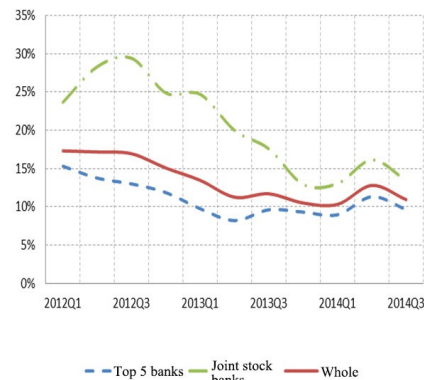


Chart 13 Y-o-Y Liability Growth of Listed Banks



Source: Wind, Institute of International Finance BOC (the same below)

The slowdown of asset and liability growth was mainly due to the slowing economic growth and relatively tight monetary policy. In the first three quarters of 2014, China's GDP and M2 grew by

5. Listed banks mean the commercial banks issuing A shares in domestic stock market. The listed banks include: top five banks, i.e. ICBC, ABC, BOC, CCB and BOCOM; national joint stock banks ("joint stock banks"), i.e. China Merchants Bank, Shanghai Pudong Development Bank, Minsheng Banking Corporation, CITIC Bank, Industrial Bank, China Everbright Bank, Huaxia Bank and Ping An Bank; three city commercial banks, i.e. Bank of Beijing, Bank of Nanjing and Ningbo Bank.

7.4% and 12.9% respectively. The relatively low growth has restricted, to a certain degree, the growth room of banks. As the trend of China’s slowing economic growth and relatively tight money supply will continue, it is forecast that listed banks’ assets and liabilities will remain a sound year-on-year growth of about 10% in the whole year of 2014.

**III.1.2 Profitability remained stable mainly due to interest margin improvement and cost control**

Commercial banks’ profit growth has slowed down. Commercial banks generated net profits of RMB1.26 trillion in the first nine months of 2014, a year-on-year increase of RMB142.9 billion or 12.74%. Listed banks’ operating income reached RMB2.50 trillion, a year-on-year increase of 14.82%, 2.21 percentage points higher than the growth in the same period of last year; net profits stood at RMB1.02 trillion, a year-on-year increase of 9.74%, 3.22 percentage points lower than the growth in the same period last year. The top five banks’ operating income totaled RMB1.79 trillion, up 12.04%, 0.74 percentage point higher than the growth in the same period of last year; net profits amounted to RMB752.5 billion, up 8.31%, 3.70 percentage point lower than the growth in the same period of last year. Listed banks are expected to maintain a net profit growth of around 9.6% in the whole year 2014, as the scale expansion, interest margin and cost control capability will not undergo major changes in the last quarter of the year.

**Chart 14 Y-o-Y Operating Income Growth of Listed Banks**

**Chart 15 Y-o-Y Net Profit Growth of Listed Banks**

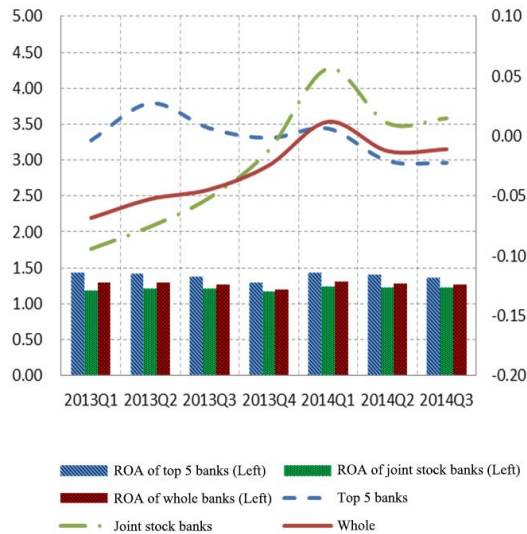


--- Top 5 banks    ··· Joint stock banks    — Whole

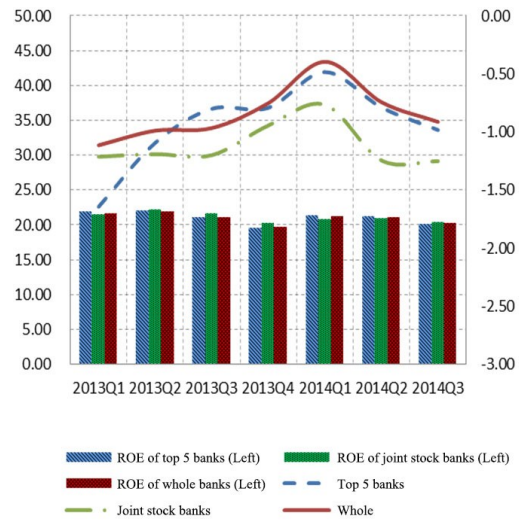
--- Top 5 banks    ··· Joint stock banks    — Whole

Despite the slowdown of profit growth, banks' profitability remained stable as indicated by return on assets (ROA) and return on equity (ROE). In the first three quarters of 2014, listed banks’ ROA (annualized, the same below) was 1.26%, slightly down 1 basis point from the same period of last year; the top five banks’ ROA edged down 2 basis points to 1.36%; joint stock banks’ ROA rose by 2 basis points to 1.23%. Since most listed banks replenished capital in 2014, their leverage ratios declined, ROE underwent a temporary decline but still remained high. In the first three quarters of 2014, listed banks’ average ROE (annualized, the same below) was 20.24%, down 0.91 percentage point from the same period of last year; the top five banks’ ROE dropped by 0.98 percentage point to 20.12%; joint stock banks’ ROE fell by 1.25 percentage points to 20.40%. Given that scale growth was higher than net profit growth, it is forecast that listed bank’s ROA and ROE will slightly decline in the whole year 2014, but will still remain at a relatively high level of 1.2% and 19.5%.

**Chart 16 ROA and Y-o-Y Growth of Listed Banks (%)**

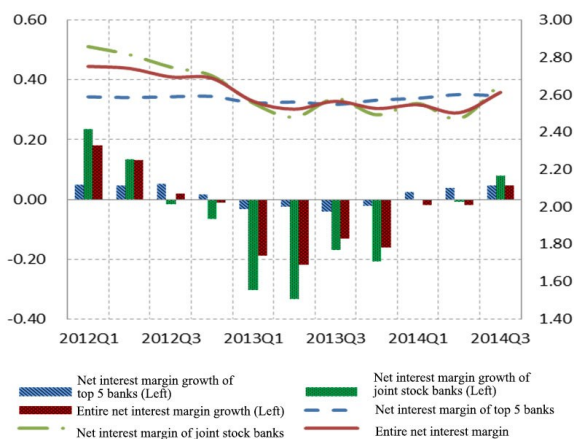


**Chart 17 ROE and Y-o-Y Growth of Listed Banks (%)**

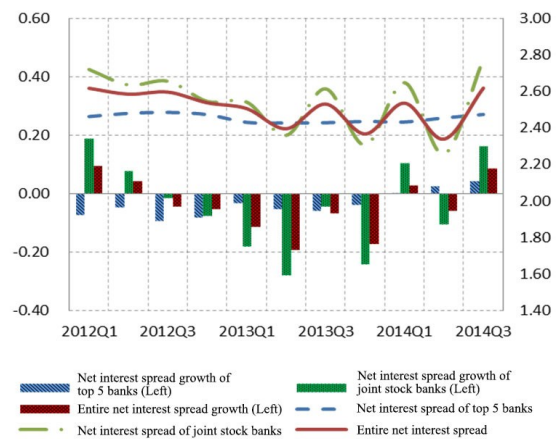


Profitability remained stable, to a certain degree, thanks to the improvement of net interest margin and net interest spread. In the first three quarters of 2014, listed banks' average net interest margin and net interest spread were 2.61% and 2.62% respectively, a year-on-year increase of around 5 and 9 basis points. The top five banks' average net interest margin and net interest spread were 2.59% and 2.47% respectively, both up around 5 basis points over the same period of last year. Joint stock banks' average net interest margin and net interest spread were 2.66% and 2.78% respectively, up about 8 and 16 basis points. Though the central bank released an interest rate cut policy, it did not have a substantial impact on existing loans. Listed banks' net interest margin and net interest spread are expected to be around 2.6% and 2.4% in the whole year of 2014.

**Chart 18 Net Interest Margin and Y-o-Y Growth (%)**

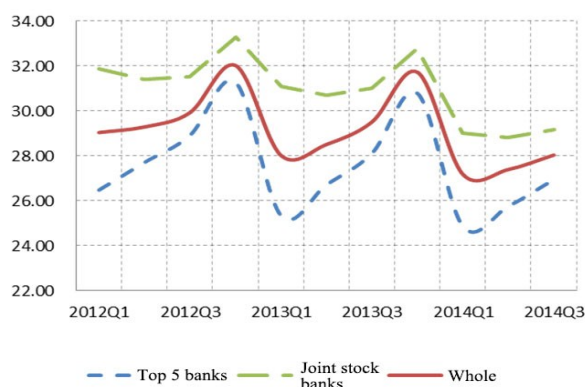


**Chart 19 Net Interest Spread and Y-o-Y Growth (%)**



Enhancement of cost control capability is one of the important reasons for listed banks to sustain profitability. As at the end of September 2014, listed banks' cost-to-income ratio was 28.04%, a year-on-year decrease of 1.47 percentage points. The top five banks' average cost-to-income ratio was 26.94%, down 1.16 percentage points. Joint stock banks' average cost-to-income ratio decreased by 1.85 percentage points year on year to 29.16%. Listed banks' cost-to-income ratio is expected to be around 28.5% in the whole year of 2014.

Chart 20 Cost-to-income Ratio of Listed Banks (%)



### III.1.3 Asset and liability structure continued adjustment and income structure continued to improve

The ratio of outstanding loans to total assets of listed banks rose remarkably in the third quarter of 2014, following a continuous decline in the first and second quarters. At the end of the third quarter, the ratio was 52.01%, a year-on-year increase of 0.49 percentage points. Among the loans, the top five banks accounted for 53.89%, up 0.89 percentage points; joint stock banks accounted for 48.00%, which basically remained stable. It is mainly because banks increased the weights of high-yield loan assets to improve the total return on interest-earning assets and respond to the pressure of profit decline. Furthermore, the Notice on Regulating Inter-bank Business of Financial Institutions (Y.F. [2014] No. 127) issued by five ministries and commissions, including the People's Bank of China, and the Notice on Regulating the Inter-bank Business Governance of Commercial Banks (Y.J.B.F. [2014] No. 140) issued by China Banking Regulatory Commission also procure some inter-bank businesses, including reverse repurchase and nonstandard business, to be included on the balance sheet, which, to a certain degree, resulted in the increase in the loan proportion of listed banks. Listed banks' loan proportion is expected to remain at a relatively high level of around 52% in 2014.

This year, the proportion of deposits in total liabilities of commercial banks continued to decrease. At the end of September 2014, the deposit balance of commercial banks was RMB97.1 trillion, accounting for 79.6% of total liabilities. The proportion of deposit balance in total liabilities of listed banks was 77.85%, a year-on-year decrease of 2.40 percentage points. The top five banks accounted for 80.89% of total deposits, down 2.43 percentage points. Joint stock banks accounted for 70.81%, down 1.82 percentage points. Due to the financial disintermediation, deposit deviation assessment and the increasing public demand for cash at the end of last year, it is forecast that listed banks' deposit proportion will drop to about 77% in 2014.

Chart 21 Outstanding Loans/Total Assets of Listed Banks

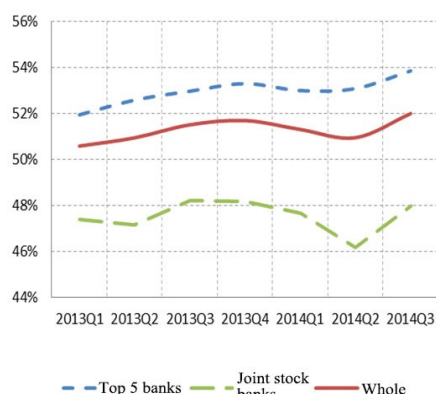
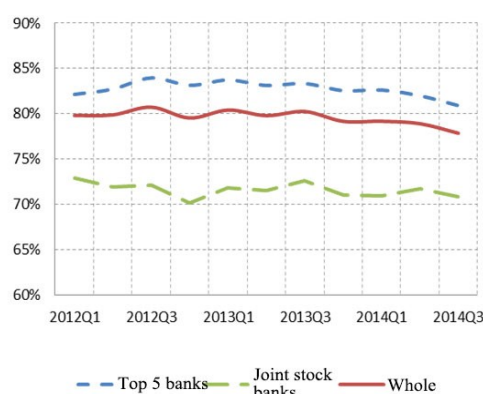
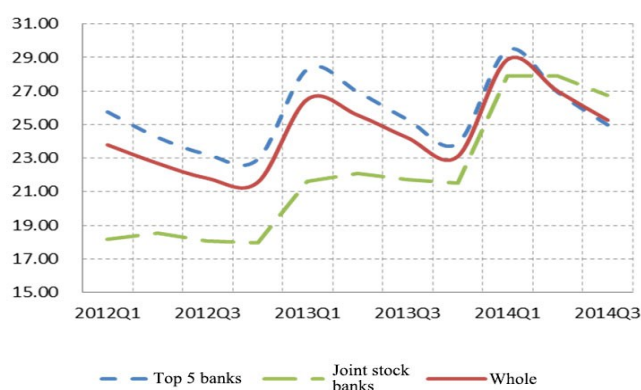


Chart 22 Deposit Balance/Total Liabilities of Listed Banks



While leading to a decline in the ratio of deposit to liabilities, the continuous financial disintermediation also diversified listed banks' income, providing a big growth room for banks' investment banking, asset management and custody, credit card and related non-interest businesses. In the first three quarters of 2014, though the proportion of listed banks' non-interest income decreased from the previous two quarters to 25.26% (weighted average, the same below) due to the seasonal factors, it was still 1.05 percentage points higher than the same period of last year; the proportion of non-interest income of the top five banks was 24.98%, down 0.31 percentage point; the proportion of non-interest income of joint stock banks was 26.74%, up 5.00 percentage points. Given the cyclical factors at the end of the year, it is forecast that the proportion of non-interest income of listed banks will increase to about 23.5% in 2014.

Chart 23 Proportion of Non-interest Income of Listed Banks

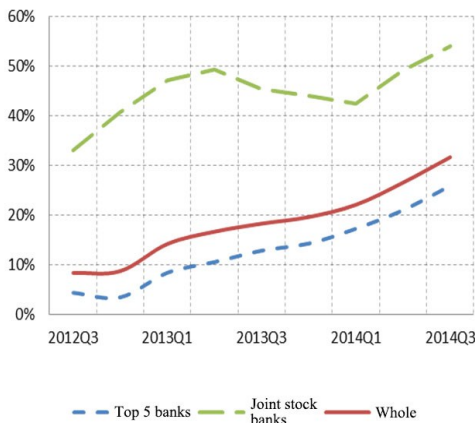


### III.1.4 NPL balance and ratio continued to increase, allowance to NPLs declined while allowance to loans rose

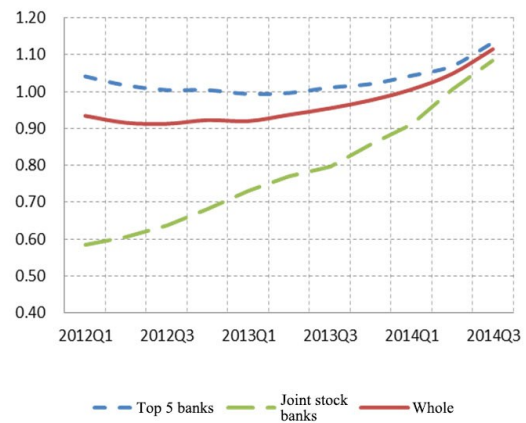
This year, commercial banks' credit risk pressure and risk exposure increased, due to the slowdown of domestic economic growth and restructuring of certain industries. As at the end of September 2014, commercial banks' NPL balance was RMB766.9 billion, an increase of RMB174.9 billion over the end of last year; NPL ratio rose by 0.17 percentage points to 1.16%. Listed banks' NPL balance was RMB604.61 billion, a year-on-year increase of 31.70%, 13.38 percentage points higher than the growth in the same period of last year; NPL ratio (weighted average, the same below) rose by 0.16 percentage points to 1.12%. Among these listed banks, top five banks' NPL balance was RMB455.82 billion, a year-on-year increase of 25.93%, 13.06 percentage points higher than the growth in the same period of last year; NPL ratio rose by 0.12 percentage point to

1.13%. Joint stock banks' NPL balance was RMB140.32 billion, a year-on-year increase of 54.12%, 8.77 percentage points higher than the growth in the same period of last year; NPL ratio rose by 0.29 percentage points to 1.08%. Credit risk spread from small and micro enterprises, private enterprises, eastern coastal areas and industries with excess capacity to large and medium state-owned enterprises and enterprises under the central government, central and western regions and upstream and downstream enterprises of the industries with excess capacity. Listed banks' NPL ratio is expected to be around 1.1% in the whole year 2014.

**Chart 24 NPL Growth of Listed Banks**

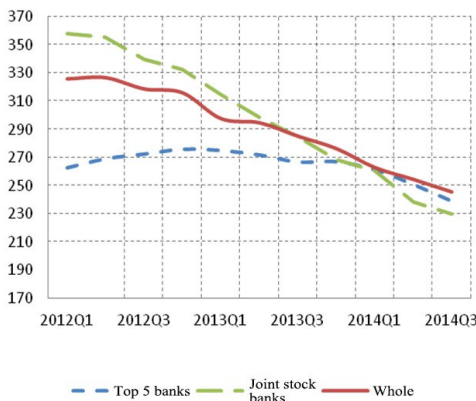


**Chart 25 NPL Ratio Growth of Listed Banks (%)**

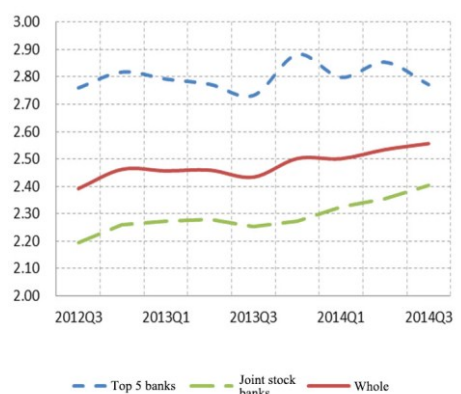


In order to counteract the risks, listed banks generally increased allowance. However, due to the NPL ratio rise, allowance to NPLs ratio declined while allowance to loans ratio went up. At the end of September 2014, listed banks' average allowance to NPLs ratio was 245.76%, down 39.46 percentage points from a year earlier; allowance to loans ratio was 2.56%, up 11.26 percentage points. The top five banks' average allowance to NPLs ratio was 239.03%, down 27.93 percentage points; allowance to loans ratio was 2.76%, up 0.74 percentage points. Joint stock banks' average allowance to NPLs ratio was 229.68%, down 54.90 percentage points; allowance to loans ratio was 2.41%, up 15.20 percentage points.

**Chart 26 Allowance to NPLs Ratio of Listed Banks (%)**



**Chart 27 Allowance to Loans Ratio of Listed Banks (%)**



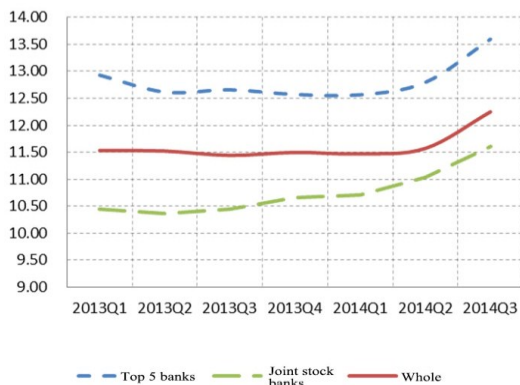
### III.1.5 CAR increased steadily and liquidity pressure rebounded

This year, commercial banks continuously replenished capital by various channels to steadily increase their CAR. At the end of September 2014, commercial banks' weighted average tier 1 CAR was 10.47%, up 0.34 percentage points over the end of the previous quarter and 0.52

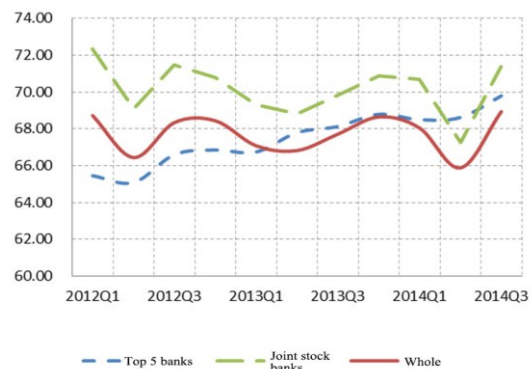
percentage points over the end of last year; weighted average CAR was 12.93%, up 0.53 percentage points over the end of the previous quarter and 0.74 percentage points over the end of last year.

Listed banks' CAR, tier 1 CAR and tier 1 core CAR were 12.25%, 9.71% and 9.71%, a year-on-year increase of 0.81 percentage point, 0.64 percentage points and 0.63 percentage points respectively. The top five banks' average CAR, tier 1 CAR and tier 1 core CAR were 13.60%, 10.79% and 10.79%, a year-on-year increase of 0.94 percentage points, 0.75 percentage points and 0.75 percentage points respectively. Joint stock banks' average CAR, tier 1 CAR and tier 1 core CAR were 11.60%, 9.14% and 9.13%, a year-on-year increase of 1.15 percentage points, 0.74 percentage points and 0.72 percentage points respectively. Listed banks' CAR is expected to be around 12.3% in 2014.

**Chart 28 CAR of Listed Banks (%)**



**Chart 29 Loan-to-deposit Ratio of Listed Banks (%)**



In the third quarter of 2014, listed banks' loan-to-deposit ratio rebounded notably to 68.94%, a year-on-year increase of 1.23 percentage points. The top five banks' average loan-to-deposit ratio was 69.79%, up 1.66 percentage points. Joint stock banks' average loan-to-deposit ratio was 71.40%, up 1.59 percentage points. Owing to the weak deposit growth, it is forecast that listed banks' liquidity pressure will continue increasing in 2014, with a loan-to-deposit ratio of nearly 70%.

### III.2. Banking industry outlook for 2015

As China has entered the "New Normal" economic and financial pattern, banking operation environment is undergoing a profound reform and facing significant challenges as follows: First, due to the slowdown of China's economic growth, commercial banks with the pro-cyclical features will face the pressure in the areas of scale expansion, interest margin and asset quality. Second, internet finance and interest rate liberalization are going ahead, quickening the process of financial disintermediation in China and further squeezing the business room of banks. Third, the deepening of interest rate liberalization requires banks to accurately calculate costs and set prices on their own, and banks' pricing mode and strategy will face a great test in the market competition. As a result of more drastic fluctuation of interest rates and a decline in deposit stability, it will be more difficult for banks to manage interest rate and liquidity risk.

Meanwhile, the profound changes in the operating environment will also bring about bigger development opportunities. First, economic restructuring, improvement of demand structure, optimization of industrial structure and promotion of regional coordinated development will all bring about enormous new financial demands. Second, cross-border financial business has a promising prospect in the building of new open economic regime. Third, interest rate liberalization and direct financing development provide a broad room for non-interest business. Fourth, internet

and other IT upgrades provide banks powerful management and service means. Fifth, lifting of the ban on private banks and advance in the mixed ownership reform will help spark the endogenous growth force and instill vitality into the market.

Overall, listed banks' operation in 2015 is expected to have the following characteristics:

First, scale growth will remain about 11%. In 2015, due to the slowdown of economic growth in China, listed banks' asset and liability growth will continue its trend in the previous year. If considering the positive influence of monetary policy, the growth is likely to go up slightly.

Second, profitability will face pressure and net profit will grow about 9%. In 2015, the contribution to profits by cost control and interest margin increase will decline slightly, and credit risk will be further released within a controllable range. Non-interest business development will be a key factor for improving profitability.

Third, capital status will be sound and overall risks controllable. At present, listed banks are embarking on a new round of capital replenishment. According to incomplete statistics, 10 banks have announced their refinancing plans with the amount of more than RMB300 billion by issuance of preference shares and private placement of ordinary shares. In 2015, with the fulfillment of these financing plans, listed banks' CAR will remain above 12%, with strong risk resistibility.

Fourth, banks' operating performance differentiation will become more obvious. Banks with a clear strategy and are able to seize opportunities will gain competitive edge and grow quickly; however, the other less competitive banks will be in trouble. In 2015, China is expected to launch the deposit insurance system, which will safeguard the stability of the banking sector.

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