

## Global Banking Industry Outlook

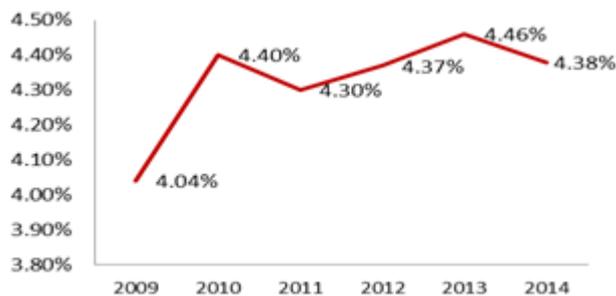
Q2 2015 (Issue 3)

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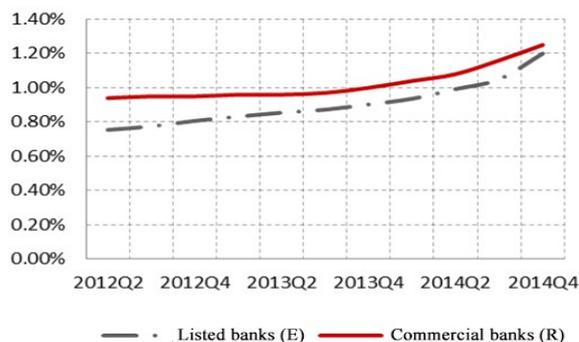
### Highlights

• In 2014, global major banks saw an overall solid performance with slightly lower assets and liabilities, steadily improving profitability and significantly stronger asset quality and risk absorption capacity. The performance of banking industry in the major economies continued to diverge: the US and UK witnessed generally steady operation; Euro Area and Japan faced remarkable challenge in the context of quantitative easing; while China maintained sound operation despite pressure. In 2015, the banking industry in China will face a more complex operating environment. With the profound changes in economic growth, monetary policy, financial reforms and the process of internationalization, the banking industry of China will be confronted with unprecedented pressure. Seizing the opportunity to make proactive transformation is crucial to sustainable sound development.

NPL ratio of 19G-SIBs



NPL ratio of listed Banks and commercial banks in China



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

Team head: Chen Weidong

Deputy heads: Zong Liang

Members: Zhang Xingrong

Shao Ke

Wang Zhifeng

Xiong Qiyue

Zhao Xue

Huang Xiaojun(New York)

Yang Bo (Frankfurt)

Qu Kang (London)

Wang Zhe (Tokyo)

Contact: Zhang Xingrong

Telephone: 010-66594076

Email:

zhangxingrong@bankofchina.com

## New Normal and New Adjustment

### -- Global Banking Industry Outlook (Q2 2015)

In 2014, global major banks saw an overall solid performance with slightly lower assets and liabilities, steadily improving profitability and significantly stronger asset quality and risk absorption capacity. The performance of banking industry in the major economies continued to diverge: the US and UK witnessed generally steady operation; Euro Area and Japan faced remarkable challenge in the context of quantitative easing; while China maintained sound operation despite pressure. In 2015, the banking industry in China will face a more complex operating environment. With the profound changes in economic growth, monetary policy, financial reforms and the process of internationalization, the banking industry of China will be confronted with unprecedented pressure. Seizing the opportunity to make proactive transformation is crucial to sustainable sound development.

## I. G-SIBs Operation Review

### I.1 Performance review

As of March 20, 2015, a total of 19<sup>1</sup> out of 30 Global Systemically Important Banks (G-SIBs) have disclosed their key figures for 2014. Given increased macroeconomic uncertainty and more stringent regulatory policy of the major economies, G-SIBs significantly reduced their risk appetite and pursued prudent strategy in general. In terms of operating business performance, G-SIBs recorded a decline in assets and liabilities; however, its profitability, interest margin and operating efficiency saw a continuously upward trend with substantial improvement in asset quality and risk absorbance capacity.

#### I.1.1 Assets and liabilities declined slightly

As of the end of 2014, the assets and liabilities of the 19 G-SIBs were USD30.79 trillion and USD28.70 trillion respectively, a decrease of 2.88% and 3.16% respectively compared with the end of 2013. Due to the negative impact from the deteriorating economic conditions and tightened regulatory environment in the Euro Area, G-SIBs in the region recorded a significant decline in assets and liabilities.

#### I.1.2 The percentage of deposits increased while that of loans decreased

In 2014, the willingness of lending for G-SIBs fell slightly. As of the end of 2014, the percentage of outstanding loans in the total assets of the 19 G-SIBs was 36.88%, down one percentage point versus 2013.

#### I.1.3 Profitability improved modestly

In 2014, the average return on assets (ROA) and the return on equity (ROE) of the 19 G-SIBs were 0.47% and 7.52%, up 0.09 and 1.28 percentage points from 2013.

#### I.1.4 Net interest margin increased slightly

In 2014, the average net interest margin of the 19 G-SIBs was 1.79%, increasing by 0.02

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<sup>1</sup> They are Bank of America, Citigroup, JPMorgan Chase, Wells Fargo, BBVA, Santander, Barclays, BNP Paribas, Credit Agricole, Credit Suisse, Deutsche Bank, HSBC, ING Bank, Nordea, RBS, Societe Generale, Standard Chartered, UBS and Unicredit Group.

percentage points from 2013. Thanks to the decline of the deposit cost, G-SIBs in the Euro Area witnessed remarkable increase in the net interest margin.

### I.1.5 Operating efficiency improved

In 2014, the average cost-to-income ratio of the 19 G-SIBs stood at 69.44%, a decrease of 2.31 percentage points versus 2013.

### I.1.6 Valuation level generally fell

As of December 31, 2014, the market capitalization of the 27 G-SIBs<sup>2</sup> totaled USD2.78 trillion, up USD0.14 trillion or 5.2% versus 2013. In terms of P/B, the 27 G-SIBs had an average P/B of 0.98, a decline of 0.01 from the same period in 2013. Although the G-SIBs' performance had improved, it had not been reflected in their valuation levels with share prices still below their book value.

### I.1.7 Risk absorbance capacity strengthened

Given the implementation of Basel III in major economies, the reduced risk appetite of the global banking industry and the capital requirement released by FSB in relation to Total Loss Absorbing Capacity, G-SIBs' capital adequacy ratio (CAR) increased significantly. As of the end of 2014, the average tier 1 core-capital ratio, tier 1 CAR and Capital ratio of the 19 G-SIBs were 11.47%, 13.47% and 16.37% respectively, an increase of 0.66, 0.26 and 0.21 percentage points over 2013.

### I.1.8 Asset quality improved steadily

In 2014, G-SIBs generally accelerated the write-off on non-performing loans (NPL), leading to material fall in NPL ratio. The average NPL ratio of the 19 G-SIBs was 4.37%, down 0.42 percentage point from the end of 2013.

## I.2 Outlook

In 2015, G-SIBs will maintain steady growth and their performance will differentiate. Changes in Monetary policy and regulatory environment will be the key drivers for the performance of G-SIBs:

**Regarding monetary policy, policy differentiation will have impact on banks' profitability.** In 2015, as the global monetary policy will further diverge, the change in the policy stance will have a significant impact on banks' profitability. While squeezing the interest margin, the launch of the quantitative easing (QE) policy in the Euro Area will also derive new trading and transactional opportunities. Therefore the banking industry in the Euro Area will see a substantial change in its income structure; the rate hike of the Fed will have a material impact on the yield curve, which in turn will have notably different impact on different banks due to different maturity structure of assets and liabilities of commercial banks.

**Regarding regulatory policy, attention should be paid on the adverse effect from capital shortage.** With the implementation of Basel III and progress of the Total Loss-Absorbance Capacity proposed by the Financial Stability Board, G-SIBs will face higher capital pressure which will drive G-SIBs to adjust business structure and engage more in lower risk and lower capital intensive businesses. Meanwhile, G-SIBs will also issue various innovative capital instruments with write-off and conversion terms to respond to regulatory requirements. These instruments tend to have higher financing cost. In 2015, the operation of G-SIBs will be significantly influenced by

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<sup>2</sup> As the latest update of share price data is available, we have collected the valuation data for a total of 27 G-SIBs, including 8 banks in addition to the abovementioned 19 banks, including Bank of China, Industrial and Commercial Bank of China, Agricultural Bank of China, Goldman Sachs, State Street Bank, Mitsubishi UFJ Financial Group, Mizuho Group and Morgan Stanley.

the tighter regulatory and compliance requirements under strong capital constraint and higher cost of innovative capital instruments.

## II. Operation profile and outlook of the banking industry in key economies

### II.1 US

#### II.1.1 Operating results

In Q4 2014, the size of assets and liabilities of US banks (FDIC members) grew steadily and net profit was squeezed; net interest income rose moderately while non-interest income fell slightly; total capital of the industry increased mildly while efficiency indicators ROA and ROE decreased significantly; NPL ratio declined sharply.

**The size of assets and liabilities grew steadily.** As of Q4 2014, the asset size of the US banking industry reached USD15.55 trillion, up 5.58% from a year earlier and 1.33% from the previous quarter; liabilities totaled USD13.8 trillion, an increase of 5.62% year on year and 1.39% quarter-on-quarter; total capital stood at USD1.74 trillion, up 5.29% year-on-year and 0.85% quarter-on-quarter.

**Profitability declined.** Due to high legal cost of large banks and the decline of mortgage related income, the operating income of the US banking industry reached USD167.2 billion in Q4 2014, up 0.56% year-on-year and down 2.41% quarter-on-quarter. Net profit was USD36.4 billion, a decrease of 8.16% compared with the same period of last year and 4.42% compared with last quarter. ROA and ROE were 0.96% and 8.56% respectively, down 0.13 and 1.2 percentage points versus last year.

**Table 1: Evolution of the size of US banking industry (in million USD)**

|                     | Q1 2013  | Q1 2014  | Q3 2014  | Q4 2014  | QoQ    | YoY    |
|---------------------|----------|----------|----------|----------|--------|--------|
| Assets              | 14731284 | 15172428 | 15349215 | 15553660 | 1.33%  | 5.58%  |
| Liabilities         | 13076581 | 13456441 | 13621680 | 13811436 | 1.39%  | 5.62%  |
| Capital             | 1654703  | 1715987  | 1727535  | 1742224  | 0.85%  | 5.29%  |
| Net profit          | 39676    | 39798    | 38123    | 36439    | -4.42% | -8.16% |
| Operating income    | 166235   | 168997   | 171284   | 167158   | -2.41% | 0.56%  |
| Net interest income | 106397   | 105453   | 106938   | 107480   | 0.51%  | 1.02%  |
| Non-interest income | 59839    | 63544    | 64345    | 59679    | -7.25% | -0.27% |

**Source:** FDIC, BOC New York Branch

**CAR fell slightly and asset quality improved steadily.** At the end of Q4 2014, tier 1 core CAR of the US banking industry fell slightly from the previous quarter to 9.46%. Tier 1 CAR also fell to 12.96%. During the same period, NPL totaled USD162.7 billion, down 27.4% year-on-year. NPL ratio fell by 0.66 percentage point from a year earlier to 1.96%.

**Table 2: Evolution of key indicators of US banking industry (in million USD)**

|                               | Q4 2013 | Q2 2014 | Q3 2014 | Q4 2014 |
|-------------------------------|---------|---------|---------|---------|
| Core capital adequacy ratio   | 9.40%   | 9.56%   | 9.51%   | 9.46%   |
| Tier 1 capital adequacy ratio | 13.10%  | 12.97%  | 13.01%  | 12.96%  |
| ROA                           | 1.09%   | 1.07%   | 1.01%   | 0.96%   |
| ROE                           | 9.76%   | 9.50%   | 8.98%   | 8.56%   |
| NPL                           | 207255  | 181580  | 171931  | 162686  |
| NPL ratio                     | 2.63%   | 2.24%   | 2.11%   | 1.96%   |

Source: FDIC, BOC New York Branch

### II.1.2 Regulatory environment

US regulators continued to implement detailed regulatory measures against major banks in the following aspects:

**First, major banks will be among the first to comply with liquidity coverage ratio.** Fed released the final version of the rule on liquidity coverage ratio in Q4 2014. According to the rule, those banks with assets between USD50 billion and USD250 billion may calculate the liquidity position on a monthly basis (the previous requirement is calculating on a daily basis), and may delay compliance with the rule until January 1, 2016; while those banks with assets of more than USD250 billion shall comply with the rule from January 2015 and calculate the liquidity position on a daily basis.

**Second, the Fed conducted the annual stress test on 31 major banks. Though all banks have passed the test, only 28 of them have obtained approval for their capital plans.** The capital plans of the US subsidiaries of Deutsche Bank and Santander were rejected by the Fed. They have to submit the revised capital plans and were prohibited from paying additional dividends to their parent banks or other shareholders. Meanwhile, Bank of America obtained a conditional approval for its capital plan and was allowed to increase dividend or repurchase shares on the secondary market subject to the provision of necessary materials.

**Third, senior management will be subject to stricter regulation.** The New York State Banking Department recently announced that the New York regulator would follow the relevant provisions on the financial fraud of senior management under the Sarbanes-Oxley Act, holding senior management of banks liable for any negative consequences of such offenses as money laundering.

### II.1.3 Outlook

In 2015, the US banking industry will continue its steady growth. As the US economy continues to grow moderately, the banking industry will maintain stable and healthy growth in general with expanding credit size and improving credit quality. However, as US regulators implement differentiated policies towards large and small banks, they will have diverging operating prospects.

## II. 2 Euro Area<sup>3</sup>

### II.2.1 Operating results

<sup>3</sup> Here refers to all monetary financial institutions in the Euro Area under the statistics of the European Central Bank. In order to be consistent with future data, the statistics includes Lithuania which joined the Euro Area on January 1, 2015. As the updated data on profitability and asset quality is not available from ECB, the report will not discuss the existing data.

**Loans and deposits maintained stable in general with huge disparity.** As of the end of 2014, the deposits of the Euro Area banking industry totaled EUR16.81 trillion, an increase of EUR169.3 billion, or 1.02% from a year earlier. The increase was much higher than that of the previous quarter of only EUR5.6 billion. Compared with the same period of last year, the deposit balance of 12 countries increased. The Netherlands, France and Germany recorded substantial increase of EUR104 billion, EUR77.7 billion and EUR44.1 billion respectively. The deposit balance of seven countries decreased. Spain, Ireland and Portugal saw notable decrease of EUR44.6 billion, EUR36.4 billion and EUR23.8 billion respectively.

As of the end of 2014, the loans of the Euro Area banking industry totaled EUR16.89 trillion, a decrease of EUR89.9 billion, or 0.53% from a year earlier. Compared with the same period of last year, the loans of nine countries increased, while the figure was five in the previous quarter. The Netherlands, France and Germany recorded substantial increase of EUR58.5 billion, EUR40.5 billion and EUR28.2 billion respectively. The remaining ten countries saw decreased loans. Spain, Germany and Ireland recorded notable decrease of EUR103.5 billion, EUR50.4 billion and EUR36.1 billion respectively.

**Table 3: Loans and deposits of the Euro Area and its core members (in billion EUR)**

| Items                      |          | Euro Area | Germany | France | Italy  | Spain  | The Netherlands |
|----------------------------|----------|-----------|---------|--------|--------|--------|-----------------|
| 2013                       | Deposits | 16645.6   | 4482.6  | 3908.2 | 2301.3 | 2045.8 | 1040.9          |
|                            | Loans    | 16981.2   | 4429.3  | 4334.8 | 2382.1 | 1828.5 | 1266.6          |
| 2014                       | Deposits | 16814.9   | 4526.7  | 3985.9 | 2339.7 | 2001.2 | 1144.9          |
|                            | Loans    | 16891.3   | 4378.9  | 4375.3 | 2410.3 | 1725   | 1325.1          |
| YoY increase in amount     | Deposits | 169.3     | 44.1    | 77.7   | 38.4   | -44.6  | 4.7             |
|                            | Loans    | -89.9     | -50.4   | 40.5   | 28.2   | -103.5 | -0.3            |
| YoY increase in percentage | Deposits | 1.02%     | 0.98%   | 1.99%  | 1.67%  | -2.18% | 9.99%           |
|                            | Loans    | -0.53%    | -1.14%  | 0.93%  | 1.18%  | -5.66% | 4.62%           |

Source: ECB, BOC Frankfurt Branch

**Capital strength improved and individual diverges.** As of the end of 2014, the capital base of the Euro Area banking industry totaled EUR2.40 trillion, an increase of EUR5.6 billion, or 0.23% from a year earlier and a decrease of EUR85.9 billion, or 3.45% from the previous quarter. Compared with the same period of last year, four countries (one more country than the previous quarter) saw decreased capital base, including Spain, Ireland and Austria. The decrease for the three countries was EUR91.5 billion, EUR18.5 billion and EUR6.6 billion respectively. The remaining 15 countries saw increased capital base. Italy, Germany and Greece were among the top gainers, with the increase of EUR33.6 billion, EUR27 billion and EUR15.2 billion respectively.

**Table 4: Capital base of the Euro Area and its core members (in billion EUR)**

| Items                      | Euro Area | Germany | France | Italy | Spain   | The Netherlands |
|----------------------------|-----------|---------|--------|-------|---------|-----------------|
| 2013                       | 2398.60   | 437.6   | 509.4  | 390.6 | 428.2   | 112.3           |
| Q3 2014                    | 2490.10   | 464.9   | 518.2  | 419.9 | 421.1   | 118.3           |
| 2014                       | 2404.20   | 464.6   | 523.9  | 424.2 | 336.7   | 121.6           |
| YoY increase in amount     | 5.60      | 27.00   | 14.50  | 33.60 | -91.50  | 9.30            |
| YoY increase in percentage | 0.23%     | 6.17%   | 2.85%  | 8.60% | -21.37% | 8.28%           |
| QoQ increase in amount     | -85.90    | -0.30   | 5.70   | 4.30  | -84.40  | 3.30            |
| QoQ increase in percentage | -3.45%    | -0.06%  | 1.10%  | 1.02% | -20.04% | 2.79%           |

Source: ECB, BOC Frankfurt Branch

## II.2.2 Regulatory environment

**The single supervisory mechanism was officially launched and the significance and impact of the reform will be far-reaching.** On November 4, 2014, the single supervisory mechanism for the Euro Area banking industry -- the first element of the European banking union was officially launched. ECB began to fully undertake the regulatory function of the Euro Area banking industry to directly supervise around 130 largest banks in the Euro Area and assume the ultimate responsibility for over 6,400 banks in total. The key mandates include unifying the regulatory rules and standards, reforming the financial system and developing financing plans for distressed banks.

Under the single supervisory mechanism, ECB will follow a “strict, equal and independent” principle to act independently of all governments and financial systems and create a fair regulatory environment to ensure a consistent rule, standard and decision-making process for the regulator of each country. Meanwhile, ECB will play a role in granting banking business license, approving corporate M&A, imposing fines etc. The implementation of the single supervisory mechanism marks a milestone in the European banking union program and will profoundly change the operation pattern of the European banking industry.

**The regulator conducted stress tests to comprehensively assess the health of the banking industry.** At the end of 2014, ECB announced the results of the one-year risk assessment, asset quality check and stress test for about 130 major banks. Among the 130 major banks, 25 failed in the stress test. 13 banks need to raise capital of EUR10 billion in the next six to nine months. The results of the stress test partly reflect the health of major banks in Euro Area since the financial crisis and will help ECB restore the balance sheet of the troubled banks, prevent potential risks in a timely manner, promote lending and support economic growth. Though the comprehensive assessment achieved some results, ECB will face even tougher road ahead, such as disposal of bad loans, improving profitability, restructuring the banking system etc.

## II.2.3 Outlook

On March 9, 2015, ECB officially launched the QE policy to buy EUR60 billion of assets each month until September 2016 with the total purchase reaching nearly EUR1.2 trillion. On March 19, ECB released EUR97.8 billion in funds through the third round of TLTRO, much higher than expected, demonstrating the determination of ECB to stimulate economy by reducing the financing cost. Even though some economic data in the Euro Area has shown signs of improvement, its economic growth still face obstacles, such as the balance sheet restructuring of various sectors and slow progress of the structural reform of each country. Therefore, in general, the banking industry still faces significant challenges.

## II. 3 UK

### II.3.1 Operating results

**In 2014, the UK banking industry experienced a stable operation with mild expansion of credit.** As of the end of 2014, total M4<sup>4</sup> reached GBP1,844.3 billion, up 0.7% from a year earlier. Personal credit contributed the most with balance standing at GBP1,466.3 billion, up 2.3% year-on-year; while the loans of non-financial companies reached GBP435.3 billion, down 2.8%.

In terms of personal credit, the biggest contributor comes from real estate mortgages which reached GBP1,297.5 billion, up 1.8% year-on-year. In terms of consumer credit, though its size is relatively small at only GBP168.8 billion, its year-on-year growth reached 6.6% in 2014.

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<sup>4</sup> M4 includes all GBP denominated short term debt of the monetary financial institutions (i.e. banks and building societies).

Corporate loans took on a negative growth trend. Net loans of the construction, real estate and transportation sectors fell 8.6%, 6.1% and 5.9% respectively. As the real estate and construction sectors accounts for 40% of the total loans, they caused the corporate loans to fall. Meanwhile, loans of the manufacturing sector, amid the improved export, grew 9.4%.

In terms of bank financing cost, the wholesale financing cost declined dramatically, reflecting the increasing confidence in the UK banking industry. The stress test results of the UK banking industry for 2014 also confirmed lower systematic risk.

### II.3.2 Regulatory environment

**First, generally, banks in UK have passed the stress test with only one bank failed.** In December 2014, Bank of England (BoE) announced the results of the stress test of the UK banking industry for 2014. The test is on the basis of the stress test of European banks conducted by the European Banking Authority. The test includes 8 major UK banks and building societies. It assesses the impact of changes in EU-wide stress scenarios on the balance sheet at 2013 end. Only the Cooperative Bank will use up its capital base under the stress scenario, therefore it needs to improve its capital plan.

**Second, the European banking union is established and BoE might implement more rigorous regulatory requirements.** ECB officially started the regulation of all the banks in the Euro Area from November 4, 2014, which marked the initial execution of the single supervisory mechanism under the European banking union; subsequently, the Single Resolution Board was officially established on January 1, 2015 and was expected to start on March 25. Non-Euro Area member countries may voluntarily choose to join the banking union. As the European banking union was just established, its direct impact on the UK banking industry is yet to be seen. In the long run, the mutual recognition of the banking regulations and consistency between BoE and ECB will be a key focus. It is expected that UK will, on the basis of the rules of the banking union, impose more rigorous standards on the CAR requirements of its domestic banks, especially in Capital Requirement Directive IV and Capital Requirement Regulation. In addition, BoE is communicating actively with the Single Resolution Board regarding the single resolution mechanism being established under the banking union.

**Third, the UK budget for 2015 has exerted impact on the banking industry.** (1) Tax rate was raised from 0.156% to 0.21% of a bank's global assets. It is estimated that an increment of GBP4.4 billion will be collected by 2020, thus eating into banks' profit; (2) The UK government will continue to sell around GBP9 billion worth of Lloyds shares in 2015 to reduce its holdings below 10%; (3) In view of increasing the competition of banking industry, the UK government plans to sell RBS shares at a loss.

**Finally, UK has strengthened its qualification management on senior executives of the branches of foreign banks.** BOE's Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) announced on March 16, 2015 that the regulators will implement new qualification management rules on senior executives of the branches and offices of banks from Non-European Economic Area. The details of the new rule is still not available, however, according to the existing rule, the qualification examination of foreign banks' senior executives is principally via written application and interview. The basic principle is to ensure that the senior management has adequate capability to take responsibility in the case of bankruptcy or liquidation risks and ensure that they take corresponding responsibility in the event of any irregularities.

### II.3.3 Outlook

The key challenges and risks faced by the UK banking industry in Q2 2015 will come from the uncertainties arising out of the general election and monetary policy.

The general election is due to take place on May 6. It is likely to create two possibilities: Hung Parliament (no single party holding majority seats of the parliament) and National Government (the Conservative Party and the Labor Party forming coalition). If so, it will create uncertainty on the direction of the financial policy and regulation reform. The new government's stance on EU exit will also have a material impact on the banking industry. Moreover, if the Labor party wins the election and forms the cabinet, it will likely adopt austerity measures such as increasing tax on the financial industry.

In terms of monetary policy, the UK has maintained its benchmark rate at the record low of 0.5% for almost six years. BoE hinted on several occasions that a rate hike is incoming. Amid global monetary war, if the UK insists to raise rate, it will push higher the GBP exchange rate and might harm the UK's economic growth. However, the unpredictability of the monetary policy is also one of the key uncertainties faced by the UK banking industry.

Despite the political and policy uncertainties, the UK economy is already on a recovery track in Q2 2015. Meanwhile, the bottoming out of the Euro Area economy will also be positive for the UK banking industry. Therefore, the UK banking industry is expected to maintain stable operation in Q2 2015.

## II.4 Japan

### II.4.1 Operation profile

**The size of assets and liabilities continued to grow.** As of December 31, 2014, the deposit balance of the 116 banks in Japan<sup>5</sup> totaled<sup>6</sup> JPY638.55 trillion, an increase of JPY18.25 trillion, or 2.9% from a year earlier, the 14<sup>th</sup> year rise in a row; the outstanding loans totaled JPY453.87 trillion, an increase of JPY10.86 trillion, or 2.5% from a year earlier, the fourth year straight rise<sup>7</sup>. Driven by the monetary easing of Bank of Japan, the size of assets and liabilities continued to grow and most banks' asset structure changed from "reducing loans and increasing government bonds" to "increasing loans and reducing government bonds".

**Profitability kept at stable level.** As of September 30, 2014<sup>8</sup>, the current income of the 116 banks totaled JPY8.64 trillion, down JPY137.9 billion from a year earlier; the current expense stood at JPY5.21 trillion, down JPY341.3 billion. The current profit was JPY2.85 trillion, an increase of JPY203.4 billion, or 7.7% from a year earlier, the second semi-annual increase in a row.

**Loan demand was weak and interest margin continued to narrow.** The domestic operation features abundant deposit, insufficient loan, small interest margin and lower profitability. In order to boost loans, the banks carried out the following measures: extend mid and long term low interest loans to equipment investment and growth sector, delegating approval authority to lower level, increasing the limit of single credit line and reducing the credit rating requirement for applicants.

**Bond investment declined while trust and securities investment rose.** Due to narrowing interest margin and continuously low government bond yield, Japanese banks increased their share of trust investment and adopted a higher risk appetite. Large banks took advantage of their overseas businesses to gradually reduce the domestic bonds; while local banks and credit cooperatives had

<sup>5</sup> It includes a total of 116 banks, including metro banks (five banks, Bank of Tokyo-Mitsubishi UFJ, Mizuho Bank, SMBC, Resona and Saitama Resona), local banks (64 banks), local banks II (41 banks, joined secondary local banks association), trust banks (four banks, Bank of Tokyo-Mitsubishi UFJ Trust, Mizuho Trust, SMBC Trust, Nomura Trust), Shinsei Bank and Aozora Bank.

<sup>6</sup> Deposit balance is nominal deposit subtracted by outstanding bills and checks.

<sup>7</sup> According to data released by Japanese Bankers Association on January 9, 2015.

<sup>8</sup> Japanese fiscal year starts from April 1 and ends on March 31 of the next calendar year. Semi-annual period ends on September 30.

strong preference for municipal bonds and corporate bonds with higher yields. Overall, Japanese banks' investment in domestic bonds is falling slowly though still at high level. Moreover, both large banks and local banks and credit cooperatives have increased investment in those trust with higher yields. The financial institutions, principally local banks, also significantly increased investment in foreign securities.

#### **II.4.2 Regulatory development**

Financial Services Agency (FSA) imposed stricter requirements on comprehensive risk management, sustainability of the operation model, asset utilization capability and information safety through integration of supervision and inspection policies. The new policies put a stronger emphasis on being forward-looking and prescient. In addition, FSA enhanced the early remedial measures and early warning mechanism. When the CAR of a financial institution falls to a specific threshold, FSA will carry out remedial measures on it. Under the early warning mechanism, financial institutions implementing early remedial measures will be urged to strengthen their risk management through such measures as interviews or increasing reporting frequency. FSA relaxed the restrictions on industries where the financial holding companies are allowed to establish subsidiaries. It will allow financial holding companies to establish general industry subsidiaries that are closely linked to their principal financial business, such as smart phone clearing subsidiary. The new measure will help the integration of finance and IT and enhance the overall competitiveness.

#### **II.4.3 Outlook**

Generally, the Japan's banking industry will still face tremendous challenges in Q2 2015. The rise in the cost of imported raw materials caused by depreciating Yen. The rise of consumer prices and consumption tax rate will significantly influence the personal consumption in Japan. The weak economic recovery will also curb the growth of the Japanese banking industry. Given the QE policy, the interest rate in Japan is kept at low level and interest margin continues to narrow. In order to maintain the profitability, large banks in Japan will continue to draw upon their early-mover advantage in overseas business to accelerate overseas expansion and increase income from fee-based business. Local banks will share resources advantage through cooperation or M&A or reconstructing in an effort to respond to challenging business environment.

### **III. Review and outlook of Chinese banking industry**

#### **III.1 Review of the operation situation of the banking industry in 2014**

In 2014, commercial banks maintained an overall solid performance. Scale and net profit growth slowed down but still stayed at high level. While both NPL and NPL ratio grew rapidly, provision and capital adequacy level remained strong and risk endurance was still robust.

Recently, 16 listed banks<sup>9</sup> (listed banks) have been reporting operating results. We estimate the listed banks to have better performance than the overall commercial banks in 2014, however, they face pressure in scale expansion in the following aspects:

##### **III.1.1 Assets and liabilities grew at a reasonable pace.**

Since 2014, the scale of the banking industry in China has maintained solid growth. The assets and

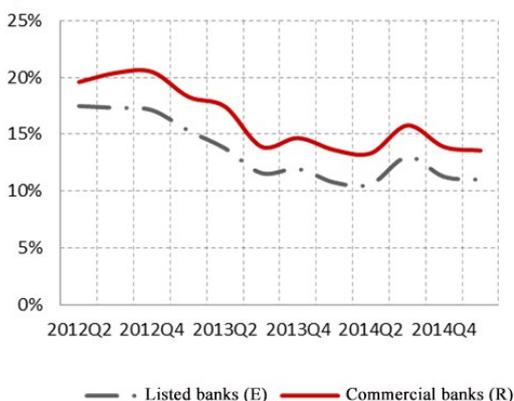
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<sup>9</sup> Listed banks refer to the commercial banks with A share listing in PRC, including major commercial banks, joint stock commercial banks (excluding Guangfa, Hengfeng, Zheshang and Bohai) and Bank of Beijing, Bank of Nanjing and Ningbo Bank. The total assets of the listed banks represent over 75% of that of all commercial banks.

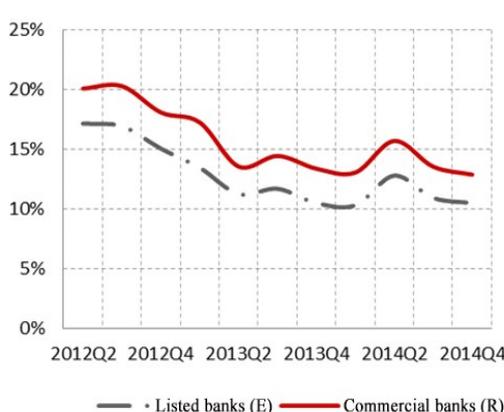
liabilities of commercial banks was RMB134.8 trillion and RMB125.1 trillion respectively, up 13.5% and 12.9% from a year earlier. The growth was down by 0.14 and 0.5 percentage points compared with the previous year. The assets and liabilities of major commercial banks was RMB71 trillion and RMB65.7 trillion respectively, up 8.3% and 7.4% from a year earlier. The growth was down by 1.01 and 1.61 percentage points compared with the previous year. The assets and liabilities of joint stock commercial banks was RMB31.4 trillion and RMB29.5 trillion respectively, up 16.5% and 16.3% from a year earlier. The growth was up by 2.01 and 2.17 percentage points compared with the previous year.

The slowdown was mainly due to economic slowdown and tighter monetary policy. In 2014, China’s GDP grew at 7.4% and M2 grew at 12.2%, both at lower levels, partly restricting the growth of banks. Assets and liabilities of listed banks are estimated to reach RMB105.6 trillion and RMB98.3 trillion at the end of 2014, registering a year-on-year growth of 11.0% and 10.5%, basically unchanged from the growth of last year.

**Figure 1: YoY growth of assets**



**Figure 2: YoY growth of liabilities**

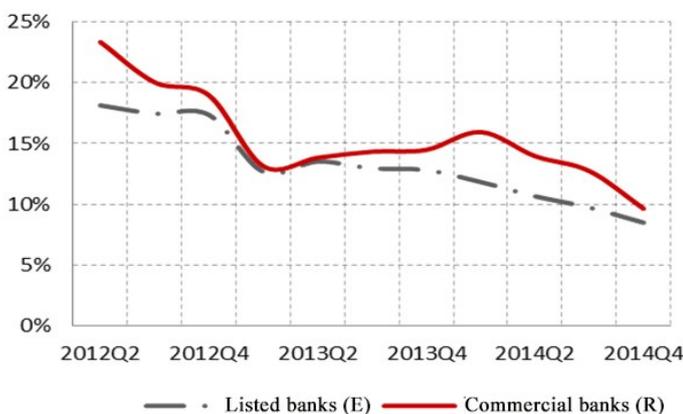


Source: wind; BOC International Finance Institute (the same below)

### III.1.2 Profitability stayed at high level

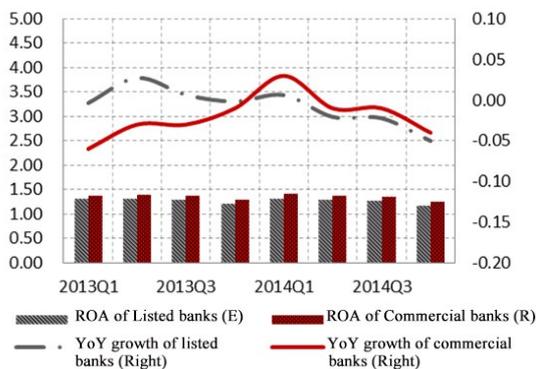
As of the end of 2014, commercial banks reported net profit of RMB1.55 trillion, up 9.6% year on year. The growth was down 4.84 percentage points from a year earlier. Given the strong anti-risk capacity and that the scale growth, interest margin and cost control capacity will continue the trend of the previous three quarters, the net profit growth of listed banks for the year 2014 is estimated to maintain at a rate of around 8.5%, 4.3 percentage points lower than the rate of last year.

**Figure 3: YoY growth of net profit**

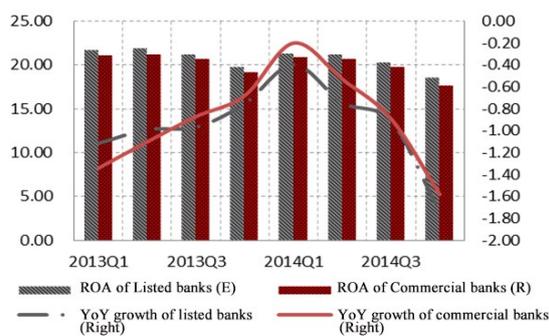


Though profit growth slowed down, the profitability maintained basically stable with higher ROA and ROE compared with international peers. At the end of 2014, ROA and ROE of commercial banks stood at 1.23% and 17.59%, down 0.04 and 1.58 percentage points from a year earlier. The average ROA (annualized) of listed banks is estimated to be 1.15% in 2014, down five basis points from a year earlier; the average ROE (annualized) is estimated at 18.5%, down about 1.3 percentage points.

**Figure 4: ROA and YoY growth (%)**



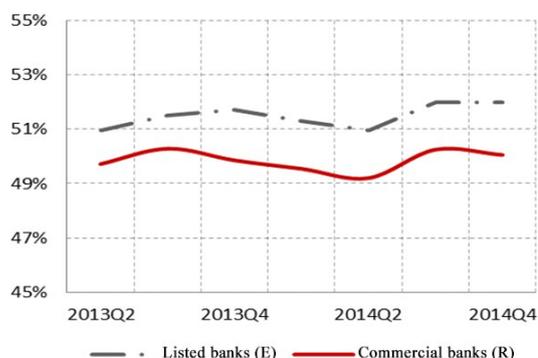
**Figure 5: ROE and YoY growth (%)**



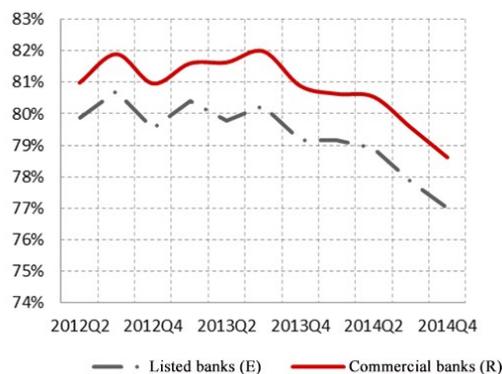
### III.1.3 Adjustment of asset liability structure and income structure

Since 2014, the loan balance of commercial banks has kept a relatively stable share of the total assets, while the share of deposit balance in total liabilities has continued to fall. As of the end of 2014, the loan balance of commercial banks represent 50% of the total assets, up 0.2 percentage point from a year earlier; while the deposit balance occupied 78.6% of the total liabilities, down 2.27 percentage points. It is estimated that as of the end of 2014, the loan balance of listed banks represents 52% of the total assets, basically unchanged from the previous year; while the deposit balance represents 77% of the total liabilities, down 2 percentage points. The reasons mainly include: first, banks increased investment in higher yielding loan assets to boost the overall performance of the interest earning assets, so as to address the pressure of profit decline; second, regulation caused some inter-bank operations (e.g. non-standard reverse repurchase agreements) to be booked in the balance sheet, which partly drove the rise of the loan proportion of listed banks; third, due to disintermediation and deposit deviation assessment, the deposit pressure increased.

**Figure 6: Loan balance/total assets**



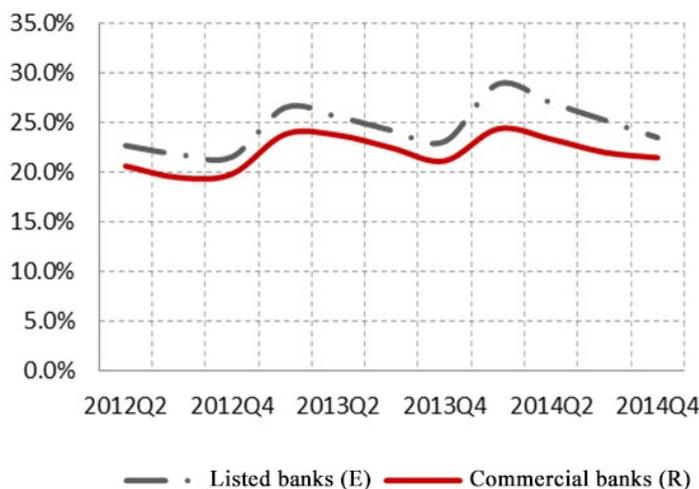
**Figure 7: Deposit balance/total liabilities**



While the fall of deposit in total liabilities, the continued disintermediation provided significant growth potential in non-interest business to listed banks, including investment banking, asset management and custody, and credit card, thus diversifying the banks' income structure. At the end of 2014, non-interest income of commercial banks accounted for 21.47%, up 0.32 percentage

points from a year earlier. It is estimated that non-interest income of listed banks will account for 23.5% (weighted average), up 0.4 percentage point from a year earlier.

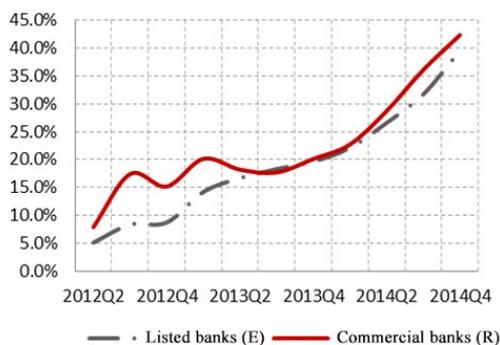
**Figure 8: Non-interest income/total income**



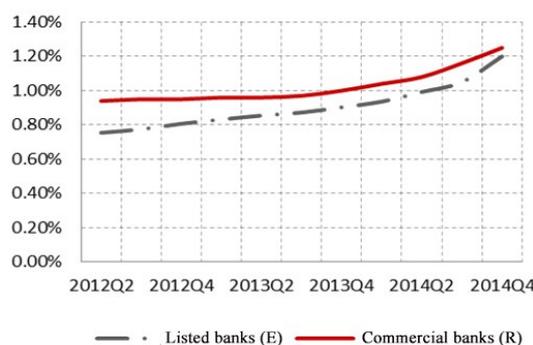
### III.1.4 Credit risk pressure continued to release

Since 2014, due to economic slowdown and industry restructuring, commercial banks have experienced increasing credit risk pressure with higher risk exposure. As of the end of 2014, the outstanding NPL of commercial banks was RMB842.6 billion, up 42.3% year on year, 22.2% higher than last year. NPL ratio was 1.25%, up 0.25 percentage point. As of the end of 2014, the outstanding NPL of listed banks is estimated to reach RMB671 billion, up 39.5% from a year earlier, 20 percentage points higher than last year; NPL ratio (weighted average) is estimated at around 1.2%, up 0.22 percentage point year on year.

**Figure 9: Growth of outstanding NPL**

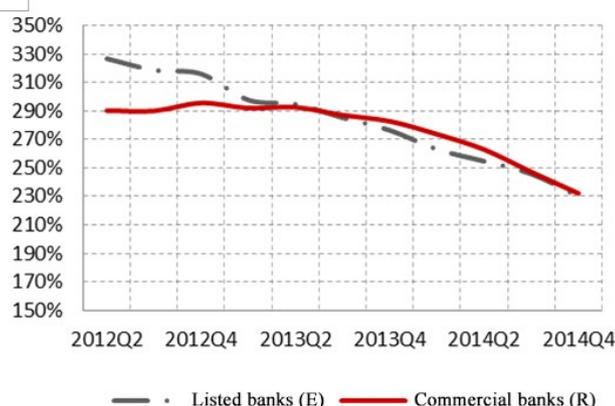


**Figure 10: NPL ratio**



While banks have generally increased loan provisions to fight against the risk of NPL growth, the provision coverage ratio still declined from high levels. At the end of 2014, the provision coverage ratio of commercial banks was 232.1%. Specifically, the ratio was 232.7% and 218.0% respectively for major commercial banks and joint stock commercial banks. As at the end of 2014, the ratio for listed banks is estimated at 230%, down 40 percentage points from a year earlier.

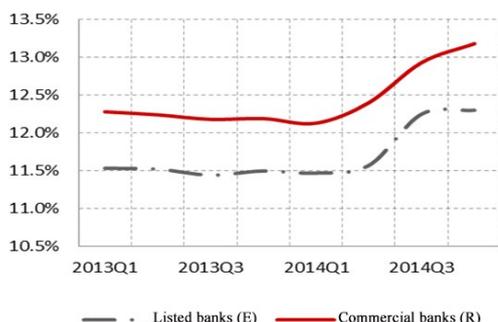
**Figure 11: Provision coverage ratio of commercial banks**



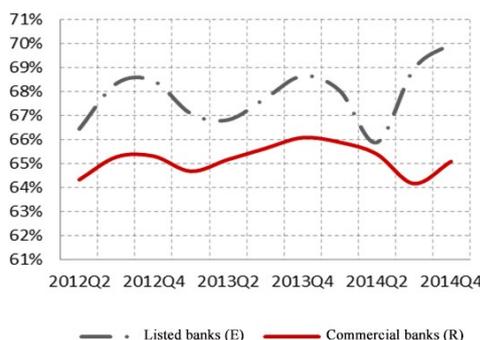
### III.1.5 Capital position continued to improve

Since 2014, commercial banks have been supplementing capital base through various channels, thus steadily improving their CAR. As of the end of 2014, the CAR, tier 1 CAR, and core tier 1 CAR of commercial banks was 13.18%, 10.76% and 10.56%, up 0.99, 0.81 and 0.61 percentage points from the previous year. It is estimated that the CAR of listed banks will maintain at around 12.3% during the same period, up 0.8 percentage point.

**Figure 12: CAR**



**Figure 13: Loan-to-deposit ratio**



As of the end of 2014, the loan-to-deposit ratio of commercial banks was 65.09%, down 0.99 percentage points from a year earlier. Given high percentage of loans and weak growth of deposit, the listed banks will face even more liquidity pressure. The loan-to-deposit ratio is estimated to be near 70% at the end of 2014.

## III. 2 Outlook of listed banks in 2015

### III.2.1 Analysis of Q1 performance

**Under the new normal, the following three factors are expected to significantly influence the performance of listed banks:**

**First, economic growth.** from January to February, retail sales grew at a year-on-year rate of 11.0% in real terms. Industrial value added of enterprises above the designated size grew at a year-on-year rate of 6.8% in real terms. Fixed-Asset Investment (excluding farmers) increased by 13.9%. Real estate investment and exports rose 10.4% and 15.3% respectively. We expect GDP in Q1 to slow down to around 7%. The further release of credit risk will challenge loan pricing power and limited growth of non-interest business, the banking industry in China will face more pressure in profitability. Factors leading to economic growth are expected to drive down the growth of net profit by three to four percentage points for listed banks in Q1.

**Second, monetary policy.** On February 5, PBOC reduced the Required Reserve Rate by 0.5 percentage points for financial institutions and implemented extra reduction for some urban commercial banks, rural commercial banks and the Agricultural Development Bank. As of the end of February, outstanding M2 stood at RMB125.74 trillion, up 12.5% from a year earlier. We estimate M2 to grow 12% in Q1. The moderate monetary policy will help maintain the stable growth of scale of the banking industry in China. The monetary policy is expected to slow down the growth of net profit by 0.5-1 percentage points for listed banks in Q1.

**Third, financial reform.** On November 22, 2014, PBoC carried out asymmetric rate cut. On February 28 of this year, PBoC cut the benchmark rate for loan and deposit while further promoted market-oriented interest rate reform by raising the upper limit of deposit rate to 1.3 times of the benchmark rate from the previous 1.2 times. The two cuts will narrow the interest margin, as the cut of loan rate will directly reduce banks' loan income and the cost of deposit will see limited reduction as a result of expanded floating band. The financial reform is expected to drive down the growth of net profit by 1.5-2 percentage points for listed banks in Q1.

In conclusion, we expect the net profit of listed banks to grow about 5.5% year-on-year in Q1 2015, assets and liabilities to grow around 10% and 9.5%, and NPL ratio to rise slightly to 1.21%.

### III.2.2 Full year operation outlook of listed banks

During the last three quarters of 2015, the operation of listed banks is expected to be influenced by the following factors:

**First, economic growth will continue to slow down.** China sets the GDP growth target for 2015 at around 7%. The economic slowdown will, on the one hand, further release the credit risk, increasing banks' credit cost. On the other hand, it will squeeze public financial demand, causing pressure on ROA. We expect the net profit growth for the year to slow down by four to five percentage points.

**Second, the monetary policy is moderate.** M2 growth target is set at 12% for 2015, which will provide the basis for scale up of banks and the possibility of "making up for the loss of price with adequate volume", partly offsetting the negative effect from narrowed interest margin. However, the M2 growth is still below that of 2014, which is likely to slow down full-year net profit by 0.5 percentage point.

**Third, interest rate liberalization continues.** According to PBOC governor Zhou Xiaochuan, the central bank is likely to launch the deposit insurance scheme this year and abandon the upper limit of deposit rate if appropriate. With the liberalization of interest rate, the intense market competition will rise deposit cost. As such, the net profit growth of listed banks will likely to shrink by two percentage points.

**Fourth, financial innovation is expected to make significant progress.** We expect banks to make notable progress in CD to individuals and enterprises and asset-backed securitization, which will lower capital cost and increase fee-based business income. It will exert positive impact on banks' interest margin and income structure adjustment.

**Fifth, cross-border development will face new opportunities.** The implementation of the "One Belt and One Road" national strategy, the global allocation of domestic capacities and the internationalization of RMB will bring immense opportunities of cross-border businesses and drive profit growth of banks. Considering the positive effects of the reduction of real tax rate, we expect the financial innovation and cross-border development opportunities to improve the full year net profit by one to two percentage points.

After evaluating the above factors, we expect that listed banks will face operation pressure in 2015, which will be reflected in the following:

**First, stable growth of scale.** Assets and liabilities will grow at around 9% and 8.5% year-on-year with higher growth at the year beginning and slowdown in the following quarters.

**Second, profitability is under pressure.** Net profit will grow at about 3%. The effect of “making up for the loss of price with adequate volume”, credit risk control ability and non-interest business development will be the key drivers behind diverging performance of banks.

**Third, structural adjustments continue.** Loans will rise to about 53% of total assets while deposits will fall to around 76% of total liabilities, thus putting more pressure on loan-to-deposit ratio. Meanwhile, income structure will be more diversified with non-interest income increasing to about 24.5% of total income.

**Fourth, asset quality tends to be stabilized.** The growth of NPL ratio will slow down and is expected to be kept under 1.25%. Meanwhile, the provision coverage ratio will face downward pressure.

**Fifth, capital position maintains sound.** Given the “making up for the loss of price with adequate volume” strategy and slowdown of net profit in 2015, listed banks will face pressure in capital position. However, with the implementation of capital raising plans and mixed ownership reform, CAR will remain at around 12%.

**Table 5: Forecast of Key Indicators of Listed Banks in 2015**

|               |                                | 2012  | 2013  | 2014  | 2015  |              |
|---------------|--------------------------------|-------|-------|-------|-------|--------------|
|               |                                | (R)   | (R)   | (E)   | Q1 E  | Full year F  |
| Scale         | Asset growth                   | 15.3% | 10.8% | 11.0% | 10%   | Around 9%    |
|               | Liability growth               | 15.1% | 10.1% | 10.5% | 9.5%  | Around 8.5%  |
| Profitability | Net profit growth              | 17.4% | 12.8% | 8.5%  | 5.5%  | Around 3%    |
| Structure     | Loan/assets                    | 50.7% | 51.7% | 52%   | 52.3% | Around 53%   |
|               | Deposit/liabilities            | 79.5% | 79.2% | 77%   | 77.2% | Around 76%   |
|               | Non-interest income percentage | 21.6% | 23.1% | 23.5% | 28%   | Around 24.5% |
| Quality       | NPL ratio                      | 0.81% | 0.90% | 1.2%  | 1.21% | Below 1.25%  |
|               | Provision coverage ratio       | 316%  | 276%  | 230%  | 225%  | Around 220%  |
| Capital       | Capital adequacy ratio         |       | 11.5% | 12.3% | 12.2% | Around 12%   |

**Note:** R: review; E: estimation; F: forecast

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