

Global Banking Industry Outlook

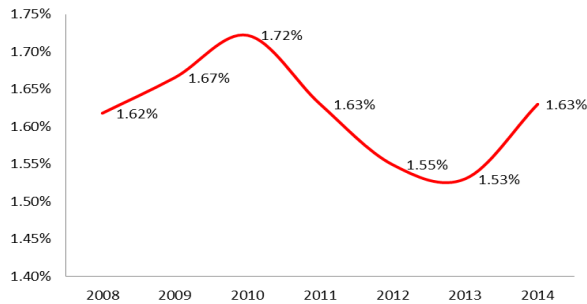
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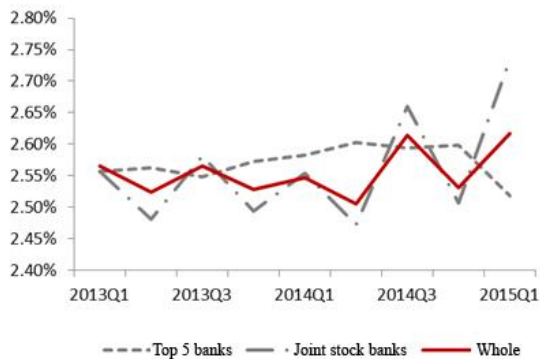
Highlights

- Entering 2015, the asset volume of the Global Systemically Important Banks (G-SIBs) has been steadily expanding amid improvement in their interest margin and asset quality. However, the operating efficiency declined in the meantime. Among the major economies, outlooks of the banking industry of the US and UK are relatively optimistic, while Japan and the Euro Zone are subject to great uncertainties. Chinese banking industry realized steady development on the whole, although it is under sever operating pressure.
- In the third quarter of 2015, the macro economy, monetary policies, reform of the financial market and the “One Belt and One Road” initiatives will continuously affect operation of the Chinese banking industry, maintaining steady operation is the key to meeting the challenges of the banking industry.

Net Interest Margin Movements of 30 G-SIBs



Net Interest Margin of 16 Listed Banks in China



BOC Institute of International Finance Global Banking Industry Research Team

Head of Team: Chen Weidong

Deputy Head: Zong Liang

Team members: Zhang Xingrong

Shao Ke

Xiong Qiyue

Zhao Xue

Huang Xiaojun (New York)

Yang Bo (Frankfurt)

Qu Kang (London)

Wang Zhe (Tokyo)

Contact: Zhang Xingrong

Telephone: +86-10-66594076

Email: zhangxingrong@bankofchina.com

Maintain Steady Operation against Challenges

-- Global Banking Industry Outlook of Bank of China (Q3, 2015)

Entering 2015, the asset scale of the Global Systematically Important Banks (“G-SIBs”) has been expanding amid improvement in net interest margin and asset quality. However, the operating efficiency has declined in the meantime. Among the major economies, outlooks of the banking industry of the US and UK are relatively optimistic, while Japan and the Euro Zone are subject to great uncertainties. The Chinese banking industry realized steady development on the whole, though it is under severe operating pressure. Looking ahead to the third quarter of 2015, macro economy, monetary policies, reform of the financial market and the “One Belt and One Road” initiative will continuously affect the performance of the Chinese banking industry, maintaining steady operation is the key to meeting the challenges of the banking industry.

I. Operating characteristics of G-SIBs

I.1 Performance

In 2014, the 30 G-SIBs realized steady expansion in asset scale. Their balance sheets reflected a trend towards “disintermediation”, as evidenced by decline in shares of deposits and loans. Among others, traditional commercial banks showed remarkable feature of “disintermediation”. Profitability of the G-SIBs ticked up thanks to the improved net interest margin, and their ROA and ROE climbed concurrently. Impacted by increasing number of lawsuits and penalty expenses, operating efficiency of G-SIBs declined. Meanwhile asset quality improved remarkably with dramatic decline in non-performing loans (“NPLs”). However, affected by decline in both capital ratio and provision coverage ratio, risk absorption capability of G-SIBs was weakened.

Compared with the foreign G-SIBs, Chinese G-SIBs kept fast growth in assets and liabilities and registered excellent performance in terms of net interest margin, profitability, cost-to-income ratio, NPL ratio and provision coverage ratio.

Table 1: Asset & liability indicators of G-SIBs, 2014 (unit: USD100 million, %)¹

	Assets	Growth rate	Liabilities	Growth rate	Deposits/liabilities	Changes	Loans/assets	Changes
Industrial and Commercial Bank of China	33555	8.95	31052	8.13	81.56	-1.32	53.5	1.05
Agricultural Bank of China	26007	9.7	24326	8.92	83.88	-2.22	50.69	1.08
Bank of China	24830	9.93	22904	8.95	77.38	-0.82	55.62	0.79
HSBC	26341	-1.39	24342	-2.02	55.49	0.69	37.47	-0.24
Barclays	21206	1.08	20176	0.91	33.1	-0.63	31.89	-0.96
RBS	15551	2.23	14660	2.26	35.77	-7.01	33.47	-7
Standard Chartered	7259	7.64	6792	8.23	60.98	-1.32	39.77	-3.85
Unicredit Group	9082	-0.19	8514	-0.54	45.61	-0.48	61.33	0.07
Santander	13623	13.49	12658	13.56	48.24	-3.02	58.92	-0.44
BBVA	6799	8.45	6243	7.84	50.74	0.07	54.55	-2.65
Credit Suisse	10920	4.83	10364	4.64	40.77	0.2	29.81	1.43
UBS	9472	5.57	9010	6.16	42.11	1.76	29.66	1.26
Nordea	7201	6.17	6880	6.37	30.12	-2.17	45.02	-3.53
Mitsubishi UFJ FG*	25366	10.01	24091	9.69	67.46	-0.03	43.04	0.86
Sumitomo Mitsui FG*	14914	13.56	14044	11.7	59.12	-2.73	41.48	-0.76
Mizuho FG*	14295	-0.9	13510	-1.27	54.34	1.18	38.7	-0.72
Bank of America	21045	0.11	18611	-0.46	60.12	0.26	42.49	-2.2
JPMorgan Chase	20750	6.66	18887	6.34	76.21	1.55	31.43	-1.08
Citigroup	18425	-2.01	16305	-2.61	55.16	-2.68	34.99	-0.4
Wells Fargo	16872	10.49	15019	10.76	77.79	-1.8	52.33	-2.86
Goldman Sachs	8562	-6.06	7730	-7.17	10.74	2.23	3.41	1.76
Morgan Stanley	8015	-3.75	7294	-4.49	18.31	3.59	8.33	3.16
Bank of New York Mellon	3853	2.94	3466	3.22	76.71	-1.06	15.35	1.55
State Street	2741	12.67	2526	13.34	82.74	0.97	6.64	1.1
ING Bank	10682	-8.18	10052	-9.12	51.79	5.65	52.72	2.99
BNP Paribas	22354	14.76	21346	15.38	32.1	0.22	32.82	-2.35
Group Credit Agricole	21401	4.41	20288	4.02	36.68	-2.49	41.39	-1.93
Societe Generale	14074	7.74	13441	7.68	26.23	-0.83	28.43	-1.39
Group BPCE	13161	8.88	12486	8.94	38.44	-3.29	48.45	-2.66
Deutsche Bank	18383	6.04	17595	5.08	32.59	-1.32	24.04	0.33
Total (average)	466739	5.13	7.06	434612	51.41	-0.56	37.59	-0.59

Source: Bankscope, BOC Institute of International Finance

I.1.1 Assets and liabilities steadily expanded

As of the end of 2014, total assets and liabilities of the 30 G-SIBs amounted to USD46.67 trillion and USD43.46 trillion, representing growth of 5.96% and 5.56% year on year. Among them, 24 banks realized positive growth in asset scale, with the highest growth reaching 14.76%. Overall, the Chinese G-SIBs kept fast growth, registering 9.53% on average.

I.1.2 Weight of deposits and loans slightly declined

As of the end of 2014, the average deposits/liabilities ratio and loans/assets ratio of the 30 G-SIBs arrived at 59.12% and 41.48%, down 0.56 and 0.59 percentage point compared with 2013. In terms of the deposits/liabilities ratio, 17 of the 30 G-SIBs recorded a decline, and most of them were traditional commercial banks. The biggest drop reached 7.01 percentage points. Institutions with the highest growth were not traditional commercial banks, instead, these institutions mainly

^①Data are converted into USD based on the closing price between USD and the currency of countries/regions where the G-SIBs are located as at December 31, 2014. Data of Japan is as of the end of March 2015 as based on its fiscal year.

focused on insurance and investment banking businesses. On the other side, institutions with the sharpest decline focused on traditional banking business. This reflected that operating strategies of the large financial institutions were changing. In terms of the loans/Assets ratio, 19 of the 30 G-SIBs recorded declines, and the largest decline reached 7 percents.

Changes in deposits and loans of the Chinese G-SIBs differed from that of G-SIBs. Affected by interest rate liberalization, financial disintermediation and the booming stock market, Chinese G-SIBs witnessed significant decline in deposits, and total deposit ratio of the three Chinese G-SIBs dropped by 1.45 percents. Meanwhile, spurred by a series of stimulus policies released by the government and tightening supervision, loans/assets ratio of the Chinese G-SIBs increased slightly by an average of 0.97 percents.

Table 2: Operating indicators of G-SIBs, 2014² (%)

	ROA	ROE	NIM	C/I	CAR	RCR	NPL
Industrial and Commercial Bank of China	1.4	19.62	3.13	27.89	14.53	206.9	1.13
Bank of China	1.22	16.52	2.84	31.67	13.87	188.93	1.18
Agricultural Bank of China	1.18	19.13	3.52	36.77	12.82	286.53	1.54
HSBC	0.55	7.6	1.46	65.1	15.6	42.13	2.97
Standard Chartered	0.39	5.78	1.9	59.64	16.71	50.3	2.74
Barclays	0.06	1.32	0.95	79.82	16.5	30.53	4.13
RBS	-0.26	-4.54	1.04	89.34	17.1	64.95	7.64
	ROA	ROE	NIM	C/I	CAR	RCR	NPL
Santander	0.58	8.19	2.89	56.15	13.3	67.42	5.41
BBVA	0.51	6.41	2.77	50.95	15.1	62.74	6.59
Unicredit Group	0.28	4.64	1.67	64.23	13.41	60.96	14.95
Credit Suisse	0.35	7.01	0.73	92.05	25.6	58.31	0.38
UBS	0.26	5.04	1.23	84.55	20.8	54.53	0.51
Nordea	0.51	11.29	0.93	51.92	20.7	42.76	2.13
Sumitomo Mitsui FG	0.8	9.2	1.52	55.67*	15.98	67.10*	0.97
Mizuho FG	0.48*	11.6	1.15	61.82*	14.36	59.15*	1.21
Mitsubishi UFJ FG	0.4	9.31	0.92	58.71	15.53	40.32	1.69
Wells Fargo	1.47	13.25	2.93	58.14	15.53	48.49	2.88
Goldman Sachs	0.96	10.47	0.57	64.21	16	-	-
State Street	0.79	9.74	1	74.66	19.8	-	0
JPMorgan Chase	0.74	8.31	2.35	70.25	14.11	59.67	3.07
Bank of New York Mellon	0.7	6.87	0.86	70.4	12.5	-	0.02
Morgan Stanley	0.45	5.2	0.24	88.94	16.4	-	0.03
Citigroup	0.4	3.59	2.91	72.16	14.53	77.86	3.19
Bank of America	0.23	2.03	2.35	89.16	16.5	51.6	3.24
ING Bank	0.14	2.58	1.47	66.2	15.53	-	-
Group Credit Agricole	0.31	6.09	1.34	62.82	18.4	82.26	3.69
Group BPCE	0.29	5.57	1.13	69.39	15.4	53.62	3.87
Societe Generale	0.24	5.3	0.92	66.97	14.3	62.34	6.91
BNP Paribas	0.03	0.55	1.23	67.72	12.6	61.59	6.29
Deutsche Bank	0.1	2.64	0.96	85.85	16	55.76	2.28
Average	0.52	7.34	1.63	66.55	15.98	106.47	3.24

Source: Bankscope, BOC Institute of International Finance

②Some data may vary from those announced in relevant bank's annual report. Bankscope hasn't updated the latest data of the three Japanese banks as the latter have just published their fiscal-year data. We calculated related data based on annual reports of relevant banks and marked them with "*" in Table 2. In Table 2, ROA = return on asset, ROE = return on equity, NIM = net interest margin, C/I = cost-to-income ratio, CAR = capital adequacy ratio, RCR = provision coverage ratio, NPL = the ratio of non-performing loans.
 BOC Institute of International Finance

I.1.3 Profitability continued to improve

In 2014, average return on assets (“ROA”) and return on equity (“ROE”) of the 30 G-SIBs stood at 0.52% and 7.34%, up 0.03 and 0.19 percents compared with 2013, respectively. The three Chinese G-SIBs registered the highest ROE, although their ROE growth declined compared with 2014.

I.1.4 NIM edged up slightly

In 2014, average NIM of the 30 G-SIBs was 1.63%, up 0.1 percents compared with 2013. Thanks to decline in deposit cost, NIM of G-SIBs in the Euro Zone increased noticeably, while affected by declining return on assets, large banks in the US recorded remarkable decline in NIM. Chinese G-SIBs posted leading NIM among the 30 G-SIBs against impact of the “slowing economic growth, throes of structural adjustment and absorption of previous stimulus measures” as well as interest rate liberalization reform.

I.1.5 Operating efficiency weakened

In 2014, affected by increase in litigation cost and penalty expense, operating efficiency of G-SIBs declined. The average cost-to-income ratio was 65.77%, up 0.96 percentage point compared with 2013. Average cost-to-income ratio of Chinese G-SIBs was less than 35%, far lower than the average level.

I.1.6 Capital ratio declined slightly

Affected by changes in the capital and risk-weighted asset measurement rules, CAR of the G-SIBs slightly declined in 2014 to 15.98% on average, down 0.02 percentage point compared with 2013. Average provision coverage ratio of the G-SIBs was 77.47%, down 5.99 percentage points compared with 2013. This reflects that banks’ risk resistance capability was weakened.

CAR of Chinese G-SIBs was lower than average level of the 30 G-SIBs, but it demonstrated a steady increase trend. Provision coverage ratio of Chinese G-SIBs was noticeably higher than the average of G-SIBs, but was exposed to severe downside pressure as economic slowdown intensified.

I.1.7 Asset quality steadily improved

In 2014, asset quality of the G-SIBs continued to improve, and the NPL ratio dropped significantly. In 2014, average NPL ratio of the G-SIBs came in at 3.24%, down 0.41 percentage point compared with the end of 2013. Chinese G-SIBs registered fast growth in NPL ratio against “slowing economic growth, throes of structural adjustment and absorption of previous stimulus measures”.

I.2 Outlook

In 2015, the G-SIBs are expected to extend steady growth albeit divergence in each bank’s performance. Economic fundamentals, stance of monetary policies, changes in regulatory environment and bank’s strategic choice will be the main factors influencing operating results of G-SIBs:

Macro environment will impact operation of G-SIBs. By the countries/regions where G-SIBs are located, the US, China and UK maintain relatively healthy economic fundamentals, and operation of their banking industry will be relatively optimistic. Economic prospect of Japan and

the Euro Zone is unclear, which may increase uncertainties in performance of their banking industry.

Stance of monetary policy will impact profitability of G-SIBs. The US Fed and the Bank of England are exposed to large probabilities of interest rate hike, which brings banking industry of the US and UK into interest rate risks. Meanwhile, the banking industry of the Euro Zone and Japan are expecting declining return on various categories of assets due to the quantitative easing policy, and domestic commercial banks are exposed to the risk of declining interest rate. In China, growing expectations for interest rate cut is coupled with ongoing interest rate liberalization, and large banks need to cope with impact of the declining benchmark interest rate in the context of gradual interest rate liberalization.

Basel III will continue to impact operation of G-SIBs. In terms of capital management, as the capital regulation policy continues to tighten, banks will meet increasing compliance pressure from the regulators in 2015. Meanwhile, rise in banks' financing cost due to capital innovation will also noticeably impact the G-SIBs. In terms of liquidity management, major economies have rolled out regulatory rules on the liquidity coverage ratio and the net stable funding ratio. In order to meet the new liquidity requirements, commercial banks' demand for highly liquid financial assets will remarkably increase. This will affect banks' asset allocation strategy to some extent.

II. Banking industry operation and outlook of major economies

II.1 Banking industry in the US

II.1.1 Operating profile

Scale of assets and liabilities grew moderately. During the first quarter of 2015, the US banking industry had total assets of USD15.8 trillion, a quarter-on-quarter increase of 1.44% and a year-on-year increase of 5.82%. It posted total liabilities of USD14 trillion, a quarter-on-quarter increase of 1.40% and a year-on-year increase of 5.88%.

Table 3: Indicators of the US banking industry (unit: USD100 million)

	2015Q1	2014Q4	2014Q3	2014Q1	Q-o-Q change (%)	Y-o-Y change (%)
Assets	157781	155537	153488	149100	1.44	5.82
Liabilities	140064	138126	136220	132287	1.40	5.88
Capital	17716	17410	17268	16813	1.75	5.37

Source: FDIC, BOC New York Branch

Profit and operating income grew remarkably. During the first quarter of 2015, the US banking industry realized net profit of USD39.8 billion, a quarter-on-quarter increase of 9% and a year-on-year increase of 6.92%. Operating revenue reached USD168.4 billion, a quarter-on-quarter increase of 0.5% and a year-on-year increase of 2.61%. Net interest income of the US banking industry stood at USD105.7 billion, a quarter-on-quarter decrease of 1.65% and a year-on-year increase of 1.46%. Non-interest income amounted to USD62.7 billion, a quarter-on-quarter increase of 4.35% and a year-on-year increase of 4.6%. During the first quarter of 2015, ROA of

the US banking industry was 1.02%, a quarter-on-quarter increase of 9% and a year-on-year increase of 6.92%; and the ROE was 9.12%, a quarter-on-quarter increase of 7.55% and a year-on-year increase of 1.45%.

Table 4: Profit and income of the US banking industry (unit: USD100 million)

	2015Q1	2014Q4	2014Q3	2014Q1	Q-o-Q change (%)	Y-o-Y change (%)
Net profit	398	366	384	372	9.00	6.92
Operating income	1684	1675	1715	1640	0.50	2.61
Net interest income	1057	1075	1069	1042	-1.65	1.46
Non-interest income	627	600	646	598	4.35	4.61
ROA	1.02%	0.95%	1.01%	1.01%	7.37	0.99
ROE	9.12%	8.48%	8.98%	8.99%	7.55	1.45

Source: FDIC, BOC New York Branch

Credit quality steadily improved. As at the end of Q1 2015, outstanding NPL balance of the US banking industry was USD153.0 billion, a quarter-on-quarter decrease of 5.95% and a year-on-year decrease of 21.65%. The average NPL ratio slipped from 1.96% to 1.83%, the lowest level over the past seven years.

Capital adequacy ratio declined slightly. During the first quarter of 2015, core capital adequacy ratio of the US banking industry was 9.48%, basically the same with the previous quarter with a slight decrease of 0.52% year on year. Tier-1 capital adequacy ratio was 12.75%, declining on both quarter-on-quarter and year-on-year terms (-1.54% and -4.06%, respectively).

Table 5: NPLs and capital adequacy ratio of the US banking industry (unit: USD100 million)

	2015Q1	2014Q4	2014Q3	2014Q1	Q-o-Q change (%)	Y-o-Y change (%)
NPLs	1530	1627	1719	1952	-5.95	-21.65
NPL ratio	1.83%	1.96%	2.11%	2.46%	-6.63	-25.61
Core CAR	9.48%	9.45%	9.51%	9.53%	0.32	-0.52
Tier-1 CAR	12.75%	12.95%	13.00%	13.29%	-1.54	-4.06

Source: FDIC, BOC New York Branch

II.1.2 Regulatory environment

During the second quarter of 2015, the US regulators further improved the regulatory framework. Changes in regulatory policies are mainly reflected in the following four aspects:

First, the US Fed ramified the liquidity management rules for banking institutions, and recommended including the general obligation state/municipal bonds into the liquidity asset assessment in order to meet the requirements of liquidity coverage ratio (“LCR” hereinafter). The LCR requirements were put into implementation across federal banking institutions in September 2014. It stipulates that, large banking institutions must hold high-quality liquidity assets (“HQLA”

hereinafter) that can be easily and conveniently converted into cash, i.e. the assets should be able to be converted into cash within 30 days when the financial stress increases. New proposal of the US Fed plans to include the investment-grade (adopts the same liquidity standards with corporate bonds) general obligation state/municipal bonds into the scope of HQLA. In the meantime, according to the unique liquidity features, limits of every class of state/municipal bonds being included into HQLA also vary.

Second, the US Fed, the FDIC and the OCC jointly brought forth detailed requirements on disclosure of annual stress test information by the mid-sized financial institutions (with consolidated assets ranging between USD10 billion and USD50 billion), including: (1) describing risks of various categories of assets within the stress test scope; (2) introducing the main methods of stress testing; (3) estimating the gains/losses, income and net profit; (4) announcing capital adequacy ratio under each stress scenario; (5) explaining main reasons for changes in the capital adequacy ratio.

Third, due to concerns that the interest rate hike by the US Fed may cause negative impact on large banks, the BASEL Committee on Banking Supervision announced a proposal on issues such as the risk management, capital governance and interest rate risk management of banking books. The proposal puts forward detailed requirements based on the Principle For the Management and Supervision of Interest Rate Risk (developed by the BASEL Committee in 2004), and aims to ensure that banks have adequate capital to cope with interest rate risks. It also sets forth restrictive measures on capital regulatory arbitrage between the trading and banking books and among the investment portfolio accounts that are subject to different accounting rules. The proposal sets forth two main principles for bank's interest rate risk management: (a) setting down new requirements on minimum capital; and (b) establishing forceful regulatory standards. It is applicable to the large internationally active banks with assets of over USD250 billion, including JPMorgan Chase, Bank of America, Citigroup and Wells Fargo. The applicable scope may be further expanded in future. The market expects the proposal to influence banks' profit in the short term.

Last, in terms of regulatory punishment, the US financial regulators imposed a combined fine of around USD6 billion on six financial institutions, namely Credit Suisse, Barclays, Citigroup, JPMorgan Chase, RBS and Bank of America for their illegal behavior in the foreign exchange market. The US Fed also requested the above-mentioned banks to adopt appropriate policies and procedures in the foreign exchange market (including the foreign exchange wholesale and similar market activities) to reinforce supervision and control risks.

II.1.3 Outlook

During the second half of 2015, along with moderate rebound of the US macro economy, the US banking industry is expected to maintain its steady growth. Profitability is expected to continue improving, and the credit quality will be maintained at a high level. But due to difference in regulatory measures, large banks are expected to meet increasingly stringent regulatory requirements, while the regulatory environment for small to mid-sized banks will likely ease.

In 2015, the greatest challenge for the US banking industry is the interest rate risks caused by normalization of the US Fed's monetary policies. At present, the large US banks adjusted their asset and liability structures for exposure of interest rate sensitive assets, in order to cope with

impact of the US Fed's policies. In the next step, the US regulators are expected to roll out a series of policy measures to tighten interest rate risk management. This is forecast to significantly change banks' asset and liability structures. Overall, given the expectations for interest rate hike and proactive plans of the regulators, normalization of the monetary policy is expected to produce limited impact on the US banking industry.

II.2 Banking industry in the Euro Zone³

II.2.1 Operating profile

Deposits and loans steadily increased, with deposits growing faster than loans. As of the end of Q1 2015, the banking industry in the Euro Zone recorded total deposits of EUR17.1 trillion, a year-on-year increase of EUR446.6 billion (the increase was EUR169.3 billion higher compared with the prior quarter). Deposits increased year on year in 14 countries, an increase of 2 countries compared with the prior quarter. Netherlands, Germany and Italy recorded considerable increase in deposits, reaching EUR147.0 billion, EUR124.0 billion and EUR76.6 billion, respectively. Deposits decreased in five countries, especially in Spain, Ireland and Portugal where deposits dropped by EUR35.5 billion, EUR33.3 billion and EUR16.8 billion, respectively. As of the end of Q1 2015, the banking industry in the Euro Zone recorded total outstanding loans of EUR17.16 trillion, a year-on-year increase of EUR208.4 billion (the increase was EUR89.9 billion less than that of the prior quarter). Loans increased in ten countries, an increase of one country compared with the prior quarter, among which loans of Netherlands, Germany and Belgium grew considerably by EUR112.8 billion, EUR93.1 billion and EUR49.3 billion, respectively. Loans decreased in nine countries, especially in Spain, Ireland and Portugal where loans dropped by EUR51.8 billion, EUR37.1 billion and EUR17.3 billion, respectively.

Table 6: Deposits and loans of the Euro Zone (unit: EUR billion)

Item		Euro Zone	Germany	Spain	France	Italy	Netherlands
2014Q1	Deposits	16653.7	4484.0	2043.5	3918.2	2311.8	1042.3
	Loans	16946.8	4408.1	1780.7	4343.0	2413.7	1265.8
Item		Euro Zone	Germany	Spain	France	Italy	Netherlands
2015Q1	Deposits	17100.3	4608.0	2008.0	3988.2	2388.4	1189.3
	Loans	17155.2	4501.2	1728.9	4343.2	2427.5	1378.6
Year-on-year change	Deposits	446.6	124	-35.5	70	76.6	147
	Loans	208.4	93.1	-51.8	0.2	13.8	112.8
Year-on-year growth	Deposits	2.68%	2.77%	-1.74%	1.79%	3.31%	14.10%
	Loans	1.23%	2.11%	-2.91%	0.00%	0.57%	8.91%

Source: ECB, BOC Frankfurt Branch

Capital strength continued to increase, and core countries performed well. As of the end of Q1 2015, the banking industry in the Euro Zone recorded total capital of EUR2.42 trillion, EUR20.2 billion or 0.84% higher than the end of 2014. Compared with the end of 2014, the banking industry of 11 countries in the Euro Zone saw an increase in capital, and among others, Italy, Netherlands, Germany and France registered a remarkable increase of EUR13.8 billion, EUR6.8 billion,

^③It includes all of the monetary and financial institutions in the Euro Zone that are within statistical scope of the European Central Bank, including financial institutions in Lithuania which joined the Euro Zone on January 1, 2015 (the same below).

EUR4.1 billion and EUR4.1 billion, respectively. The banking industry of eight countries saw a decline in capital, and among others, Greece, Spain and Ireland recorded an evident decline of EUR4.7 billion, EUR3.6 billion and EUR3.4 billion, respectively.

Table 7: Capital of the banking industry in the Euro Zone (unit: EUR billion)

Item	Euro Zone	Germany	Spain	France	Italy	Netherlands
2014Q4	2404.20	464.6	336.7	523.9	424.2	121.6
2015Q1	2424.40	468.7	333.1	528	438	128.4
Change	20.20	4.10	-3.60	4.10	13.80	6.80
Growth	0.84%	0.88%	-1.07%	0.78%	3.25%	5.59%

Source: ECB, BOC Frankfurt Branch

II.2.2 Regulatory Environment

The European Central Bank (“ECB”) continued to maintain the negative interest rates and unconventional monetary policies. In the beginning of June, the ECB announced the latest decisions on interest rates, and kept the main interest rates unchanged. The main refinancing rate was kept at 0.05%, the overnight deposit rate was -0.2%, and the overnight lending rate was 0.3%, all consistent with market expectations. In the meantime, Draghi, President of the ECB, noted that smooth progress had been achieved in QE implementation, and that the ECB Governing Council hadn’t discussed any QE exit strategies. Draghi emphasized that the inflation rate had reached its bottom at beginning of this year, and the inflation rate will continue to linger at the low levels over the upcoming months. Over the short term, it’s necessary to keep an accommodative stance before any increase in the Euro Zone’s core inflation rate is noticed. The QE is forecast to last into September, 2016.

The single supervisory mechanism was further deepened, but there were still challenges for uniform supervision. First, the Euro Zone needs to set up a uniform set of legal requirements suitable to all countries in the Euro Zone. On the issue of regulatory legislation, there are currently over 150 topics to be resolved. The ECB and regulators of all countries in the Euro Zone are making assessment and negotiating over the common standards. Second, the Euro Zone needs to set up a supervisor team that is able to work across different regions. At present, most of the supervisors have only working experience at his/her own country and they need to adapt to the requirements of cross-country supervision as soon as possible. Third, the Euro Zone needs to set up a cross-country coordination mechanism and properly manage cross-border banks, especially large transnational banks with business in multiple countries, in order to avoid risk accumulation and expansion and further occurrence of financial crisis.

II.2.3 Outlook

Thanks to the QE and other policies released in the Euro Zone, the economic and financial conditions in the Euro Zone improved, and the banking industry ushered in some positive changes: First, during the first quarter of 2015, GDP of the Euro Zone realized a quarter-on-quarter increase of 0.4% and a year-on-year increase of 1.0%, and confidence of the consumers and entrepreneurs improved. Second, the treasury bond yield of most countries in the Euro Zone continued to decline while prices of stocks and other assets climbed, issuing a signal of recovery in the financial market. Third, due to impact of the QE policies, financing cost and lending interest rate of banks declined, and the credit conditions were further relaxed. Fourth, the inflation expectations bottomed out and decline in the Consumer Price Index gradually narrowed.

Overall, however, economic growth of the Euro Zone is still weak, the inflation rate is still excessively low and is exposed to deflation risk. The unemployment ratio is high, and commercial banks are slack about issuing credits. Implementation of QE policies brings about huge challenge to NIM management capability of banks. In the meantime, political situation of Greece and Ukraine is still unstable, and the internal political problems and slow progress of structural reform are still hindering recovery of the Euro Zone. Comprehensive improvement of the banking industry's external environment is still not in sight.

II.3 Banking industry in the UK

II.3.1 Operating profile

During the first quarter of 2015, the British banking industry realized moderate pickup in credit growth rate. As at the end of Q1 2015, M4 of the UK totaled GBP1,787.8 billion, a year-on-year increase of 2.9% and a quarter-on-quarter increase of 0.6%.

The retail loans grew considerably, and growth in corporate loans slipped. In the UK, balance of personal credit was GBP1,432.2 billion, a year-on-year increase of 2.4% and a quarter-on-quarter increase of 0.2%. Specifically, the balance of loans related to property mortgage was GBP1,261.8 billion, a year-on-year increase of 1.8%; the balance of consumer credit was GBP170.3 billion, a year-on-year increase of 6.9%; and outstanding loans issued to non-financial enterprises amounted to GBP441.1 billion, a year-on-year decrease of 0.5% and a quarter-on-quarter increase of 0.1%. Balance of loans issued to the small and medium-sized non-financial enterprises was GBP168.2 billion, a year-on-year decrease of 1.0%.

The financing cost of the British banking industry declined. During the first quarter of 2015, wholesale fund cost of the British commercial banks was generally stable, and the premium of 5-year credit default swaps declined slightly compared with the prior quarter. In terms of retail funds, interest spread of the 2-year retail bonds slipped from 0.6% in the fourth quarter of 2014 to 0.4%, and that of the 3-year retail bonds fell from 0.9% to 0.7%. In terms of loan pricing, service charges of banks over corporate loans declined, and interest rate of corporate loans and floating interest rate of new loans kept stable. Interest rate of new mortgage loans continued the downtrend starting from the second half of 2014, while the number and amount of mortgage loans increased compared with the same period of last year. Meanwhile, the probability of default (PD) and the Loss Given Default (LGD) of NPLs declined, showing that asset quality of the British banking industry was improved.

II.3.2 Regulatory environment

The British regulatory authority will promote financial market reform to increase competition in the banking industry. The Financial Conduct Authority noted that the British government would approve the establishment of about 15 new banks over the next five years, including the Internet banks that are currently applying for business licenses. In addition to increasing the number of banks and balancing competition between large banks, financial reform of the UK also encourages innovation of the financial services. It calls for introduction of an "arbitrage" mechanism to make sure the consumers' rights are placed at the uttermost important position.

At the end of March 2015, the Bank of England released the Stress Testing the UK Banking

System: Key Elements of the 2015 Stress Test. Compared with 2014, the latest stress testing rules were exclusively designed, calibrated and formulated by the Bank of England. On the basis of models applied in the existing stress tests, stress test of 2015 will make developments in the following aspects, mainly: (1) an extension of the stress scenario to explore global as well as domestic risks; (2) introduction of the trading risk as a new indicator; (3) enhanced guidance on management actions relating to real-economy lending in the stress scenario; and (4) introduction of a leverage ratio threshold as part of the hurdle rate framework. Results of the stress testing in 2015 will be published in the Financial Stability Report of the Bank of England during the fourth quarter of 2015.

II.3.3 Outlook

The winning of the Conservative Party in the general election will help the market maintain optimistic about the stability and continued recovery of the British economy. Meanwhile, the British non-financial enterprises' demand on banking loans is also expected to improve. Overall, fundamentals of the banking industry are positive. Meantime, the British banking industry is also facing a series of challenges, such as impact of the hike in banking tax on large banks. Hike in the banking tax and stricter financial supervision policy are forecast to increase banks' operating cost and enhance the difficulties of their local operation. This will urge the banking industry to ramp up exploration of the EMs in future. In addition, after the Conservative Party comes into power, chance for the UK to break away from the European Union increases. Given importance of the European Union market, the British banking industry needs to consider impact of the departure on its business development. In terms of monetary policy, the timing of interest rates hike by the British central bank is still uncertain. Commercial banks are expected to develop countermeasures to respond to the possible interest rate risks arising from unexpected increase in interest rates.

II.4 Banking industry in Japan

II.4.1 Operating profile

Assets and liabilities grew steadily. Affected by the quantitative easing policies, assets and liabilities of the Japanese banking industry kept solid growth. As of the end of May 2015, actual deposit balance⁴ of the 116 Japanese banks⁵ totaled JPY656.46 trillion, a year-on-year increase of 4.1%. This marked the 104th successive month of year-on-year increase. Outstanding loans totaled JPY454.34 trillion, a year-on-year increase of 2.7%, the 45th successive month of year-on-year increase.

Profitability slid slightly. During the fiscal year in 2014⁶, the seven metropolitan banks in Japan recorded total after-tax profit of JPY2,882.0 billion, 2.3% lower than that at the end of the 2013 fiscal year; and their NPLs declined from JPY4.0 trillion to JPY3.5 trillion and the NPL ratio

⁴Nominal deposits less the unpaid bills and cheques.

⁵ Includes metropolitan banks (five in total, i.e. Bank of Tokyo-Mitsubishi UFJ, Mizuho FG, Sumitomo Mitsui, Resona and Saitama Resona Bank), local banks (64), second local banks (41, these banks join the Second Association of Regional Banks), trust banks (4, i.e. Tokyo-Mitsubishi UFJ, Mizuho Trust & Banking, Sumitomo Trust & Banking, and Nomura Trust and Banking), Shinsei Bank and Aozora Bank, 116 in total.

⁶ The fiscal year of Japan starts from April 1 and ends on March 31 of the next year.

dropped from 1.33% to 1.10%. Among them, the capital adequacy ratio of the four banks applying international standards⁷ was 15.36%, up 0.45 percentage point compared with the end of the 2013 fiscal years. Capital adequacy ratio of the rest three banks applying domestic standards⁸ declined by 0.32 percentage point to 13.95% due to repayment of government funds and other reasons.

During the 2014 fiscal year, the 106 regional banks in Japan⁹ recorded total after-tax profit of JPY1,062.9 billion, slightly lower than the JPY1,070.9 billion in the 2013 fiscal year; their NPLs declined from JPY6.2 trillion to JPY5.6 trillion and the NPL ratio fell from 2.72% to 2.38%. Among them, capital adequacy ratio of the ten banks applying international standards increased by 0.36 percentage point over the previous year to 14.64%; and that of the rest 96 banks came in at 10.50%, down 0.54 percentage point.

Against declining deposit-loan interest spread in domestic market, banks actively developed overseas business. Although domestic fund demand in Japan increased, the excessive fund supply in Japan was not improved due to banks' high willingness to lend. The deposit-loan interest rate continued to narrow. According to statistics of the Bank of Japan, as at the end of March 2015, average interest spread of large banks was only slightly higher than 1%. Due to assumption of greater credit risks, regional banks kept slightly higher deposit-loan interest spread, at approximately 1.5%. In order to get higher returns, the large Japanese banks generally turned to overseas markets with higher yields. According to statistics of Bank of Japan, during the 2014 fiscal year, the outstanding overseas loans issued by large Japanese banks increased by approximately 10%, and the loan limit increased by over USD50 billion. Despite a weaker advantage, regional banks are more active in developing overseas business and boosted their overseas loan balance by approximately 20% or over USD4 billion during the 2014 fiscal year.

II.4.2 Regulatory environment

Since the last year, the Financial Services Agency of Japan increased the frequency of inspection over financial institutions, causing Japanese banks and foreign banks to pay more attention. On June 10, 2015, the Financial Services Agency ordered the Japanese branches of Woori Bank and the Industrial Bank of Korea to suspend business for one month and making rectifications. The Financial Services Agency pointed out that, the two banks attached excessive importance to profit, and didn't have sound financing examination mechanism and mid-office restriction mechanism.

The regulators urged local banks to accelerate business integration. Since the Financial Services Agency consolidated the regulatory and inspection policies, it brought forth stricter requirements on comprehensive risk management and business model sustainability of the banking industry. Regarding the local banks facing declining local population, sluggish local economy and narrowed interest spread due to ultra-low interest rates, the Financial Services Agency increased the frequency of inspections and talks to promote business consolidation among local banks. In such a backdrop, following announcement of Bank of Yokohama to integrate with the Higashi Nippon Bank, Higo Bank and Kagoshima Bank in November of last year, the TOMONI Holdings, which owned the Kagawa Bank and Tokushima Bank in Shikoku of Japan, announced to acquire the

⁷ Controlled by Mizuho FG, Mitsubishi UFJ, Sumitomo Mitsui FG and Sumitomo Mitsui Trust Holdings.

⁸ Resona, Shinsei Bank and Aozora Bank.

⁹ Includes 64 local banks, 41 second local banks and Saitama Resona Bank.

Taisho Bank in Kansai in April 2015. Additionally, on June 12, the ShinGinko Tokyo which is held by Tokyo Metropolitan Government also announced to merge with the Tokyo TY Financial Group.

Along with development of the online banking system and information technology, the Financial Services Agency put forth stricter requirements on banks' information security management. In April 2015, the agency revised some regulatory rules and requested banks to make proper plans to prevent their servers from being attacked and further reinforce information security management. In terms of customer information protection, it required banks to comprehensively sort out important information of the customers and implement effective management by identifying importance of the customer information, enhancing information encryption management and keeping data backup.

II.4.3 Outlook

During the third quarter of 2015, the Japanese banking industry will continue to face challenges. Although the Japanese GDP realized a quarter-on-quarter increase of 1.0% and the unemployment rate continued to decline during the first quarter in 2015, personal consumption continued to decline on a year-on-year basis for the 13th month due to drop in actual household income. The production index and equipment investment of the mining industry showed signs of mild recovery since beginning of the year, but its contribution to the Japanese economic growth is very limited given the declining public investment. During the second half year, the Japanese central bank is expected to maintain loose monetary policy. The ultra-low interest rate environment led by easing policies will further narrow NIM of banks, making domestic operating environment of the Japanese banking industry more austere.

III. China's banking industry review and outlook

III.1 Banking operation review

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

The scale of commercial banks' assets and liabilities has kept steady growth since the beginning of 2015. As of the end of March 2015, total assets and liabilities of commercial banks reached RMB140.6 trillion and RMB130.3 trillion, an increase of RMB5.8 trillion and RMB5.2 trillion or 12.05% and 11.39% over the end of last year. Assets and liabilities of listed banks reached RMB110.27 trillion and RMB102.41 trillion, a year-on-year increase of 9.92% and 9.23% respectively; 0.69 and 1.09 percentage points lower than the same period of last year. Total assets and liabilities of the top 5 banks reached RMB78.36 trillion and RMB72.53 trillion, a year-on-year increase of 8.40% and 7.59% respectively, 0.82 and 1.37 percentage points lower than the same period of last year. Total assets and liabilities of joint stock banks reached RMB29.12 trillion and RMB27.25 trillion, a year-on-year increase of 13.69% and 13.27% respectively, 0.14 and 0.23 percentage point higher than the same period of last year.

Figure 1 y-o-y asset growth of list banks

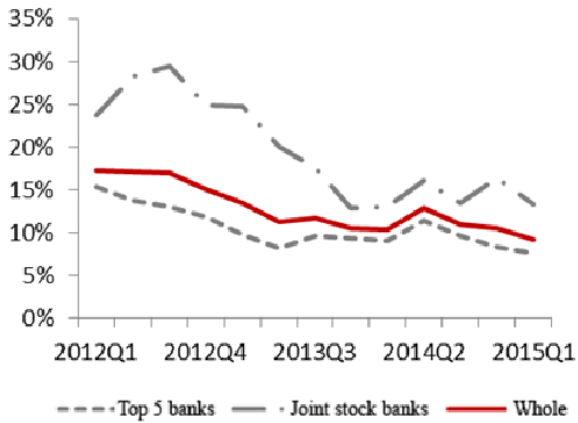
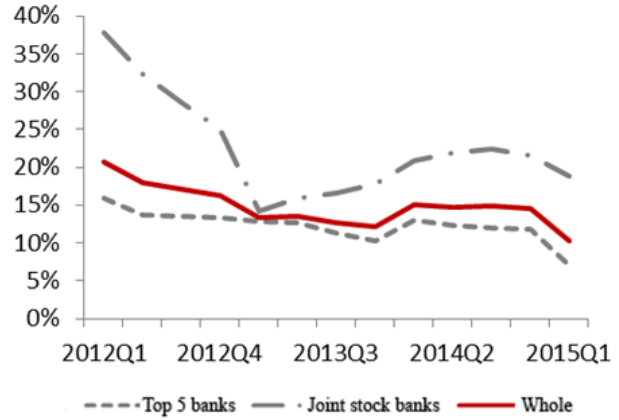


Figure 2 y-o-y liability growth of listed banks



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

III.1.2 Profitability declined, and NIM and NIS diverged

Since the beginning of 2015, commercial banks' net profit has slowed down. As at the end of the first quarter of 2015, commercial banks generated net profits of RMB443.6 billion, a year-on-year increase of 3.74%, and the growth rate was 12.2 percentage points lower than the same period of last year. The listed banks recorded operating income of RMB916,687 million and net profit of RMB357,609 million, a year-on-year increase of 10.31% and 3.25% respectively, 4.67 and 8.59 percentage points lower than the same period of last year. The top 5 banks generated operating income of RMB653,819 million and net profit of RMB262,727 million, a year-on-year increase of 7.03% and 1.49% respectively, 6.02 and 8.69 percentage points lower than the same period of last year. The joint stock banks generated operating income of RMB242,777 million and RMB86.33 billion, a year-on-year increase of 18.77% and 7.86% respectively, 2.11 and 9.59 percentage points lower than the same period of last year. During the first quarter of 2015, net profit growth declining exceeded our expectation, mainly as a result of the further slowdown in domestic economic growth and accelerated exposure of credit risks.

Figure 3: y-o-y operating income growth of listed banks

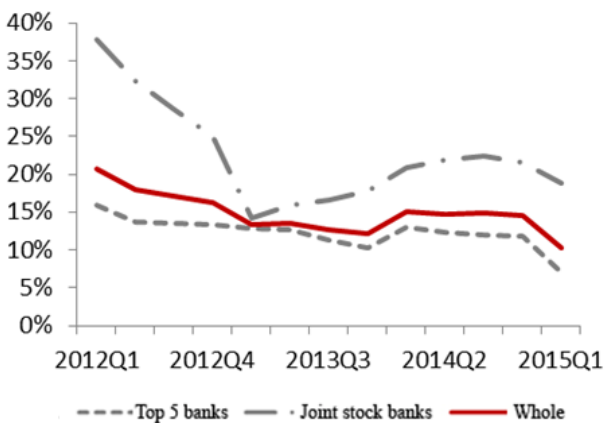
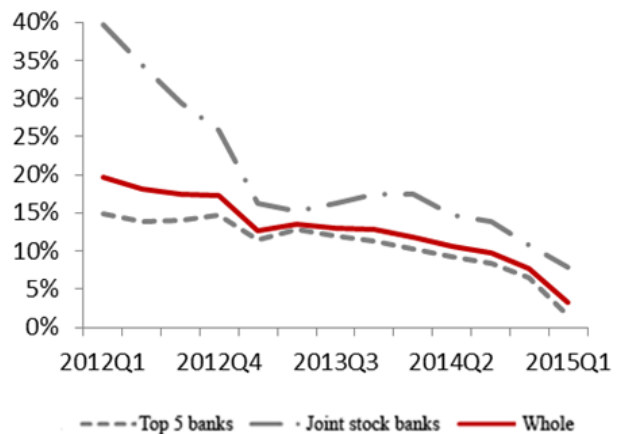


Figure 4: y-o-y net profit growth of listed banks



During the first quarter of 2015, average ROA of listed banks (annualized, the same below) was 1.23%, a year-on-year decrease of 7 basis points. ROA of the top 5 banks was 1.34%, a year-on-year decrease of 9 basis points. ROA of the joint stock banks was 1.17%, a year-on-year decrease of 8 basis points. Average ROE of the listed banks (annualized, the same below) was 18.89%, a year-on-year decrease of 2.32 percentage points. ROE of the top 5 banks was 18.27%, a year-on-year decrease of 3.16 percentage points. ROE of the joint stock banks was 18.65%, a year-on-year decrease of 2.16 percentage points.

Figure 5: ROA of listed banks

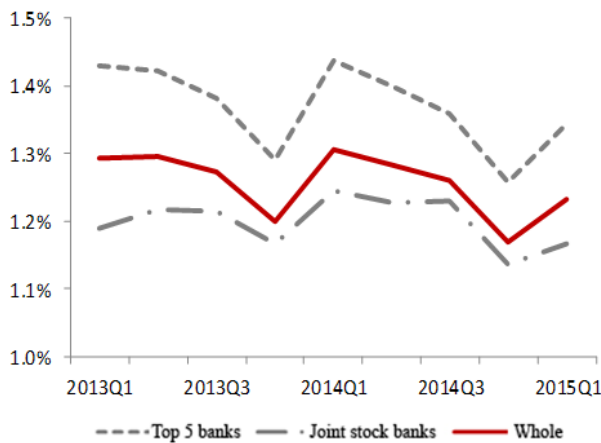
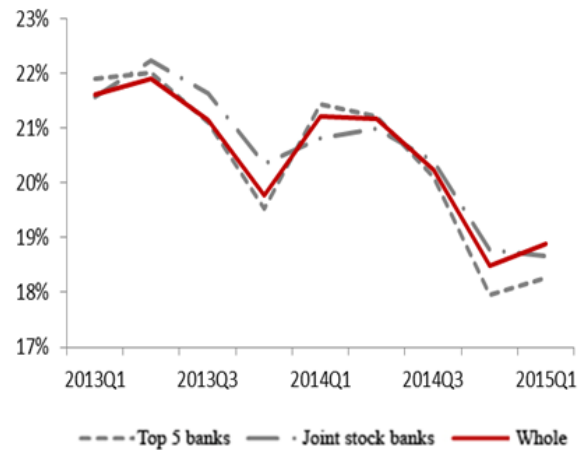


Figure 6: ROE of listed banks



During the first quarter of 2015, average NIM and NIS of listed banks were 2.62% and 2.72%, an increase of 7 and 19 basis points year on year. Average NIM and NIS of the top 5 banks were 2.52% and 2.40%, a decrease of 6 and 2 basis points year on year. Average NIM and NIS of the joint stock banks were 2.73% and 3.04%, an increase of 18 and 39 basis points year on year.

Figure 7: NIM of listed banks

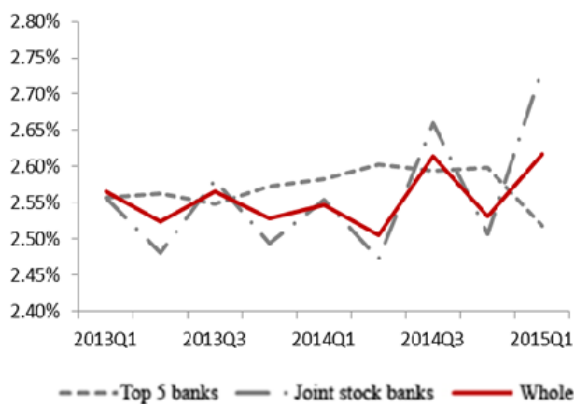
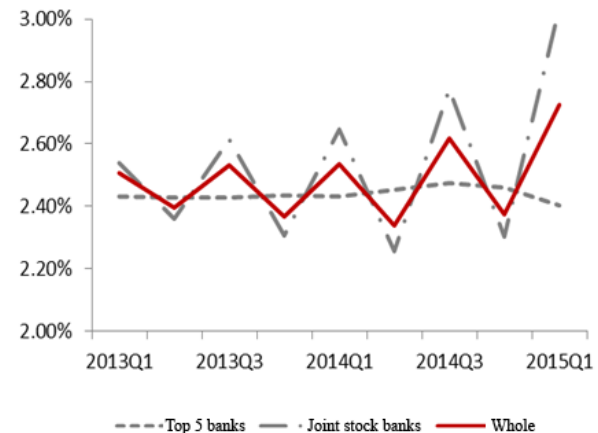


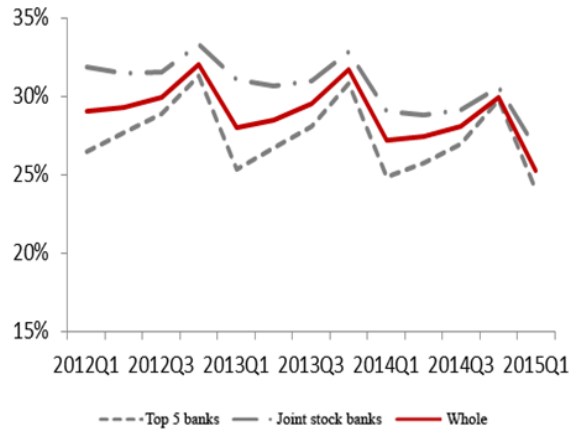
Figure 8: NIS of listed banks



During the first quarter of 2015, Average cost-to-income ratio of listed banks was 25.27%, a year-on-year decrease of 1.91 percentage points. Average cost-to-income ratio of the top 5 banks

was 24.06%, a year-on-year decrease of 0.80 percentage point. And average cost-to-income ratio of the joint stock banks was 26.67%, a year-on-year decrease of 2.36 percentage points.

Figure 9: Cost-to-income ratio of listed banks



III.1.3 Proportion of loans increased while proportion of deposits continued to decline; ratio of non-interest income slipped

As of the end of Q1 2015, the ratio of outstanding loan to total assets of listed banks accounted for 51.81%, a year-on-year increase of 0.49 percentage point. Among the loans, the top 5 banks accounted for 53.63%, a year-on-year increase of 0.63 percentage points; and the joint stock banks accounted for 48.05%, a year-on-year increase of 0.38 percentage point. As at the end of the first quarter of 2015, the proportion of deposits in total liabilities of commercial banks accounted for 77.02%, a year-on-year decrease of 2.15 percentage points. The deposit proportion of the top 5 banks was 80.80%, a year-on-year decrease of 1.82 percentage points; and the deposit proportion of joint stock banks was 68.12%, a year-on-year decrease of 2.83 percentage points.

Figure 10: Outstanding loans/total assets ratio of listed banks

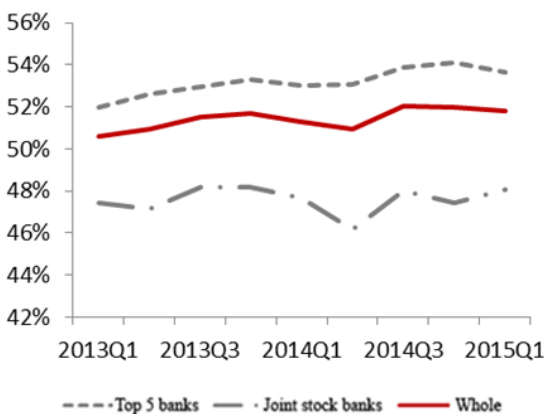
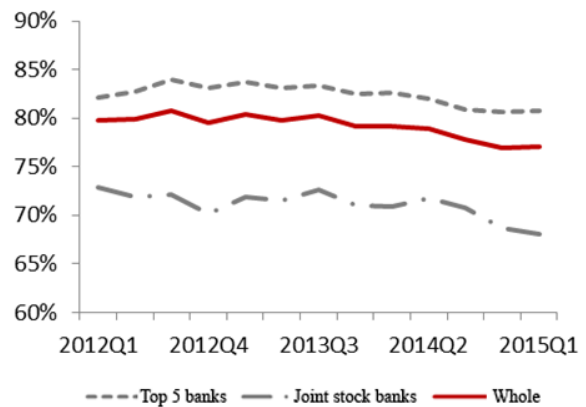


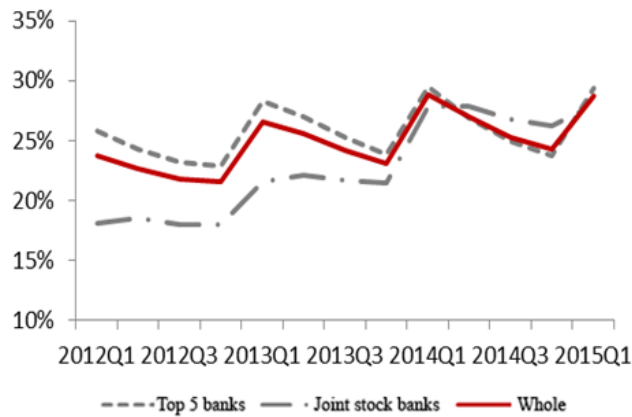
Figure 11: Deposit balance/total liabilities ratio of listed banks



As at the first quarter of 2015, the proportion of non-interest income in listed banks' total income

(weighted average, the same below) was 28.76%, a year-on-year decrease of 0.13 percentage point. The ratio was 29.33% on average for the top 5 banks, a year-on-year decrease of 0.12 percentage point; and it was 27.97% on average for the joint stock banks, a year-on-year increase of 0.05 percentage point.

Figure 12: Proportion of non-interest income of listed banks



III.1.4 NPL balance and NPL ratio continued to increase, while the provision coverage ratio declined considerably

As of the end of Q1 2015, NPL balance of listed banks was RMB758.06 billion, a year-on-year increase of 46.38%, 24.26 percentage points higher over last year; and the NPL ratio of listed banks (weighted average, the same below) was 1.33%, a year-on-year increase of 0.32 percentage point. Among these banks, NPL balance of the top 5 banks amounted to RMB576.41 billion, a year-on-year increase of 44.20%, 26.92 percentage points higher over last year; and the NPL ratio of the top 5 banks was 1.37%, a year-on-year increase of 0.33 percentage point. NPL balance of the joint stock banks was RMB171.35 billion, a year-on-year increase of 54.18%, 11.73 percentage points higher over last year; and their NPL ratio was 1.22%, a year-on-year increase of 0.31 percentage points. Accelerated exposure of non-performing loans during the economic downturn led to faster-than-expected rise in the NPL ratio.

Figure 13: NPL growth of listed banks

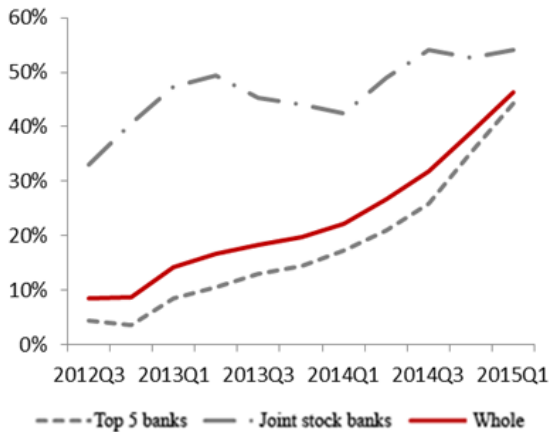
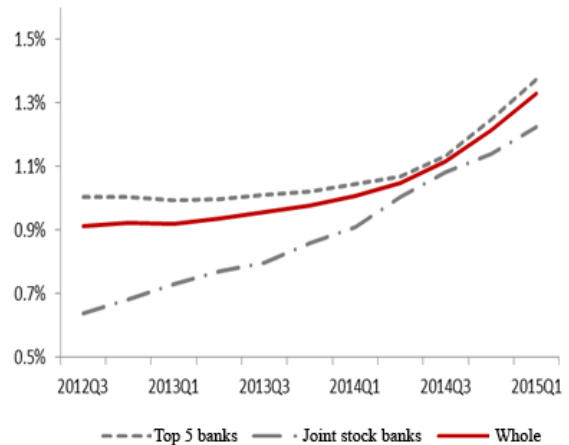
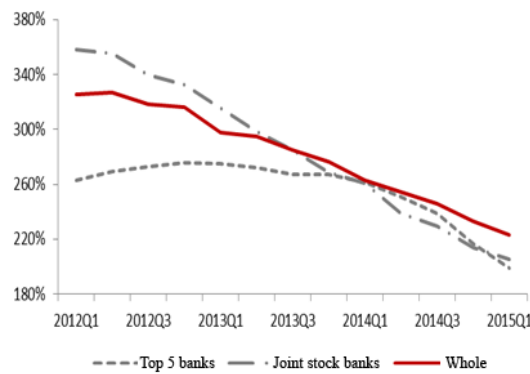


Figure 14: NPL ratio of listed banks



During the first quarter of 2015, average provision coverage ratio of the listed banks was 223.13%, a year-on-year decrease of 39.92 percentage points; that of the top 5 banks was 199.12%, a year-on-year decrease of 62.28 percentage points; and that of the joint stock banks was 205.28%, a year-on-year decrease of 55.42 percentage points.

Figure 15: Provision coverage ratio of listed banks



III.1.5 Capital adequacy ratio remained stable, while the liquidity pressure rebounded

During the first quarter of 2015, capital adequacy ratio, tier-1 capital adequacy ratio and core tier-1 capital adequacy ratio of listed banks were 12.35%, 10.00% and 9.81%, an increase of 0.88, 0.65 and 0.46 percentage points respectively compared with the same period of last year. Ratios of the top 5 banks were 14.06%, 11.64% and 11.24%, a year-on-year increase of 1.50, 1.42 and 1.02 percentage points respectively; and ratios of the joint stock banks were 11.34%, 9.15% and 9.07%, a year-on-year increase of 0.62, 0.37 and 0.30 percentage points respectively.

Figure 16: Capital adequacy ratio of listed banks

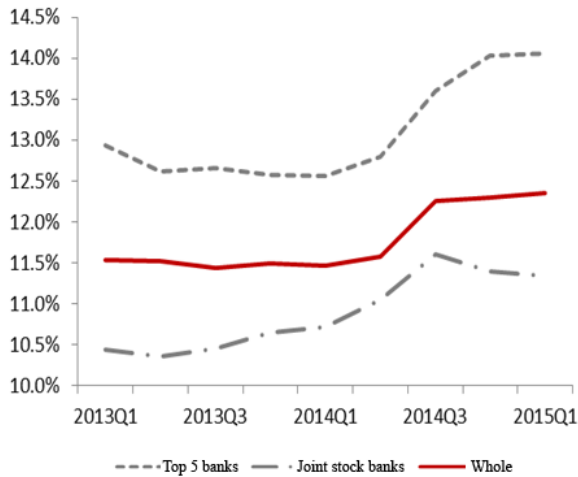
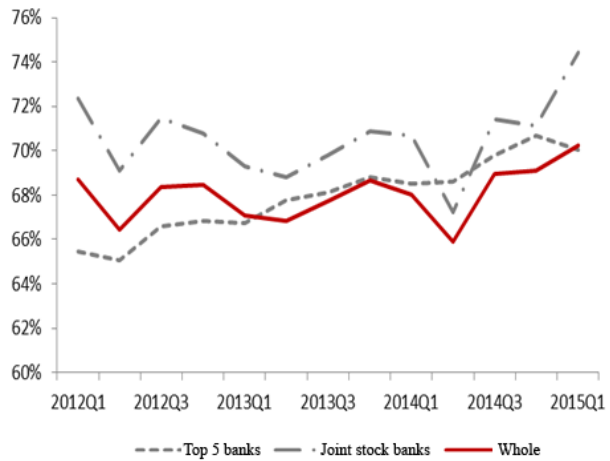


Figure 17: Loan-to-deposit ratio of listed banks



During the first quarter of 2015, loan-to-deposit ratio of listed banks noticeably rebounded and reached 70.24%, a year-on-year increase of 2.20 percentage points. Average loan-to-deposit ratio of the top 5 banks was 70.03%, a year-on-year increase of 1.53 percentage points; and average loan-to-deposit ratio of the joint stock banks was 74.42%, a year-on-year increase of 3.75 percentage points.

III.2 Banking industry outlook for 2015

III.2.1 Operation in Q2 2015

During the second quarter of 2015, the following three factors imposed significant impact on operation of the banking industry:

First, economy. During the second quarter of 2015, growth of the “three engines” continued to slow down. During January to May, retail sales of consumer goods increased by 10.4% over the same period of last year, a year-on-year decrease of 1.7 percentage points; the fixed asset investment saw a year-on-year increase of 11.4%, a decrease of 5.8 percentage points over last year, while the real estate investment grew by 5.1%, a decrease of 9.6 percentage points over last year; and total import and export registered a year-on-year decrease of 8.0%. We estimate that GDP growth in Q2 will decline to around 6.8% along with continued release of credit risks. This put profitability of the Chinese banking sector under severe challenges.

Second, policy. During the second quarter of 2015, the central bank launched one interest rate cut and one RRR (i.e. required reserve ratio) cut. In terms of RRR cut, on April 20, the People’s Bank of China (“PBOC”) reduced the RRR on RMB deposits of various deposit-taking financial institutions by one percentage point, and had an extra cut for the rural credit cooperatives, township banks, Agricultural Development Bank of China, as well as the national banks and joint stock banks which meet the prudent operation requirement and keep a certain percentage of “agro-related” or SME loans. In terms of interest rate cut, on May 11, PBOC reduced the benchmark interest rate for RMB deposits and loans of financial institutions by 0.25 percentage point. Guided by the moderate monetary policies of PBOC, the M2 growth rate slipped slightly and fell to 10.1%/10.8% in April/May respectively. We estimate that the growth rate of M2 will be 11% during the second quarter of 2015.

Third, reform. On May 11, PBOC raised upper limit of the deposit rate floating range to 1.5x the benchmark while cutting the benchmark rates of RMB deposits and loans. Additionally, along with issuance of CDs to corporate and personal customers, interest rate liberalization is approaching to an end, which will bring down profit of banks in the short term. Meanwhile, reform measures on asset-backed securitization, mixed ownership reform were rolled out in succession, and received warm response in the capital market.

From the above, we estimate that compared with the same period of last year, Q2 net profit of the listed banks will grow by around 2.5%, their assets and liabilities will increase by around 10% and around 9.5% respectively; and their NPL ratio will edge up slightly to hit about 1.45%.

III.2.2 Operation outlook of listed banks for Q3 2015

During the upcoming third quarter of 2015, factors influencing operation of the Chinese listed banks mainly include:

First, the economic growth rate is likely to bottom out. China aims to achieve a GDP growth rate of 7% in 2015. GDP growth rate in the first quarter of 2015 was 7%, broadly flat with the annual target. Considering the continuous sluggish performance of macro economy, the GDP growth rate is estimated to further decline in the second quarter of 2015. In order to attain the 7% annual target, a sort of “growth-stabilizing” policies and projects are expected to be launched during the second half year, calling for financial support. This creates a new growth driver for commercial banks.

Second, financial support will be stepped up. China’s M2 growth target for 2015 is 12%. This lays down a foundation for growth of banks’ business scale. In view of the slower-than-expected economic growth during the first half year, the authorities are expected to further cut the interest rate and RRR during the second half year. This provides possibility of the “making up for the loss of price with adequate volume” strategy and may neutralize impact of the shrinking interest margin.

Third, reform will be further deepened. In addition to cutting the interest rate, PBOC also expanded the upper limit of the interest rate floating range of RMB deposits. Zhou Xiaochuan, Governor of the PBOC, noted that the upper limit will likely be completely removed within this year. At present, upper limit of the interest rate of RMB deposits is 1.5x the benchmark rate, but none of the commercial banks raised deposit interest rate to the upper limit in practice. Competitions in the deposit market are differentiated. Negative expectations for the interest rate liberalization have been partly absorbed by the market. Looking ahead, its impact on banks will gradually diminish. Meanwhile, deepening of the reform initiatives such as the asset-backed securitization and mixed ownership reform will vitalize idle capitals of commercial banks, increase their growth momentum and boost their operating results. Additionally, the State Council reviewed and adopted the draft of the revised Commercial Banking Law recently, which changed the loan-to-deposit ratio from a statutory regulatory indicator to a liquidity monitoring indicator. This helps to ease the restrictions on banks, and encourages banks to offer more liquidity to support the real economy.

Forth, the “One Belt and One Road” initiative will bring in new opportunities. On March 28, the National Development and Reform Commission, the Ministry of Foreign Affairs, and the BOC Institute of International Finance

Ministry of Commerce jointly released the Visions and Actions on Jointly Building the Silk Road Economic Belt and 21st-Century Maritime Silk Road. Implementation of the “One Belt and One Road” initiative creates an important opportunity for commercial banks to support “Going Global” enterprises and transform operations. This will become a new growth driver of the commercial banks.

After analyzing impact of the above factors, we believe Chinese listed banks will continue to meet operating pressures during the third quarter of 2015. Overall, we project listed banks’ net profit to record a year-on-year increase of around 3%, their assets and liabilities will grow by about 10% and 9.5% respectively; and their NPL ratio will edge up slightly to reach about 1.5%.

Table 8: Forecast on main indicators of Chinese listed banks in 2015

		2013 (R)	2014 (R)	2015			
				Q1 R	Q2 E	Q3 F	2015 F
Scale	Asset growth rate	10.8%	11.2%	9.9%	10%	10%	~9.5%
	Liability growth rate	10.1%	10.6%	9.2%	9.5%	9.5%	~9%
Profit	Net profit growth rate	12.8%	7.8%	3.3%	2.5%	3%	~3%
	Percentage of loans	51.7%	52.0%	51.8%	52%	52.5%	~53%
Structure	Percentage of deposits	79.2%	77.0%	77.0%	77%	76.5%	~76%
	Percentage of non-interest income	23.1%	24.3%	28.8%	27.5%	25.5%	~24.5%
Quality	NPL ratio	0.90%	1.21%	1.33%	1.45%	1.5%	~1.5%
	Provision coverage ratio	276%	233%	233%	210%	205%	~200%
Capital	Capital adequacy ratio	11.5%	12.3%	12.3%	12.5%	12.5%	~12.5%

Note: R: review, E: estimate, F: forecast

IV. Hot topics

IV.1 Internationalization of domestic banks

As the second largest economy and the largest trade country in the world, China maintains trade exchanges with nearly 200 countries and regions in the world, and launches direct investment over 180 countries and regions. In 2014, along with China’s opening-up, advancement of RMB internationalization and “Going Global” of customers, internationalization of the Chinese banking industry accelerates.

IV.1.1 The top 5 banks recorded considerable progress in terms of internationalization

The top 5 Chinese banks, namely Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of China, China Construction Bank and Bank of Communications, are the main driving forces of internationalization in the Chinese banking industry. In 2014, overseas assets,

operating income and pre-tax profit of the top 5 banks reached RMB8.65 trillion, RMB172.4 billion and RMB92.9 billion respectively; and the number of their overseas employees and institutions came in at 39,000 and 1,138. Overseas business of the top 5 banks mainly demonstrates the following three characteristics:

First, overseas business grew faster than the group average. Average growth rate of the top 5 banks' overseas assets, operating income and pre-tax profit reached 21.6%, 29.5% and 35.5%, 6.9, 17.7 and 28.0 percentage points higher than their overall business growth rate.

Second, contribution of overseas business to the group company continues to increase. Overseas assets, operating income and pre-tax profit accounted for 8.7%, 7.2% and 7.7% of the top 5 banks' total assets, operating income and pre-tax profit, an increase of 0.5, 1.0 and 1.6 percentage points compared with 2013. Of these banks, Bank of China has the highest share of international business, whose overseas assets, operating income and pre-tax profit accounted for 27.4%, 19.4% and 23.0% of the group's total, an increase of 1.7, 1.7 and 3.6 percentage points compared with 2013.

Third, overseas business realized intensive development amid continued increase in operating results. This is mainly reflected in the phenomenon that the operating income and pre-tax profit of the top 5 banks' overseas business grew much faster than their overseas assets (7.9 and 13.9 percentage points higher respectively), and even higher than the less than 8% growth rate in the number of their overseas employees and institutions. The ROE, per capita net profit and per outlet net profit of overseas operations remarkably increased.

IV.1.2 The top 5 banks continued to boost investment in international business

Considerable achievements of the top 5 banks in the international business owed mainly to these banks' increased attention in terms of business strategy and resources input.

First, the top 5 banks increased attention to development of overseas business in terms of strategy. Bank of China clearly noted in the overall requirements on development strategy that, it aims to "keep leading advantages in the process of globalization". As of the end of 2014, it had 628 overseas institutions which covered 41 countries and regions; and 7 of these overseas institutions (including those in Hong Kong) had acquired the qualification for RMB clearing banks. Industrial and Commercial Bank had been resolutely following the overseas M&A strategy to push ahead internationalized development. It had 338 overseas institutions at the end of 2014 which covered 41 countries and regions; and 5 of these overseas institutions (including those in Singapore) had acquired the qualification for RMB clearing banks. China Construction Bank accelerated its internationalization pace and had set up an extensive overseas network that covered 20 countries and regions and won the RMB clearing bank qualification in London. Overseas network of Agricultural Bank of China and Bank of Communications had covered 13 countries and regions respectively; and Bank of Communications has become an RMB clearing bank in Seoul.

Second, the top 5 banks significantly increased resources input, and their capital input in the overseas institutions grew remarkably. In 2014, the top 5 banks' overseas capex reached RMB74.8 billion, an increase of nearly one fold compared with the RMB37.8 billion in 2013. These capex accounted for 33.3% of the top 5 banks' overall capex, an increase of 21.2 percentage points compared with 2013. Increase of the top 5 banks' capex in overseas market means that these

banks had beefed up investment in long-term assets of the overseas institutions, such as fixed assets, constructions in progress and intangible assets. This laid down a solid foundation for further expansion of their overseas business.

Third, Bank of China still maintained an absolute lead. The ratio of overseas business in Bank of China's total operation continued to stay at above 50%, marking a leading level in the industry. However, the peer banks were catching up.

IV.1.3 Main problems during internationalization of the Chinese banking industry

First, contribution of overseas business to the group's operation remains low, especially in terms of profit indicators. Based on the experience of developed countries, there are generally several large international banks that maintain solid strength as well as differentiated and complementary operations. International business generally contributes a high percentage of the group's overall return, in order to meet the massive financial service demand of "Going Global" companies in the real economy. Relative to large international banks, proportion of the top 5 banks' overseas business is still low. In 2014, overseas business accounted for less than 10% of the top 5 banks' overall assets, and the ratio was less than 30% even in Bank of China which had the largest share of overseas business. Overseas operating income and pre-tax profit of the top 5 banks took up 7.2% and 7.7% of the total in 2014, 1 percentage point lower than the ratio by assets (8.7%), showing a greater gap compared with the large international banks. Low profitability of the overseas business will impact the top 5 banks' enthusiasm of developing international business.

Second, degree of business diversification declined, and sustainable development is up against challenges. In 2014, development of the top 5 banks' overseas business was excessively concentrated on the interest margin business and corporate customers. In general, these businesses are featured in large business scale and low access threshold. Banks are able to rapidly boost their business size, although serious fluctuations may occur during the operation. If the operating environment changes, sustainable development of these businesses may come under challenges and the growth rate will decline. In 2014, percentage of interest income in the top 5 banks' overseas operations continued to increase and reached 53.6%, 8 percentage points higher than 2010; and the ratio of corporate loans in overseas operations rose close to 90%, much higher than the around 70% average in the industry.

Third, outlet distribution needs to be enhanced, and the top 5 banks have yet to establish a mainstream position in key regions. Decentralization and coverage of the Chinese banking industry's overseas institutions, assets and operating revenue is weaker than coverage of the investment and trade. This is especially true in regions along the "One Belt and One Road". As of the end of 2014, Bank of China which had the largest share of overseas business had set up operating branches and representative offices in 18 countries and regions along the "One Belt and One Road", lower than CitiGroup (32) and HSBC (27).

Additionally, synergy between the domestic and overseas business needs to be further improved. Relative to capital cooperation, domestic and overseas operations of the top 5 banks seldom cooperated over agency sale, customer marketing, investment banking service etc.

IV.1.4 Countermeasures and advices

In the backdrop that China is entering a new normal, the large banks are facing increasingly fierce competition in the domestic market. Acceleration of the “Going Global” drive lays down a sound foundation for internationalization of Chinese banks. Additionally, exchange rate of RMB has come to a relatively equilibrium level, and the small likelihood of substantial appreciation will effectively remove the concerns over depreciation on foreign currency assets and revenue in internationalization of banks. At present, the Chinese banking industry shall grasp the historical opportunity to consolidate its advantages in the international market.

First, the industry should develop a strategic plan that meets needs of the country’s opening-up and reform and supports proper overseas development of the financial industry as soon as possible, and change the disorderly competition landscape of the financial industry in overseas markets. The regional location, product categories and services of each bank’s overseas operation should be decided based on their unique characteristics to orderly promote expansion of overseas business.

Second, Chinese banks shall start from the regions along the “One Belt and One Road” to speed up international expansion over the next 5-10 years. On the basis of boosting organic growth, banks shall launch M&As at opportune time to accelerate pace of internationalization. Banks shall insist on the principles that the M&A target shall complement with their development strategy, management capability and development stages, and seize the accurate timing to effectively reduce the cost of M&A and restructuring.

Third, banks shall formulate standards for decisions on the group’s investment and capital allocation strategies when planning the global development. They shall give full consideration to the group’s strategies such as business connections and regional development potential, as well as the performance indicators such as profitability, operating efficiency and liquidity, make comprehensive assessment of the target market and adopt corresponding strategies.

Fourth, banks shall give full play to their professional competence, improve the business model of guiding customers through moderate loan resources and focusing on comprehensive financial arrangements, and maximize business development with a small scale of capital. While enhancing cooperation over financing issues, banks shall encourage domestic and overseas branches to innovate business, cooperate and set up a profit distribution mechanism in fields such as customer recommendation, market survey, financial advisory and agency services, in an effort to jointly improve the comprehensive customer service capability.

Fifth, banks shall give priority to globalization of the corporate business, meet financial needs of the “Going Global” Chinese corporate customers, and strive to offer deposit, lending, remittance, foreign exchange and cash management services for the overseas transnational companies that are entering the Chinese market. Banks shall formulate a set of criteria for decisions on business line allocation, and, with sound corporate business, give consideration to the difference in culture and supervisor requirements, relevance to the group’s strategy, as well as the market factors such as market potential and competition landscape to decide whether to launch retail services in local market.

IV.2 Capital management experience of G-SIBs and implications on the Chinese banking industry

As the Basel III capital regulation plan was successively implemented across the major economies, G-SIBs were under severe capital pressure and have adopted a series of measures in response.

IV.2.1 Main strategies adopted by the G-SIBs to increase their capital ratio

Boosting capital (i.e. the numerator strategy) becomes the main capital management strategy after the crisis. After the crisis, rollout of the Basel III increased requirements on banks' capital and quality; meanwhile the requirements on risk-weighted assets became more stringent. This reduced the room for banks to boost their capital ratio by "reducing" the denominator. Therefore, the G-SIBs changed their capital management strategy from the denominator strategy to the numerator strategy. They mainly adopted the following strategies to increase their numerators:

IV.2.1.1 reducing the dividend payout ratio. After the crisis, main banks converted an increasing share of profit to capital surplus by reducing the dividend payout ratio, thus boosting their capital. From 2004 to 2007, average dividend payout ratio of main G-SIBs was 44.48%, and this ratio declined to 20.76% after the crisis, a decrease of 23.72 percentage points. Based on net profit of these banks in 2013, reducing the dividend payout ratio by 23.72 percents can boost their capital adequacy ratio by 0.44 percentage point on average. It may boost capital ratio of the G-SIBs cumulatively by 2-2.5 percents in five years.

IV.2.1.2 managing the market capitalization to support additional stock issuance. After the crisis, the G-SIBs adopted a series of market capitalization management strategies (such as adjusting the dividend payout ratio, repurchasing stocks, adjusting the compensation incentive mechanism for employees and the management) to continuously increase their stock valuations, and took advantage of the valuation increase to support additional stock issuance. Since 2009, main banks raised a total of USD100.87 billion from the stock market, which increased their capital adequacy ratio by 1.87 percentage points on average.

IV.2.1.3 making use of the remuneration incentive mechanism to replenish capital. Equity incentive is an important means of capital replenishment. Using part of the employees' remuneration to buy stocks during the additional issuance programs not only helps banks to boost their capital but also aligns interests of the bank with those of their employees. In this way, it works to improve banks' corporate governance mechanism. In addition to equity incentive mechanism, G-SIBs have also tried other remuneration incentive mechanisms, for instance the deferred contingent capital plan launched by UBS.

IV.2.1.4 Issuing a large scale of contingent convertible capital instruments. The Basel III raised stricter requirements on risk absorption capability of the banking capitals. Changes in the rules made issuance of contingent convertible capital instruments (CoCos) an important means for G-SIBs to expand their capital size. Since 2009, main banks of the G-SIBs raised USD66,667 million through issuance of CoCos, including USD27,385 million in other tier-1 capital and USD39,282 million in tier-2 capital.

Adoption of the denominator strategy noticeably declined with reduced overestimation in capital adequacy ratio. After the crisis, as Basel III put forth stricter supervisory requirements on

application of the internal rating-based approach, the denominator reduction (based on regulatory arbitrage) remarkably declined, and the condition of overestimated capital adequacy ratio was noticeably reduced. Commercial banks were inclined to meet the capital adequacy ratio requirement through de-leveraging and adjustment of asset structure.

IV.2.2 Effect of the strategies

Implementation of the strategies for boosting capital produced a series of impact:

First, banks' capital steadily increased. As of the end of Q2 2014, average capital adequacy ratio and tier-1 capital adequacy ratio of the 30 G-SIBs was 15.63% and 12.81%, an increase of 2.03 and 2.75 percentage points, respectively, compared with the end of 2008.

Second, banks' capital structure evolved towards the regulatory requirements. As of the end of Q2 2014, the tier-1 capital/total capital ratio of the G-SIBs averaged 82.3%, an increase of 8.59 percentage points compared with 2008 and 1.5 percentage points higher than the ideal condition under Basel III. The core tier-1 capital/total capital ratio of the 24 G-SIBs averaged 72.54%, an increase of 3.16 percentage points compared with 2012 but 0.56 percentage point lower than the ideal condition under Basel III.

Third, banks' asset structure remarkably changed. The ratio of capital-intensive assets continued to decline, and that of assets with low capital occupation continued to increase. The banking system became increasingly reluctant to lend.

Fourth, capital cost increased. As the newly issued capital instruments included equity conversion and write-down articles, banks' financing cost increased. Comparison shows that premium of the coupon rate of CoCos relative to the benchmark rates is 50 to 100 basis points higher than the same-class capital instruments prior to the crisis.

Fifth, "de-leveraging" became a noticeable trend and caused negative impact on recovery of the real economy. From 2009 to 2013, average asset growth rate of the 30 G-SIBs was only 0.91%, significantly lower than the average level prior to the crisis. The increasingly strict supervisory requirement on capital was an important reason for the decline in asset growth rate. Slowdown of the asset growth was mainly reflected in extension of credits. The banking industry of major economies was generally reluctant to lend during recovery of the real economy, which to some extent subdued the economic recovery.

Sixth, landscape of the global banking industry changed. Another impact of the capital regulation on G-SIBs was that large banks generally adopted a "slimming strategy": RBS -- the largest bank in the world by asset scale prior to the crisis -- significantly reduced overseas business and shifted its business focus to the local markets; Barclays considerably downsized its overseas investment banking business. In sharp contrast to the foreign G-SIBs, Chinese banks were subject to relatively mild capital regulation pressure due to their steady operation during the crisis, and noticeably accelerated overseas expansion after the crisis.

IV.2.3 Main gap of the domestic banks

In terms of capital management, the large domestic banks still lagged behind the foreign G-SIBs. This is mainly reflected in:

First, gap in capital size. As of the end of 2014, average tier-1 capital adequacy ratio and capital adequacy ratio of the three domestic G-SIBs were 11% and 13.74%, 2.47 and 3 percentage points lower than the average level of the rest 19 G-SIBs, respectively. Along with wide implementation of the TLAC regulatory rules, Chinese G-SIBs may be required to keep the total loss-absorbing capacity at 19.5%-23.5%. Although the capital of the domestic G-SIBs is relatively abundant in the short term, they are still subject to heavy capital replenishment pressure compared with the foreign G-SIBs and the future regulatory requirements.

Second, relatively simple capital structure. Based on requirements of the Basel III, other tier-1 capital shall account for 8% to 9% of banks' total capital. In China, domestic commercial banks barely have any other tier-1 capital, while the ratio is generally around 10% in foreign G-SIBs.

Third, simple means of the numerator strategy. In terms of internal financing, first: domestic banks' adjustment of the dividend payout ratio is insignificant; second, they make little capital replenishment arrangement based on the remuneration incentive policy; third, their efforts on raising funds from the overseas market are weak; fourth, domestic banks show weak market value management capability, and restrained by the legal requirements, they can't effectively manage their market value through stock repurchase or other measures; fifth, due to incompleteness of capital instruments, domestic banks have little choices in terms of other tier-1 capital instruments.

Fourth, weak capability in independent risk measurement. Although the China Banking Regulatory Commission has approved six banks to adopt the "advanced approach" to measure risk-weighted assets in 2014, the independence of such "advanced approach" was merely equivalent to the foundation IRB approach of the Basel II, while an absolute majority of the foreign G-SIBs have adopted the advanced IRB approach to assess risks.

IV.2.4 Policy advices

The Chinese banking industry may refer to the main strategies adopted by the G-SIBs after the crisis in capital management, and adopt a prudent approach that is "dominated by the numerator strategy, and combines the numerator and denominator strategies":

First, enhance market value management and create conditions for IPO and additional issue. As the capital market recovers, valuation of the banking industry will remarkably improve. This will pave the way for the listed and non-listed banks to launch equity financing. Domestic banks shall adapt to the trends of market-oriented reform, develop effective market value management strategies, guide share prices on the secondary market through stock repurchase, dividend policy, equity incentive plans etc., in order to create conditions for IPO and additional issue.

Second, promote mixed ownership reform and expand the capital source through remuneration incentive policies. Implementing mixed ownership reform and launching employee stock ownership plans are important development directions of the banking industry. Domestic commercial banks shall actively study the feasibility of rolling out such plans and relevant remuneration incentive policies, broaden the capital channels through innovation of the remuneration incentive mechanism, enhance corporate governance and stimulate the enthusiasm of employees.

Third, push ahead with internationalization and take advantage of the overseas market to

increase capital. Large domestic banks shall push ahead with the internationalization process based on their strategic needs, and make full use of the historical opportunity presented by mixed monetary policies and record-low financing cost in major economies to raise low-cost funds through overseas branches.

Fourth, step up innovation of capital instruments and tactically select the financing instruments. As for other tier-1 capital, domestic banks still enjoy vast potential of capital instrument innovation, for instance the CoCos and trust preferred securities that increase banks' other tier-1 capital. While innovating capital instruments, commercial banks shall also select proper financing instruments according to the market changes, and try to raise fund through IPO, additional issue, equity incentive plan, adjustment of the dividend payout ratio etc. when the stock market is active, and select debt capital instruments such as preferred shares and CoCos when the stock market is sluggish.

Fifth, prudently implement the denominator strategy. First, domestic commercial banks shall implement the advanced rating approach, improve allocation of economic capital and reduce the scale of risk-weighted assets. They shall step up efforts on asset-backed securitization, diversify risks and reduce occupation of risk-weighted assets. Meanwhile, they shall adapt to the slowing economic growth, promote transformation of banking business, focus on development of the business with fewer capital occupation (such as fee-based business and non-interest income business), reasonably control the pace of asset expansion, and put an end to the development model of "asset expansion - capital expansion - asset expansion".

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