



Global Banking Industry Outlook

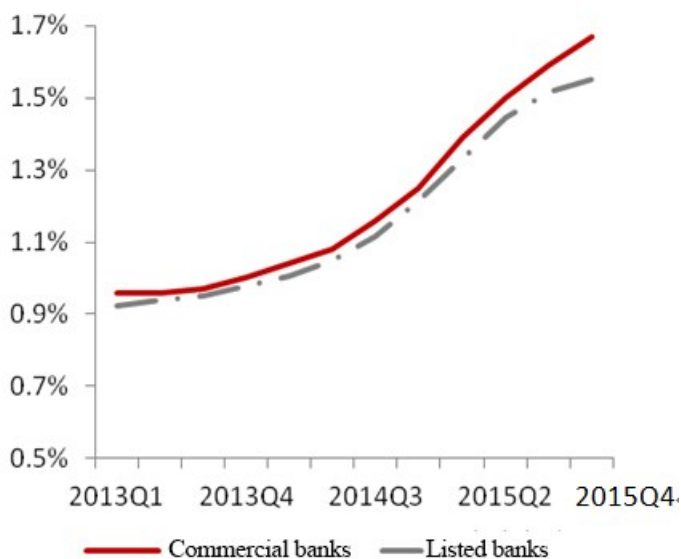
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Highlights

- In 2015Q4, the banking industry in Eurozone and Japan did not perform well due to slow economic growth, wide fluctuation of commodity price and introduction of negative interest rate policy; in comparison, the banking industry in the US and the UK posted healthy operation.
- In 2016Q1, China's listed banks was faced with strong operation pressure, with growth of net profits estimated at 2% year on year and NPL ratio rising to 1.65%. They must adapt to the macro environment of supply-side reform and seize opportunities for robust growth.
- The report also looks at such special subjects as inclusive finance development of China's banking industry, FSB's launching of TLAC policy and recent operating loss of large European banks, etc.

NPL Ratio of Chinese Commercial Banks and 16 Listed Banks



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Adapting to Supply-side Reform and Mitigating Existing Operation Pressure

----Global Banking Industry Outlook (2016Q2)

Since 2015Q4, against the backdrop featuring continual slumping price of bulk commodity, significant depreciation of emerging economies' currencies and introduction of negative interest rate policy by Eurozone and Japan, operation and growth of major countries' banking industry have faced with great uncertainty, with that in Eurozone and Japan in bad operation and that in the U.S. and the UK operating steadily. In 2016, the uncertainty in operation and growth of global banking industry further aggravated, presenting Eurozone and Japan with major challenges. In 2016Q1, China's banking industry maintained stable growth on the whole, and the overall risk was controllable albeit some local exposures. In general, China's economic downward pressure may continue and the banking industry still faces enormous challenges. Meanwhile, China proposed to strengthen the supply-side reform and put forth five development concepts of "innovation, coordination, green, openness and sharing", providing structural opportunities for China's banking industry and vital timing for mitigating operation pressure.

I. Banking Industry Operation and Outlook of Major Economies

I.1 U.S. banking industry

I.1.1 Operating profile

The size of assets and liabilities grew stably. As of 2015Q4, total assets of the U.S. banking industry^① stood at USD16 trillion, up 2.7% year on year and 1.1% higher than the previous quarter; total liabilities amounted to USD14.2 trillion, up 2.5% year on year and 1.1% higher than the previous quarter; total capital registered USD1.8 trillion, up 4% year on year and 0.7% higher than Q3. Profitability grew significantly and operation efficiency kept improving. Driven by sharp decrease of legal costs, net profit of the U.S. banking industry recorded USD40.8 billion, an increase of 11.9% from the previous year and 6.3% from the previous quarter; though the net interest margin (NIM) fell by 0.1 percentage points, the net interest income grew by 3.6% year on year. ROA and ROE was 1.1% and 9.3%, growing by 0.03 percentage points and 0.3 percentage points respectively; the cost/income ratio was 59.9%, down by 0.08 percentage points from the previous year and 1.97 percentage points from Q3 (Table 1).

Table 1: Size Change of the U.S. Banking Industry (USD100 million, %)

	2015Q4	2015Q3	2014Q4	Change from the previous quarter	Change from the previous year
Assets	159679	158001	155538	1.06	2.66
Liabilities	141576	140030	138129	1.10	2.49
Capital	18103	17971	17409	0.73	3.99
Net profit	408	384	365	6.25	11.92
Net interest income	1113	1087	1075	2.39	3.53
Non-interest income	630	633	600	-0.47	5.00

Sources: FDIC, BOC Institute of International Finance

① Banking industry herein refers to all deposit financial institutions protected by FDIC deposit insurance.

The capital adequacy ratio (CAR) edged down while asset quality remarkably improved. As of 2015Q4, the tier 1 CAR of U.S. banking industry was 12.7%, down 0.3 percentage points year on year and 0.1 percentage lower than Q3; NPL ratio was 2.3%, dropping by 0.5 percentage points from the earlier year and 0.5 percentage points lower than the earlier quarter (Table 2)

Table 2: Change of Indicators of the U.S. Banking Industry (%)

	2015Q4	2015Q3	2014Q4	Change from the previous quarter	Change from the previous year
NIM	3.07	3.05	3.14	0.02	-0.07
ROA	1.04	1.05	1.01	-0.01	0.03
ROE	9.31	9.33	9.01	-0.02	0.30
Cost/income ratio	59.91	59.99	61.88	-0.08	-1.97
Tier 1 CAR	12.67	12.73	12.96	-0.06	-0.29
NPL ratio	2.29	2.32	2.80	-0.51	-0.48

Sources: FDIC, BOC Institute of International Finance

I.1.2 Regulatory environment

Since 2015Q4, the regulatory environment of the U.S. banking industry had the following changes:

(1) The Fed slowed down interest hike

The Fed launched the monetary policy normalization process and raised the interest rate for the first time in 2015. The impact of monetary policy evolution in 2016 on the U.S. banking industry merits attention. On March 16, 2016, the Federal Open Market Committee (FOMC) decided to maintain the benchmark rate within the range of 0.25%-0.5%. It's highly probable that the Fed will raise interest rate in 2016 amidst overall healthy development of the U.S. economy, although it didn't do so at this meeting, slowing down the process. The monetary policy stance of the U.S. will impose substantial influence over the banking industry's NIM and trading gains.

(2) The Fed's TLAC regulation standard is higher than the overall requirement of FSB

On October 30, 2015, the Fed published its proposal on Total Loss Absorbing Capacity (TLAC) requirements for G-SIBs, and completed opinion solicitation at the end of February 2016. It is expected that the final TLAC regulation will be released within 2016. The TLAC regulation released by the Fed is stricter than the FSB's international requirements on TLAC in the following aspects:

First, the Fed imposes internal TLAC requirements on intermediate holding companies. The Fed imposes minimum internal TLAC requirements on intermediate controlling companies, the amount of which depends on the resolution plan^② of the parent bank of foreign banks' U.S. operations. Second, the Fed applies a penalty mechanism to branches implementing multi-point resolution plan. The Fed tends to apply a single-point resolution plan to U.S. operations of foreign banks and imposes stricter regulatory requirements on foreign entities implementing multi-point resolution

^② Single-point resolution plan refers to resolution led by home regulators, which generally applies to financial institutions with most assets in the home country; for financial institutions with similar size of assets in each country, a multi-point resolution plan is typically adopted, meaning that the resolution will be jointly carried out by regulators of several countries.

plan, including higher capital requirements.

Third, it applies more stringent requirements on TLAC long-term debt instruments. For long-term bonds due within 1-2 years eligible for inclusion in TLAC capital, the Fed requires that they can be treated as TLAC capital only with 50% deduction. Debt instruments used to meet internal TLAC requirement shall also satisfy the following conditions: the debt must be issued directly by a branch to the head office; the debt repayment priority is inferior to debt of other branches; the contract must contain share conversion provisions.

Based on calculation, to meet TLAC requirements of 16% and 18%, eight globally systemic important banks (hereafter “G-SIBs”) of the U.S. will face total fund gap of USD73.55 billion and USD86.72 billion respectively. It is foreseeable that implementation of the TLAC policy will exert certain impact on the operations of large U.S. banks.

(3) The Fed published the Comprehensive Capital Analysis and Review 2016

On January 28, 2016, the Fed published the Comprehensive Capital Analysis and Review 2016 (hereafter “CCAR 2016”). CCAR 2016 covers 33 bank-controlled companies whose asset size exceeds USD50 billion. The report describes in detail the ways in which bank-controlled companies apply latest technology innovation to stress testing and capital planning. CCAR is a comprehensive review on the capital planning and capital adequacy of large U.S. bank-controlled companies. A critical link of CCAR is to test whether the capital adequacy level of large financial institutions can pass the stress testing scenarios specified in Dodd-Frank Act. In 2016, stress testing will focus on such scenarios as 5-10% higher unemployment rate, distressed corporate financial position and negative short-term T-bond yield. Scenarios are divided into severely adverse, stress and baseline scenarios, as per different degrees of influence.

I.1.3 Outlook

In the rest period of 2016, the U.S. banking industry will continue to be influenced by monetary policy keynote and rate hike steps of the Fed. As the banking industry is very sensitive to interest rate, monetary policies of the Fed as well as other determinants of interest rate, such as real GDP, labor market and inflation, will influence the banking industry’s operating income to a large extent.

On the other hand, the U.S. regulators will introduce new implementing rules based on provisions of the Dodd-Frank Act; in terms of overall thoughts, they will stick to the principle of differentiated treatments to large and small banks, as large banks face higher regulatory cost as a whole while small-sized banks with high ratings face less regulatory pressure; as the U.S. macro economy continues its mild growth, the U.S. banking industry will maintain healthy development on the whole.

I.2 Eurozone banking industry

I.2.1 Operating profile

Money supply slowed down and inter-bank rate continued to fall. As of the end of 2015Q4, the M3 in the Eurozone increased by 4.9% (1.4 percentage points lower than Q3) from a year earlier to EUR10.8 trillion. In the same period, the 3-month and 1-year Euribor was -0.13% and 0.06% respectively, down 0.09 and 0.08 percentage points versus Q3.

Deposits and loans maintained modest expansion with the growth of deposits higher than loans. As of the end of 2015Q4, the deposit balance in the Eurozone totaled EUR8.7 trillion, an increase of 3.4% from a year earlier, up 0.4 percentage points from Q3. By country, Malta, Estonia and Slovenia grew faster at 12.9%, 11.1% and 9.9% respectively; Greece and Luxemburg recorded substantial decrease of 23% and 8.6% respectively. In the same period, the outstanding loans in the

Eurozone totaled EUR9.6 trillion, a year-on-year increase of 1.1%, but down 0.5 percentage points from Q3. By country, loans of Luxemburg, Slovakia and Belgium grew faster at 13.6%, 9.7% and 8.2% respectively, while Ireland, Slovenia and Malta recorded substantial decrease of 10.3%, 5.3% and 4.4% respectively.

Profitability fell slightly and operating efficiency declined substantially. As of the end of 2015Q4, the ROA of major banks in the Eurozone was 0.4%, unchanged from Q3; the ROE fell by 0.7 percentage points from Q3 to 7.1%; net interest margin stood at 1.5%, unchanged from Q3; cost/income ratio was 71.8%, up 11.9 percentage points from Q3.

CAR decreased while asset quality improved. As of the end of 2015Q4, tier 1 CAR of major banks in the Eurozone stood at 15%, down 0.7 percentage points from Q3; NPL ratio was 3%, down 0.7 percentage points from Q3. Geographically, banks with poor asset quality in the Eurozone mainly concentrate in “PIIGS”. As of the end of 2015, NPL ratio of banks in Greece, Italy, Portugal and Spain reached 34.4%, 17.3%, 12.3% and 7% respectively. In contrast, the banking industry of Germany, Netherlands, Austria, France and Belgium enjoyed better asset quality, with NPL ratio at 2.3%, 2.9%, 3.5%, 4.2% and 4% respectively.

I.2.2 Regulatory environment

The Single Resolution Mechanism (hereafter “SRM”) of Europe has been fully implemented since January 1, 2016. SRM operates as follows: The regulatory authorities supervise financial institutions through the Single Supervision Mechanism (hereafter “SSM”) and timely identify institutions with severely distressed financial position or in need of bailout; subsequently, regulators of the host country, SSM and the Single Resolution Board (hereafter “SRB”) discuss and agree on a bailout plan, including whether, when and how to bail out these institutions and how to use the Single Resolution Fund (hereafter “SRF”), as well as other specific rules. SRB is responsible for supervising implementation of the bailout plan. Fund of SRF is paid annually in 8 years by all financial institutions under supervision and the payment amount is primarily linked to their deposits.

The establishment of SRM is a milestone in the development of European Banking Union which helps restrict any country’s intervention in bailout of “troubled institutions”, improve bailout efficiency and reduce related cost; meanwhile, by monitoring risks in an overall perspective of the Eurozone, it may effectively prevent cross-border spillover effect brought by resolution of “troubled banks”; the creation of SRF provides guarantee for rights of depositors and taxpayers and facilitates enhancement of financial stability.

I.2.3 Outlook

Affected by weak economic recovery, introduction of the negative interest rate policy and other factors, growth prospect of the Eurozone banking industry is faced with severe challenges. Meanwhile, with continuous increase of the regulatory compliance cost and staff expenses, the banking industry’s overall performance is unlikely to improve in a short time and risks in some large banks merit intense attention.

I.3 UK banking industry

I.3.1 Operating profile

Retail deposit continued to grow while wholesale deposit continued to fall. As of the end of 2015Q4, total M4 in the UK reached GBP2,114.68 billion, up 0.5% year on year, an increase of one percentage point from Q3. Among the M4, retail deposit and cash stood at GBP1,580.66 billion, up 5.8% year on year, 0.4 percentage points higher than Q3; wholesale deposit was

GBP530.78 billion, down 12.5% year on year, 1.7 percentage points higher than the previous quarter.

Retail loan grew rapidly while institutional loan witnessed negative growth. As of the end of 2015Q4, the outstanding retail loans stood at GBP1,229.7 billion, up 3.4% year on year, 0.5 percentage points higher than Q3. Specifically, the real estate mortgage loans rose by 3.3% year on year to GBP1,109.9 billion while consumer credit grew by 4.4% to GBP119.8 billion; the outstanding loans of financial and non-financial institutions totaled GBP905.1 billion, down 3.6% year on year. The net loans in the construction and service sectors fell by 27.6% and 2.3% respectively.

CAR increased and asset quality improved. As of 2015Q4, the tier 1 CAR of G-SIBs in the UK stood at 15.5%, an increase of 3 percentage points from a year earlier and 1 percentage point from a quarter earlier; NPL ratio declined by 0.7 percentage points to 3.3%, up 0.2 percentage points from the previous quarter.

I.3.2 Regulatory environment

On July 8, 2015, the British government announced to gradually reduce the highly controversial bank levy and replace it with bank corporation tax surcharge.

UK introduced bank levy upon global liabilities of UK-headquartered banks and British liabilities of foreign banks in 2011, aimed at increasing fiscal tax revenue on the one hand, and restricting maturity mismatch caused by overexpansion of banks, guiding them to properly cut liability size, strengthen loss absorption capacity and avoid “too big to fail” on the other hand. However, bank levy triggered dissatisfaction of large international banks, including HSBC, towards operation and competition environment in the UK. They even proposed to move the headquarters out of the UK. As bank levy has largely completed its mission, the British government has decided to substantially lower the bank levy rate step by step starting from 2016. By 2021, banks’ taxable short-term liability tax rate will have been decreased from 0.21% to 0.1% and taxable long-term liability tax rate from 0.105% to 0.05%. Bank levy cut will encourage local banks like HSBC to stay in the UK and strengthen their competitiveness.

Meanwhile, the British government creates a new tax named “Bank Corporation Tax Surcharge” to offset the negative impact of bank levy cut on fiscal revenue. An additional 8% bank corporation tax surcharge will be imposed on banks starting from January 1, 2016. The tax base of bank corporation tax surcharge is bank profit, which is more reasonable than the liability size-based bank levy, thus welcomed by mainstream UK banks. The UK will cut its corporate tax rate from 20% to 17% by 2020. By then, the overall corporation tax rate of UK banking industry will be 25% (including an 8% bank corporation tax surcharge), relatively competitive among global developed countries.

I.3.3 Outlook

British economy slowed down in 2015, but is expected to maintain positive growth in 2016. In February 2016, Bank of England lowered economic growth and inflation expectation for the next two years, and announced that in terms of monetary policy, the benchmark interest rate would be maintained at 0.5%. It is predicted that an easing monetary policy will dominate development of the future market and no risk hike is scheduled in the short term. As the downward oil price and sluggish global economy and trades impose negative impact on the overall British economy, return on capital of the UK banking industry is faced with challenges. However, since 2009, major banks in the UK have increased capital and shares, resulting in enhanced emergency response capability and strong loss absorption ability. Overall, the UK banking industry has a stable outlook in 2016.

I.4 Japanese banking industry

I.4.1 Operating profile

Money supply grew steadily while deposit and lending rate continued to fall. Due to quantitative easing, the growth of monetary aggregates in Japan continued to climb. As of the end of 2015Q4, the broad money M3 totaled JPY1,239.3 trillion, an increase of 2.3% year on year. In the context of loose monetary and credit environment, the deposit and lending rate of Japanese financial institutions continued its downward trend. According to the latest statistics of BoJ (February), demand deposit rate of domestic banks was 0.001% and the most preferential 10-year mortgage loan rate was 0.9%, both of which hit record low.

Size growth picked up pace and percentage of deposit and loan was basically the same. As of the end of 2015Q4, asset size of JP banking industry was USD8.4 trillion, an increase of 2.3% year on year. The liability size stood at USD7.3 trillion, up 2.5% year on year. Seen from the structural change of assets and liabilities, the percentage of loans in assets was 46.1%, unchanged from 2014Q4; the percentage of deposit in liabilities was 57.3%, also unchanged from 2014Q4.

Deposits and loans maintained modest expansion with largely the same growth rate. As of the end of 2015Q4, domestic loan balance of the JP banking industry added up to USD4.1 trillion, up 2.6% from the earlier year; domestic deposit balance of the JP banking industry amounted to USD5.6 trillion, up by 2.4% from the previous year.

I.4.2 Regulatory environment

(1) Far-reaching influence of negative interest rate policy

BOJ officially launched negative interest rate policy on February 16, 2016. Amidst growing expectation on economic slowdown and continuous volatility of global financial market, the resolution of BOJ triggered wide fluctuations of the global market. As of the end of February, interest rate of Japan's 10-year treasury bond had declined to -0.055%, the lowest ever. At the same time, private commercial banks cut deposit and residential mortgage rates to their record lows.

Implementation of the negative interest rate policy will lower the overall interest level of Japanese financial industry at large and mitigate the interest payment pressure on the government generated from huge debts.^③ Theoretically speaking, the negative interest rate will promote private investment and personal consumption and maintain JPY exchange rate at a low level, but its role in driving economic growth is limited. On the one hand, Japan has enjoyed adequate liquidity due to its long-acting easing monetary policy, but suffered from weak corporate credit demand for a long time. On the other hand, residents' real income hasn't increased. There is widespread pessimism towards results of the collective bargaining this Spring. Personal consumption is unlikely to grow substantially. For the banking industry, the deposits with the central bank priced at positive interest rates previously will apply negative rate of -0.1% while pricing of customer deposits lags behind, further narrowing the interest margin and pulling down overall yield of JPY-denominated assets. In addition, due to restrictions of local laws and regulations on the interest rate of customer deposits and limited room for further reduction of banking cost, it is expected that banks' deposit-taking ability will be impaired in the long term.

(2) The new TLAC requirements have limited impact on Japanese G-SIBs

Taking into account 2.5% of countercyclical capital buffer, 1%-1.5% of additional capital requirement for G-SIBs and Japan's deposit insurance, TLAC capital of Mitsubishi UFJ, SMBC and Mizuho Bank represented 15.2%, 17.8% and 15.4%, respectively of risk-weighted assets, and

^③ Japan's government debt topped the world, accounting for 2.5x of the country's GDP by the end of 2015.

the TLAC-benchmarked leverage ratio stood at 7.0%, 7.1 and 5.9%.^④ Thus, Japan's three G-SIBs can easily meet the new TLAC requirements. As internationalization degree of the three banks has kept increasing, considering the large overseas asset size, they lack of overseas liability and capital sources, resulting in high overseas deposit-loan ratio and capital shortage of major entities. With growing proportion of international banking business of these banks, their overseas fundraising ability will be greatly challenged. (3) The Financial Services Agency encourages stronger financing support to SMEs with growth potential

Recently, the Financial Services Agency of Japan requires in its Financial Inspection Guidelines that banks shall decide whether to provide financing support to enterprises based on comprehensive analysis of their growth and future potential, instead of verifying credit based merely on their financial position.

In 1990s, the Financial Services Agency rigorously restricted loans to enterprises with poor profitability, in order to solve the distressed debt problem of the Japan banking industry. As of the end of 2015, banks' outstanding loans to SMEs stood at JPY183 trillion, representing about 70% of that in the first half of 1990s, in spite of slight recovery. Driven by gradual resolution of distressed debt problem of the banking industry as well as deflation and long-term depression risk faced by the economy, the Financial Services Agency introduced the above policy aimed at promoting economic recovery through supporting SMEs with technology and growth potentials or at the start-up stage. This policy shift will put forth new requirements on bank's credit verification and risk control.

I.4.3 Outlook

In 2015, Japan's GDP grew by merely 0.4% year on year in real terms, while recurring profit and sales of all industries decreased by 1.7% and 2.7% respectively from the same period of last year. Depression of the real economy will lead to insufficient domestic loan demand. Meanwhile, BoJ introduces negative interest rate policy in 2016, which has limited effect on stimulating bank lending, and will increase banks' risk appetite.

On the whole, overall operation and development of Japan's banking industry faces great challenges amidst the economic and financial environment featuring sluggish domestic economy, weak corporate funding demand and narrowing interest margin. In comparison, large banks outperform small and medium banks due to their high degree of internalization and strong ability of integrated operation.

II. China's Banking Industry Review and Outlook

II.1 Operating situation of the banking industry in 2015

Despite facing certain pressure in 2015, China's commercial banks managed to operate stably overall. The assets and liabilities continued a double-digit growth rate while the profit growth slowed down; as the structural adjustment progressed, the proportion of loans dropped but the contribution of non-interest income kept increasing; the assets quality went under the growing pressure, evidenced by the rise in both the NPL amount and ratio, the provision coverage ratio still remained at a high level after a rapid fall, the CAR was stable, and the risks were controllable overall.

Recently, 16 listed banks^⑤ ("listed banks") have been disclosing 2015 business results. According

^④ Based on estimates of Daiwa Institute of Research and Mizuho Research Institute.

^⑤ Listed banks herein refer to the 16 commercial banks listed in the domestic A share market, including five major banks: ICBC, ABC, BOC, CCB, BOCOM; eight national joint-stock commercial banks ("joint-stock banks"): Merchants Bank, SPDB, Minsheng Bank, CITIC Bank, Industrial Bank, Everbright Bank, Huaxia Bank, Ping An Bank; and three city commercial banks: Bank of

to estimation, listed banks outperformed commercial banks in general in 2015, however, they faced pressure in scale growth in the following aspects:

1. The assets and liabilities continued a double-digit growth

At the end of 2015, the assets and liabilities of commercial banks registered RMB155.8 trillion and RMB144.3 trillion respectively, up 15.6% and 15.3% year on year, 2.1 and 2.5 percentage points higher than the growth of last year. The assets and liabilities of five major banks were RMB78.2 trillion and RMB72.0 trillion respectively, up 10.1% and 9.6% year on year. The growth rate increased by 1.8 and 2.2 percentage points compared with the previous year. The assets and liabilities of joint-stock banks were RMB37.0 trillion and RMB34.7 trillion respectively, up 17.9% and 17.7% year on year. The growth rate of both went up by 1.4 percentage points compared with the previous year.

At the end of 2015, the assets and liabilities of listed banks were estimated at RMB119.0 trillion and RMB110.2 trillion respectively, up 12.5% and 12.0% year on year, 1.3 and 1.5 percentage points higher than the growth of last year (Figure 1 and Figure 2).

Figure 1: YoY Assets Growth^⑥

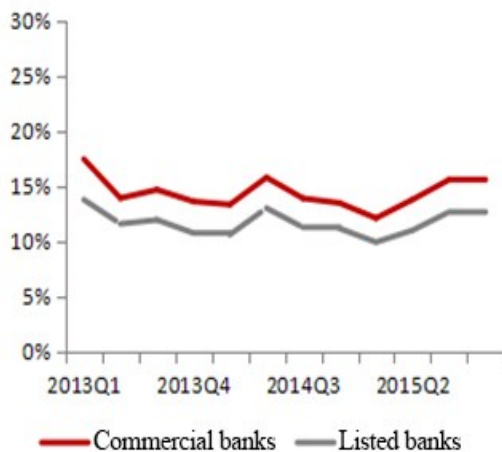
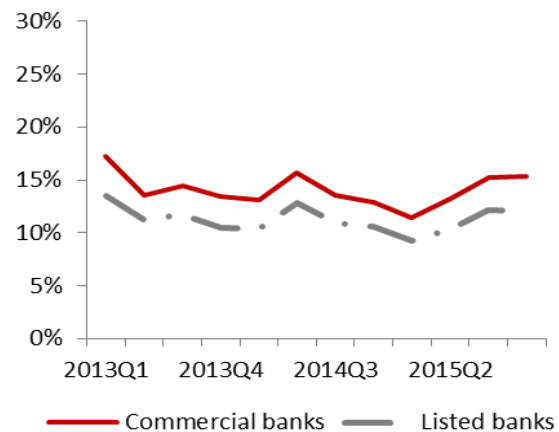


Figure 2: YoY Liabilities Growth



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

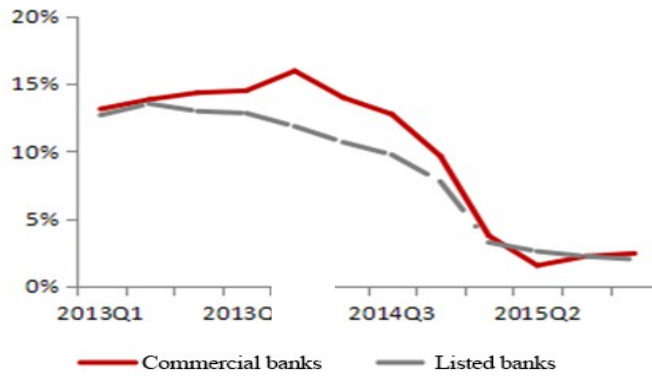
2. Profit growth slowed down and profitability faced challenges

At the end of 2015, commercial banks reported net profit of RMB1.6 trillion, up 2.4% year on year. The growth rate went down by 7.2 percentage points from a year earlier. As estimated, listed banks saw their net profit growth rate roughly at 2.0% throughout the year, down 5.8 percentage points over a year earlier (Figure 3).

Beijing, Bank of Nanjing, and Bank of Ningbo.

⑥ The data of listed banks at the end of 2015 in Figure 1 were estimated and below will be the same.

Figure 3: YoY Net Profit Growth



In 2015, the ROA and ROE^⑦ of commercial banks stood at 1.10% and 14.98%, down 0.1 and 2.6 percentage points from a year earlier. For five major banks, the ROA was 1.20%, down 0.1 percentage points over 2014. For joint-stock banks, the ROA was 0.99%, down 0.1 percentage points over 2014. The ROA and ROE of listed banks in 2015 were estimated at 1.13% and 17.0%, respectively, down 4 base points and 1.5 percentage points over 2014 (Figure 4 and Figure 5).

Figure 4: ROA

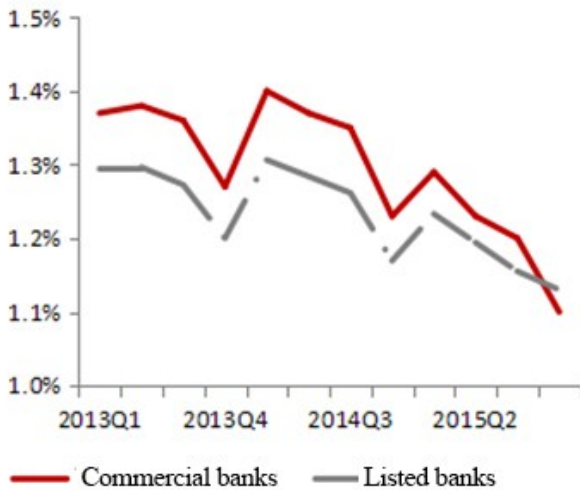
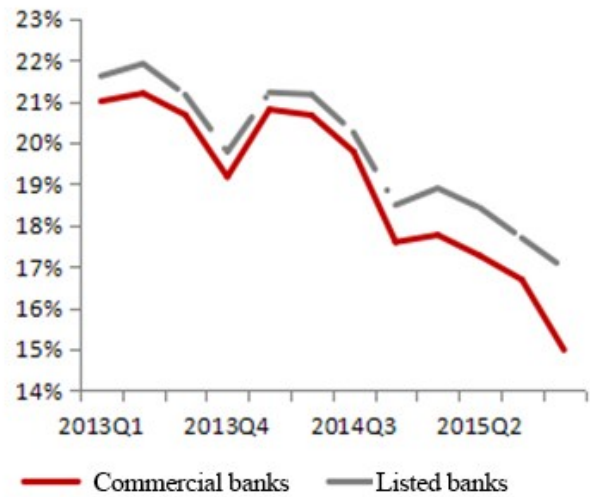


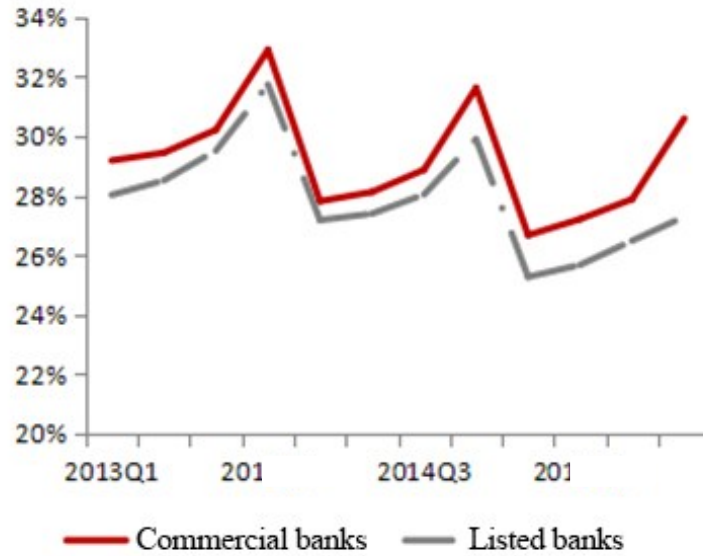
Figure 5: ROE



In 2015, the cost-income ratio of commercial banks reported 30.59%, down 1.0 percentage points over 2014. The ratio of listed banks in the same year was estimated at 27.29%, down 2.6 percentage points over 2014 (Figure 6).

⑦ The ROA, ROE, cost/income ratio, CAR, tier 1 CAR, core tier 1 CAR and loan-to-deposit ratio are arithmetic average; the non-interest income ratio, NPL ratio and provision coverage ratio are weighted average.

Figure 6: Cost-income Ratio



3. The percentage of loans dropped while the contribution of non-interest income increased

At the end of 2015, the deposit balance of listed banks represented 78.7% of the total liabilities while the loan balance represented 49.0% of the total assets, up 0.1 percentage points and down 1.1 percentage points respectively year on year. The two indicators of listed banks were estimated at 74.0% and 52.0% respectively, down 3.0 percentage points and up 0.02 percentage points from a year earlier (Figure 7 and Figure 8).

Figure 7: Deposit Balance/Total Liabilities

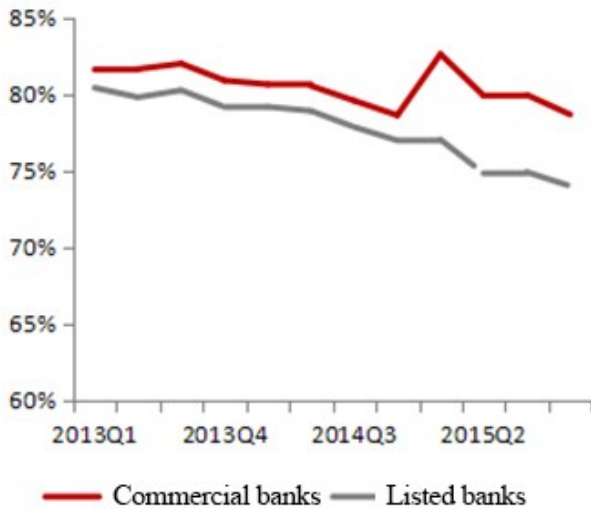
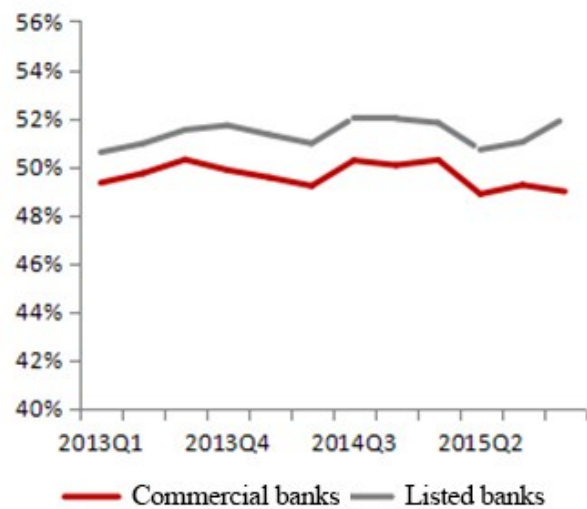
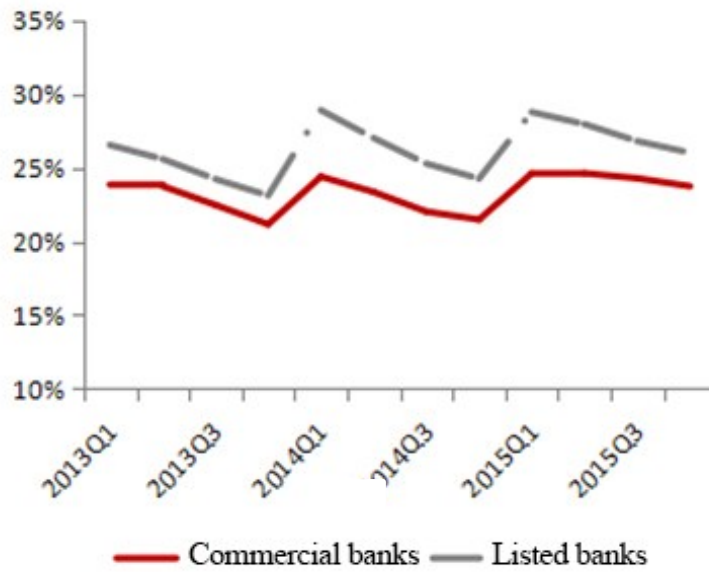


Figure 8: Loan Balance/Total Assets



In 2015, the non-interest income of commercial banks accounted for 23.7%, up 2.3 percentage points from a year earlier. The ratio of listed banks was 26.0%, up 1.8 percentage points from a year earlier (Figure 9).

Figure 9: Non-interest Income/Total Income



4. Both the NPL amount and ratio continued to decline while the provision coverage ratio remained at a high level despite a drop

At the end of 2015, the outstanding NPL of commercial banks posted RMB1.3 trillion, up 47.0% from a year earlier, 10.8 percentage points higher than the growth of last year; the NPL ratio was 1.67%, up 0.4 percentage points over the end of 2014. For five major banks, the outstanding NPL stood at RMB700.2 billion, up 47.0% from a year earlier, 10.8 percentage points higher than the growth of 2014; the NPL ratio was 1.66%, up 0.4 percentage points over the end of 2014. For joint-stock banks, the outstanding NPL registered RMB253.6 billion, up 56.6% from a year earlier, 8.2 percentage points higher than the growth of 2014; the NPL ratio was 1.53%, up 0.4 percentage points over the end of 2014.

At the end of 2015, the outstanding NPL of listed banks were estimated at RMB965.8 billion, up 44.5% from a year earlier, 5.6 percentage points higher than the growth of last year; the NPL ratio was 1.55%, up 0.3 percentage points over the end of 2014 (Figure 10 and Figure 11).

Figure 10: Growth of Outstanding NPL

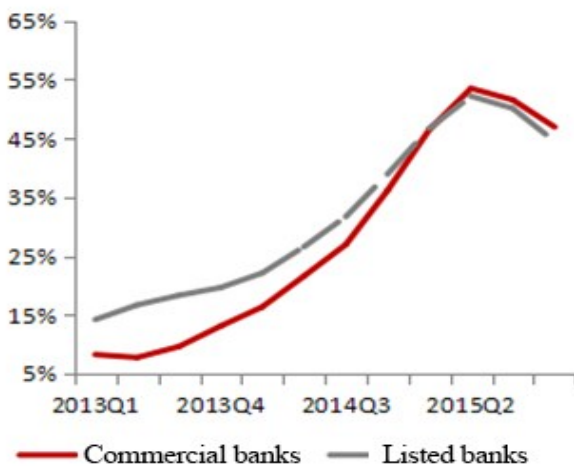
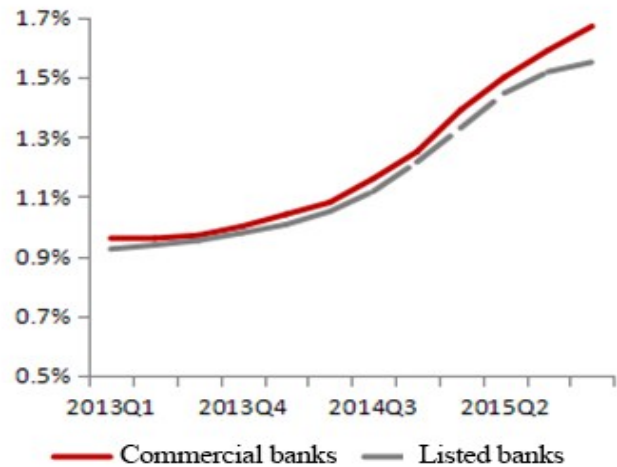
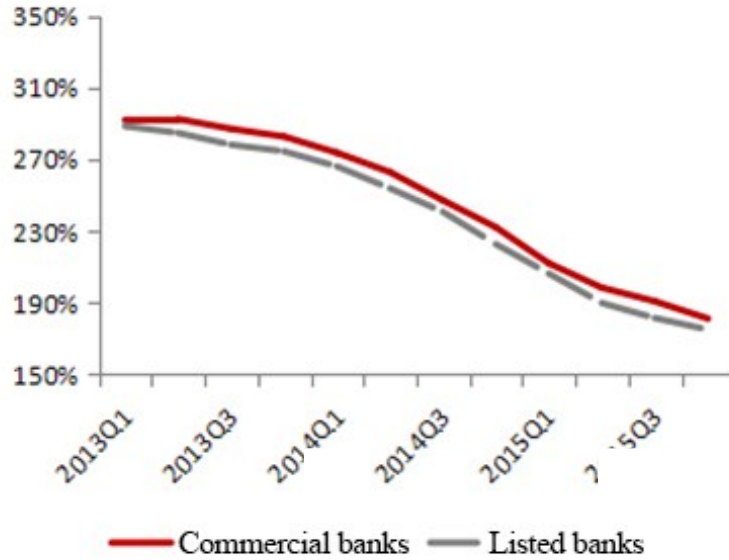


Figure 11: NPL Ratio



At the end of 2015, the provision coverage ratio of commercial banks stood at 181.2%, down 50.9 percentage points compared with the same period of last year. The ratio of five major banks and joint-stock banks reported 171.7% and 181.0% respectively, down 61.0 percentage points and 37.0 percentage points over the end of 2014. At the end of 2015, the provision coverage ratio of commercial banks was estimated at 175.0%, down 47.7 percentage points compared with the same period of last year (Figure 12).

Figure 12: Provision Coverage Ratio



5. CAR remained stable while the loan-to-deposit ratio continued to rise

At the end of 2015, the CAR, tier 1 CAR, and core tier 1 CAR of commercial banks reported 13.5%, 11.3% and 10.9% respectively, up 0.3, 0.6 and 0.4 percentage points from the previous year. The CAR of five major banks and joint-stock banks was 14.5% and 11.6% respectively, each up 0.4 percentage points over 2014. At the end of 2015, the ratio of listed banks was estimated at 12.6%, down 0.1 percentage points over 2014 (Figure 13 and Figure 14).

Figure 13: CAR

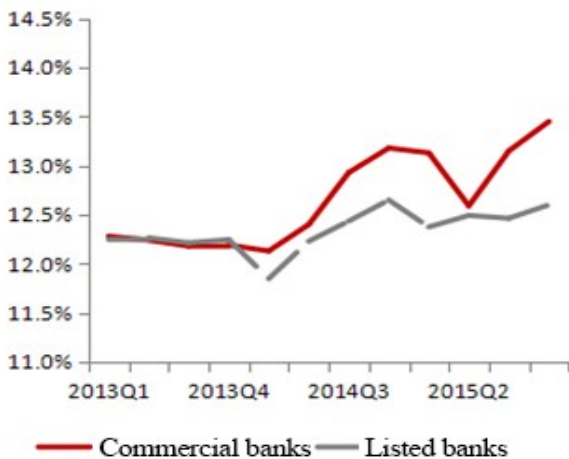
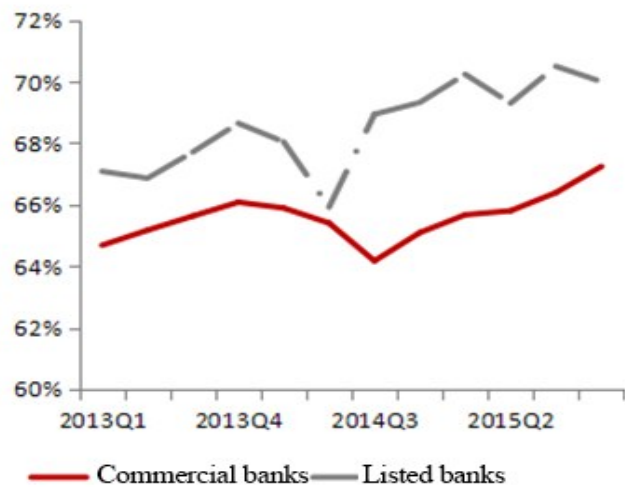


Figure 14: Loan-to-Deposit Ratio



At the end of 2015, the loan-to-deposit ratio of commercial banks was recorded at 67.2%, up 2.2

percentage point over the end of last year. At the end of 2015, the ratio of listed banks was estimated at close to 70% since such banks usually had a relatively high proportion of loans and went under a comparatively great liquidity pressure.

II. 2 Outlook of the operating performance of the banking industry in 2016

II.2.1 Analysis of Q1 performance

In 2016Q1, China's banking industry delivered a stable performance as a whole. Despite some local exposures, the overall risks remained under control. Influenced by economic downturn and other factors, the industry saw its overall profitability down. At the same time, as the supply-side reform progressed, commercial banks would be given new engines for profit growth. Against such a backdrop, the following three factors are expected to significantly influence on the operating performance of listed banks:

First, economic factor. In 2016Q1, import and export remained weak, consumption kept stable, and investment delivered a mixed performance, all of which added up to the three demands. In January and February, the cumulative imports and exports dropped by 12.6 percentage points over the same period of last year, representing a further enlarged decrease; the total retail sales of consumer goods grew by 10.2% over the same period of last year, a slightly reduced rise compared to the end of 2015; and the total fixed asset investment increased by 10.2% over the same period of last year, seeing a slightly higher growth rate than the end of 2015. Among it, the investment in the manufacturing industry reduced slightly while the investment growth in the real estate industry turned from negative to positive. We estimate that the slowed GDP growth will pose pressure on listed banks in profitability.

Second, monetary policy. PBC has decided that the RRR for all financial institutions would be cut by 0.5 percentage points since March 1, for the purpose of maintaining a reasonably ample liquidity across the financial system and creating a monetary environment in favor of the structural reform on supply front. At the end of February, the outstanding M2 stood at RMB142.5 trillion, up 13.3% from a year earlier. We estimate that the moderate monetary policy in Q1 will help maintain stable growth of scale of the banking industry in China.

Third, financial reform. Since PBC removed the cap on deposit interest rate in October 2015, the market saw the deposit and loan interest rates remain stable, free from sharp fluctuations. At the same time, the central bank kept improving the "interest rate corridor" mechanism to help market rates stay within a reasonable range. In January and February 2016, it conducted the standing lending facility operations worth RMB523.4 billion, a move that ensured a reasonably ample liquidity across the banking system.

In conclusion, we expect the net profit of listed banks to grow about 2%, assets and liabilities to grow around 13% and 12.5% respectively, and NPL ratio to rise slightly to about 1.65% year on year in 2016Q1.

II.2.2 Operating outlook

The year of 2016 not only marks the beginning of the 13th Five-Year Plan period but also bears significance to the comprehensively building of a moderately prosperous society. At present, the Chinese economy still goes under the downturn pressure with prominent structural imbalances. It is possible for the economic growth to slow down further. Under such a background, the central government required to strengthen the supply-side structural reform. To do so, it listed "de-capacity, de-stocking and de-leveraging" as a priority task throughout the year and continued to push forward the financial reform, with a view to creating a monetary environment in favor of the reform on supply front. In addition, the new development concepts of innovation, coordination,

green, openness and sharing raised in the outline of the 13th Five-Year Plan bring some ideas about how the reform on supply front can achieve long-term outcomes. As its measure are put in place gradually, the reform will exert influence on commercial banks in the later three quarters of 2016 from the following perspectives.

The de-capacity, de-stocking and de-leveraging processes may worsen the asset quality of banks and drag down their profitability. The steel, coal, cement, and other industries with over-capacity will face great pressure during the adjusting process, thus leaving banks more concerned about NPL, squeezing commercial banks' profit space, and making them less capable of defusing risks and supplementing funds.

In the long run, the new development concepts of innovation, coordination, green, openness and sharing will bring some ideas about how the supply-side structural reform to achieve long-term outcomes and provide commercial banks with new engines for profit growth.

First, seeking for innovation-driven growth will facilitate commercial banks to transform and upgrade, with more credit resources diverted to modern service industries, strategic emerging industries, and creative and pioneering companies. The practices in such fields as new-generation info-communications, new energy, new materials, aerospace, biomedicine for innovative growth shed some light on banks' transformation and upgrade. The boom of creative and pioneering companies makes it possible for commercial banks to explore a business mode of combining investments and loans and contribute to mass entrepreneurship and innovation.

Second, coordinated development will fuel commercial banks in new forms. According to the outline of the 13th Five-Year Plan, the construction of city clusters will gather pace. Specific measures include optimizing the existing city clusters in East China, developing the city clusters of the Beijing-Tianjin-Hebei Region, Yangtze River Delta and Pearl River Delta into world-class ones, fostering new city clusters in Central West China, turning those in Northwest China, North China, middle reaches of Yangtze River, Chengdu-Chongqing Region, and Central Shaanxi Plain much stronger and larger. All of these are aimed to form multiple growth poles to boost coordinated advancement of different regions across China. The three national strategies of "Belt and Road" Initiative, Coordinated Development of Beijing-Tianjin-Hebei Region and Yangtze River Economic Belt as well as the construction of city clusters will bring along a number of major programs and projects, which means new growth engines for commercial banks. With them, financial institutions get further clear about where and how they can serve the real economy.

Third, it is impossible for commercial banks to enhance sustainability without green development. Developing green finance constitutes a major measure for green development and represents an important direction of commercial banks towards sustainable growth. As more green finance-conducive measures are put in place, green bonds will see their scale on the rise and commercial banks will gradually improve the green credit mechanism.

Fourth, open wider to the rest of the world, commercial banks will further align themselves with international standards and become more capable of comprehensive operation. With more companies going global, they can win more reserved room for carrying out full-license operation and increasing global presence. In the future, the license allowing commercial banks to engage in comprehensive operation covering insurance, trust, securities, leasing, etc. will become highly sought-after. With such license, they can further tap their potential for business growth and increase their presence overseas.

Fifth, sharing development outcomes with others can be seen as a major move commercial banks take in fulfilling social corporate responsibilities. The release of the *Plan for Advancing Inclusive Finance Development (2016-2020)* marks that the inclusive finance has been ascended to a

national strategy and taken as a great measure to practice the sharing ideas. Small and micro-sized enterprises, agriculture-related business and senior care services, poverty reduction and other fields, with their further advancement, will generate enormous financial needs worth thousands of billions yuan, representing great market potential. Through developing inclusive finance, commercial banks can not only fulfill their social corporate responsibilities but also get into new markets.

Based on the overall evaluation of the above factors, listed banks are expected to go under operating pressure in 2016, which can see in the following aspects. With a stably rising scale, the assets and liabilities will grow by nearly 12% and 11.5% respectively year on year; the profitability faces pressure and the net profit will witness zero growth; the NPL amount and the NPL ratio continue to rise with the latter to reach nearly 2%; and the capital position maintains sound and the CAR will stay around 12.5% (Table 3).

Table 3: Forecast of Key Indicators of China's Listed Banks in 2016

		2013 (R)	2014 (R)	2015 (E)	2016	
					Q1(E)	Full Year (F)
Size	Asset growth	10.8	11.2	12.5	13.0	12.0
	Liability growth	10.1	10.6	12.0	12.5	11.5
Profit	Net profit growth	12.8	7.8	2.0	2.0	0
	Share of loans	51.7	52.0	52.0	52.5	51.5
Structure	Share of deposits	79.2	77.0	74.0	73.5	72
	Share of non-interest income	23.1	24.3	26.0	30.0	27.5
	NPL ratio	0.90	1.21	1.55	1.65	2.0
Quality	Provision coverage ratio	276	233	175	165	150
	CAR	12.2	12.6	12.6	12.6	12.5

III. Analysis of Hot Topics

III.1 Why and How China's Banking Industry Develops Inclusive Finance

III.1.1 The significance for China's banking industry to develop inclusive finance

Firstly, taking a greater part in serving the national strategies and facilitating the transformation and development of domestic economy. Through vigorously developing inclusive finance, the banking industry, as an integral part of the modern financial system, may build up a good image in the society and achieve a balance among creating commercial value, serving national strategies and assuming social responsibilities.

Secondly, spotting the relevant business opportunities to speed up transformation and development. During the 13th Five-Year Plan period, the development of inclusive finance may provide the banking industry with the opportunities necessary for own transformation and development.

(1) RMB30 trillion financing needs from MSEs: By 2020, China will have more than 23 million MSEs and their loan size will increase to RMB33.4 trillion. With their growth and expansion, these enterprises will need a huge amount of payment and settlement, cash management, payroll service, tax payment, investment banking, and other comprehensive financial services.

(2) RMB30 trillion financial needs from the agriculture-related business: To realize the goal of

doubling the 2010 per-capita income of rural residents by 2020 set by the *Central Document No.1 in 2016*, the loan balance for rural areas by then will amount to RMB36.7 trillion and the premium income will increase to RMB97.99 billion.

(3) RMB30 trillion financing needs from the elder care industry: During the 13th Five-Year Plan period, the market value of elder care services in China will total nearly RMB30 trillion, thus boosting the growth of old-age insurance, wealth management, real estate and other forms of financial industries. Take the old-age insurance market as an example, by 2020, the premium income will exceed RMB100 billion.

(4) RMB3 trillion poverty relief inputs in need of financial support: According to the central plan, a total of 70.17 million population will be lifted out of poverty by 2020. To this end, an investment of RMB600 billion is to be made for relocating 10 million people with per-capita input about RMB60,000. In the next five years, the Chinese government is estimated to pump around RMB3 trillion into poverty alleviation endeavors.

Thirdly, exploring new approaches to institutional reform and innovation. The specialized institution-based operation and the business division reform suggest one important direction for banks to push through their reform measures, for they provide basis and means for their further explorations in institutional reform with the help of inclusive finance platforms.

III.1.2. Major problems China' banking industry encounters while developing inclusive finance

Firstly, the financial supporting system is not complete. (1) The system of inclusive finance needs to be improved. At present, China falls short of specialized financial institutions at all levels and with wide coverage to provide services for individuals and MSEs. (2) The growth of inclusive finance is uneven. In China, Agricultural Development Bank, Postal Savings Bank, rural credit cooperatives and small-loan companies play the main role in developing inclusive finance while commercial banks have been slower in this regard. (3) The financial infrastructure is not sophisticated. Some rural areas and especially those poor and remote lack sound financial institutions and payment platforms, if at all.

Secondly, the commercial sustainability faces challenges. On the one hand, the risk-adjusted return is lower than expected. Loans for MSEs and agriculture-related loans bear the interest rate 1.2 times, 1.4 times, or even higher than those for large companies. But the formers are more likely to default. So the risk-adjusted return is actually lower than it seems, thus leaving banks less motivated. On the other hand, service costs are excessively high. Loans under inclusive finance usually come in small amounts but they still need to undergo pre-loan investigation, credit review and post-loan management, thus incurring per-unit time and manpower cost much higher than large loans.

Thirdly, services and products undersupply. (1) Loans fall short of needs. In 2015, the loans of Chinese banks to rural households only accounted for 6.3% of their total loans throughout the year and those to MSEs only made up 23.9%, which was grossly disproportionate to their contribution of above 60% to GDP. (2) More innovative products and services are needed. Most products available through inclusive finance come from deposit, loan, fund transfer, payment, settlement and other traditional businesses. Online loan, investment, wealth management and other innovative products are underdeveloped and their service radius and influence are quite limited as well.

Fourthly, the financial ecosystem suffers a weak foundation. When it comes to the construction of social credit system, the credit reference systems of the central bank, since rollout, have had a limited coverage of vast rural areas and MSEs, hence leaving sound credit reporting, rating, disclosure, punishment and other policies to be put in place. Given the financial and legal

knowledge has not been widely disseminated, some regions and groups as targeted customers of inclusive finance only come to a basic understanding of financial laws, regulations and policies, financial products, financial risks and risk prevention, thus hindering the healthy development of inclusive finance to some extent.

Fifthly, the supporting policies are yet to be unveiled. It is hard to comprehend how inclusive finance really develops since there are no specific indicators to measure that. In the meantime, no differentiated policies and encouraging measures have yet been issued. In addition, considering inclusive finance entails considerable risks and a variety of hidden risks are being exposed in the economic downturn, a mechanism aimed to defuse and share such risk needs to be established as soon as possible.

III.1.3. Countermeasures China's banking industry takes to promote inclusive finance

Firstly, attaching importance to inclusive finance strategically. Inclusive finance is positioned to serve MSEs, agriculture, farmers and rural areas, poverty reduction and elder care finance. With their risk under control, these targeted customer groups boasting great potential for growth can develop into major sources of supplemental operating income to banks.

Secondly, developing a differentiated positioning with its own characteristics. Differentiated measures will be taken to operate a variety of businesses on the premise of commercial sustainability. The efforts shall be focused on the specialized development in the hopes of expanding the scale of MSE loans. The "Internet Plus" strategy and the new-type rural financial institutions will play a bigger role in creatively conducting the agriculture-related business. The bancassurance strategy and diversified operation of group shall be strengthened to bring the elder care business in great depths. Better account services and other relevant financial services shall be available to carry out the poverty alleviation business in a meticulous manner.

Thirdly, maintaining cost control in operation and strengthening self-development. Lowering costs and improving fund usage efficiency are key to commercial sustainability. Such information technologies as mobile Internet can be used to help reduce service and management costs, optimize risk management, and thus drive down risk cost. Diversified funding channels will be conducive to controlling funding cost and innovative cooperation modes will improve fund usage efficiency.

Fourthly, advising the government to roll out supporting policies. The central government is recommended to implement more taxation, subsidy and other guiding policies and take more vigorous evaluation and management measures concerning banks' engagement in the inclusive finance business. At the same time, investments banks make in inclusive finance are expected to be listed as risk-weighted assets rather than directly deducted capital and some regulatory requirements for separately-listed inclusive finance business are advised to be relaxed appropriately in terms of provision-to-loan ratio, reserve requirement ratio, capital adequacy ratio, etc.

III.2 Large European banks saw shrinking operating results

According to the 2015Q4 report on operating results released by the large European banks recently, six out of the 15 large European banks began to lose money in Q4 and the remaining nine witnessed a decline in net profit year on year. Among them, Credit Suisse, Royal Bank of Scotland, Deutsche Bank ranked top three, reporting a loss of CHF5.83 billion, GBP2.25 billion and EUR2.13 billion, respectively. The declining operating income in the banking industry resulted in a plunge of their stock prices. Since 2016, the stock prices of the 15 banks dropped at an average of 19.2%, a decline markedly larger than major European stock indices over the same period.

III.2.1 Reasons for falling operating results

Firstly, the policy of negative interest rates dragged down banks' net interest income. Since June 2014, the ECB and the central banks in Denmark, Switzerland and Sweden adopted the policy of negative interest rates successively, which drove down the interest rate corridor and eroded the already low net interest margin of European banks. At the end of 2015Q4, seven out of the 11 large European banks suffered a decline in net interest income year on year. Among them, Standard Chartered Bank, Royal Bank of Scotland and Nordea came out top three, down by 16.2, 9.2, 8.5 percentage points, respectively. In general, the relatively prominent declines occurred to the banks that are mainly engaged in deposits and loans in European markets.

Secondly, the rocky global financial market reduced the trading business income substantially. Influenced by the soaring global credit spread, the more volatile foreign exchange markets, the continuously depressed trading of crude oil, and the remarkable decline in the turnover of stock markets, the large banks in the Eurozone witnessed their trading income dropping substantially in 2015Q4, among which six banks suffered a falling trading income year on year and Credit Suisse and Deutsche Bank even sustained a single-quarter loss.

Thirdly, banks paid increased operating expenses. In 2015, the loan provision grew, the write-off of NPLs gathered pace, the staff cost increased notably and the business transformation of banks cost more, all of which drove up large banks' operating expenses, instead of lowering them.

Fourthly, regulatory compliance cost grew. In 2015, the implementation of new capital regulatory requirements, the payment of single resolution fund, the increase in penalties and litigation costs posed the increasing regulatory pressure on the large European banks, thus exerting adverse influence on their operating results.

Fifthly, goodwill and other intangible assets devalued. Swayed by the overall sluggish capital market and the worrisome operating outlook, the goodwill of many assets with future operating cash flows as price began to devalue. Deutsche Bank wrote down EUR5.8 billion, mainly due to the impairment in intangible assets caused by the takeover of Bankers Trust by its two business divisions Corporate & Banking Securities and Private, Wealth & Commercial Clients taking.

III.2.2 Prediction of how the large European banks will operate in 2016

We expect that the large European banks are hard to substantially improve the weak operating results in a short run but it is unlikely for these banks all to suffer systemic risk, although some of them have their risk worthy great attention.

Firstly, banks are hard to improve their operating results in a short period of time. Many of the contributing factors behind the slipping operating results of the large European banks remain stubborn in a short term.

(1) The weak economic recovery in the Eurozone and the great reluctance to lend by the banking system make it impossible to change the negative or relatively low interest rates within a short time and even may drive the ECB to continue adopting the easing policy. The interest rate cut by the end of 2015 will generate more prominent marginal effects in 2016. Therefore, we estimate that the net interest margin of the large European banks will drop further.

(2) The sluggish financial market can hardly begin an all-round recovery, despite some slight improvement. The low oil price and the growing credit spread render a considerable trading book risk to banks holding oil commodity positions, unsecured bonds and derivatives in large amounts and meanwhile impair the relevant market making and commission income. In addition, the market share squeeze from the large U.S. banks in the fixed income clearing corporation (FICC) business also cannot be belittled. Since 2008, the large European banks have seen their trading share in the FICC market down from 55% to 47%.

(3) The banking industry cannot be transformed all at once. Layoff, dissolution and reduction of outlets, as well as adjustment in assets allocation will keep the operating expenses on the rise. The Internet and IT system development will also continue crowding out banks' profits.

(4) As risk exposures increase, credit and market risks will also grow accordingly, which further highlights the capital regulatory pressure confronting banks. In 2016, the European banking industry still faces a worrisome operating outlook and most local banks will see their income and profit lowered over 2015.

Secondly, risks of some banks should be paid particular attention. Although the European banking industry is unlikely to incur a systemic risk, we should be vigilant about some banks' growth prospects.

Thirdly, systemic financial risk is unlikely to occur. Among the banks with the most severe loss, Deutsche Bank and Credit Suisse suffered the loss mainly attributed to the impairment of goodwill and other intangible assets and the soaring litigation expenses. But the two banks delivered a satisfactory performance in principal business. At present, the write-down of goodwill and other intangible assets can make bank valuation return to a reasonable level, a move conducive to banks' long-term growth. As for derivative risk the market is greatly concerned about, Deutsche Bank, Credit Suisse and BNP Paribas all sharply cut their positions in derivative business in 2015, slightly defusing the systemic risks derivatives have gathered.

III.3 Assessment and inspirations from the influence generated by FSB's TLAC requirements

In November 2015, the Financial Stability Board (hereinafter referred to as "FSB") issued the *Principles on Loss-absorbing and Recapitalization Capacity of G-SIBs in Resolution and Total Loss-absorbing Capacity (TLAC) Term Sheet*, aimed at enhancing banks' loss absorbing capacity and preventing the "too-big-to-fall" problem from damaging taxpayers' rights and interests.

III.3.1 Major features of TLAC requirements

TLAC requirements are well targeted at G-SIBs; apart from having the group up to the standard, the G-SIBs subject to regulation shall ensure its material entities^⑧ (subsidiaries) can meet the relevant criteria. The biggest difference between the Basel III capital requirements and the TLAC requirements lies in their definitions of capital. The major features of the TLAC capital are listed below:

Firstly, the TLAC capital has a wider coverage than the Basel III regulatory capital. It falls into two categories: (1) the 8% Basel III minimum regulatory capital including the core tier-1 capital (at least 4.5%), other tier-1 capital and tier-2 capital; (2) the debt capital that is outside the Basel III regulatory capital and has a write-down or conversion term with the original maturity less than five years and the remaining maturity more than one year, like subordinated debts and senior unsecured debts.

Secondly, stricter regulatory requirements are applicable. (1) The size of TLAC capital. The TLAC capital, if the capital reserve (2.5%), additional capital (1%-3.5%) and countercyclical capital (0-2.5%) are taken into account, shall account for no less than 21.5%-26.5% of a G-SIB's risk-weighted assets. (2) The composition of TLAC capital. According to a provision on the debt capital set by the *Principles and Detailed Terms on Total Loss-absorbing Capacity*, the debt capital

^⑧ To be defined as a material subsidiary, an internal entity of a G-SIB shall meet at least one of the following criteria. (1) It has more than 5% of the risk-weighted assets of the G-SIB group, like BOCHK; (2) it generates more than 5% of the operating income of the G-SIB group, like HSBC Asia; (3) it has a total leverage exposure larger than 5% of the G-SIB group's total leverage exposure, like State Street Bank and Trust Company under State Street Bank and Bear Stearns of Bank of America; (4) it has been identified by the G-SIB's Contingency Management Group (CMG) as material, like BOC Macau Branch.

held by a G-SIB shall account for 8%-8.5% of the total risk-weighted assets, or no less than 33% of the minimum TLAC capital requirement. (3) The earlier repayment sequence of TLAC debt capital in resolution. The TLAC debt capital is repaid before the tier-2 capital and after the general bonds.

Thirdly, comparatively strong risk-absorbing capital is a must. The risk-absorbing capacity of the TLAC capital can be mainly seen in its write-down or conversion term. The write-down term means a G-SIB is entitled to pay less or no debts without approval of debt holders when the trigger clause is met. The conversion term means a G-SIB is entitled to convert debts into common shares without approval of debt holders when the trigger clause is met.

III.3.2 The large Chinese banks are in an unfavorable position.

According to the latest list of G-SIBs released in 2015, four Chinese banks, ICBC, ABC, BOC and CCB, found their way into it. Given it is quite challenging for the Chinese G-SIBs to meet the TLAC requirements in 2019 and 2022, the FSB gave them an additional six-year transitional period by pushing out the deadline to 2025 and 2028. Compared with their counterparts in the developed countries, the Chinese G-SIBs still remain in a disadvantaged position, as seen in the following aspects.

Firstly, the Chinese G-SIBs face huge pressure in terms of capital replenishment and especially need the TLAC debt capital. By 2015Q3, the Chinese G-SIBs had a total TLAC capital gap of USD765.5 billion. Since 2016, they shall fill USD63.79 billion TLAC capital every year. To be specific, they fall short of USD434.5 billion TLAC debt capital, accounting for 73.8% of the total of 30 G-SIBs over the same period. To fill in such a gap, the Chinese G-SIBs shall increase USD36.21 billion TLAC debt capital additionally every year.

Secondly, the “high provision and high capital” requirement results in a heavy compliance burden. By the end of March 2015, the Chinese G-SIBs had an average provision coverage ratio of 177.2% while at the end of 2014, that of the 27 G-SIBs (excluding Chinese ones) stood at only 77%. By the end of 2014, the Chinese G-SIBs saw the ratio of average provision to net capital hitting 17.6%, higher than 12.8%, the average of the 30 G-SIBs. In terms of capital requirements, China fully implemented the capital management measures in 2013, basically localizing the requirements of the Basel Accord and putting its relevant requirements higher than average across the world. As state-owned banks, the Chinese G-SIBs adhere to an overall prudential operating strategy and rarely enter into resolution under the guidance of the Chinese government. To withstand the risk arising from small probability events, they have sustained heavier regulatory costs than necessary.

Thirdly, the operating models cannot totally fit in the TLAC regulatory orientation. As advocated by the TLAC requirements, the G-SIBs will adopt an operating model where they replace some deposits with debts, carry out asset-light business and expand non-interest income. Influenced by the institution, policy and other comprehensive factors, the Chinese G-SIBs are operating in a model far away from what the TLAC advocates.

Fourthly, the excessively stringent capital regulatory requirements hold back the development of real economy. At present, the Chinese economy is experiencing a gradual slowdown in growth rate and the real economy is facing the mounting pressure from “stabilizing growth and maintaining employment”. Against such backdrop, a stable credit supply provides important support for the realization of countercyclical regulation and control. As measured, every 1 percentage point increment in the credit assets growth rate will contribute to a faster GDP growth rate by 0.17 percentage points. Combined with the GDP growth target and the employment level during the 13th Five-Year Plan period, it is fairly secure for China to maintain its annual credit growth rate at 10%. If the stricter TLAC requirements are put in place and the large banks cannot

promptly roll out the matching capital replenishment plan, the overall credit supply pace of the Chinese banking industry will be inevitably interrupted.

Fifthly, the progress towards international operation will be impacted to some extent. A G-SIB shall meet the TLAC requirements as a whole and meanwhile its material subsidiaries are required to comply with some of the requirements as well. Therefore, the Chinese G-SIBs need to ensure both their group and material subsidiaries can comply with TLAC. Although the overseas entities of the Chinese G-SIBs now cope with lower TLAC regulatory pressure, the stricter capital requirements will become an issue they have to take into account and address in their business as the large Chinese banks keep advancing towards international operation.

Sixthly, the flawed supporting measures hinder the implementation of TLAC requirements. Despite an already fast growth, the Chinese bond market has much to do, compared with the well-developed market. No sound articles and measures have been developed to match the term of converting debt capital instruments into equities, for which China is yet to issue tier-2 capital instruments with such term. In the resolution plan, there are no clear legal definitions concerning debt/claim offsetting, net settlement, separation of client assets, etc.

III.3.3 Implications and recommendations

At present, China's regulatory authorities and the large China's banks shall attach high importance to the implementation of TLAC policies in China and develop the relevant plans in a timely manner.

Recommendations for the regulatory authorities:

Firstly, step up research on the policies' influence. China's regulators should strengthen the research on the TLAC regulatory policies and draw upon the experience and lessons from the practice of developed countries promptly; carry out thorough inspections into the large Chinese banks, timely detect the possible problems and challenges while these banks are implementing the TLAC requirements, and sort out what has been identified; and assess the possible influence arising from the implementation of TLAC requirements.

Secondly, get fully involved in the making of TLAC rules. Compared with other countries, China sees its banking industry under more marked influence of the TLAC policies. As the world's largest developing country, it should make better use of its favorable position as a G20 member to take a greater part in formulating and carrying out the TLAC rules. It may suggest properly lowering the identification standards in the hope of including more liabilities into the TLAC debt capital and putting transitional-period requirements and TLAC capital requirements under differentiated supervision based on G-SIBs' difference in principal business.

Thirdly, work hard to push through the countercyclical regulation reform and coordinate overseeing efforts. Against the economic growth rate slowing down, the regulators are advised to steadily put the TLAC policies in place, reduce the adverse influence arising from the implementation of TLAC requirements on credit supply by introducing more fundraising channels for commercial banks, and guide commercial banks to meet the TLAC requirements by "molecule behaviors". At the same time, they may also consider lowering the requirements on provision coverage ratio and provision-to-loan ratio so that commercial banks can reduce their compliance cost while maintaining prudent operation.

Fourthly, put sound supporting measures in place. China's regulators should optimize the bond issuance, approval, pricing and circulation links, increase the size and category of bond investors, and render banks' debt capital better liquidity; make greater efforts to push forward the development and implementation of banks' resolution plan, establish a legal system governing

financial institution resolution and bankruptcy that fits well into the actuality of China's banking industry, enhance the efficient cohesion between exit with administrative interference and judicial bankruptcy, set up a regular exit mechanism for financial markets, and ensure the resolution plan can be followed in the actual practice.

Recommendations for the large banks:

Firstly, introduce more targeted capital replenishment channels. In terms of Basel III regulatory capital, large banks should properly lower the dividend ratio against the downward cycle of China's economy; adapt to the trend of mixed ownership reform and push through the employee stock ownership plan; step up efforts to raise fund overseas and enhance material subsidiaries' capacity in this regard particularly; and strengthen market value management and issue additional stocks when needed. As for TLAC capital, large banks should continue to issue the sophisticated debt capital instruments like tier-2 capital instruments with write-down feature and preference shares classified as liabilities; vigorously develop innovative capital instruments including tier-2 capital instruments with conversion term and senior unsecured bonds with write-down or conversion term; and on equal issuance conditions, give priority to tier-2 capital instruments with conversion or write-down term which can be simultaneously included in regulatory capital and TLAC debt capital.

Secondly, optimize assets and liabilities management. In the light of assets, large banks should keep improving the assets allocation efficiency and strengthen the RAROC evaluation mechanism; enrich the functions of financial services based on the traditional credit business and develop the assets management, custody services and other fee-based businesses at an accelerated pace; actively respond to the implementation of the national "Belt and Road" initiative, optimize the distribution of overseas outlets, branches and institutions, and introduce a separate capital evaluation mechanism for material subsidiaries; and adapt to the transformation in economic growth mode, vigorously develop the retail banking business and improve its proportion, and lower the risk capital occupation. As for liabilities, large banks should phase out some liabilities with high cost, inadequate transparency and low marketed-based operation (e.g. non-traditional inter-bank business) with bond issuance and increase banks' active liabilities; strengthen the issuing term management of debt capital instruments and complete the alteration of capital nature like eligible TLAC debt capital deduction at critical time points. Besides, in the face of severe pressure from the TLAC debt capital replenishment, large banks are suggested to adjust the risk assets structure, optimize the overseas assets structure, reduce the size of proprietary business with high risk, and quicken the transformation process towards an intensive and asset-light growth model.

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