

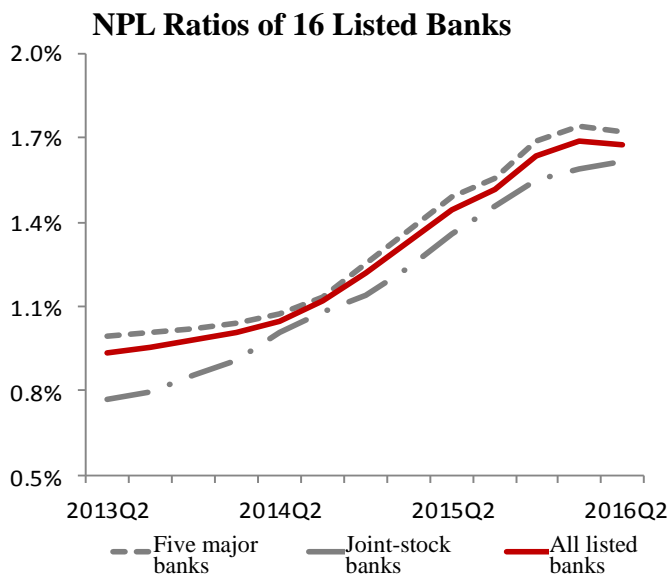
Global Banking Industry Outlook

2016Q4 (Issue 9)

September 29, 2016

Highlights

- In 2016H1, the global banks headed in different directions: the U.S. banking industry kept broadly stable operation, the banks of Eurozone and the UK improved slightly, and the banking industry of Japan deteriorated.
- In 2016Q4, operation of China's listed banks is projected to remain under pressure. Overall net profit of the Chinese banking industry is estimated to grow by 2.6% year on year, and the NPL ratio is expected to jump further to ~1.70%. Maintaining stable asset quality and developing non-interest business are the keys to keeping stable operation.



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Operation Steadied, but Sustainability Remains to be Seen

— Global Banking Industry Outlook (2016Q4)

In 2016Q2, the assets and liabilities of the 30 Global Systemically Important Banks (G-SIBs) expanded, the ratio of their deposits and loans continued to increase, net profit continued to decline, NIM dipped slightly, ROA and ROE retreated marginally, capital adequacy ratio (CAR) jumped and the asset quality kept broadly stable. Compared to their foreign counterparts, China's G-SIBs fared well in aspects such as the growth rate of assets/liabilities, NIM, asset quality and profitability, but the mounting pressure on asset quality merits close attention. By country, the banking industry of the U.S. maintained stable operation overall; affected by accelerating economic growth and rebound in the commodity prices, the banking industries of the Eurozone and the UK rebounded; yet operation of the Japanese banking industry deteriorated due to impact of the "negative interest rate" policy. The Chinese banking industry kept stable profitability: the proportion of non-interest income increased and the "dual increases" in NPL balance and NPL ratio eased, pointing to controllable credit risks. Looking ahead into Q4, China is expected to keep stable economic growth against the heavy downside pressure. Facing both development opportunities and challenges, keeping steady growth and preventing risks become important tasks for banks.

I. Operational Characteristics of G-SIBs

I.1. Operating profile

I.1.1 The scale of assets and liabilities expanded; and the ratio of deposits and loans continued to increase

As of the end of June 2016, total assets and liabilities of the 30 G-SIBs stood at USD50.7 trillion and USD47.1 trillion, up 2.1% and 2.1% year on year, respectively. The growth rates were 1.2 percentage points and 1 percentage point lower than the same period of last year. Compared to international peers, the Chinese G-SIBs recorded relatively fast growth in assets (7.1% on average) and liabilities (6.6% on average).

As of the end of June 2016, the average deposit/liability ratio and the average loan/asset ratio of the 30 G-SIBs were 55.3% and 38.4%, respectively, which were 2.2 percentage points higher and 0.1 percentage points lower than the same period of last year. On the asset side, the loan/asset ratio of 13 banks jumped among the 30 G-SIBs, with the highest hitting 23.1 percentage points. On the liability side, the deposit/liability ratio of 16 banks increased, with the highest being 10.8 percentage points. The Chinese G-SIBs reported slightly higher deposit/liability ratio and loan/asset ratio than other G-SIBs, and their average deposit/liability ratio and loan/asset ratio jumped by 1.1 percentage points and 1.0 percentage point from the same period of last year, respectively.

I.1.2 Net profit continued to decline

In 2016H1, net profit of the 30 G-SIBs totaled USD159.12 billion, down 3.2% year on year; and net profit of the Chinese G-SIBs came in at USD74.93 billion, representing 47.1% of the total net profit of all G-SIBs.

I.1.3 NIM edged down

In 2016H1, average NIM of the 30 G-SIBs was 1.6%, down 0.1 percentage points from the same

period of last year. NIM of the Chinese G-SIBs came in at 2.2%, down 0.3 percentage points from the same period of last year.

I.1.4 Operating efficiency decreased marginally

In 2016H1, the average cost/income ratio of the 30 G-SIBs was 64%, up 1.4 percentage points from the same period of last year. That of the Chinese G-SIBs stood at 24.5%, notably lower than the average level of their international peers.

I.1.5 CAR jumped

As of the end of June 2016, the average CAR of the 30 G-SIBs went up 0.8 percentage points from the same period of last year to 17.0%, pointing to continued enhancement of the steady business development momentum. The CAR of Chinese G-SIBs was 14.5%, 0.9 percentage points higher than the same period of last year.

I.1.6 The asset quality stood broadly stable

As of the end of June 2016, the average NPL ratio of the 30 G-SIBs was 2.7%, down 0.7 percentage points from the same period of last year. That of the Chinese G-SIBs came in at 1.8%, up 0.3 percentage points from the same period of last year but still significantly lower than the average level of peers.

I.1.7 The ROA and ROE retreated slightly

In 2016H1, the ROA and ROE of the 30 G-SIBs were 0.5% and 6.2%, respectively, down 0.1 percentage points and 1.9 percentage points from the same period of last year. Over the same period, the ROA and ROE of the Chinese G-SIBs continued to linger at the high levels, staying at 1.3% and 16.5%, respectively.

I.1.8 Valuation continued to decrease

As of the end of June 2016, price/book value ratio (P/B) of 30 G-SIBs averaged to 0.7x, 0.3x or 30% lower than the same period of last year. The average PB of the Chinese G-SIBs was 0.7x, flat versus that of the international peers.

I.2 Outlook

In 2016Q4, the global G-SIBs are expected to demonstrate the following trends:

The scale of assets and liabilities will “contract in some banks and expand in others”. At present, balance sheets of the global G-SIBs are clearly “contracting”. The overall assets and liabilities of the G-SIBs in the Eurozone are expected to continue shrinking, while those of the Japanese and Chinese G-SIBs are projected to continue expanding.

The profit prospect is mixed. In the forthcoming 2016Q4, profit of the G-SIBs in the Eurozone and the U.S. is projected to recover notably alongside the rebound in commodity prices (such as crude oil price, natural gas price etc.) in the international market; as formation of new NPLs slows, the Chinese G-SIBs are expected to keep slight profit growth; and due to deepening of the “negative interest rate” policy, prospect of the Japanese G-SIBs is not optimistic.

The CAR will rise steadily. As the regulatory requirements tighten, the CAR of the global G-SIBs is projected to rise further in 2016Q4.

The asset quality will continue to diverge. Thanks to a clear recovery momentum in the economy, the NPL ratio of the U.S. G-SIBs is expected to stay at relatively low levels; battered by slowing economic growth and difficulties to dispose of the NPAs, the NPL ratio of Japanese and European

G-SIBs is projected to come under greater pressure; and Chinese G-SIBs are expected to continue facing immense NPA resolution pressure as the inflection point for NPA growth hasn't come into sight.

II. Banking Industry Operation and Outlook of Major Economies

II.1 U.S. banking industry

II.1.1 Operating profile

The scale of assets and liabilities continued to grow. As of the end of 2016Q2, total assets of the U.S. banking industry^① stood at USD16.5 trillion, up 5.0% from the same period of last year and 1.5% from the previous quarter; total liabilities stood at USD14.7 trillion, up 4.9% from the same period of last year and 1.5% from the previous quarter; and total capital stood at USD1.9 trillion, up 5.3% from the same period of last year and 1.7% from the previous quarter (Table 3).

Table 3: Size Change of the U.S. Banking Industry (USD100 million, %)

	2016Q2	2016Q1	2015Q2	QoQ change	YoY change
Assets	165340	162934	157533	1.48	5.00
Liabilities	146634	144532	139776	1.45	4.91
Equity	18706	18403	17757	1.65	5.34
Net profit	436	391	430	11.51	1.40

Sources: FDIC, BOC Institute of International Finance

Profitability rose, and operating efficiency improved. In 2016Q2, the U.S. banking industry reported net profit of USD43.6 billion, up 1.4% from the same period of last year and 11.5% from the previous quarter; the ROA came in at 1.0%, down 0.1 percentage points from the same period of last year but up 0.1 percentage points from the previous quarter; the ROE was 9.1%, down 0.4 percentage points from the same period of last year but up 0.4 percentage points from the previous quarter; the cost/income ratio was 58.8%, down 1.13 percentage points from the same period of last year and 1.1 percentage points from the previous quarter; and the proportion of non-interest income was 36.7%, down 2.37 percentage points from the same period of last year but up 5.0 percentage points from the previous quarter (Table 4).

The CAR stood basically stable, and the asset quality continued to improve. As of the end of 2016Q2, the U.S. banking industry reported a tier-1 CAR of 12.7%, up 0.1 percentage points from the same period of last year and 0.1 percentage points from the previous quarter; and the NPL ratio was 2.1%, down 0.2 percentage points from the same period of last year and 0.1 percentage points from the previous quarter (Table 4).

① Cover all deposit financial institutions protected by FDIC deposit insurance.

Table 4: Change of Indicators of the U.S. Banking Industry (% , percentage points)

	2016Q2	2016Q1	2015Q2	QoQ change	YoY change
ROA	1.02	0.97	1.06	0.05	-0.04
ROE	9.05	8.62	9.45	0.05	-0.04
NIM	3.10	3.10	3.05	0.00	0.02
Proportion of non-interest income	36.70	34.95	37.59	5.01	-2.37
Cost/income ratio	58.76	59.85	59.89	-0.02	-0.02
Tier 1 CAR	12.74	12.69	12.67	0.00	0.01
NPL ratio	2.13	2.24	2.38	-0.05	-0.11

Sources: FDIC, BOC Institute of International Finance

II.1.2 Regulatory environment

In 2016Q3, changes in the regulatory environment of the U.S. banking industry are mainly reflected in the following two aspects:

First, the Federal Reserve published the stress testing results of the banking industry in 2016. Data shows that among the 33 bank holding companies, the capital plans of 30 were “approved”, that of Morgan Stanley was “conditionally approved”, but those of Deutsche Bank and Santander Bank were “failed”. During assessment of a bank holding company’s capital plan, the Federal Reserve will measure the capital plans on quantitative and qualitative dimensions: the quantitative factors include relevant company’s expected CAR in the extreme scenario; and the qualitative factors include risk management, internal control and corporate governance structure of the company. Deutsche Bank and Santander Bank failed to pass the stress test mainly because they failed to meet the qualitative requirements of the Federal Reserve.

Second, the chairman of the House Financial Services Committee plans to vote on the *Financial Choice Act*. The Act was first published in June 2016, and it aims to replace the *Dodd-Frank Wall Street Reform and Consumer Protection Act* that was released in 2010. The Act allows banks to adopt the simple leverage measurement rules and controls the ratio no lower than 10%, in order to avoid the requirement of some rules in Basel III and the *Dodd-Frank Wall Street Reform and Consumer Protection Act*. Seen from the current situation, the proposal will likely be approved by the House Financial Services Committee, but it won’t be presented to the Senate and the House of Representative until 2017.

II.1.3 Outlook

Looking ahead into Q4, we believe the Federal Reserve will very likely raise the interest rate once in the quarter, considering the Fed stated in resolutions of the September FOMC meeting that “the case for an increase in the federal funds rate has strengthened”. Under this expectation, we forecast that the yield curve will steepen in the short term, which will benefit the asset-sensitive banks. As the inertia effect of the growing credit demand and the widening NIM bode well for the entire banking industry, we believe operation of the U.S. banking industry will continue to turn around in the future.

II.2 Eurozone banking industry

II.2.1 Operating profile

The scale of deposits and loans kept mild growth, and growth rate of deposits was slightly lower than that of loans. As of the end of 2016Q2, the outstanding deposits of the Eurozone totaled EUR17.23 trillion, up 1.41% from the same period of last year. The growth rate moderated slightly compared to the previous quarter. By country, Slovakia (+8.1%), Estonia (+7.7%) and Cyprus (+7.5%) reported the fastest growth in outstanding deposits; and Greece (+0.9%), Finland (+1.2%) and the Netherlands (+2.3%) reported relatively slow growth. Over the same period, the outstanding loans of the Eurozone totaled EUR17.55 trillion, up 2.63% from the same period of last year. The growth rate was 1.63 percentage points higher than the previous quarter. By country, Luxembourg (+12.2%), Slovakia (+6.6%) and Estonia (+6.5%) reported the fastest growth in outstanding loans; and Ireland (-8.2%), Slovenia (-7.2%) and Cyprus (-6.9%) registered the steepest declines.

Profitability rose slightly, and the cost/income ratio dipped. In 2016Q2, the ROA of major banks in the Eurozone was 0.5%, up 0.1 percentage points from the previous quarter; their ROE was 7.4%, up 0.2 percentage points from the previous quarter; the NIM was 1.5%, flat versus the previous quarter; and the cost/income ratio was 58.4%, down 10.5 percentage points from the previous quarter.

The CAR jumped, and the NPL ratio declined. As of the end of 2016Q2, the tier-1 CAR of major banks in the Eurozone was 12.7%, up 0.3 percentage points from the previous quarter; and their NPL ratio was 3.0%, down 0.3 percentage points from the previous quarter.

II.2.2 Regulatory environment

According to information released by the European Central Bank recently, overall risk in the Eurozone banking market hasn't waned noticeably. Many banks are still facing immense risks and obstacles. The European Central Bank noted that it would make endeavors to improve the visibility of supervisory measures. It plans to complete the regulatory reform in light of the Basel Accord prior to the year end, and focus on avoiding significantly raising the overall capital requirements for banks.

Recently, the European Central Bank released the draft of its guiding opinions on NPL management, aimed at helping the European banks resolve their NPL problems. The European Central Bank will monitor the NPL level of banks across the Eurozone, and resort to the supervisory review and evaluation process (SREP) to monitor banks' NPL management efforts, assess the appropriateness of their strategies, the governance structure and procedures.

In addition, due to increase in the number of working staff and the growing cost to evaluate risks of individual banks and launch stress test over the European banking industry, the European Central Bank has raised the supervisory fees by 1/4 this year, and will likely continue to raise it in the future. This may increase the cost pressure on the troublesome European banking industry.

II.2.3 Outlook

Overall, problems plaguing the banking industry, such as negative interest rate, NPLs, tightening supervision and black swan events will continue to grow and challenge development of the Eurozone banking industry. On one hand, in the context of negative interest rates, banks need to review their business models, enrich the source of income, cut costs and boost profitability. Digitalization represents possibly a new direction of reform. On the other, the banking industries of Italy and Portuguese are still suffering high NPL ratios; and issues such as tightening supervision,

stricter capital requirement and the regulatory reform may increase the challenges facing the banking industry. Moreover, the impact of unexpected incidents shall also not be underestimated. For instance, the Deutsche Bank disclosed recently that, the United States Department of Justice request it to pay USD14 billion to close the probe in its residential mortgage-backed securities (RMBS) business. The amount of fine far exceeds expectation of the Deutsche Bank and investors.

II.3 UK banking industry

II.3.1 Operating profile

The retail deposits continued to increase; and the wholesale deposits stabilized and recovered. As of the end of 2016Q2, M4 of the UK reached GBP2,183.91 billion, up 3.8% from the same period of last year. The growth rate was 2.5 percentage points higher than the end of the previous quarter. Among it, retail deposits and cash rose by 3% from the same period of last year (growth rate was flat versus the previous quarter) to GBP1,583.98 billion; and the wholesale deposits amounted to GBP602.45 billion, up 5.8% from the same period of last year (3 percentage points higher than the previous quarter).

The retail loans grew steadily, and the institutional loans registered slow growth. As of the end of 2016Q2, the outstanding personal credit of the UK was GBP1,292.27 billion, up 4.7% from the same period of last year. The growth rate was 0.4 percentage points higher than the previous quarter. Among it, the housing mortgage loans grew 4.7% from the same period of last year to GBP1,137.1 billion; and the consumer credit rose by 6.6% from the same period of last year to GBP124.5 billion. Total outstanding credit of non-financial institutions was GBP562.15 billion, up 3.4% from the same period of last year, and among it, net outstanding loans of the construction industry was GBP30.26 billion, down 6.4% from the same period of last year.

II.3.2 Regulatory environment

The Brexit may deal a blow to the UK banking industry: the subsequential rate cut by Bank of England may worsen the NIM environment of the UK; the probability of falling property prices grows in the UK; the banking system becomes more fragile; depreciation of the local currency leads to shrinkage of banks' assets; downgrade of investment rating undermines banks' chance and cost of obtaining financial resources; slump in share prices weighs down on banks' recapitalization and risk-absorption capability.

Additionally, the Brexit will also affect operation of the UK banking industry and the UK headquarters of foreign banks. After the Brexit, banks taking London as their European business center will stop enjoying the "passporting" and can no longer plan their European operations under the current framework unless a new agreement is reached between the UK and the European Union. These banks will have to reconsider their strategic arrangement and business layout in Europe. Moving the headquarters and business centers from London to other European Union members is possibly one of the options, which is set to lift the operational cost of these banks in the European Union. Therefore, some international banks will play down their attention to the UK market, and review their global business strategies.

II.3.3 Outlook

The Brexit takes a toll on the UK banking industry. Whether the UK is able to retain or partly retain the "passporting" after the Brexit will significantly influence the position of the UK as the European financial center. The European Union's requirements for the UK to guarantee free flow of people serves as a condition of the unified market (inclusive of the "passporting"), while re-controlling the migrant flows is one of the most important aims that have persuaded the UK to leave the European Union. Viewed from the current situations, partly retaining the "passporting" is

more feasible for the UK. In a nutshell, the relation between the UK and the European Union after the Brexit merits close attention.

Moreover, the UK may become more open to countries and regions outside the European Union in order to make up for its lost market share in Europe. This means that the UK will further align its financial regulatory rules with those of the countries and regions outside the European Union as an important means to attract financial institutions outside the European Union, neutralize the adverse impact of Brexit on the position of the UK as an international financial center, and increase the competitiveness of the UK.

II.4 Japan's banking industry

II.4.1 Operating profile

Aggregate money supply grew steadily, and lending rate continued to decline. Affected by the new round of economic stimulus, growth rate of Japan's aggregate domestic money supply continued to rise. As of the end of August 2016, Japan's M3 hit JPY1,263.4 trillion, up 2.3% from the same period of last year. In the context of loose monetary and credit policies, the lending rate required by Japanese financial institutions continued to decline. According to the latest data published by the Japanese central bank (July data), the annualized lending rate of new long-term and short-term loans in Japan fell by 0.2 percentage points and 0.1 percentage points from a year ago to 0.78% and 0.68% respectively.

The scale of deposits and loans kept medium-speed growth, with deposits growing faster than loans. As of the end of August 2016, the total outstanding deposits of Japanese banks amounted to JPY654.2 trillion, up 3.3% from the same period of last year: among it, total deposits of the five major banks^② were JPY329.9 trillion, up 4.4% from the same period of last year; those of first-tier regional banks were JPY258 trillion, up 2.2% from the same period of last year; and those of the second-tier regional banks were JPY66.2 trillion, up 1.9% from the same period of last year. In terms of loans, the total outstanding loans of Japanese banks was JPY499.9 trillion, up 2% from the same period of last year: among it, total loans of the five major banks were JPY204.9 trillion, up 0.5% from the same period of last year; those of the tier-1 regional banks were JPY181.7 trillion, up 3.5% from the same period of last year; and those of the tier-2 regional banks were JPY47.9 trillion, up 2.8% from the same period of last year.

Profitability dropped considerably. In 2016H1, net profit of the three Japanese G-SIBs totaled JPY776.8 billion, down 20% from the same period of last year; their average ROA was 0.3%, down 0.1 percentage points from the same period of last year; and their average ROE was 6.9%, down 1.5 percentage points from the same period of last year.

II.4.2 Regulatory environment

(1) The Financial Services Agency of Japan brought forth the tax reform opinions, including creation of the "cumulative NISA" system

On August 31, the Financial Services Agency of Japan brought forth the tax reform opinions, including creation of the "cumulative NISA"^③ system, in an effort to boost prosperity of the Japanese financial market. The prevailing NISA system of Japan sets forth a five-year tax-exemption period for the projects with annual investment of less than JPY1.20 million. The

^② The five major banks include Bank of Tokyo-Mitsubishi UFJ, Mizuho Bank, Sumitomo Mitsui Banking Corporation, Resona Holdings and Saitama Resona Bank.

^③ NISA (Nippon Individual Savings Account) refers to the small-lot investment tax exemption scheme rolled out since Abe took the office for the second time. It targets the investment in stocks and trust products and aims to vitalize the Japanese stock market and boost investment. As of the end of March 2016, the number of NISA accounts had exceeded 10.12 million.

Financial Services Agency proposed to create a “cumulative NISA” system that offers a 20-year tax-exemption period for the projects with annual investment of less than JPY0.6 million as an option. In addition, when the investment generates returns after the tax-exemption period, Japan will waive part of the taxes on the extra returns; and when the investment incurs losses, the original investment will be taken as the initial investment cost. If the abovementioned proposals are put into implementation smoothly, it will effectively boost the expected investment returns for financial institutions and individuals, increase banks’ commission and fee income, and bolster growth of the Japanese banks’ non-interest income.

(2) The new round of economic stimulus introduced by Japan may pose a positive to the Japanese banking industry

On August 2, the Japanese government rolled out a JPY28 trillion-worth new economic stimulus, under which, direct fiscal spending by the national and local governments will reach JPY7.5 trillion. On August 24, the Japanese government adopted the second revised budget plan (JPY4.5 trillion) for 2016, under which the government will increase the investment in the construction of infrastructure facilities such as ports and shinkansen, post-disaster reconstruction, disaster prevention etc. The Japanese government aims to increase the country’s real GDP by 1.3% during the 2016~2017 year. Growth of the government expenditure is well poised to reinforce the economic growth vitality, and stimulate private investment, thus boding well for the banking industry.

II.4.3 Outlook

Boosted by the new round of economic stimulus launched by the Japanese government, the operating environment of the Japanese banking industry is expected to improve slightly, but its prospect remains unoptimistic. If the Japanese central bank further lowers the already negative interest rate to support implementation of the fiscal policy, it will bring a new challenge to the banking industry.

Due to slack growth in the fee & commission income from investment, trust and other business, the Japanese banks are facing an increasingly austere operating environment. We expect the local Japanese banks to continue exploring business transformation through M&A, restructuring, consolidation of operations in some fields, cross-industry cooperation etc.

III. China’s Banking Industry Review and Outlook

III.1 Operating situation of the banking industry in 2016Q2

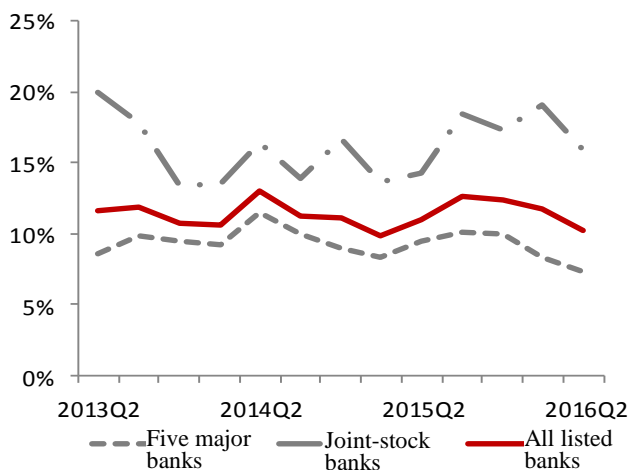
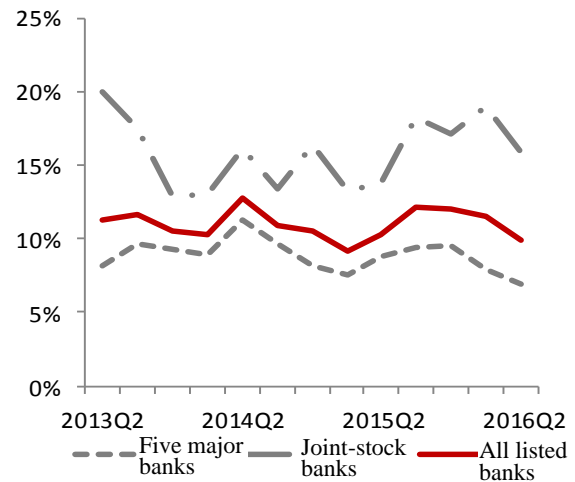
In 2016H1, operation of the Chinese listed banks^④ displayed the following characteristics: growth of the assets and liabilities slowed, and the momentum of divergence across different types of banks eased; the profitability stood stable, thanks to cost control; the deposit/liability ratio declined against rise in loan/asset ratio, and the proportion of non-interest income continued to expand; the “dual increases” in the NPL balance and ratio softened, and the provision coverage ratio stabilized despite slight decline; the CAR stood flat, and the loan/deposit ratio continued to increase.

III.1.1 Growth of the assets and liabilities slowed, and the momentum of divergence across different types of banks eased

As of the end of June 2016, total assets and liabilities of the Chinese listed banks came in at

^④ “Listed banks” herein refer to the 16 commercial banks, not including Bank of Jiangsu, Bank of Guiyang and Bank of Jiangyin, that are 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 Beijing, Bank of Nanjing, Bank of Ningbo.

RMB127.6 trillion and RMB118.5 trillion, up 10.2% and 9.9% from the same period of last year, respectively. The growth rates were 0.8 percentage points and 0.5 percentage points lower than the same period of 2015, respectively. Among it, total assets and liabilities of five major banks were RMB87.5 trillion and RMB80.9 trillion, up 7.4% and 6.9% from the same period of last year respectively (the growth rates were 2.1 percentage points and 1.9 percentage points lower than the same period of last year); those of the joint-stock banks were RMB36.3 trillion and RMB34.0 trillion, up 15.9% and 15.9% from the same period of last year respectively (the growth rates were 1.6 percentage points and 2.2 percentage points higher than the same period of last year) (Figure 1 and Figure 2).

Figure 1: YoY Assets Growth

Figure 2: YoY Liabilities Growth


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

III.1.2 The profitability stood stable, thanks to cost control.

In 2016H1, the listed banks realized operating income of RMB1.9 trillion and net profit of RMB736.07 billion, up 5.4% and 3.9% from the same period of last year, respectively. The growth rates were 4.5 percentage points lower and 1.3 percentage points higher than the same period of last year. Among them, five major banks recorded operating income of RMB1.3 trillion and net profit of RMB534.84 billion, up 3.0% and 3.1% from the same period of last year (the growth rates were 2.8 percentage points lower and 2.1 percentage points higher than the same period of last year); and the joint-stock banks recorded operating income of RMB565.06 billion and net profit of RMB182.00 billion, up 9.8% and 5.4% from the same period of last year (the growth rates were 10.2 percentage points and 1.1 percentage points lower than the same period of last year) (Figure 3 and Figure 4).

Figure 3: YoY Operating Income Growth

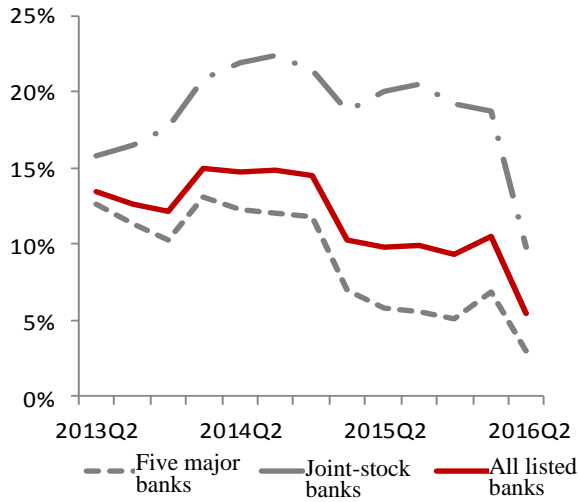
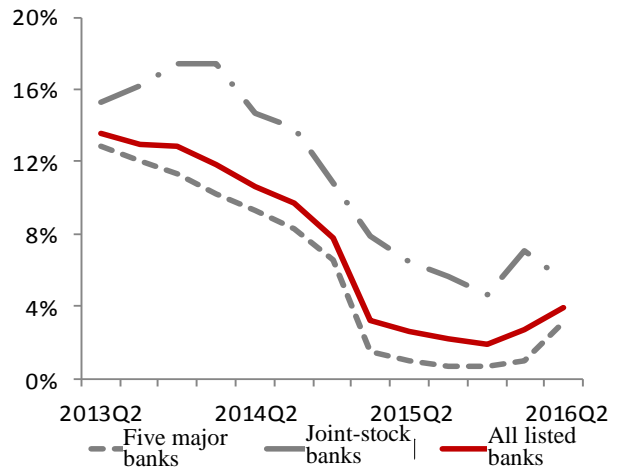


Figure 4: YoY Net Profit Growth



In 2016H1, ROA and ROE of the listed banks^⑤ stood at 1.09% and 16.29%, respectively, down 0.1 percentage points and 2.1 percentage points from the same period of last year. Among them, the ROA and ROE of five major banks were 1.23% and 15.93%, respectively, down 0.1 percentage points and 2.1 percentage points from the same period of last year; and the ROA and ROE of the joint-stock banks were 1.03% and 16.16%, respectively, down 0.1 percentage points and 2.1 percentage points from the same period of last year (Figure 5 and Figure 6).

Figure 5: ROA

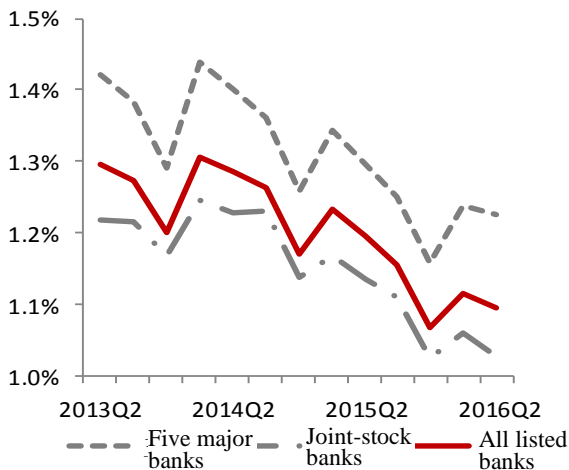
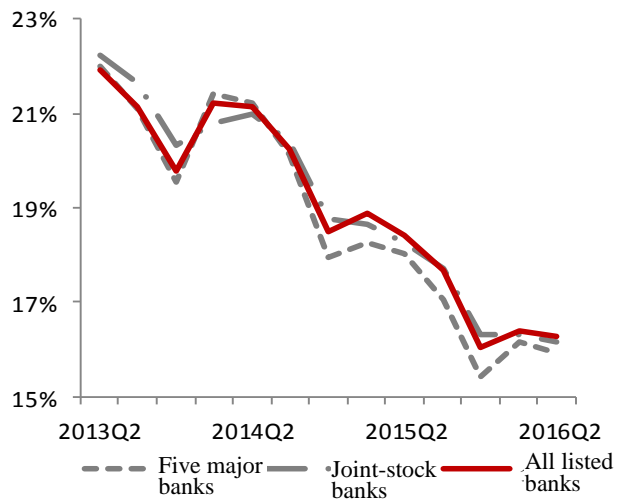


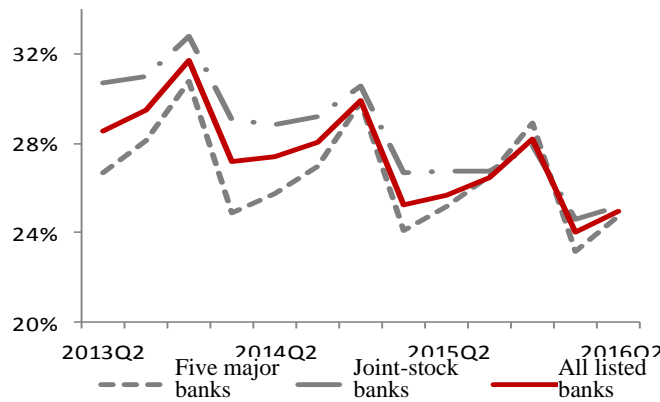
Figure 6: ROE



In 2016H1, the cost/income ratio of the listed banks was 24.92%, down 0.8 percentage points from the same period of last year. Among them, the cost/income ratio of five major banks was 24.70%, down 0.4 percentage points from the same period of last year; and that of the joint-stock banks was 25.19%, down 1.6 percentage points from the same period of last year (Figure 7).

^⑤ The ROA, ROE, cost/income ratio, CAR, tier 1 CAR and core tier 1 CAR are arithmetic averages; the proportion of non-interest income, NPL ratio, provision coverage ratio and loan/deposit ratio are weighted averages.

Figure 7: Cost/Income Ratio



III.1.3 The deposit/liability ratio declined against rise in loan/asset ratio, and the proportion of non-interest income continued to expand

As of the end of June 2016, the deposit/liability ratio and the loan/asset ratio of the listed banks were 73.5% and 51.0%, respectively, 1.4 percentage points lower and 0.3 percentage points higher than the same period of 2015. Among them, the two indicators of five major banks were 78.9% and 53.6%, respectively, up 0.4 percentage points and 0.7 percentage points from the same period of last year; and those of the joint-stock banks were 61.7% and 45.9%, respectively, down 4.7 percentage points and 0.1 percentage points from the same period of last year (Figure 8 and Figure 9).

Figure 8: Outstanding Deposits/Total Liabilities

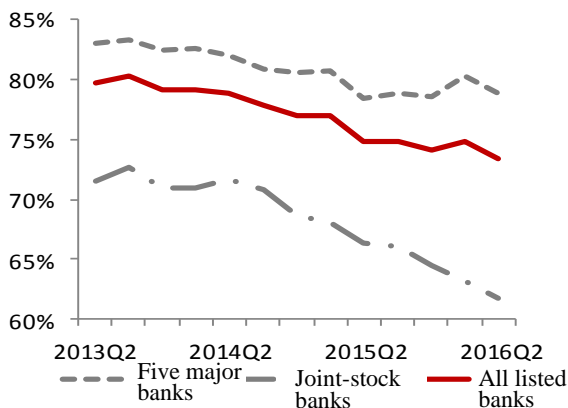
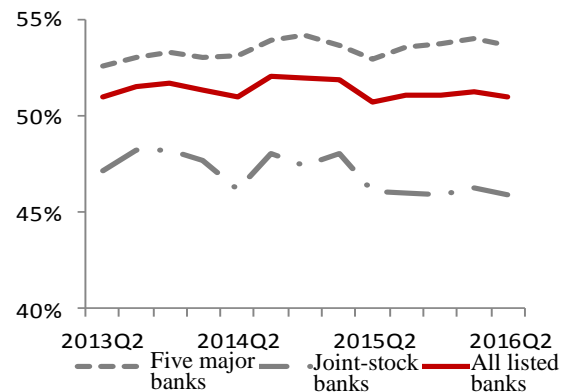
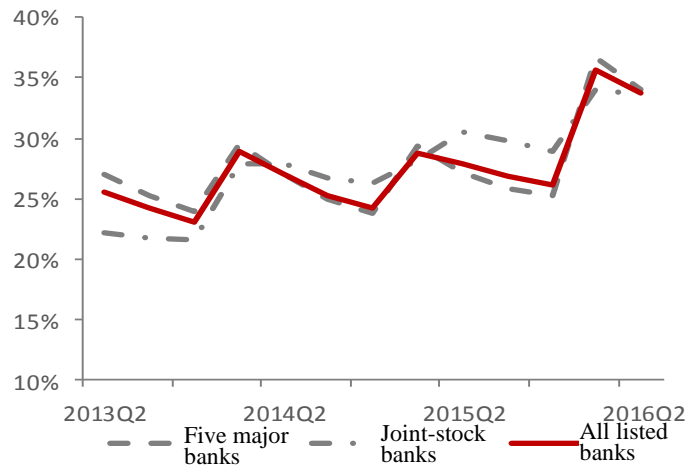


Figure 9: Outstanding Loans/Total Assets



In 2016H1, the proportion of non-interest income of the listed banks was 33.7%, up 5.8 percentage points from the same period of last year. Among them, the indicator of five major banks was 34.1%, up 6.9 percentage points from the same period of last year; and that of the joint-stock banks was 33.6%, up 3.0 percentage points from the same period of last year (Figure 10).

Figure 10: Non-interest Income/Total Income



III.1.4 The “dual increases” in the NPL balance and ratio softened, and the provision coverage ratio stabilized despite slight decline

As of the end of June 2016, the NPL balance of the listed banks was RMB1.1 trillion, up 28.5% from the same period of last year. The growth rate was 23.7 percentage points lower than the same period of 2015. The NPL ratio of the listed banks was 1.68%, up 0.2 percentage points from the same period of last year. Among them, the NPL balance and NPL ratio of five major banks were RMB807.95 billion and 1.72%, up 25.7% (26.0 percentage points lower than the same period of 2015) and 0.2 percentage points from the same period of last year; the NPL balance and NPL ratio of the joint-stock banks were RMB268.88 billion and 1.61%, up 37.2% (17.0 percentage points lower than the same period of 2015) and 0.3 percentage points from the same period of last year (Figure 11 and Figure 12).

Figure 11: Growth Rate of Outstanding NPL

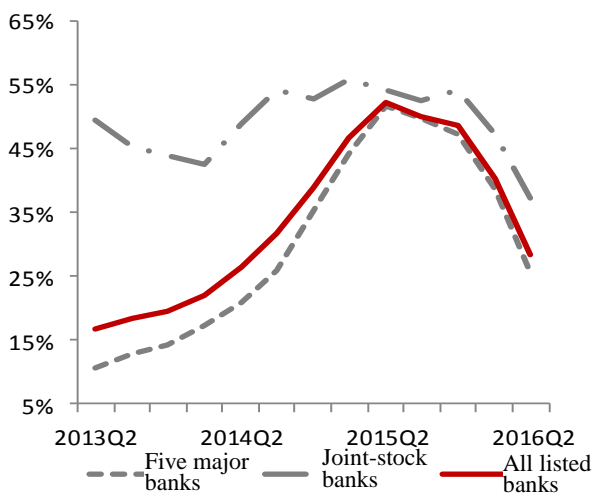
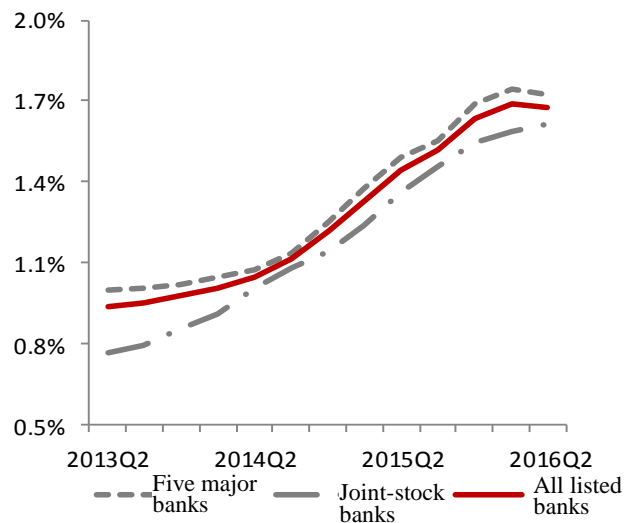


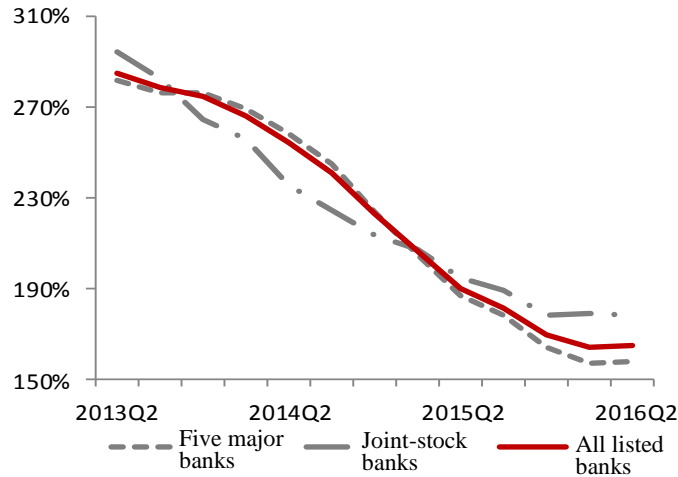
Figure 12: NPL Ratio



In 2016H1, the provision coverage ratio of the listed banks was 164.7%, down 25.1 percentage

points from the same period of last year. Among them, the provision coverage ratio of five major banks was 157.3%, down 29.1 percentage points from the same period of last year; and that of the joint-stock banks was 178.2%, down 16.0 percentage points from the same period of last year (Figure 13). The provision coverage ratio of some listed banks has dropped below the 150% regulatory red line.

Figure 13: Provision Coverage Ratio



III.1.5 The CAR stood flat, and the loan/deposit ratio continued to increase.

In 2016H1, the CAR, tier-1 CAR and core tier-1 CAR of the listed banks were 12.8%, 10.2% and 9.8%, respectively, up 0.3 percentage points, 0.2 percentage points and 0.1 percentage points from the same period of last year. Among them, the three indicators of five major banks were 14.3%, 11.4% and 11.5%, respectively, up 0.2 percentage points, down 0.1 percentage points and up 0.5 percentage points from the same period of last year; and those of the joint-stock banks were 11.9%, 9.7% and 9.1%, respectively, up 0.2 percentage points, 0.4 percentage points and 0.1 percentage points from the same period of last year (Figure 14).

As of the end of June 2016, the loan/deposit ratio of the listed banks was 74.7%, up 2.0 percentage points from the same period of last year. Among them, the loan/deposit ratio of five major banks was 73.5%, up 0.9 percentage points from the same period of last year; and that of the joint-stock banks was 79.5%, up 5.4 percentage points from the same period of last year (Figure 15).

Figure 14: CAR

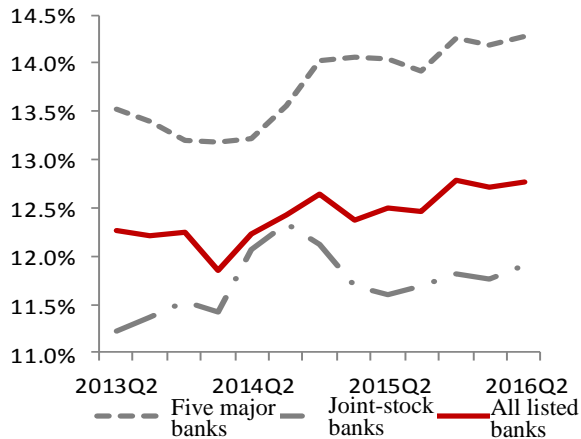
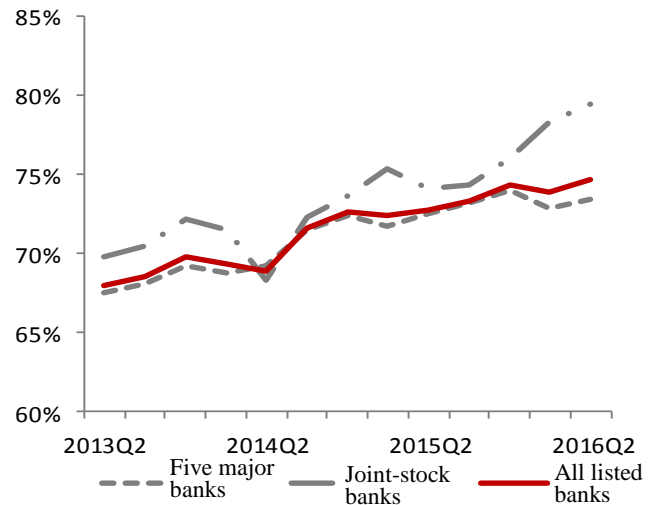


Figure 15: Loan/Deposit Ratio



III.2 Outlook

III.2.1 Analysis of operating environment in 2016Q3

In 2016Q3, the following three factors are expected to dictate the operation of the Chinese banking industry:

First, economy. China's economy is expected to steady forward in 2016Q3. During January-August, the cumulative FAI of China grew by 8.1% from the same period of last year, flat versus the growth rate during the first seven months; and the cumulative real estate investment went up 5.4% from the same period of last year, 0.1 percentage points faster than the growth rate in the first seven months. These suggest that China's social investment started to stabilize. The cumulative total retail sales of consumer goods grew by 10.3% from the same period of last year, flat versus the growth rate during the first seven months; and the cumulative gross import and export value fell by 7.9% from the same period of last year, 0.9 percentage points milder than the decline in the first seven months. We forecast that China's GDP growth rate will sustain the momentum in Q2 and stay at ~6.7% in 2016Q3. The stable and improving economic growth will help banks to keep stable operating results.

Second, policy. In Q3, China's monetary policy maintained the "prudent" tone. As of the end of August 2016, China's M2 balance was RMB151.1 trillion, up 11.4% from the same period of last year (1.2 percentage points higher than the growth rate in July 2016). The growth rate continued to linger above 10%. We forecast that China's M2 will grow by ~12% in 2016Q3. The moderate monetary policies help banks to maintain a reasonable pace of growth.

Third, reform. In Q3, reform of the banking regulation system achieved periodical results. On July 6, the CBRC drafted the *Guidelines on Comprehensive Risk Management of Banking Institutions (Exposure Draft)*, which encourages banks to improve the awareness of comprehensive risk management, establish prudent risk culture etc. On July 15, the CBRC released the *Guiding Regulatory Opinions on the Information Technology Development Plan of the Chinese Banking Industry during the "13th Five-Year Plan" Period*, pointing out the directions for banks to boost technology innovation and grasp business opportunities from the development of financial

technologies. On August 24, four ministries/commissions including the CBRC jointly released the *Temporary Administrative Measures on Activities of Online Lending Information Intermediaries*, laying down the institutional base for standard development of the online lending industry. On August 31, seven ministries/commissions including the People's Bank of China jointly released the *Guiding Opinions on Building the Green Finance System*, setting forth the institutional rules for development of the green finance. On September 9, the CBRC printed and issued the *Circular about Properly Performing the Functions of the Creditor Committee of Banking Institutions*, which sets forth a collective negotiation mechanism for banks to jointly resolve the debt crisis of borrowers, and opens the room for development of new businesses such as syndicated loan, establishment of the joint credit mechanism etc.

In a nutshell, we forecast that the assets and liabilities of listed banks will grow by ~10.0% and ~9.5% from the same period of last year in 2016Q3. Their net profit is expected to grow by ~3.0%, and their NPL ratio is expected to rise slightly to ~1.69%.

III.2.2 Q4 outlook

In 2016Q4, factors influencing the operation of Chinese listed banks mainly include:

First, the economic growth will remain stable and improve. In Q4, China's GDP is expected to grow still at ~6.7%. The stable economic growth is mainly driven by: (1) Continued implementation of the "OBOR" initiative. Along with rollout of the *Mid-to-Long-Term Railway Network Plan*, construction of the "eight vertical and eight horizontal" railway lines will speed up, which creates enormous opportunity for infrastructure construction; and distribution of the *Working Plan for Reduction of the Real Economic Entities' Cost* bears critical significance to effectively easing the operating difficulties of real economic entities and coping with the downside pressure in macro economy. (2) Economic transformation needs financial support: The *National Technology Innovation Plan for the "13th Five-Year Plan" Period* outlined the blueprint and overall objectives for technology innovation and development over the next five years, and creates new opportunities for development of banks' Fintech business. (3) Upgrade and expansion of the free trade area (FTA) strategy. Currently, the number of China's FTAs has increased to 11, and the 7 new FTAs are expected to boost the financial reform and offer opportunities for banks to expand their business. (4) RMB is to be officially included into the SDR basket. Looking ahead, RMB will evolve from a paying & clearing currency in the international market to a currency of international investment and government reserves. This not only helps consolidate the global leadership of Chinese banks in the RMB business market, but also offers a great chance for banks to develop the financial market business etc.

Second, monetary policy will remain prudent. In Q4, China's M2 is expected to sustain a ~12% growth rate, which leaves some room for banks to continue expanding their assets. Affected by interest rate liberalization and low interest rate, the deposit and lending rates of financial institutions are projected to dip slightly, and their NIM and net interest spread are expected to continue shrinking, which puts forth stricter requirements on banks' pricing capability. In order to effectively meet the fund demand in real economy, the regulators will likely maintain steady growth in the annual credit by guiding banks to reasonably increase the credit support to infrastructure construction projects (such as transportation), small & micro businesses and poverty alleviation projects, and maintaining steady growth in the consumer credit such as personal housing loans, auto loans etc. Moreover, slight depreciation of RMB relative to the basket of currencies and notable bilateral movement of the exchange rate since 2016 show that the exchange rate is becoming increasingly flexible. The stable expectations for RMB exchange rate help banks to grasp business opportunities in the forex market.

Third, reform measures will likely be put into implementation. (1) On top of soliciting opinions, the *Guidelines on Comprehensive Risk Management of Banking Institutions* will likely be put into implementation, which helps banks to upgrade their awareness of comprehensive risk management and improve the asset quality. (2) Successive rollout of the *Guiding Regulatory Opinions on the Information Technology Development Plan of the Chinese Banking Industry during the “13th Five-Year Plan” Period* and the *Temporary Administrative Measures on Activities of Online Lending Information Intermediaries* create an opportunity and lays down the institutional rules for banks to accelerate development of Internet finance business and realize business development. (2) As the venture loan pilot is launched in Zhongguancun, other regions (including Donghu of Wuhan Province, Zhangjiang of Shanghai Municipality, Binhai of Tianjin Municipality and the Xi’an national innovation demonstration area) will likely follow the lead and successively launch the program. This offers an opportunity for banks to develop relevant business. (3) Measures will likely be rolled out to support construction of the green finance system and implement resolutions of the Hangzhou G20 summit about green finance, offering a vast potential for banks to take their social responsibility, innovate and develop the green finance business etc.

In conclusion, we forecast the assets and liabilities of Chinese listed banks will grow by approximately 10.0% and 9.5% in 2016 respectively; their combined net profit will jump by ~2.6% from last year, and the average NPL ratio will edge up to ~ 1.70%.

Table 5: Forecasts on Key Indicators of Chinese Listed Banks in 2016 (%)

Type	Key indicator	2013 (R)	2014 (R)	2015 (R)	2016			
					Q1R	Q2R	Q3E	2016F
Scale	Asset growth rate	10.8	11.2	12.4	11.8	10.2	10.0	10.0
	Liability growth rate	10.1	10.6	12.0	11.5	9.9	9.5	9.5
Profit	Net profit growth rate	12.8	7.8	1.9	2.7	3.9	3.0	2.6
Structure	Loans/assets	51.7	52.0	51.1	51.3	51.0	51.3	51.5
	Deposits/liabilities	79.2	77.0	74.1	74.9	73.5	73.5	72.5
	Proportion of non-interest income ratio	23.1	24.3	26.1	35.7	33.7	32.5	32.0
Quality	NPL ratio	0.90	1.21	1.64	1.69	1.68	1.69	1.70
	Provision coverage ratio	276	233	169	164.0	164.7	160	150
Capital	Capital adequacy ratio	12.2	12.6	12.8	12.7	12.8	12.7	12.5

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