

Global Banking Industry Outlook

2018Q4 (Issue 36)

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Highlights

- In the first three quarters of 2018, the global banking development environment is stable overall, except for turbulence in some emerging markets (EMs). Banks around the world remained basically stable, but extra attention should be paid to the impact of the Federal Reserve's interest rate hike, EM volatility and the global trade war on banks.
- China's banking industry remained in solid growth. Listed banks generally performed well in terms of balance sheet, operating revenue, net profit and various risk mitigation indicators. In the future, the banking industry is expected to see continued profit growth, controlled overall risk and strengthened loss-absorbing capacity.
- In the face of reshaped economic landscape, enhanced financial supervision and intensified market competition after the crisis, global banks have made major strides forward in lightweight transformation. In the next step of lightweight transformation, the banking industry should take a broader range of comprehensive measures in line with policy changes.

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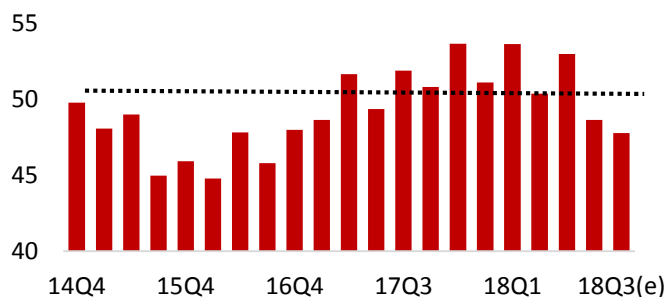
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IIF Index for EM Bank Lending Condition



Brace for New Uncertainties with a Light Burden

-- Global Banking Industry Outlook (2018Q4)

In the first three quarters of 2018, the global banking development environment is stable overall, except for turbulence in some emerging markets (EMs). Banks around the world remained basically stable, but extra attention should be paid to the impact of the Federal Reserve's interest rate hike, EM volatility and the global trade war on banks. China's banking industry remained in solid growth. Listed banks generally performed well in terms of balance sheet, operating revenue, net profit and various risk mitigation indicators. In the future, the banking industry is expected to see continued profit growth, controlled overall risk and strengthened loss-absorbing capacity. In the face of reshaped economic landscape, enhanced financial supervision and intensified market competition after the crisis, global banks have made major strides forward in lightweight transformation. In the next step of lightweight transformation, the banking industry should take a broader range of comprehensive measures in line with policy changes.

I. Global Banking Review and Outlook

I.1 The banking development environment is stabilizing overall, except for some local risks deserving intense attention

Global economic development is at a stable level. In Q3, JPMorgan Chase's global composite PMI stayed above 50, standing at 53.7 in July and 53.4 in August, slightly down from Q2 (Figure 1). The World Trade Outlook Indicator (WTOI) released by the World Trade Organization was 100.3 in Q3, staying above the trend level of 100 but slightly lower than in Q1 and Q2. According to the latest IMF forecasts, global economic growth is expected to reach 3.9% in 2018, up 0.1 ppts from 2017. Stable economic growth and trade expansion provide a generally good environment for sustainable development of the global banking industry.

Financial risks in EMs are on the rise. Global financial markets remained stable as a whole in 2018Q3, but risk events hit EMs frequently. The Turkish lira crisis broke out in August, the second EM currency crisis in 2018 following Argentina. The Indian rupee has depreciated by 2% against the US dollar since September, or cumulatively down nearly 13% year-to-date, showing a risk outlook under cloud. The Institute of International Finance (IIF) released its composite index for EM Bank Lending Conditions in 2018, which was 48.7 for Q2, below the median level of 50 and down 1.7 ppts from Q1, and is estimated to be 47.8 for Q3 due to continued credit tightening (Figure 2).

Figure 1: Changes in JPMorgan Chase's Global PMI Index

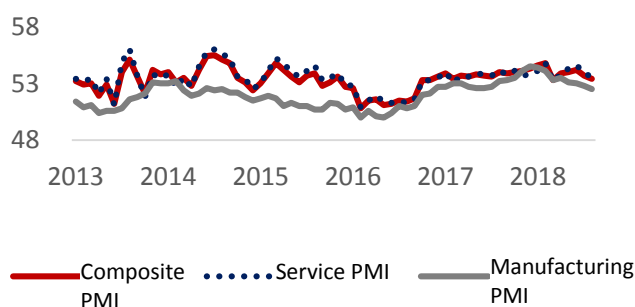
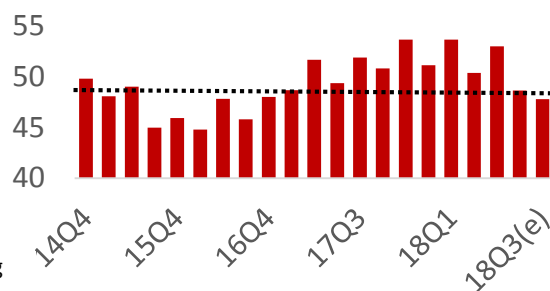


Figure 2: IIF Index for EM Bank Lending Conditions



Source: IIF, Wind, BOC Institute of International Finance

The financial regulation is still being tightened. On June 21, the Financial Stability Board (FSB) issued the *Principles on Bail-in Execution* and the *Funding Strategy Elements of an Implementable Resolution Plan* to ensure that global systemically important banks (G-SIBs) can better implement the resolution plan through the bail-in mechanism. On July 5, the Basel Committee published the *Global Systemically Important Banks: Revised Assessment Methodology and the Higher Loss Absorbency Requirement* to optimize the G-SIB assessment framework, including introducing a trading volume indicator in the financial institution infrastructure category, extending the scope of consolidation and revising the disclosure requirements. The EU has stepped up its supervision of digital currency and anti-money laundering. The *EU Fifth Anti-Money Laundering Directive* came into force on July 9, setting out requirements directed at the use of anonymous payments through prepaid cards and “virtual currency exchange platforms” for the purposes of money laundering and terrorist financing. The financial regulation has been increasingly tightened. The banking industry is facing strict supervision over compliance and operation.

I.2 The international Banking Industry Registered Growth at a Stable Risk Level

As shown by comprehensive indicators for banking in major economies, international large banks and financial markets, the global banking industry has shown some new features and developments.

First, assets and business scale continued to grow, with local problems and competition trends deserving attention. Except Brazil seeing a 4.6% decline in banking assets at the end of 2018Q2 from the beginning of the year, all major economies ended the first two quarters of 2018 with an increase in banking assets. Economies with faster growth in banking assets included India, Singapore and South Korea (Table 1). The decline in Brazil's banking assets was a microcosm of Latin America's economic downturn and financial system crisis. In Q3, Argentina suffered a bank run and sharp currency depreciation and Venezuela experienced hyperinflation. The risks involved deserve special vigilance.

Second, interest rates were rising with a wider spread while profits remained stable. The continued economic recovery and the rising benchmark interest rates of major central banks help to improve the interest spread and profitability of banks. The Bank of England raised interest rates by 25 bps to 0.75% in August. The Federal Reserve has announced two rate hikes year-to-date. The Eurozone and Japan kept interest rates unchanged. The weighted average interest rate in developed economies was 0.98% at the end of August, up 20 bps from the end of Q2. In EMs, Indonesia's central bank raised its benchmark interest rate to 5.5% in August, while the Philippine's central bank raised its benchmark rate to 4% in August in its third rate hike this year. Overall, the weighted average interest rate in major EM economies reached 5.66% at the end of August, up 40 bps from the end of Q2.

The interest rate rises has greatly improved the interest margin and interest spread income of global banks. The US banking sector, the biggest beneficiary, saw its net profit growing by 25.1% (or 11.7% without tax cuts) to USD60.2 billion in 2018Q2 and recorded a net interest margin (NIM) of 3.38%, much higher than the 3.13% and 3.25% in 2016 respectively. As a result, net interest income rose by 8.7% year-on-year (YoY). Since the European Central Bank has not yet raised interest rates, the European banking sector has not enjoyed noticeable benefits. Chinese commercial banks registered 2.12% in NIM in 2018Q2, still at a low level lasting for many years. Net profit for H1 was RMB1,032.2 billion, up 6.4% YoY.

Third, the quality of assets improved steadily but the risk resilience weakened. As for trends in risk and regulatory indicators, the following new developments deserve special attention:

First, the overall quality of assets has improved steadily, except for a significant rise in the

non-performing ratio (NPL) of a few banks. The average NPL of 28 G-SIBs has been in decline since 2010, reaching 2.0% in 2018H1, down from 2.1% at the end of 2017. This trend shows sustained improvements in the quality of banking assets along with the global recovery. However, Also notable is that the improvements moderated in 2018H1. Specifically, only two of the 28 G-SIBs showed a decline in asset quality. Barclays/Credit Suisse reported a rise of 0.5 ppts/0.1 ppts in NPL respectively.

Second, the risk absorption capacity has decreased, yet still at high levels. The average capital adequacy ratio (CAR) of 28 G-SIBs in 2018H1 was 17.2%, down from 17.7% at the end of 2017. From the trend point of view, the CAR of global banks remains high under strengthened supervision. Specifically, banks with a larger drop in CAR include Morgan Stanley, UniCredito Italiano and Sumitomo Mitsui Banking Corporation SMBC, whose CAR fell by 2.3 ppts, 1.7 ppts and 1.7 ppts respectively. However, these banks had a high CAR before the fall, and still have a strong risk absorption capacity after the drop.

Table 1: Growth of Total Banking Assets in Major Economies

Country/region		At the end of 2017		At the end of 2018Q2	
		Banking assets (USD'00mn)	Growth, YoY (%)	Banking assets (USD'00mn)	Growth, YTD (%)
Developed markets	Eurozone	316,030	-1.5	312,274	1.7
	US	174,154	3.8	175,328	0.7
	UK	107,449	4.8	106,950	1.8
	Japan	97,750	2.3	101,086	1.2
	Australia	35,371	-1.0	34,372	2.6
BRICS	China	376,383	8.6	383,034	3.1
	India	42,235	-14.3	44,672	13.5
	Brazil	17,350	-0.5	14,213	-4.6
	Russia	14,790	6.4	13,797	1.6
	South Africa	4,196	5.7	3,854	2.7
East Asian countries	South Korea	31,167	4.9	31,106	3.9
	Singapore	9,158	6.6	9,419	5.2
	Malaysia	6,148	4.3	6,369	3.1
	Thailand	5,670	3.8	5,708	2.2
	Indonesia	5,452	9.8	5,311	3.6

Note: Banking assets are converted into US dollar at the exchange rate prevailing at the end of the reporting period; the growth rate is calculated based on amounts in local currency.

Source: Central banks and regulatory authorities, Wind, BOC Institute of International Finance

I.3 Pay close attention to future risks facing the global banking industry

The global banking environment has deteriorated since 2018Q3. In particular, the escalating trade war, worsening financial turmoil in EMs and the Federal Reserve's interest rate hikes will unleash their negative impact gradually.

First, the impact of escalating US-China trade war on the banking industry of both countries.

Earlier the global trade war launched by the Trump administration was confined to selected regions and industries and relatively limited in scale, having no significant impact on banking development and operation. On September 17, the US government announced that it would impose a 10% tariff on USD200 billion worth of imports from China from September 24, which would rise to 25% on January 1 next year, and that any retaliation from China would result in the imposition of tariffs on all Chinese exports to the US. The further escalation of the US-China trade war will have an important impact on the bilateral trade, related industries and related financial services of the two major economies.

Second, the impact of financial turmoil in Turkey, Argentina and other countries on the European banking industry.

Since 2018, the Turkish lira/Argentine peso has depreciated by more than 40%/50% against the US dollar respectively, especially in Q3 when the sharpest depreciation was recorded. The financial turmoil in EMs represented by the two countries will adversely affect banks with large risk exposures and business footprint in the region. Many European banks have nearly 20% of their total exposures in Turkey. The Deutsche Bank, BNP Paribas, UniCredito Italiano, BBVA and many other European banks all have large loan exposures to Turkey. Spain's major multinational banks rely more on Latin American markets. Turkey's worsening currency crisis is likely to push up NPLs and rapidly bring down CAR of European banks, resulting in a credit crunch.

Third, the overall impact of the Fed Reserve's continued interest rate hikes on the global banking industry.

The Federal Reserve's progressive rate hikes have had a very significant spillover effect now, bearing a close tie to the latest round of financial turmoil in EMs in 2018. As the trade war is escalating, US inflation is likely to rise further and put the Federal Reserve under a rising pressure from further rate hikes. The market participants have begun to pay close attention to whether the too-fast USD rate hikes will send the US economy into a recession. The rise in USD interest rates helps widen the interest spread of USD assets of commercial banks, which will, however, be partially offset by the accompanying risks of international capital flows and EM crises.

II. China's Banking Industry Review and Outlook

II.1 The current banking environment is generally good

In the first three quarters of 2018, China's economic growth was stable under a prudent and neutral monetary policy. The enhanced supervision policy kept unleashing its effects. The banking market underwent continuous decline in concentration and increasingly fierce competition. Specifically:

The economy grew steadily. Main economic indicators showed steady readings in the first three quarters of 2018. GDP growth is expected to be 6.6% in Q3. As for the three major dimensions of demand influencing the economy, in August 2018, the growth of fixed asset investment slowed down to 5.3%. Total retail sales of consumer goods increased by 9.0% YoY, a pickup in growth rate. Exports/imports increased by 9.8%/20% YoY respectively, representing a stable growth rate.

Interbank liquidity improved under a prudent and neutral monetary policy. Since 2018 began, PBOC has maintained a prudent and neutral monetary policy and flexibly used various policy tools to keep market liquidity stable. In 2018Q3, the 7-day Shibor, inter-bank offered rate and pledge-style repo rate all declined to varying degrees on RRR cuts and the prudent and neutral monetary policy. In June 2018, the weighted average interest rate on RMB loans rose by 1 bp from the end of Q1, showing overall stability.

Policies began to work under continued enhanced supervision. In 2018Q3, in view of the dramatic changes in the social financing structure since the introduction of the *Guidelines on*

Regulating the Asset Management Business of Financial Institutions, PBOC and CBIRC issued the *Notice on Further Clarifying Matters Related to Guidelines on Regulating the Asset Management Business of Financial Institutions* and the *Administrative Measures for Supervision of the Wealth Management Business of Commercial Banks (Exposure Draft)* successively in 2018Q3, which helped ease the rapid adjustments to financing structure. With a series of major regulatory policies introduced in 2018, China's interbank and shadow banking irregularities have been well addressed under enhanced supervision. Risk mitigation work such as debt-for-equity swaps has been steadily progressing. In Q4, China will continue to issue and optimize regulatory policies under the principle of defusing systemic risks.

Continued decline in concentration has intensified competition increasingly. At the end of July 2018, the Big Five banks contributed 35.5% of the total assets of banking institutions, indicating a continuing downtrend. As China's banking industry continues to open to the outside world, more foreign financial institutions will compete in China's financial market. In addition, large Internet companies are also exploring to set up Internet banks to compete with traditional banks.

Fintech is extending its business outreach. BATJ and other Internet giants have kept improving their financial service portfolio in 2018, and obtained the licenses for funds, payment, insurance brokerage, banking, third-party payment and credit reporting. Meanwhile, commercial banks are actively exploring digital transformation and cooperating with large Internet firms to expand business scenarios and extend service reach. Some Internet giants have also gradually clarified their corporate positioning, showing a trend of "de-financing" with a view to returning to their origin as tech firms. For example, JD Finance was renamed JD Digital to better export technology to finance.

II.2 China's banking industry remained solid through the first three quarters

Interim reports disclosed by 26 listed banks showed continued solid development in 2018H1. Profit growth reached a new high in recent years while assets and liabilities were steadily expanding in scale. Further improvements in profitability continued to bring down the leverage level of listed banks. In addition, listed banks saw their NPL ratio falling and found their PCR and CAR rising further, demonstrating stronger ability to cover risks and greater soundness of operation.

II.2.1 The structural adjustments to assets and liabilities were furthered

In 2018H1, listed banks' assets and liabilities reached RMB153.9 trillion and RMB142.3 trillion, up 5.8% and 5.4% respectively. Due to such factors as deleveraging and enhanced supervision, commercial banks are under pressure for non-loan assets.

Loans continued to take up a larger share of assets. As at the end of June 2018, loans from listed banks accounted for 53.7% of their total assets, up 2 ppts YoY and 0.8 ppts over Q1. Loans from the Big Five banks accounted for 55.1% of their total assets, up 1.3 ppts YoY. That percentage was 53.2% for joint-stock banks, up 3.7 ppts YoY, 41.2% for city commercial banks, up 3 ppts YoY and 12.5 ppts below average, and 52.5% for rural commercial banks, up 1.1 ppts YoY.

The proportion of deposits remained stable. At the end of June 2018, listed banks' share of deposits was 73.5%, flat with Q1 and up 0.8 ppts YoY. By category, the share of deposits was 1.0%, 0.1% and 1.1% for the Big Five banks, joint-stock banks and city commercial banks, respectively. Rural commercial banks recorded a decline of 1.2 ppts in its share of deposits.

II.2.2 Profitability improved significantly.

In 2018H1, the total net profit of listed banks was RMB835.89 billion, up 6.3% YoY, 0.8 ppts faster than Q1. City commercial banks and rural commercial banks registered the strongest profit growth of 15.1% and 15.0% respectively, and some of them even achieved a growth rate of over

25%. Net profits of the Big Five banks and joint-stock banks grew by 5.4% and 6.9% respectively.

II.2 The ability to cover risks continues to strengthen

The NPL ratio continued in decline. At the end of June 2018, NPL ratio of listed banks stood at 1.55%, down 0.09 ppts YoY. The Big Five banks, joint-stock banks, city commercial banks and rural commercial banks recorded were 1.52%, 1.70%, 1.20% and 1.51%, respectively. Rural commercial banks saw the largest NPL drop of 0.2 ppts, while joint-stock banks recorded the smallest NPL ratio decline of 0.04 ppts.

Provision coverage ratio (PCR) picked up. The average PCR of listed banks was 194.6% at the end of June 2018, up 27.1 ppts YoY. The Big Five banks, joint-stock banks, city commercial banks and rural commercial banks recorded 192.5%, 187.7%, 274.5% and 241.9% in PCR, respectively. By category, rural commercial banks registered the strongest growth of 39.1 ppts, followed by the Big Five banks (32.3 ppts). City commercial banks and joint-stock banks had a PCR gain of 24.8 ppts and 13.2 ppts respectively.

Capital adequacy ratio (CAR) kept rising. At the end of June 2018, the capital adequacy ratio (CAR) of listed banks was 13.3%, up 0.7% YoY. The Big Five banks, joint-stock banks, city commercial banks and rural commercial banks recorded 14.6%, 12.3%, 12.9% and 14.5% in CAR, respectively. In terms of growth rate, rural commercial banks recorded the strongest gain of 1.8 ppts, while joint-stock banks had the weakest gain of 0.11 ppts.

Table 2: Results of 26 Listed Banks in the First Half of 2018 (RMBtrn, %)

	Assets	Growth rate	Liabilities	Growth rate	Loans/ assets	Change	Deposits/ liabilities	Change
ICBC	27.3	7.0	25.1	6.9	54.7	0.4	82.9	1.9
CCB	22.8	5.1	20.9	4.5	59.0	1.3	81.0	-0.2
ABC	21.9	6.5	20.4	5.9	52.3	1.7	83.2	-0.6
BOC	20.3	4.5	18.7	4.4	56.2	1.4	76.8	0.1
BOCOM	9.3	4.4	8.7	4.5	51.4	2.5	66.3	6.6
Big Five	101.6	5.7	93.7	5.4	55.1	1.3	79.8	1.0
Industrial Bank	6.6	2.8	6.1	2.3	40.8	5.0	50.7	0.4
China Merchants Bank	6.5	5.4	6.0	4.4	59.3	2.2	70.6	-1.1
SPD Bank	6.1	3.0	5.6	2.2	54.9	3.7	56.9	-0.6
Minsheng Bank	6.1	5.1	5.7	4.8	50.4	3.4	55.9	-0.2
China CITIC Bank	5.8	2.8	5.4	2.4	58.2	3.5	66.6	1.0
Everbright Bank	4.3	6.2	4.0	5.6	52.1	3.4	61.2	0.9
Ping An Bank	3.4	8.9	3.1	9.0	54.9	3.3	66.2	-0.1
Hua Xia Bank	2.6	5.9	2.4	5.6	59.9	5.8	61.2	0.3
Joint-stock	41.3	4.6	38.3	4.1	53.2	3.7	60.8	0.1
Bank of Beijing	2.5	11.0	2.3	10.2	48.9	2.9	60.3	-0.4
Bank of Shanghai	1.9	12.1	1.8	11.0	40.7	5.6	56.1	0.7
Bank of Jiangsu	1.8	7.0	1.7	5.5	44.9	4.3	62.3	2.3
Bank of Nanjing	1.2	5.4	1.1	4.9	36.5	4.0	67.9	0.5

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Bank of Ningbo	1.1	14.7	1.0	14.3	35.2	0.5	63.0	0.3
Bank of Hangzhou	0.9	13.6	0.8	12.4	36.5	0.3	61.6	8.1
Bank of Guiyang	0.5	15.3	0.4	14.8	29.3	2.8	68.0	-1.9
Bank of Chengdu	0.5	25.3	0.4	25.2	34.4	-3.7	77.5	-2.8
Urban commercial banks	10.3	11.1	9.6	10.2	41.2	3.0	62.3	1.1
Changshu Rural Commercial Bank	0.2	16.2	0.2	16.1	53.5	2.4	74.7	0.4
Wuxi Rural Commercial Bank	0.1	11.1	0.1	10.8	50.6	0.0	84.0	-1.5
Jiangyin Rural Commercial Bank	0.1	5.9	0.1	5.4	53.9	2.3	79.3	-0.1
Wujiang Rural Commercial Bank	0.1	23.1	0.1	24.8	51.2	-5.0	78.6	-10.9
Zhangjiagang Rural Commercial Bank	0.1	3.1	0.1	2.5	53.4	4.9	80.2	4.5
Rural commercial bank	0.6	11.8	0.6	11.8	52.5	1.1	79.2	-1.2
Total	153.9	5.8	142.3	5.4	53.7	2.0	73.5	0.8

Data source: Wind, BOC Institute of International Finance

Table 3: Results of 26 Domestic Listed Banks in 2018 (RMB'100mn or %)

	Net profit	Growth rate	NIM	ROA	ROE	NI/I	C/I	NPL	PCR	CAR
ICBC	1606.6	4.5	2.30	1.20	14.90	28.3	19.97	1.54	173.2	14.7
CCB	1474.7	6.1	2.34	1.31	16.21	29.5	22.11	1.48	193.2	15.6
ABC	1159.8	6.7	2.35	1.08	15.48	23.7	26.67	1.62	248.4	14.8
BOC	1155.8	4.5	1.88	1.16	14.43	29.7	25.78	1.43	164.8	13.8
BOCOM	409.9	4.5	1.41	0.89	12.22	40.5	29.26	1.49	171.0	13.9
Big Five	5806.7	5.4	2.06	1.13	14.65	28.7	24.76	1.52	192.5	14.6
Industrial Bank	338.4	6.3	1.78	1.04	15.80	37.9	24.09	1.59	209.6	11.9
China Merchants Bank	448.7	13.7	2.54	1.40	18.25	39.0	26.84	1.43	316.1	15.1
SPD Bank	289.0	1.3	1.77	0.95	13.19	37.6	24.28	2.06	146.5	12.2
Minsheng Bank	298.5	4.3	1.64	1.00	15.27	55.1	23.99	1.72	162.7	11.9
China CITIC Bank	261.8	8.3	1.89	0.91	12.69	38.5	26.66	1.80	151.2	11.3
Everbright Bank	181.0	6.7	1.63	0.86	11.87	47.7	29.16	1.51	173.0	12.7
Ping An Bank	133.7	6.5	2.26	0.81	11.88	34.6	29.66	1.68	175.8	11.6
Hua Xia Bank	101.1	2.1	1.86	0.80	11.66	27.3	34.40	1.77	158.5	12.0
Joint-stock	2052.2	6.9	1.92	0.97	13.83	40.4	27.39	1.70	187.7	12.3
Bank of Beijing	118.9	6.6	2.19	0.99	13.29	21.7	21.73	1.23	260.5	11.9
Bank of Jiangsu	69.2	11.2	1.57	0.76	12.06	26.1	26.19	1.40	182.1	12.7
Bank of Shanghai	93.9	20.3	1.55	1.01	12.51	35.4	20.26	1.09	304.7	13.4
Bank of Nanjing	60.4	17.0	1.89	1.03	17.18	21.6	26.86	0.86	463.0	13.1
Bank of Ningbo	57.2	19.8	1.81	1.09	18.79	36.9	34.19	0.80	499.3	13.4
Bank of Hangzhou	30.2	19.3	1.72	0.71	11.37	16.7	27.96	1.56	228.8	13.5
Bank of Guiyang	23.1	21.3	2.34	0.98	17.53	11.5	26.15	1.39	262.7	11.4
Bank of Chengdu	21.2	28.6	2.16	0.94	15.87	19.7	24.02	1.61	232.0	13.7

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Urban commercial banks	474.1	15.1	1.90	0.94	14.82	25.6	25.92	1.20	274.5	12.9
Changshu Rural Commercial Bank	7.7	27.8	3.49	1.00	12.86	14.2	36.21	1.01	386.3	14.5
Wuxi Rural Commercial Bank	5.8	10.7	2.19	0.83	11.87	7.4	26.72	1.33	206.8	17.3
Wujiang Rural Commercial Bank	5.1	15.5	2.69	1.02	11.83	15.8	30.95	1.46	224.9	12.3
Zhangjiagang Rural Commercial Bank	4.1	17.1	2.54	0.81	9.66	11.4	37.49	1.72	207.1	12.9
Jiangyin Rural Commercial Bank	3.3	-4.2	2.34	0.59	7.76	26.7	32.51	2.29	206.5	15.5
Rural commercial bank	26.0	15.0	2.65	0.85	10.80	14.8	32.78	1.51	241.9	14.5
Total	8358.9	6.3	2.08	0.97	13.71	31.8	27.47	1.55	194.6	13.3

Source: Wind, BOC Institute of International Finance.

Note: NIM stands for net interest margin. ROA stands for return on assets. ROE stands for return on equity. NII stands for non-interest income/income. C/I stands for cost/income. NPL stands for the non-performing loan ratio, PCR stands for provision coverage ratio. CAR stands for capital adequacy ratio.

II.3 Annual Outlook for 2018

According to current changes in the macroeconomic and banking environments, we predict that China's banking development will show the following characteristics in 2018:

First, asset growth will not rebound significantly. In 2018Q4, economic growth will not accelerate markedly and the deleveraging policy will hardly reverse in the short run. However, we expect the stringent supervision not to tighten further considering that the enhanced supervision in H1 led to the rapid contraction of financing in all forms. We maintain our forecasts made in Q2 expecting an annual growth rate of about 6% for assets and liabilities of listed banks. We also expect loans/deposits to take up a larger share (54%/74%) in banking assets/liabilities respectively.

Second, profitability will remain stable. Usually commercial banks' profitability is directly proportional to the pace of asset expansion. Q2 data show a decline in NIM of commercial banks. Taking into account the policies encouraging commercial banks to inject more credit resources into the real economy, we expect the NIM of listed banks to narrow further. NIM of listed banks is expected to remain around 2.2% for 2018. ROA/ROE is expected to remain unchanged at 0.98%/13.3% respectively.

Third, the overall risk of assets is under control. Commercial banks recorded significant improvements in the overall quality of assets in H1, as shown by a falling NPL ratio of the Big Five banks. However, listed banks will likely see their NPL ratio pick up slightly under the stricter criteria for recognition of non-performing assets. The NPL ratio of listed banks is expected to be around 1.58% for 2018.

Fourth, the ability to cover risks has been further cemented. The strong external constraints at the regulatory level will not be relaxed in the short run. Driven by further diversification of capital replenishment tools and adjustments to MPA parameters, commercial banks will further strengthen their ability to cover risks while improving their operational autonomy. We expect PCR and CAR to remain stable. Considering adjustments to some assessment policies, we expect listed banks' PCR/CAR to be around 195%/13.5% for 2018 respectively.

III. Special Research: Progress, Logic and Prospects of Lightweight Transformation in the Global Banking Industry

III.1 Lightweight Transformation in the Global Banking Industry

The lightweight transformation of banks mainly means that banks meet customer needs, improve operating efficiency, create bank value and achieve high-quality development through less capital

consumption, more intensive operation and more effective management. After the global financial crisis broke out in 2008, the global banking industry has generally been pursuing lightweight transformation, showing the following main characteristics:

First, light assets. Banks across the globe has generally begun to control their expansion in size since 2008. Banks in some countries have even “slimmed down” via divestiture from non-core businesses, in sharp contrast to their earlier aggressive expansion. According to data from *The Banker*, the world’s top 1,000 banks have been experiencing a deceleration in growth of assets and CET1 capital, which averaged 2.5% and 7.0% respectively during 2009-2017, compared with 12% and 10% during 2000-2008.

Second, light businesses. Global banks have made great efforts to develop businesses that generate income without or with less consumption of assets and capital, so as to create more income with less assets and capital and improve the efficiency of the utilization of assets and capital. In 2017, loans from the world’s top 1,000 banks accounted for 62.7% of their total assets, down nearly 2 ppts from 64.6% in 2010. Meanwhile, the world’s largest banks have continued to improve their efficiency of capital utilization, manifesting a notable CAR rise. The average capital/assets ratio and CAR of the world’s top 100 banks increased from 5.0% and 13.2% in 2008 to about 6.5% and 16.5% in 2017, respectively.

Third, light costs. Global banks actively reduce management costs by optimizing their management structure and improving the efficiency of their outlets and manpower. In 2017, the average cost-income ratio of the world’s top 1000 banks dropped to 54.0% from 56.5% in 2008, down nearly 2.5 ppts.

In addition to management cost cuts, the decrease in risk costs is also an important dimension of lightweight development. To reduce the NPL ratio, global banks have continuously improved the risk management capability and endeavored to control credit risk by strengthening internal rating of customers, strict examination of repayment sources, and carry out credit risk inspection regularly. Also, global banks adjusted the risk strategy under the “selective” approach to development, attached greater importance to prudence and sustained growth and strictly controlled credit threshold. In addition, global banks actively handled potential risks to avoid the intensive outbreak of NPLs. They approached customers with uncertain solvency and tackled potential risks by developing a repayment plan or adjusting accounts and transferred risks partially to institutional investors. In 2017, NPL ratio of the world’s top 100 banks dropped to about 2.5% from 3.6% in 2008, suggesting fruitful efforts on credit risk management.

In the future, the global banking industry will remain on track for lightweight development: **First, the global growth momentum continues, yet with weaker marginal dynamics and equilibrium.** The International Monetary Fund (IMF) expects the world economy to grow at 3.4%/3.3% in 2018/2019 respectively in a bottleneck period of expansion and slow gradually down to 2.9% in 2023. With the medium and long-term prospects under cloud, banks are on a fragile foundation for business expansion, still under a pressure from profitability enhancement. **Second, global capital regulation is still being strengthened.** Basel III, revised by the end of 2017, will be phased in from January 1, 2022 to place higher requirements on banks’ capital adequacy and liquidity. Global Systemically Important Banks (G-SIBs) are facing increasingly stringent requirements on macro-prudential supervision. In addition to capital add-on requirements, total loss-absorbing capacity (TLAC) requirements will also be fully implemented in January 2019. IFRS 9 will come into effect on January 1, 2018 to place higher impairment allowance requirements on banks. Capital has become a scarce resource and core variable that restricts the development of banks. **Third, the challenge from Fintech companies is becoming more and more serious.** Take China for example, the transaction volume of China’s third-party mobile payment market increased from RMB1.3 trillion in 2013 to RMB74.93 trillion in 2017, and Alipay has 353 million monthly active

users (MAU), more than the mobile banking MAU of any commercial bank. Facing the challenge from Fintech firms, the global banks will continue their efforts to improve operating efficiency and reduce its costs. **Fourth, banks are actively promoting digital transformation.** According to a research report of PwC in 2017, nearly 90% of banks are worried that competition from Fintech companies would affect their income, nearly 80% of banks planned to continue to invest more in digital technology in one year, more than 80% of banks planned to increase cooperation with Fintech companies in the coming three years, nearly 80% of large banks planned to launch blockchain applications by 2020, and 30% of large banks were deploying AI technology. Banks' push for digital transformation will provide support for banks to improve efficiency and reduce costs.

III.2 Lightweight Transformation of China's Listed Banks

China's banking environment has changed significantly since 2013. Economic growth has entered a new normal, the interest rate and exchange rate liberalization have been accelerating, the banking system has officially implemented the Chinese version of Basel III and the asset management business represented by banker's wealth management has developed rapidly. These changes have had a significant effect on the lightweight transformation of the banking system.

III.2.1 Main facts of lightweight transformation of China's listed banks

The lightweight transformation of listed banks can be profiled in three dimensions: risk density, manpower density and profit density. Since 2013, the lightweight transformation of listed banks in China has shown the following characteristics:

Risk density has decreased and varied markedly across banks. Risk density is equal to a bank's risk-weighted assets divided by total assets. It determines the amount of capital consumed per unit of asset expansion, and is an important measure of a bank's lightweight transformation. At the end of 2017, the risk density of 16 listed banks was 63.1%, down 2.4 ppts from the end of 2013. The decrease in risk density indicates the less capital consumption per unit of asset, manifesting effective lightweight transformation. However, listed banks showed divergent trends in risk density. From 2013 to 2017, 6 of the 16 listed banks saw their risk density falling.

The manpower density dropped, especially at large banks. Manpower density refers to the number of employees a bank uses per RMB100 million of assets. In 2013, 16 listed banks used an average of 2.17 employees per RMB10,000 of assets. At the end of 2017, the manpower density of listed banks dropped to 1.51 employees per RMB100 million. Listed banks have achieved remarkable results in less manpower-intensive transformation by adjusting their channels, organizational structure and human resources assessment. From 2013 to 2017, most banks showed a downward trend in manpower intensity, especially at large banks.

Profit density showed a general downtrend. Profit density reflects the ability to produce profit per unit of asset. Generally speaking, banks have two ways to improve ROE: one is to improve the profit-making ability per unit of asset; the other is to increase the ratio of assets to equity. In the context of lightweight transformation, the first method is applauded. A higher ROA means better performance in lightweight transformation. In 2017, the average ROA of listed banks was 0.92%, down 0.29 ppts from 2013. As for overall trend, listed banks showed an obvious downtrend in profit density. ROA of all 16 listed banks was in decline.

III.2.2 Factors affecting lightweight transformation

Since 2013, listed banks have made remarkable progress in lightweight transition under the dimensions of risk density and manpower density. However, the profit density showed an obvious downtrend. The effectiveness of lightweight banking transformation is influenced significantly by financial supervision, Fintech and changes in the macroeconomic environment:

Changes in the banking environment are not conducive to profit density enhancement. Since 2013, the asset management business represented by banker's wealth management has developed

rapidly, changing the traditional fund operation and pricing methods in the financial system. The interest margin in the banking system has dropped rapidly. China's entry into a new economic normal put a pressure on banks asset quality. The increase in loan loss reserves caused by the deterioration in asset quality has had a significant impact on the profitability of banks. It is estimated that the decline in NIM and the rise in loan impairment reserve have become the biggest contributor to the decline in ROA of listed banks in recent years.

Financial supervision policies have limited the risk density transformation to some extent. China officially implemented its local version of Basel III in 2013 imposing higher requirements on the RWA assessment of banks: First, more risk factors are included in RWA measurement. The coverage of RWAs has expanded continuously. Second, strict restrictions are placed on the application of the advanced internal ratings-based (IRB) approach. ICBC, ABC, BOC, CCB, BOCOM and CMB are allowed to use the advanced IRB approach, yet subject to strict restrictions on the floor of RWAs. Third, stricter capital requirements are imposed on some businesses, such as risk weight requirements for banks' equity holdings before adjustment and the risk retention requirements for asset securitization. Fourth, enhanced supervision of shadow banking has turned funds back onto the balance sheet.

Transformation of channels and technology are major contributors to lower manpower density. In terms of channel transformation, the rapid development of mobile banking and Internet banking has gradually shifted the focus of commercial banks from offline to online, greatly reducing the consumption of human resources. In terms of physical outlets, commercial banks pay more attention to "lightweight" elements. The application of AI robots, facial recognition and remote online account opening help reduce the outlet floor space and fixed assets. The channel transformation has brought about new adjustments to the organizational structure of banks, which show increasingly prominent characteristics of "lighter front office, stronger back office and stable internal control".

III.2.3 Relevant Suggestions

Lightweight development is one of the options of banks' future transformation. But it is not the only choice of development model. China's banking industry is in need of the differentiated development. A number of financial institutions pursuing lightweight development should emerge in this process. For well-organized lightweight transformation of the banking industry, all levels from the regulators down to individual banking institutions need pay attention to new environmental changes and make new adjustments to policies, strategies and business tactics.

Create a stable macro environment. China should ensure "soft landing" of the economy by pushing for supply-side structural reforms and increasing potential growth rates and sustain the growth at a medium-to-high pace. China should move steadily forward with financial "deleveraging" and guide commercial banks to reduce the stock of "bad leverage" through debt-for-equity swap, asset securitization and loan assignment. The pace and intensity of monetary policy regulation should be properly controlled to create a stable monetary environment and prevent market interest rates from fluctuating sharply in a short period of time, so as to keep the spread of benchmark deposit and lending rates stable.

Create a good regulatory environment. The "gradient" with international regulatory standards should be appropriately reduced to create a favorable regulatory environment for the lightweight transformation of banks. Relevant regulatory requirements on risk weight of equity holdings and risk retention in asset securitization should be lowered, so as to better serve the real economy while promoting the lightweight transformation of the banking system.

Commercial banks should improve their strategic business planning. Commercial banks should identify areas of business breakthroughs, with focus on consumer finance, pension finance and wealth management, and make ongoing trials on the business entry and expansion in line with

the actual needs of customers. In addition, commercial banks should seize the opportunities afforded by asset management and financial market transactions to deepen the financial service chain and build a broader service system. Commercial banks should add a technological dimension to their business transformation to continuously reduce operating costs and improve operating efficiency.

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