Institute of International Finance

Global Banking Industry Outlook

2019 (Issue 37) **November 28, 2018**

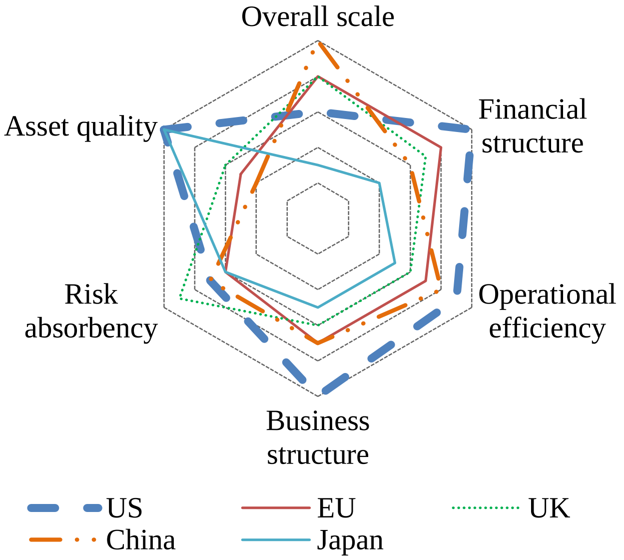
Highlights

● In 2018, there was greater uncertainty in the global banking industry, and some emerging markets became unstable; the banking industry in various countries basically remained stable, but the trade frictions, the Fed's interest rate hikes and enhanced regulations on the banking industry have had significant impacts.

● Based on a comparison of banking in different countries, G-SIBs and listed banks in China, this report forecasts the ten main trends in global banking development in 2019, including the operating and regulatory environment, scale and profitability, inclusive finance and wealth management.

● FinTech is profoundly changing the innovation-driven development pattern of the banking industry. This report takes the representative countries in America, Europe and Asia-Pacific region to discuss the role of technology empowerment and regulations in creating new drivers of global banking development.

Banking Operation in Major Economies in 2018



Source:BOC Institute of International Finance

BOC Institute of International Finance

Global Banking Industry Research Team

Team leader: Chen Weidong

Deputy leader: Zhang Xingrong

Team members: Wang Jiaqiang
Shao Ke
Xiong Qiyue
Zhao Xue
Yuan Xiaohui
Sun Yiyang
Liang Si
Liu Yaying (Hong Kong)
Yu Yigong (Sydney)
Wang Zhe (Tokyo)
Qu Kang (London)
Lu Mengchu (Russia)
Yang Bo (Hungary)
Li Wenjun (Johannesburg)
Huang Xiaojun (New York)
Shi Xiaodong (Brazil)

Contact: Wang Jiaqiang

Telephone: 010-66592331

Email: wangjiaqiang@bankofchina.com

Strike Overall Balance to Tackle New Uncertainties

-- Global Banking Industry Outlook (2019)

The global banking industry developed divergently in a complex, ever-changing environment in 2018. It is imperative to strike an overall balance in the future among scale, structure, quality, efficiency, risk and market performance to maintain sustainable development amid new uncertainties.

I. Ever-changing Environment of Global Banking Industry in 2018

Some obvious structural changes emerging in the global banking environment weighed on the growth of banking business and income in 2018. The rise of more risk factors impaired the capital base and profits of banks.

I.1 The banking industry grew moderately on the weak macroeconomic momentum

Given such factors as the US policies on tax, investment and trade protection, tightening financial environment in emerging markets in the context of the Fed's interest rate hikes, and geopolitical tensions in the Middle East, the global economic growth is expected to be only 3.7% in 2018, flat with one year ago. In particular, the growth of global international trade and cross-border direct investment was sluggish. The global trade in goods grew by only 3.7% YoY in 1Q-3Q2018, and expected to grow by 3.9% YoY annually in 2018, down 0.8 percentage points from the previous year. Global FDI flows slumped by 41% in 1H2018, making it difficult to end the year with positive growth. By major region, the US economy grew faster than last year on fiscal stimulus policies such as tax cuts and spending increases. The Eurozone and Japan slowed down in economic growth. Emerging economies showed mixed performance while remaining flat with last year overall. Against this background, the global banking industry staged mild growth as expected.

I.2 Rising global financial risks weakened investors' expectations for the banking industry

The world remained financially relaxed overall in 2018, yet at higher risks than last year. Financial conditions tightened slightly mainly due to the Fed's continuous interest rate hikes, coupled by the negative impact of global trade frictions. Emerging markets faced higher financing costs and greater pressure from capital flight. In the foreign exchange market, the US dollar appreciated significantly while emerging market currencies generally fell in value, benefiting international banks holding more USD assets. However, banks with more exposure to Latin America and the Middle East and Africa suffered. In the capital market, the US stock market fluctuated sharply after hitting a series of records, showing risks. The US Treasury yields have risen substantially and global USD liquidity has tightened. Argentina, Venezuela, Turkey and some other emerging markets experienced financial turmoil and slump in their government bonds price. The unstable international capital markets have had a significant impact on multinational banks seeking diversification of business. In the commodity market, international oil prices lost momentum after a run of price hikes, and the price slump in Q4 has increased the transaction risk. As shown by comprehensive indicators for banking in major economies, large international banks and financial markets, the global banking stock index has declined as a whole and banking stocks traded at unreasonably low PBs, indicating investors' low confidence in the future banking growth.

I.3 The monetary policy environment is conducive to keeping NIM stable across the banking industry

The Fed remained on the track of interest rate hikes in 2018, with the target federal funds rate rising to 2.25%, up 0.75 percentage points from the beginning of the year. The Fed's continued rate hikes have laid the groundwork for global monetary policy. Some developed economies have raised interest rates in succession, with their policy interest rates gradually convergent with the long-term neutral level. The Bank of England raised its policy interest rate from 0.5% to 0.75%, and the Bank of Canada hiked its policy rate from 1% to 1.75%. The Eurozone and Japan with ongoing quantitative easing and negative interest rates are also actively considering withdrawing from the easing and taking steps to normalize interest rates. Monetary policies in emerging economies have become divergent. Some emerging economies followed the Fed's rate hikes in a bid to ease the pressure from local currency depreciation and capital flight triggered by the Fed's rate hikes. For example, Turkey raised its policy rate from 7.25% to 22.5% and Indonesia adjusted its benchmark rate from 4.25% to 6%. Some emerging market countries responded to the downturn pressure by cutting interest rates. For example, the Brazilian central bank lowered its benchmark rate from 14.25% in 2015 to 6.5% at present. Russia lowered its benchmark rate from 11% to 7.5%. The maturity conversion of assets and liabilities is an important function of banks. As banks' debt duration is shorter than asset duration as a whole, banks can gradually restore NIM to normal in support of profitability when the monetary environment tends to be neutral.

I.4 The global financial supervision continues to tighten, putting the banking system under a rising compliance pressure

Since 2008, financial supervision has kept tightening as a chain of financial regulatory policies were introduced and improved gradually. The post-crisis enhanced supervision continued into 2018, with a series of important regulatory policies introduced and improved. Details are provided below:

First, *Basel III (Final Version)* was implemented. *Basel III* is an important theoretical achievement in global financial supervision, and also a crucial policy basis for post-crisis financial supervision reform in major economies. Under its guidance, major economies have generally adopted more prudent regulatory standards and found their banking system becoming increasingly sound. By the end of September 2018, all 27 members of the Basel Committee on Banking Supervision had implemented stricter minimum capital adequacy ratio (CAR), liquidity coverage ratio and capital conservation buffer requirements. Among them, 26 members have implemented the countercyclical capital buffer requirements and adopted stricter regulatory requirements for domestic systemically important banks (D-SIBs).

Second, large financial institutions are under a rising regulatory pressure. "Too big to fail" is an important post-crisis issue for all financial regulatory reforms to address. In 2018, regulatory measures for large financial institutions have been strengthened, including the following:

1. The Financial Stability Board (FSB) revised the G-SIBs assessment methods. The new methods modified the definition of cross-border liabilities; introduced the trading volume indicator into the financial institution infrastructure indicator system; included the exposure, interbank assets and interbank liabilities of insurance subsidiaries into the G-SIBs relevance and complexity assessment on a consolidated basis respectively; expanded the scope of institutions covered by information disclosure; raised the 3.5% ceiling of additional capital buffer requirement for G-SIBs, and allowed the introduction of the sixth or higher bucket according to the systemic importance score of G-SIBs to set stricter additional capital buffer requirement.

2. Progress in implementation of the *Principles for Effective Risk Data Aggregation and Risk Reporting* dents optimism. In January 2013, the Basel Committee issued the *Principles for Effective Risk Data Aggregation and Risk Reporting* in a bid to further improve the risk management, decision making and risk handling capabilities of banks. G-SIBs encountered major difficulties in its implementation over the past five years. As of the end of 2017, only 2 of the 30 G-SIBs had announced to be able to fully implement the principles. According to the survey report released by

FSB in 2018, the compliance deadline for each required item in the principles will be extended for another 2.2 to 2.8 years, for G-SIBs have felt under great pressure to meet the requirements.

3. The total loss-absorbing capacity (TLAC) requirement will soon bring about a major regulatory pressure. FSB adopted the TLAC principles and term sheet in November 2015. The term sheet requires G-SIBs to keep TLAC capital at no less than 16% of risk-weighted assets and 6% of on- and off-balance-sheet exposures in January 2019, and no less than 18% of risk-weighted assets and 6.75% of risk exposure in January 2022. In addition, the term sheet also requires TLAC debt capital to account for more than 33% of TLAC capital. As shown by the balance sheets of G-SIBs in 2018, the US, Japanese and Chinese G-SIBs face greater pressure on TLAC capital replenishment due to the significant differences in financing methods.

4. The framework for bail-in and implementable resolution plan funding of G-SIBs has been improved. In 2018, FSB issued the *Principles on Bail-in Execution* and the *Funding Strategy Elements of an Implementable Resolution Plan* to regulate the two key components of the recovery and resolution plan (RRP) execution of G-SIBs. Bail-in refers to a mechanism of writing down or converting debt obligations into capital to absorb losses. The *Principles on Bail-in Execution* sets higher regulatory requirements for G-SIBs in terms of information disclosure, valuation ability, exchange mechanics, legal system and institutional arrangements. The implementable resolution plan funding refers to the funding arrangements for financial institutions in a liquidity trouble. The *Funding Strategy Elements of an Implementable Resolution Plan* requires G-SIBs to have the ability to calculate the funding gap and implement the funding strategy. The funding plan should be implemented in compliance with legal requirements of the home country and the host country. G-SIBs are advised to raise funds through corporate assets (mortgage) and private funding. G-SIBs should have access to public-sector backstop funding mechanisms and ordinary central bank facilities.

Third, the financial infrastructure supervision reform continued to advance. Specifically:

1. IFRS 9 was officially launched and implemented. Accounting standards are an important infrastructure of the banking system and a key area of post-crisis financial supervision reform. The *International Financial Reporting Standard 9* (IFRS 9) was officially implemented worldwide as from January 1, 2018. IFRS 9 reclassifies financial assets, resulting in less bank assets measured using the amortized cost method and a larger proportion of assets measured at fair value through other comprehensive income. This change has made equity items more volatile, and will have an impact on banks' capital management. In addition, IFRS 9 introduced a forward-looking approach to asset impairment, which increases banks' impairment allowances and erodes profits.

2. Progress has been made in the benchmark interest rate reform. The Libor manipulation scandal in 2012 exposed the loopholes and deficiencies in the global benchmark interest rate mechanism. FSB continued with the benchmark interest rate reform in 2018, exploring to substitute the overnight risk-free rate or fixed rate for the current interbank offered rate. At present, some developed economies have made progress in the benchmark interest rate reform. In 2017, the US launched the Secured Overnight Financing Rate (SOFR), the Eurozone selected the Euro Overnight Index Average (EONIA) as risk-free rate, and the Bank of England introduced the Sterling Overnight Interbank Average Rate (SONIA). In 2018, FSB released a report envisaging the overnight risk-free rate and fixed rate as an important goal of future benchmark interest rate reform, and will formulate relevant financial regulatory policies.

3. The "Unique Product Identifier (UPI)" system for OTC derivatives was launched. The numerous OTC derivatives excluded from monitoring resulted in a rapid buildup in risks during the financial crisis. Since the crisis, FSB has been committed to strengthening the supervision of OTC derivatives trading. One of its important tasks is to build a facility system that monitors OTC derivatives trading. In September 2017, FSB released the technical guide to UPI. This technical standard has been promoted across the global banking system in 2018. The UPI mechanism can identify the products in OTC derivatives trading, allowing regulators to gain a clear picture of the transactions in the OTC derivatives market.

Fourth, China, Europe and the US take different regulatory stances towards foreign banks. Since the crisis, the US and the EU have enhanced their supervision of foreign banks to varying degrees. The US has introduced a series of regulatory policies for financial institutions operating in the US, typically including the *Dodd-Frank Act*, the *Volcker Rule* and the *Foreign Account Tax Compliance Act* (FATCA). The US has enhanced supervision of foreign banks by toughening the requirements on capital, liquidity, organizational structure and AML compliance. By establishing a single banking supervision mechanism, the EU issued the *Capital Requirements Directive IV* (CRD IV) and the *Bank Recovery and Resolution Directive* to strengthen the capital, liquidity and AML supervision requirements of banks in Europe. In particular, the EU has gradually pushed for measures to manage branches of foreign banks as subsidiaries, requiring an Intermediate Parent Undertaking (IPU) to be set up for a non-EU financial group with over EUR30 billion of EU-based assets. This policy will have a great impact on the European organization structure of foreign banks. Unlike the EU and the US, which has persistently strengthened the supervision of foreign banks, China has stepped up efforts to further open up its financial sector in 2018. In the banking sector, China has relaxed its restrictions on foreign banks' equity share in Chinese banks, expanded the business scope of foreign banks in China and simplified relevant business approval procedures.

Fifth, the supervision of FinTech, digital currency and shadow banking has been improved and strengthened continuously. The UK, Singapore and Australia have explored to introduce and improve the "regulatory sandbox" in an effort to better promote FinTech development and isolate the possible risks from financial innovation. As for the supervision of internet finance security, FSB issued a regulatory guidance on financial-sector cybersecurity in late 2017 proposing supervisory practices for enhancing cybersecurity. The European Central Bank, the Bank of Japan and the People's Bank of China have all issued announcements to warn of risks in digital currencies, typically Bitcoin. All countries are cautious about the use of digital currency. As for shadow banking supervision, China issued new rules for asset management in April 2018, resulting in a sharp contraction in off-balance-sheet financing in the banking system and stemming the expansion of shadow banking.

Sixth, the US has opened the door to a period of "regulatory relief". US President Trump officially signed the *Economic Growth, Regulatory Relief and Consumer Protection Act* in May 2018. The "regulatory relief" in the financial sector consists of six elements, namely relaxing regulatory requirements for residential mortgages, simplifying capital assessment requirements for community banks, allowing more banks to take reciprocal deposits, exempting selected banks from the Volcker Rule, raising the asset threshold of systemically important financial institutions (SIFIs) and exempting selected banks from regulatory requirements. The "regulatory relief" policy is good for small and medium-sized US banks, directly benefiting the banks contributing about 40% of total US banking assets. It should be noted that along with the relaxation of financial supervision, some US banks have begun to lower credit standards and potential risks are growing. Foreign banks benefit less from the "regulatory relief" policy as their organizational structure is dominated by branches and many banks are not covered by the policy.

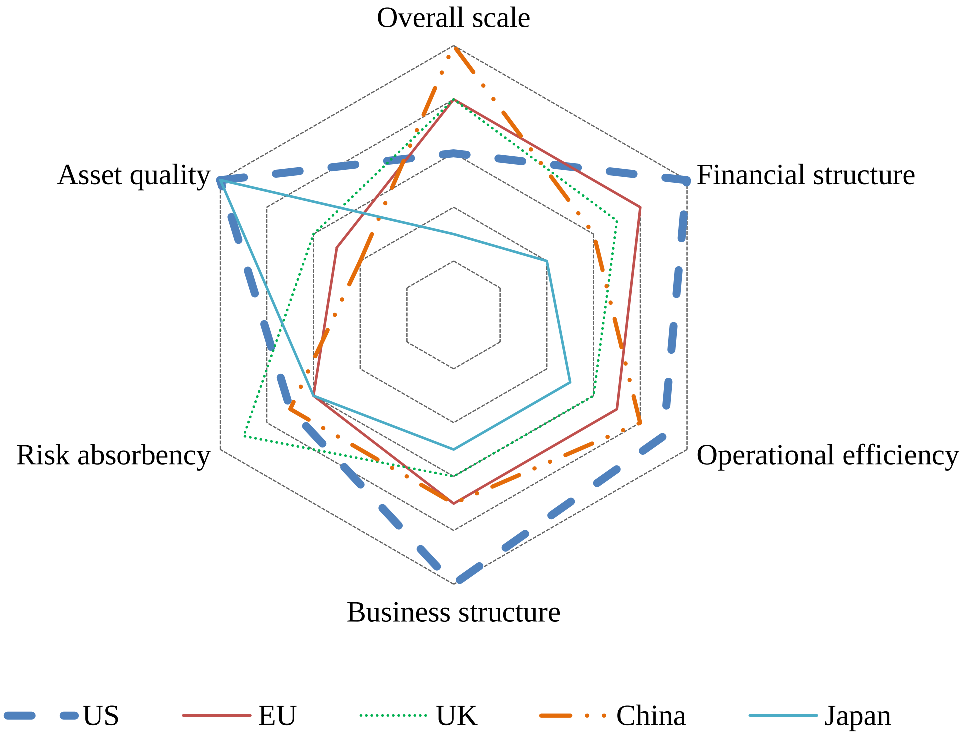
II. Comparison of Global Banking Development in 2018

We have comparatively analyzed the global banking developments in 2018 through six-dimensional observation in an uncertain environment and identified weaknesses in banking operation and management of major economies.

II.1 Overview

We have assessed and compared the banking industries of China, the US, the EU, Japan and the UK using over 10 indicators under six dimensions (i.e. overall scale, asset quality, risk absorbency, operational efficiency, income structure and business structure) based on relevant data at the end of 1H2018[1](Fig. 1). As shown by the areas in the spider diagram, the US with the best banking industry performance receives an overall score of 23, ranking first among the five largest economies. China and the UK tie for the second place with an overall score of 18. The EU ranks fourth with an overall score of 17.5. The Japanese banking industry shows weak overall performance for its smaller scale and lower efficiency.

Fig. 1: Banking Industry Results of Major Economies in 1H2018



Source: National/regional regulatory authorities, BOC Institute of International Finance

In terms of overall scale, China ranked first by either absolute value or growth rate of banking assets. The UK and the EU tied for the second place. The US ranked third and Japan took the last place. At the end of the Q2, China's banking assets totaled USD39.3 trillion, followed by the EU (USD34.9 trillion) and the US (USD17.5 trillion). The UK and Japan recorded USD7.6 trillion and USD6.4 trillion in banking assets, respectively. By growth rate, the UK's banking assets expanded fastest at 4.6%, followed by China (3.1%), the EU (3.0%) and the US (0.7%). Japan's banking assets shrank by 0.6% from the beginning of the year.

In terms of operational efficiency, the US banking industry is most profitable, followed by China, the EU, the UK and Japan in descending order. The strongest growth (30.58%) of net profit was

[1]The scoring rationale for the indicator system is to rank assessed countries according to each indicator. 100 points will be assigned to the top-ranking country, with 20 deducted for each notch below the top, and the lowest-ranking country will receive a score of 20. Based on scores assigned for all indicators, the scores for the six dimensions are determined through arithmetical averaging. Finally the overall score is calculated as the arithmetical mean of scores for the six dimensions.

recorded by the US at the end of Q2, followed by the US (25.0%), Japan (8.4%), the EU (6.5%) and China (6.4%). The ranking of banking ROA is as follows: The US (1.4%), China (1.0%), the EU (0.5%), the UK (0.4%) and Japan (0.4%).The ranking of banking ROE is as follows: China (13.7%), the US (12.2%), Japan (9.5%), the EU (7.2%) and the UK (6.6%).

From the perspective of asset quality, Japan and the US show the best asset quality, followed by the UK, the EU and China in descending order. Japan's banking industry registered the lowest NPL ratio of 0.71% at the end of Q2, while the EU had the highest of 3.60%.The NPL ratio of the US, the UK and China was 1.06%, 1.40% and 1.86%, respectively. In terms of NPL balance,the US, Japan, the EU and the UK registered a drop by 10.4%, 8.4%, 8.2% and 0.3% at the end of Q2, respectively.

In terms of risk absorbency, the UK scored the highest, China and the US tied for the second place and Japan and the EU tied for the third place. At the end of Q2, the UK's banking industry had a CAR of 20.4%, the highest among the five major economies. The EU, Japan, the US and China recorded 18.8%, 18.0%, 14.6% and 13.6% in CAR, respectively, all at a fairly high level. China saw the fastest growth (3.7%) in tier-1 capital in the banking industry when compared with the beginning of 2018, followed by the US (1.8%), the UK (10.8%) and Japan (0.1%). The tier-one capital of the EU banking industry fell by 0.3% from the beginning of the year.

In terms of financial structure, the US scored the highest, followed by the EU, the UK, China and Japan in descending order. At the end of Q2, the US banking industry recorded a non-interest income ratio of 33.7%, ranking second among the five major economies. But it possessed a strong interest-generating business capacity with an interest margin of 3.38%, far higher than that of other economies. The EU's banking industry recorded 43.2% in non-interest income ratio, ranking first among the five major economies, but its interest margin was only 1.43%. In Japan and the UK, largest banks had a relatively high non-interest income ratio but a relatively low NIM (about 0.9% and 1.5% respectively). China's banking industry had a non-interest income ratio of merely 23.9% and an interest margin of 2.12%.

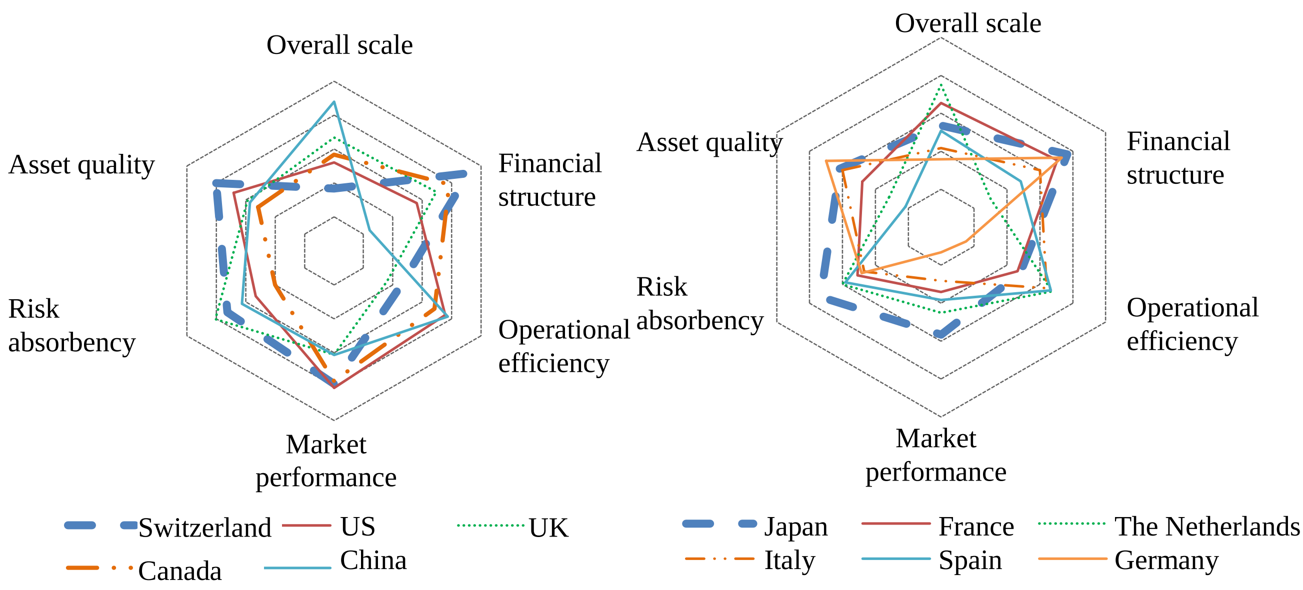
In terms of business structure, the US showed strong performance in deposit and lending in the banking industry. China and the EU tied for the second place, while the UK and Japan ranked fourth and fifth respectively. At the end of Q2, the US banking industry recorded 86.6% in deposits as a percentage of total liabilities and 56.2% in loans as a percentage of total assets, ranking in the higher range among the five major economies based on its solid foundation of core activities. China and Japan showed a relatively high ratio of deposits but a relatively low ratio of loans. In the EU's banking industry, deposits accounted for 55.4% of total liabilities, the lowest among the five largest economies, but loans accounted for 62.5% of total assets, the highest among the five largest economies. The UK stayed in the middle of the ranking by either ratio.

II.2 Comparison of G-SIBs

The Global Banking Industry Research Team has assessed the performance of 29 global systemically important banks (G-SIBs) using an indicator system composed of over 20 factors under six dimensions (i.e. overall scale, asset quality, risk absorbency, operational efficiency, income structure and market performance) through scoring and ranking (Fig. 2)[2].

[2]The scoring rationale for the indicator system is to rank assessed banks according to each indicator. 100 points will be assigned to the top-ranking bank, with 3.44 deducted for each notch below the top, and the lowest-ranking bank ranked 29th will receive a score of 3.6. Based on scores assigned for all indicators, the scores for the six dimensions are determined through arithmetical averaging. Finally the overall score is calculated as the arithmetical mean of scores for the six dimensions.

Fig. 2: Results of G-SIBs in 1H2018, by Country



Top 5 Countries by Overall Score **Courtiers Ranked 6th to 11th by Overall Score**

Source: Bloomberg, annual reports and interim reports of banks, BOC Institute of International Finance

By country, G-SIBs from Switzerland, the US, the UK, Canada and China have a strong overall capacity. Swiss G-SIBs performed well due to sound asset quality and financial structure. US and Canada's G-SIBs mainly benefited from good operational efficiency and market performance. G-SIBs in the UK had its strengths mainly in risk absorbency. China's G-SIBs led by overall scale, yet with a low level of income diversity. In contrast, Japan's G-SIBs were weak in operational efficiency and overall scale, while G-SIBs in the Eurozone ranked low in overall performance due to poor asset quality, operational efficiency and market performance. By individual bank, HSBC Holdings, UBS and JPMorgan Chase benefited from solid expansion in scale, diversified financial structure, outstanding operational efficiency and positive market performance, ranking among the top three by overall performance.

By individual indicator, the 29 G-SIBs had their own strengths.

First, in terms of overall scale, ICBC ranked first, with its total assets and liabilities standing at USD4.12 trillion and USD3.79 trillion, a growth rate of 4.7% and 4.9%, respectively. BNP Paribas and BOC ranked second and third by overall scale respectively, thanks mainly to the strong growth of assets and liabilities. In contrast, Deutsche Bank, State Street, Credit Suisse and BNY Mellon with a big share of investment banking ranked in the lower range by overall scale. Their assets and liabilities are relatively small in scale and keep shrinking.

Second, in terms of operational efficiency, JPMorgan Chase from the US ranked first, with its net profit in 1H2018 rising by more than 26% YoY, and annualized ROA and ROE reaching 1.2% and 12.1% respectively. China Construction Bank with huge net profit and Bank of America with fast net profit growth ranked second and third by profitability, respectively. Relatively, Germany's Deutsche Bank, the UK's Barclays Bank and Japan's Mizuho FG profitability index ranked in the lower range by profitability, with even negative net profits.

Third, in terms of risk absorbency, Japan's Mizuho FG ranked first with a CAR of 17.7%, up 1.9 percentage points YoY. The UK's Standard Chartered and UBS ranked second and third by capital ratio, respectively. Standard Chartered had the highest CAR of 21.3%. By contrast, the capital ratio of Citibank and Bank of America in the US and Bank of BNP Paribas in France ranked in the lower range with a low CAR that registered a drop.

Fourth, in terms of asset quality, UBS ranked first with a NPL ratio of only 0.6%, down 0.2 percentage points YoY. Bank of America and Japan's Sumitomo Mitsui FG Bank ranked second and third by asset quality, respectively, with a good level of NPLs showing an obvious downward trend. Relatively, France's Crédit Agricole and Groupe BPCE and Spain's Santander ranked in the lower range by asset quality, with a high level of NPLs showing not notable improvements.

Fifth, in terms of financial structure, UBS ranked first with a non-interest income ratio of 82.1%, up 3.1 percentage points YoY. The UK's Barclays Bank and Japan's Mizuho FG ranked second and third respectively by income structure. By contrast, China's ICBC, CCB and BOC ranked in the lower range by income structure with a non-interest income ratio of less than 30%, near the bottom of the ranking of 29 G-SIBs, down about 3 percentage points YoY.

Sixth, in terms of market performance, Wells Fargo ranked first with a PB ratio of 1.5%, up 0.2 percentage points YoY, the strongest growth of all. JPMorgan Chase in the US and HSBC Holdings in the UK ranked second and third by market performance, respectively. By contrast, Germany's Deutsche Bank, France's Societe Generale and Italy's Unicredit Group ranked in the lower range by market performance with a PB ratio of 0.3, 0.5 and 0.6, respectively, a level near the bottom among the 29 G-SIBs and showing a significant YoY decline.

II.3 Comparison of China's listed banks

In 1Q-3Q2018, China's A-share listed banks[3] showed a solid development trend as a whole.

By assets and liabilities, listed banks recorded RMB158.1 trillion in assets and RMB145.9 trillion in liabilities at the end of Q3, up 7.1% and 6.7%, respectively. Over the same period, the assets and liabilities of all banking institutions stand at RMB264 trillion and RMB243 trillion, up 7% and 6.7%, respectively. Listed banks' loans accounted for 53.9% of assets at the end of Q3, up 1.8 percentage points YoY; their deposits accounted for 73.4% of liabilities, up 0.89 percentage points YoY.

By profitability, net profits of listed banks totaled RMB1,220.57 billion for 1Q-3Q2018, up 6.9%. Over the same period, the net profits of China's banking institutions totaled RMB1,511.8 billion, up 5.91%, and the profit growth of listed banks was faster than the banking industry. In addition, listed banks registered 2.2%, 0.7% and 10.2% in NIM, ROA and ROE, respectively. NIM and ROA remained flattish YoY, while ROE dropped by 0.5 percentage points YoY. Over the same period, the NIM, ROA and ROE of all banking institutions were 2.15%, 1% and 13.15%, respectively. Except for NIM, listed banks' ROA and ROE were lower than industry average.

In terms of operational efficiency, the non-interest income ratio of listed banks was 30.6% in Q3, up

[3]At present, there are 28 listed commercial banks in the A-share market. More specifically, there are five state-owned large commercial banks (Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China, Bank of China and Bank of Communications), eight joint-stock commercial banks (Industrial Bank, China Merchants Bank, Shanghai Pudong Development Bank, Minsheng Bank, China CITIC Bank, China Everbright Bank, Ping An Bank and Hua Xia Bank), 10 city commercial banks (Bank of Beijing, Bank of Shanghai, Bank of Jiangsu, Bank of Nanjing, Bank of Ningbo, Bank of Hangzhou, Changsha Bank, Bank of Guiyang, Bank of Chengdu and Zhengzhou Bank) and five rural commercial banks (Changshu Rural Commercial Bank, Wuxi Rural Commercial Bank, Jiangyin Rural Commercial Bank, Wujiang Rural Commercial Bank and Rural Commercial Bank of Zhangjiagang).

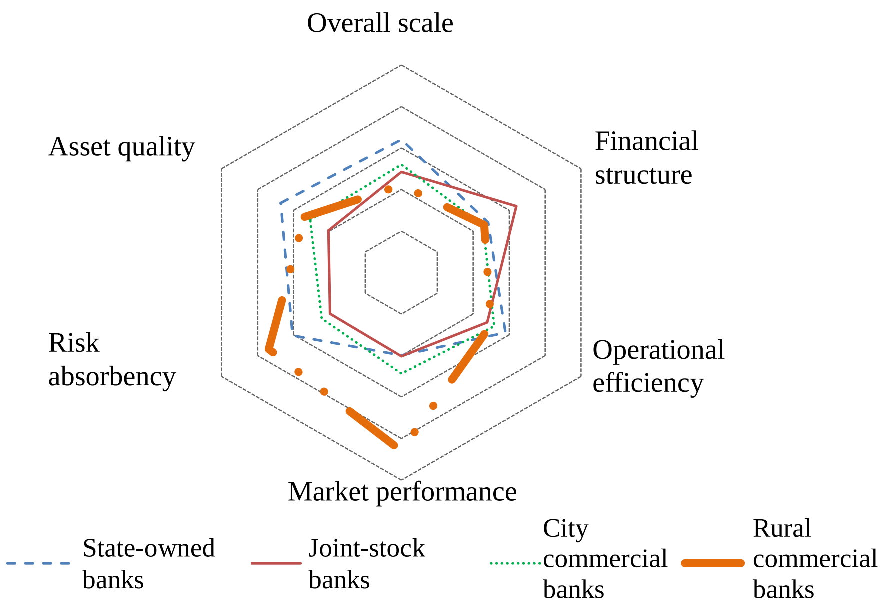
0.9 percentage points YoY. Cost/income ratio was 27.9%, down 0.6 percentage points YoY.

By risk absorbency, the NPL ratio, PCR and CAR of listed banks remained sound at 1.5%, 197.7% and 13.5% at the end of Q3, respectively.

To comparatively analyze the overall performance of the 28 A-share listed banks, we have assessed the results of the 28 A-share listed banks using an indicator system composed of 32 factors under six dimensions (i.e. overall scale, asset quality, risk absorbency, financial structure, operational efficiency and market performance) through scoring and ranking[4].

Fig. 3 shows the 1Q-3Q2018 results of state-owned banks, joint-stock banks, city commercial banks and rural commercial banks listed in the A-share market. As shown by cobweb area diagram, listed rural commercial banks and state-owned banks delivered better performance. Listed rural commercial banks had bright points in market performance and risk absorbency. State-owned banks had strengths in overall scale, asset quality and operational efficiency. Listed joint stock banks showed a better financial structure while city commercial banks ranked relative backwardness by this indicator.

Fig. 3: Results of Listed Banks in 1Q-3Q2018



Source: Wind, BOC Institute of International Finance

III. Ten Forecasts for Global Banking Development in 2019

III.1 Global banking development in a gloomy environment

The global banking industry is expected to operate in a gloomy environment in 2019 that is even

4. The scoring rationale for the indicator system is to rank assessed banks according to each indicator. 100 points will be assigned to the top-ranking bank, with 3.6 deducted for each notch below the top, and the lowest-ranking bank ranked 28th will receive a score of 2.8. Based on scores assigned for all indicators, the scores for the six dimensions are determined through arithmetical averaging. Finally the overall score is calculated as the arithmetical mean of scores for the six dimensions. Six variables of overall size are used, namely assets, liabilities, net profit, assets growth rate, liabilities growth rate and net profit growth rate. There are four indicators of asset quality, namely NPL ratio, NPL ratio change, risk-weighted assets (RWAs)/total assets, and RWAs/total assets change. There are six indicators of financial structure: non-interest income ratio, change of non-interest income ratio, loans/assets ratio, change of loans/assets ratio, deposits/liabilities ratio and change of deposits/liabilities ratio. There are six indicators of risk-absorbing capacity: capital adequacy ratio (CAR), change of CAR, provision coverage ratio (PCR) and change of PCR. Market performance indicators are price-to-book (PB) ratio and change of PB ratio. There are six indicators of operational efficiency: ROA, ROA growth rate, ROE, ROE growth rate, cost/income ratio and change of cost/income ratio.

more unfavorable to the banking development in general. In terms of real economy, the global growth is expected to decelerate from 3.2% to 3.1% in 2019, showing a continued downtrend. Specifically, the US growth rate will drop to 2.6% from 2.9% in 2018, the Eurozone growth rate will drop from 2.0% to 1.8%, and emerging market economies will increase to 4.7%, flat with one year ago. The overall weakness of economic momentum will weigh on banking growth. From the perspective of policy interest rate and financial market environment, the rising inflationary pressure will push the Fed to further hike interest rates, and other developed economies may continue with tightening monetary policy. Though higher interest rates help improve the interest spread of bank credit, they may increase the financing cost and credit risk of the real economy amid sluggish economic growth. In particular, emerging market economies will feel rising financial pressure driven by the Fed's continued rate hikes and under sustained pressure from capital outflow and currency depreciation. Global banks will see their business diversification efforts frustrated by the continued turbulences in global financial markets and the continued correction in stock markets of developed countries.

III.2 The global financial supervision will keep tightening, some countries will loose up

Global financial supervision will continue to tighten in 2019. A series of regulatory policies will be implemented. The *Basel III (Final Version)* will be gradually introduced into the banking industry in various countries to have far-reaching effects on long-term operation and development of the industry. In addition, the supervision over large banks will continue to intensify, TLAC will be applied to G-SIBs in non-emerging markets, and the compliance deadline for effective data aggregation is approaching. The international financial infrastructure reform will continue. The higher provisioning level required by IFRS 9 will erode profits. The benchmark interest rate reform will also have a significant effect on the pricing mechanism in the banking system. In addition, along with the rise of the populism, the US and the Eurozone will continue to maintain tough supervision over foreign banks. A few countries will also continue with regulatory relief in 2019. The US will further push for "regulatory relief". Trump losing control of the House of Representatives adds some uncertainties to regulatory reform. Brexit will enhance local regulatory autonomy, and the British government said it would create a more favorable financial regulatory environment.

III.3 Global banks will further improve their regional structure of overseas development

The financial markets of Argentina, Turkey and some other countries have been volatile through 2018. India and South Africa have also showed potential financial risks and vulnerabilities. In the future, the global economic growth and the stability of financial markets in emerging economies will be further challenged by the USD interest rate hikes and escalating global trade frictions. Many multinational banks, especially large global banks that produce a substantial proportion of its income from overseas operations, will gradually shift the focus of international development to regional operations, i.e. vigorously develop overseas business in adjacent regions to their home countries. Large global banks are all looking for transformation after crisis. They pursue streamlined development and focus more on core businesses and core markets, evidenced by their vigorous efforts to grow regional business. Fast-expanding emerging multinational banks, at a crucial turning point from rapid growth to high-quality development, will pay more attention to centralized management of regional business and gradually shift their goal from expanding overseas business to improving overseas business.

III.4 Developed countries will show not-in-lockstep economic growth and marked divergence in banking development

Developed countries will show divergence in economic growth in 2019, especially in banking operations. Overall, the banking industry will grow relatively well in the US and Japan. The US commercial banks will see their assets and liabilities expanding steadily as they do now, up about 3.5% YoY. Their profitability will remain stable, with net profit up about 6.5% YoY, driving YoY growth of ROA. Tier-1 CAR will edge up YoY to about 14.7%. NPL ratio will continue to decline to about 0.6%. Japan's banking industry will maintain solid growth, with net profit expected to still grow steadily at about 3%-4% in 2019 and NPL ratio to continue to decline. Relatively, the EU's banking industry will face some challenges. The European economy will show the following characteristics in 2019: First, the EU's recovery will weaken to produce an average economic growth rate of 1.8% in the next five years. Second, the monetary policy tends to be normalized and the market interest rate will enter an up-cycle to usher in a turning point of liquidity. Third, uncertainties in Brexit negotiations will have a great impact on the financial business. Against this background, the growth of banking assets will continue to decelerate in the UK and the EU, coupled by weaker growth in net profit and certain pressure on CAR and NPL ratio.

III.5 Developing countries' banking industry will face new challenges

Developing countries will still generally face slowing economic growth, wider exchange rate fluctuations and frequent cross-border capital flows in 2019 in the context of changing international economic and international situations. These factors will mount to challenges to banking operations in developing countries in 2019.

Southeast Asian banks demonstrated good overall performance driven by infrastructure investment in 2018, with assets expanding by about 4%, net profit growing at double digits YoY but NPL ratio rising slightly. Due to the suspension of several large infrastructure projects in Malaysia and other countries and the possibility of further interest rate hikes in some countries to curb currency depreciation, the ASEAN banking industry will likely experience a slowdown in asset growth, decline in profitability and a continued rise in NPL ratio in 2019.

The South African rand has fluctuated widely since August 2018, hitting a two-year low of 15.6925 against USD. The South Africa shows a dark economic outlook, as revealed by its YoY GDP growth of only 0.6% in 1H2018, which may continue to fall in 2019. Against such a backdrop, South Africa's banking industry will be under great pressure from, for example, asset quality problems and weaker profitability.

Brazil's GDP grew by only about 1.3% in 2018, far less than expected, still facing some uncertainties in 2019. In this context, Brazil's banking assets are expected to grow by 1% to 1.5% and net profit by 2% in 2019. Asset quality problems will remain prominent and the NPL ratio will remain at a high level of around 5% to 6%.

Thanks to the banking crackdown measures taken by the Bank of Russia in recent years, the systemic risks in the Russian banking industry have decreased. Moody's issued a report in October 2018 upgrading its outlook for Russian banks from "Stable" to "Positive". However, the Russian banking industry is still challenged by the large size of NPLs and weak profitability. In 2019, Russia's banking industry will remain under pressure given uncertainties in international economic and financial development.

III.6 China's banking industry will stick to their founding mission of serving the real economy while steadily expanding in scale

China's banking assets growth have geared down, from "fast" to "medium-to-fast", as China is adjusting the industry structure and transforming and upgrading the economy. The assets of banking institutions expanded by 6.96% YoY at the end of 3Q2018. More specifically, the assets of commercial banks increased by 6.95% YoY, down 4.25 percentage points from the same period of last year. Growth rate of assets varied with the size of commercial banks. Large commercial banks showed steady pickup in assets growth from quarter to quarter, while joint stock banks, city commercial banks and rural commercial banks showed deceleration in assets growth from quarter to quarter. Looking ahead to 2019, China's economy will continue to grow steadily with a GDP growth rate of about 6.5%. The monetary policy will remain prudent and neutral, with M2 growing at about 8.5%. The regulatory environment will remain stringent, and the regulatory policies issued previously will be gradually implemented. The negative impact of US-China trade friction has been partially absorbed. In addition, Chinese will introduce a series of policies conducive to expansion of banking assets, including policies on encouraging development of private enterprises, the Belt and Road Initiative, regional coordinated development and Hainan Free Trade Zone. The assets of state-owned commercial banks are expected to expand slightly faster in 2019. Joint stock banks, city commercial banks and rural commercial banks will maintain stable growth in assets. Assets of listed banks are expected to grow by about 8%.

III.7 "volume" and "price" Stabilization: China's banking industry will show steady acceleration in profit growth

With China's economy staying in the "new normal" of medium-to-high growth rate, China's banking industry has become less profitable. The net profit of commercial banks dropped sharply from over 10%, followed by a pickup. By the end of the third quarter of 2018, commercial banks posted combined net profit of RMB1.51 trillion as of the end of 3Q2018, up 5.91% YoY, down 1.49 percentage points from the same period last year. A series of policies affecting profitability of commercial banks have been issued. By "volume", the four required reserve ratio (RRR) cuts provide commercial banks with the possibility of compensating lower "price" with bigger "volume", partially offsetting the negative effects of sluggish growth in aggregate financing to the real economy and slower growth in new lending. By "price", the RRR cuts have driven down costs of deposits. The weighted average lending rate of financial institutions was 6.19% at the end of Q3, a rise for the third consecutive quarter, pushing NIM of commercial banks to pick up slightly. However, commercial banks feel under greater pressure from economic downturn and revised criteria for NPL identification. Looking forward to 2019, the monetary policy will remain stable while tending to relax as necessary for tradeoffs between steady macro-economic growth and deleveraging and for absorbing the impact of China-US trade friction. Previously issued policies, including new rules for asset management, will be gradually implemented and the toughening supervision will be marginally improved, with some of their negative impact already released. In particular, the increasingly proactive fiscal policy gives an impetus to infrastructure investment, coupled by policies issued in succession to support private enterprises. All these factors help commercial banks to improve their performance. However, the local government debt risk, credit risk of large enterprises, and non-performing risk of consumer credit and other retail loans will remain to be addressed. In addition, effects of RRR cuts will gradually ripple from the liability side to the asset side, likely to bring down loan yield rate. It is expected that the net profit growth of listed banks will remain around 7% in 2019.

III.8 China's listed banks will speed up reforms

China's fast-growing financial sector sees increasingly fierce competition in the banking industry, as shown by the continuous decline in concentration, ROA and NIM in the industry. China's financial sector has opened markedly wider to the outside in 2018, intensifying competition in the banking market. The downside pressure to China's economy has increased since 1H2018. The impact of US-China trade friction will be continuously felt by the real economy in 2019 and the financial system will obviously strengthen its support for the private sector of the economy, placing higher requirements on banks' risk management ability. The NPL ratio of China's banking industry is expected to edge up in 2019. Some city commercial banks and rural commercial banks will be under a big pressure from NPLs, but the banking industry as a whole will kept NPL ratio within 2%. In 2019, changes in the external environment will accelerate the deepening reform of China's listed banks. Listed banks will re-examine their development model, deepen reforms in organizational structure, risk management system and business expansion model, continuously improve their performance, and reduce business risks.

III. 9 Digital inclusive finance is expected to become an important facet of development as a number of policies have been issued to boost inclusive finance

Policy support for inclusive finance has kept strengthening in 2018. The central bank has announced a number of RRR cuts targeted at inclusive finance. The State Council established a National Financing Guarantee Fund of RMB500 billion to support the funding of small and micro enterprises and cut taxes to reduce their costs. China has made remarkable achievements in inclusive finance so far, with an expanding range of products and services offered by an increasingly diverse mix of entities. The digital inclusive finance business continues to heat up. Innovative products and services such as internet payment, P2P lending and digital insurance have given a significant boost to the inclusive finance development. In the future, inclusive finance will continue to merge with digital technology, and digital inclusive finance will gradually become the mainstream of development. More financial institutions will apply digital technology to customer acquisition, risk assessment and pricing, post-lending management, cybersecurity and consumer protection. With the digital inclusive finance further evolving, inclusive finance will become platform-based, which means the integration between banks and non-banks as well as tech firms and non-tech firms will be further enhanced to form a more open, comprehensive and professional industry chain and provide customers with access to "one-stop" financial services in a single platform.

III.10 The direct financing function of the financial system will be restored to facilitate banks' transformation in wealth management

The structure of aggregate financing to the real economy has changed significantly since the new rules for asset management were introduced. With off-balance sheet financing downsized remarkably, the share of bank credit in aggregate financing once reached a high of more than 90%. The share of direct financing will expand steadily in 2019 as bond and stock markets become a greater contributor to aggregate financing. The new rules for asset management have had a significant effect on the asset management industry and even the entire financial system of China. The banker's financial management business in China will continue to transform in 2019. The contraction of wealth management business seen in 2018 will continue in the coming year. The removal of implicit guarantees for wealth management will lead to continued reduction in principal-guaranteed wealth management. Wealth management products will increasingly become NAV-based and shorter-term products. The share of non-standard assets linked to wealth management products will further decline, and the yield of wealth management product will drop as a result. To fill the funding gap resulting from the contraction of wealth management products, banks will issue more interbank CDs and large denomination CDs, which will further push up the share of high-cost liabilities. By organizational structure, the banking industry will gradually establish financial subsidiaries to institutionalize the operation of wealth management. For some large organizations with investment and fund subsidiaries, how to integrate the boundaries and functions of subsidiaries within the group becomes a hard nut.

Institute of International Finance
1 Fuxingmen Nei Street, Beijing, 100818 China
Postal Code: 100818
Tel: +86-10-66592331
Fax: +86-10-66594040