

Global Banking Industry Outlook

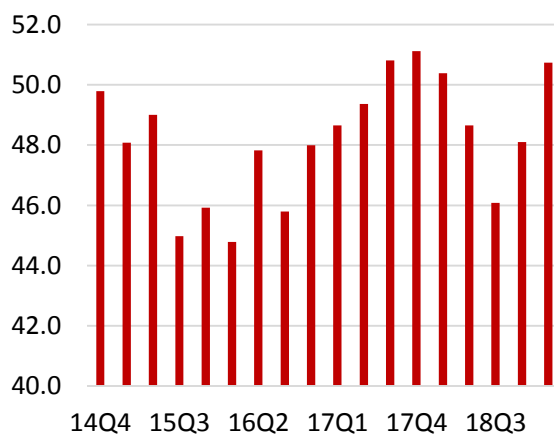
2019Q2 (Issue 38)

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Highlights

- Since 2019, the world has enjoyed an overall stable environment for banking industry and a more stabilized financial market, but seen weakening growth momentum of the real economy and tightening financial regulation. Against this backdrop, the banking industry has shown continuously divergent development in major economies and rapid growth in emerging markets.
- Since 2019, China's banking industry has maintained a steady expansion in balance sheet and further enhanced its risk absorbency. It is expected that the banking industry will see relatively stable NPL ratio and actively promote supply-side structural reform to increase support for the real economy.
- This report provides a special study on the financial supply-side structural reform in China's banking industry.

Composite Index for the EM Bank Lending Conditions Survey



Source: IIF

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Financial Supply-side Structural Reform: New Missions in Banking

Development

-- Global Banking Industry Outlook (2019Q2)

Since 2019, the world has enjoyed an overall stable environment for banking industry and a more stabilized financial market, but seen weakening growth momentum of the real economy and tightening financial regulation. Major economies have shown continued divergence in banking development, but the overall risk profile was stable. China's banking industry has maintained a steady expansion in balance sheet and further enhanced its risk absorbency, providing stronger support for micro and small businesses (MSBs) and private-sector economy. This report provides a special study on the financial supply-side structural reform in China's banking industry.

I. Global Banking Outlook for 2019Q2

I.1 The stable overall banking environment brings new opportunities and challenges

Since 2019, the global banking environment has shown the following characteristics:

The momentum of global growth has weakened. The world economy face increasing risk of downwards pressures in 2019 posed by Brexit delay, US government "shutdown" and escalating trade frictions, etc. Global Purchasing Managers' Index (PMI) dropped to 52.6 in February 2019, with a manufacturing PMI score down to 50.6, close to the boom-or-bust line. According to IMF's January 2019 report, the world economy grew at 3.7% in 2018, with the growth projections for 2019 and 2020 revised downward to 3.5% and 3.6%, respectively. The uncertainties in global growth pose new challenges to banking development.

Global financial markets remained robust in general. Central banks are more prudent on policy rate adjustments in 2019, in the context of expected global slowdown, rising trade tensions and stronger risk aversion. The Fed decided to slow down the pace of rate hikes in 2019 and 2020, while the European Central Bank (ECB) announced to keep the key Eurozone interest rates at zero, seeing no rate hikes by the end of 2019. Since 2018, emerging economies including Chile, Indonesia, Mexico, Russia and South Africa have raised policy rates successively. The interest rate environment remains stable in 2019 in these countries and regions. India and China respectively cut interest rates and reserve requirement ratio (RRR) to gradually improve their domestic financing environment. In 2019, the Fed's slower pace of rate hikes, the possibility of the US economy peaking in the year and the limited room for a sharp USD appreciation will have a softer impact on emerging financial markets and ease their capital outflows. The notable rise in MSCI banking indices for developed countries and emerging economies in 2019 reflects market participants' overall optimism about the banking prospects.

Financial supervision tightened further. The Basel Committee on Banking Supervision has completed a review of its 2008 *Principles for Sound Liquidity Risk Management and Supervision*, confirming that the Principles remains fit for purpose. The Financial Stability Board (FSB) revised the measurement framework for market risk capital requirements, expected to put stricter regulatory requirements on capital and liquidity of financial institutions. Global systemically important banks (G-SIBs) have formally implemented the total loss-absorbing capacity (TLAC) requirements. The US and Japanese G-SIBs are under certain pressures of capital replenishment. The Fed is considering stricter regulatory measures for US branches of foreign banks, possibly putting them under more stringent regulatory requirements. The European Banking Administration (EBA) has stepped up anti-money laundering (AML) supervision, planning to impose asset value and capital regulatory

review on multinational banks moving their global operations from the UK to EU. EU has decided to strengthen the supervision of investment companies and other “quasi-bank” institutions in accordance with regulatory standards on banking activities. The Bank of Japan is considering setting up an initial coin offering (ICO) regulatory framework.

I.2 Major economies will continue to see divergence in banking development

In 2019 when the overall environment is relatively stable, the global banking industry is expected to advance as it did in 2018 with the following main characteristics:

I.2.1 Banking assets will grow steadily in developed countries and expand faster in emerging economies. At the end of 2018, China had the largest size of banking assets worldwide of USD39.1 trillion, followed by Eurozone with USD34.1 trillion and the US with USD17.9 trillion. Developed countries saw modest growth in banking assets in 2018, evidenced by a 3.03% growth rate of the US, and 0.11%, -0.03% and 2.6% in Eurozone, Japan and Australia respectively. Emerging economies underwent faster expansion in banking assets. Malaysia, Thailand and Indonesia recorded a growth rate of 6%, 3.1% and 10% respectively, compared with 10.44% in Russia and 7.4% in South Africa.

The composite index for the EM Bank Lending Conditions Survey (EMBLCS)¹ published by the Institute of International Finance (IIF) indicates that the emerging markets will maintain rapid growth in banking assets in 2019, representing a divergent trend from developed countries. The index rose to 48.1 and 50.7 in 2018Q4 and 2019Q1 respectively, the first time back to the median level of 50 after 2018Q1, up 4.64 from 2018Q3 (Fig. 1). In recent years, middle-income countries, mainly emerging economies, have experienced strong expansion in bank credit, which takes up a rising percentage of GDP. At the end of 2017, bank credit in middle-income countries accounted for 137.5% of their GDP on average, approaching the global average of 181% (Fig. 2).

Fig. 1: Composite Index for the EM Bank Lending Conditions Survey

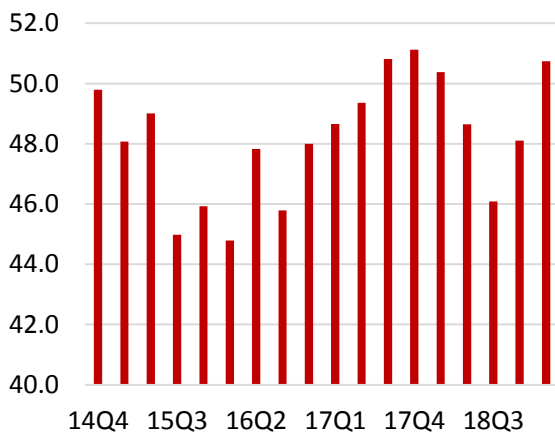
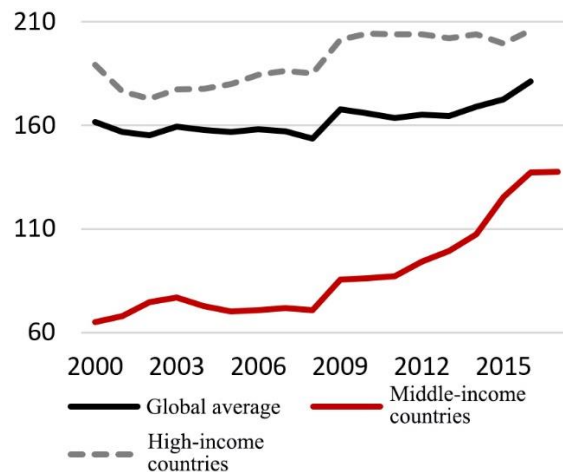


Fig. 2: Domestic Credit as % of GDP



Source: IIF, World Bank, BOC Institute of International Finance

¹The composite index for the EM Bank Lending Conditions Survey comes from IIF’s report on its quarterly survey on bank executives in major emerging markets. The index has five components: credit criteria, loan demand, financing conditions, trade finance and non-performing loans. A reading above 50 on the index indicates loose credit and improving lending conditions; a reading below 50 suggests tight credit and deteriorating lending conditions.

Developed economies and emerging markets are expected to see further divergence in banking development. At the end of 2018, Russia, India and Indonesia posted 12.5%, 15.1% and 13.7% in YoY growth of outstanding bank loans respectively, all faster than a year earlier. Developed countries found their bank loans growing modestly, at a more-or-less lower pace. The US, Australia and Eurozone showed a YoY decline of 0.01 percentage point, 0.3 percentage point and 5.77 percentage points in growth rate, respectively. The growth in global banking assets is expected to remain divided in 2019Q2. The US and Japanese banking assets will expand at around 1.7% over the year beginning. Emerging economies will keep their banking industry on the fast track, with Indonesia expected to see a roughly 5.0% rise over the year beginning (Table 1).

Table 1: Total Banking Assets of Major Economies and Growth Projections²

Unit: USD100 million

	Country /region	Total assets (2018)	Growth, YoY (2018)	Total assets (2019H1 ¹)	Growth (%) over year beginning (2019H1 ¹)
Developed countries	US	179,431	3.03%	182,504	1.7%
	Eurozone	341,306	0.11%	--	--
	Japan	64,137	-0.03%	65,248	1.7%
	Australia	32,794	2.60%	33,004	0.6%
Emerging economies	China	390,838	6.40%	407,543	4.3%
	Brazil	15,058	1.58%	15,228	1.1%
	Russia	13,533	10.44%	13,521	-0.1%
	Malaysia	6,399	6.00%	6,590	3.0%
	Thailand	5,846	3.10%	5,936	1.5%
	Indonesia	5,546	10.00%	5,821	5.0%
	South Africa	3,830	7.40%	3,955	3.3%

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

I.2.2 The global banking industry is estimated to maintain good profitability. Major economies maintained good profitability in 2018. In developed economies, Eurozone, the US and Australia achieved positive growth in net profit. Notably, the US recorded YoY growth of 43.4% thanks to tax reform and deregulation³. Among emerging economies, Russia, Indonesia and Thailand posted net profit growth of 70.3%, 18.3% and 10.7% respectively, all above 10%. China, Brazil, Malaysia and South Africa maintained steady growth in net profit at 4.7%, 1.3%, 2.8% and 4.8% respectively. The global banking industry is expected to continue to present good profitability in 2019Q2, while fluctuations are likely to hit some countries. For example, the US banking industry will face a downward pressure on net profit in 2019Q2 due to fading effects of tax reform (Table 2).

²Banking data for Eurozone are as of September 31, 2018; the same below.

³Excluding tax reform effects, YoY growth rate was 13.6%, still a remarkable level.

Table 2: Net Profit of Banks in Major Economies and Growth Projections⁴

Unit: USD100 million

	Country /region	Net profit (2018)	Growth, YoY (2018)	ROA (2018)	ROE (2018)	Net profit (2019H1 ^f)	Growth, YoY (2019H1 ^f)
Developed countries	US	2,374	43.37%	1.35%	11.78%	1,195	-0.3%
	Eurozone	1,653	2.45%	0.48%	7.20%	--	--
	Australia	268	5.80%	0.80%	12.37%	136	1.5%
	Japan	173	-3.38%	0.27%	8.54%	56	-11.1%
Emerging economies	China	2,667	4.72%	0.90%	11.73%	1,600	6.4%
	Russia	193	70.30%	1.50%	13.80%	95	4.1%
	Brazil	174	1.31%	1.23%	--	95	7.5%
	Indonesia	105	18.30%	2.55%	15.83%	60	16.5%
	Malaysia	90	2.80%	1.40%	13.50%	45	-3.6%
	South Africa	62	4.84%	1.31%	15.98%	31	4.3%
	Thailand	6	10.70%	1.13%	9.60%	4	7.5%

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

1.2.3 The global banking industry has a stable risk profile. Developed countries showed a sound risk profile in 2018, while some of the emerging economies witnessed a worsening, yet controlled in general, risk profile (Table 3). As at the end of 2018, Eurozone, the US and Japan recorded a YoY decline of 16.4%, 13.8% and 13.5% in balance of NPLs respectively; Australia reported a 10.4% YoY growth rate in balance of NPLs, but its NPL ratio was still as low as 0.4%. Emerging economies saw a rise in balance of NPLs at varying degrees, with stable NPL ratio. At the end of 2018, China, Malaysia, Indonesia and Thailand had an NPL ratio of 1.83%, 1.60%, 2.37% and 3.10% respectively. Russia's NPL ratio was 4.68%, slightly higher but down 0.58 percentage point YoY. Brazil was in a worse risk situation, with NPL balance up 7.2% YoY and NPL ratio reaching 6.35%, up 0.11 percentage point YoY.

Capital adequacy ratio (CAR) remained high. As at the end of 2018, the US, Eurozone, Japan and Australia had a CAR of 14.6%, 19.0%, 18.1% and 14.8% respectively. Among emerging economies, Thailand, Indonesia and Malaysia had a CAR of 17.9%, 23.0% and 17.4%. Russia posted a low CAR of 8.3%, but its tier 1 capital surged by 9.3%, improving the capital base. Given the ongoing improvements in national regulatory systems and relatively stable financial markets at present, the global banking industry is expected to embrace continued improvements in both asset quality and capital base in 2019Q2. The risk profile will remain stable, with signs of improvement. Of course, ongoing attention should be paid to some European regions. Italy's real-sector recession and heavy public debts caused high uncertainty in its banking prospects. Spain-based Banco Santander

⁴Japan's banking data are as of the end of the calendar year 2018, other than the data as of the end of the fiscal year 2018 (end of March 2019). YoY growth of net profit represents a comparison with the same period of the previous year.

postponed the redemption of its perpetual capital bonds, arousing wide concern among investors.

Table 3: Risk and Capital Changes in Selected Countries and Regions (USD100 million, %)

	Country /region	Balance of NPLs	Growth, YoY	NPL ratio	Tier 1 capital	Tier 1 capital Growth	Capital adequacy ratio
Developed countries	Eurozone	8,179	-16.40	3.40	--	--	19.00
	US	1,005	-13.82	0.99	17,405	3.81	14.60
	Japan	173	-13.46	0.67	3,254	0.02	18.06
	Australia	91	10.40	0.40	1,807	5.33	14.80
Emerging economies	China	2,951	18.74	1.83	22,571	11.06	14.20
	Russia	439	1.90	4.68	1,009	9.26	8.30
	Brazil	436	7.17	6.35	1,133	0.59	--
	Thailand	136	3.20	3.10	592	4.00	17.88
	Indonesia	87	2.00	2.37	836	2.70	22.97
	Malaysia	59	-0.80	1.60	534	-4.70	17.40
	South Africa	--	--	--	147	6.70	15.98

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

II. China's Banking Outlook for 2019Q2

II.1 The current banking environment remains stable

Since the beginning of 2019, China's main economic indicators have shown steady performance as the economy runs within a reasonable range.

Chinese economy remains fundamentally stable. According to some of the major economic indicators published by the National Bureau of Statistics (NBS) of China for January and February, Chinese economy remained fundamentally stable in the first two months of the year. In January and February, total retail sales of consumer goods grew by 8.2% YoY, flattish with the end of 2018. Catering spending grew faster, while automobile consumption was still sluggish. In January and February, fixed asset investment grew at 6.1%, up 0.2 percentage point from the end of 2018. Real estate and infrastructure investment performed well, compared with a pullback in private-sector fixed asset investment. Growth in imports and exports weakened in January and February due to seasonal factors of the Chinese New Year. Profits improved in the business sector. With the Chinese New Year factors excluded, the industrial value added of enterprises above designated size added 6.1% YoY nationwide during January and February. The downward pressure on manufacturing PMI still deserves special attention. Stable economic fundamentals provide favorable development conditions for financial supply-side structural reform in the banking industry.

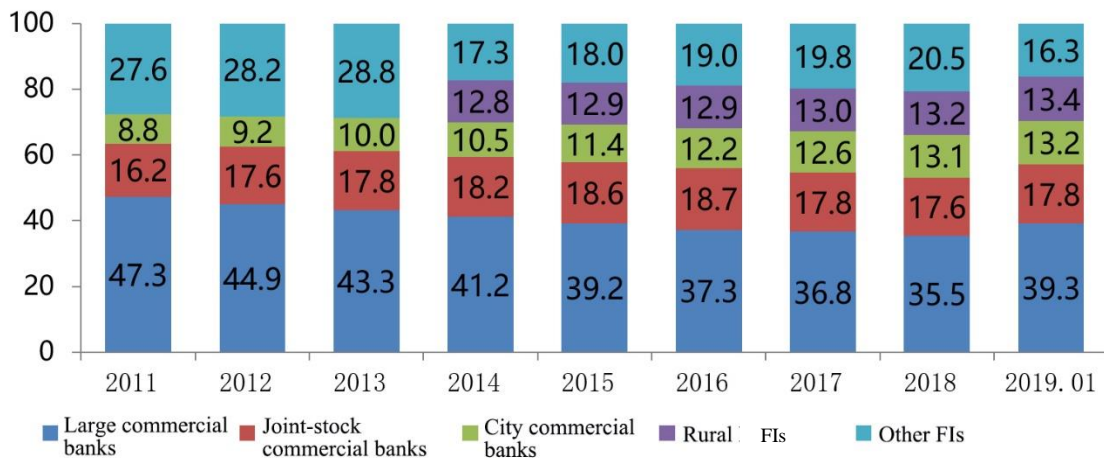
The monetary policy remains prudent with sufficient liquidity. PBOC advanced to keep its monetary policy prudent in 2019 in terms of counter-cyclical adjustment, appropriate aggregate supply, structural improvement and internal and external balance. Broad money supply (M2) and the aggregate financing to the real economy grew basically at the same pace with nominal GDP to further increase support for MSBs and private enterprises. PBOC flexibly used a combination of policy tools to keep market liquidity stable. Weighted average rate of interbank lending and pledge-style

repurchases fell more or less from one year ago, with the liquidity remaining largely in balance.

The tightening supervision has been improved and a series of policies were released to support the real economy. CBIRC has issued regulatory measures on anti-money laundering and counter-terrorist financing (AML/CTF) and compliance of overseas institutions in 2019. The tightening supervision seen previously has been relaxed somewhat. Regulators further cause commercial banks to support the real economy, including encouraging them to replenish their capital through various channels. CBIRC launched a series of policies to serve rural vitalization and poverty alleviation, strengthen financial services for private enterprises and encourage rural commercial banks to stay true to their founding mission, enhance governance and improve financial service capability, thereby providing a policy backing for commercial banks to improve their business structure and asset portfolio and explore new drivers of profit growth.

With competition continuing to intensify in the banking industry, it is good time to set up small and medium-sized banks. At the end of January 2019, large commercial banks contributed 39.3% of banking institutions’ total assets (Fig. 3), a two-year high driven mainly by CBIRC’s inclusion of the Postal Savings Bank of China (PSBC) in state-owned large commercial banks. Starting from 2019, PSBC and its relevant data will be included in the statistics on large commercial banks, which will further intensify competition across the industry. In addition, with financial supply-side structural reform aiming to increase the number and business weight of small and medium-sized financial institutions, more specialized banks serving private enterprises, MSBs and customers related to agriculture, rural areas, and rural people (“agro-related” fields) are expected to emerge. Small and medium-sized banks will see new growth opportunities.

Fig. 3: Assets (%) of Banking Institutions by Category



Source: CBIRC, BOC Institute of International Finance

FinTech supervision has worked positively. Commercial banks are likely to make new breakthroughs in FinTech development. In recent years, China has made measurable progress in its crackdown on internet irregularities, including cleanup of P2P microcredit platforms, regulation of third-party payment services, shutdown of domestic cryptocurrency exchanges and crackdown on online payday lending. The runaway growth of internet finance has been contained to soften its shock on commercial banks. In addition, commercial banks are increasingly aware that FinTech gives a boost to business process reengineering, risk management and marketing, and most of them are actively pushing for digital transformation. During the 2019 NPC and CPPCC Annual Sessions, PBOC announced to step up the rollout of its FinTech development plan and encourage commercial banks to strengthen FinTech application to make financing more accessible and affordable to private firms and MSBs. It also claimed to strengthen IT infrastructure development, pursue integrated use

of digital resources and intensify the application of RegTech, providing commercial banks with guidance on FinTech-driven business development.

II.2 China's Banking Outlook in 2019Q2

First, balance sheet growth remains stable. As at the end of 2018, Chinese banking institutions posted RMB268.24 trillion in assets and RMB246.58 trillion in liabilities, up 6.27% and 5.89% YoY, and down 2.41 and 2.51 percentage points from the same period of 2017, respectively. Following its slowdown to 8.68% in 2017 from 15.8% in 2016, the growth in assets further declined in 2018 into a range of medium-to-high growth. Since the Chinese government launched the policy on five priority tasks of cutting overcapacity, reducing excess inventory, de-leveraging, lowering costs, and strengthening areas of weakness, China's economy has started transformation to high-quality development. Driven by the economic restructuring and industrial structure upgrades on all fronts, more inefficient and excessive investments are phased out. In addition, work has been done to prevent and defuse financial risks. A spectrum of financial supervision measures have been launched. For example, MPA assessment has been expanded to off-balance sheet wealth management business of commercial banks and interbank certificates of deposit (CDs) of commercial banks with over RMB100 billion of assets. The new regulations on asset management and wealth management were introduced. Therefore, financial risks have been reined in gradually and all banking institutions see their asset growth slowing down.

It is unlikely to see financial supervision relaxing in 2019. Commercial banks can hardly expand their assets through “channel” cooperation. In particular, the new regulation on asset management issued in 2018 has been reshaping the asset management industry, leaving a rare chance for commercial banks to expand assets through non-conventional channels. Regulators shifted their focus of work from “deleverage” gradually to “stable leverage” in 2018H2, requiring commercial banks to fulfill their duty of serving the real economy and continue to provide stronger support for the real economy. Based on overall data available on banking institutions, we expect no major deviation of listed commercial banks. Given the high probability of the economic growth firming up in late Q2 or early Q3, listed banks' asset growth is projected to recover to around 7.5% at the end of Q2.

Second, risk absorbency is further enhanced. At the end of 2018, commercial banks posted RMB2,025.4 billion in balance of NPLs and 1.83% in NPL ratio, up 0.09 percentage point YoY. Provision coverage ratio (PCR) stood at 186.31%, up 4.89 percentage points YoY. Allowance to total loans ratio was 3.41%, up 0.35 percentage point YoY. Commercial banks saw a rise in both balance and ratio of NPLs over 2017. With the economy under a rising downward pressure, some real sectors of the economy were struggling with bigger risk exposures and higher credit risk of enterprises. In such a context, joined by stricter criteria for NPL recognition and slowing write-off of losses, both the balance and ratio of NPLs of commercial banks rose in 2018H1. In Q3, however, the stronger write-offs drove down the balance and ratio of NPLs of commercial banks and also pushed up their PCR and allowance to total loans ratio, making commercial banks more resilient to risks.

2019 still faces interwoven economic and social complexities and a variety of destabilizing factors. Many challenges and uncertainties still exist at home and abroad. Close attention should be paid to potential risks in the following fields: Firstly, as the economic growth has not stabilized yet, some small and medium-sized enterprises will possibly find their credit risk erupt, which deserves great attention. Secondly, banks should remain vigilant to the expansion of local governments' hidden debt. Thirdly, as the housing price may reach a tipping point in some regions, sufficient attention should be paid to development in the real estate industry and quality of real estate loans. Listed banks will see their asset quality remaining stable thanks to better economic environment, stronger counter-

cyclical adjustments to the macroeconomic policy and gradual implementation of structural reform policies. NPL ratio is projected to stay around 1.5% in Q2.

Third, stronger support is provided for MSBs and public wellbeing fields. Commercial banks continued to strengthen their support for the real economy, especially for MSBs. Total loans to MSBs stood at RMB25.21 trillion in 2018, up 8% YoY. Of them, RMB7.10 trillion was from large commercial banks, down 4.3% YoY; RMB4.56 trillion was from joint-stock commercial banks, up 6.5% YoY; RMB6.26 trillion was from city commercial banks, up 6.5% YoY; RMB6.96 trillion was from rural commercial banks, up 16.09% YoY. All commercial banks except for large ones posted positive YoY growth in lending to MSBs; in particular, rural commercial banks increased its support remarkably for MSBs. In addition, banking institutions continued to strengthen support for public wellbeing fields, where the total lending amounted to RMB5.95 trillion in 2018, up 32.7% YoY. More specifically, RMB770.4 billion was from large commercial banks, up 75.6% YoY; RMB426.8 billion was from joint-stock commercial banks, up 50.23% YoY; RMB249.8 billion was from city commercial banks, up 61.48% YoY; RMB64.5 billion was from rural commercial banks, up 43.65% YoY. In the future, Chinese banks will keep serving the real economy, put the regulatory policy requirements into action and step up support for MSBs, private-sector economy and public wellbeing fields.

III. Supporting High-quality Economic Development via Financial Supply-side Structural Reform

At the 13th group study session of the Political Bureau of the CPC Central Committee in February 2019, Chinese President Xi Jinping underscored that China should deepen supply-side structural reform in the financial sector. The financial supply-side structural reform aims to improve the ability to serve the real economy, prevent and defuse financial risks, promote healthy development of the Chinese financial sector and sharpen its global competitive edge. In support of the financial supply-side structural reform, Chinese banks should pursue high-quality development of the real economy with focus on the following five respects:

III.1 Intensifying the ability to serve MSBs and “agro-related” fields

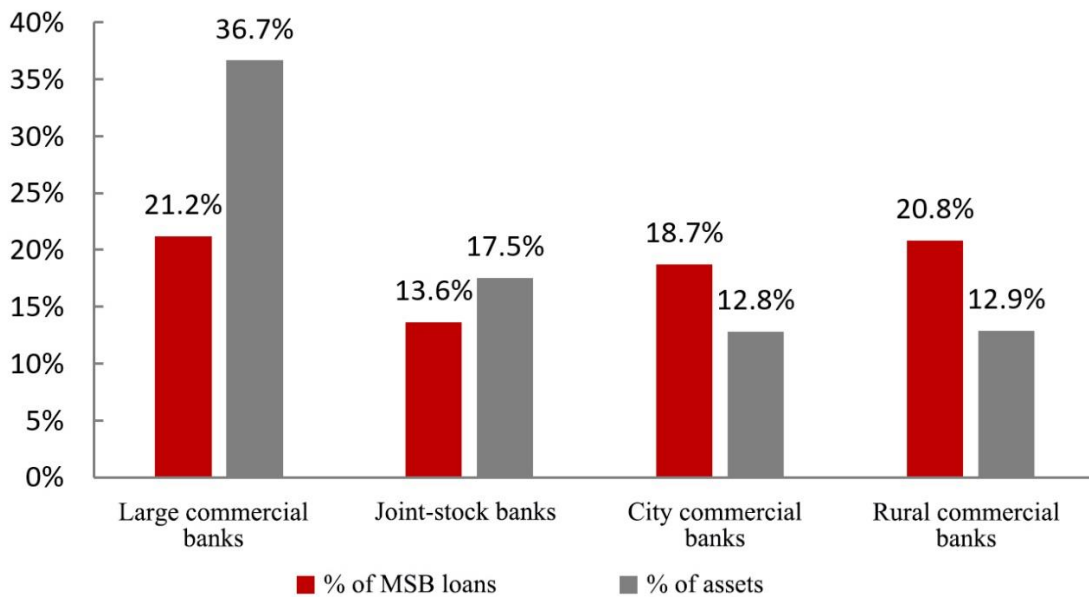
MSBs are the cornerstone of national economic and social development, playing a pivotal role in expanding employment, increasing income and improving living standards. Refining the hierarchy of financial institutions to build a multi-tier banking system that covers the broadest customer base and provides differentiated services is a crucial move to increase financial service supply to MSBs and agro-related fields in the financial supply-side structural reform.

Banks are at the core of China’s financial system. In 2018, RMB and foreign currency loans accounted for 68.7% of outstanding aggregate financing to the real economy, the combination of entrusted loans and trust loans taking up 9.8%. Currently, China has established a diverse commercial banking system composed of large commercial banks, joint-stock commercial banks, city commercial banks, rural financial institutions, foreign banks and private banks. However, certain problems still existed in the system, such as limited supply of individualized, differentiated and customized financial products and services as well as undersupply of financial services to MSBs and agro-related fields. Take MSB services for example, though large commercial banks and joint-stock commercial banks have innovated their systems and mechanisms and set up inclusive finance departments specializing in MSB loans and related financial services, the MSB loans from large commercial banks and joint-stock commercial banks accounted for merely 21.2% and 13.6% of total loans respectively, showing room for further improvement given these banks’ size of assets (Fig. 4). City commercial banks and rural commercial banks are the main force to serve MSBs. In recent years, however, these banks have showed prominent problems including deviation from principal business, cross-regional expansion, weak risk control and inadequate capacity of risk-based pricing,

weighing on their ability to serve MSBs.

It is imperative to diversify suppliers of financial services and shore up weakness areas in financial services. On the one hand, a multi-tier banking system that covers the broadest customer base and offers differentiated services will provide financial services to a wide variety of economic groups, economic tiers, industries, sectors and financial investors and consumers, especially MSBs and agro-related fields. On the other hand, increasing the quantity and business weight of small and medium-sized financial institutions to strengthen the market competition mechanism and unleash the “catfish effect” will help ease the current imbalance and inadequacy of banking development. To enhance market efficiency, promote the financial supply-side structural reform and improve the mix of small, medium-sized and large financial institutions, it is necessary to set up and develop small and medium-sized banks. China strives to increase small and medium-sized banks, steadily lift restrictions on establishing private banks and community banks and encourage the setup and development of small and medium-sized financial institutions dedicated to MSBs and agro-related customers. Banks are supported to differentiate their operations. For example, large commercial banks will focus on major state investment projects and public wellbeing projects, while small and medium-sized banks will focus on MSBs and agro-related customers with clear principal business and sound credit standing.

Fig. 4: Breakdown of Assets and MSB Loans by Category of Commercial Banks



Source: Wind, BOC Institute of International Finance

For the banking industry, the *Report on the Work of the Government* for 2019 set forth new requirements on banking services for MSBs and agro-related customers. PBOC and CBIRC also put forward specific measures to tackle MSBs’ difficulties in getting affordable financing, offering an opportunity for banks to pursue high-quality development and pursue financial supply-side structural reform.

First, banks should leverage regulatory policies encouraging credits to MSBs and agro-related customers and make good use of supporting policy measures such as reserve requirement cuts, to continuously improve the efficiency of financial resource allocations by shifting to MSBs and agro-related customers from larger customers that receive more-than-needed credit from a number of lenders.

Second, banks should remain oriented to market demand, rebuild their business philosophy and work

out the service modes, risk management mechanisms and assessment mechanisms fit for the purpose of serving MSBs and agro-related customers.

Third, banks should base on the financing demand characteristics of MSBs and agro-related customers, to explore and establish tailored financial products and services. Such as, supply chain financing.

Fourth, banks should upgrade their traditional financial products and services leveraging on cutting-edge technologies including big data, cloud computing, blockchain and artificial intelligence. They should strengthen cooperation with third-party organizations to acquire business data on MSBs and agro-related customers, diversify credit enhancement methods and innovate in credit modes.

III.2 Increasing the ability to serve private-sector economy

Private-sector economy is very important to China's economic development, but the difficulty in accessing financing remains a major hurdle to growth of private enterprises. According to non-exhaustive data, loans to private enterprises account for about 25% of banking loan balance, far below the private sector's weight (about 60%) in the national economy. On the one hand, private enterprises usually do not have a big asset base and thus can offer limited assets as collateral, making it difficult to meet the credit underwriting standards of commercial banks. In addition, there is serious information asymmetry between private enterprises and commercial banks. Some private firms have to pay guarantee and other additional charges for financing, which add to their costs of financing. On the other hand, by financing structure, short-term loans, notes financing, bond financing and non-standard financing take up a substantial proportion of total financing to private enterprises, which are vulnerable to changes in market conditions and regulatory policies. Structure and maturity mismatches of financing will easily cause cash flow disruptions, further worsening the financing conditions for private enterprises. In addition, some weak private enterprises susceptible to external and cyclical factors will, when in difficulties, find financing even less accessible. The pro-cyclical behavior of financial institutions will reduce risk appetite and make them wary of or even stop lending, which adds to private firms' difficulties in accessing financing.

Providing better support for private-sector economy is one of the top objectives of the financial supply-side structural reform. To implement the financial supply-side structural reform and support the private-sector economic development, we should get work well done in the following two respects. On the one hand, China will issue RRR cut, capital replenishment and other relevant policies in order to be strong backing for commercial banks' efforts to enhance the credit supply ability and support the development of private enterprises. On the other hand, banks will be guided to improve their credit structure by phasing down or even phasing out credit resources for overcapacity industries and zombie enterprises while giving priority to private enterprises that align with China's orientation of industry development, focus their principal business on the real economy, advanced in technology, products demand by markets, while face temporary difficulties.

Well-targeted support for private enterprises will provide a rare opportunity for high-quality development of the banking industry.

First, Chinese banks should improve credit resource allocations by increasing credit support for advanced manufacturing, strategic emerging industries and modern service sectors while phasing down or out the credit support for overcapacity industries and zombie enterprises.

Second, Chinese banks should improve their management capability, accelerate financial innovation, allocate resources in line with China's relevant industrial policies, spatial layout of key industries and local governments' development plans, and provide comprehensive, integrated financial services according to private enterprises' financing needs in different lifecycle stages.

Third, Chinese banks should explore to create a long-term mechanism for serving private enterprises and develop a “whitelist” of private enterprises according to their financing needs. In addition, Chinese banks should improve the credit granting process for private enterprises, establish sound mechanisms for exempting those that have diligently fulfilled their duties from liabilities and for tolerating and correcting mistakes, and improve the performance assessment mechanism for serving private enterprises.

III.3 Strengthening financial capability support in key areas and projects

China’s economy remains in a highly promising period with critical opportunities, having an urgent demand for financial supports in terms of industrial development, rural vitalization, regional coordination and green development. As for industrial development, it is urgent to establish global industrial chains and market system to accommodate the rapid development of high-tech industries and strategic emerging industries, and to invest resources in industrial capacity adjustments, technological transformation and product upgrades. As for rural vitalization, infrastructure development is critical to building rural areas with pleasant living environments; agricultural modernization requires more resources to build the systems of industries, production and operation; and farmers’ income and wealth cannot be increased without consumption system support. As for regional coordination, financial support is absolutely necessary for implementing key regional strategies including the Beijing-Tianjin-Hebei region, the Yangtze River Delta, the Guangdong-Hong Kong-Macao Greater Bay Area and Hainan Free Trade Zone, promoting in-depth development of the Belt and Road Initiative and stepping up efforts to build China into a strong maritime country. As for green development, there is a huge financial demand in the development of energy-saving and environmental protection industries as well as clean production and clean energy industries and in the deep-going campaigns to prevent and control air, water and soil pollution.

To better serve the financial supply-side structural reform, the banking industry should further increase the financial support scale and the precision and efficiency of financial services and enhance the financial support ability for key areas and projects. First, development-oriented finance. Given the large investment size, long payback period and complicated risk factors of infrastructure projects, banks should adhere to capital-light development and provide funding support by exploring to use medium- and long-term fund resources from domestic and overseas capital markets by means of syndication, bond underwriting or securitization. Second, high-tech finance. Banks should build a risk management framework based on the investment philosophy of venture capital, strengthen cooperation with professional venture capital organizations and technology incubation platforms and provide financing to target high-tech firms via industry funds and investment-loan linkage. Third, industrial finance. Tailored financial services should be provided for leading industries and strategic emerging industries. Banks should provide comprehensive financial services that principally include general credit, supplemented by leasing, insurance and trust, and cover the entire industrial chain and lifecycle. Fourth, green finance. Banks should raise medium- and long-term funds at home and abroad by issuing green bonds and other means, offer customers a broad range of green financial services, including green loans and green bond underwriting and investment, green industry funds and carbon finance, and provide replicable good practices for global green finance development.

III.4 Reducing the costs of serving the real economy

Against the backdrop of financial supply-side structural reform, commercial banks should provide higher-quality, more efficient services for the real economy. By cutting costs, commercial banks relieve their own burden and also reduce the cost of serving the real economy. The cost reduction effort has three dimensions: cutting the costs of risks, funding and operations.

First, proactive actions should be taken to cut the cost of risk. Since 2018, the increasingly inaccessible and unaffordable financing to businesses and the frequent bond defaults have put

commercial banks at a higher credit risk from customers. In addition, the shrinking financing channels in the context of deleveraging have led to limited funding sources for enterprises, giving commercial banks a stronger bargaining power. The concurrent rise in enterprises' credit risk and banks' bargaining power has influenced the lending rate. The weighted average lending rate of financial institutions remained above 5.9% during 2018Q1-Q3. After rounds of actions were taken to support financing for the business sector, that rate fell to 5.63% in Q4 to ease the difficulty in accessing affordable financing. Lowering the financing costs to support the development of enterprises remains a major task of commercial banks through 2019. In such a context, commercial banks should take actions in a proactive and responsible manner. On the one hand, commercial banks should reasonably control the lending rates and profit growth to avoid "fleecing the flock" of the real economy excessively. On the other hand, commercial banks should control asset risks and accelerate write-off of non-performing assets to ensure the quality of assets and release more credit resources to support small and medium-sized enterprises.

Second, a variety of tools should be used to cut the cost of funding. China's commercial bank loans are mostly priced based on deposit interest rate. The cost of liability is what banks use to determine their lending rate. Changes in a bank's costs on the liability side will transmit to the asset side and affect the lending rate. As some small and medium-sized banks suffer a medium- and long-term liquidity gap and insufficient liquidity sources, they usually acquire liquidity at high costs, pushing up lending rates. PBOC has started to converge its two-track system for interest rates in 2019. The market-based interest rate reform will speed up to intensify financial institutions' competition for liquidity. The situation will test banks' ability to get liquidity via active liabilities as the financial supervision is unlikely to relax. In such a context, commercial banks should use various tools, including interbank loans, interbank CDs, compliant structured deposits and lower-cost deposits, to replenish liquidity, stabilize core liabilities and reduce costs of funding.

Third, the cost of operations should be reduced by improving quality and efficiency. A bank passes onto customers all its internal costs, including administrative expenses, marketing costs and financial expenses. Lower cost of serving the real economy requires banks to control their internal costs and expenses. High costs of operations will weigh on the operating efficiency of commercial banks and restrict the availability of better services to customers. Therefore, commercial banks should take actions to improve quality and efficiency. On the one hand, costs can be controlled by reducing physical outlets and adding smart ones. On the other hand, commercial banks should step up integration of emerging technologies to update infrastructure, increase operating efficiency, reduce operational expenses and control operating costs.

III.5 Strengthening weaknesses in global competitiveness and service capability

China's banking industry has much room for improvements in global competitiveness and service capability, especially when it comes to internationalized and diversified operations. As for internationalization, Chinese banks are not highly internationalized overall, lagging behind global leaders in share of overseas business and physical presence. Their internationalization level cannot match the opening-up needs of China's real economy. Overseas institutions have a lower average return on assets than the group average, a drag on development. Their customer base simply concentrates on Chinese customers and corporate customers. The risk management ability has yet to be improved, as it is hardly adaptive to global economic and financial developments. In terms of diversification, China's large banks still rely heavily on conventional deposit and lending businesses and have a weak diversification capability, though they all have in place a fairly complete diversification framework. In the field of investment banking with higher value added and profitability, for example, Chinese banks show fair performance in leveraged finance only in the 2017 rankings for global large investment banks.

Global Banking Industry Outlook

The financial sector will further open up to implement the financial supply-side structural reform, giving a boost to “brining in” foreign financial institutions and the “going global” of Chinese financial institutions. China will pursue healthy development of the direct financing market, further increase the breadth, depth and resilience of capital markets and shape a comprehensive, multi-tier financial system to support the real economy in a well-targeted manner. To better serve the financial supply-side structural reform, the banking industry should further improve the internationalized and diversified operations and strengthen weaknesses in global competitiveness and service capability.

In international operations, Chinese banks have different focuses in terms of geography, product and service, therefore they can pursue differentiated development in an orderly, hierarchical and coordinated manner. It is made clear that internationalization aims ultimately to serve China’s real economy. The number of covered regions and business contribution of international operations should be based on China’s demand and pace of opening up the real economy. Chinese banks should improve their global business layout by focusing on developed countries and emerging markets friendly to China and selectively tapping into the Belt and Road regions, develop the group-wide criteria for decision making on investment and capital allocations and increase the output/input ratio of overseas institutions. Chinese banks should also strengthen comprehensive risk management, attaching great importance to overseas compliance management.

In terms of diversified operations, Chinese banks should remain oriented to customer demand and selectively pursue development of key businesses taking into full account their own characteristics, rather than pursuing a “large and all-inclusive” pattern blindly. Chinese banks should fully unleash their strengths in specialized areas and improve the business model guided by an appropriate volume of loan resources and centered on integrated financial arrangements, so as to expand the space for business in a capital-light fashion. Chinese banks should value the development of asset-light businesses, such as investment banking, cash management, asset management and transaction banking, in an effort to reduce capital occupation and risk exposure.