

# Chinese Banks' Financial Performance Points To A "Matthew Effect" In The Making

April 18, 2018

*(Editor's Note: see the end of this report for the full names of banks discussed in this report, and the acronyms used in the charts.)*

A tougher regulatory regime has put Chinese financial institutions to the test. China's megabanks have so far passed with high marks, aided by buoyant economic conditions in 2017. However, S&P Global Ratings believes that many smaller banks are having a harder time adjusting to reforms aimed at repairing bank balance sheets.

In our view, we are increasingly seeing a "Matthew Effect" among Chinese financial institutions--one where the strong banks get stronger, and the weak weaker. This may push some banks to fundamentally transform their business models.

## Key Takeaways

- China's megabanks showed resilience in 2017 despite a regulatory crackdown on shadow-banking activities.
- Divergent results for other banks indicate deepening credit polarization
- All banks face increasing capital constraints, but the megabanks have more options to shore up capital.

While China's megabanks have always enjoyed a stronger funding base, in 2017 that advantage deepened. Net interest margins (NIMs) improved and pressure on credit costs eased for those banks. The larger institutions are better positioned to adjust to regulatory curbs on shadow banking and excessive interbank borrowing.

However, an analysis of 2017 results show that NIMs and capital buffers are thinning for many small and mid-sized banks. Tightened interbank liquidity and intensified supervision pose greater challenges for them. These smaller institutions are also often more exposed to downside credit risks in certain economic sectors or regions, due to their limited business diversity and geographical reach.

### PRIMARY CREDIT ANALYST

**Liang Yu, PhD**  
Hong Kong  
(852) 2533-3541  
liang.yu  
@spglobal.com

### SECONDARY CONTACTS

**Qiang Liao, PhD**  
Beijing  
(86) 10-6569-2915  
qiang.liao  
@spglobal.com

**Ryan Tsang, CFA**  
Hong Kong  
(852) 2533-3532  
ryan.tsang  
@spglobal.com

### RESEARCH ASSISTANTS

**Wenyi He**  
Hong Kong  
**Jiewei Xu**  
Beijing

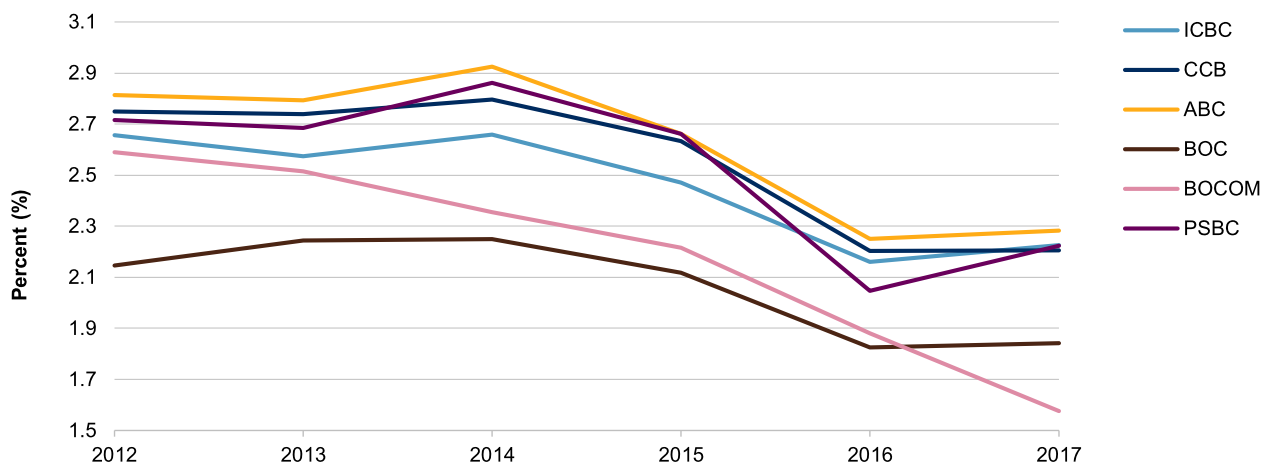
## Megabanks Show Their Mettle

For the megabanks, prospects are looking up for the two recent constraining factors on the profitability--NIMs and credit costs. Average net profit for China's six largest banks increased by 4% in 2017. In the previous two years, their profit growth was almost flat.

Interest spreads turned around for most, though not all of financial majors (see chart 1). The recovery in NIMs reflect the positive repricing cycle following policy rate hikes since August 2016. As net lenders in the interbank market, the mega banks benefit from large increases in interbank rates. They also shifted their business mix away from the thinner-margin interbank business. The People's Bank of China has pushed up interbank rates since late 2016 to discourage shadow banking activities, including leveraged investments.

Chart 1

### Net Interest Margins For Mega Banks Have Generally Improved

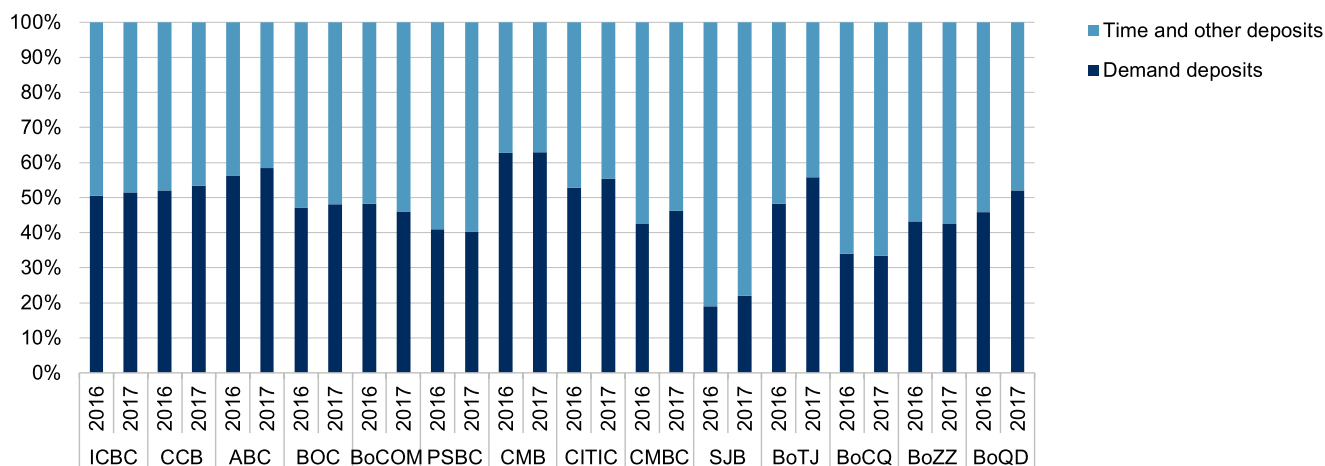


Source: Banks' annual reports. For acronyms, see list of full bank names at end of this report.  
Copyright © 2018 by Standard & Poor's Financial Services LLC. All rights reserved.

We expect most mega banks to be beneficiaries of an overall tighter market liquidity given their higher ratio of low-cost demand deposits and their windfall from lending to liquidity-thirsty banks in the interbank market (see chart 2). In terms of the loan mix, megabanks have a relatively stronger bargaining power to secure higher-yield long-term loans and cherry pick those with better quality. Anticipating a rising interest rate environment, borrowers have been trying to lock in longer-term obligations (see chart 3).

Chart 2

### Demand Deposits Are Rising As A Percentage Of The Total



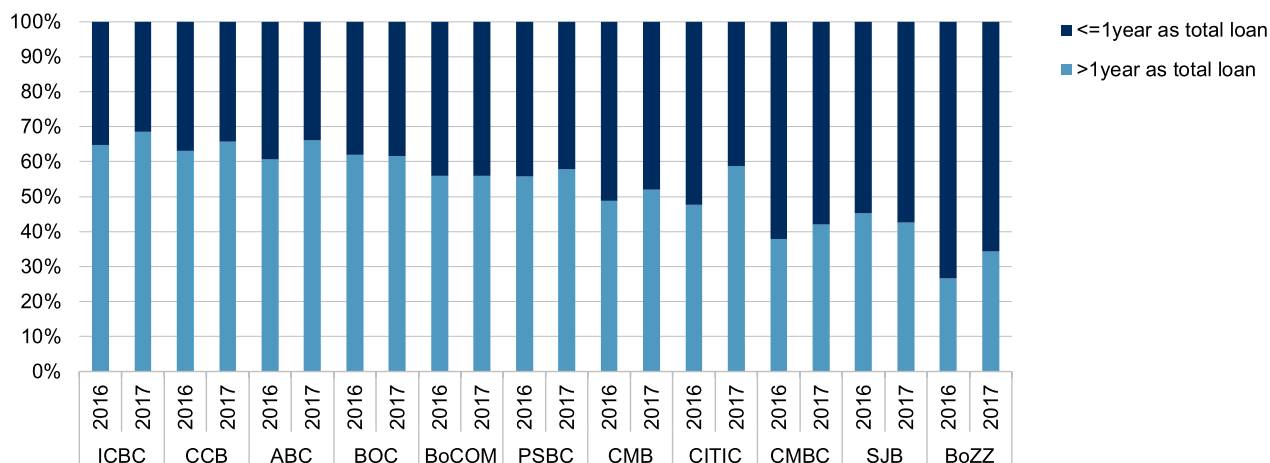
Source: Banks' annual reports. For acronyms, see list of full bank names at end of this report.

Copyright © 2018 by Standard & Poor's Financial Services LLC. All rights reserved.

Chart 3

### Banks Are Increasing Longer Term Loans In Their Loan Mix

Mid- to long-term loan as a percentage of total loans



Source: Banks' annual reports. For acronyms, see list of full bank names at end of this report.

Copyright © 2018 by Standard & Poor's Financial Services LLC. All rights reserved.

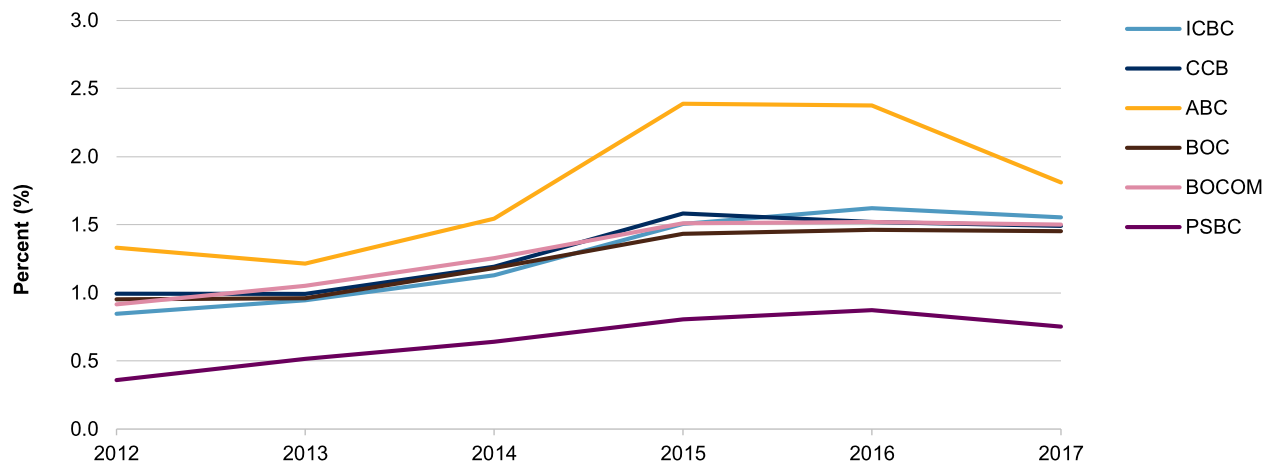
BoCom is an outlier among peers. Its NIM stayed on a narrowing trend in 2017, contracting by 31 basis points (bps). BoCom is more heavily reliant on the interbank market as a funding source due to its weaker deposit franchise. Its cost of funding increased by 22bps over the year.

## Chinese Banks' Financial Performance Points To A "Matthew Effect" In The Making

The positive trend in asset quality became more prominent in 2017 for mega banks, thanks to a positive corporate earning cycle and improved solvency. The ratio of nonperforming loans (NPL) to outstanding loans improved for all the mega banks (see chart 4); and for ABC, absolute NPLs also declined.

Chart 4

### Reported NPL Ratios For The Megabanks Have Generally Stabilized



Source: Banks' annual reports. For acronyms, see list of full bank names at end of this report.

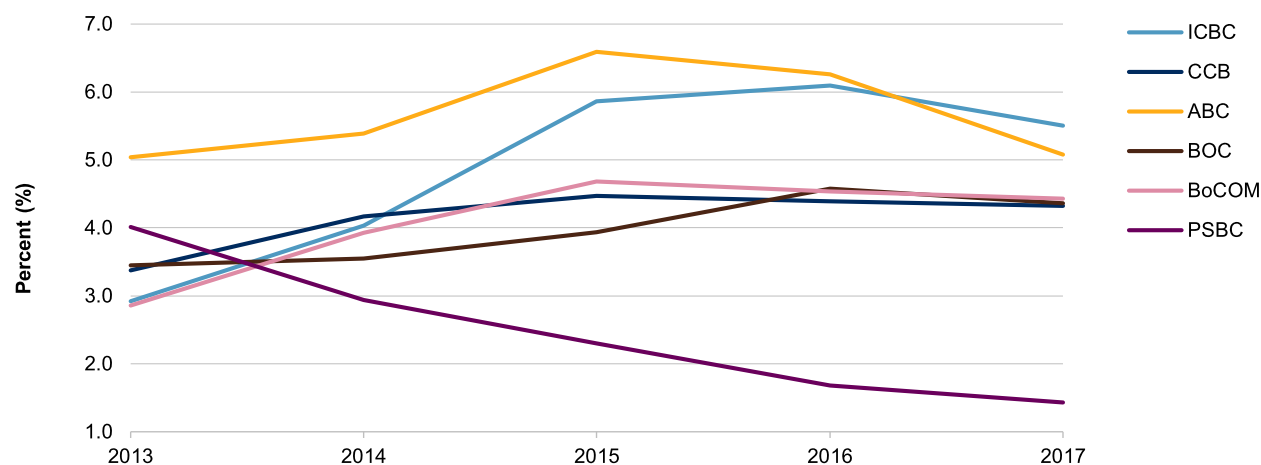
Copyright © 2018 by Standard & Poor's Financial Services LLC. All rights reserved.

We generally view the combined NPL and special-mention loan (SML) ratio as providing a better picture of bank credit quality. We estimate a nonperforming assets (NPA) ratio by combining NPLs plus unimpaired over 90-day delinquent loans. Both of these ratios improved to various extents for all the megabanks in 2017 (see charts 5- 6).

Chart 5

### The Combined NPL And SML Ratio Is Stabilizing For The Megabanks

NPLs + SMLs\* as a percentage of total loans

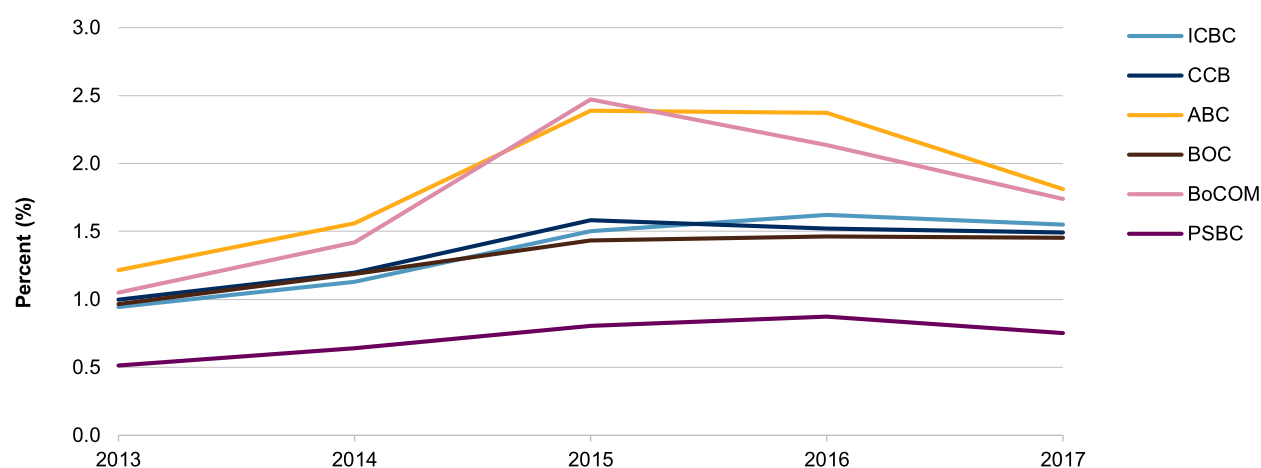


NPL--Nonperforming loans. SML--Special mention loans. For acronyms, see list of full bank names at end of this report. Source: Banks' annual reports.

Chart 6

### This Indicative Ratio Is Also Stabilizing For The Megabanks

NPLs + loans over 90 days overdue unimpaired as a percentage of total loans



NPLs--Nonperforming loans. For acronyms, see list of full bank names at end of this report. Source: Banks' annual reports.

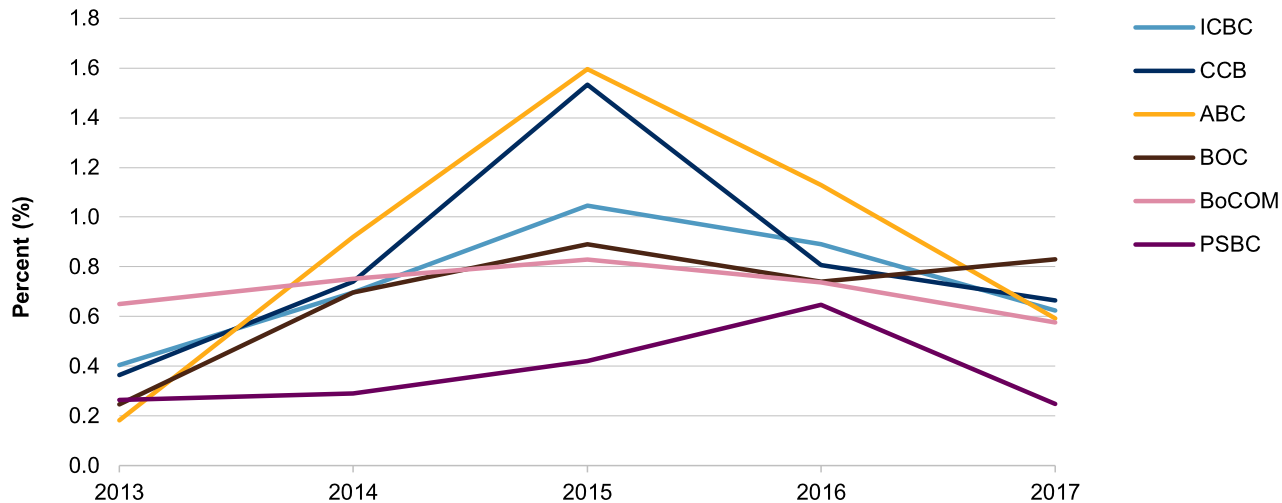
Copyright © 2018 by Standard & Poor's Financial Services LLC. All rights reserved.

## Chinese Banks' Financial Performance Points To A "Matthew Effect" In The Making

New NPL formation rates also eased last year, with the exception of BOC (see chart 7). We believe this reflects BOC's more conservative NPL recognition rather than an underlying deterioration in the bank's loan quality. BOC enhanced its charge-offs policy in 2017 and reduced credits to higher-risk private-sector firms. Most of its new NPL formation comprised private-sector companies.

Chart 7

### New NPL Formation Rates Generally Slowed For The Megabanks



NPL--Nonperforming loan. For acronyms, see list of full bank names at end of this report. Source: Banks' annual reports.

Note: NPL formation is calculated as (end of period NPL - Beginning of period NPL + write off and disposals during the period) / Beginning of period gross loans.

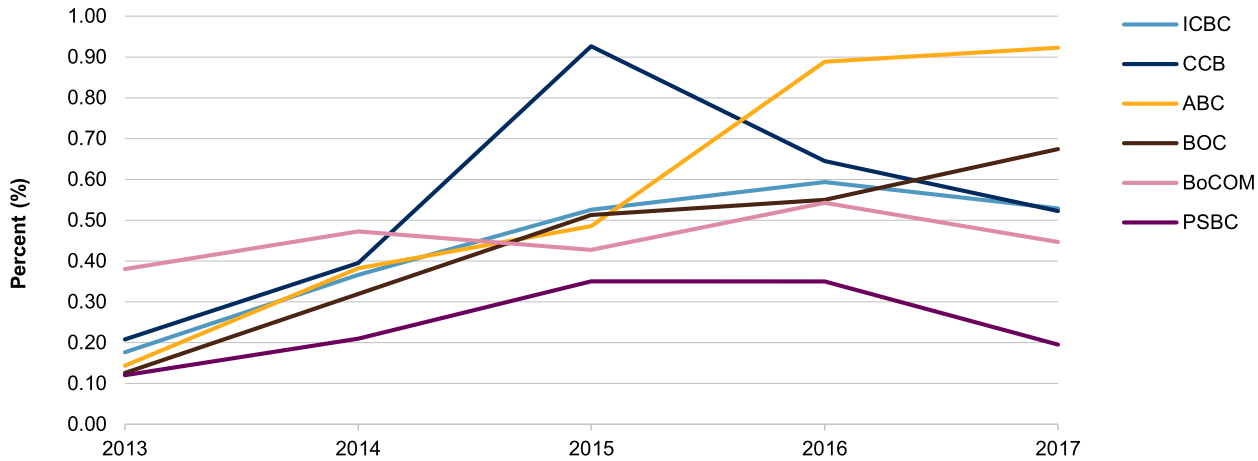
Improving asset-quality metrics partly reflect recent efforts to resolve distressed loans in the banking sector. Authorities have launched new programs to encourage banks to repair their balance sheets. This includes the licensing of provincial-level asset management companies (AMCs) in addition to the four large AMCs to quickly dispose of problematic loans. Pilot programs now also allow banks to securitize NPLs.

Many banks have increased their NPL write-offs and disposals over the past two years as part of the balance-sheet cleanup effort (see chart 8). The improved asset quality helped to lift the buffer on the NPL provision coverage ratio and maintain relatively stable credit costs (see chart 13).

Chart 8

### Writeoff And Disposal Ratio Indicates Enhanced Charge-Off Efforts

Writeoffs and disposals as a percentage of average loans



For the acronyms, see list of full names at the end of this report. Source: Banks' annual reports.  
Copyright © 2018 by Standard & Poor's Financial Services LLC. All rights reserved.

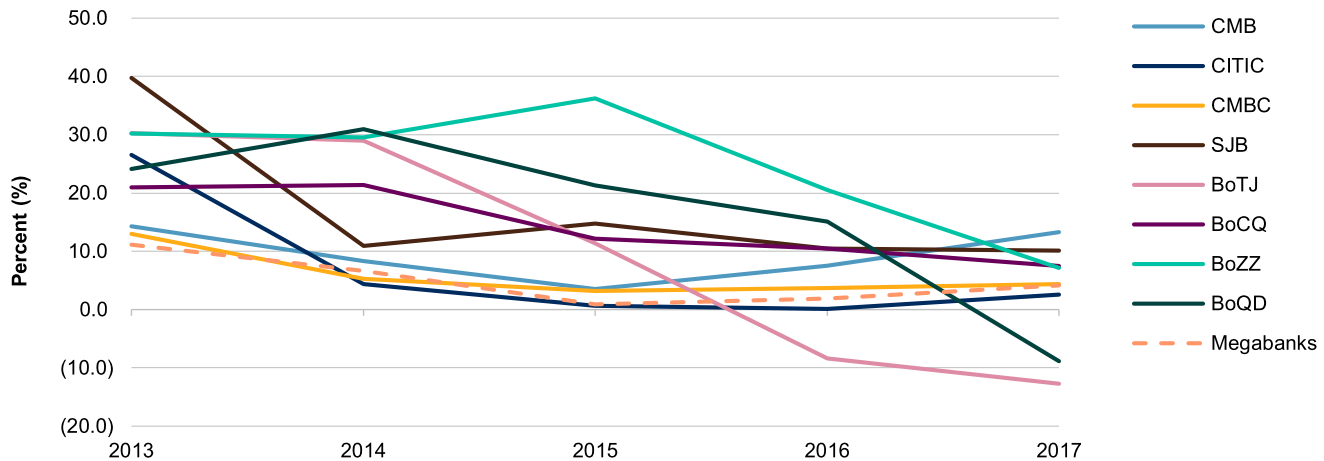
## Credit Polarization Is Deepening

Positive trends on asset quality and financial metrics will continue to elude some midsized banks, in our view. We note mixed performance results and a deepened polarization in credit conditions among national and regional banks in 2017. Whereas CMB achieved double-digit profit growth and most national banks moved in line with mega banks, profits swung sharply negative for several small banks last year (see chart 9). Some regional banks face higher pressure on funding costs and asset quality due to their greater reliance on wholesale funding and the local economic conditions.

Chart 9

### Divergent Trends On Net Profit Growth

Net profit, year-on-year growth



For the acronyms, see list of full names at the end of this report. Source: Banks' annual reports.

Copyright © 2018 by Standard & Poor's Financial Services LLC. All rights reserved.

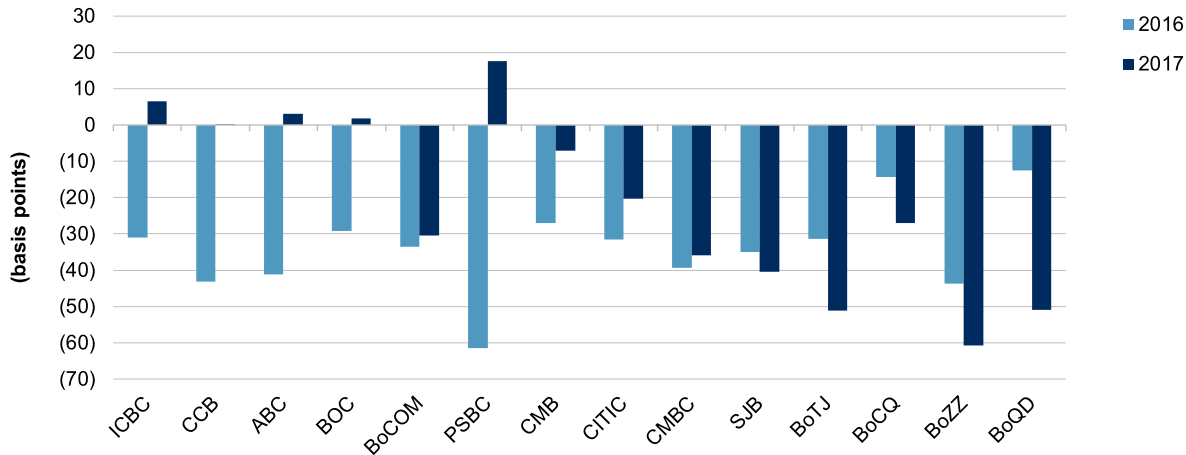
While we expect sector-wide NIMs to expand in 2018, we anticipate that NIMs will continue to contract for the smaller banks. In 2017, NIMs fell a sizable 20-60 basis points (bps) for the regional or national banks we examined. Bank of Tianjin (BOTJ), Bank of Qingdao (BOQD), and Bank of Zhengzhou (BOZZ) recorded contractions of more than 50 bps. Only CMB escaped with a slight NIM contraction of 7bps (see chart 10).



Chart 10

### Divergent Trends On NIMs For Most Megabanks Versus Others

NIM year-on-year change, basis points



NIM—Net interest margin. For acronyms, please see full bank names at the end of this report. Source: Banks' annual reports.

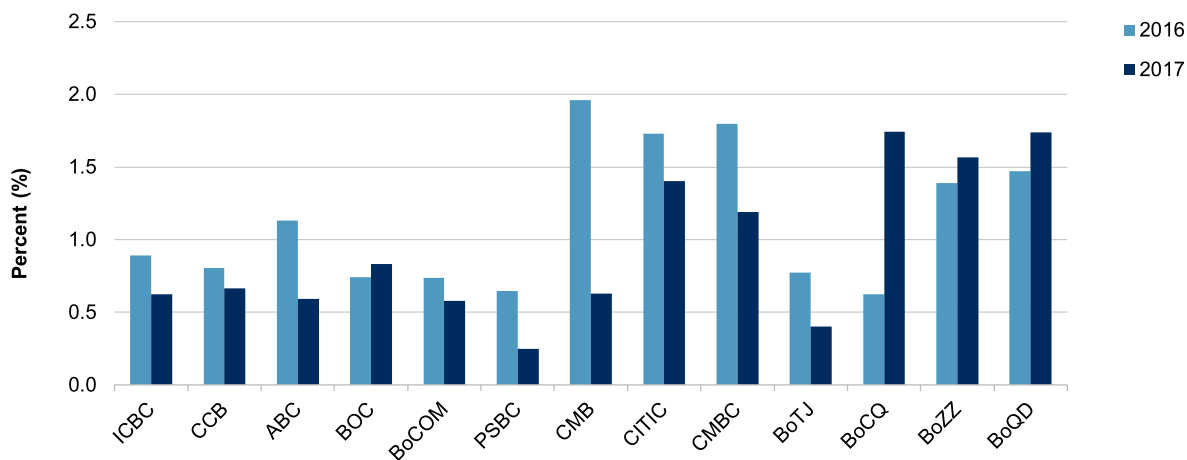
In our view, competition for low-cost deposits could be even more severe in 2018 amid ongoing interest-rate liberalization in China and the rise of "fintech." Banks can better address the challenges if they have the resources to invest in advanced technology to acquire clients, or if they enjoy "sticky deposits," for example due to captured geographical markets. But some smaller banks have to continue relying on the issuance of negotiable certificates of deposit (NCD) for short-term liquidity, straining spreads and profitability in turn.

In addition, regional banks have narrower revenue bases, relying primarily on interest income from lending. Fee income generally represents less than 10% of their revenue mix.

Despite supportive macroeconomic conditions in 2017, the mid-sized banks reported varied loan quality performance. Asset quality has generally stabilized for rated national banks. CMB reduced outstanding NPLs as well as its NPL ratio. But gross NPL formation remained high for CMBC and CITIC Bank, though pressure eased somewhat from a year earlier (see chart 11)

Chart 11

NPL Formation Rates Generally Eased For The Megabanks But Not The Others

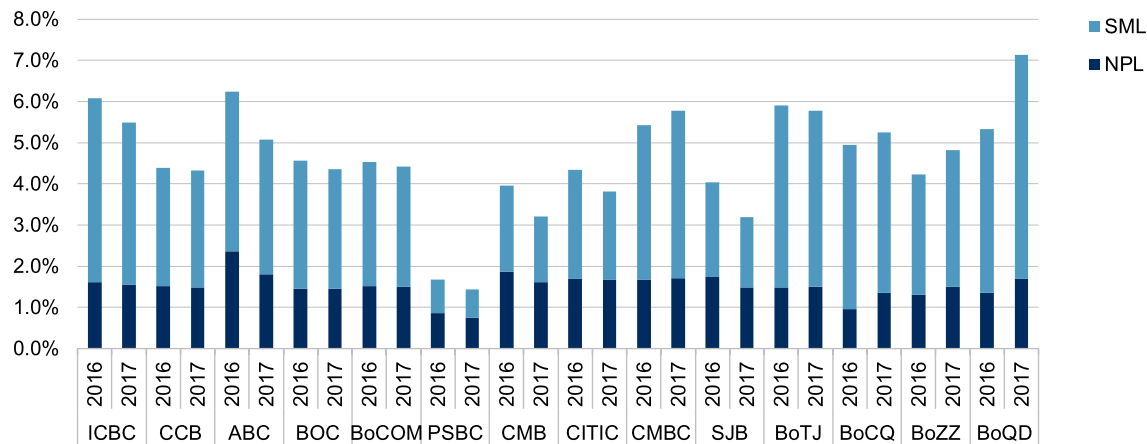


NPL--Nonperforming loan. For acronyms, please see full bank names at the end of this report. Source: Banks' annual reports.

Outstanding NPLs and reported NPL ratios markedly increased for some regional banks, including regional banks in Chongqing, Qingdao, and Tianjin. Other asset quality metrics are also diverging compared with the majors (see chart 12). The gross NPL formation rate is increasing at BOCQ, BOZZ, and BOQD because China's mid-west and northeast regions are increasingly exposed to credit stress (see chart 11).

Chart 12

**NPLs And SMLs Generally Decreased For Mega Banks But Increased For Other Banks**  
NPLs + SMLs as a percentage of total loans



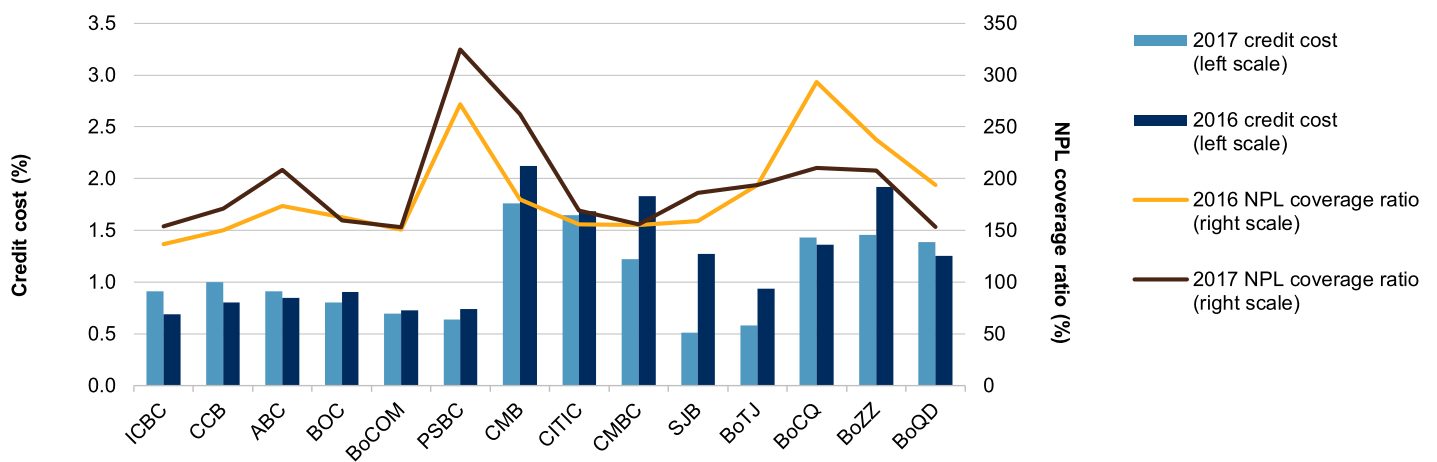
NPLs--Nonperforming loans. SMLs--Special mention loans. For acronyms, please see full bank names at the end of this report. Source: Banks' annual reports.

Copyright © 2018 by Standard & Poor's Financial Services LLC. All rights reserved.

Smaller banks diverged with their bigger peers on NPL recognition and provision. Whereas megabanks enhanced provisional coverage in 2017, many smaller banks reported decreasing credit costs at the expense of running down their NPL coverage ratio (see chart 13) However ,this practice may weaken buffers to absorb future loan losses and lead to greater volatility in profits.

Chart 13

Many Smaller Banks Lowered Credit Costs By Running Down NPL Coverage



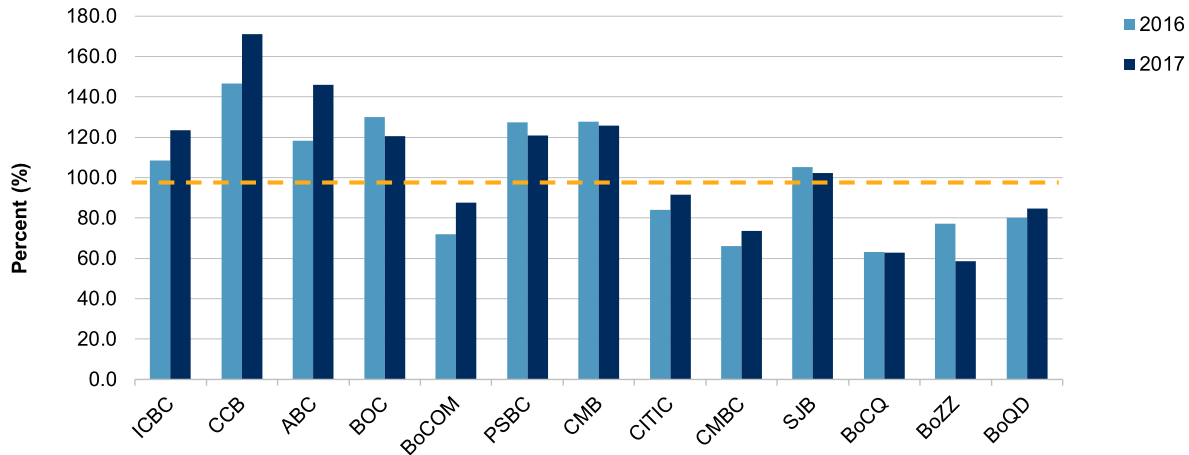
NPL--Nonperforming loan. For acronyms, please see full bank names at the end of this report. Source: Banks' annual reports.

Furthermore, we see signs that smaller banks are less stringent with their loan classification. One indicative ratio is NPLs divided by loans overdue by more than 90 days. While this ratio has been increasing in 2017, for many small to midsize banks this ratio is still at quite a lower end (see chart 14) .Because of their more prudent provision recognition policies, we believe the big banks are better prepared to adopt International Financial Reporting Standard 9.

Chart 14

### This Ratio Is Higher For Megabanks, Indicating More Conservative NPL Classification

NPLs as a percentage of total loans overdue more than 90 days



NPLs—Nonperforming loans. Source: Banks' annual reports.

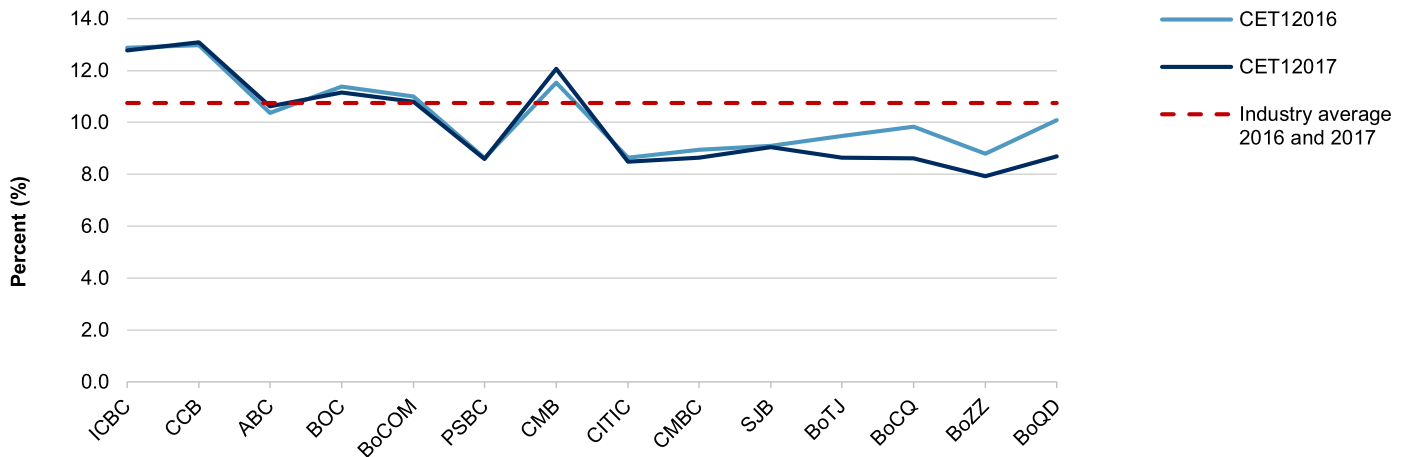
Copyright © 2018 by Standard & Poor's Financial Services LLC. All rights reserved.

### Capital Is Getting Constrained: But More Options For The Megabanks

We expect many Chinese banks will face capitalization pressures in the next few years under enhanced regulatory capture and tighter regulatory discipline. New rules have already forced banks to start reclassifying shadow credits as on-balance-sheet loans, a process that is chipping away at their capital bases even as regulatory capital requirements continue to phase-in, in line with global norms. In 2017, the common equity tier 1 (CET1) ratio declined by various degrees for more than half of the listed Chinese banks we examined (see chart 15).

Chart 15

### CET1 Capital Ratio Is Under Constraint For Some Small Banks



CET1—Common equity tier-1 capital. For acronyms, please see full bank names at the end of this report.

Source: Banks' annual reports.

In our opinion, small and midsize banks are more likely to face regulatory capital strain as additional initiatives on shadow banking are rolled out. Many of them have relatively low CET1 standing as of end 2017 compared with big peers; they also tend to be more exposed to shadow-banking related off-balance sheet activities, and subject to further credit cost and funding cost challenges.

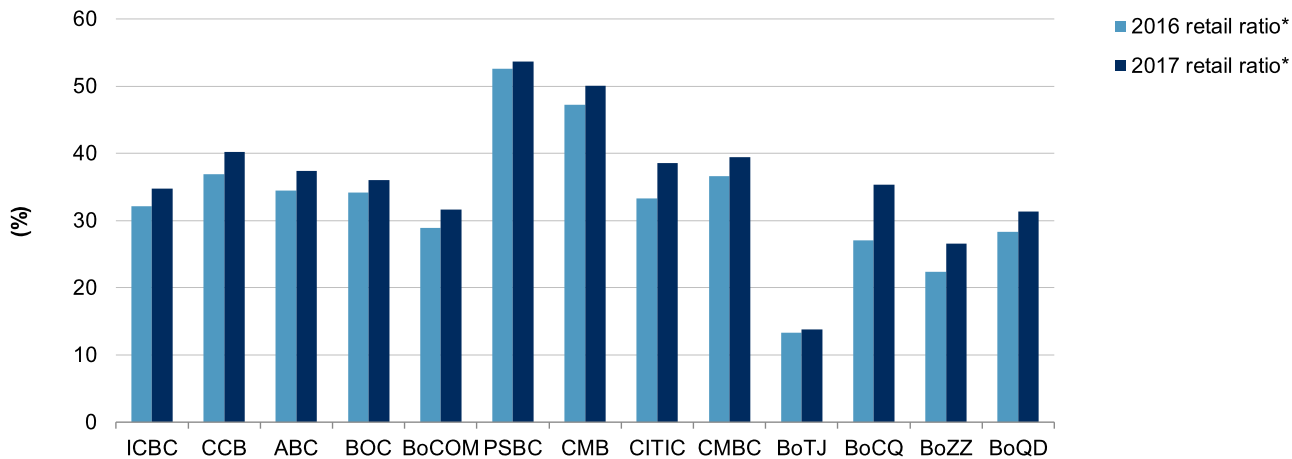
We expect the phase-in period of regulatory capital requirements will end by 2018 and banks are required to meet the minimum standards. (For non-systemically important financial institutions (SIFI) banks: CET1, T1 and CAR of 7.5%, 8.5% and 10.5%; for the SIFI banks including the big five these ratios need to be at least 8.5%, 9.5% and 11.5% respectively). Most banks will choose to keep buffers of around 50-100bps on top of the regulatory minimum requirement. We expect that under the regulatory capital strain, banks would raise capital, scale down risk weighted assets or cut dividend payments to reserve earnings.

Mega banks are likely to rely on internal capital generation to sustain their CET1 ratios in the coming year while speeding up the issuance of hybrid capital instruments to prepare for meeting new requirements on total loss-absorbing capacity (TLAC). Cost cutting will also be on their agenda. That said, cost to income ratios are unlikely to come down in the short run because banks need to make investment in areas such as technology to for long-term efficiency.

We expect small and midsize banks to curb their overall credit growth though loan growth will remain relatively strong. In 2017, joint-stock banks in particular have seen a considerable slowdown in total assets growth to 3.4% from 17.5% in 2016, and loan growth to 15% in 2017 from 18% in 2016. Most banks have turned to capital-light assets and we have seen a general change in the asset mix towards more retail loans in 2017 (see chart 16). Some of these banks may also be forced to cut dividends.

Chart 16

### Banks Are Increasing Retail Loans In Their Loan Mix



\*Retail loans to total loans. For acronyms, please see full bank names at the end of this report. Source: Banks' annual reports.

Copyright © 2018 by Standard & Poor's Financial Services LLC. All rights reserved.

We anticipate strong capital-raising activities in the coming years. Many local banks are making preparations for potential IPOs to widen channels to replenish capital. Issuance of convertible bonds will likely to be a popular option for listed banks.

Major Chinese banks will likely continue to issue Basel III qualified hybrids this year. In 2017, Chinese banks issued nearly RMB500 billion in tier-2 instruments, a record high. A number of regional banks including Bank of Qingdao, Bank of Chongqing, and Bank of Zhengzhou, have issued preference shares either on-shore or off-shore since 2017, in addition to larger-scale issuance by CMB, CCB, and PSBC. Regulators will likely speed up the development of new capital replenishing instruments and be supportive in this respect. In 2018, policymakers issued guidance to support the potential use of perpetual notes, convertible tier-2 bonds, and other innovative loss-absorbing debt instruments.

We note that the Matthew Effect applies to capital-raising exercises. While the stronger banks will have an easier time shoring up capital, many smaller players have relatively limited channels to do so. From a rating perspective, we expect risk-adjusted capital (RAC) ratios will continue to indicate moderate or weak capitalization for most rated Chinese banks. A few megabanks have adequate capital bases, levels which we also anticipate will be maintained.

### Bank Acronyms Used In This Report

In line with our top 50 study, megabanks consist of the 'big five' commercial banks---ICBC, CCB, ABC, BOC, BoCom- --plus PSBC. The short names in this report and its charts refer to the following institutions: ICBC-- Industrial and Commercial Bank of China Ltd. (A/Stable/A-1), CCB---China Construction Bank Corp.(A/Stable/A-1), ABC--Agricultural Bank of China Ltd. (A/Stable/A-1), BOC--Bank of China Ltd. (A/Stable/A-1), BOCOM--Bank of Communications Co. Ltd. (A-/Stable/A-2), PSBC---Postal Savings Bank of China Co. Ltd. (A/Stable/A-1), CMB--China

## Chinese Banks' Financial Performance Points To A "Matthew Effect" In The Making

Merchants Bank Co. Ltd. (BBB+/Stable/A-2), CITIC--China CITIC Bank Co. Ltd. (BBB+/Stable/A-2), CMBC-- China Minsheng Banking Corp. Ltd. (BBB-/Stable/A-3), SPDB--Shanghai Pudong Development Bank Co. Ltd. (BBB/Stable/A-2), BOCQ---Bank of Chongqing Co. Ltd. (BBB-/Stable/A-3), SJB--Shengjing Bank Co. Ltd., BOTJ--Bank of Tianjin Co. Ltd., BOZZ--Bank of Zhengzhou Co. Ltd., BOQD--Bank of Qingdao Co. Ltd.

Only a rating committee may determine a rating action and this report does not constitute a rating action.



Copyright © 2018 by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw or suspend such acknowledgment at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, [www.standardandpoors.com](http://www.standardandpoors.com) (free of charge), and [www.ratingsdirect.com](http://www.ratingsdirect.com) and [www.globalcreditportal.com](http://www.globalcreditportal.com) (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at [www.standardandpoors.com/usratingsfees](http://www.standardandpoors.com/usratingsfees).

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.