This book provides an overview of China’s financial markets and their latest developments. The book explores and discusses the difficulties in building modern financial markets that are compatible with an increasingly complicated market economy and examines the various strategies to reform China’s financial system. It covers a range of topics: China’s financial structure, financial regulation, financial repression and liberalization, monetary policy and the People’s Bank of China, banking reforms, exchange rate policy, capital control and capital-account liberalization and development of the stock markets.

The book provides a basic understanding of the current issues related to the development of China’s financial markets. It enhances knowledge of China’s regulatory framework which has helped to shape China’s financial landscape. It provides specific, useful knowledge about investment in China, such as market sense, to identify the investment opportunities in various asset classes.

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Routledge Advances in Risk Management
Edited by Kin Keung Lai and Shouyang Wang

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China’s Financial Markets
Issues and opportunities

Ming Wang, Jerome Yen
and Kin Keung Lai
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*Preface*  

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Preface

Since it embraced economic reforms and the free-market principle, China’s economic boom has spawned burgeoning financial markets and driven them up into unprecedented levels. China’s government has succeeded in creating a financial sector that has served as an engine for this massive economic growth in spite of global problems elsewhere in the world. But alone with the consumption of reforms bonuses, new challenges emerge in China’s financial markets.

This book will deep-dive into the study of the different factors or issues that will make or break the future of China’s financial markets, and will take a close look at the various measures that the government could take to prevent heavy headwind from threatening the health of the financial markets, and by channel effect, the overall Chinese economy. Besides, opportunities should be explored in some sectors.

This book is intended as a manual for investors, researchers and professionals. Recent practices were collected in major financial markets in China. Analyses of hot topics were emphasized in some markets. Some chapters present a brief description of the developing history of the market during the past 30 years.

As China and Chinese markets are still undergoing reformation, some of the discussion in this book will become obsolete soon. Most of our data is updated to annual data for 2012, some earlier. After publication we will continue revising data used in this book. Important reforms and regulatory changes will also be followed closely. We hope to revise the data and publish new editions every two years.

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1 Development of China’s banking industry and new direction

China’s banking industry has experienced rapid growth in recent years in terms of both profitability and outstanding credit. Despite the sluggish global economy and declining growth of China’s own economy due to reduction in external trade volume, the banking industry has reported great performance in its financial statements. It is intriguing that the performance of banks was largely contrary to the macro-environment, when it is viewed as the primary vehicle of the local economy.

The two main reasons for the rapid growth are the comparable fast growth of the Chinese economy and the high net interest margin earned by China’s banks. Although the growth of China started weakening, infrastructure development was still growing at a higher pace compared to US and Europe, resulting in continued and large expansion of credit. Besides, interest rates payables to customer deposits and loan advances have been largely controlled by the People’s Bank of China. The net interest margin between loan and deposit was established at about 3.00 percent, which is comparatively higher than other countries. Since over 70 percent of net operating income is generated from interest income, it is unsurprising that China’s banks could keep earning high profits in these few years.

However, China’s banks do face several challenges over the next few years, which may hinder their growth. First, the release of Basel III would increase the capital and liquidity requirements of banks, limiting the expansion of high yield loans and encouraging low yield bond portfolios. Moreover, the People’s Bank of China has cut the interest rate for loans and deposits twice and widened the floating zone, which further affirms liberalization of interest rates. The liberalization surely threatens the subsistence of high interest income. In addition, economic turmoil also poses the threat of deterioration of asset quality of the banks. The recent increase of non-performing loans (NPL) coverage ratio of banks indicated this phenomenon; it is discussed below.

1.1. History of the Chinese banking sector and foreign involvement

The Chinese banking and financial sector started to develop more than 3,000 years ago, in the West Zhou period (from 1100 to 771 BC) when money and credit started playing a role in China’s economy. It gained importance during the Qin period
(221–206 BC), when small-scale deposit taking and credit extension became frequent. After paper money was introduced during the Song Dynasty (AD 960–1279), until the Ming Dynasty (AD 1380–1600) small family or community-owned money shops were founded, which steadily expanded the business. This included deposit taking, lending, trade finance, money exchange and remittances. These small “quasi-banks” became the dominant financial institutions during the Opium War. After the Opium War, several Western banks entered the Chinese market quite successfully. The Qing government in the early 1900s set up a quasi-central bank, which was later named Bank of China. During these years, few regulations existed and many private banks were established. When the Nationalist government took over, tighter restrictions were imposed. By 1936, the big four government controlled banks (Central Bank of China, Bank of China, Bank of Communications and Farmers Bank) accounted for 56 percent of the total deposits in the Chinese banking system and their share rose to 80 percent during the Second World War and it went further up to 96.5 percent in the post-war period (Hu 2006). These figures show that China’s banking industry had moved from free and open competition to heavy government involvement that resulted in a few dominant players.

During the next era, starting in 1949, private banking came to a full stop in China. Shutting down the Bank of Communications and limiting the Bank of China to a few foreign exchange transactions, the central government established the People’s Bank of China (PBoC) as basically the country’s “one and only” bank. It took care of all the important central and commercial banking processes simultaneously, from issuing notes and coins to collecting household deposits and setting the interest rates. At the end of the central-planning era in 1979, China’s banking industry was primitive and fairly uninteresting.

The year 1980 marked the beginning of reforms in China, which also impacted the banking industry. The first step of the government in reforming the system was to break up the mono-bank dominance. The government set up two specialized banks: China Construction Bank (CCB) and China Agriculture Bank (ABC). Furthermore, PBoC functioned as the country’s new central bank, while the commercial banking operations were spun off, resulting in the foundation of the Industrial and Commercial Bank of China (ICBC) in 1984. The second step of the government was to relax barriers of entry and thus foster competition. This led to the creation of the Bank of Communications and several banks with smaller equity bases in the late 1980s as well as a rapid expansion of rural credit cooperatives in the early 1990s. Another important change in the banking policy took place in 1993, when specialized banks were freed from the burden of policy lending, which was transferred to the newly set-up China Development Bank, China Export-Import Bank and China Agricultural Development Bank.

Involvement of foreign financial institutions in China started slowly after 1979. Operational foreign banks were allowed in the Special Economic Zones, leading to the first license in Shenzhen in 1981. Several other coastal and eastern Chinese cities followed in the early 1990s, Shanghai being the first to let in foreign financial institutions. In 1996, the PBoC allowed foreign banks meeting
certain requirements to conduct business in RMB in Pudong and Shanghai under a pilot project.

The government also passed the Commercial Banking Law in 1995 which recognized banks as profit-seeking institutions and paved the way for market-oriented operations in the banking industry. It furthermore established supervision departments at the PBoC to oversee all banks and set up stock and government bond markets. The 1997 Asian crisis impacted China too, though not as hard as other countries. After the collapse of the Hainan Development Bank, fears of a financial crisis rose and the government decided to abolish the “National Credit Plan” giving banks greater autonomy in an attempt to improve their loan portfolio. Subsequently, the big banks adopted a cautious attitude and smaller banks increased their market shares by taking higher risks. In order to improve risk management in banks, the newly set-up China Banking Regulatory Commission (CBRC) imposed rules on capital adequacy, loan classification and corporate governance, which successfully improved banking supervision in China. The big banks were able to get their non-performing-loan-problem under control to some extent through injection of additional capital by the government in 2003, which further stabilized the Chinese financial sector.

Additionally, the Chinese government took a step towards reforming the banking sector by opening it up to foreign strategic investment, hoping to attract the much-needed banking experience as well as capital. However, ownership of any single foreign investor is still limited to 20 percent and all foreign investors together can hold a maximum of 25 percent equity in a bank. Despite these limitations, banks have attracted significant amounts of foreign investment.

The latest wave of opening up started in June 2005 with the successful IPO of Bank of Communications, which attracted USD 2.2 billion in overseas offerings. In October 2005, China Construction Bank followed, marking the world’s largest IPO since 2001 with USD 9.2 billion. Bank of China and ICBC then followed in 2006. Bank of China broke yet another record, making the largest IPO in the world since 2000, and the fourth largest IPO in the world ever, raising USD 9.7 billion. This record, however, did not last for long. In October 2006, ICBC marked the world’s largest IPO to date, raising a total of USD 21.9 billion in Hong Kong and Shanghai simultaneously (Bremner 2006; Chandler 2006).

1.2. The Chinese banking sector: players and structure

The development of the Chinese banking sector led to the emergence of four large, state-owned players that dominate the industry today: Bank of China, China Construction Bank, Agricultural Bank of China and Industrial and Commercial Bank of China, called the “Big Four”. In addition to that, there are three major policy banks, carrying out the government’s policy financing: Agricultural Development Bank of China, Export-Import Bank of China and China Development Bank. Besides these large players, there are 12 joint-stock commercial banks (JSCBs), about 120 domestic commercial banks and around 36,000 credit cooperatives, as well as many non-banking financial institutions.
To date, foreign banks still do not play a major role in the Chinese banking industry, however, it is expected that the opening of China’s banking sector will very likely increase their share in the years to come.

We will therefore analyze the domestic players in the Chinese market, before shedding light on foreign involvement in the Chinese banking sector. We conclude with highlighting the opportunities and challenges for FDI in the Chinese banking industry from a supply-side perspective, before completing the analysis from the demand-side in part three of this chapter. The policy banks are not included in our analysis, as they neither compete in the private banking sector nor do they represent potential opportunities for involvement of foreign players.

The “Big Four”

After the reforms and opening up of the Chinese banking sector, the extreme domination of the market by the Big Four has very slowly started to diminish. At the end of the year 2007, they held 53 percent of the total assets of the banking sector (Hansakul et al. 2009), compared to about 60 percent in 2003 and as high as 77 percent in 1995 (García-Herrero and Santabárbara 2004). However, to put these figures into perspective, the Big Four range among the largest banks in the world in terms of assets, employees and number of branches. The recent decline in market share is expected to continue, at a pace that is unlikely to worry the Big Four. This development is considered somewhat normal and has been observed in other countries and industries that opened up the once quasi-monopolistic markets (e.g. Deutsche Telekom after the reform and opening of the German telecommunications market).

Other issues are more pressing for the Big Four. As often is the case with state-owned companies in a centrally planned economy, the Big Four have been subject to government influence in the past, which is now hurting the companies as the markets have opened up. In the case of the banking industry, the issue has been soft constraints on lending, especially for large state-owned enterprises, thus leading to high NPLs (non-performing loans) on the Big Four’s balance sheets. These continue to constrain their profitability (García-Herrero and Santabárbara 2004). Even though the share of NPLs in total assets has been significantly reduced in recent years (Hansakul et al. 2009), some people argue that this is cosmetic. Chovanec (2009) pointed out that “the bulk of bad debts were not written off as losses by the banks, but off-loaded onto state-run Asset Management Companies (AMCs)”. Hence, it is not yet clear how these former NPLs will affect the Big Four in the future. As for now, they pay the interest on these to the AMCs, although interest payments are not as frightening as potential large-scale write-offs.

Joint-stock commercial banks

JSCBs are the second largest category of banks, after the Big Four, holding 14 percent of the banking sector’s assets at the end of 2007 (Hansakul et al. 2009). Their assets grew by 33 percent in 2007, clearly outperforming the average industry growth of 20 percent.
JSCBs are partially owned by local governments, state-owned enterprises and partly the private sector. Currently, there are 12 JSCBs licensed in China, the biggest ones being Bank of Communications, China Minsheng Bank, China Merchants Bank, Shanghai Pudong Development Bank and Shenzen Development Bank. While China Minsheng Bank is the only entirely privately owned bank, five of them are listed on stock markets. JSCBs have focused more on private consumer loans as well as small and medium-sized enterprises, as the Big Four already have a strong footprint with larger corporate clients such as the state-owned enterprises. Their market-oriented mindset has brought them success and they are expected to continue gaining market share and importance in the Chinese banking sector. The main impediment to rapid growth is their still local focus and the disadvantages they face in terms of branch networks compared to the Big Four.

City commercial banks and credit cooperatives

The smallest domestic players in the Chinese banking sector are city commercial banks and credit cooperatives, who together account for more than 6 percent and 10 percent of total assets, respectively.

While city commercial banks have outperformed the average market growth by growing 29 percent in 2007 (Hansakul et al. 2009), the share of credit cooperatives in total banking sector assets declined sharply from 16 percent in 1995 (García-Herrero and Santabárbara 2004) to about 10 percent in 2006. However, this trend is not surprising, as city commercial banks were created in the 1990s to take over urban credit cooperatives. Hence, many have merged into city commercial banks with only rural credit cooperatives maintaining their position for agricultural financing and individuals. However, due to the localized set-up they are often subject to local government influence on their lending policies; the share of NPL in their portfolios is estimated to be extremely high. City commercial banks furthermore are limited to their respective regions as their license does not extend to national levels. This is a clear disadvantage compared to the state-owned commercial banks (SOCBs) and JSCBs.

Foreign banks

As the Chinese banking sector has only recently opened up and still has some restraints and regulations for foreign banks, their influence in the market is not very significant. Two milestones in policy reforms strongly affected foreign direct investment: first, in 2003, the Chinese government opened up the banking sector for foreign strategic investments, where foreign banks could hold minority shares in Chinese banks. However, despite tight regulations, FDI in banking has rapidly grown to USD 14 billion in 2005 (Hu 2006). Second, since late 2006, as a follow-up of China’s World Trade Organization (WTO) accession, foreign banks are allowed to conduct RMB business with individuals. Nevertheless, to date foreign banks account for only about 2 percent of total banking assets in China. In the next paragraphs we discuss opportunities and challenges for foreign investment in China and thus touch upon some reasons why the share of foreign banks is still this low.
Development of China’s banking industry

1.3. China domestic banks

Current NPL situation of China’s domestic banks

On the surface the asset quality of the domestic banks appears to be very good and improving, however, there are concerns on debts to local governments and the potential increase of NPLs due to a possible big drop in property prices.

The good appearance of the asset quality

According to a research report published by DBS in August 2010, the asset quality of China’s banks is good and new NPLs formation will be low, going forward. They only expect a moderate rise in NPLs (before write-offs) of 25 percent to 26 percent p.a. during 2010 and 2011. After the write-offs, NPLs should rise 11 percent and 14 percent in 2010 and 2011. NPL ratios should decline to 1.2 percent in 2010 and 2011 diluted by the continued and relatively fast loan expansion.

The Local Government Investment and Finance Platform

According to Ba Shu Song, the head of the Institute for Finance Research of the State Council Development Research Centre, the Local Government Platform has become the most actively growing debtor.

Starting from November 2008 when China started enforcing active fiscal policy and appropriately loosened monetary policy to respond to the financial tsunami, the growth in credit has been extremely fast. Outstanding credit was RMB 9.6 trillion in 2009. Among the debtors of these loans, Local Government Platform is the most active, most eye-catching and deserves the most attention and concern.

The so-called Local Government Platform broadly includes different types of city construction investment corporations, city construction development corporations and city construction asset operation corporations, etc., organized and set up by local governments. These corporations make use of allocation of assets such as land to organize and set up corporations assets and cash flow of which can more or less reach the standard of financing, and if necessary they are patched by repayment guarantees and financial subsidies, and the key is to invest the proceeds of the financing into projects of city construction, public business, etc.

Since the end of 2008, financing of the Local Government Platform has shown a fast growing trend. According to initial statistics, there are more than 3,000 such platforms of all and different levels of local governments, of which more than 70 percent are at county and district levels. In early 2008, the total debt of all levels of platforms was more than RMB 1 trillion; in mid-2009, it rapidly rose to more than RMB 5 trillion. Financial Times reported in July 2010 that according to its information from a senior Chinese official, the total debt had reached RMB 7.7 trillion then and 20 percent of that had a high risk of default; most of such loans were bank loans from China’s domestic banks. The huge loans not only increased the burden of local governments but also put significant pressure on banks’ operational
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risks. In November 2010 Jia Kang, the Head of the Institute of Financial Science of MoF, stated that the local government loans had gone up to more than RMB 8 trillion of which 23 percent had obvious risk.

**How much damage can the platform cause?**

Using the data in the DBS report, and the assumption that the total net new bank loans in China in 2009 and 2010 are RMB 7.5 trillion and RMB 7 trillion, respectively, we can assume the total loan outstanding at the end of 2010 to be around RMB 47 trillion.

If we assume the worst scenario that 20 percent of the RMB 7.7 trillion will become NPL, then the additional NPL due to the platform = 7.7 trillion x 20 percent = 1.54 trillion.

The ratio of this additional NPL to total loan = 1.54 trillion / 47 trillion = 0.0377.

Then making use of the financial data from Q3 2010 reports of the above-mentioned three big domestic banks, we can compile the ratio of the additional NPL to equity and profit before tax for the three banks, assuming the above ratio of additional NPL due to Local Government Platform is applicable for all the banks:

<table>
<thead>
<tr>
<th>B/RMB</th>
<th>Equity</th>
<th>Annualized PBT</th>
<th>Total loan</th>
<th>NPL</th>
<th>NPL/equity</th>
<th>NPL/annualized PBT</th>
</tr>
</thead>
<tbody>
<tr>
<td>ICBC</td>
<td>760</td>
<td>222</td>
<td>6572</td>
<td>248</td>
<td>0.33</td>
<td>1.12</td>
</tr>
<tr>
<td>CCB</td>
<td>598</td>
<td>192</td>
<td>5368</td>
<td>202</td>
<td>0.34</td>
<td>1.05</td>
</tr>
<tr>
<td>BOC</td>
<td>598</td>
<td>143</td>
<td>5555</td>
<td>209</td>
<td>0.35</td>
<td>1.46</td>
</tr>
</tbody>
</table>

Source: China Banking Regulatory Commission

The back-of-envelope estimate is that the worst scenario could be more than 30 percent of the equity or more than one year of profits of the banks might vaporize. Maybe this is the reason why the banks have been instructed to increase their CAR and they have been making second offerings of equity.

The quick conclusion is that the Local Government Platform will not kill the banks but the shareholders may suffer much from it if it turns sour one day, and it may hurt the Chinese economy for several years.

**Impact of property price fall to NPL**

China’s central government has been suppressing property prices in China. The government has been setting up and enforcing new rules for this and the market believes the central government will even impose new property taxes. Although the transaction volume has been lowered much, property prices have not declined significantly. It has even been reported that property prices have been increasing slowly in many cities. So this may provoke the central government to enforce more
and much harder measures and the market, the banks and CBRC are worrying that property prices may finally drop substantially and that may increase greatly NPLs of the banks and even lead to a huge and damaging systemic destruction of China’s banking system.

CBRC has instructed the banks to perform stress tests to forecast the potential damage a fall in property prices may cause at the end of July 2010. CBRC did explicitly instruct the merchant banks to perform stress tests based on the scenarios that the property prices will drop 50 percent to 60 percent.

On 20 August 2010, www.stnn.cc reported that one senior executive of a joint-stock bank commented that it was possible property prices would drop 50 percent under the increasingly tightening policy and the price after such a drop would be at the same level as that in the first quarter of 2009; we believe that the worst scenario could be a price drop of 50 percent.

According to the media reports, domestic banks had released the results of their stress tests and said impact on NPLs (as released by major domestic banks) was expected to be very mild. The following were the reported results upon 50 percent property price drop released by several domestic banks.

<table>
<thead>
<tr>
<th>% NPL increase to total mortgage loan</th>
<th>% NPL increase to total property development loan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minsheng</td>
<td>1.2%</td>
</tr>
<tr>
<td>CMB</td>
<td>1%–2%</td>
</tr>
<tr>
<td>BoCOM</td>
<td>1.2%</td>
</tr>
<tr>
<td>BoC</td>
<td>2%</td>
</tr>
<tr>
<td>CCB</td>
<td>Insignificant</td>
</tr>
<tr>
<td></td>
<td>2.1%</td>
</tr>
<tr>
<td></td>
<td>1%–2%</td>
</tr>
<tr>
<td></td>
<td>1.6%</td>
</tr>
<tr>
<td></td>
<td>4%</td>
</tr>
<tr>
<td></td>
<td>Insignificant</td>
</tr>
</tbody>
</table>

Source: China Banking Regulatory Commission

The figures look too mild to be believable and the media also doubt them because the banks themselves did the stress tests, i.e. there were no third-party referees for the tests and their results.

Theoretically the highest damages should be on banks which were the most aggressive in lending the two types of loans during the property boom in 2009, some media reviewed the published loan figures of the banks and concluded that the most aggressive major domestic bank in that period was BoC, and the figures in the previous table also show that BoC’s NPLs on the two types of loans would rise the most under the stress test scenario. It was also reported that the situation for the Beijing Branch of BoC was even worse: under the 50 percent price drop scenario, the mortgage loan NPLs would be 7 percent of its total mortgage loan outstanding!

If we take BoC’s data in the above table as the worst case, and take its financial data from its 2010 Interim Report, we can compile the worst scenario for BoC as follows (as at 30 June 2010):
This does not look good, but compared to the potential damage of the Local Government Platform, this is much smaller, if the stress tests results given by the banks themselves are correct.

1.3.2. Future opportunities

Responding to the challenges and difficulties in the PRC banking industry, the domestic banks are proactively implementing different strategies.

Penetration in county areas

Driven by China’s fast-paced urbanization and industry’s migration to county areas, the economy in these areas is skyrocketing and is deemed to be more important to domestic banks’ business development in the future. In accordance with National Bureau of Statistics of China, the county areas had a total population of 928 million, which accounted for 95.2 percent of China’s total land mass and 69.8 percent of China’s total population as of 31 December 2008; it accounted for 49.6 percent of China’s total GDP in 2008.

In response, most domestic banks have decided to intensify their market expansion efforts and speed up the penetration in the county areas. For example, as of 30 June 2010, ABC has already established 2,072 branches in the county areas. Meanwhile, BoC and Temasek Holdings have set up a joint venture called BOC Fullerton Village Bank (中银富登村镇银行) with the aim of opening 400 branches in these areas in the coming years. CCB will also join hands with Banco Santander Central Hispano Sa (西班牙桑坦德银行) for establishing branches in county areas as well as implementing new operational systems. The initial registered capital has reached RMB 3 billion.

New market establishments outside China

More banks are going abroad either by setting up overseas branches or through cross-border M&A. To cite an example, ICBC, the world’s largest bank by market value, has entered the markets of Vietnam, Malaysia and Canada and has applied for establishment of six branches in Europe, including Paris in the first half of 2010. In fact, ICBC has already acquired 20 percent stake in South Africa’s
Standard Bank Group Ltd for USD 5.4 billion and it bought Thailand’s ACL Bank for USD 545 million in October 2008 and September 2009, respectively. Howard Davies, former deputy governor of the Bank of England and adviser to the Chinese banking regulator, called the acquisition of Standard Bank Group Ltd “strategic logic” as ICBC can take advantage from the growing economic links between China and Africa.

Meanwhile, CCB has been approved to set up the Sydney Branch and the Moscow Representative Office in August and September 2010, respectively. John Foley of breakingviews.com has pinpointed that overseas expansion is likely to continue as Chinese banks are seeking to build their global presence. As further explained by Xiao Gang, the Chairman of Bank of China, Chinese banks that have the ability should hasten their pace in going abroad and increase their international competitiveness.

Cross-selling

In face of intense competition in the Chinese banking industry, domestic banks are targeting revenues from credit cards, wealth management services, financial leasing and fund management and insurance businesses through improving cross-selling efforts.

- Credit card

From 2001 to 2008, issued credit cards soared by 514 percent to 142.3 million and became one of the major consumer financial products for Chinese commercial banks. This growth can be attributed to rising household incomes and the resulting life-style change. Moreover customers are much better educated in regard to their investing and financing options. As such retail banking is presented with significant growth opportunities associated with increasing demand for consumer financial products.

As the domestic banks fully recognize the potential of this market, they are ready to intensify their marketing efforts and fight hard to attract customers. In fact, most domestic banks offer special promotions to attract new customers on a regular basis. In addition to waiving the annual fees permanently, some domestic banks have even offered lifetime bonus point programs to attract new customers. In short, we fully expect that the stiff competition will be in parallel with the market growth in the future.

- Wealth management and private banking

Recently, a new market for wealth management services has emerged as a result of the rapid increase in household wealth and an expanding class of wealthy individuals. In fact, China’s household savings reached RMB 20 trillion in 2008 which was equivalent to 72.5 percent of China’s GDP in that year. The combined wealth of China’s millionaires overtook that of the UK; China ranked fourth worldwide in
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Hence, there is no doubt that wealth management and private banking have promising prospects in China. In response to these growth trends, domestic banks have begun to offer customized and professional wealth management services to mid- to high-end customers, such as asset allocation, dynamic wealth management and corporate finance advisory services. Besides, domestic banks have set up their own private banking departments and started to expand their market penetration in private banking services to high net-worth individuals in the PRC.

- Financial leasing and fund management

Besides credit card and wealth management businesses, domestic banks have diversified into other financial products / services also, such as financial leasing and fund management. As of 31 December 2008, seven domestic banks have already invested in or established financial leasing subsidiaries while eight domestic banks have established fund management subsidiaries. As of 31 December 2008, bank-owned fund management companies commanded a market share of 12.4 percent in terms of the total net assets under management in China.

For example, in 2008, Industrial Bank (興業銀行) set up a financial leasing unit with RMB 2 billion (or USD 283.5 million) in registered capital and bought a 20 percent strategic stake in Jiujiang City Commercial Bank, based in central Jiangxi Province to expand into the fund management and leasing businesses and invested in a smaller lender.

- Insurance

Traditionally, domestic banks were prohibited from underwriting insurance products and services. However, investments in insurance business have grown steadily since 2008, when CBRC designated four banks including ICBC, CCB, BoC and Bank of Beijing to take part in a pilot program allowing domestic banks to take stakes in insurance companies. Subsequently ICBC (Asia) has been approved for holding a 12.45 percent stake in Taiping Insurance; CCB has applied to take a stake in Beijing-based Happy Life Insurance Company; the Bank of Communications (BOCOM) has received China Insurance Regulatory Commission (CIRC) approval for the purchase of a 51 percent stake in China Life-CMG Life Insurance Company and Bank of Beijing has been approved to take a stake in ING Capital Life Insurance Company, Ltd.

In November 2009, CBRC promulgated the Pilot Administrative Measures for Commercial Banks to Make Equity Investments in Insurance Companies, permitting commercial banks to invest in the insurance industry. By leveraging their extensive distribution networks and customer base, this should become a significant business opportunity for domestic banks in the future. For example, as of 31 December 2009, ABC had 23,624 domestic branch outlets, covering all cities and 99.5 percent of the counties in China with approximately 320 million retail customers and 2.6 million corporate customers. Thus its potential sales revenue from insurance premiums is substantial.
1.4. Interest rate development and liberalization in China

**Background of interest rate cut**

People’s Bank of China (PBoC) has long controlled the deposit and loan interest rate of all banks in China. In mid 2012, PBoC cut interest rates twice in less than a month. It was also the first interest cut in three-and-a-half years, which reflected that the growth of China’s economy faced a great challenge.

On 7 June 2012, the PBoC cut the one year benchmark deposit and lending rate by 25 bps. At the same time, it also raised the cap on deposit rate to 10 percent premium and lowered the floor of lending rate to 20 percent discount. Previously, deposit rate did not have a floating area and lending rate only had floor of 10 percent discount. The flexibility allowed to banks implied further interest rate liberalization.

The second interest rate cut was in 5 July 2012 when the PBoC further cut the one year benchmark deposit rate by 25 bps and one year benchmark lending rate by 31 bps. The central bank further lowered the floor of lending rate to 30 percent discount to provide relief to sectors with high debt burden. It reflected growing government support for the economy at the expense of bank profitability. Details are shown in Table 1.1.

<table>
<thead>
<tr>
<th></th>
<th>Before adjusted</th>
<th>Adjustment (7 June 2012)</th>
<th>Variance pp (vs previous adj)</th>
<th>After floating</th>
<th>Adjustment (5 July 2012)</th>
<th>Variance pp (vs previous adj)</th>
<th>After floating</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Retail deposit</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Current deposit</td>
<td>0.50</td>
<td>0.40</td>
<td>−0.10</td>
<td>0.44</td>
<td>0.35</td>
<td>−0.05</td>
<td>0.39</td>
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<tr>
<td><strong>Fixed deposit</strong></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>3 months</td>
<td>3.10</td>
<td>2.85</td>
<td>−0.25</td>
<td>3.14</td>
<td>2.60</td>
<td>−0.25</td>
<td>2.86</td>
</tr>
<tr>
<td>6 months</td>
<td>3.30</td>
<td>3.05</td>
<td>−0.25</td>
<td>3.36</td>
<td>2.80</td>
<td>−0.25</td>
<td>3.08</td>
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<tr>
<td>1 year</td>
<td>3.50</td>
<td>3.25</td>
<td>−0.25</td>
<td>3.58</td>
<td>3.00</td>
<td>−0.25</td>
<td>3.30</td>
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<tr>
<td>2 year</td>
<td>4.40</td>
<td>4.10</td>
<td>−0.30</td>
<td>4.51</td>
<td>3.75</td>
<td>−0.35</td>
<td>4.13</td>
</tr>
<tr>
<td>3 year</td>
<td>5.00</td>
<td>4.65</td>
<td>−0.35</td>
<td>5.12</td>
<td>4.25</td>
<td>−0.40</td>
<td>4.68</td>
</tr>
<tr>
<td>5 year</td>
<td>5.50</td>
<td>5.10</td>
<td>−0.40</td>
<td>5.61</td>
<td>4.75</td>
<td>−0.35</td>
<td>5.23</td>
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<tr>
<td><strong>Loan and advance</strong></td>
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<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 months</td>
<td>6.10</td>
<td>5.85</td>
<td>−0.25</td>
<td>4.68</td>
<td>5.60</td>
<td>−0.25</td>
<td>3.92</td>
</tr>
<tr>
<td>1 year</td>
<td>6.56</td>
<td>6.31</td>
<td>−0.25</td>
<td>5.05</td>
<td>6.00</td>
<td>−0.31</td>
<td>4.20</td>
</tr>
<tr>
<td>1–3 year</td>
<td>6.65</td>
<td>6.40</td>
<td>−0.25</td>
<td>5.12</td>
<td>6.15</td>
<td>−0.25</td>
<td>4.31</td>
</tr>
<tr>
<td>3–5 year</td>
<td>6.90</td>
<td>6.65</td>
<td>−0.25</td>
<td>5.32</td>
<td>6.40</td>
<td>−0.25</td>
<td>4.48</td>
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<tr>
<td>&gt; 5 year</td>
<td>7.05</td>
<td>6.80</td>
<td>−0.25</td>
<td>5.44</td>
<td>6.55</td>
<td>−0.25</td>
<td>4.59</td>
</tr>
</tbody>
</table>

*Source: China Banking Regulatory Commission*
Development of China’s banking industry

Reasons behind the rate cut

The first purpose of the rate cut was to cope with the less rapid local GDP growth due to Europe’s debt crisis. China has faced increasing pressure of sluggish GDP growth because of debt issues in US and Europe, with its GDP growth rate continuously declining from 2010 onwards. As of September 2012, the GDP growth rate was only 7.4 percent, which was even below the critical point of 8 percent as shown in Figure 1.1.

Besides, China’s manufacturing PMI has declined to its lowest point of 49.2 percent in August 2012, a figure below the critical level of 50 percent (Figure 1.2), implying that the manufacturing sector was shrinking in the period.

In the 12 Five-Year Plans and 18th Big Meeting, leaders of China have repeatedly emphasized the importance of stable growth of the economy. Therefore, China would try to increase the extension of macro-adjustment and adopt new policies to expand demand for consumption and investment. PBoC has lowered deposit and loan interest rates twice to increase the confidence of investors and stimulate demand for borrowing and investment as a result.

![Figure 1.1](image1.png)  
*Figure 1.1* China’s GDP growth rate from 2010 to 2012  
*Source: National Bureau of Statistics of China*

![Figure 1.2](image2.png)  
*Figure 1.2* China’s PMI in 2012  
*Source: National Bureau of Statistics of China*
Another reason for the cut was that the decreasing inflation rate has provided the opportunity to reduce deposit and lending rates. As the debt crisis of the US and Europe has caused economic growth to slow down globally, making the investment sentiment more risk averse and causing commodity and oil prices to drop accordingly, China’s CPI growth rate has also decreased to 2.2 percent on June 2012 as shown in Figure 1.3 and the real interest rate has turned from negative to positive, which provided an opportunity to lower the deposit rate.

In addition, China’s PPI dropped 2.1 percent in June 2012 and the extent of decline increased in following months (Figure 1.4). This reflects that the real financing cost of corporations was high, thus decreasing the lending rate may help act as a relief for them.

Figure 1.3  China’s CPI year-to-year growth rate from 2011 to 2012

Source: National Bureau of Statistics of China

Figure 1.4  China’s PPI year-to-year growth rate from 2011 to 2012

Source: National Bureau of Statistics of China
Impact of interest rate cut and rate floating expansion

The first rate cut appeared to be symmetrical, the extent of the rate cut for both deposit and lending rates was about the same for tenures of one year or below. The interest rate cut was about 25 bps; and deposit rates for two years, three years and five years, the interest rate cuts were 30 bps, 35 bps and 40 bps, respectively. However, the interest rate cut was implemented simultaneously with interest rate liberalization which made the interest rate intrinsically non-symmetrical.

As mentioned before, the first rate cut allowed a premium of 10 percent on the deposit rate. Owing to the keen competition for deposits, banks were already using other deposit-related investment products to circumvent the limit. The recent drop in bank deposits implied that banks would raise deposit rates by offering the 10 percent premium immediately to attract more funds, despite the slow rise of long tenor deposit rates due to the expectation of continuous cutting of interest rates by PBoC.

On the other hand, the lending rate will also be dropped due to the decreasing debt financing demand in order to maintain the loan market share. Although lending will still be priced according to assessment of credit risk of customers, it was believed that most loans will be priced at the floor of the 20 percent discount on the benchmark rate in the long run. Therefore, because of the keen competition for loans and deposits, one year deposit and lending rates will be changed from 3.25 percent and 6.31 percent to 3.58 percent and 5.05 percent, respectively. Compared with the rate cut before (deposit rate: 3.50 percent; lending rate: 6.56 percent), the deposit rate was raised by about 8 bps and the lending rate was cut by about 150 bps. Thus it could be seen that the deposit rate was increased eventually under this rate cut.

If the second rate cut is viewed as a standalone action, it seems closer to a symmetrical rate cut than the first. Under the second rate cut, the deposit rate still had a cap of 10 percent premium and the lending rate had a lower floor of 30 percent discount. According to the keen competition assumption mentioned above, the one year deposit rate and lending rate would be changed from 3.00 percent and 6.00 percent to 3.30 percent and 4.20 percent, respectively. Compared to the intrinsic rate before the cut, both the interest rate, deposit and lending rates appeared to have dropped. In short, it could be found that the one year deposit rate has dropped 20 bps and one year lending rate has dropped 236 bps, which was much greater than the deposit rate after the two interest rate cuts.

The interest rate cut has multiple impacts on the banking industry and the macro-environment. First, the interest rate cut and the expansion of the benchmark rate’s floating zone could further reduce the financing cost of individuals and corporations. As discussed previously, the one year intrinsic lending rate will most likely be decreased 236 bps to 4.20 percent after the two rate cuts. The reduction of financing costs will further stimulate investment decisions, property markets and even consumption which in turn help economic growth.

In addition, expansion of the benchmark rate’s floating zone will decrease banks’ net interest spread which would suppress their profitability. Taking one year deposit and loan as an example, the net interest spread before the rate cut was
Development of China’s banking industry

3.06 percent, decreasing to 1.47 percent after the first cut and liberalization and to 0.90 percent after the second cut. Net interest income has long been the major income of Chinese banks so the reduction of net interest spread would force them to transform their business model to expand their non-interest income, such as insurance and unit trust commission income. Besides, banks would target small and medium enterprises due to their lower bargaining power, hoping to prevent the sharp drop in the net interest spread in loan portfolios. Yet on the other hand, better credit assessment of companies is needed to prevent deterioration of asset quality which would further erode banks’ profit.

Expansion of benchmark rate’s floating zone was the main implication of the change from planned economy to market driven, which helped to better allocate the resources among different counterparties. A partial free floating of interest rates gave banks more power to decide deposit and lending rates, thus larger and higher credit quality corporations could enjoy better lending rates which in turn lowered the financing cost and made the entire economy more efficiently financed. Besides, lowering the lending rate also helped reallocate the profit between banks and corporations by reducing the profit of banks to an appropriate level and translated it into profits of corporations. This overturns the phenomenon that banks always earn good profits even under economic downturns.

Peer banks comparison

Having discussed that interest rate cuts will shrink the interest margin and hence the profit of China’s banks, real statistics of the banks are described and discussed to confirm these findings.

Sector Q3 net interest margin surprisingly raised by 4 bps, contrary to market expectations (Figure 1.5). It was believed that this was mainly driven by large banks’ NIM expansion, given they had relatively long loan durations but very liquid deposit bases. PBoC’s interest rate cuts in June and July almost immediately helped large

![Figure 1.5 Banks’ Q3 NIM and change in Q3](source: China Banking Regulatory Commission)