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Expert view

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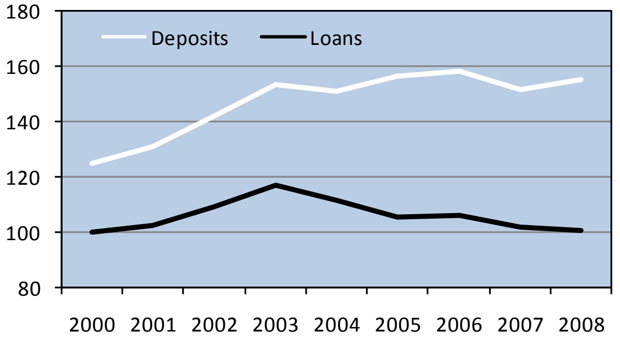
Juuso Kaaresvirta: Structural changes in Chinese economy will require banks to adopt new operating models

Significant structural changes have been carried out in the Chinese banking sector over the last ten years. Nonetheless, the sector is, in practice, still fully state-controlled, although the activities of foreign banks in China have increased and some banks have been listed on the stock exchange. So far, Chinese banks have responded well to the challenges they face, but as the structure of the Chinese economy in the future becomes increasingly consumption-driven, they will face a significant transformation of their operating models.

Chinese banks among the largest in the world

The Chinese financial sector is very bank-dominated. At the end of 2008, the stock of bank deposits was 50% larger than GDP, while loan stock was equal to GDP. The sector is dominated by four large state-controlled banks: Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), Bank of China (BoC) and Agricultural Bank of China (ABC). Together, these banks hold more than half of all deposits. All four have been restructured within the past ten years with direct state support. A large proportion of their nonperforming assets were at this time transferred to asset management corporations. These measures, as well as rapid economic and loan stock growth, have helped to lower commercial banks' nonperforming assets to a level equivalent to 2% of the loan stock on average.

Developments in the stock of deposits and loans, % of GDP



Source: People's Bank of China and National Bureau of Statistics.

In the turmoil of the international financial crisis, these four Chinese banks have in terms of market value become the largest banks in the world. ICBC is the largest, CCB the second largest and BoC the third largest. ABC, too, which is currently preparing for listing, will probably rank high on the list of largest banks. Measured with the amount of capital three big Chinese banks are placed around ten in rankings.

In line with China's deepening integration into the world economy, Chinese banks have also increased their foreign activities. The three large listed banks have branches around the world, and some corporate acquisitions have also occurred. The foreign activities of Chinese banks are expected to grow only slowly in the years ahead.

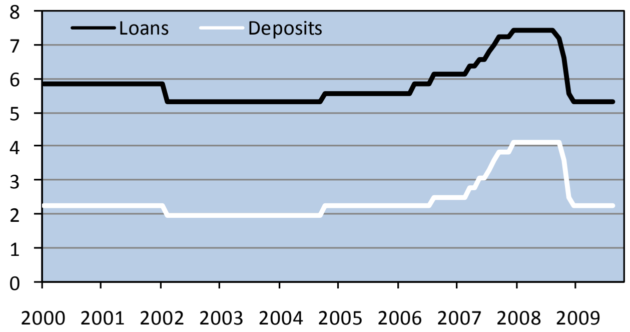
Banks very profitable

Although Chinese state-led banks have much room to improve their efficiency, bank profits have grown very rapidly with support of rapid economic growth in recent years. Although earnings development has suffered from the economic slowdown, the four largest banks still increased their profits last year by 10–40% from 2007, to a total of more than CNY 200 billion (EUR 20 billion). Most of the income of the large banks stems from core operations: the banks receive an abundant flow of deposits, which they lend forward at a higher interest rate. In the large banks, various service fees account for 10–15% of their total income, although for the Bank of China, which has always focused more than the others on foreign trade services and foreign exchange, the proportion is somewhat larger.

The banks find it hard to compete in interest rate margins, as they cannot set interest rates freely. Lending rates must be at least 90% of the reference rate set by the central bank, while interest rates on deposits can be a maximum of 10% larger than the reference rate. About one third of loans are granted at reference rate, and the share of loans granted at higher than reference rate has been closing one third this year. In recent years, the net margins of the largest banks have been around 3%, which is not particularly high by international standards.

Accordingly, the huge bank profits are due largely to increased lending volumes. There has been some discussion on eliminating the interest rate restrictions, but, at least so far, the authorities have not wanted to take any steps in this direction.

Central bank's 12-month reference rates, %



Source: People's Bank of China.

Foreign banks present no competitive threat on the domestic market

At the end of 2006, China liberated the operating conditions for foreign banks in accordance with its WTO commitments. However, activities by foreign banks are still fairly insignificant (just a few per cent of sector assets) and mostly concentrated on private business customers. The expansion of foreign bank operations is being slowed particularly by the capital requirements at branch level imposed by the authorities.

Foreign banks are involved in several Chinese banks as strategic investors, which is hoped to boost the risk management skills of the Chinese banks. However, the holdings sold to foreign investors are small and their scope for affecting the operations of the large Chinese banks has been questioned. As a result of the international financial crisis, several foreign banks have in the current year backed off from their strategic investments.

Financial crisis having little direct impact on the banks

The Chinese banking sector has emerged from the international recession with very little damage. The foreign market activities of the banks have been comparatively small, as China tightly restricts capital flows. In all, the banks have written down their subprime debt securities by a few billion dollars.

Indirectly, Chinese banks are nonetheless key players in the financial crisis, as the authorities in November 2008 demanded banks to increase lending heavily as a part of their economic recovery policy. In 2009, the stock of loans has increased very rapidly, and at the end of August it was a third larger than a year earlier. Encouraged by the government, banks have had to finance new projects decided on a very tight timetable. A part of the loans is feared to be poor investments, which is expected to increase banks' nonperforming loan ratios in the next few years.

Banks will need to change their operating models

Over the longer term, China will need to lower its savings ratio so that the economic structure can become more consumption-driven. As savings decrease, or at least growth in savings slows, the flow of deposits to commercial banks will also fade. Banks will therefore have to start looking for new business models to make profit alongside their core operations.

As consumption increases, credit card operations and consumer credits are expected to provide new sources of income for the banks. At the same time, China is continuously developing its financial system, thus providing the banks with new earnings opportunities. As the system develops and China prospers, ia an increased demand for various asset management services will emerge. For the time being, the existing investment alternatives are, in practice, limited to bank deposits and the high-risk Chinese stock market. And even with the envisaged changes, it is hard to believe that the new services could fully replace the decreased income from core banking operations when savings shrink in the future.

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