Lazard Insights

Chinese Banking: Are Risks Misunderstood?

Summary

- Starting in 2009 credit growth in China expanded at a dramatically fast pace. Credit has reached high aggregate volumes, but growth has not been uniform across sectors.
- Credit from shadow banking and other informal lending activities has grown faster than credit from traditional banking. Regulators are challenged to slow the pace of credit without halting economic activity.
- We conducted a scenario analysis for stress testing in the Chinese financials sector: while non-performing loans would rise, profitability remains adequate and appears to be priced in.
- China has a centrally planned economy where the government plays a key role in lending activities for local governments and state-owned enterprises.

Where Is China in the Credit Cycle?

Following roughly three decades of double-digit growth, China has evolved into a global economic force and recent trends in credit issuance have now focused investors' attention on its banking sector. Credit growth in China has expanded rapidly since 2009. By the broadest measure of credit issuance—known as total social financing (TSF)—total credit has reached significant levels. The lion's share of outstanding TSF is composed of bank loans in local currency. Nevertheless, the volume of less formal means of loans and credit is expanding (Exhibit 1). The often-cited trust loans are one form of informal lending and generally correspond to activities of approximately seventy licensed trust companies, which offer higher yields and thereby, are attractive to many investors.

The term shadow banking is heavily used to name all forms of lending outside the traditional banking channel; however, it is a broad term without a precise definition. Loosely, shadow banking is lending by non-bank and bank entities where this activity sidesteps oversight and loan restrictions to certain industries. As such, some of the categories that we do not classify as informal in Exhibit 1 also have a portion of shadow banking activity (i.e., the intersection of shadow banking and informal lending is blurred).

The rate of growth in credit has been dramatic: in 2009 total credit was approximately 140% of GDP and through the first quarter of 2014 it is over 200%. Importantly, not all credit sectors have grown uniformly. Bank loans have grown in the mid-teens, per annum (p.a.) through 2013. By contrast shadow banking has grown at double the rate of bank loans for the same period (Exhibit 2). Not surprisingly, this rate of growth is a key concern for many observers.

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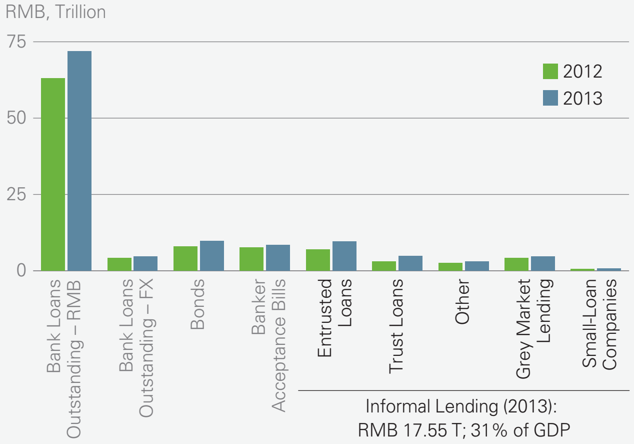
Exhibit 1
Bank Loans Dominate Total Social Financing, but Informal Activities Are Growing

Total Social Financing (TSF), 2012 versus 2013



As of December 2013
Source: PBOC, CEIC, Bernstein estimates

To further assess China's position in the credit cycle, non-performing loans (NPLs, or those loans in default or close to default) are an important metric. The ratio of NPLs to total loans is at a cyclical low and has been flat at around 1% since 2011. As the credit cycle matures, this ratio will rise from its current low level. Moreover, the anticipation of regulatory changes—if undertaken rapidly—can be viewed as a potential headwind as China reduces leverage.

A notable feature of the Chinese banking system is that deposit rates are regulated, which has kept healthy interest margins (therefore profitability) for banks. Liberalizing interest rates toward a market-based system is part of the reform agenda. However, in our opinion, while this would be favorable in the long term it must be done gradually and in an orderly manner to avoid short-term disruptions.

Other regulatory elements for consideration include a tight clamp-down on shadow banking, the emergence of alternative financing channels using the internet, and reforms for state-owned enterprises (SOEs). Essentially, regulators in China are tasked with maintaining adequate levels of credit to support growth while slowing down the flow of new credit.

Despite the rapid growth in credit and potential for regulatory headwinds, there are signs for optimism. Domestic liquidity remains high and as the Chinese capital account remains closed, domestic deposits are funding the loans (as opposed to less-sticky foreign funds). The overall result is that the loan-to-deposit ratio for the banking system remains adequate. The total level of deposits in China exceeds that of other BRIC countries combined. In addition, cash and other liquid instruments represent upward of 20% of total assets for larger banks and mid-teens levels for smaller institutions (Exhibit 3).

Scenario Analysis: Weathering the Storm

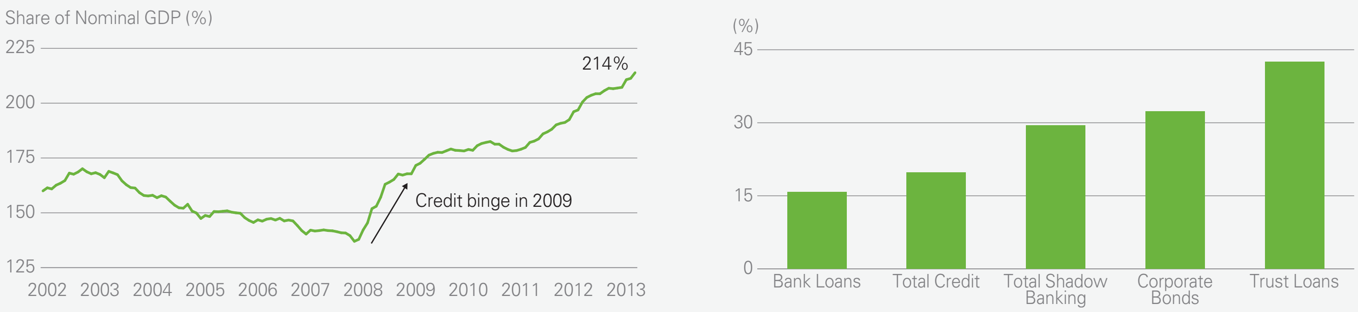
We performed a detailed scenario analysis of the Chinese banking sector to evaluate how changes from current credit conditions would affect profitability. Essentially, we calculated how the overall NPL ratio would behave by altering this ratio for some lending sectors off the cyclical low.

Under the assumption that some lending activities warrant greater risk, we divided the loan universe into stressed and non-stressed (other) sectors. Stressed sectors represent 56% of the loan mix (as of year-end 2013) and include lending to manufacturing, wholesale/retail, property, and small enterprises. In our first scenario, we assumed that for these sectors the NPL ratio would revert to the high level experienced at year-end 2008 (and to 5% for small enterprises); this corresponded to the last episode where challenging credit conditions were observed. Other sectors (44% of the loan mix) with less risk were considered to maintain the 1% NPL (or 0% for interbank loans).

Exhibit 2
Credit Growth Has Raised Investors' Concerns

Total Non-Government and Non-Financial Debt

Major Categories of Credit Growth, CAGR 2009–2013

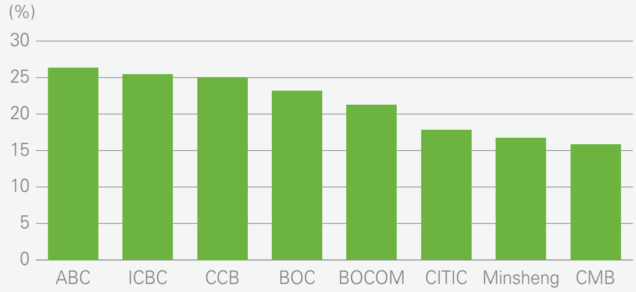


As of March 2014
Source: PBOC, CEIC, Bernstein estimates

Exhibit 3
Adequate Liquidity in China's Banking System

Loan to Deposit Ratio (Total Banking System)

Cash, Reserves, and Government Securities as Share of Total Assets



As of February 2014
ABC = Agricultural Bank of China; ICBC = Industrial and Commercial Bank of China; CCB = China Construction Bank; BOC = Bank of China; BOCOM = Bank of Communications; CITIC = CITIC Bank; CMB = China Merchants Bank. The securities mentioned are not necessarily held by Lazard for all client portfolios, and their mention should not be considered a recommendation or solicitation to purchase or sell these securities. It should not be assumed that any investment in these securities was, or will prove to be, profitable.
Source: PBOC, CEIC, Bernstein estimates

Exhibit 4
Stress Testing on the Chinese Banking System

Scenario Assumptions for Stress Testing

Scenario 1	Scenario 2	Scenario 3
Stressed sectors: manufacturing, wholesale/ retail, and property NPLs revert to 2008 year-end level, small enterprises (SE) at 5%		Stressed sectors and SE sector NPL ratio doubles Scenarios 1 and 2
35% of bank wealth management products are non-standard credit assets (NSCA) and reclassified on the balance sheet as loans with NPL ratio of 10%	50% of bank wealth management products are NSCA, which are reclassified on the balance sheet with NPL ratio of 25%	75% of bank wealth management products are NSCA, which are reclassified on the balance sheet with NPL ratio of 25%
Interbank assets see no asset quality issues		Interbank assets equivalent to 20% of loans are NSCA and classified as loans with 25% NPL ratio
NPLs for other bank loans: 1%	NPLs for other bank loans: 2%	NPLs for other bank loans: 4%

Scenario Analysis Results

	2013[a]	Scenario 1	Scenario 2	Scenario 3
Credit cost (%)	0.6	1.3	1.8	2.5
NPL ratio (%)	1.0	3.2	6.0	12.0
NPL coverage (%)	270	150	100	60
ROE (%)	18	12	8	3
Valuation (weighted average for HK-listed Chinese banks)				
P/B fair value	0.79	1.05	0.60	0.15

As of April 2014
a Historical comparable data as of 2013.
This information is for illustrative purposes only. Estimated or forecasted data are not a promise or guarantee of future results and are subject to change.
There could be some double-counting as some SE loans are also in the stressed sectors.
Source: PBOC, J.P. Morgan, Lazard estimates

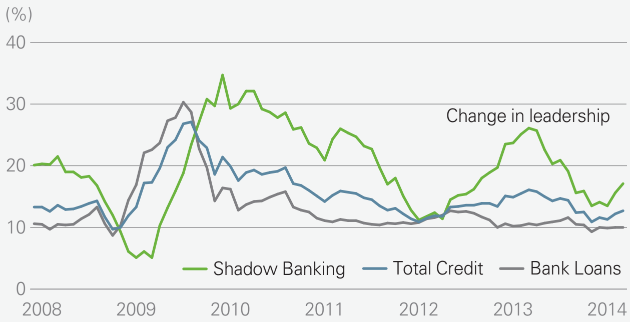
To address shadow banking assets—which often fall under the nomenclature of "wealth management products"—we intended to shed some light into the shadows, so to speak. Given the off-balance-sheet nature of many wealth management products, we have elected to reclassify a fraction of these into banks' balance sheets. In each scenario, a share of these products was reclassified into the balance sheet and each instance was assigned an NPL ratio. The top table in Exhibit 4 summarizes the assumptions for our scenario analysis.

Chinese banks have been able to generate good earnings and strong capital over time, which enables the build-up for provision reserves. In our opinion, this broad trend will continue. However, it is important to note that the results of our scenario analysis suggest non-performing loans and credit costs will mean-revert from their low bases affecting future profitability. The bottom table in Exhibit 4 summarizes the results. We believe the most likely outcome lies between the year-end 2013 figures and those of Scenario 1. In our view, the bearish cases in Scenarios 2 and 3 are very low probability outcomes. As the banking system transitions toward Scenario 1, we see that return on equity would fall but is still adequate and, from a valuation standpoint, this transition appears to be already priced in (indicated by the price-to-book ratio).

As China de-levers, our overall analysis indicates NPLs will rise and credit costs will normalize. However, this would occur in the face of several positive factors. The People's Bank of China (PBOC) and the China Banking Regulatory Commission (CBRC) are expected to act with continued regulatory forbearance. We believe this policy stance is favorable, if applied carefully. Importantly, 75% of loans are to SOEs and, in our view, are ultimately a claim on the Chinese central government, which has a healthy balance sheet. Another key consideration is that many banks have sufficient reserves and liquidity—built up from historical profitability—and, in our opinion, are well-positioned for future challenges.

Exhibit 5
Deceleration in Shadow Banking Growth

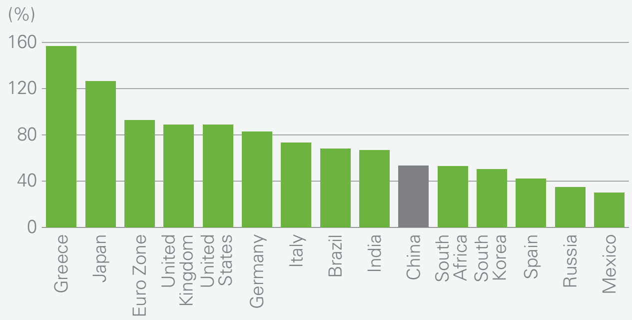
Total Credit Growth in China (9-Month Growth)



As of April 2014
Source: PBOC, CEIC, Bernstein estimates

Exhibit 6
Government Debt Is Manageable

General Government Debt as Share of GDP



As of 2012
Source: IMF

Nevertheless, risks remain and we are closely watching factors such as interest-rate deregulation, tighter regulation around shadow banking, and the opening of China's capital account. As we alluded earlier, interest-rate deregulation must take place in a measured way in order to avoid disrupting the financial system. Shadow banking serves a valuable purpose for many borrowers. Lending through traditional banking channels remains closed to many industries, only providing to those with the highest level of creditworthiness. As such, an overly tight clampdown on shadow banking runs the risks of slowing down credit and economic activity in many businesses. However, outsized growth is eventually a systemic risk. Last, China is a closed system with capital controls. While there are early hints for opening the capital account, once again, we believe this must be implemented cautiously to avoid potentially destabilizing outflows.

Further Insights on Shadow Banking and Government Debt

Recent headlines often assign a negative connotation to shadow bank lending in China. However, significant lending outside traditional banking is not exclusive to China. For example, in developed markets such as the United States and the euro zone shadow banking represents a large share in relation to the total of other liabilities in the system. At the start of 2013, by some estimates, shadow banking relative to total other liabilities represented close to 90% in the United States, 50% in the euro zone, and 20% in China.[1]

However, President Xi Jinping's administration appears to be undertaking efforts to curb the growth of shadow banking. Despite a long-term growth trend since the most recent transition of power in China, there has been an important deceleration in shadow banking growth (Exhibit 5).

The indebtedness of local governments in China has also been signaled as a concern. A particular characteristic of government finances in China is that most sources of tax revenue flow directly to the central government whereas spending remains the responsibility of the local governments. This mismatch has been acknowledged by the current administration and in our view the central government can be seen as a backstop in this respect.

Notably, government debt in China is manageable, with general government debt as a share of GDP at about 50%, which is lower than the ratio in other large emerging economies, and significantly below than that in developed countries (Exhibit 6). From this total, central government debt represents one-third and local government debt comprises the remainder (approximately 18% and 36% of GDP respectively). In addition, foreign-exchange reserves in China are about one-third of total global reserves, estimated to be about $4 trillion.

Conclusion

China has a favorable growth and inflation track record. The country's massive investments in infrastructure mean that for many businesses fixed costs can remain low. With this backdrop, China is in its first credit cycle since the early 2000s when banks were recapitalized. At that time, banks were mostly used as policy tools for directed loans controlled by the government. Today, as many bank entities have become listed, the scenery is different as institutions run more on market-based principles, which continue to be refined.

In our opinion, asset-quality risk for Chinese financials is largely contained by continued regulatory forbearance, reserve capital, and liquidity. Additionally, to understand the current challenges one must not lose sight that China is a top-down, centrally planned economic system. The largest capital allocator in China is its government, and local government debt and private sector lending (SOEs) are ultimately a claim on the Chinese central government. We believe that generally banks maintain adequate liquidity and are well-positioned to withstand a stressed scenario; moreover, the Chinese government's finances remain stable to address systemic risk.

Notes

1 Source: Simon Ogus, DSG Asia. As of January 2013.

Important Information

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