China's Small and Medium-Sized Banks' Credit Profiles Diverge on Shadow Banking and Regional Dependences

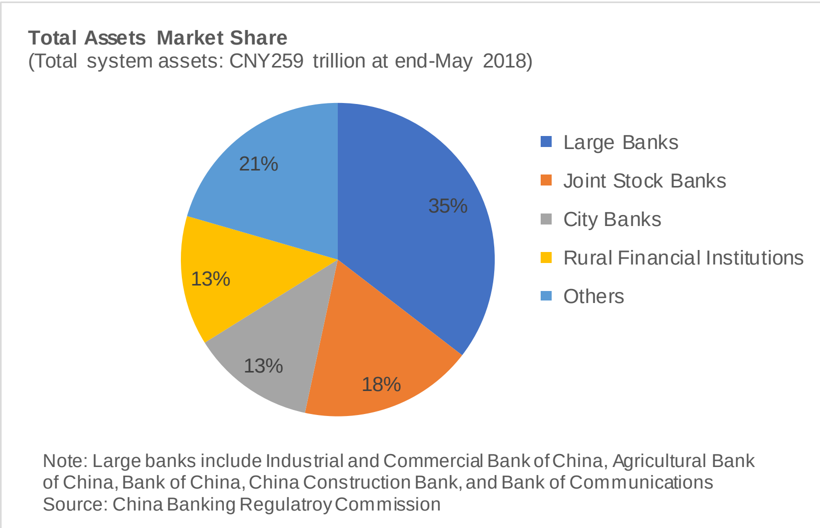
China's small and medium-sized banks (including joint stock banks and city commercial banks) have been active in shadow lending activities (such as alternative investments and off-balance-sheet wealth management products (WMPs)) and in providing credits to support the regional economic developments. This has resulted in their stronger business growth than large banks with increased market shares in the banking system and pose greater systemic importance as well as divergent credit profiles. Joint stock banks and city commercial banks accounted for 18% and 13% of the system assets, respectively, at end-May 2018, compared with 14% and 6% at end-2007. The share of large banks decreased to 35% as of end-May 2018 from 54% at end-2007.

Chinese banks' capitalisation and liquidity are facing challenges as the regulator China Banking and Insurance Regulatory Commission (CBIRC) has strengthened supervisions and regulations in reining in shadow lending and interbank activities. Capital deficits could arise when the banks bring back their underlying assets of off-balance-sheet WMPs back on to their balance sheets. Joint stock banks would be under more pronouced capital pressure given their generally larger off-balance-sheet WMP exposures (equivalent to 20% of their overall on-balance-sheet assets at end-2017), compared with 8% of large banks and 11% of city commercial banks.

The small and medium-sized banks have also incurred difficulties in managing their liquidity on tightened interbank funding. They sourced around 23% of on-balance-sheet funding at end-May 2018 from interbank, including funds from banks, non-bank financial institutions, and the Central Bank. The big four banks (i.e. Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of China, and China Construction Bank) relied much less on interbank funding at 8% at end-May 2018, due to their stronger deposit-taking franchises. Financial institutions have also funded WMPs, although their investments in WMP decreased to 11% of outstanding WMP balance at end-2017 from 21% at end-2016.

Credit profiles of China's small and medium-sized banks remain closely linked to regional economies of the provinces/cities they domiciled although they have gradually increased their geographic diversifications on rapid business expansions. Joint stock banks generally have more diversified credit profiles with wider geographic coverage and stronger retail banking franchises, while city commercial banks usually have higher concentrations in their home regions. Some banks' business strategies may be under influence of their respective local government shareholders and may relax their underwriting standards under certain circumstances in order to support their local economic development.

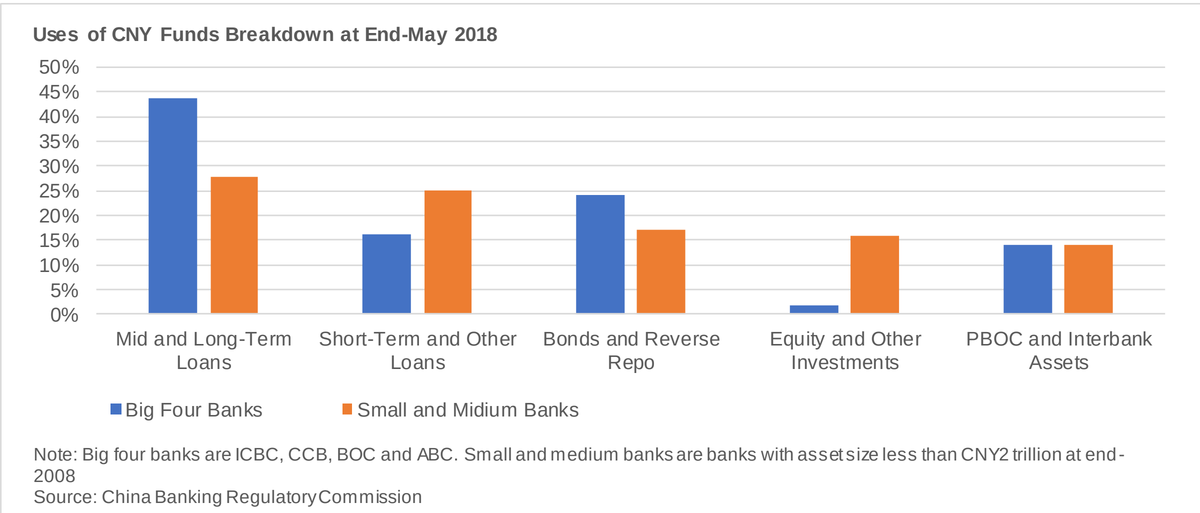
EXHIBIT 1: Total Assets Market Share



More Active in Non-Loan Business and Off-Balance-Sheet Activities

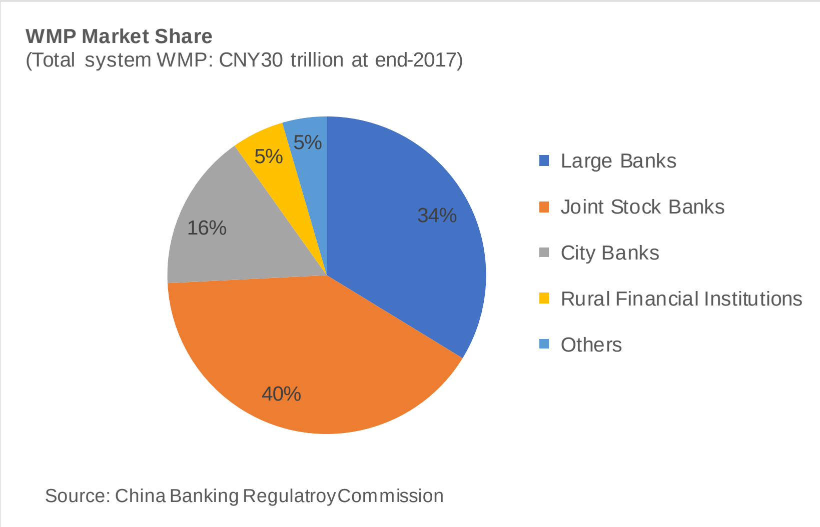
China's small and medium-sized banks have been more active in non-loan business than large banks for better yields and avoidances of regulatory lending restrictions, such as the previous 75% cap (removed in 2015) on the loan-to-deposit ratio and constraints in extending loans to certain industries. The share of equity and other investments accounted for 16% of uses of funds of these banks at end-May 2018, much higher than the 2% for large banks. We believe that the majority of the other investments are credit-related alternative investments, including trust and asset management plans and WMPs.

EXHIBIT 2: Uses of CNY Funds Breakdown



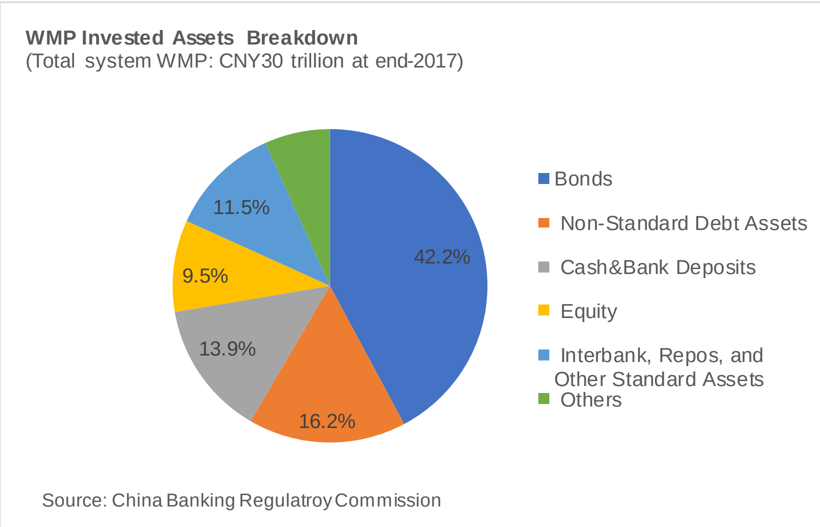
China's small and medium-sized banks have also expanded aggressively in off-balance-sheet exposures by offering WMPs to investors, resulting in higher financial leverages. Joint stock banks represented a 40% market share of China's 2017 WMP market, while city commercial banks had a 16% share. However, we expect the regulatory tightening on WMPs (aiming to strengthen investment disciplines and to break the practice of providing implicit guarantees against defaults) to curb the business and to force banks to bring shadow lending back on to their balance sheets.

EXHIBIT 3: WMP Market Share



The outstanding amount of WMPs stood at CNY30 trillion at end-2017. About 75% of the balance was non-guaranteed products and were classified as off-balance-sheet assets. Standard assets, such as bonds, deposits and interbank lending, constituted about 68% of the portfolio. Meanwhile, non-standard debt assets, which typically refers to shadow lending, represented 16%.

EXHIBIT 4: WMP Invested Assets Breakdown

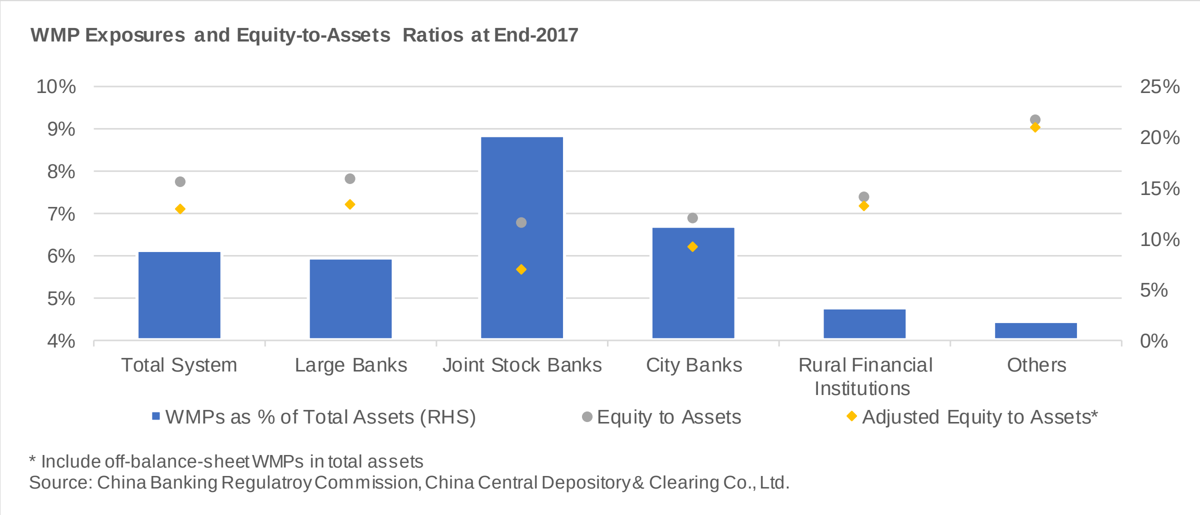


New Capital Needed to Mitigate Potential Deficits

We expect Chinese banks to continue to seek new capital raising to mitigate the potential capital deficits arising from bringing shadow lending back on to balance sheets and to meet the tightened regulatory capital requirements. China's capital rules require systemically important banks maintaining their total capital adequacy ratios (CAR) at 11.5% or above by end-2018 and 10.5% or above for the other banks.

Joint stock banks face the potential biggest capital deficits as their off-balance-sheet WMP exposures were among the largest, equivalent to 20% of their overall on-balance-sheet assets at end-2017. Their aggregated equity-to-assets ratio would have dropped by 1.1% to 5.7% (vs. 7.2% for large banks and 6.2% for city commercial banks) at end-2017 if non-guaranteed WMPs were accounted for as on-balance-sheet assets. City commercial banks' and large banks' off-balance-sheet WMP exposures were relatively moderate, equivalent to 11% and 8%, respectively, of their on-balance-sheet assets at end-2017. Meanwhile, joint stock banks' aggregated total CAR was 12.3% at end-Q118, lower than the large banks' 14.6% and city commercial banks' 12.8%.

EXHIBIT 5: WMP Exposures and Equity-to-Assets Ratios

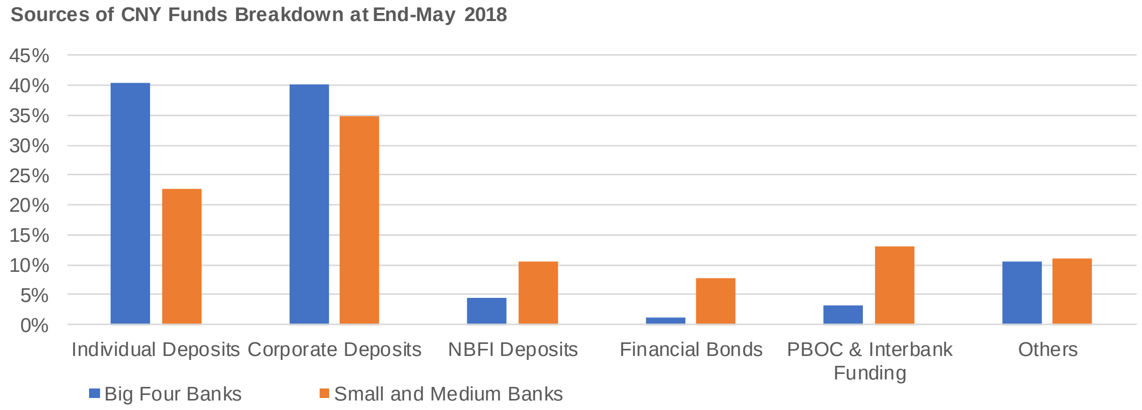


Reliance on Wholesale Funding Exposed to Greater Liquidity Risk

China's small and medium-sized banks are more susceptible to liquidity risk as their disadvantages in attracting customer deposits compared with large banks. This has resulted in a significant reliance on more volatile wholesale funding, particularly on interbank borrowings. The notable interbank exposures also indicate potential contagion risk as the failure of one bank in the interbank network might spread the problem to a larger part of the banking system.

We estimate that about 23% of small and medium-sized banks' on-balance-sheet funding at end-May 2018 were from interbank, including funds from banks, non-bank financial institutions, and the Central Bank, while the interbank funding represented much less at 8% for big four banks. The big four banks' strong banking franchises with ubiquitous network branches contribute to their large deposit base. The generally steadier individual deposits accounted for 40% of their total funding, compared with only 23% of the total of small and medium-sized banks.

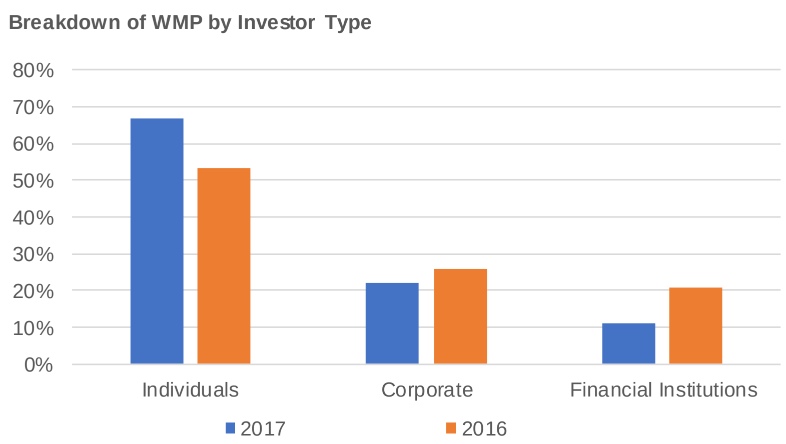
EXHIBIT 6: Sources of CNY Funds Breakdown



Note: Big four banks are ICBC, CCB, BOC and ABC. Small and medium banks are banks with asset size less than CNY2 trillion at end-2008
Source: China Banking Regulatory Commission

Financial institutions have also been one of the major WMP investors. However, their investments in WMPs have notably decreased since 2016 to 11% of outstanding WMP balance at end-2017 from 21% at end-2016 as a result of tightened regulations on interbank activities. Individuals remain the primary investors. Their share of outstanding WMP balance significantly increased to 67% at end-2017 from 53% at end-2016.

EXHIBIT 7: Breakdown of WMP by Investor Type



Source: China Central Depository & Clearing Co., Ltd.

Credit Profiles Tied to Regional Economies

Credit profiles of China's small and medium-sized banks are closely linked to regional economies of the provinces/cities they domiciled as providing lending and financial services to support local economic development has been one of their major missions. The extent of linkage and credit quality can vary significantly depending on their franchise, network coverage, respective economic conditions and influences from local governments.

Joint stock banks generally have more diversified credit profiles than city commercial banks with wider geographic coverage and stronger retail banking franchises supported by their broader distribution outreaches. On the other hand, city commercial banks usually have higher concentrations as a majority of their lending business are originated from their home region. The share of loans originated from the home province for some city commercial banks reached above 70% of their respective gross loans at end-2017, such as Bank of Nanjing and Bank of Jiangsu.

China's small and medium-sized banks generally have state ownership, including local governments. Local governments own stakes through direct holding or indirect holding by state-owned enterprises to exert influence on their respective banks. For example, Industrial Bank was 19% owned by The Finance Bureau of Fujian Province, and Shanghai Pudong Development Bank was about 30% owned by State-owned Assets Supervision and Administration Commission of Shanghai Government through its wholly-owned subsidiary Shanghai International Group as of end-2017. We believe that some banks' business strategies are closely aligned with the development strategies of their government owners; they may relax their underwriting standards under certain circumstances in order to support local economic development.

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