Highlights

- In 2017, global banking industry is expected to see an improvement in profitability, but to improve its asset quality, the pressure remains great and regional financial risks still need to be highly focused.
- In 2016, Chinese banking industry kept on prudent development in general. In 2017, the “de-leverage” initiative will continue in the financial sector; NPL ratio will remain stable and possibly decline; there will be a shift in credit allocations; the downward trend of NIM will be eased; pension finance, green finance and inclusive finance are going to embrace development opportunities.
- The present report will make a research into such hot topics as the Italian banking crisis and the new asset management regulations.

NPL Ratios of Chinese Commercial Banks and 16 Listed Banks

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<th>Year</th>
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<th>Listed banks</th>
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<td>0.5%</td>
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<td>2015Q1</td>
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<td>2016Q4</td>
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Sources: Wind, BOC Institute of International Finance
Lay the Groundwork for Higher Risk Resilience

-- Global Banking Industry Outlook (2017Q2)

Since 2016, global banking industry continued the trend of divergence: banks in the U.S. and UK recorded prudent operation, profitability of banks in Japan and major member countries of ASEAN was challenged, NPL (non-performing loan) ratio of Australian banks, a relatively low figure, was under the increasing pressure, Brazilian banks faced a great pressure in improving their asset quality, the Eurozone banks, being still depressed, had a lot of uncertainties in their growth prospect, banks in major African countries witnessed a rapid development but the overall NPL ratio was relatively higher. In 2016, Chinese banking industry maintained a positive trend of prudent growth, achieving a good start of the 13th Five-Year Plan period. Both assets and liabilities kept on a two-digit increase; growth rate of net profits continued to pick up, but profitability further declined; both deposits and loans accounted for a smaller proportion while non-interest income managed to contribute increasingly more; the rise in the amount and ratio of NPLs was weakened, and allowance-to-NPL ratio tended to stabilize with a slight decrease; capital adequacy ratio (CAR) held steady while loan-to-deposit ratio continued to rise. Looking into 2017, global banking industry is expected to improve earnings, but the asset quality issue and regional financial risks still need to be highly concerned. As to China’s financial sector, the “de-leverage” initiative will continue; NPL ratio will remain stable and possibly decline; there will be a shift in credit allocations; the downward trend of NIM will be eased; pension finance, green finance and inclusive finance are going to embrace development opportunities.

I. Operational Characteristics of Global Banking Industry

The lackluster and continued divergence of global economy caused global banks to draw differentiated development pictures in 2016:

I.1 The U.S. banking industry maintained the trend of prudent operation

Business results were sound and steady. Assets and liabilities continued to scale up. As of the end of 2016, total assets of the U.S. banking industry stood at USD16.8 trillion, up 5.1% year on year; total liabilities amounted to USD14.9 trillion, up 5.3% year on year. Profitability showed a stabilization trend overall, and interest income made a higher contribution. In 2016, the U.S. banking industry recorded USD171.3 billion in net profits cumulatively, an increase of 4.6% from the previous year; because of the interest hike by the Fed, interest income growth of banks picked up speed, resulting in a year-on-year increase of 0.1 percentage points in net interest margin (NIM) to 3.16%; non-interest income accounted for 34.35% in operating income, down 0.8 percentage points compared with the same period of last year. CAR remained steady overall and asset quality became steady. As of the end of 2016, the tier 1 CAR of U.S. banking industry was 13%, up 0.3 percentage points year on year; NPL ratio was 2.1%, dropping by 0.2 percentage points from a year earlier.

New changes surfaced in the operating environment. First, the Fed hiked 25 basis points on March 15, after which the monetary policy environment remained relatively loose. In the meantime, the Fed emphasized it would coordinate with the Department of Treasury in participating in international exchanges. Second, President Trump issued three executive orders on scaling back financial services regulations. These executive orders, symbolic more than substantive in the short term, will be subject to the final voting results of the Congress as to whether to modify and to which degree.

In 2017, the following two aspects of changes in the operating environment of the U.S. banking

1 Banking industry herein refers to all deposit financial institutions protected by FDIC deposit insurance.
industry will possibly exert profound influence on its operation: first, Trump may have the chance this year to alter the existing pattern and framework of the Fed through appointing three members of the Fed’s Board of Governors to put into effect the “de-regulation” policy. As a result, banks will possibly enhance their capability of generating incomes from diversified sources substantially; second, the continuous promotion of the interest hike process will overall push higher net interest income of U.S. banks, especially those the assets of which are very sensitive to interest rate. Therefore, we expect that the U.S. banking industry will score good performance at large in 2017 with assets having the potential of reaching USD17.7 trillion, net profits growth rate at around 5% and NPL ratio between 1.90% and 2.12%.

I.2 Eurozone banking industry, still in downturn, faces lots of uncertainties in its future development

Profitability saw slight improvement. Both registering a slow growth, outstanding deposits increased by 0.46% year on year to EUR17.01 trillion, and outstanding loans grew by 2.4% year on year to EUR17.58 trillion in the Eurozone as of the end of 2016. Profits nudged up. Major banks in the Eurozone reported ROA at 0.5%, up 0.1 percentage points year on year; ROE at 7.8%, up 0.2 percentage points year on year, and NIM at 1.4%, down 0.1 percentage points year on year in 2016. As of the end of 2016, the tier 1 CAR of major banks in the Eurozone was 13.4%, up 0.8 percentage points year on year; NPL ratio was 2.8%, dropping by 0.2 percentage points from a year earlier; allowance-to-NPL ratio was 59.7%, 5.5 percentage points higher than the same period of last year.

Operating environment changed little. On the one hand, the European Central Bank (ECB) continued to improve the Supervisory Review and Evaluation Process (SREP). It conducted sensitivity analysis of the banking book of directly supervised banks with a focus on the interest rate changes. ECB released a revised draft on supervising financial information reporting rules, requiring banks to fully reflect the changes brought by the International Financial Reporting Standards No. 9: Financial Instruments (IFRS 9) and the “expected loss”. On the other hand, since the U.S. President Trump has ordered to reassess the bank regulation policy and intended to take measures on scaling back financial services regulations, it is a common concern among European regulatory authorities that their strict regulation will weaken competitiveness of the banking industry in the globe, so they may choose to lower the regulatory requirements on banks. Besides, ECB published an interest rate resolution on March 9, holding the benchmark interest rate (main refinancing rate) of the Eurozone steady at 0%, marginal deposit rate at -0.4% and marginal lending rate at 0.25%, all consistent with the market expectation. The quantitative easing (QE) program of EUR80 billion each month is to run by the ECB until the end of March 2017 and after March 2017 the ECB will step down its purchases to EUR60 billion a month through the end of the year. In addition, net purchases will synchronize with the reinvestment with the principals of matured securities paid. In the “negative interest rate” environment, European banks are still under great pressure to develop their interest margin business.

We expect that the European banking industry will present steady operation overall in 2017 but will still face great uncertainties. Loan amount will possibly increase to EUR18 trillion and deposit amount will possibly edge up to EUR17.5 trillion. Indicators like ROA, ROE and NIM may stay at the current level but the pressure from improvement of asset quality is to be heavy. The operation

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uncertainties are mainly reflected in the following three aspects: first, the presidential election in France may trigger a chain effect. Once Le Pen wins the election and promotes France to leave the EU, the European refugee crisis, unemployment and other issues will have an outbreak, producing unpredictable influence on the political picture of the entire Eurozone and the operation of banks there. The second deals with the regulatory arbitrage accompanying the Brexit. After the UK leaves the EU, local financial institutions may transfer part of their business to the European Continent. Financial centers in Europe will offer them various preferential measures, which may exert profound influence on the operating environment of banks. Third, the monetary policies do not show a clear orientation yet. ECB says that the future deflation risk in the Eurozone has been mitigated basically, but it will increase its QE program given a worsened political and economic prospect in the Eurozone. If this comes true, banks will find it favorable for them to expand the scale but unfavorable to improve the interest margin. Therefore, the combined influence will be uncertain.

I.3 The UK banking industry maintained the trend of prudent operation

The operation results were ameliorated. Retail deposits registered a slower growth, as opposed to the growth trend of wholesale deposits. As of the end of 2016, total M4 in the UK reached GBP2,246.41 billion, up 6.1% year on year. Wholesale deposits arrived at GBP618.53 billion, up 15.8% year on year. Retail loan growth slowed down while institutional loan growth picked up speed. As of the end of 2016, outstanding retail loans in the UK increased by 4.1% over the same period of last year to GBP1,312.93 billion. Outstanding loans of financial institutions and non-financial institutions combined to GBP1,155.51 billion, up 8.1% year on year. Earnings showed improvement but operating efficiency decreased slightly. In 2016, the UK banking industry reported an ROA at 0.2%, at par with that in 2015, an ROE at 2.8%, down 0.4 percentage points over a year earlier and cost-to-income ratio at 63.5%, down 3.7 percentage points on a year earlier.

The operating environment will undergo a series of changes. First, the Prudential Regulation Committee (PRC) will take over the regulation and supervision of financial stability in the UK from March 1, 2017 onwards. For the UK banking industry, this shift may signify an end of the major adjustments made to the UK’s financial regulatory system in the wake of the financial crisis. In the future, the regulatory environment in which the UK banks run business will remain stable, being conducive to further resuscitation of the local banking industry. Second, the Financial Conduct Authority (FCA) has recently proposed stricter rules for firms selling “contract for difference” (CFD) products to retail customers to improve standards across the sector and ensure consumers are appropriately protected. The new measures include: introducing standardized risk warnings and mandatory disclosure of profit-loss ratios on client accounts by all providers to better illustrate the risks and historical performance of these products; and setting lower leverage limits for inexperienced retail clients who do not have 12 months or more experience of active trading in CFDs. Since banks in the UK usually do not participate in CFD trading directly, the said new rules will have a limited impact on the local banking industry. Besides, to grow the UK into the world’s leading FinTech Hub, FCA has actively carried out a series of innovations and reforms in the regulatory model which include the Regulatory Sandbox implemented since 2015. Sandbox testing is recognized by the financial regulators in Singapore, Australia, Hong Kong of China and Japan and has been adopted by them to varied degrees. On the whole, the UK regulators are supporting the expansion of financial customer base and the positive attitude is favorable for the UK banking industry to remain a global leader in this sector.

We expect an overall improvement in the operation of UK banking industry in 2017 with total assets

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3 A regulatory sandbox allows banks to test innovative products, services and business models.
remaining basically stable, net profits hitting GBP38 billion and NPL ratio staying at 3%.

I.4 Profitability of Japanese banking industry met challenges

**Business results fell sharply.** Deposit amount of major banks grew relatively fast while loans of regional banks sized up relatively fast. As of the end of 2016, deposit balance of Japanese banks totaled JPY666.2 trillion, up 4.3% from a year earlier; their loan balance was JPY509.6 trillion in aggregate, up 2.6% from a year earlier. Profitability was weakened significantly and asset quality had slight improvement. As of the end of 2016, top three banks in Japan\(^4\) generated net profits of JPY1.8 trillion cumulatively, a year-on-year decrease of 8.2%; and their NPL ratio averaged to 1.2%, a year-on-year decrease of 0.02 percentage points.

**The operating environment was challenging.** At the monetary policy meeting held in January, the Bank of Japan decided upon the following: still apply a negative interest rate of minus 0.1 percent, purchase Japanese government bonds (JGBs) at more or less the current pace -- an annual pace of increase in the amount outstanding of its JGB holdings of about 80 trillion yen so that 10-year JGB yields will remain at around zero percent and extend the purchase program by one year.

As the monetary policy of “negative interest rate” continues, it is still hard for banks to develop their interest margin business. On December 28, 2016, the Financial Services Agency proposed the draft amendments to the “Order for Enforcement of the Banking Act”, pertaining to the enforcement of the “Act for Partial Revision of the Banking Act” which was published in May of the year, mainly involving the heightened management of financial group holding companies over groups, strengthening of financial intermediaries through intensifying connected and repetitive business inside the groups and improvement of capabilities to deal with technical revolutions such as IT and virtual currency. Following the official implementation of the “Order for Enforcement of the Banking Act”, bank subsidiaries will choose not to establish the risk management and internal audit departments on the premise of strengthening groups’ overall control, back-office business including customer service centers separately run by the subsidiaries as well as development/maintenance of general systems, marketing and asset use, etc. will possibly be put under intensive operation, which is good to the saving of operating cost; subject to the approval of FSA, the regulation over financial enterprises’ investment in related IT firms will also be relaxed; enterprises doing the exchange of virtual currencies and legal tenders will be under registration management and their development will be guided so as to realize well-regulation of the market.

In 2017, Japanese banks will face great operating pressure in the overall context of continued “negative interest rate” policy. We expect another 5% increase in total assets, -5% in net profits and decrease in NPL ratio of Japanese banking industry over the year. Average NPL ratio of top five banks will possibly decline to less than 1% while that of regional banks is expected to fall to around 1.8%.

I.5 Profitability of banks in major member countries of ASEAN\(^5\) was challenged

**Operating results continued to be weak.** In 2016, Indonesian banking industry reported a year-on-year increase of merely 1.8% in net profits, less than that in 2014; Malaysian banking industry managed to turn out a year-on-year growth of 2.5% in net profits after a decline for two years in a row; the year-on-year increase of 3.6% in net profits of Thailand’s banking industry still lagged behind that of 2014 by 7 percentage points. NPL ratio rose significantly. In 2016, NPL ratio of Indonesian banking industry jumped from 2.49% in 2015 to 2.93% while that of Thailand’s banking

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\(^4\) The top three banks refer to Bank of Tokyo-Mitsubishi UFJ Ltd., Mizuho Financial Group, Inc. and Sumitomo Mitsui Financial Group.

\(^5\) Mainly refer to Indonesia, Malaysia and Thailand.
industry grew from 2.55% in 2015 to 2.83%; Malaysian banking industry managed to maintain relative stability of its asset quality with NPL ratio edging up from 1.58% in 2015 to 1.59%.

Operating environment changed little. In view that the exchange rates of currencies in Southeast Asia, especially Malaysian ringgit, were still under stress, none of the major central banks in ASEAN changed the benchmark interest rate in 2017Q1. Without any obvious change in overall interest rate environment of banks, the influence upon interest margin business remained basically stable. The requirements of Basel III will gradually become binding upon the banks in ASEAN in 2017, so the regulatory requirements are increasingly stricter, causing banks’ compliance cost to rise, but this is conducive to protecting the stability of financial system and boosting the confidence of investors. At the same time, new types of financial operation will be encouraged as a supplement to the banking system. In February 2017, the Financial Services Authority of Indonesia published an announcement that it was making a legislation over the supervision of FinTech firms in the P2P lending sector to permit them to grant loans to customers directly. To address the obviously higher loan interest rate, the Indonesian regulator circulated a letter in 2016, informally requiring to cut the rate below 10% in order to stimulate economy. This Moral Suasion would not exert any big substantial influence because Indonesian banks had to bear great operating pressure and give foremost attention to the control of NPL ratio.

We expect that the ASEAN banking industry will operate in a largely stable environment throughout 2017 as compared with that in 2016 but there will not be too many highlights. Growth rate of assets will remain stable. Indonesian banking industry is likely to welcome another high growth rate of loans at about 9%, the figure for Malaysian banking industry will decline slightly to about 5% and the year-on-year growth rate of Thailand banking loans is expected at merely 5% or so. However, it is hard for the growth rate of net profits to achieve a breakthrough. In view of the possibility that the cap on deposit interest rates will be removed, NIM of Indonesian banking industry is under stress and net profits are expected to grow by merely 2% around. Malaysian banking industry, with a higher cost of funds, is expected to report a 2% growth rate of net profits. As the asset quality problem is serious, Thailand’s banking industry has to set aside additional allowance and its net profits are expected to grow slower at about 3%. It is difficult for NPL ratio to be notably improved. Modest economic growth will not bring a substantial improvement in the NPL ratio of ASEAN banking industry in 2017. Specifically, it is very possible for NPL ratio of Indonesian banking industry to stay at a high rate of 3% around while that of Malaysian banking industry will steady at 1.6% around and the Thailand figure is to be about 2.8%.

I.6 Major African countries\textsuperscript{6} reported fast development of banking industry but relatively high NPL ratio

There was a clear division in the business results. In 2016, the four major banks in South Africa registered a year-on-year increase of 2.1% in net profits and a decrease of 0.54 and 0.01 percentage points in ROC and ROA respectively; the four biggest Egyptian banks scored a year-on-year increase of 65.49% in net profits and a rise of 7.41 and 0.35 percentage points in ROC and ROA respectively; top four banks in Nigeria witnessed a year-on-year growth of 11.59% in net profits and a drop of 0.7 and 0.14 percentage points in ROC and ROA respectively. Overall asset quality was improved. In 2016, NPL ratio of the four major banks in South Africa decreased by 0.2 percentage points to 3.25%; NPL ratio of the four biggest Egyptian banks dropped by 1.56 percentage points to 3.15%; top four banks in Nigeria were greatly different in terms of asset quality: Zenith Bank and United Bank for Africa had an NPL ratio of only 3.0% and 2.5% respectively, in sharp contrast with that of First Bank.

\textsuperscript{6} Mainly refer to South Africa, Egypt and Nigeria.
of Nigeria at 18.1%.

**There was a large difference in the operating environment of African countries.** The difference in the real economy determines that the business operation of banking industry is different across the African countries. Due to the globe’s weak demand for and low price of minerals and the serious drought, GDP of South Africa grew merely 0.3% in 2016, the lowest since 2009. Consequently, the country’s banking industry grew slowly in the year. Egyptian banking industry developed fast mainly benefiting from the large business space brought by the gigantic investments in a series of construction projects such as the Suez Canal Economic Corridor, the country’s new administrative and commercial capital, the network of high railway roads and the tourism projects under the Egypt Renaissance Program released in June 2014. Low oil price and other factors got down the GDP of Nigeria by 1.7% year on year, but the inflation rate soared to 15.4%, so profitability and asset quality of the country’s banking industry were under great strain in spite of a rapid expansion in scale.

According to our expectation, the operating performance of African banks will remain different throughout 2017. South Africa’s banking industry will operate healthily overall, but the change in sovereign credit ratings will possibly deal a great blow; there are uncertainties on the fast growth track of Egyptian banking industry; Nigerian banking industry will at great risks.

**I.7 Brazilian banking industry is under great stress to improve its asset quality**

**Profitability declined severely but NPL ratio continued to rise.** In 2016, Brazilian banking industry realized total profits of BRL113.1 billion, a year-on-year decline of 23%. Specifically, net profits of the biggest five banks fell by 18.8% year on year; performance decline or loss-making was common to see among the 45 small and medium-sized banks with 20 of them reporting a loss netting to BRL500 million. As of the end of 2016, NPL ratio of Brazilian banking industry registered an 18-month growth to 3.7%.

**The operating environment was worsening.** On the one hand, the economic recession in Brazil had an impact on the operation of the country’s banks. In 2016, GDP went down 3.6%, bankrupt enterprises numbered 7% higher than a year earlier and unemployment rate hit 11%. In this context, banks were greatly challenged when they intended to expand scale, improve earnings and perform risk management. On the other hand, the Banco Central do Brasil, Brazil’s central bank, announced to cut interest rates, the first time in the past four years. The downward market rates imposed big pressure upon the interest margin increase of Brazilian banks. In the meanwhile, there were heightened regulatory requirements on the architectures of enterprise risk management and capital management. The National Monetary Council (NMC) under the Banco Central do Brasil made No. 4.557 Resolution on February 23, 2017, raising new requirements on the architectures of enterprise risk management and capital management of financial institutions, including the appointment of full-time Chief Risk Officers. As per the resolution, financial institutions are classified into S1 through S5 by capital/GDP, indicating the size from big to small. The bigger the size is, the more complicated the risk and capital management architectures will be and the stricter the governing regulations and requirements are, aimed at effectively warding off the systematic risk brought by big banks.

We expect that the operation of Brazilian banking industry will become better in 2017 while the credit growth will stop slowing down but nudge up 1-4%, back to the level before 2015. With an expected stable profitability, net profits of Brazilian banks will be kept basically the same with that of last year at around BRL110 billion in 2017. However, with the asset quality problem ongoing, Brazilian banking industry is expected to see a further rise in NPL ratio to about 3.9% in 2017.

**I.8 NPL ratio of Australian banking industry is low but under upward pressure**
Profitability declined, both NPL amount and ratio increased, the first time since 2011. In 2016, albeit an increase of 2.52% in net interest income, non-interest income of Australian banking industry slumped by 15.74%, allowance cost rose by 19.51%, pre-tax profits declined by 3.23% and ROE fell by 3.9 percentage points to 10.1%, all measured on a year-on-year basis. Ratio and amount of NPLs both increased for the first time following a five-year decrease due to the continued shrinkage of mining industry and the cooler real estate market in the regions closely related to mining industry. As of the end of 2016, Australian banking industry reported an NPL balance of about AUD15.2 billion and an NPL ratio of about 0.50%, representing a year-on-year growth of 11.73% and 0.03 percentage points respectively.

The regulatory environment became increasingly stricter while the market rate stayed unchanged. Regulatory authorities heightened the supervision of housing loan extension to secure the prudential operation of banks, and they also reinforced the supervision of anti-money laundering to urge banks to improve their conducts. To further help banks review own AML/CTF practice, the Australian Transaction Reports and Analysis Center (AUSTRAC) released the Insights from Compliance Assessments report to introduce banks’ good business practices and areas for improvement in March 2017. AUSTRAC is going to strengthen interaction with banks in 2017 so that the communication will become more transparent. The Reserve Bank of Australia (RBA), the country’s central bank, kept market rate the same, providing a stable interest margin environment for banks. Following two interest cuts in 2016, the RBA decided to un-change the benchmark interest rate (1.5%, a historic low) in 2017Q1 by taking the positive influence of current low interest/exchange rate on national economy, the stimulation of interest cut to real estate market and the negative influence of inflation into consideration, so it would not affect banks’ interest margin business much.

We expect that the operation of Australian banking industry will face great pressure throughout 2017, reporting a size basically the same with that of 2016, further rise of regulatory cost, downward profitability, relative concentration of NPAs and stable asset quality.
II. China’s Banking Industry Review and Outlook

II.1 Operation of the Banking Industry in 2016

1. Both assets and liabilities maintained a double-digit growth

As of the end of 2016, the assets and liabilities of commercial banks registered RMB181.7 trillion and RMB168.6 trillion respectively, up 16.6% and 16.9% year on year. The assets and liabilities of large commercial banks were RMB86.6 trillion and RMB79.9 trillion respectively, up 10.8% and 11.0% year on year. The assets and liabilities of joint-stock commercial banks were RMB43.5 trillion and RMB40.8 trillion respectively, up 17.5% and 17.7% year on year. As of the end of 2016, the assets and liabilities of listed banks\(^7\) were estimated at RMB131.3 trillion and RMB121.2 trillion respectively, up 12.0% and 12.5% year on year.

2. Growth of net profits picked up, but profitability kept weakening

As of the end of 2016, commercial banks reported net profits of RMB1.6 trillion cumulatively, up 3.5% year on year. As estimated, listed banks saw their net profit growth rate roughly at 3.0% throughout the year.

**Figure 1: YoY Growth of Net Profits**

![Figure 1: YoY Growth of Net Profits](image1)

In 2016, the ROA and ROE\(^8\) of commercial banks stood at 0.98% and 13.38%, down 0.1 and 1.6 percentage points from 2015 respectively. For large commercial banks, the ROA was 1.07%, down 0.1 percentage points over 2015. For joint-stock banks, the ROA was 0.88%, down 0.1 percentage points over 2015. The ROA and ROE of listed banks in 2016 were estimated at 1.03% and 15.41%, down 0.04 and 0.6 percentage points over 2015 respectively. In 2016, the cost/income ratio of commercial banks was 31.11%, up 0.5 percentage points over 2015. The ratio of listed banks in the same year was estimated at 27.92%, down 0.3 percentage points over 2015.

\(^7\) There are 25 A-share listed commercial banks in China. Yet, to maintain the consistency of analysis, 16 commercial banks listed in the domestic A share market are selected as samples, including large commercial banks (ICBC, ABC, BOC, CCB and BOCOM), joint-stock commercial banks (Merchants Bank, SPDB, Minsheng Bank, CITIC Bank, Industrial Bank, Everbright Bank, Huaxia Bank and Ping An Bank) and city commercial banks (Bank of Beijing, Bank of Nanjing and Bank of Ningbo).

\(^8\) The ROA, ROE, cost/income ratio, CAR, tier 1 CAR, core tier 1 CAR and loan-to-deposit ratio are arithmetic average; the non-interest income contribution, NPL ratio and allowance-to-NPL ratio are weighted average.
3. The percentage of deposits and loans dropped while the contribution of non-interest income kept increasing

As of the end of 2016, the deposit balance of commercial banks represented 76.3% of the total liabilities while the loan balance represented 47.8% of the total assets, down 2.4 and 1.1 percentage points respectively over 2015. The two indicators of listed banks were estimated at 73.0% and 51.5% respectively, down 1.1 percentage points and up 0.4 percentage points from a year earlier. In 2016, the non-interest income of commercial banks accounted for 23.8%, up 0.1 percentage points from a year earlier. The ratio of listed banks was estimated at 30.5%, up 4.4 percentage points from a year earlier.

4. Growth of NPL amount and ratio slowed down while the allowance-to-NPL ratio tended to stabilize despite a slight drop

As of the end of 2016, the outstanding NPLs of commercial banks posted RMB1.5 trillion, up 18.7% from a year earlier, representing a deceleration of 32.6 percentage points compared with the end of 2015; the NPL ratio was 1.74%, up 0.1 percentage points over the end of 2015. For large commercial banks, the outstanding NPLs stood at RMB776.1 billion, up 10.8% from a year earlier, 0.4 percentage points lower than the growth of 2015; the NPL ratio was 1.68%, up 0.02 percentage points over the end of 2015. For joint-stock banks, the outstanding NPLs registered RMB340.7 billion, up 34.3% from a year earlier, 22.2 percentage points lower than the growth of 2015; the NPL ratio was 1.74%, up 0.2 percentage points over the end of 2015. As of the end of 2016, the outstanding NPLs of listed banks were estimated at RMB1.2 trillion, up 20.1% from a year earlier, 28.7 percentage points lower than the growth of last year; the NPL ratio was 1.70%, up 0.1 percentage points over the end of 2015.

Figure 2: NPL Ratio

As of the end of 2016, the allowance-to-NPL ratio of commercial banks stood at 176.4%, down 4.8 percentage points over the end of 2015. The ratio of large commercial banks and joint-stock commercial banks reported 162.6% and 170.4% respectively, down 9.1 and 10.6 percentage points over the end of 2015. As of the end of 2016, the allowance-to-NPL ratio of listed banks was estimated at 160.0%, down 9.2 percentage points over the end of 2015.
5. CAR remained stable while the loan-to-deposit ratio continued to rise

As of the end of 2016, the CAR, tier 1 CAR, and core tier 1 CAR of commercial banks stood at 13.3%, 11.3% and 10.8% respectively, down 0.2, 0.1 and 0.2 percentage points from the previous year. The CAR of large commercial banks and joint-stock banks was 14.2% and 11.6%, down 0.3 percentage points and up 0.02 percentage points over 2015 respectively. As of the end of 2016, CAR of listed banks was estimated at about 13.0%, up 0.2 percentage points over 2015. As of the end of 2016, the loan-to-deposit ratio of commercial banks was recorded at 67.6%, up 0.4 percentage points over the end of 2015. As of the end of 2016, the ratio of listed banks was estimated at 75.5%, up 1.1 percentage points over the previous year.

II. 2 Outlook on the operating performance of banking industry in 2017

II.2.1 Business environment of banking industry in Q1

Since the beginning of 2017, China’s banking industry has delivered a stable performance as a whole. The previous NPL risks have been effectively mitigated and asset quality showed signs of marginal improvement. Affected by monetary policy and operations of the central bank, market rates have kept increasing, which likely to help curb the trend of shrinking NIM in 2016. Meanwhile, the stricter regulatory requirements on banking book and asset management will promote compliant business development and healthy operation of the banking industry. Specifically, the following three factors have significantly influenced the operating performance of the banking industry:

The first is stable economic development. In 2017Q1, China witnessed stable economic development overall. As of the end of February 2017, completed investments in fixed assets increased by 8.9% year on year; the total retail sales of consumer goods grew by 9.5% year on year; cumulative imports and exports rose by 13.3% year on year. The GDP was expected to grow at about 7% in 2017Q1. Staged progress was made to cut overcapacity, reduce excess inventory, de-leverage, lower costs, and strengthen areas of weakness. The PPI rose and profitability and solvency of industrial enterprises improved. PBC survey showed that the Business Confidence Index stood at 61.5%, up 17.8 percentage points over 2016Q1. All these combined to reflect gradual recovery of credit demand from the real economy.

The second is tighter monetary policies. Since the beginning of 2017, under the ongoing influence of Fed interest hike and the expectation on it, the exchange rate of RMB against USD has been facing great downward pressure. At the end of January 2017, PBC raised the interest rates for reverse repos and standing lending facility (SLF), leading to increasingly higher average interest rates. In addition, PBC made the yield curve flatter by “reducing short-term liquidity while releasing long-term liquidity”, which effectively restrained maturity mismatch risks in inter-bank fund management. In 2017, PBC’s monetary policy should be largely stable and moderately tighter. Both M2 and total financing size are targeted to grow by 12% in 2017, lower than the actual growth in 2016. Meanwhile, PBC is unlikely to cut the benchmark deposit & loan rates and the reserve requirement ratio (RRR). The rising short-term interest rate in the money market will gradually transmit to long-term interest rate as well as the bond and credit market.

The last one is stricter regulatory requirements. Since the beginning of 2017, to address problems in asset management and inter-bank business, PBC, CBRC, CSRC and CIRC have introduced a series of regulatory policies. Currently, PBC is preparing to release the Guidelines on Regulating Asset Management Business of Financial Institutions, aiming to break the “rigid repayment” mechanism for asset management business, limit the leverage ratio, prohibit cash pool manipulation and strengthen requirements on capital constraint and risk reserve provisioning, which will play a positive role in lowering financial leverage and controlling systemic financial risks. In addition, PBC
made greater efforts to carry out the Macro Prudential Assessment (“MPA”) and reduced tolerance for banks failing to meet CAR requirement, helping curb the rapid growth of banking leverage. At the same time, MPA has incorporated off-balance sheet wealth management business into general credit assessment, constraining the expansion of banks’ off-balance sheet wealth management business.

In conclusion, we expect the net profits, assets and liabilities of listed banks in 2017Q1 to grow by about 4.0%, 12.0% and 12.5% over 2016Q1 respectively while NPL ratio to remain stable, with a slight decrease to 1.68% or so.

2. Operating Outlook

In the 2017 Government Work Report, Chinese government reiterated the importance of cutting overcapacity, reducing excess inventory, de-leveraging, lowering costs, and strengthening areas of weakness. We should enhance financial institutions’ capability in serving the real economy, initiative propel opening up, vigorously develop green finance, steadily advance financial regulation reform and orderly resolve and dispose of accidental risks. After promoted to the new position, CBRC Chairman Guo Shuqing repeatedly requested to dispose of NPLs in a market-oriented way according to law, impose differentiated real estate financial regulation policies, enhance services of financial institutions, fight against illegal fundraising and regulate the development of private banks. Chinese banking industry faces new challenges and opportunities in 2017.

First, financial “de-leveraging” will be further advanced. In October 2016, the State Council released the Guidelines on Market-based Debt-for-Equity Swap of Banks. The large banks have invested to found asset management companies specializing in debt-for-equity business. Therefore, market-based debt-for-equity swap is expected to accelerate in 2017. Six banks issued 14 tranches of NPA-backed securities products in total, summing up to RMB15.61 billion in 2016. The number and amount of NPA-backed securities products are likely to grow rapidly in 2017. PBC is preparing to release the Guidelines on Regulating Asset Management Business of Financial Institutions, which will play a positive role in regulating the development of asset management business and controlling systemic financial risks. In addition, PBC made greater efforts to carry out the MPA, incorporated off-balance sheet wealth management business into general credit assessment and reduced tolerance for banks failing to meet CAR requirement. Amidst continuous advancement of financial “de-leveraging”, it is expected that asset quality of commercial banks will improve, maturity mismatch pressure on the inter-bank market be mitigated and inter-bank leverage tend to decline.

Second, NPL ratio is likely to stabilize with a slight drop. In 2016Q4, the NPL ratio of commercial banks stood at 1.74%, 0.02 percentage points lower than the previous quarter, ending the persistent increase over 19 quarters in a row. The potential NPL ratio, which is calculated based on the times interest earned (below 1 or not), change of NPL ratio and special-mention loan ratio as well as degree of deviation between the share price and earnings per share of listed banks, indicates that the accumulative NPAs of China’s banking industry have been significantly reduced, with NPL ratio showing signs of marginal improvement. In 2017, NPL ratio is highly likely to stabilize, even to drop, if the real economy maintains steady growth.

Third, credit allocations will be changed. In 2017, aligned with adjustments to national industrial and regulatory policies, credit allocations of banks will be changed: growth of residential mortgages will slow down to some extent due to stricter regulatory requirements; more corporate loans will be channeled to infrastructure and mid and high-end manufacturing, with transportation, electricity, construction of city agglomeration and urbanization and new agriculture as the priorities in 2017. Compared with 2016, corporate loans will grow steadily in 2017 while consumer loans, micro and
small-sized enterprise loans and agriculture-related loans will witness rapid growth underpinned by national industrial policies.

**Fourth, shrinking of NIM will slow down.** In 2016, NIM of commercial banks dropped by 26 basis points, which adversely affected profitability of Chinese banks that primarily rely on deposits and loans. In 2017, against the tightening of monetary policies, commercial banks will benefit from rising average interest rates. Higher interest rates in the money market will transmit to the bond market and lending market, thus helping banks improve their NIM. For banks with less presence in the inter-bank market and relatively balanced off-balance sheet business (mostly large banks), the improvement of NIM will be more meaningful.

**Fifth, pension finance, green finance and inclusive finance will embrace growth opportunities.** In 2017, potential expansion of basic endowment insurance, occupational annuity payment and the planned tax deferred pension will provide new upside for commercial banks in the field of pension finance. Besides, with gradual adoption of measures to support green finance development, the size of green bonds is likely to grow fast and the green loan mechanism of commercial banks will be improved step by step. In addition, in terms of inclusive finance, large commercial banks are likely to launch inclusive finance division reform, to better implement the national policy of financial poverty alleviation.

**Sixth, highly internationalized banks will benefit from USD appreciation.** The Fed is expected to launch 2-3 rate hikes in 2017, resulting in greater possibility of a stronger US dollar. As most of the foreign-currency assets held by China’s large banks are denominated in USD or HKD that is pegged to USD, highly internationalized banks will benefit from USD appreciation as a whole and obtain exchange gains. With the accelerated advancement of the national “Belt and Road” initiative, we expect large Chinese banks to enhance internationalization and steadily increase presence in countries along the “Belt and Road”.

### 3. Forecast of key operating indicators

**Table 1: Forecast of Key Indicators of China’s Listed Banks in 2017 (%)**

<table>
<thead>
<tr>
<th>Type</th>
<th>Key indicator</th>
<th>2014 (R)</th>
<th>2015 (R)</th>
<th>2016 (E)</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Q1 (E)</td>
</tr>
<tr>
<td>Size</td>
<td>Asset growth</td>
<td>11.2</td>
<td>12.4</td>
<td>12.0</td>
<td>12.0</td>
</tr>
<tr>
<td></td>
<td>Liability growth</td>
<td>10.6</td>
<td>12.0</td>
<td>12.5</td>
<td>12.5</td>
</tr>
<tr>
<td>Profits</td>
<td>Net profit growth</td>
<td>7.8</td>
<td>1.9</td>
<td>3.0</td>
<td>4.0</td>
</tr>
<tr>
<td></td>
<td>Proportion of loans</td>
<td>52.0</td>
<td>51.1</td>
<td>51.5</td>
<td>52.5</td>
</tr>
<tr>
<td>Structure</td>
<td>Proportion of deposits</td>
<td>77.0</td>
<td>74.1</td>
<td>73.0</td>
<td>73.5</td>
</tr>
<tr>
<td></td>
<td>Contribution of non-interest income</td>
<td>24.3</td>
<td>26.1</td>
<td>30.5</td>
<td>29.5</td>
</tr>
<tr>
<td>Quality</td>
<td>NPL ratio</td>
<td>1.21</td>
<td>1.64</td>
<td>1.70</td>
<td>1.68</td>
</tr>
<tr>
<td></td>
<td>Allowance-to-NPL ratio</td>
<td>233.0</td>
<td>169.2</td>
<td>160.0</td>
<td>161.0</td>
</tr>
<tr>
<td>Capital</td>
<td>CAR</td>
<td>12.6</td>
<td>12.8</td>
<td>13.0</td>
<td>13.0</td>
</tr>
</tbody>
</table>

Note: R: Review; E: Estimation; F: Forecast
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