Global Banking Sector Outlook

2023Q2 (Issue 54) **April 3, 2023**

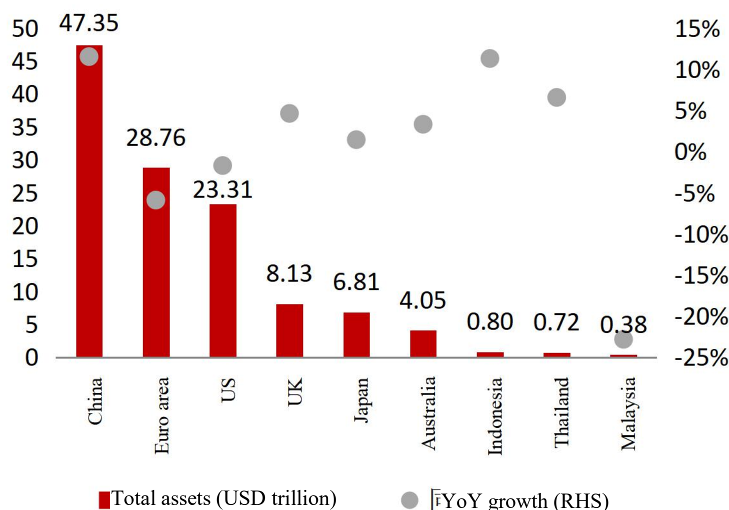
Highlights

●Global economic growth has been under pressure amid persisting uncertainties in 2023 to date. Facing such challenges, the global banking industry has seen an overall contraction and hindered capital replenishment.

● Since 2023 began, China has undergone a notable recovery in economic growth. The Chinese banking industry maintained a fast expansion in an improving environment, showing a solid recovery of profitability and sound asset quality and capital adequacy.

● In the post-epidemic era, the global and Chinese banking environments have changed profoundly. This quarterly report provides a special analysis on the global banking transition and the Chinese banking industry's push for a new development paradigm.

Growth in Banking Assets in Major Economies at the End of 2023Q2 (Estimated)



Sources: BOC Research Institute

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The Banking Sector Pushes for a New Development Paradigm

-- Global Banking Sector Outlook (2023Q2)

The world economy has been facing growth challenges in 2023, seeing a financial turmoil triggered by the continuous and sharp interest rate hikes in major economies. The global banking assets are contracting while banking operations are under mounting pressure, which has dented earnings growth and capital replenishment. By contrast, China's banking environment is improving across the board as the domestic economic recovery is gaining momentum. The fiscal and monetary policies are working effectively. Financial regulators focus on advancing reforms, strengthening weaknesses, promoting development, improving living standards and guarding against risks, navigating solid growth of the financial industry in a sound ecosystem of competition and cooperation. Against such a backdrop, the Chinese banking sector has maintained a fast expansion in an improving environment, showing a solid recovery of profitability and sound asset quality and capital adequacy. Overall, the global and Chinese banking environments have changed profoundly in the post-epidemic era, entailing the push for a new development paradigm.

I. Global Banking Review and Outlook

I.1 Global banking environment under mounting pressure

The world economy is under great pressure, adding to uncertainties in banking operations. In January 2023, the IMF released a report predicting an annual growth of 2.9% for the world economy in 2023, down 0.2 percentage points (pcts) from its October 2022 forecast. The World Bank further lowered its forecast for global growth in 2023 to 1.7%, saying the world economy entered a protracted period of feeble growth. In general, the global supply and value chains are still fragile due to geopolitical and other factors. With global investment and trade losing steam, the downward economic pressure has weakened banking profitability.

The banking sector sees the interest rate risk rising amid continuous rate hikes in major American and European economies. The US Federal Reserve (the Fed), the European Central Bank (ECB) and the Bank of England (BoE) have all raised interest rates twice in 2023 to date, with their policy rates increased by 50 bps, 100 bps and 75 bps respectively. The central banks in Canada, New Zealand and South Korea have also announced small rate hikes in succession. Market interest rates and banks' net interest margin (NIM) are rising as major economies tighten the monetary policy to curb inflation. With the existing debts exposed to the risk of losses from falling prices, however, the relevant interest rate risks have sent some banks in the US and Europe into a crisis.

Financial regulation continues to tighten, driving up the compliance costs of banks. Since the beginning of 2023, countries have intensified supervision over digital technology and traditional banking activities. Review reports, rules and regulations have been issued with respect to decentralized finance (DeFi), cryptocurrency, cybersecurity and capital management, guiding the banking sector to properly cope with fresh uncertainties and boost its ability to prevent, control and resolve risks.

With a burgeoning Fintech ecosystem, the central bank digital currencies (CBDCs) have achieved milestones to empower digital transition of the banking sector. Since 2023 began, central banks have stepped up the CBDC research, development and testing, with breakthroughs made in Japan, Iran, Saudi Arabia and other countries. The artificial intelligence (AI) tools represented by ChatGPT have attracted worldwide attention. Their powerful functions in

information integration and smart dialogue will have a disruptive impact on remote advisory service, consumer education and intelligent customer service in the financial industry. In addition, regulators and large banks are exploring how metaverse, blockchain and other technologies can serve the supervision and innovation of financial products.

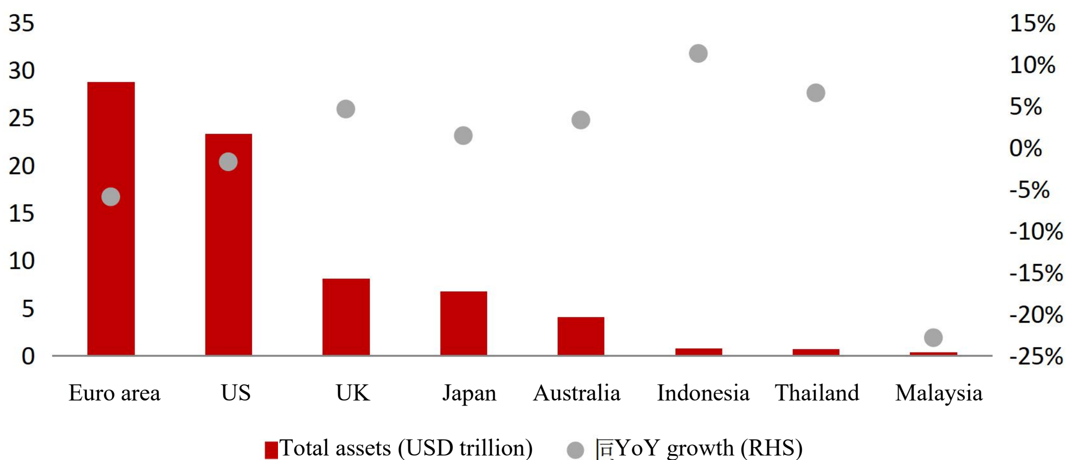
I.2 Global banking activities are dampened

Curbing inflation is an important goal of global monetary policies in the current turbulent geopolitical and geoeconomic landscapes. The tightening of financial conditions has to some extent put a damper on banking activities. The global banking sector has shifted from slower expansion to moderate contraction. The scale change has offset part of the profit-boosting effect brought by the widening NIM and asset management services, and to some extent encouraged banks to focus more on high-quality assets and improve asset quality. However, the shaky capital markets across the world frustrated banks' capital replenishment attempts.

1. Assets are shifting from expansion to contraction

In 2022, global inflation reached its highest level since 1996. The tightening monetary policy adopted by central banks in major economies dampened financial demand and further slowed the expansion of banking assets. On the one hand, aggressive rate hikes quickly push up borrowing costs, leading to weakened customer demand for financing and slowing growth in bank loans. On the other hand, rising market rates lead to a sharp decline in bank asset valuations. The world remains turbulent in 2023. With the impact of monetary tightening in advanced economies still lingering there, some countries and regions may slip into a mild recession. The expansion of global banking assets will remain under pressure. By the end of 2023Q2, banking assets in the US and the euro area are expected to shrink by 1.7% and 5.9%, respectively, year-on-year. The UK, Japan and Australia will also see a sharp slowdown in the growth of banking assets, with year-on-year growth falling to 4.6%, 1.4% and 3.3% respectively (Figure 1). Emerging economies see their growth in banking assets less affected. Through the year, the banking sector in most economies is expected to maintain a prudent stance to rein in the expansion of assets.

Figure 1: Banking Assets[1] in Selected Economies and Their YoY Growth in 2023Q2 (Estimated)



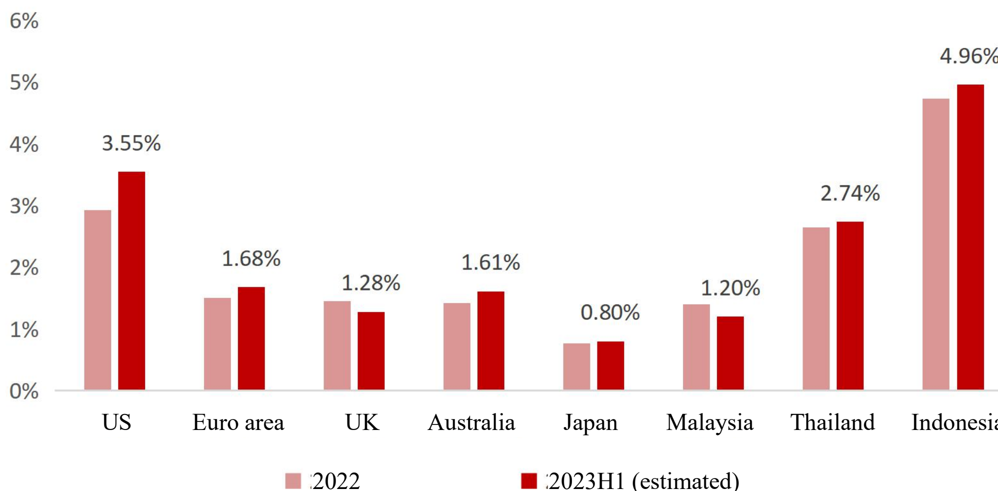
[1] European data cover 36 major banks. The UK data cover five major banks, namely HSBC Holdings, National Westminster Bank, Lloyds Bank, Standard Chartered Bank and Barclays Bank. The big five contribute about 70% of the UK's total banking assets. Japan's banking data cover three major financial groups, namely Mitsubishi UFJ, Sumitomo Mitsui and Mizuho Financial Group, which contributed about 60% of Japan's total banking assets. The same applies below.

Sources: Central banks and regulatory authorities, financial statements of banks, BOC Research Institute

2. Profitability has recovered somewhat

The global banking sector generally registered weak earnings in 2022. It will be difficult for most major economies to change the monetary policy in 2023. NIM is expected to remain high in the banking sector, coupled by wealth management and asset management services to bolster a recovery of banking profitability. NIM in the US banking sector will further rise to more than 3%, with net profit expected to grow by over 10% from a low comparison base. The euro area, Australia and Japan are estimated to see their banking NIM rise to 1.68%, 1.61% and 0.80%, respectively, as a driver of net profit growth. The UK's five biggest banks are likely to register a shrinking NIM due to lower mortgage rates in the domestic market, denting the earnings expectations. Emerging economies such as Malaysia, Thailand and Indonesia may experience small NIM fluctuations due to their different pace of monetary policy (Figure 2). In the year 2023, the global banking NIM will remain stable with steady growth in earnings.

Figure 2: Banking NIM in Selected Economies

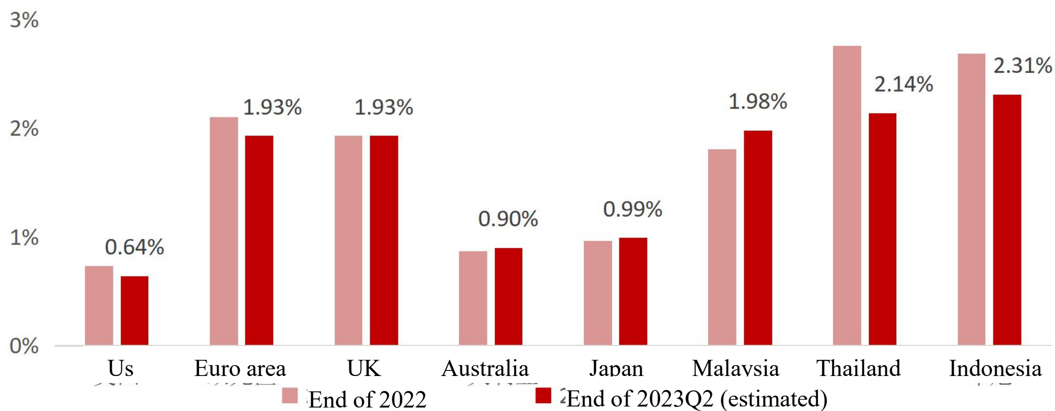


Sources: Central banks and regulatory authorities, financial statements of banks, BOC Research Institute

3. Asset quality is relatively manageable

In 2022, the banking sector in major economies generally set aside additional bad debt allowances to tackle the risk of recession, helping ensure stable asset quality and reduce the balance and ratio of non-performing loans (NPLs) at a steady pace. The banking sector will focus more on higher-quality assets in 2023 as banking assets are scaling back and continue to increase loan loss provisions, keeping the asset quality relatively stable. By the end of Q2, the US banking sector is expected to record a further decline in NPL ratio to 0.64%. Japan and Australia will see the NPL ratio reach 0.99% and 0.90%, respectively, a slight year-on-year increase. The euro area will see the NPL ratio fall below 2% amid a continued recovery of asset quality, roughly flat with that of the UK. Emerging economies in Southeast Asia will maintain a positive trend in the banking asset quality, with the NPL ratio in Thailand and Indonesia estimated to fall to 2.14% and 2.31%, respectively (Figure 3).

Figure 3: Banking NPL Ratio in Selected Economies

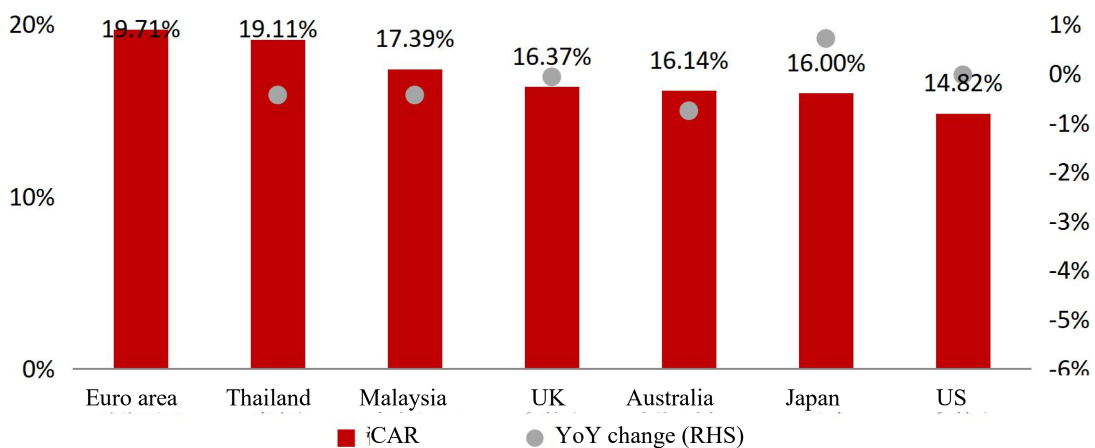


Sources: Central banks and regulatory authorities, financial statements of banks, BOC Research Institute

4. The capital base is weakening.

The year 2022 witnessed a falling capital adequacy ratio (CARs) and weaker ability to cover risk exposures in the global banking sector. In 2023, Silicon Valley Bank, Credit Suisse and some other banks fell into crisis, sending ripples across global capital markets and further hampering banks' capital replenishment ability. By the end of Q2, the US banking CAR may fall to 14.82%. The CAR of Australian and British banks is expected to drop to 16.14% and 16.37% respectively. Thailand and Malaysia may see their banking CAR slip to 19.11% and 17.39%, respectively (Figure 4). Many central banks have called for strict implementation of international standards for banking capital management, posing challenges to capital adequacy in the global banking sector.

Figure 4: Banking CAR in Selected Economies at the End of 2023Q2 (Estimated)



Sources: Central banks and regulatory authorities, financial statements of banks, BOC Research Institute

II. China's Banking Review and Outlook

II.1 The banking environment keeps improving amid solid economic recovery

China's COVID-19 policy has been optimized with notable recovery in the national economy in 2023, providing a favorable environment for the sound operation and steady expansion of the domestic banking sector.

First, the increasingly stronger internal drivers of China's economy cement the foundation for the banking sector to scale up and serve the real economy. The national economy will show a more evident recovery trend in 2023. Consumption will continue to recover as an economic growth driver, creating broad space for banks' consumer finance business. Investment will remain a stable engine for economic growth. The investment in manufacturing is expected to keep growing fast, especially in hotspots such as green manufacturing and high-tech manufacturing. In this context, the banking business is expected to see more opportunities. With imports and exports obviously strained, the banking sector still needs to increase support for cross-border financial services and help boost the stability and quality of cross-border trade.

Second, the fiscal and monetary policies together effectively guide banks to meet the financing needs of the real economy and steadily scale up. China will enhance the intensity and effectiveness of its proactive fiscal policy, improve preferential tax and fee policies, extend and further refine policies on tax and fee cuts, tax rebates, and tax deferrals and see that at the primary level, basic living needs are met, salary payments are ensured, and normal government functioning is maintained. China will do more to implement a prudent monetary policy in a targeted way, give consideration to both the aggregate and the structure and maintain a prudent stance of regulation. Banks are guided to properly control the intensity and pace of lending, further step up the support for key areas and weaker links in the national economy, such as inclusive finance, green development, sci-tech innovation and infrastructure construction.

Third, financial regulators focus on advancing reform, strengthening weaknesses, boosting development, improving living standards and guarding against risks while ensuring steady development of the banking sector. In 2023, financial regulators remain focused on advancing reform, strengthening weaknesses, boosting development, improving living standards and guarding against risks, guide the banking sector toward steady development, enhance the quality and efficiency of financially serving the real economy and forestall systemic financial risks, thereby ensuring financial stability and promote high-quality economic growth.

Fourth, the broader financial industry maintains solid development with a sound ecosphere of competition and cooperation. The financial industry has maintained good momentum, with the total assets of financial institutions growing steadily. By the end of 2022, the total assets of China's financial institutions reached RMB419.64 trillion, up 9.9% year-on-year. The insurance and securities industries advanced steadily, forming a sound ecosystem of competition and cooperation with the banking sector. The operation subsidiaries of banking conglomerates, relying on the capital, talent and channel resources of their groups, have heightened their industry position and contributed more to their groups. For example, ICBC Credit Suisse, CCB Principal Asset Management, China Merchants Fund and BoCom Schroder are among the top 20 companies in the industry.

II.2 China's Banking Outlook

First, China's banking sector is expected to keep scaling up fast. China's commercial banks recorded a year-on-year growth of 10.0% in total assets and 10.4% in total liabilities in 2022, 1.42 pcts and 1.64 pcts faster than a year ago. Large commercial banks continued to play the role of "ballast stone", with the total RMB and foreign-currency assets reaching RMB156.3 trillion, up 12.9% year-on-year, accounting for 41.2% of the industry total. Their total liabilities rose 13.4% year-on-year to RMB143.5 trillion, accounting for 41.2% of the industry total. Since 2023, the balance sheets of commercial banks have expanded steadily amid the economic recovery, expected to maintain a fast growth of more than 11%. Loan expansion will continue to scale up the banking system. Considering the pace of credit supply, the bank lending is expected to begin the year with fast growth that will then moderate through the rest of the year.

Second, the profit level firmed up as the impact of price cuts was offset by volume increases. Commercial banks recorded RMB2.3 trillion in accumulated net profit in 2022, up 5.4% year-on-year, with the growth rate down 7.23 pcts from the previous year. Their return on average equity stood at 9.33%, down 0.31 pcts year-on-year. The slowing growth of profit is mainly attributable to the following factors. First, the good banking profits realized last year heightened the base for comparison. Second, the interest income was under pressure, for PBOC kept guiding banks to lower financing costs for the real economy, and the drop in LPR led to continued shrinking of banking NIM. Third, non-interest income contributed less due to market volatility. In 2023, offsetting price cuts with volume increase will remain the groundwork for keeping bank profits growing steadily. The credit demand will further expand in both household and business sectors amid ongoing economic recovery. The banking NIM decline will likely narrow. As comprehensive operation is making steady progress, non-interest business is expected to pick up. In 2023, commercial banks will further improve the revenue structure, with net profit growth likely to regain 6%.

Third, asset quality kept improving as active steps were taken to address risks and challenges posed by scale-up. Macroeconomic policies maintained the tone of ensuring stable growth in 2022. While actively supporting the recovery of the real economy, the banking sector took a raft of measures to forestall and defuse financial risks. As a result, banking assets have maintained good quality. The balance of NPLs of commercial banks was about RMB3 trillion, up 4.8% year-on-year, down 0.6 pcts year-on-year, and the growth rate narrowed marginally. The NPL ratio further dropped to 1.63%. In 2023, a host of major regulatory measures were launched to cement the foundation for “strong supervision”. Commercial banks are expected to keep their asset quality stable with a mild rise in the balance of NPLs, with the NPL ratio staying low at 1.63%.

Fourth, capital adequacy remains robust, solidifying the cornerstone of scale-up. China’s banking sector stepped up capital replenishment in 2022, with the CAR remaining solid in general. At the end of 2022, commercial banks’ common equity tier 1 (CET1) CAR stood at 10.74%, down 0.04 pcts year-on-year. Tier 1 CAR and CAR were 12.30% and 15.17%, down 0.05 pcts and 0.04 pcts year-on-year, respectively. In 2023, the CBIRC and PBOC jointly issued the *Capital Rules for Commercial Banks (Exposure Draft)* to optimize the measurement methods for risk-weighted assets, which may impact capital adequacy and banking business deployment. Also, with diversified channels of capital replenishment, such as perpetual bonds and Tier 2 capital bonds, commercial banks have had an adequate capital base with stronger resilience against risks.

Table 1: Forecasts on China’s Commercial Banking Development Indicators in 2023

	Indicator	2020	2021	2022	2023H1(E)	2023(E)
Size	Assets (RMB trillion)	265.8	288.6	319.8	338	355
	Liabilities (RMB trillion)	244.5	264.7	294.3	311	327
	Growth of assets, YoY (%)	10.98	8.58	10.8	11.5	11.0
	Growth of liabilities, YoY (%)	11.13	8.26	11.2	11.5	11.0
Profit	Net profit (RMB trillion)	1.94	2.18	2.30	2.37	2.44
	ROA (%)	0.77	0.79	0.76	0.8	0.8
	Net interest margin (%)	2.10	2.08	1.91	1.92	1.92
	Cost/income ratio (%)	31.19	32.08	33.97	33.0	33.0
Risk	NPL ratio (%)	1.84	1.73	1.63	1.63	1.61

Provision coverage ratio (%)	184.5	196.9	205.9	207	200
CAR (%)	14.70	15.13	15.17	15.0	15.2
CET1 CAR (%)	10.72	10.78	10.74	10.5	11.0

Sources: CBIRC, BOC Research Institute

III. Special Research: Business Environment Changes and Banking Transition in Post-pandemic Era

III.1 Global banking transition in the post-pandemic era

With the aim of maintaining steady and sustainable growth independent of economic cycle and creating new growth engines, the global banking sector has embarked on strategic transformation and organizational restructuring to stand out in a highly uncertain market environment.

1. Drivers of global banking transition

First, the business space has been squeezed by setbacks in the real economy. The real economy has weakened significantly under the combined effect of multiple factors across the world, especially in Europe and the US. On the one hand, commercial banks have slowed down in scaling due to subdued credit demand. On the other hand, the weaker willingness to invest has substantially squeezed the business space for consulting, underwriting and financing services relating to investment banking and M&A projects. **Second, customer behaviors have changed, leading to a shift in service channels.** Contactless banking services are mushrooming. Online products and services have changed customer preferences in all respects. Mainstream daily life scenarios and consumer behaviors are highly digitized. There is growing demand for agile, tailored, online and diverse financial services. **Third, financial supervision is enhanced, requiring higher sustainability.** The world's major economies have improved the regulatory framework and measures to enhance sustainable banking by requiring commercial banks to identify, quantify and manage climate-related financial risks, defining the role of bank management in climate risk management and introducing relevant incentives. **Fourth, cost-income mismatch is a prominent problem.** The global economic downturn has strained commercial banks' income streams from principal business. Moreover, inflation has pushed up operating costs, and the scale and growth of non-interest expenses have raised eyebrows. High costs have become a major drag on banking performance.

2. Global banking transition trends

First, balanced operation. In order to create more robust revenues in a highly uncertain market environment, the global banking sector is committed to diversifying the profit channels, and attaching more importance to providing value-added services for customers to cope with the fierce competition. JPMorgan Chase continues to strengthen its asset and wealth management services and improve its product mix. Meanwhile, it focuses on opportunities in emerging markets, actively tapping into retail and inclusive business in Brazil, Africa, India and other countries, and seeking more diversified and balanced income avenues. Itaú Unibanco, the largest bank in Latin America, has diversified into insurance, trust, investment and payment services away from commercial banking. By launching a comprehensive investment platform, the bank provides customers with more comprehensive services and better experience, effectively expanding its sources of income.

Second, digital transition. The global banking sector is investing more in technologies to expand

online business channels, create digital products and services, establish open cooperation platforms and externalize digital capabilities and technologies, so as to empower business development, customer retention and commercial cooperation across the board. Bank of America (BofA) has fully embedded digital technology into all segments. In retail banking, Zelle P2P payments have grown by 50% a year on average. In corporate banking, BofA provides tailored services for government contractors, non-profit organizations, healthcare institutions and customers in other emerging sectors. In capital management, new electronic platforms and E-banking tools have been launched. In global markets, a broad-based trading platform was used to address risks. In addition, digital inclusive finance has become a focus of the global banking sector in the post-pandemic era.

Third, development of sustainable finance. Banks manage financial risks associated with climate change through a forward-looking and strategic approach, while integrating ESG into their business strategies and decisions. Barclays has embedded low carbon and emissions into all its business lines and taken steps to tighten lending criteria for coal power, restrict financing for oil sands exploration and production, and set emission reduction targets for auto manufacturing. Its financing for energy, power, steel and cement industries has been scaled back. Barclays is investing more in emission reduction technologies such as carbon capture to help customers achieve sustainable development and net-zero transition. Banco Santander (Brasil) issued a USD1.4 billion sustainability bond in 2022 to support sustainable development projects. The bank has signed a cooperation agreement with the United Nations Development Programme (UNDP) to promote sustainable development of financial institutions.

Fourth, enhanced cost management. To address elevated costs and expenditure, the global banking sector takes lower cost and higher efficiency as an important goal of strategic transition. A major transition measure is to promote the capital-light business model to control business development costs. Barclays, for example, is allocating less capital to businesses such as equity and debt underwriting and refocusing its investment banking on lower-cost, capital-light activities, such as mergers and acquisitions, fundraising and advisory service. Regional rebalancing by reducing resource allocation to regions with weaker competitiveness are also strategic adjustments being implemented by international banks. For example, Mitsubishi UFJ is increasing its investment in the Asia-Pacific market while reducing its footprint in North America. It leverages on the burgeoning digital economy in Southeast Asia and digitally taps into the regional market in pursuit of long-term returns.

3. Suggestions for China's banking sector

First, resources should be reasonably allocated among business segments. Balanced business development is a cornerstone for sound operation. Banks should expand into new segments based on well-established principal business. They should remain strategically pragmatic and flexible, carefully analyze the trends and temporary factors reshaping the market environment, make timely adjustments to the regional strategy, segment strategy, cost strategy and other strategies while keeping the overall development strategy stable to avoid adverse effects on the brand and reputation. **Second, the capacity of digital development should be enhanced.** The digitalization should gradually extend from the project level to the business level and eventually to core competitiveness, with the digital strategy positioned as a core strength of a bank. Taking best customer experience as a core goal, banks should increase Fintech investment and its percentage of revenue and speed up the technology iteration, business practice and market-based reform of data factors. Centering on core strengths, banks should accelerate the application of digital technologies through appropriate cooperation and investment, diversify the product portfolio, improve the ability to serve core customers and boost the ability to attract long-tail customers. **Third, business opportunities in sustainable development should be seized.** Climate change response should be incorporated in strategic planning, with climate change factors fully factored in own operations and

investment and financing portfolios and the green businesses related to climate change response advanced from the perspective of supervision, decision-making, management, assessment and evaluation, in a bid to increase the proportion of related businesses. Green financial products and services should be aligned with international standards to further expand customer base and market share. **Fourth, business development should be based on enhanced cost control.** Cutting-edge tools such as Fintech should be utilized to reduce the costs of operations and risk controls, strengthen investment banking, asset management and transaction banking services and increase the revenue and profit contribution of capital-light businesses.

III.2 The Government Work Report steers China’s banking sector toward a new development paradigm in 2023

In March 2023, the first session of the 14th National People’s Congress (NPC) adopted by voting resolutions on the Government Work Report (the “Report”), which set out tasks for 2023 and charted the course for development of the banking sector.

1. The strategies are more proactive to support an overall recovery of China’s economy

China’s economy has bright growth prospects. The Report set a target GDP growth of “around 5.0%”, higher than the average growth in 2022 and that in the 2020-2022 period. The target, aligned with the requirement of “doubling the GDP or per-capita income by 2035”, is paving the way for Chinese modernization. In fact, China’s economy has the potential for stronger growth, reserving some room for the GDP objective with the aim of rationalizing the economic structure. Meanwhile, China’s economy still faces growth challenges. The Report notes that “uncertainties in the external environment are on the rise. Global inflation remains high, global economic and trade growth is losing steam, and external attempts to suppress and contain China are escalating”. The global turbulence has continued into 2023 to have a significant impact on the China’s economy, especially exports. It is urgent for the banking sector to take the initiative and work harder in further supporting key areas and weaker links of China’s economy, boosting the expectations of private investment and private enterprises and turning China’s economic potential into real growth.

2. Making a deep penetration into five customer groups to help boost domestic demand

The banking sector will make a deep penetration into the consumer customer group. The Report stresses that “we should give priority to the recovery and expansion of consumption”, underlining the importance of consumption in the national economy. Consumer customers will become a focus area of banking. The banking sector will make a deep penetration into the industrial customer group. The Report calls for “accelerating the modernization of the industrial system”, guiding financial institutions to strength credit support for manufacturing, accelerate the development of manufacturing clusters, especially cluster projects involving strategic emerging industries and innovative enterprises that use special and sophisticated technologies to produce novel and unique products, and upgrade traditional industries toward the medium- and high-end. The banking sector will make a deep penetration into the infrastructure-related customer group. The Report states that “implementation of major projects set out in the 14th Five-Year Plan will be sped up. Urban renewal projects should also be launched”. Investment contributed 50.1% to China’s economic growth in 2022, playing a major part in stabilizing the macro-economy. The banking sector will further tap the credit needs of customers in the infrastructure sector to ensure financing support for investment. The banking sector will make a deep penetration into the inclusive finance and agriculture-related customer group. The Report lays emphasis on “meeting people’s basic living needs and developing social programs” and “stabilizing grain output and advancing rural revitalization”. In the future, banks will further strengthen their services for inclusive finance customers and agriculture-related customers, attaching more attention to the penetration into

agriculture-related scenarios and small and micro businesses eligible for inclusive finance. The banking sector will make a deep penetration into the foreign investor customers. The Report calls for “intensifying efforts to attract and utilize foreign investment”. In the future, the banking sector will further improve the financing environment for foreign investors, strengthen the matchmaking services between foreign investors and Chinese governments, enterprises and institutions at all levels and support foreign investors in extending their producer services toward specialization and the higher end of the value chain.

3. Speeding up the optimization of four product categories, and providing targeted services for key sectors

Green finance products will be optimized at a faster pace. Given the fact that carbon-intensive industries have a large weight in the national economy at present, the Report calls for “continuing the transition to green development”, “with priority on controlling fossil fuel consumption”. Green finance is promising in the future, and green financial products have bright market prospects. Investment banking products will be optimized at a faster pace. The Report states that “scientific and technological policies should aim at building up our country’s strength and self-reliance in science and technology, and enterprises should be encouraged and supported in playing the principal role in innovation”. As high-tech industries are characterized by “high threshold, high risk and high return”, bank products will serve high-tech industries in a more targeted manner in the future and accelerate innovation to accommodate the high-tech development pattern. Supply chain products will be optimized at a faster pace. The Report states that “in adopting industrial policies, we should give consideration to both development and security imperatives” and “take forceful steps to shore up weak links in industrial chains”. In the future, China will strengthen the weaker links of the industrial chain, deeply integrate the innovation chain with the industrial and supply chains. The banking sector will accelerate the innovation of supply chain finance products, tap into the upstream and downstream businesses of core enterprises, effectively meet the financing needs of enterprises in the industrial chain and provide financial support for stabilizing, solidifying, reinforcing and fixing these chains. Digital products will be optimized at a faster pace. The Report states that we should “strive to develop the digital economy”. In the future, banks will rely on modern data tools to transform the operating, service and risk control models with more mature and higher-quality digital products.

4. Risk management has entered a new phase that focuses more on targeted efforts to defuse particular risks

Regulatory reform enhances the risk management ability of banks across the board. To assure the quality and efficiency of financial services and forestall systemic financial risks, the Report calls for deepening reform of the financial system, improving financial regulation and ensuring all those involved assume their full responsibilities. During the NPC and CPPCC annual sessions in 2023, The State Council unveiled the reform plan for financial institutions. China’s financial supervision landscape has ushered in a major shuffle, which is a major move to deepen the financial system reform. With banking supervision becoming more comprehensive, look-through and efficient, the banking sector will usher in a new phase of risk management. The risk culture, risk identification, risk pricing and cross-cyclical risk management will be comprehensively upgraded to consolidate the foundation of sustainable development and enhance core competitiveness. In addition, banks’ efforts to prevent risks should be more targeted. The Report stated that “we should ensure effective risk prevention and mitigation in high-quality, leading real estate enterprises” and “prevent and defuse local government debt risks”.

5. The governance model is further modernized and empowered by technology

The governance mechanism for financial institutions will be further modernized. The Report states that "we should continue with a category-based approach to reform and see that SOEs fulfill both their economic and social responsibilities and that they improve their modern corporate governance with distinctive Chinese features". China's commercial banks still have room for improvements in the governance of shareholders, board of directors, board of supervisors and the management, risk management, internal control and related-party transactions management. In 2023, the banking sector will further emphasize the missions and responsibility of financial institutions, refine the corporate governance mechanism and cement the foundation of sustainable development. Banks will enhance technological empowerment to play an in-depth part in building a digital China. The Report states that "we should accelerate R&D and application of cutting-edge technologies" and "strive to develop the digital economy". The banking sector will involve itself deeply in building a digital China, develop new capabilities of "technology + ecosystem + experience + data", reshape the models of operation and management and create new dimensions of digital transition.

III.3 New Capital Rules: amendments, impact and how to respond

On February 18, 2023, the former CBIRC and PBOC jointly issued the *Capital Rules for Commercial Banks (Exposure Draft)* (hereinafter referred to as "New Capital Rules").

1. Main amendments in the New Capital Rules

First, a differentiated supervision approach is adopted. Commercial banks are classified into three buckets. The largest banks or those with more cross-border exposures fall into the first bucket subject to international rules for capital supervision. The second-bucket banks with smaller assets and cross-border exposures than the first bucket are subject to more simplified rules. The third-bucket banks, with less than RMB10 billion in balance of assets and zero cross-border exposure, are subject to the most simplified capital standards and guided to focus on serving county-level customers and micro and small businesses.

Second, the rules for Pillar 1 risk-weighted assets (RWAs) measurement are optimized. By adding and refining various types of exposures, the sensitivity of risk measurement is improved, and the standardized approach and advanced approach are made more logically consistent. The credit risk weighting approach relaxes the risk weights of local governments and enterprises on the whole, increases the risk weights of banks in general, and loosens or tightens the risk weights of individuals as appropriate. The internal ratings-based (IRB) approach is aligned with international rules, the application of advanced IRB approach is restricted, and the loss given default (LGD) is lowered for exposures to commercial and residential real estate, exposures to accounts receivable and corporate exposures without eligible collateral.

Third, the Pillar 2 supervisory review process is refined. For banks that use the advanced approach to measure RWAs, the floor for RWAs is lowered from 80% to 72.5%. Limits are imposed on dividend ratio depending on the conformity level of banks' reserve capital. The risk assessment requirements for credit, market and operational risks are improved. The assessment standards for the interest rate risk in the banking book (IRRBB), liquidity risk and reputational risk.

Fourth, the Pillar III disclosure standards and scope are refined. A differentiated disclosure system covering all types of risk information is established. First-bucket banks are required to disclose the full set of over 70 reports. Second-bucket banks are required to disclose eight reports on RWAs, capital components, capital adequacy ratio, leverage ratio, etc. Third-bucket banks are only required to disclose two reports, namely capital adequacy ratio and capital components.

2. Impact of New Capital Rules on the banking development in China

First, high-quality development is underlined for corporate banking. Firstly, the concept of "investment grade" companies is introduced, with their risk weight lowered from 100% to 75% in support of key corporates. "Investment-grade" companies are required to have stocks or bonds in existence without any major risks in operations, defaults or external guarantees. Banks are encouraged to increase credit support for key industries and enterprises. **Secondly, the risk weight of property developers that "meet prudence requirements" remains unchanged (100%), while developers' risk weight are raised to 150% to prevent and control real estate development risks.** Multiple risk-weight buckets are set for real estate business, guiding banks to increase graduality of management for targeted credit support.

Second, the inclusive finance business is more comprehensive. Firstly, the risk weight for loans to small and micro businesses remains unchanged at 75% under the guiding principle of bolstering weaker links of the real economy while ensuring financial stability. In the post-pandemic era, small and micro businesses still need policy support. Maintaining a low risk weight for them helps keep policies stable and control relevant risks. **Secondly, the risk weight for loans to SMEs is lowered from 100% to 85%, highlighting comprehensive support.** Medium-sized enterprises will become an important drivers of China's banking sector in the future. By reducing the risk weight of SMEs and easing their capital pressure, banks are encouraged to strengthen support for SMEs.

Third, retail banking focuses more on boosting real domestic demand. In the non-mortgage retail business, the concept of "qualified trader" is emphasized and the risk weight for revolving credit card loans is lowered from 75% to 45%. Under the strategy of expanding domestic demand, banks are effectively encouraged to enhance the customer onboarding and credit support for high-quality credit card holders, so as to unleash credit card business as a catalyst for consumer consumption. **For residential mortgages, the "loan-to-value ratio (LTV)" is introduced as a new dimension, with differentiated risk weights set for exposures in support of non-speculative housing demand.** The LTV standard emphasizes a reasonable relationship between loan amount and housing value, encouraging banks to provide credit support for prudent homebuyers to prevent speculation and reduce risks.

Fourth, the interbank business attaches greater importance to preventing funds from being diverted out of the real economy. Firstly, the risk weight for interbank business is raised across the board, significantly differentiated according to counterparty ratings. This move encourages banks to conduct three-month or shorter-term interbank transactions with high-rating counterparties, reining in longer-term, lower-rating interbank business and reducing idle funds. **Secondly, the risk weight for counterparties that fall in the category of other "investment grade" financial institutions in line with corporate lending standards.** The risk weight for first-bucket banks' exposures to other "investment grade" financial institutions is lowered to 75%, encouraging banks to assess the qualifications of non-bank financial institutions and expand the use of funds.

Fifth, investment banking attaches greater importance to risk prevention and control. Firstly, risk weights for interest rate bonds and high-grade credit bonds are lowered to produce a capital-saving effect. The risk weight for local government ordinary bonds is lowered from 20% to 10% and the risk weight for local government special bonds remain unchanged at 20%, encouraging banks to invest in local government ordinary bonds and supporting local government investment in public welfare projects. The risk weight for investment-grade corporate bonds is lowered from 100% to 75%, encouraging banks to invest in high-grade credit bonds and reduce risk exposures. **Secondly, the risk weight for financial institutions' subordinated bonds is**

substantially raised to prevent risk contagion among banks. To prevent the spread of risks, the risk weight for subordinated claims on China's development financial institutions, policy banks, commercial banks and other financial institutions, and for exposures to total loss absorbing capacity (TLAC) debt instruments issued by global systemically important banks has been raised from 100% to 150%.

3. Future trends of China's banking sector

First, the capital savings should be effectively used to support the real economy. The banking sector should increase its support for major projects included in the National 14th Five-Year Plan and the major infrastructure projects, such as transportation and water conservancy. It should focus on industrial development fields, support industrial upgrading, technological innovation and green transition, pay due attention to the financing needs of small, medium and micro enterprises, give a boost to consumer finance and support the recovery and expansion of consumption.

Second, the asset base should be restructured in an orderly manner according to policy guidance. Banks should adhere to the principle of "capital-light" operation and make orderly adjustments to the asset structure. The financial needs of high-quality corporate, individual and interbank customers should be further tapped to scale up business while using capital more efficiently. The customer-specific pricing ability should be enhanced, with various tools used for tradeoffs among risk, return and cost.

Third, the risk management system should be reinforced in line with the latest regulatory requirements. The New Capital Rules uphold the philosophy of risk-based supervision established in the Basel Capital Accord. The banking sector should put forestalling and defusing risks higher in the priority list and comprehensively improve the risk management system.

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