

Boosting credit: Commercial banks are about to get squeezed, and they won't mind

In recent years, Beijing has been reluctant to squeeze bank profits. Banks need healthy profits to replenish capital, and local governments need the taxes they pay on that profit. That's constrained the central bank's (PBoC) ability to reduce interest rates.

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Key takeaways

- 2022 is different. Banks could potentially post record profits this year, freeing the PBoC to squeeze banks as it attempts to stimulate the economy.
- Based on data we collected from China's 50 biggest banks, we found that between 2019 and 2021, regulations designed to clean up wealth management products (WMPs) eroded bank profits. Over that period, banks set aside significant impairments to dispose of bad assets packaged into WMPs.
- At the end of 2021, China's banks were fully compliant with the rules, which means they no longer have to maintain such high levels of impairments. Lower impairments will boost bank profits significantly in 2022.
- That allows the PBoC to have its cake and eat it, too – it can pursue policies that erode bank profits, safe in the knowledge that banks will still be very profitable.
- We expect the PBoC to use this opportunity to push banks to accelerate lending to fund infrastructure, ramp up lending to small firms, and reduce lending rates without first lowering bank funding costs.
- Still, we believe the PBoC remains worried about putting small banks under too much pressure, which could explain the lopsided loan prime rate (LPR) reduction on May 20.

We at Trivium have spent a lot of time wondering how China will fund efforts to boost growth by year-end. We've written about how Beijing might issue special treasury bonds and deploy the policy banks (see our May 10 report, "[Funding additional infrastructure – who picks up the bill?](#)"). But there's one channel we overlooked – the commercial banks.

There's a good reason for that. Commercial banks were previously Beijing's primary stimulus tool, but since 2016 they've been cleaning up their books and, if anything, have been a constraint on stimulatory efforts.

But 2022 will be different. For the rest of the year, we expect the authorities to lean heavily on commercial banks to stimulate the economy.

Over the past year, we've often argued that the central bank (PBoC) is wary of deploying monetary policy in ways that erode bank profits. That's affected interest rates, in particular, with the PBoC striving to reduce bank funding costs in advance of any reduction in lending rates. Part of the reason is that the PBoC was already squeezing profits as part of efforts launched in 2018 to clean up the shadow banking sector. Since then, many banks have had trouble maintaining minimum capital levels. Further eroding profits – the main tool for replenishing core tier-one capital – worsens the problem.

However, the cleanup was completed at the end of last year. That means that, despite pressure on asset quality from lockdowns and the property sector's decline, China's banks will be able to significantly reduce impairments on credit losses this year. The reduction will translate directly into higher profits, which means regulators no longer need to worry about squeezing banks' bottom lines. Consequently, commercial banks are likely to be pressed into national service for the remainder of the year.

1. We expect that will translate into a sharp acceleration in the growth of bank loans to fund infrastructure investment. Lending growth requires capital, and the banks will have no trouble meeting minimum regulatory requirements.
2. Banks will ramp up lending to small firms, a group that costs banks more to service than large customers and have higher delinquency rates.
3. The PBoC will feel less obliged to offset lower lending rates by first reducing bank funding costs. Lending rates might also decline faster than the market anticipates, although that will be tempered by US Federal Reserve tightening. We also believe that the PBoC remains wary of eroding profit at small banks, which likely explains the lopsided structure of the most recent reduction of the loan prime rate (LPR).

The sanctity of bank profits

Preserving bank profits is important for two reasons. The first is that retained earnings are the main way banks replenish core tier-one capital. In other economies, banks can do that by issuing new shares, but Chinese regulations preclude banks from doing this when their market value is below price-book. The market value of most Chinese banks – listed and non-listed – has been below that level for at least the last three years. As a result, over the past few years, many small banks have been recapitalized by state entities paying above market price for shares. However, many local authorities didn't have sufficient financial resources to do that, so the Ministry of Finance (MoF) permitted them to issue special-purpose bonds (SPBs) to recapitalize their banks. Given these

pressures, it's even more important for banks to recapitalize themselves organically with retained earnings.

Bank profits are also crucial for local governments. Banks are big taxpayers, and taxes are calculated based on banks' profits. Unfortunately, we don't have precise, holistic data on this. However, by way of example, in 2021, financial-sector firms were responsible for more than 10% of total taxes collected in Chongqing, 8.3% in Liaoning, 15.5% in Fujian, and 9.1% in Hunan. With local governments' fiscal resources declining due to pandemic-related pressures and the decline in land sales, these authorities have a vested interest in banks maintaining healthy profits.

Crucially, however, bank profits have been under pressure for the last three years because of regulatory efforts to clean up the shadow banking system.

Cleaning up shadow banking

In 2018, China's financial regulators rolled out sweeping new regulations designed to overhaul banks' wealth management products (WMPs). Banks were given until the end of 2021 to comply with the rules, which involved banks moving some of the loans that had previously been packaged into WMPs back onto their balance sheets. Some of these loans were distressed. Banks hadn't previously needed to set aside provisions for losses on loans packaged into WMPs. However, once those assets migrated onto banks' balance sheets, they had to set aside these provisions (see our July 21, 2021 report, "[The PBoC's changing liquidity stance: Why WMP reform is a key driver](#)").

"Provisions" or "impairment losses" are the funds banks put aside each year to cover expected losses on loans and other financial assets. They're recorded by banks as an annual expense, thereby reducing banks' net profits and, by extension, retained earnings. Impairment losses accumulate each year as "allowances for impairments," which is a charge against loans and other financial assets. In other words, it's a way of acknowledging that total loans and financial assets are worth less than their face value because a certain amount is unlikely to be repaid. When a bad loan is eventually written down, allowances are reduced by a comparable amount.

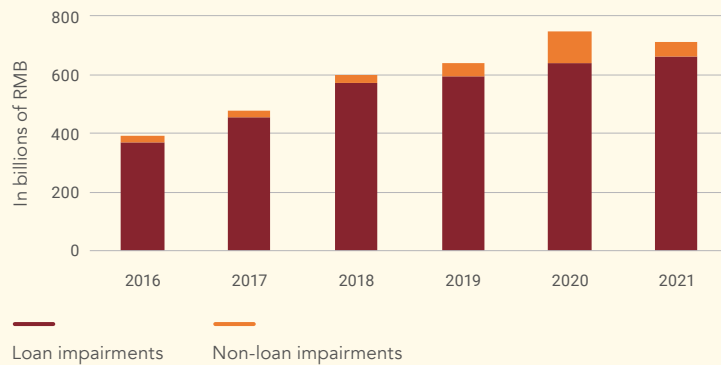
We collected impairment data from China's 50 biggest banks by assets. We found that bank impairments have grown rapidly over the last three years. However, the growth hasn't been driven by impairments on loans but by impairments on other types of financial assets (which we will refer to as "non-loans"). Few banks explain the increase in "non-loan" impairments, but the handful that do have said that the growth in impairments was due to WMPs. (Note that for loans to be packaged into WMPs, they first need to be structured as trusts and directional asset management plans by securities companies. Hence, when they move back on balance sheet, they're recorded as assets, not loans).

In 2021, non-loan impairments accounted for 18.4% of total impairments, up from 7.7% in 2017, before the WMP regulations were introduced. However, there's significant variation between banks. In 2021, non-loan impairments accounted for only 8.8% of total impairments at the state-owned commercial banks (SOCBs) – the "big six" that includes Industrial and Commercial Bank of China, China Construction Bank, Bank of China, Agricultural Bank of China, Bank of Communications, and Postal Savings

Bank [Fig. 1] – but 26.1% at joint-stock banks [Fig. 2], and 27.4% at the 32 city and rural commercial banks in our sample [Fig. 3].

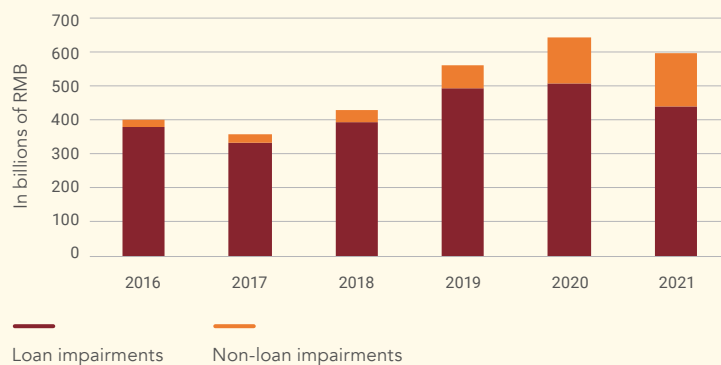
(Note: Our data is based on disclosures by China's biggest 50 banks, which includes 32 city and rural commercial banks)

Fig. 1 – Impairments on credit losses by SOCBs



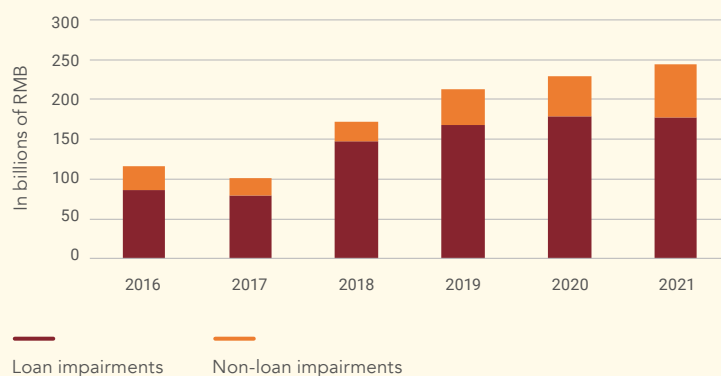
Source: The banks, Trivium

Fig. 2 – Impairments on credit losses by joint-stock banks



Source: The banks, Trivium

Fig. 3 – Impairments on credit losses by city and rural commercial banks



Source: The banks, Trivium

From this year, banks no longer need to set aside provisions for legacy WMPs. That should mean banks can drop “non-loan” impairments to 2017 levels, significantly boosting profits. We estimate that China’s joint-stock banks’ 2021 profits would have been 20% higher if they didn’t have to make impairments for WMPs. This year they should be able to realize that increase in profit.

That allows the PBoC to have its cake and eat it, too – and implement measures that erode bank profits without worrying about banks’ capital. Moreover, banks can maintain loan impairments, which are necessary to sustain the pace of bad loan disposals.

The 2021 anomaly

It’s worth noting that China’s big banks already had an incredibly profitable year in 2021. However, profit growth wasn’t driven by operations. Despite the PBoC’s efforts to soften the impact of lower interest rates, banks’ net interest margins (NIM) contracted last year. Of the 12 joint-stock banks, only Zheshang and Hengfeng saw their NIM increase. For the others, the average decline was 22 basis points (bps).

Bank of Gansu – which saw its NIM decline by 24 bps in 2021 – explained the contraction like this:

“The Bank actively responded to...national policies, reduced the burden on small and medium-sized enterprises, and supported small and medium-sized enterprises to tide over the difficult times through measures such as lowering interest rates on loans.”

Despite the decline in NIM, it was nonetheless a great year for bank profits. That’s because loan impairments not only failed to keep up with loan growth – they actually declined. (Note that total impairments on loans dropped, but for joint-stock banks and rural and city commercial banks, non-loan impairments rose to meet the WMP deadline). In 2021, 66.7% of the combined profit growth (i.e., profit before tax) of China’s 12 joint-stock banks could be attributed to reduced impairments.

We suspect that joint-stock banks lowered their 2021 loan impairments (as opposed to non-loan impairments, which rose) knowing they’d be able to boost them – and still post robust profit growth – in 2022. In effect, the banks anticipated the 2022 profit boost from lower non-loan impairments and so have tried to smooth profit growth over 2021 and 2022.

Putting the banks to work

How will the authorities make the most of banks’ profit boost? We expect they will push banks to lend more aggressively. The State Council has already called on banks to increase “large, long-term loans.” Meanwhile, the PBoC said that it will:

“Guide financial institutions to spare no effort to increase loan issuance”

We could also see a shift in how the PBoC pushes banks to increase lending to micro and small enterprises (MSEs). On May 26, it published a document designed to push banks to increase MSE lending even further than they have over the past few years. The document told banks to develop a “philosophy of serving small and micro firms,” and that MSE loan growth needs to be faster than other types of loans.

We also think the PBoC will have more latitude to lower lending rates or reduce them without feeling compelled first to cut bank funding costs. However, there's a catch. We suspect that the PBoC remains wary of squeezing the profits of small banks. The banks in question are well outside our sample of China's biggest 50 banks, and they're not systemically important. However, they're important to local economies. Their asset quality is far worse than larger banks, and WMPs weren't a significant part of their business, so they're less likely to see a profit bump in 2022.

The way the PBoC implemented the most recent reduction in the loan prime rate (LPR) may reflect the central banks' newfound willingness to squeeze large banks' profits while trying to shelter small banks.

On May 20, the five-year LPR – the benchmark lending rate against which home mortgages are priced – declined by 15 bps, from 4.6% to 4.45%. It was the biggest fall since the PBoC changed the way banks set lending rates in 2019, and more than market expectations – and ours as well. However, the one-year LPR remained unchanged. We expected both one- and five-year tenors to decline around 10 bps. The PBoC delivered even more relief for the property market earlier the same week when it reduced the minimum interest rate banks can charge on mortgages for first-time buyers to 20 bps below the LPR. Previously the LPR had been the floor.

The two measures combined could translate into a reduction in interest rates on new mortgages of up to 35 bps. Bank funding costs have marginally declined in recent months – the PBoC cut the reserve requirement ratio for most banks by 25 bps in April, and local media reported that banks reduced the rate on large deposits by 10 bps around the same time – but nowhere near enough to offset such a large decline in lending rates.

However, the LPR reduction and the cut to the mortgage rate floor disproportionately affect large banks, which are well-positioned to absorb the contraction in their net interest margins (NIM) and subsequent decline in profits. China's banks are subject to mortgage lending limits based on their size. The six state-owned commercial banks can allocate up to 32.5% of their loan book to mortgages. Joint-stock banks are limited to 20.0% of total lending. Meanwhile, village banks are limited to 7.5% [Fig. 4]. Given that mortgages aren't a big part of small banks' business, the lower rates will have only limited impact on their profitability – and, by extension, their capital.

Fig. 4 – Limits on commercial bank real estate loans as a proportion of total lending

		Combined real estate loans	Residential mortgages
Tier 1	Large state-owned commercial banks	40.0%	32.5%
Tier 2	Joint-stock banks plus Bank of Beijing, Bank of Shanghai, and Bank of Jiangsu	27.5%	20.0%
Tier 3	City commercial banks and large rural commercial banks	22.5%	17.5%
Tier 4	County-based rural banks	17.5%	12.5%
Tier 5	Village banks	12.5%	7.5%

Source: PBoC

Conclusion

WMP regulations have taken a toll on bank profits over the last few years. However, now that the banks are compliant with the rules, profits can bounce back. That gives the PBoC space to implement measures that are good for economic growth, but that eat into bank profits. With Beijing pushing local governments hard to ramp up infrastructure investment, we believe responsibility for funding such projects will fall on the banks. The increase in funding won't be on the scale we saw in the wake of the global financial crisis. Still, it will be a meaningful increase beyond the pace at which banks have been lending over the last few years.