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Could China suffer a banking crisis?

Andrew Collier, Orient Capital Research Author alerts Nov 20 16:33 Comment

Could a banking crisis erupt in China? The commonly accepted answer among western analysts is no, for the simple reason that China has huge State owned banks that dominate the country's banking industry. But dig a little deeper and a different picture emerges.

It turns out that within China's smaller cities, the market share of the big banks fades away. Instead, local banks take over. With few national branches, these local banks will have a much more difficult time spreading risk geographically, and are thus more prone to failure.

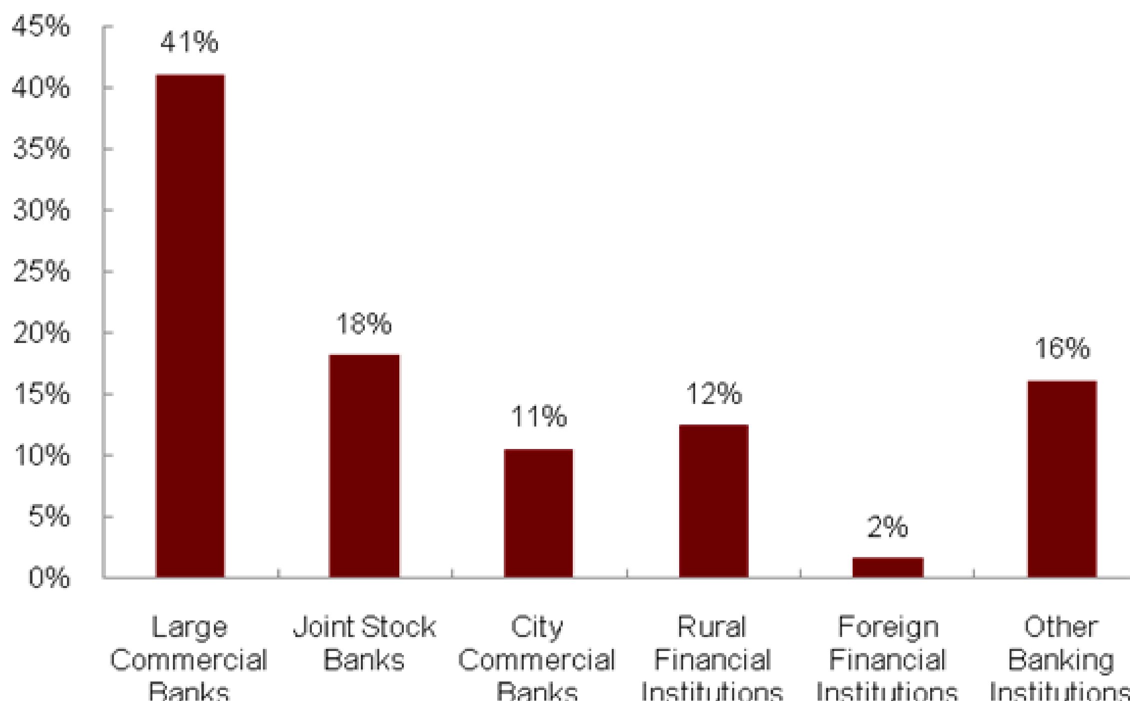
While there is very little information on local finances, we examined the IPO prospectuses for several banks about to list in Hong Kong and unearthed a treasure trove of information on the geographical breakdown of China's banking system.

The China Banking Regulatory Commission (CBRC) categorises banks into six groups. (Excluding non-financial institutions in the shadow banking sector). The six categories are: large state-owned banks, joint stock banks, city commercial banks, rural financial institutions, foreign financial institutions and other banks.

The five big state banks dominate the country's banking assets with a 41 per cent share. They are followed by the joint stock banks (12) with an 18 per cent share, the city commercial banks (133) with an 11 per cent share and the rural banks (2,350) with a 12 per cent share.

There are 213,000 bank branches in China, with the state banks controlling a significant share. The Bank of China alone has 10,691 branches. Combined with the other state banks, they have in total have more than 50,000 branches, or about a 25 per cent share.

China banks by asset share.



Source: Orient Capital Research

But the picture changes radically when we start moving down to smaller geographical locations. We examined data from one area due to the listing of the Bank of Jinzhou in the northeastern province of Liaoning. The market share breakdown in Liaoning, with a population of 43.7m, is much different from the national analysis. The state bank share drops to 33 per cent from 41 per cent, and the city commercial bank share rises to 26 per cent from 11 per cent.

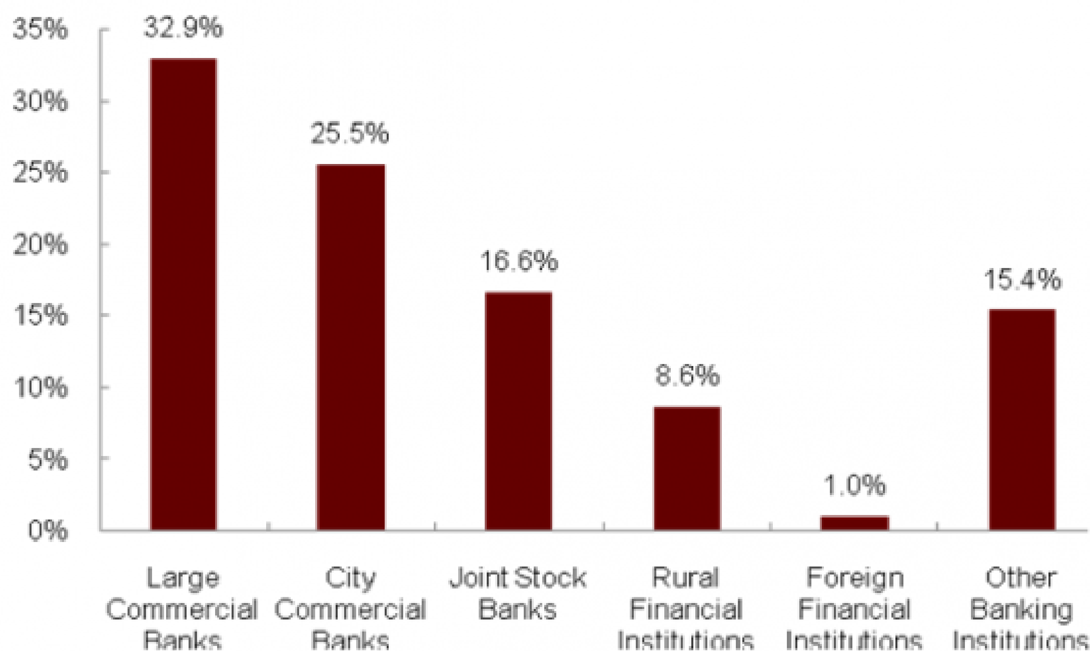
Bank market share by assets in Liaoning province

Further Concentration Within Cities

If we shift down another level to the city, the market share market share breakdown again changes significantly. In the city of Jinzhou, population 810,000, the state bank share drops by more than half to 19.4 per cent. Most of the slack is taken up by just one bank, the Bank of Jinzhou, with 62.6 per cent of assets.

At this point, the people of Jinzhou are putting most of their eggs in one basket – and that basket is the Bank of Jinzhou. Much of the lending activity is going through a single financial institution.

Among the independent banks in the province, the Bank of Jinzhou is by far the largest, almost



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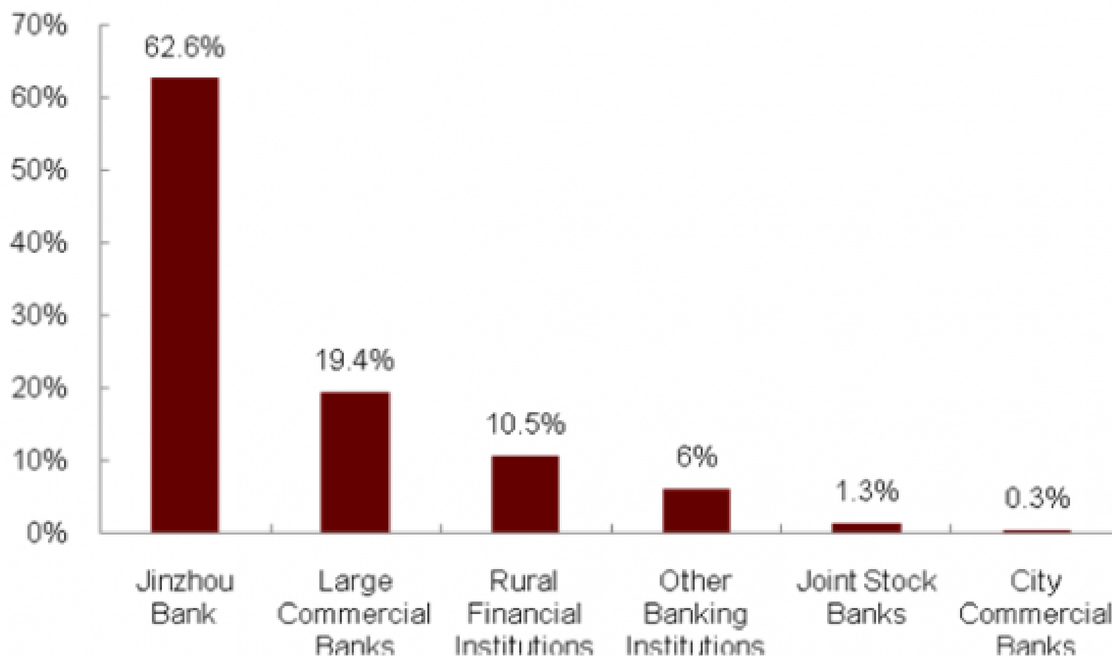

Source: Orient Capital Research

equal in size to eight other banks combined. However, they still are relatively small as the city commercial banks have only a 25 per cent share. Most of their business is concentrated in the smaller cities.

How healthy is the Jinzhou economy?

Jinzhou has posted a 13.3 per cent average GDP growth from 2008 to 2014. The Bank of Jinzhou argues that the city is under-banked. They use a measure dividing total loans by local GDP and come up with a number of 83.7 per cent, below the 115.4 per cent in Liaoning and

RmbBln	Assets	Equity	Net Profit	ROA	ROE
Shengjing Bank	503.4	36.1	5.42	1.1%	15.0%
Bank of Jinzhou	250.7	15.9	2.12	0.8%	13.4%
Bank of Yingkou	81.6	7.1	1.04	1.3%	14.5%
Bank of Liaoyang	81.6	6.5	0.82	1.0%	12.7%
Bank of Anshan	80.6	6.9	0.79	1.0%	11.5%
Bank of Fuxin	78.6	6.1	0.71	0.9%	11.7%
Bank of Huludao	41.7	3.7	0.43	1.0%	11.7%
Bank of Dandong	41.1	3.7	0.57	1.4%	15.6%
Bank of Fushun	38.8	3.5	0.57	1.5%	16.3%
Bank of Chaoyang	37.7	3.7	0.36	1.0%	9.9%
Median/Total	**1,235.8**	**93.1**	**12.85**	**1.0%**	**13.0%**
US Average				**1.04%**	**9.30%**

Source: Orient Capital Research

136.4 per cent for all of China.

However, this analysis does not take into account the heavy reliance on property in most small cities. Pressure on local governments to generate revenue forces them to sell land at high valuations even if demand is low. Our interviews in Sichuan in June suggests as much as 80 per cent of GDP in some small towns is property related. The slowing property market is going to have a disastrous impact on local banks in these areas.

National banks reduce risk.

In their excellent book, "Fragile by Design," authors Charles Calomiris and Stephen Haber argue that US banks suffered 19 banking crises in 180 years mainly because states sharply curtailed interstate banks and were thus unable to spread risk across the country.

In contrast, Canada has not suffered a banking crisis since 1839 – because it has long had a system with a small number of banks with nationwide branches. This distributed risk. In China, the concentration of risk within isolated geographic areas increases the potential for a local banking crisis.

Would China allow banks to default?

It is commonly assumed that as centralized political and economic system China would not allow a bank failure. Let us look at one comparison –Japan. Japan is an example of a country that vowed to protect its banking system, but eventually let more peripheral institutions fail.

During the postwar period, the Ministry of Finance provided assurances that no bank would be allowed to fail. But as the economic crisis deepened, they gradually let small financial companies like leasing companies, credit associations and regional banks fail.

Has China ever allowed a bank collapse? In the 1980s, Zhu Rongji shuttered 40,000 rural cooperative banks due to excessive debt. That debt ended up on the balance sheets of the local governments and formed the beginning (albeit a small piece) of the estimated Rmb30tn in current local debt. So there is a precedent for the closure of a smaller, weaker financial institutions in China.

How regulators could respond to the threat of a banking crisis.

The PBOC and other government agencies are attempting to fend off a banking crisis. They also have a number of options to handle bank failures:

1) *More Liquidity*. First, the People's Bank of China (PBoC), the central bank, is focusing generally on improving liquidity in the system through cuts in the Reserve Rate Requirement (RRR) and other macroeconomic measures.

2) *Bond Swaps Are Helpful*. Second, the program to swap bonds for debt, although a net negative for banks (replacing lower interest rate bonds for loans), it is positive for local government financing, upon which many banks rely for local economic activity. It is also the first "baby steps" toward the creation of a market for local debt in the form of bonds, similar to the Muni Bond market in the US.

3) *Increase Monitoring*. Third, the CBRC generally is increasing inspection of the banking system as it is concerned about defaults due to the declining property market.

4) *Find New Capital*. Fourth, the banks (both state and local) are important *sources and conduits of capital* for cash-starved governments and their Local Government Financing Vehicles (LGVFs). The regulators in Beijing would likely put pressure on local governments or the Provincial branches of SoE banks to bail out any failing financial institutions.

5) *Launch a New Bond Swap*. Devise another "bond swap" type program under which there would be a national program to recapitalise weak rural banks. This could occur like the bond swap – swapping national bonds for local debt – or the recapitalization of the state banks a decade ago by creating "bad banks" in the form of Asset Management Companies (AMCs) that swallowed the bad debt.

Still, the scope of the problem will make it difficult for the PBoC to engineer a national solution. In the end, there are likely to be local banks that will fail with problematic effects on local government revenue and fiscal stability.

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