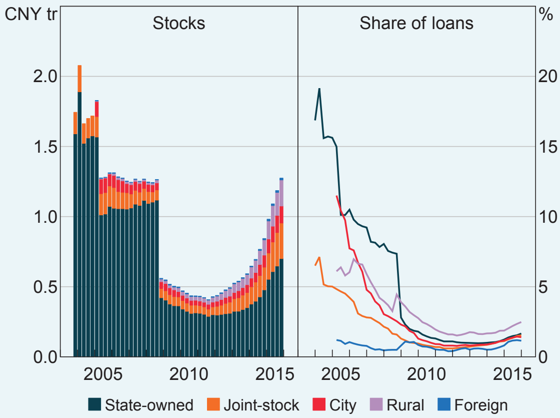
Box A

Asset Performance in the Chinese Banking Sector

Chinese commercial banks' reported non-performing loans (NPLs) have risen in recent years, though as a share of bank lending they remain low relative to their history (Graph A1).[1] Recent increases in reported NPLs have been driven largely by the wholesale & retail trade and manufacturing sectors (Graph A2), and have been concentrated in the geographic areas where some of these industries (particularly heavy manufacturing) are prevalent. NPLs as a share of loans (NPL ratios) are fairly similar across the bulk of the commercial banking system – the large state-owned banks, joint-stock banks and city banks – but in recent years they have been consistently higher at the smaller rural banks. This box reviews a range of asset performance indicators and considerations that collectively suggest that NPLs in China are likely to increase further in the period ahead.[2] That said, as noted in Chapter 1, 'The Global Financial Environment,' the Chinese banking system reports adequate levels of capital, and is currently quite profitable.

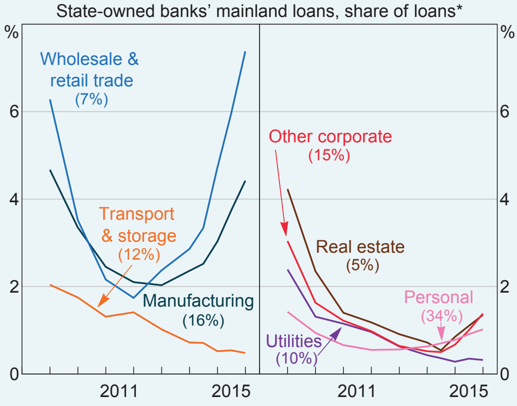
Graph A1
Chinese Banks' Non-performing Loans*
Commercial banks



* The large falls in 2005 and 2008 reflect the removal of non-performing loans from several large banks

Source: CEIC Data

Graph A2
Chinese Banks' NPLs by Sector
State-owned banks' mainland loans, share of loans*



* December 2015 borrower share of total loans in brackets; Bank of Communications is excluded as it does not report these data

Source: Banks' Annual and Interim Reports

1 The large falls in NPLs in 2005 and 2008 reflect policy actions. In the past, where it has been required, large build-ups of NPLs at Chinese banks have been addressed by sales of NPLs to asset management corporations (AMCs; essentially 'bad banks') and public injections of capital.

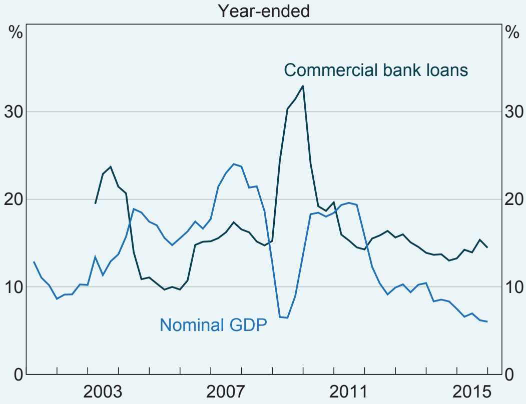
2 This box focuses on the commercial banking system, which accounts for 80 per cent of financial system assets. Asset quality and performance in the shadow banking sector is generally thought to be worse in the formal banking sector. Borrowers in the shadow banking sector are more likely to be small and medium size enterprises, which are more concentrated in the poor-performing wholesale & retail trade and manufacturing sectors, or from a sector where access to the formal banking sector is restricted due to regulation. This includes sectors where there is overcapacity such as steel and cement production and real estate development.

Reasons to Expect Further Increases in NPLs

Bank credit, GDP and profit growth are slowing

NPL ratios are inherently backward looking, because new loans generally take some time to become impaired. Periods of fast credit growth, such as that between 2009 and 2012, therefore tend to hold measured NPL ratios down mechanically, because both the denominator of the ratio is boosted and the share of relatively new loans, which have not had time to become impaired, is higher. As credit growth has slowed – albeit to levels still well above nominal GDP growth – this effect has waned, placing upward pressure on NPL ratios (Graph A3).

Graph A3
China – Credit and GDP Growth
Year-ended



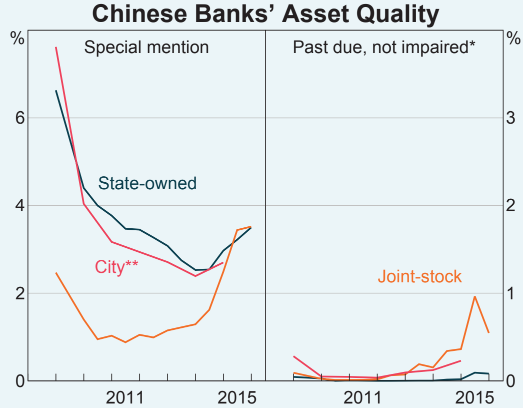
Sources: CEIC Data; RBA

In addition, some information suggests that the flow of new impairments has been rising in recent years, as financial pressures on borrowers have been increasing. Economic growth has slowed from the very fast post-crisis pace and signs of overcapacity and deflation have emerged in some industries, leaving the corporate sector with lower profits to service its higher level of debt. This increased flow of newly impaired loans has added to the stock of NPLs and is likely to continue to do so. Another indication that asset performance is declining is that some banks are reported to have been selling loans to asset management corporations before the point at which the loans must be classified as non-performing. Although such transfers can strengthen banks' balance sheets and allow banks to concentrate on new and performing assets, they might still involve losses if the loans are sold below book value.

Marginal performing loans are rising quickly

The stock of loans in the 'special mention' and 'past due but not impaired' categories has risen noticeably over 2014 and 2015, particularly for the joint-stock banks (Graph A4). While these loans are considered to be performing loans in China, they are likely to be of poorer credit quality than other performing loans. Loans are classed as special mention if there are some factors that may have an adverse effect on loan repayment, but they are not yet classed as non-performing. Past due but not impaired loans are those that are in arrears by more than 90 days (and in some cases more than 360 days), but their repayment is not considered to be in doubt. To the extent that these categories provide an indication of the pipeline of loans that may become impaired in the future, this points to further increases in NPLs.

Graph A4
Chinese Banks' Asset Quality



* 90 or more days past due
** Data for many of these banks are not yet available for 2015
Source: SNL Financial

Some of the loans included in these categories would be classified as non-performing in other jurisdictions, implying that the aggregate NPL ratio in China would likely be higher if it were reported on an internationally comparable basis. While there is variation in national accounting and regulatory standards on the classification of problem loans, the IMF (2006) *Financial Soundness Indicators* (FSI) guidelines recommend that loans be classified as non-performing if the interest and/or principal are more than 90 days past due, or if there are other good reasons to doubt that payments will be made in full.[3] Accordingly, loans past due but not impaired are classified as non-performing in many other jurisdictions (including Australia). In addition, the FSI guidelines suggest that loans should be classified as non-performing when interest payments 90 days or more past due have been capitalised (added to the principal amount), refinanced or rolled over. In China, restructured loans must be classified at least as special mention, but do not need to be classed as non-performing. Restructuring loans in this way does give the borrower time to repair their finances and in some cases can minimise realised losses, but this kind of forbearance becomes increasingly tenuous if done repeatedly for the same borrower.

3 See IMF (2006) *'Financial Soundness Indicators Compilation Guide'.* Available at <http://www.imf.org/external/pubs/ft/fsi/guide/2006/index.htm>.