

Box A

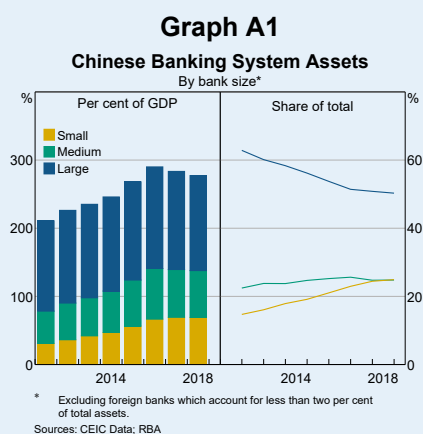
Small Banks in China

In recent months, vulnerabilities of small banks in China have been in focus following a tightening in liquidity conditions, which has prompted a concerted response by the authorities. Small banks in China have expanded rapidly over recent years and play an increasingly significant role in China's financial system.^[1] In particular, small banks are important providers of financing to private enterprises, including micro- and small-sized enterprises (MSEs), which struggle to compete with larger firms for credit from large banks. However, the rapid growth of small banks has also increased some risks, in part because the small banks have become increasingly reliant on wholesale (often short-term) funding and much of their credit has been extended via opaque channels where questions of credit quality have surfaced.

There are around 4,000 small banks in China – defined as those outside of the 20 largest domestic banks by asset size. Together, these banks now account for around a quarter of banking system assets (up from 10 per cent a decade ago), equivalent to around 70 per cent of China's GDP (Graph A1). While these banks are individually small relative to the big state-owned banks that have traditionally dominated China's banking system, many of them are still quite large by international standards. For example, the largest small bank in China has more than A\$200 billion in reported assets, larger than the fifth largest bank in Australia.

Vulnerabilities of small banks have been building

Concerns about the balance sheets of small banks have been building for some time.^[2] The rapid expansion of their assets has been driven by an increase in opaque forms of credit. In particular, small banks have lent to, and purchased securities issued by, non-bank financial institutions (NBFIs), which in turn extend credit to firms, including MSEs. This has enabled small banks to circumvent restrictions on lending to certain sectors and other prudential requirements, including holding lower capital than otherwise. In addition, lending by small banks has tended to be concentrated in certain industries and/or regions. Almost all are unlisted, limiting their scope to access fresh capital quickly. Some small banks also have weak corporate governance and/or underdeveloped risk-management systems. In recent years, for example, a number of small banks have failed to publish financial accounts and provide data to independent auditors. These factors



have contributed to the broader build-up of indebtedness in China and associated medium-term risks to financial stability.

Small banks tend to have weaker asset quality than large banks, and typically report lower capital adequacy ratios (Graph A2). Small banks have a relatively high share of distressed loans despite also having a greater share of loans being written off or disposed of in other ways. Some small banks, especially those based in regions experiencing significant economic slowdowns, have reported a substantial rise in non-performing loans (NPLs). Moreover, Chinese authorities have strengthened standards for recognising NPLs, which has required an increase in provisions at small banks. These developments have led to a decline in small banks' profitability and capital levels over the past few years. That has prompted several banks to raise capital in order to lift their capital adequacy ratios.

Small banks are also exposed to considerable liquidity risks. The expansion of the balance sheets of small banks has been mainly funded by an increase in wholesale debt, as an implicit regulatory ceiling on deposit rates has made it harder for them to attract

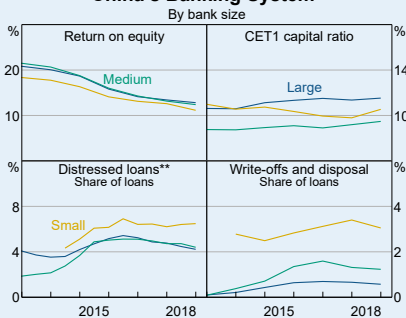
conventional deposits than for larger state-owned banks (Graph A3).^[3] In addition, small banks have relied heavily on short-term funding, with around 90 per cent of wholesale funding (including wholesale debt and inter-bank deposits) of small banks expected to mature within one year. Many small banks have also accumulated significant implicit liabilities through their use of off-balance sheet investment vehicles to raise funding. This has increased the potential calls on the capital and liquidity of small banks.

In recent months, investors have been reluctant to lend to small banks

In May, Chinese regulators announced that they would take over Baoshang Bank – the 36th largest bank in China, with around A\$120 billion in reported assets – due to concerns about its solvency and reported misappropriation of funds. This was the first reported takeover of a private bank by Chinese regulators since 1998. In addition, while China's deposit insurance fund took over some debts of Baoshang Bank, the authorities allowed some large creditors to bear losses (in contrast to the widely held

Graph A2

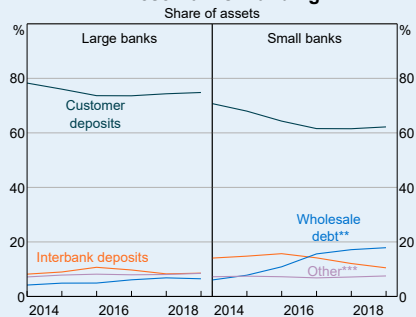
China's Banking System*



* Includes RBA estimates
 ** Includes non-performing loans and special mention loans
 Sources: CEIC Data; RBA; S&P Global Market Intelligence

Graph A3

Chinese Banks' Funding*



* Includes RBA estimates
 ** Includes debt securities, repurchase agreements and central bank loans
 *** Other financial liabilities and equity
 Sources: RBA; S&P Global Market Intelligence

perception of government guarantees).^[4] More recently, state-owned financial institutions have acquired shares in the Bank of Jinzhou, the country's 30th largest lender, following the suspension of its Hong Kong listed equity some months earlier.

The Baoshang takeover prompted investors to reassess the risks of lending to other small banks, and liquidity conditions for small banks tightened sharply (Graph A4). For example, interest rates on negotiable certificates of deposit (NCDs), which are unsecured funding instruments predominantly used by small banks, increased relative to larger banks.^[5] In addition, net issuance of NCDs by small banks declined sharply in May, although it has increased more recently. There have also been reports that small banks have experienced difficulty accessing funding markets altogether or have had to provide higher-quality collateral when borrowing on a secured basis.

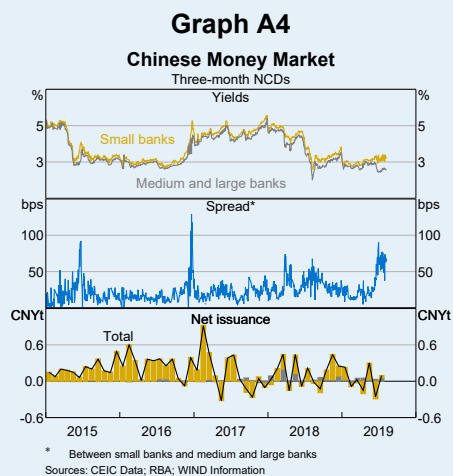
The authorities have responded

The direct implications of the takeover of Baoshang Bank appear to be limited, given

the bank's small size relative to China's banking system (0.2 per cent of total banking assets). In addition, the fact that some large creditors will bear losses might help in reducing perceptions of implicit guarantees in the Chinese banking system, which could improve risk management and credit allocation over the medium term. However, in the short term, the associated tightening in liquidity conditions has increased some risks to China's small banks and the broader financial system. This includes the risk that small banks will be unable to roll over wholesale funding, which could disrupt funding markets more generally. In turn, this could tighten financial conditions and undermine the authorities' efforts to ensure favourable financing conditions, particularly for MSEs.

The People's Bank of China (PBC) has sought to maintain favourable financing conditions by ensuring a generally high level of liquidity in China's banking system. It has reduced reserve requirement ratios for banks and injected liquidity into money markets via open market operations and various lending facilities. However, in light of recent developments, the authorities have implemented additional targeted measures to support funding conditions for small banks, including by:

- directing state-owned financial institutions to make strategic investments in the Bank of Jinzhou
- adding NCDs and bank bills to the list of eligible collateral in PBC operations
- increasing the quotas for certain PBC lending facilities that are accessible to small banks^[6]
- providing additional funding to a prominent issuer of credit risk mitigation



instruments. These instruments are a form of insurance that compensates investors if the issuer of the underlying asset defaults. To date, these have been used by at least one small bank (Bank of Jinzhou) to facilitate access to the NCD market

- instructing financial institutions to continue trading in instruments that are issued by small banks. The PBC has also allowed brokerages to raise additional funds to support their operations in money markets.

The recent measures have contributed to a stabilisation in funding conditions for small banks, although yields on NCDs issued by

small banks remain elevated relative to larger banks. Small banks are likely to continue to face challenges in the period ahead, including issues with asset quality and thin capital buffers, particularly those in regions with weaker economic conditions. There is also ongoing uncertainty around the authorities' approach to bank resolution and, relatedly, the role of government agencies and state-owned firms in absorbing potential losses. These issues are likely to remain in focus as Chinese authorities continue their efforts to manage risks in China's financial system, while ensuring favourable financing conditions for private enterprises. ✎

Endnotes

[1] Small banks include city and rural commercial banks, village banks, rural credit unions, and credit cooperatives. Analysis in this box is based on city and rural commercial banks where data for other small banks are not available. Medium banks refers to joint-stock banks and large banks captures large state-owned commercial banks.

[2] For more details, see RBA (2016) 'Box A: Recent Growth of Small and Medium-sized Chinese Banks', *Financial Stability Review*, October, pp 14–16. Available at <<https://www.rba.gov.au/publications/fsr/2016/oct/box-a.html>>.

[3] The explicit ceiling on deposit rates was abolished in 2015.

[4] China's deposit insurance scheme was created in 2015 and covers personal and corporate deposits at participating financial institutions in foreign

and local currency up to a maximum of CNY500,000. However, in Baoshang Bank's case, the scheme and Chinese authorities guaranteed corporate and interbank deposits valued up to CNY50 million, and personal deposits were fully guaranteed.

[5] NCDs and other interbank funding instruments account for around 10 per cent of small banks' liabilities.

[6] The PBC expanded the size of its rediscount facility by CNY200 billion, which enables banks to obtain funding from the PBC in exchange for loans that they have extended to customers, typically small businesses. The Standing Lending Facility, which provides banks with access to emergency liquidity, was expanded by CNY100 billion. The stock of lending under each facility remains well below their respective limits.