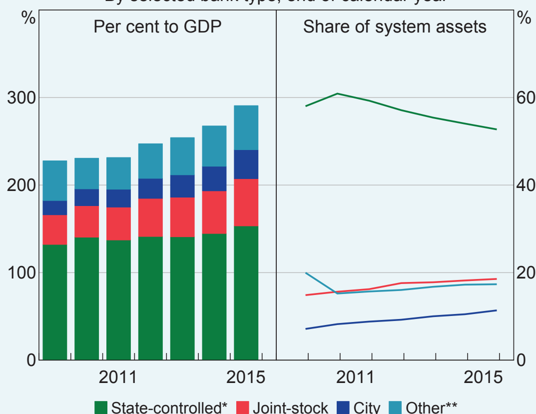
Box A

Recent Growth of Small and Medium-sized Chinese Banks

Small and medium-sized Chinese banks have grown rapidly over recent years, with their combined share of system assets rising from around 40 per cent in 2009 to 50 per cent in 2015 (Graph A1). In doing so, they have expanded less transparent forms of credit and increasingly relied on short-term funding, which has increased the risks of their distress and of contagion to other institutions. This box examines the recent growth and performance of smaller Chinese banks, and the associated risks to financial stability in China.

The banking system in China is highly regulated and banking activities are dominated by the state-controlled banks, which include the large state-owned banks and policy banks. The rest of the system is made up of a myriad of smaller banks: twelve joint-stock banks, hundreds of city and rural banks and thousands of credit cooperatives.[1] The analysis in this box is based on the joint-stock banks and an available sample of city banks.[2]



Recent Performance

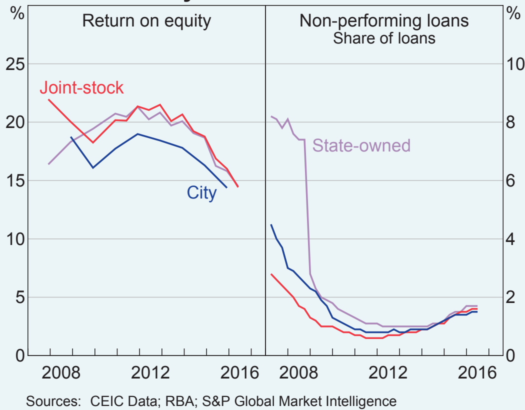
For several years the reported rate of return on equity of Chinese banks has trended lower, yet remains high relative to global peers (Graph A2). As economic growth has slowed, smaller Chinese banks have expanded their balance sheets in an effort to support profitability despite higher write-offs and loan-loss provisions. While the return on equity for joint-stock banks has remained similar both in its rate and trend decline to that of the large state-owned banks, the return on equity for city banks has been persistently lower. The reported non-performing loan (NPL) ratios for all types of banks have been similar to date, increasing from low levels over recent years.[3]

Small and medium-sized banks face some risks from their traditional lending activities, which in some cases is heavily concentrated in just a few industries, such as the mining, farming and retail sectors. However, the rapid expansion of assets at small and medium-sized banks has in fact been driven by an increase in less transparent forms of credit via the shadow banking sector. In particular, there has been a sharp run-up in smaller banks' holdings of securities known as 'investments classified as receivables' (Graph A3). Much of this increase has reportedly been driven by 'shadow' credit products: investment products packaged together by trust and securities companies with loans and other

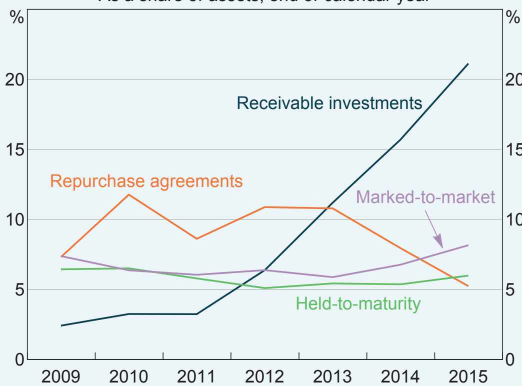
1 Foreign banks in China account for only a small share of system assets (less than 2 per cent).

2 The sample of city banks varies over the period of assessment. Data for many city and joint-stock banks are not yet available for 2016.

3 For more information about NPLs in China, see RBA (2016), 'Box A: Asset Performance in the Chinese Banking Sector', *Financial Stability Review*, April, pp 17–19.



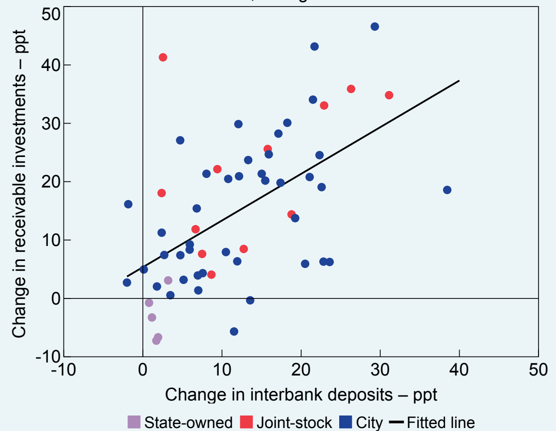
Sources: CEIC Data; RBA; S&P Global Market Intelligence



Sources: RBA; S&P Global Market Intelligence

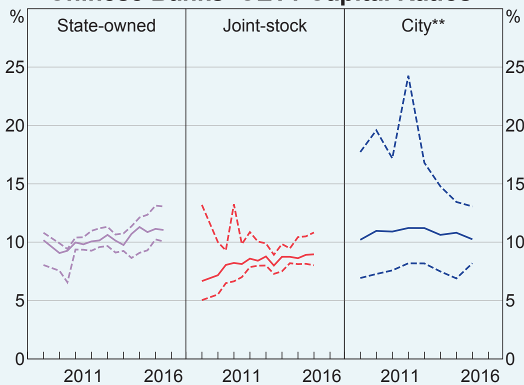
credit products as the underlying assets (somewhat akin to asset-backed securities). These products have been purchased by banks and booked as securities on their balance sheets. In the highly regulated Chinese financial system, the use of this lending channel may have allowed smaller banks more discretion in lending decisions. In absolute terms, the rise in receivable investments has been driven by a few of the biggest joint-stock banks. But when scaled as a share of their assets, the increase in receivable investments varies widely across the smaller banks. While some banks report that these securities now account for more than one-third of total assets, others report a much lower share. In contrast, the large state-owned banks have generally shied away from holding these types of securities.

Furthermore, on the liabilities side of their balance sheet, small and medium-sized banks have become more reliant on short-term funding from the interbank market (whose participants include non-bank financial institutions as well as banks). Interbank deposits at smaller banks in aggregate are estimated to have more than doubled from slightly over 10 per cent of liabilities in 2009 to be more than 25 per cent in 2015. The smaller banks that have most increased their reliance on interbank funding have also tended to be the ones that expanded their holdings of receivable investments the most (Graph A4).



Sources: RBA; S&P Global Market Intelligence

The aggregate reported Common Equity Tier 1 (CET1) capital ratios of small and medium-sized banks meet international requirements. But individual banks' ratios vary widely, with some banks having thin capital buffers (Graph A5). The capital buffers at some banks may be even thinner than the reported figures suggest, especially since receivable investments may not be subject to the same level of risk-weighted capital as traditional loans. There are also reports that banks have packaged deteriorating loans into these securities to avoid recognising and provisioning for them, because securities do not seem to be subject to the same asset performance classification as traditional loans.



Risks

The extent and nature of their recent asset growth suggest greater risk-taking by many smaller Chinese banks, as does their increased use of short-term interbank borrowing. As noted in the main text, the shadow lending that underpins much of their asset growth is, on average, likely to be riskier than traditional bank lending.

Taken together, these factors suggest that many smaller banks are exposed to a heightened risk of loan losses, particularly as overall economic growth slows in China. Larger banks' exposures to smaller banks appear to be relatively small, so direct contagion may not pose a material risk. But the banking system could be affected through indirect channels of contagion: high loan losses in one or more smaller banks could cause investors to reconsider their funding to other banks that they believe may have a similar vulnerability. In these circumstances, concerns about the financial system more broadly could quickly spread and test the authorities' ability to stem liquidity pressures, facilitate capital injections and resolve any small bank failures.

Recent Regulatory Developments

Chinese authorities have scope to tackle the build-up of risk in smaller banks' balance sheets. To start with, they have regulatory tools and frameworks to protect against liquidity risk. Recent guidance has also reinforced that banks should treat loan-like products as if they were loans for provisioning and capital purposes. As a result, some small and medium-sized banks will need to raise capital, and some have reportedly already done so. Some recent regulations also aim to enhance the recognition of impaired loans by limiting banks' ability to transfer new NPLs into shadow credit products. In addition, regulators have proposed rules to limit retail investors' indirect exposure to shadow credit products. Nonetheless, given the increasing complexity of the system and ongoing financial innovation, further supervisory actions might be needed.