Sumitomo Mitsui DS Asset Management

China Market Report: China's Financial Sector

Sound financial position and strong policy support: keys to avoid financial crisis

1. Introduction

Last several months, we saw a heightened concerns about the global banking system in Western countries. In the U.S. the collapse of Silicon Valley Bank (SVB) triggered fears of contagion across the country's banking industry. Signature Bank followed SVB's shutdown, although First Republic Bank was eventually rescued by JPMorgan Chase Bank. In Europe, Credit Suisse was forced to merge with larger rival UBS by Swiss authority in March.

What has the state of the Chinese banking system been in the midst of the global banking turmoil? SMDAM believes the system will remain healthy and continue to take steady steps toward further development.

2.1 Strength of China's financial system: Differences from Europe and the United States

1) The content of B/S is simple;

According to PBOC (People's Bank of China), China banks had total assets at Rmb379trn and liabilities at Rmb348trn in 2022. The banks' funding source was mainly from deposit accounting for 88.7% of total where deposit from China Mainland was 98.8%. Bank loan accounted for 73.7% of total fund usage, where the mainland market accounted for 98.1%, followed by 26.2% of bond & other securities investment.

Exhibit 1: **Breakdown of the Balance Sheet of China Banks**

Fund usage		Funding source	
Bank loan	74%	Deposit	89%
Bond & other securities investment	26%	Bond finance	4%
Others	0%	Others	7%

Source: PBOC, SMDAM

2) ALM is also properly managed;

The liquidity ratio measured by coverage of current assets to current liabilities increased from 50% in 2017 to 62.85% in 2022, and the ratio is even higher at regional and rural banks, 76.8% and 74.9% respectively. Besides, the deposit mainly goes to loan as loan to deposit ratio was 82.2% in 2022, up from 73.4% in 2017.

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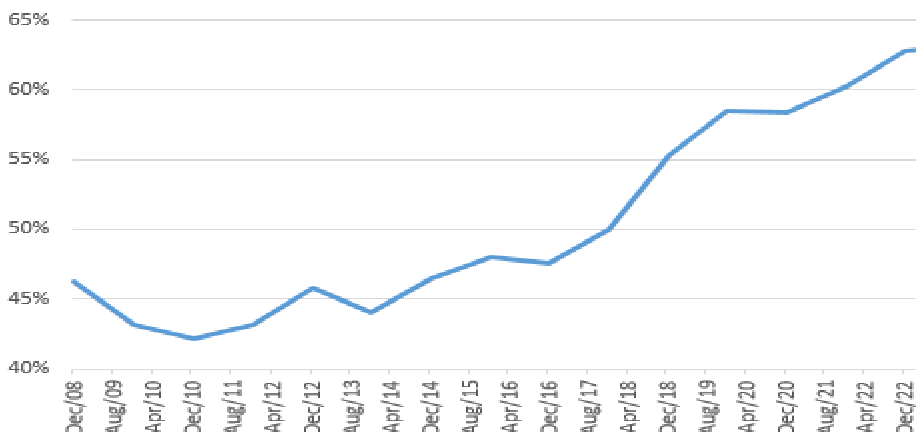
Exhibit 2: **Commercial banks: Liquidity ratio**



Source: China Banking and Insurance Regulatory Commission (CBIRC), SMDAM

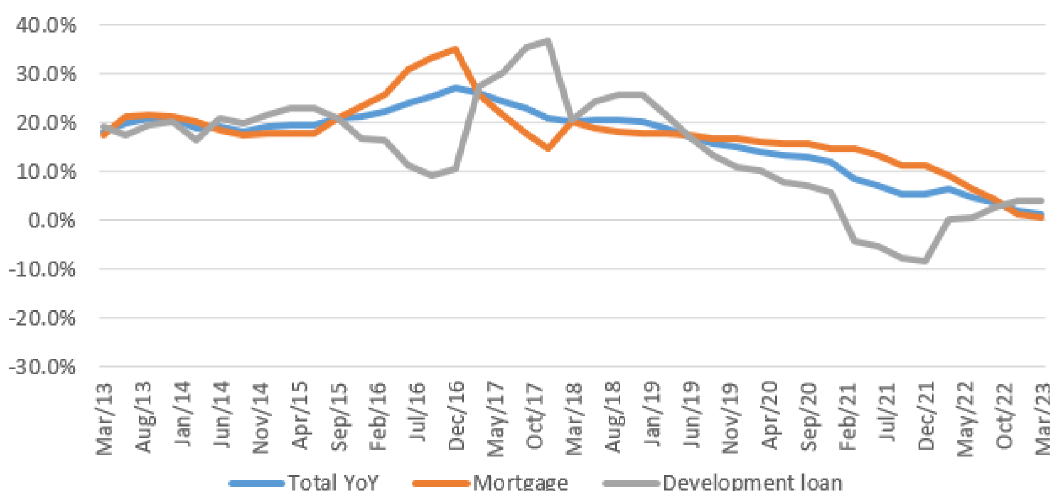
2.2 Risks on China's financial system: Different sources of concern from Europe and the United States

The debt of both real estate sector and local government raised quickly in the past decades and the leverage is already high.

1) Real estate issues;

Total real estate loan amounted to 53trn in 2022, 44% of GDP, and grew at 10-yrs CAGR (2012-2022) at 16%. China citizen's leverage reached 62% in 2022, which is in par with that in the developed market. Domestic developers operate under high gearing and high turnover model, and took high yield borrowing from bank's Off-B/S channels of which the balance was closed to bank loan at 7.5trn in 2016.

Exhibit 3: **Property loan yoy growth-rate**

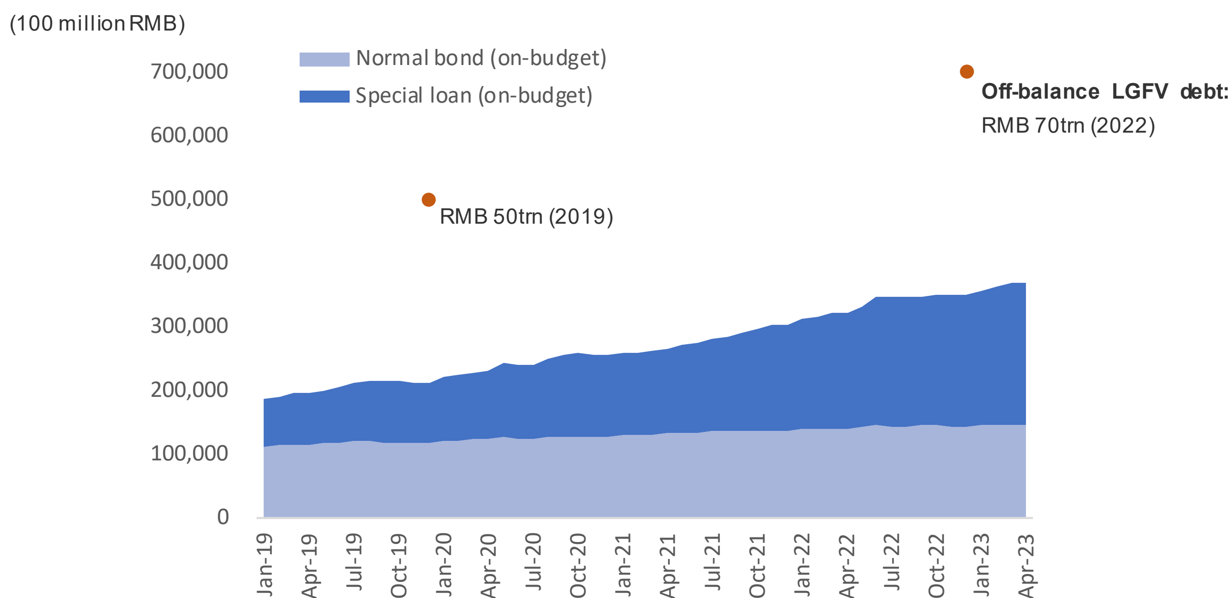


Source: PBOC, SMDAM

2) Financial issues of local governments;

Under the current system of tax distribution, local governments have to raise fund through off-budget channel, or Local Government Financing Vehicles (LGFVs), to support infrastructure investment, and the debt grew at 20% 10-yrs CAGR (2012-2022) to 70trn, 58% of GDP. The payment of such lending relies on land sales revenue. As such, the debt serving capability of local government and real estate sector becomes concern especially in market downturn.

Exhibit 4: Chinese local governments: debt balance by type



Source: Ministry of Finance of the People's Republic of China (MoF), SMDAM

3. SMDAM's view on those risks

Although the real estate problem and the local debt problem are major risk factors, we judge that they can be managed. The reason is: 1) The bank's exposure to each; and 2) de-risking situation.

1) The bank's exposure to problematic sectors

China bank's loan exposure to property sector was 25% in 2022, where the exposure to property development was 6.8% and 18.3% to mortgage. The direct exposure to development is relatively small but it can be magnified considering the entire supply chain which contributed around 30% of China GDP. Because of that, China government carefully manages to contain the risk in long-term, and sometimes the launched regulation can be postponed based on market condition.

For example, they launched the Three Red lines policy in 2020 which requires major developers to deleverage and the deadline is set at 1H23, but it has been downplayed since 4Q22 after developers appeared to have liquidity crisis, meanwhile those developers still need to report their debt condition to PBOC on monthly basis.

That said, major developers' debt is under strict monitor. China banks' risk exposure is more directly linked to mortgage and is sensitive to property price. Considering mortgage only accounted 33% as of total housing payment in 2022, the risk buffer is thick. Also the urbanization rate in China reached 65.2% in 2022 but lower than in developed market, which means China still have housing demand and have room to stabilize housing price.

China banks' loan and bond exposure to LGFVs is estimated at 17.5% and around 5% respectively in 2022. Comparing to global peers, China government debt level is much lower at 108% and the amount of local state-owned enterprise (SOE) assets can cover 3x the debt at 60-70trn, which means the risk of local government debt issue is mainly on liquidity side.

Also the public bond default is strictly prohibited as it reflects local government credit. Provincial government plays a key role in coordinating debt repayment, as some regions with weak fiscal condition is supported by Tier-1 cities and central government through fund transfer. We note that PBOC previously granted provincial government credit lines to prevent further spillover risk in extreme condition.

On the other hand, we see MoF is dedicated to resolve LGFV debt risk by curbing new financing to local SOEs on MoF's list, and makes market aware of potential risk by reducing low quality LGFVs through restructuring, consolidation, and assets optimization in order to refinance the existing debt. In short-term, the risk can be avoided, while it's a complicate case in long-term as it's associated with property market and the political topic under the current tax scheme.

2) Policy measures;

The property sector has entered into a long-term regulating period since 2016 when "Housing-for-living-not-for-speculation" policy was initiated. Also the "Stabilizing land price, housing price, and expectation" and Three Red Lines were launched in 2020.

Such polies are frequently mentioned in the high level meetings and sometimes can be highlighted or downplayed based on the market condition. When a lot of privately owned enterprise developers were facing liquidity crisis at the end of 2022, PBOC launched supportive policies such as the 16 Articles of financing and Three Arrows to stabilize the market.

The regulator's early de-risk effort has made those risk contained within banks' on-B/S. They launched The New Assets Management Rule in 2018 which requires bank to clean-up Off-B/S lending with the deadline set in 2021. During 2018-2021, banks' Off-B/S lending are strictly regulated and they are also required to account provision. A big portion of those credits are lent to property developers and LGFVs, as 77% of WMP's investment went to real economy in 2020, and features with assets duration mismatch and product nesting, which added systemic risk.

Under the regulation, such credit has completed transition to standard products, e.g. bond and loan, and new credit is banned. Banks' provision of such lending has already reached a similar level to the loan provision by 2021.

Besides, banks' wealth management products have finished valuation methodology change from the guaranteed return to NAV-based of which product price is based on market value. The total WMP (wealth management product) balance reached 30trn in 2022 whereas non-guarantee products accounted for 92% and NAV-type of product accounted for 88%, up from 6% in 2017. Such effort helps to curb systemic risk in long-term.

In addition, the Communist Party strengthened the management and supervision of all the way down to local financial institutions by reforming the structure of financial supervision (attitude of seriously trying to suppress risk).

After the new leadership is elected in 2023, a new Central Financial Commission will be set up to lead and manage the financial reform and will replace the Stake Council's Financial Stability and Development Committee. Also, a Central Financial Working Commission will be formed to guide on discipline in the financial system and the implementation of major policy directions.

The bureaucratic change is the continuation of de-risk effort initiated since 2018, and the direct response to the risk happened in past few years especially at local government level.

The key objectives include 1) ensuring the support to real economy in a sustainable way, e.g. rational growth vs. pro-growth, and 2) controlling financial risk especially at local government. Having said that, the financial regulation is expected to tighten going forward while the systemic risk could be more strictly monitored and contained by the central government.

4. Stock prices and valuations of the sector

Actually, the stock prices of Chinese bank-related stocks (mainly major banks) are doing well.

The reason behind this is the attractiveness of the dividend and the cheap valuation. As end of May 2023, the YTD share price performance of SOE banks is 18% outpaced the 4% return of A-share banks' average. Previously SOE banks traded at depressed valuation, i.e., 0.5-0.6x P/B, compared to 10.5% ROE, which is under estimated in our view given China government can manage to avoid systemic risk while the previous valuation had reflected crisis scenario.

Furthermore, State-owned Assets Supervision and Administration Commission of the State Council (SASAC) strengthens its efforts to reevaluate the valuation of state-owned enterprises. There is ongoing discussion that SASAC has been formulating another round of SOE reform by changing KPI metrics to ROE and operation improvement, and China government could eye to supplement fiscal income by leveraging the equity value of SOEs.

It is too early to judge whether these moves will be successful. The recent liquidity preference to SOE banks could be temporary because a sustainable rally is driven by long-term funding which favors quality names or continuous operation improvement. SOE banks need to deliver hard data to improve its attractiveness, which could include higher net profit (NP) growth at least 8% yoy per year or higher dividend payout. Those require management to provide clearer guidance, at this moment, and it looks challenging. However, the Chinese government has already taken serious measures to avoid risks to China's financial system. **This government's stance is likely to be favorably appreciated by investors.**

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