Chapter II

Banking Sector

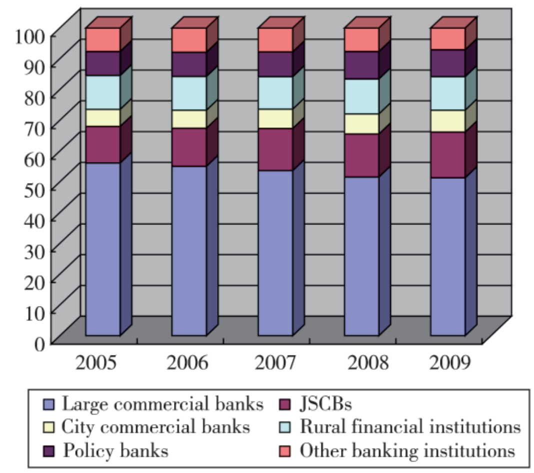
In 2009, in response to the international financial crisis, China's banking sector carefully implemented moderately loose monetary policy, increased credit extension, and played an important role in supporting and promoting economic and social development. The reform of banking institutions continued to advance, as reflected in enhanced risk management and resilience to crisis, and a strengthened basis for sound performance.

Recent Developments

Total assets and liabilities continued to increase. As of the end of 2009, total assets of banking institutions increased by 25.91 percent to RMB 79.51 trillion yuan on a y-o-y basis, and total liabilities grew by 26.46 percent to RMB 75.07 trillion yuan. In 2009, the share of assets of JSCBs and city commercial banks in the total assets of banking institutions rose by 0.84 and 0.61 percentage points. The big five commercial banks (including ICBC, ABC, BOC, CCB, and BOCOM), policy banks, rural financial institutions (including rural commercial banks, rural cooperative banks, and RCCs) and foreign banks saw a decline in their share of assets (Figure 2.1).

Figure 2.1 Proportion of Assets of Banking Institutions

(*percent*)



Source: CBRC.

The outstanding balance of deposits and loans grew by a large margin. As of the end of 2009, the outstanding deposits of banks denominated in both domestic and foreign currencies grew by 27.7 percent y-o-y to RMB 61.2 trillion yuan, representing an increase of RMB 13.24 trillion yuan from the beginning of the year; the outstanding loans in both domestic and foreign currencies rose by 32.83 percent y-o-y to RMB 42.56 trillion yuan, an increase of RMB 10.52 trillion yuan from the beginning of the year. Broken down by maturities, the outstanding balance of short-term loans registered RMB 15.14 trillion yuan, increasing by RMB 2.29 trillion yuan from the beginning of the year, up 17.8 percent; the outstanding balance of medium and long-term loans amounted to RMB 23.56 trillion yuan, increasing RMB 7.1 trillion yuan from the beginning of the year, up 43.3 percent; and the outstanding paper financing reached RMB 2.39 trillion yuan, an increase of RMB 458.44 billion yuan from the beginning of the year, up 23.7 percent y-o-y.

Asset quality improved on an overall ba-

sis. In 2009, banking institutions witnessed a further decline in both the outstanding NPLs and the NPL ratio, with the provision coverage ratio rose at high levels. At end-2009, the outstanding NPLs of commercial banks registered RMB 506.678 billion yuan, a y-o-y decrease of RMB 56.804 billion yuan; the NPL ratio recorded 1.59 percent, down 0.8 percentage point y-o-y; and the provision coverage ratio grew by 36.57 percentage points to 153.21 percent.

Capital remained adequate. The capital base of banking institutions was replenished through various channels. Commercial banks issued a total of RMB 274.6 billion yuan of subordinated bonds and hybrid capital bonds, representing a growth of 279.3 percent from the previous year. As of the end of 2009, the CAR of banking institutions stood at 10.87 percent, with the CAR of commercial banks reaching 11.46 percent.

Profits continued to increase. The net profits of banking institutions after tax reached RMB 668.423 billion yuan, representing an increase of RMB 85.068 billion yuan or 14.58 percent y-o-y, among which net profits of major commercial banks (including the big five commercial banks and 12 JSCBs) after tax totaled RMB 492.612 billion yuan, up 12.37 percent.

Reform and Achievements

Reform of Large Commercial Banks Was Steadily Pushed Forward

The reform of the large commercial banks that have been transformed into joint-stock banks was further deepened. Since the beginning of 2003, drawing lessons from the Asian financial crisis and other previous financial crises, China seized the opportunity to promote the shareholding reform of large state-owned commercial banks in a forward-looking approach before the outbreak of the current international financial crisis, which is crucial for coping with the international financial crisis and supporting the sound development of the national economy. In 2009, ICBC, BOC, CCB and BOCOM strengthened management while further advancing the reform, with their corporate governance structure steadily improved and the new mechanism increasingly played an important role; internal control and management capability further intensified and risk prevention system steadily improved; the reform of process bank further deepened with the building of business, organizations and management procedures improved, human resources and corporate culture development advanced in a orderly manner, and enterprise core competitiveness enhanced; and the efficiency and capability of serving economic and social development steadily beefed up.

The reform of CDB and ABC achieved positive results. CDB has transformed into a JSCB from a policy bank. On January 16, 2009, the Agricultural Bank of China Co., Ltd. was officially inaugurated. Corporate governance structure was initially put in place in the two banks, with their risk control system improved, internal reform further advanced, operation mechanism upgraded, and business developed at a steady and fast pace. While increasing medium-and long-term credit extension to support policy measures designed to maintain growth, expand domestic demand and restructure the economy, CDB initiated a batch of major strategic programs in accordance with the national energy, resource and "going global" strategies. After the reform, the two banks saw remarkable improvement in their financial conditions.

The reform of policy banks was progressively advanced. According to the arrangements of the State Council, in March 2009, PBC and relevant authorities established a working group on the reform of EXIM. Since its establishment, the working group, focusing on the revision of the articles of association of the EXIM, has conducted a series of researches on issues including the bank's functional positioning, scope of business, state injection of capital, corporate governance, internal reform, external supervision, coordination mechanisms, and measures to support the reform. Drawing on practices of counterparty institutions in the US and other countries, the working group formulated the overall reform plan on the EXIM and drafted the revised articles of association in order to build up a modern financial enterprise system. At present, the overall reform plan has been approved by the State Council. In addition, ADB also pressed ahead with its internal reform by strengthening risk management and internal control mechanisms and developing new business lines, so as to pave the way for a comprehensive reform in the future.

Banking Institutions' Efforts to Support Economic Growth Achieved Evident Effects

Moderately loose monetary policy was implemented. In 2009, taking into account the development needs as well as the changes in market demand, banks intensified credit extension and appropriately handled the pace of credit supply to maintain adequate liquidity in the banking system, which greatly contributed to the sound and rapid economic development. First, credit supply was increased. New RMB loans in 2009 registered RMB 9.59 trillion yuan, RMB 4.59 trillion yuan more than the growth recorded a year earlier, which effectively promoted the implementation of the policy of boosting domestic demand and maintaining economic growth. Second, the pace of credit expansion was appropriately managed according to new situations, with credit growth in Q2, Q3 and Q4 decelerating in an orderly fashion, down to a monthly average of RMB 920 billion yuan, RMB 430 billion yuan and RMB 310 billion yuan respectively.

Rural financial services continued to improve. First, ABC actively explored ways to support agriculture, rural areas and farmers in its commercial-based operation, with the priority given to business innovation and the pilot reform of its multi-divisional structure system, and steadily increase the extension of agriculture-related loans, so as to provide better financial services for agriculture, rural areas and farmers. Second, further progress has been made in the reform of RCCs. By the end of 2009, 2 054 institutions with legal person status at the county (city) level, 43 rural commercial banks and 195 rural cooperative banks had been established. The dominant role of RCCs was effectively bought into play in providing financial support to the agricultural sector. Third, vigorous efforts have been made to support the development of new-type rural financial institutions. At end-2009, 172 new-type rural financial institutions were approved to conduct business, including 148 village and township banks, 8 loan companies and 16 rural credit cooperatives. Fourth, rural financial products and services were actively innovated, and policy support was ratcheted up to improve financial services to agriculture industry chains, farmer specialized cooperatives, creation of job opportunities for the returned migrant workers and home appliances going to countryside. With concerted efforts, in 2009, new agricultural loans amounted to RMB 2.36 trillion yuan, and the outstanding agricultural loans totaled RMB 9.14 trillion yuan, accounting for 21.5 percent of the total loans and representing a y-o-y growth of 32.3 percent, up 11.5 percentage points from a year earlier.

Financing of SMEs was continued to improve. In 2009, banking institutions steadily innovated financing channels to improve credit services for SMEs. First, credit support to SMEs was stepped up. Some commercial banks regarded SME lending as a strategic priority and a source of growth of profits, and gradually increased loans to SMEs. At end-2009, outstanding SME loans in banking institutions reached RMB 10.9 trillion yuan, a y-o-y increase of 13.5 percent. Second, the building of institutions specializing in financial services for SMEs was actively promoted. At end-2009, loans issued by such kind of institutions under 17 major commercial banks accounted for over 60 percent of SME loans in these banks. Third, efforts have been made to improve credit, fiscal and taxation environment for SME financing, explore ways to conduct differentiated supervision over SME loans, and encourage credit supply to tilt toward SMEs.

Resilience to Financial Risks Enhanced

In 2009, while supporting economic development, the banking sector attached great importance to the prevention of financial risks and took concrete measures to strengthen internal management as well as external supervision, as reflected in improved risk management system and effective mitigation of certain risks, laying a solid foundation for the sound performance of the banking sector.

Internal risk management gradually improved. First, continued efforts have been made to optimize corporate governance and internal control mechanism, appropriately adjust compensation system, actively improve risk management system, and further intensify legal and market disciplines. Second, methodologies and techniques of risk identification, measurement and assessment were updated to gradually improve risk monitoring, assessment and early warning system, with risk management capability further enhanced. Third, the building of information technology application system was further promoted to enhance the safety of the system, and strengthen data integration as well as resource development. The information examination and management before, during and after lending was intensified to provide vigorous support to business innovation and development. Fourth, intensified efforts have been made to control credit risks emerging from the areas such as fixed asset investment, local financing platform and real estate sector, and strengthen credit management to prevent and mitigate potential credit risks. Fifth, penalty on cases of irregularities was strengthened to enhance banks' capability of controlling irregularities and encourage banks to take effective measures to prevent operational risks. Sixth, information disclosure system was improved, and the information disclosure in the banking sector made important strides.

Box 5 China's Banking Sector Made Significant Progress in Information Disclosure

BCBS and other international organizations have long highlighted the important role of information disclosure in bank's external governance, and set the information disclosure as one of the three pillars of Basel II. As revealed in the current financial crisis, the international banking sector failed to disclose adequate information on regulatory capital requirement, credit risks of counterparties, securitization risks and market risks of complex financial instruments, inflicting difficulties on market participants in fully assessing and comparing capital and risks among institutions. In this regard, in 2009, BCBS issued the amendments to market risks and trading book, as well as the *Strengthening the Resilience of the Banking Sector-consultative document* to further enhance information disclosure of the banking sector, specifying the detailed requirements on the information disclosure of securitization, trading business and off-balance sheet risks, and requiring banks to disclose in details the composition and adjustment of regulatory capital with an aim to strengthen market disciplines.

In recent years, in promoting the implementation of Basel II, China has taken a series of policy measures to strengthen information disclosure in the banking sector drawing on good practices in the international banking sector, and further improved information disclosure system. Banking information disclosure made significant progress, as evidenced by strengthened institutional framework and new corporate accounting standards established in line with international accounting standards. Most of the commercial banks disclosed information annually according to the requirements of regulatory authorities, with their awareness of information disclosure gradually strengthened, and the scope and depth of information disclosure steadily enhanced. Information disclosure practices of 14 listed commercial banks broadly met international standards, and were widely accepted by regulatory authorities and investors both at home and abroad. 7 commercial banks including ICBC will be among the first that implement Basel II in 2010, and will conduct information disclosure according to the requirement of Basel II. China's banking sector will see improvements accordingly in both the quality of information disclosure and the transparency and market disciplines.

The effectiveness of external supervision further enhanced. First, the *Guidelines on Banking Account Interest Rate Risk Management of Commercial Banks*, the *Guidelines on Liquidity Risk Management of Commercial Banks*, and the *Guidelines on Reputation Risk Management of Commercial Banks* were issued in an effort to strengthen the management of banking account interest rate risks, liquidity risks and reputation risks. Second, the *Guidelines on the Supervision over Capital Adequacy of Commercial Banks*, *the Guidelines on Capital Adequacy Disclosure of Commercial Banks, and the Administrative Rules on the Pilot Investment on the Equity of Insurance Companies by Commercial Banks* were formulated to improve banks' risk control mechanism in such areas as capital regulation, leverage ratio and integrated financial services. Third, steps have been taken to intensify regulatory requirements on banks' capital quality and adequacy, strengthen capital constraints on banks' exposures in trading book and asset securitization, and clearly prescribed that long-term subordinated debt cross-held by commercial banks should be deducted from the capital, and banks are prohibited to provide guarantee for corporate bonds. Fourth, the institutional building of supervision over non-banking financial institutions[1] has been reinforced, the *Administrative Rules on Pilot Consumption Financial Companies* was formulated, and the *Administrative Rules on Supervisory Rating of Trust Companies* and the *Administrative Rules on information Disclosure of Trust Companies* were revised and improved. Fifth, efforts have also been made to actively advance the cross-border supervisory cooperation, which include: explored ways to establish supervisory college for large commercial banks, signed MOU on supervisory cooperation with supervisory authorities in 25 jurisdictions, and successfully held the first international supervisory college meeting for ICBC.

Certain risks were mitigated effectively. First, steps have been taken to properly cope with the reduction of shareholdings by overseas strategic investors. Since the end of 2008, affected by the international financial crisis, some overseas strategic investors of major Chinese financial institutions started to

1 Non-banking financial institutions include TICs, finance companies affiliated to enterprise groups, financial leasing companies, auto financing companies, money brokers and consumption financial companies under the supervision of CBRC.

reduce their shareholdings in the Chinese financial institutions after the expiration of lock-up period, triggering close attention of the market. Under the Guidance of the State Council, PBC, together with relevant authorities and financial institutions, took actions in response and properly guide public opinion with a view to effectively safeguard financial market stability. Second, risk resolution was conducted in an orderly fashion. Risks of illegal fund-raising in certain areas in Jizheng, Shandong province and Bozhou, Anhui province were timely eased. Risks of the US United Commercial Bank as well as its subsidiaries in China were effectively monitored and handled.

Actively Participated in the Formulation and Implementation of International Banking Supervisory Rules

China officially joined BCBS. In March 2009, BCBS announced the expansion of its membership, PBC and CBRC joined BCBS on behalf of China, marking that China started to fully participate in the formulating of international banking supervisory rules and standards. Since their accession, PBC and CBRC actively participated in the revision of Basel II as well as the discussions of BCBS proposals on strengthening bank capital regulation, establishing global liquidity standards, introducing the supervision over leverage ratio, building counter-cyclical capital buffer mechanism, improving banks' corporate governance, revising accounting standards and promoting the reform of compensation system, and timely put forward viewpoints and positions based on the views of China's financial institutions and the general public, so as to safeguard the core interests of China's banking sector.

Preparation has been made for the implementation of Basel II. In 2009, China sped up the institutional building to support the Basel II implementation in commercial banks, and basically established the legal framework for prudential supervision covering major risks in the banking sector. Quantitative Impact Study (QIS) was actively carried out to verify and examine on site the internal rating system and risk measurement models of commercial banks to implement Basel II, so as to ensure the smooth implementation of Basel II as scheduled. Meanwhile, major commercial banks established and improved working mechanism on Basel II adoption according to their specific circumstances, and made their system, equipment, techniques, data and staff well prepared for Basle II implementation. According to the objective and time frame for the Basel II implementation in China's banking sector, supervisory authorities will accept the application of commercial banks for the Basel II adoption since 2010.

Soundness Assessment

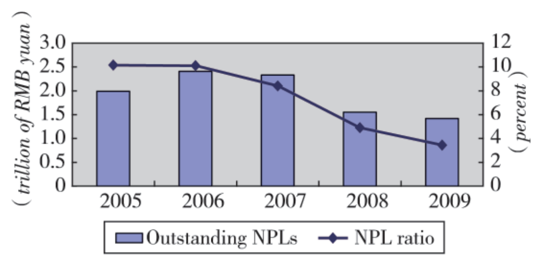
In 2009, major banking soundness indicators remained favorable, featured by improved asset quality, enhanced profitability, and abundant liquidity. However, the banking sector saw a decline in capital adequacy and an escalation in credit concentration, and faced larger financing pressures.

Asset quality continued to improve, while the risk of NPL rebound increased. As of the end of 2009, both the outstanding NPLs and the NPL ratio of banking institutions dropped evidently (Figure 2.2). Specifically, outstanding NPLs of major commercial banks recorded RMB 435.795 billion yuan, RMB 53.963 billion yuan less than that recorded at the end of 2008, with the NPL ratio decreasing by 0.82 percentage point to 1.59 percent; outstanding NPLs of city commercial banks fell by RMB 10.794 billion yuan y-o-y to RMB 37.688 billion yuan and the NPL ratio decreased by 1.03 percentage points to 1.3 percent; outstanding NPLs of policy banks and foreign banks amounted to RMB 420.641 billion yuan and RMB 6.182 billion yuan respectively, increasing by RMB 11.132 billion yuan and RMB 85 million yuan y-o-y.

With respect to the five-category loan classification, in 2009, commercial bank loans classified as special mentioned, substandard and doubtful decreased on a y-o-y basis while loans classified as loss rose by 10.08 percent y-o-y, with those in large commercial banks increasing by 7.45 percent and those in JSCBs escalating by 28.27 percent.

In terms of credit orientations, loans extended to local government financing platforms, infrastructure, and group clients grew substantially, and were increasingly issued with a large amount, long maturity and excessive concentration. With the acceleration of economic restructuring, credit funds are more likely to suffer losses.

Figure 2.2 NPLs and NPL Ratio of Banking Institutions



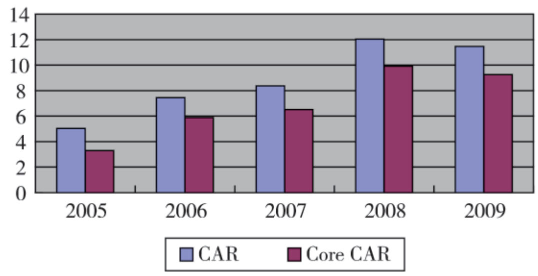
Source: PBC, CBRC.

CAR fell slightly with capital quality continued to escalate. In 2009, as a result of rapid credit expansion, the overall CAR of commercial banks declined. As of the end of 2009, the CAR of commercial banks stood at 11.46 percent, a decrease of 0.59 percentage point y-o-y. In particular, the CAR of large commercial banks, JSCBs and city commercial banks fell by 0.89, 0.27 and 0.15 percentage point to 11.25 percent, 10.27 percent and 12.96 percent respectively, building up pressures on bank financing.

Capital quality of commercial banks maintained at high level among international peers. At end-2009, core capital accounted for 81.74 percent of net capital of commercial banks, a growth of 17 percentage points from 2005 when the shareholding reform of commercial banks launched. Specifically, the proportion of paid-in capital that had the largest potential to absorb unexpected losses increased, accounting for 62 percent of net core capital, up 3 percentage points from 2008, indicating continued improvements in the resilience of commercial banks (Figure 2.3).

Figure 2.3 CAR of Commercial Banks

(*percent*)



Source: CBRC.

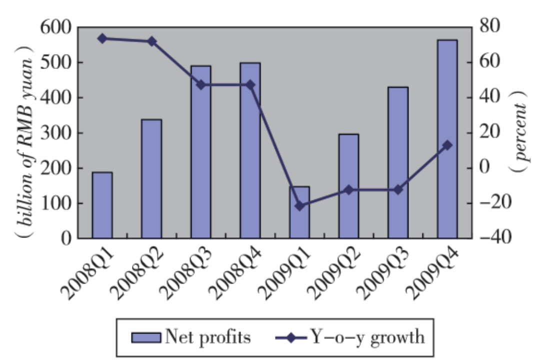
Provision coverage ratio rose at high levels with risk absorption improved. As of the end of 2009, the provision coverage ratio of commercial banks increased by 36.57 percentage points y-o-y to 153.21 percent. In particular, the provision coverage ratio of large commercial banks, JSCBs and city commercial banks posted 144.89 percent, 202.00 percent, and 182.28 percent respectively.

At end-2009, loan loss provision adequacy ratio of banking institutions rose by 18.85 percentage points to 102.28 percent y-o-y, among which loan loss provision adequacy ratio of large commercial banks, JSCBs and city commercial banks registered 180.27 percent, 161.22 percent, and 235.38 percent respectively.

Growth of profits decelerated but revenue structure gradually improved. In the first half of 2009, affected by factors such as the squeezed net interest spread, the banking sector witnessed a continued decline in profits. In the second half of the year, along with substantial credit growth and the recovery of the real economy, profits of banking institutions increased steadily. In 2009, banking institutions realized a net profit of RMB 668.423 billion yuan after tax, representing a y-o-y growth of 14.58 percent, down 16.02 percentage points from a year earlier. The ROA and ROE of banking institutions decreased by 0.07 and 0.85 percentage point y-o-y to 0.94 percent and 16.24 percent respectively. In particular, the ROE and ROA of commercial banks reached 18 percent and 1.03 percent respectively, higher than the average of the sector (Figure 2.4).

In 2009, driven by economic upturn and booming capital market, net fee and commission income of commercial banks grew at a rapid pace, with its proportion in total profits steadily increased and revenue structure continued to be improved. As of the end of 2009, net fee and commission income accounted for 14.39 percent of net operating income of commercial banks, up 4.28 percentage points from the previous year.

Figure 2.4 Growth of Net Profits in Commercial Banks

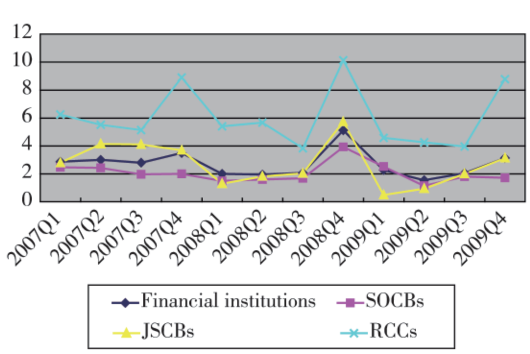


Source: CBRC.

Liquidity remained abundant while liquidity gap ratio expanded. As of the end of 2009, the liquidity ratio of commercial banks fell by 3.64 percentage points over the previous year to 42.41 percent, which was still much higher than the lower limit of regulatory indicators of 25 percent. In particular, the liquidity ratio of small and medium-sized institutions including city commercial banks and rural commercial banks maintained at above 50 percent. The loan to deposit ratio of banking institutions recorded 71.85 percent, up 2.68 percentage points y-o-y, lower than the regulatory ceiling of 75 percent. The excess reserve ratio declined y-o-y by 1.98 percentage points to 3.13 percent (Figure 2.5); and the ratio of RMB excess reserve plus cash to total deposits fell by 5.07 percentage points to 4.25 percent. Liquidity gap ratio of commercial banks expanded y-o-y by 8.74 percentage points to −14.37 percent. The maturity mismatch risk increased.

Figure 2.5 Excess Reserve Ratio of Financial Institutions

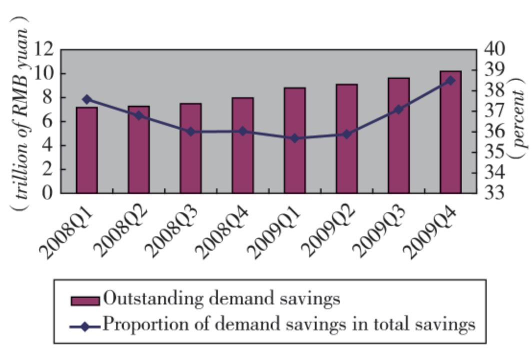
(*percent*)



Source: PBC.

Deposits of banking institutions grew at a rapid pace, tilting towards demand deposits. As of the end of 2009, the outstanding deposits of banking institutions denominated in both domestic and foreign currencies totaled RMB 61.20 trillion yuan, increasing y-o-y by 27.7 percent, up 8.4 percentage points. Outstanding household savings rose y-o-y by 19.54 percent to RMB 26.48 trillion yuan, a deceleration of 6.2 percentage points. In particular, demand savings grew by 27.88 percent to RMB 10.19 trillion yuan, 12.15 percentage points higher than the increase recorded in same period of last year (Figure 2.6).

Figure 2.6 RMB Demand Savings and its Proportion in Total Savings

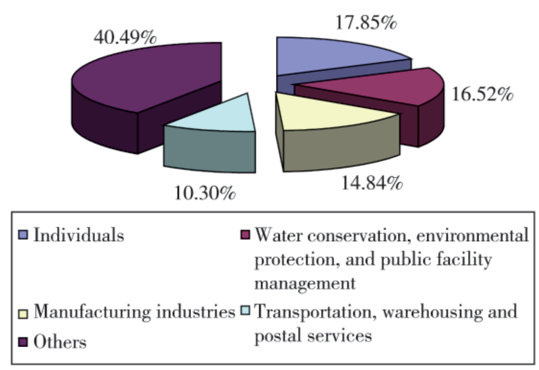


Source: PBC.

Affected by such factors as gradual economic upturn and relatively vibrant capital market, growth of household deposits slowed down, while the deposits of non-financial companies maintained rapid growth. At end-2009, outstanding RMB deposits of non-financial companies increased y-o-y by 37.2 percent to RMB 29.8 trillion yuan, an acceleration of 22 percentage points. Corporate demand deposits grew by RMB 3.82 trillion yuan, RMB 3.1 trillion yuan more than the growth recorded a year earlier.

Growth of loans hit a new record high, and credit structure was yet to be improved. As of the end of 2009, outstanding loans of banking institutions totaled RMB 42.56 trillion yuan, an increase of RMB 10.52 trillion yuan from the beginning of the year or 32.83 percent y-o-y, hitting a historical high. In particular, new medium and long-term loans amounted to RMB 7.1 trillion yuan, accounting for 67.47 percent of total new loans, suggesting a necessity of improving credit structure. In terms of loan orientations, new loans issued to individuals, public facility, manufacturing industries, and transportation accounted for 59.51 percent of the total new loans (Figure 2.7), up 5.88 percentage points on a y-o-y basis, indicating an enhanced concentration of loans. Real estate loans grew rapidly with relatively good asset quality. However, given housing price surged in 2009, attention should be paid to the potential impact of future price fluctuations on risks of real estate loans in commercial banks.

Figure 2.7 Sectoral Distribution of Loans



Source: PBC, CBRC.

Box 6 Analysis of Real Estate Finance in 2009

In 2009, domestic real estate market witnessed remarkable changes. Since the beginning of the second quarter, sales of commercial real estate continued to accelerate. In 2009, the total floor area of sold commercial real estate rose by 42.1 percent y-o-y to 937 million square meters. The y-o-y movement of housing prices turned positive in June 2009 and continued growing thereafter. In December, housing prices in the 70 large and medium cities grew 7.8 percent y-o-y (Figure 2.8). In large cities such as Beijing, Shanghai and Shenzhen, the surge in sold floor area and prices was more obvious. Due to market changes, real estate financing also expanded quickly.

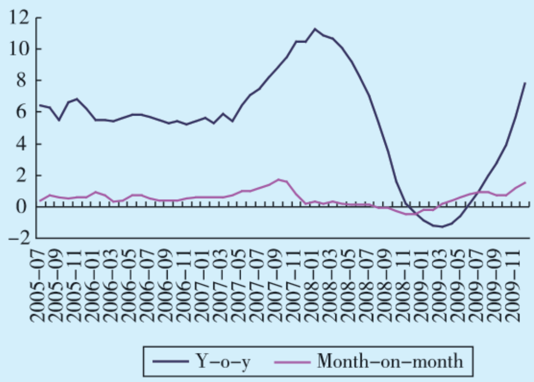
1. Commercial Real Estate Loans Maintained Rapid Growth

At end-2009, outstanding real estate loans issued by major financial institutions[1] grew by 38.1 percent y-o-y on a comparable basis to RMB 7.33 trillion yuan, representing an acceleration of 27.7 percentage points, higher than the peak of 30.9 percent in 2007 and exceeding the average loan growth

1 Major financial institutions include large commercial banks, CDB, policy banks, JSCBs, city commercial banks, rural commercial banks, UCCs, rural cooperative banks, RCCs and PSBC.

Figure 2.8 Monthly Growth of Housing Prices in the 70 Large and Medium Cities

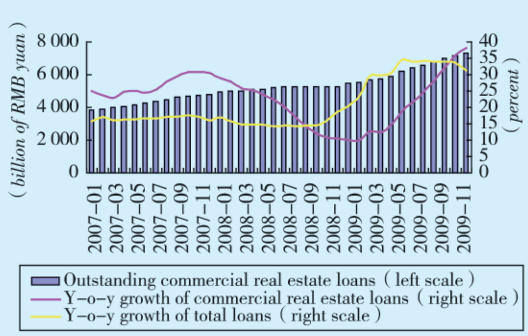
(*percent*)



Source: NBS.

rate by 6.7 percentage points. In 2009, new real estate loans posted RMB 2 trillion yuan, RMB 1.5 trillion yuan more than the growth recorded in the previous year (Figure 2.9).

Figure 2.9 Outstanding Amount and Growth of Commercial Real Estate Loans



Source: PBC.

The proportion of real estate loans in the total loans escalated. The share of real estate loans issued by major financial institutions in the total outstanding loans rebounded since May 2009, and reached 19.2 percent at the end of the year, one percentage point higher than in the previous year. In 2009, new real estate loans accounted for 21.9 percent in the total new loans, 11.1 percentage points higher than in the previous year.

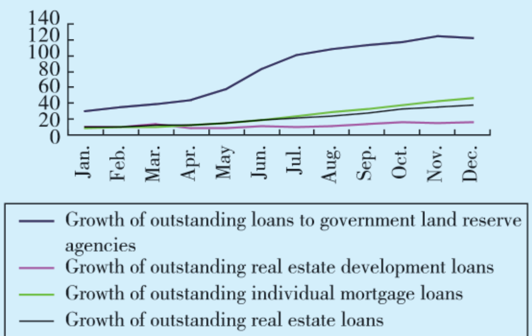
Loans issued to government land reserve authority maintained rapid growth. At end-2009, outstanding loans to government land reserve authority amounted to RMB 575.586 billion yuan, representing a y-o-y increase of 122.8 percent and an acceleration of 113.2 percentage points.

Real estate development loans grew relatively slowly. At end-2009, outstanding real estate development loans increased by 15.8 percent y-o-y to RMB 1.86 trillion yuan, representing an acceleration of 4.6 percentage points (Figure 2.10). There are mainly two reasons behind the slow growth of real estate development loans. First, real estate development investment grew at a slow pace; second, real estate development companies have limited cash demand due to ample revenues and returns from good sales performance and abundant receipt from advance sales.

Growth of individual mortgage loans bounced back to its peak level since 2007. At end-2009, outstanding individual mortgage

Figure 2.10 Growth of Different Categories of Commercial Real Estate Loans in 2009

(*percent*)



Source: PBC.

loans increased by 43.1 percent y-o-y to RMB 4.76 trillion yuan, representing an acceleration of 33.3 percentage points from the previous year. New mortgage loans in 2009 reached RMB 1.43 trillion yuan, about five times that in 2008 and 2 times that in 2007. Mortgage loans for new homes and pre-owned homes grew by 40 percent and 79 percent respectively. The ratio of loans for new real estate projects to the sales volume of new homes was 26.3 percent in 2009, higher than 22.3 percent in 2007 and up 16 percentage points from 2008.

Real estate loans in key areas, i.e. Guangdong province, Jiangsu province, Zhejiang province, Shanghai, and Beijing, continued to increase, among which the real estate loans in Jiangsu province and Beijing grew by 47.5 percent and 42.6 percent respectively. However, the top-ten highest growth areas were all central and western provinces. At end-2009, real estate loans in key areas accounted for 54.2 percent of those of the whole country, down 0.8 percentage point on a y-o-y basis.

Commercial real estate credit assets had relatively high quality. According to the statistics of CBRC, the ratio of commercial housing NPLs maintained at low levels. At end-2009, both the ratio and amount of commercial housing NPLs declined from 2008.

2. Housing Provident Fund Entrusted Loans Grew at a Faster Pace than Commercial Mortgage Loans

As of the end of 2009, housing provident fund entrusted loans rose by 44.5 percent to RMB 880.5 billion yuan, up 24.4 percentage points y-o-y and 1.4 percentage points higher than the growth of commercial mortgage loans during the same period. Housing provident fund entrusted loans accounted for 15.6 percent of the total mortgage loans (including commercial mortgage loans and provident fund entrusted loans).

Non-bank financial institutions developed rapidly, and potential risks worth attention. In 2009, the reform and development of non-bank financial institutions achieved significant progress. The introduction of domestic and foreign strategic investors by trust companies achieved visible results, the pilot issuance of financial bonds by finance companies was promoted in an orderly manner, and the consumption financial companies were launched on a pilot basis. As of the end of 2009, the assets of non-bank financial institutions totaled RMB 1.55 trillion yuan, a y-o-y growth of 31.37 percent, with their profits after tax increasing by 4.97 percent y-o-y to RMB 29.869 billion yuan, and the NPL ratio declining y-o-y by 0.29 percentage point to 0.6 percent. In general, the correlation between non-bank financial institutions and banks was increasingly strengthened. Along with movements of economic cycles and adjustment of macro policies, wealth management products of trust companies, credit products in particular, developed at a rapid pace, and the cooperation between banks and trust companies was yet to be regulated. Some financial companies rapidly expand their credit extension, with increased maturity mismatch between assets and liabilities, and the management of entrusted loans and bill business was yet to be strengthened. The size and market share of financing leasing companies was relatively small, with business undiversified and service function to be enhanced.

Aspects Worth Attention and Reform Measures

In 2009, confronted with the complex and ever-changing economic and financial situations both at home and abroad, the banking sector continued to maintain good growth momentum, vigorously supported macroeconomic management, and played a significant role in promoting economic and social development. In 2010, the banking sector will continue to implement macroeconomic management policies, provide intensified support to the transformation of economic development pattern and economic restructuring, prevent and mitigate credit risks as well as systemic financial risks, and further enhance its overall strength and resilience to risks so as to safeguard the sound performance of the banking system.

Optimize Credit Structure to Support Restructuring and Transformation of the Economic Development Mode

At present, the Chinese economy displays a good upturn momentum and is at a critical juncture of stabilization and recovery. However, endogenous forces for such a recovery remains weak, the foundation for sustained and sound development is not yet firmly established, and structural problems are increasingly acute, calling for a shift in the growth mode and economic restructuring on the agenda.

In this regard, while maintaining the appropriate growth of credit aggregates to promote sound and rapid economic development, the banking sector should continue to implement differentiated credit policies and to improve the credit structure. First, banks should ratchet up credit support to emerging strategic industries, industrial relocation and low-carbon economy, and develop new sources of economic growth. Second, efforts should be made to support the restructuring and revitalization of key industries and rein in lending to highly energy consuming and polluting industries, as well as industries with excess capacity. Third, financial policies should be carried out to support the "agriculture, rural areas, and farmers", the development of SMEs, and job creation so as to effectively address financing problems facing weak links in economic and social development. Fourth, steps should be taken to improve consumption-based credit policy, steadily advance the development of consumption financial companies on a pilot basis, vigorously develop consumption-based credit, and encourage urban and rural households to expand final consumption in an effort to effectively boost domestic demand. Fifth, credit support to enterprises in the export sector should be intensified, and the "going global" strategy of the Chinese enterprises should be further implemented to beef up the recovery of export. Sixth, housing credit services should be strengthened and improved, and credit support should be reinforced for households willing to purchase their first ordinary homes or houses for own use, for the construction of low-rent housing and affordable housing, and for shantytown renovation.

Strengthen Credit Management to Prevent and Mitigate Potential Credit Risks

In 2009, the banking sector increased credit supply to support sound and rapid economic development. At the same time, the accelerated growth of credit extensions also created several problems and potential risks, posing severe challenges to risk management of the banking sector, and banks was threatened with a rebound in NPLs.

Going forward, while supporting economic development, banks should pay more attention to prevent risks that may arise from their operation. First, efforts should be made to appropriately pace their loan extensions in line with the needs of economic development so as to promote proper and balanced credit growth. Second, banks should properly assess and effectively forestall credit risks in the local financing platform, appropriately manage the use of loans to prevent the misuse of bank loans as project capital. Third, steps should be taken to closely monitor the changes in real estate market and strictly follow real estate credit policies to promote sound financial development in the real estate industry. Fourth, banks should actively prevent and ease risks of credit-based wealth management products, steadily advance product innovation and expansion of business with risks under control, and strengthen information disclosure as well as investor education. Fifth, potential risks arising from intensive credit extension should be monitored, credit asset-backed securities should be pressed ahead with at a steady pace, and intensive credit transfer platform should be established to enhance the transferability of credit assets and alleviate the concentration of credit risks. Sixth, measures should also be taken to build up and improve credit risk monitoring and evaluation system, actively conduct stress testing, and strengthen the supervision over the implementation of credit policies so as to timely ease credit risks.

Improve Revenue Structure and Reinforce Bank Capital Supplement and Discipline Mechanism

In 2009, the banking sector witnessed a continued decline in revenue growth, and the proportion of fee and commission income remained at a relatively low level, posing larger pressures on banks to increase profits and improve revenue structure. Meanwhile, with the rapid credit expansion, the overall capital adequacy in the banking sector declined, as reflected in lower CARs of some commercial banks compared with the minimum capital requirement of 8 percent. Banks were facing increasing pressures on supplementing capital and intensifying capital discipline mechanism.

As of the next step, the banking sector should maintain appropriate growth of profits, continue to optimize revenue structure, and further improve capital supplementing and discipline mechanism with an aim to steadily intensify their capital base. First, keeping risks under control, steps should be taken to step up financial innovation and develop new products and business with distinctive features in an effort to avoid unduly homogeneous and low-level competition and enhance the overall profitability. Second, the development of fee-based business should be fostered in accordance with the current situations and the changing market demands, and further raise the proportion of fee and commission income as well as the earnings from non-credit assets. Third, scientific and feasible plans should be formulated to strengthen capital management. Banks should establish appropriate capital adequacy assessment procedures according to their risk profile and the complexity of business operation so as to ensure that their capital could fully cover various types of risks. Fourth, efforts should be made to explore and innovate capital supplement instruments, timely supplement core capital via various channels such as improving profitability, increasing internal accumulation and shareholder capital injections, and further enhance asset quality so as to concretely strengthen banks' capability of absorbing losses and their resilience to risks. Fifth, in line with the recent development of Basel II, continued efforts should be made to improve capital regulatory framework and strengthen capital discipline so as to curb the excessive asset expansion of commercial banks.

Box 7 The Introduction of New Capital Convertible Instrument

Since the outbreak of the international financial crisis, the international community has reached a consensus on strengthening banking regulatory capital framework and enhancing the soundness of the banking system. In December 2009, BCBS released the *Strengthening the Resilience of the Banking Sector-consultative document*, raising a series of reform proposals on enhancing regulatory capital quality, expanding the risk coverage of capital, conducting supervision over leverage ratio and building counter-cyclical capital buffer, etc. In addition, the international organizations and regulatory authorities are developing new capital convertible instruments in order to immediately increase banks' capital base during the crisis.

Some international organizations raised the idea of contingent capital, i. e. , banks have the capability of automatically converting non-common stock Tier 1 and/or Tier 2 capital (such as preferred equity or subordinated debt) into common stock on a trigger event (such as a bailout or insolvency). This Tier 1 or Tier 2 capital instrument is contingent capital instrument. This instrument highlights the role of common stock in absorbing loss, and enables banks to increase the size of common stocks during the crisis, which is conducive to strengthening incentives and disciplines for bank managers and investors, and reducing moral hazards. Issuing contingent capital instruments has the potential to be an effective way to strengthen banks' capital base, although certain problems need to be addressed in practice, for instance, how to define the trigger event and conversion rate, whether an internationally accepted rule on conversion rate should be formulated, how to balance the interests of all parties, and whether the market will respond negatively to the conversion of capital. These problems are not difficult to solve in practice. Rational investors will require premium against the convertibility of such capital instruments into common stock during the crisis, which may be reflected in prices or interest rates.

Drawing on the concepts of contingent capital instruments, some European regulatory authorities and banks established contingent convertible instruments (CoCos), enabling banks to expand capital and increase CAR during the crisis. In November 2009, the Lloyds Banking Group in UK issued a total of GBP 10 billion of contingent convertible instruments, which would be debt instruments in "good" states, but would convert into capital during the crisis (for instance, when CAR fell below a pre-specified level). The Swiss banking regulatory authorities also encouraged two large domestic banks to follow the practices of the Lloyds Banking Group.

New capital convertible instruments provided a feasible way for banks to convert and supplement capital, and were conducive to improving China's banking capital supplement mechanism and strengthening regulatory capital framework.

Deepen the Reform of Banking Institutions and Lay a Solid Micro Foundation for the Sound Performance of the Banking Sector

In 2009, the reform of banking institutions achieved prominent results. However, some banking institutions were still confronted with arduous tasks to deepen the reform so as to further enhance their overall strength and resilience to risks.

Banking institutions should continue to deepen the reform in an effort to lay a solid micro foundation for sound performance of the banking sector. First, the reform of large banks should be steadily deepened. Continued efforts should be made to gear up the reform of ABC, improve the multi-divisional arrangement for rural financial services, and steadily push forward the introduction of strategic investors and the IPO. Steps should also be taken to accelerate the pace of CDB for its market-oriented reform, and gradually establish a commercial bank-type business operation mechanism. Second, the reform of policy banks should be deepened. The reform of EXIM should be promoted to further identify a proper position on the market, clarify business scope, improve governance structure, innovate management pattern, strengthen risk control, establish risk compensation mechanism, and provide better services for foreign trade and enterprises investing overseas. ADBC should continue to make preparation for shareholding reform. Third, the RCCs reform should be bolstered in line with the principle of serving agriculture, rural areas and farmers, promoting sustainable development, advancing market-oriented reform, introducing appropriate competition and providing policy support. The role of market disciplines should be brought into full play and rural financial policy support system should be strengthened to improve services to agriculture, rural areas and farmers. Fourth, the reform of JSCBs, city commercial banks and other banking institutions should be facilitated to enhance their overall strength, market competitiveness and resilience to risks. Fifth, attention should be paid to the correlated risks between non-banking financial institutions and commercial banks, improve the management of collective fund trust in trust companies, the cooperation between banks and trust companies, and business innovation, and gradually alter the extensive development of some finance companies and financial leasing companies so as to further enhance the overall strength and soundness of non-banking financial institutions.

Formulate Strategic Plans to Enhance the Strength of the Overall Banking Sector and Its Resilience to Risks

In 2009, in light of the changing global economic and financial situation, the China's banking sector is facing both opportunities and challenges, with several deeply rooted problems and institutional imbalances becoming more acute, hindering the sound performance of the banking sector.

In the days to come, scientific strategic plans should be formulated to address systemic and long-term problems impeding the sound and sustained development of the banking sector. First, legal framework should be improved for the banking sector to further regulate the behaviors of market participants, regulatory authorities and relevant parties, and strengthen legal and market disciplines. Second, steps should be taken to adopt appropriate development mode under China's specific circumstances, encourage sound innovation and strengthen risk management so as to promote sound and sustained development of the banking sector. Third, integrated financial services in the banking sector should be comprehensively designed and the administrative rules on integrated financial services should be formulated based on the practices of pilot programs and international experiences to prevent risks from spreading across sectors. Fourth, the opening up strategies of the banking sector should be timely adjusted to actively introduce foreign financial enterprises that are conducive to boosting consumption, satisfying the financing needs of SMEs and serving agriculture, rural areas and farmers, and encourage foreign banks to establish branches and conduct business in underdeveloped regions. Institutional building should be improved for banks "going global", and prudential support should be provided for commercial banks to conduct M&A business overseas in an effort to strengthen cross-border risk prevention. Fifth, efforts should also be made to reinforce micro-prudential supervision of the banking sector while establishing and improving macro-prudential management framework, conduct counter-cyclical management in a scientific approach, and further enhance the effectiveness of supervision and macroeconomic management. Sixth, the building of deposit insurance system should be accelerated, and the market exit mechanism for commercial banks should be improved so as to effectively prevent and mitigate systemic financial risks and safeguard financial stability.