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City commercial banks in China

Group 1

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Contents

Introduction

The Chinese banking system has gone through significant transformation since 1978[1].

- The all-in-one mono-bank system under the planned economy was replaced by a banking sector dominated by the four state-owned banks (the Big Four).
- City commercial banks rank third in terms of business development among all the categories of Chinese financial institutions, preceded by the Big-Five state-owned commercial banks (SOCBs) and 12 joint-stock commercial banks.

[1] Ferri, G. (2009). Are new tigers supplanting old mammoths in chinas banking system? evidence from a sample of city commercial banks. *Journal of Banking & Finance*, *33*(1), 131–140.

The development of CCBs in China

- The precursor of the city commercial bank is primarily urban credit cooperatives, which evolved in the late 1970s.
- CCBs emerged in China only in 1995. On 7th September 1995, the State Council issued guidelines of the establishment of the city cooperative bank to salvage urban credit cooperatives from the NPL-endangered situation[2].

[2] Sun, J., Harimaya, K., & Yamori, N. (2013). Regional economic development, strategic investors, and efficiency of chinese city commercial banks. *Journal of Banking & Finance*, *37*(5), 1602–1611.

Current Situation

Current Situation

By now, the number of CCBs has slightly increased, with at least one CCB in almost every major city.

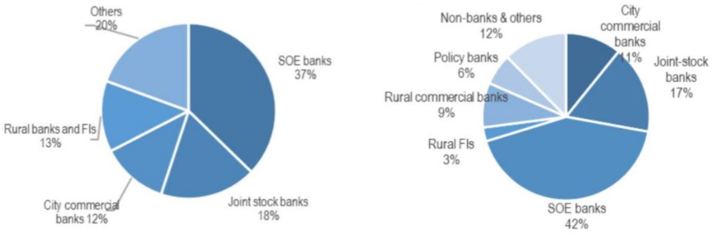
However, these banks are unevenly distributed, with more branches in the economically more developed eastern provinces (such as Jiangsu and Guangdong) than in the less developed western provinces (such as Qinghai).

As shown in Figure 1, Chinese city commercial banks make up around 12% of total assets, 11 % of net profit of all the Chinese banking.

In contrast to the Big-Five state-owned commercial banks that dominate Chinese banking, city commercial banks are small.

Figure 2 shows the relative stable amounts of city commercial banks in China, and the figure is 134 specifically at the year of 2018. Figure 3 gives us the idea of the top 15 city commercial banks ranked by total assets in China[3].

[3] Zhang, J., Wang, P., & Qu, B. (2012). Bank risk taking, efficiency, and law enforcement: Evidence from chinese city commercial banks. *China Economic Review*, *23*(2), 284–295.



(a) By asset (b) By net profit

Figure 1: China banking system market share (2017)

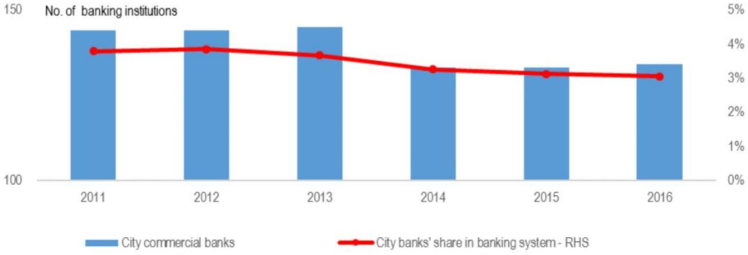


Figure 2: City banks account for 3% of banking institutions

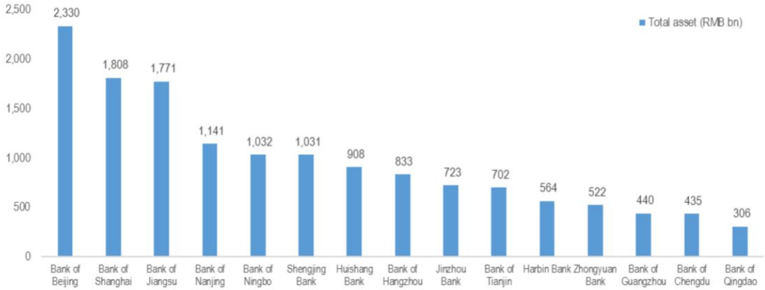


Figure 3: Top 15 city commercial banks in China by total assets

Advantages and disadvantages

Advantages

A city commercial banks success is highly dependent on the success of the local economy. And their relatively smaller size can be a double-edged sword for their further development.

1. First, the rapid response advantage brought by the less complex corporate governance structure is a key advantage for the success of CCBs in the local area.
2. Another important feature of CCBs is the geographical advantage of blending with the local economy[4].

[4] Juan, W. Q. W. W. H. (2012). Geographic diversification of city commercial banks: Lending expansion, risk level and bank performance [j]. *Journal of Financial Research, 1*.

Disadvantages I

1. The overall asset quality of CCBs is relatively poorer, the burden of non-performing assets is a bit heavier, the capital is less sufficient, and equity financing channels are lacking[5].
2. The equity structure is unreasonable, corporate governance is imperfect, and internal control and risk management are weak.
3. The operating structure and credit assets are unreasonable, the ratio of medium to long-term loans is larger, and the concentration of loans is higher.
4. Their market positioning is unclear, and some of them have excessive focus on scale expansion, lacking strategic plans.

5. Less sufficient product innovation, technological development, especially under the recent rapid development of Fin-tech.

[5] Zhang, D., Cai, J., Dickinson, D. G., & Kutan, A. M. (2016). Non-performing loans, moral hazard and regulation of the chinese commercial banking system. *Journal of Banking & finance*, *63*, 48–60.

Problems with CCBs

China’s small and regional banks, which in some cases serve as the financing arms of local governments, are particularly vulnerable to the current economic slowdown after excessive lending to projects favoured by local officials, which may leave time bombs in China’s financial system.

Two Examples


bsb
包商银行
baoshang Bank
Baoshang Bank

Baoshang Bank, based in Inner Mongolia, will be taken over by China's banking and insurance regulator over critical credit risks. The takeover starts on Friday (May 24, 2019) and will last a year, both the Insurance Regulatory Commission (CBIRC) and the Peoples Bank of China (PBOC) said on their respective websites.

Baoshang Bank came into the spotlight after one of its main stakeholders, Tomorrow Holdings, was implicated in a crackdown by the government, which was looking for systemic risks by large financial organizations.

Bank of Jinzhou

July, 2019, Bank of Jinzhou Co., a small regional lender in the northeastern rust belt province of Liaoning, got a partial bailout from three state-owned asset managers. A unit of Industrial & Commercial Bank of China Ltd., as well as distressed debt managers China Cinda Asset Management Co. and China Great Wall Asset Management Corp., agreed to buy at least 17% of Jinzhous shares.

Takeovers of banks are rare in China. The takeovers happened in our examples highlight the troubles that smaller banks in China face, like poor capital buffers, inadequate internal controls, asset quality deterioration and others.

Equity Structure

- Vertical agent problem: the collision between the shareholders and the managers
- Horizontal agent problem: the collision among the large shareholders and the small shareholders[6].

[6] Barclay, M. J., Holderness, C. G., & Sheehan, D. P. (2001). The block pricing puzzle. *Simon School of Business Working Paper No. FR*, 01–05; La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R. (2002). Investor protection and corporate valuation. *The journal of finance*, *57*(3), 1147–1170.

- Cronqvist (2009)[7] found that the property of the shareholders and the shareholding proportions among the shareholders are the two important aspects to solve it.
- Shareholding proportions
  - Too low: asymmetric information among shareholders and managers
  - Too high: asymmetric information among large and small shareholders
- Shareholders properties
  - State-owned shareholders: more resource but less efficiency
  - Private shareholders: less resource but more efficiency

[7] Cronqvist, H., Heyman, F., Nilsson, M., Svaleryd, H., & Vlachos, J. (2009). Do entrenched managers pay their workers more? *the Journal of Finance*, *64*(1), 309–339.

The optimal equity structure

- Liu et al. (2011) used the panel data of 14 listed domestic banks and found that the shareholding proportion of the largest shareholder presents the inverse-U shape with the performance of the banks, indicating that there exists an optimal equity structure.
- Yang (2012) focused on the equity structure of the Ningbo, Beijing and Nanjing city commercial banks and also found the similar result.

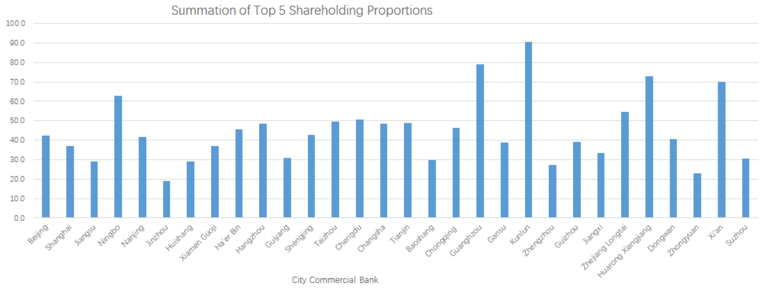


Figure 4: Summation of Top 5 Shareholding Proportions

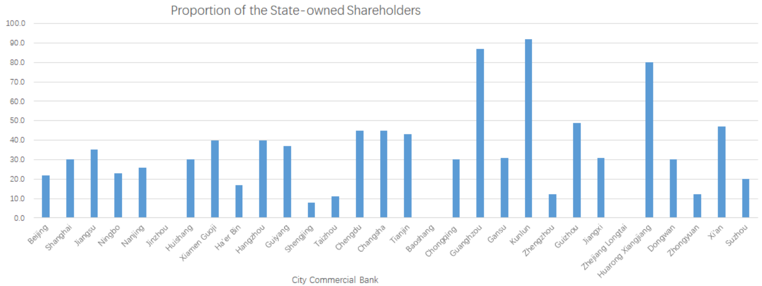


Figure 5: Proportion of the State-owned Shareholders

Reasons: Complex

In the beginning of the 2000, the government encouraged the change of city credit unions to the city commercial banks. To achieve this, many the local governments and local enterprises became the shareholders of the city commercial banks. But the participation of the local governments and the local enterprises varied in different areas.

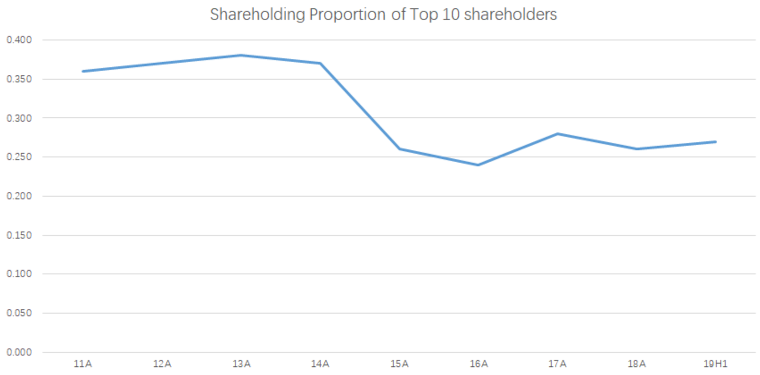


Figure 6: Shareholding Proportion

Shareholding Property

- State-owned shareholder gradually quit its shares from 2013 to 2019 and in 2019 all the shareholders are the private enterprises.
- Many shareholders were selected by the prior chairman, Zhangwei, and therefore these shareholders will essentially act in concert with Zhangwei.

Nominally, the shareholding proportion is highly diversified. But essentially, nearly 89% shares were directly and indirectly held by Mingtian Group. This trigger the severe internal control problem. Mingtian Group occupy a large amount of cash illegally, resulting in the default risk of Baoshang bank

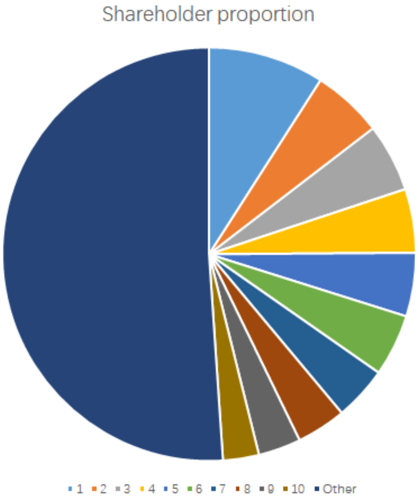


Figure 7: Proportion of deposits & Interbank debt scale & Total liabilities (billion)

Commercial Bank Financial Performance

- Balancing profitability, safety and liquidity is the three principles of commercial bank operation.
- Based on the available financial data, we selected 9 top city commercial banks and analyze their financial performance on 2018.

Financial Performance

Index	Formula
Profitability index	
Proportion of net interest income	$\frac{\textit{Net interest income}}{\textit{total profit}}$
Return on Net Assets	$\frac{\textit{Net Profit}}{\textit{Shareholders 'Equity}}$
Profit growth rate	$\frac{\textit{current profit-previous year profit}}{\textit{previous year profit}}$
Asset security	
Capital adequacy ratio	$\frac{\textit{core capital + ancillary capital-deduction}}{\textit{weighted risk assets + 12.5 * market risk capital}}$
NPL ratio	$\frac{\textit{subprime loans + doubtful loans + loss loans}}{\textit{loan balance}}$
Provision coverage ratio	$\frac{\textit{general preparation + special preparation + special preparation}}{\textit{subordinate loan + doubtful loan + loss loan}}$
Debt security	
Proportion of deposits	$\frac{\textit{Deposits}}{\textit{total liabilities}}$
inter-bank liabilities	*Inter-bank deposits + borrowed funds + sell-backs + inter-bank certificates of deposit*
Liquidity index	
Liquidity ratio	$\frac{\textit{Liquidity ratio Liquid asset balance}}{\textit{liquidity liability}}$
Reserve ratio	$\frac{\textit{bank deposit + cash}}{\textit{deposits}}$
Deposit to loan ratio	$\frac{\textit{Loan balances}}{\textit{deposit balances}}$

Profitbility Index

Profitability Index

- We mainly focus on the profitability of banks and their long-term sustainability.
- Among them, profitability can be measured by net interest income and return on net assets.
- Long-term sustainability can be measured by rate of return increase.

Net interest income

- The main source of profit for commercial banks.
- The higher its share of total profits, the more profitable the bank may be.

1. Ignore the impact of scale.
2. Shows the profit level of the net assets of each unit.
3. According to the requirements of the China Banking Regulatory Commission’s "Core Indicators of Risk Supervision of Commercial Banks", the ROE should not be less than 11%.

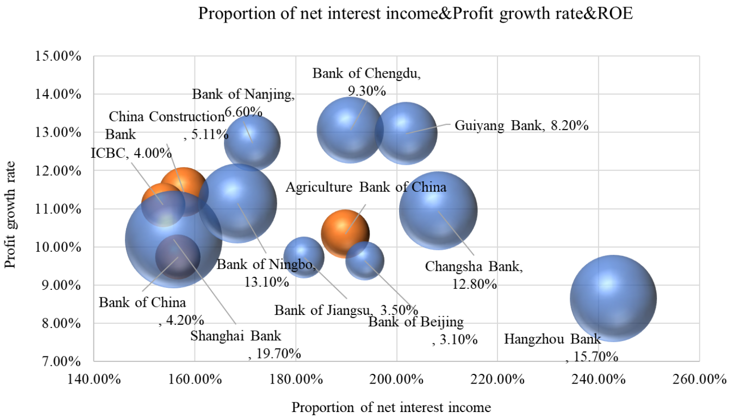


Figure 8: Proportion of net interest income & Profit growth rate & ROE

Conclusions on Profitability

1. Net Interest Income: The CCBs have concentrated income sources, the interest income, and the level of intermediate business is low.
2. The profit growth rate: CCBs are generally high.
3. ROE: As the bubble size shows, the variance of the ROE of CCBs is relatively large. And the average ROE of CCBs is 10.22% , which is higher than 4.55% of the four major banks. It may because the regional advantage.

Asset Security

- On December 8, 2017, the Basel Committee issued "Basel III: The Final Plan for Post-Crisis Reform
- Requiring the banking industry to continuously improve the capital restraint mechanism and further enhance the stability of commercial bank operations.

Two aspects: quantity and quality.

- Asset quantity:
  The more sufficient the bank s capital, the greater the flexibility of the financing
- Asset quality:
  Banks high-quality assets are the main driving force for continued profitability in the future, and differences in asset portfolios also bring different types and natures of risks.

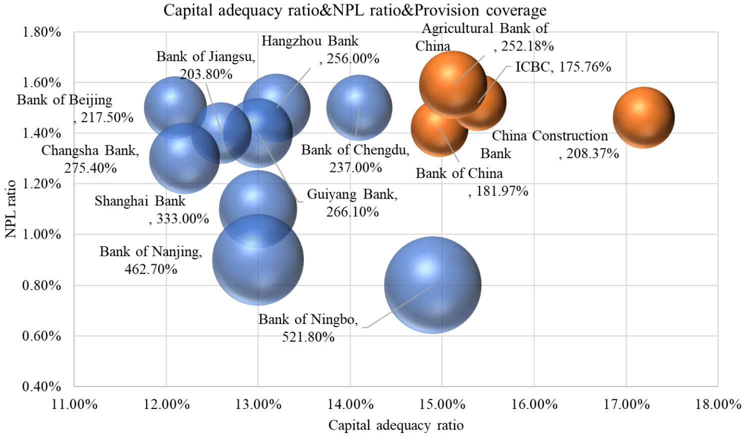


Figure 9: Capital adequacy ratio & NPL ratio Provision coverage

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[8] Data source: csmar, Wind, Huatai Securities Research Institute

Asset Security

- The capital adequacy ratio of city commercial banks is 13.12% on average, which is lower than 15.67% of the four major banks
- The average non-performing loan ratio of city commercial banks is 1.27%, which is lower than the 1.50% of the four major banks, and the security of credit assets is high.
- The average provision coverage rate of city commercial banks was 308.14%, higher than 204.57% of the four major banks. The overall provision level is high and the risk resistance ability Strong.

Debt Safety

- City commercial banks carry out asset business by absorbing deposits and borrowing funds.
- A stable source of liabilities can help the bank's business develop steadily, reduce the cost of capital, and enable the bank to maintain a good profitability level.

Here we choose three quantitative indicators:

1. The ratio of absorbed deposits to total liabilities
2. The size of interbank liabilities
3. Total liabilities

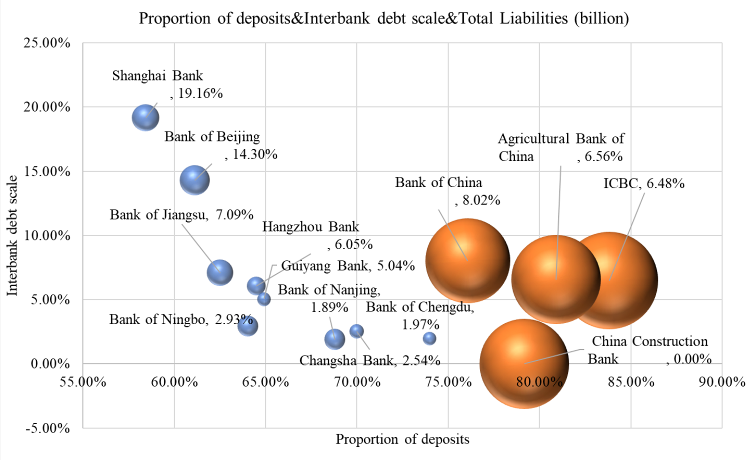

Figure 10: Proportion of deposits & Interbank debt scale & Total liabilities (billion)

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[9] Data source: csmar, Wind, Huatai Securities Research Institute

Debt Safety

- Total liabilities: CCBs are much more smaller.
- The ratio of absorbed deposits to total liabilities: CCBs have a weaker ability to absorb deposits than the four major banks and rely on other sources of debt.
- The size of interbank liabilities: CCBs have a high degree of inter-bank dependence and high systemic risk.
- Finally, we found it interesting that the greater the total liabilities of CCBs, the larger the scale of interbank liabilities, and the smaller the proportion of deposit absorption.

Liquidity Index

- Whether city commercial banks can effectively match their liquidity and debt situation:
  1. Maintain the overall profitability of assets
  2. Deal with short-term debt with lower risks.
- We analyzed the liquidity ratio, reserve ratio and deposit-loan ratio of city commercial banks.

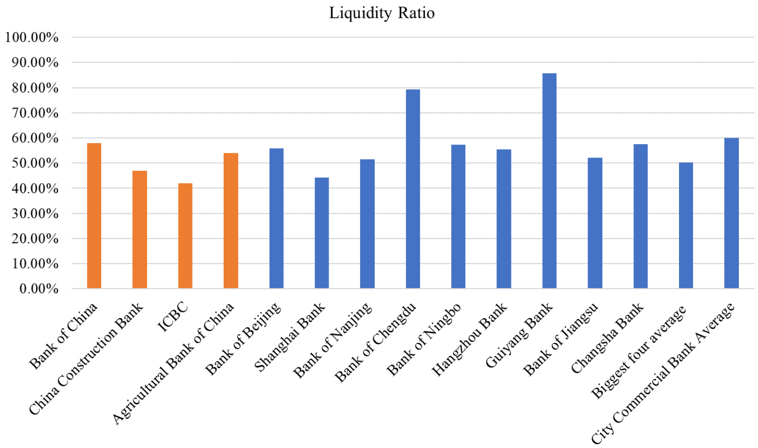

Figure 11: Liquidity Ratio

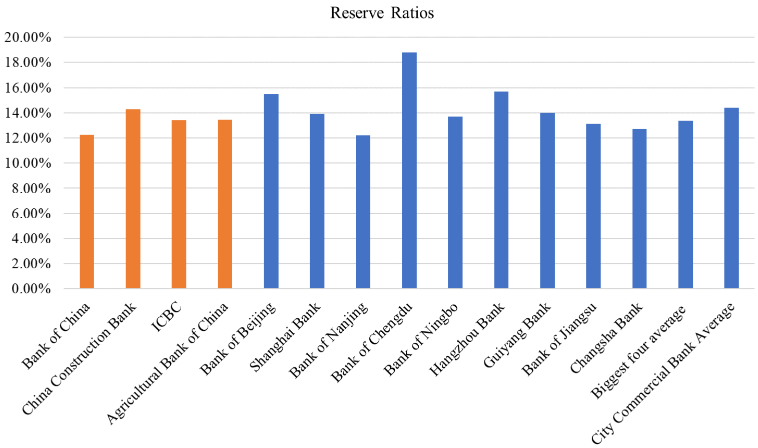

Figure 12: Reserve Ratio

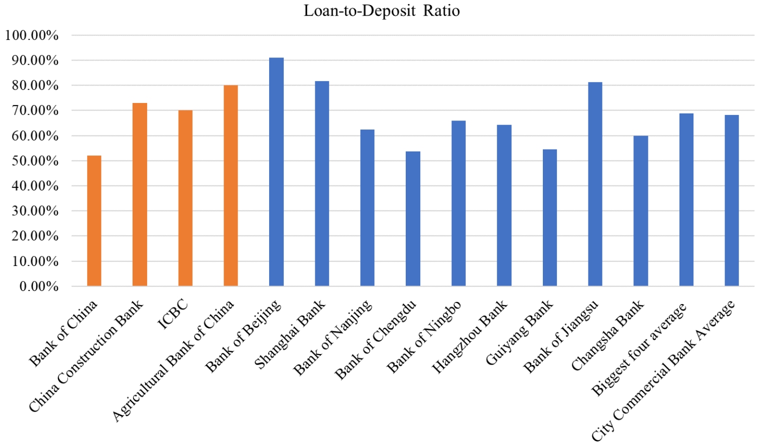

Figure 13: Loan-to- Deposit Ratio

- Liquidity ratio : CCBs have better liquidity.
- Reserve ratio : The normal payment ability of CCBs is better.
- Deposit-loan ratio : Compared with the four major banks, the operation of CCBs is relatively stable and conservative.

Conclusions

Equity Structure

- For supervision institutions
  - focus on the qualification of the shareholders and strictly forbid the related party transaction among the shareholders
  - build a framework to deal with the similar affairs like Baoshang bank and Jinzhou Bank
- For local governments
  - find the right position in the development of city commercial bank
- For city commercial bank
  - build thorough internal and external control to balance the interest among the shareholders and between the shareholders and managers

- For the quantity of assets, CCBs should enrich the types of shareholders to make its capital resources more abundant.
- For the quality of assets, CCBs can take advantage of the development of Fintech to reduce the asymmetric information between the banks and clients

The supervision institutions should pay close attention to the liability structure of CCBs and make some regulations on the proportion of interbank debts in CCBs.

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