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Bank Of China - Company Report

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THOMSON BANKWATCH

The Investext Group

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Rating

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BANK OF CHINA
Beijing, China

September 1994

    BankWatch(R) Ratings:

    Bank of China
        Intra-Country Issuer    IC-B    stable
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PERFORMANCE

OVERVIEW

NO appraisal of Bank China is possible on the basis of its published accounts. It is very likely that, with the exception of liquidity, none of its performance ratios could be taken as a faithful representation of the bank's business on the basis of a conventional analysis. Capital ratios should be adjusted to take into account the sad reality of sour loans to state-owned companies. Profits are largely influenced by the state-controlled domestic interest structure and the various tasks required from Bank of China besides commercial banking. The profits of Bank of China are the result from roughly three activities: the very profitable operations in Hong Kong and Singapore, the near monopoly in foreign exchange transactions in the PRC, and the unprofitable domestic operations. BOC is more profitable than the other three specialized banks of China, and it is likely that the authorities will ensure that it will remain that way.

Bank of China's Loans-to-Total Deposits ratio is 60% and its Loans-to-Customers Deposits ratio at 87% is comfortable, but its net interest margin is a low 1.11%, even if it is an improvement over the 1992 ratio. It is however a clear indication that a huge proportion of the bank's portfolio must be non-performing. Clearly the bank's net margins are dragged down by its domestic operations. It can be safely assumed that a large part of the "other expenses" is meant to cover bad loans. This represented only about 0.6% of the portfolio every year until 1992, but it jumped to 1% of the portfolio in 1993 and this is one of the most important factors in the bank's declining profitability.

The very high interest margins enjoyed in Hong Kong by the consolidated subsidiaries and by Bank of China's branch might account for two-thirds of the net interest income, leaving the interest margins generated by domestic operations and foreign operations outside Hong Kong at a much lower 0.25%. It shows that the bank cannot control its domestic lending and borrowing rates and must survive on whatever the monetary authorities will allow.

In 1993, non-lending income represented a hefty 0.79% of average assets (0.76% in 1992), which is highly unusual. But Bank of China has a near monopoly on import and export credits, which could generate high fees, and on foreign exchange transactions. The bank also handles the PRC's foreign reserves (approximately US$ 20 billion), the foreign exchange holdings of state-owned firms (about US$ 30 billion) and about US$ 9 billion in individual deposits in various foreign currencies.

Chinese banks are said to be threatened by rising bad debts as in the past unprofitable state corporations were able to get bank loans. Lending to badly managed state companies is part of BOC's duties. In such cases, loans are never considered as bad. The official line is that, even if the loans cannot be repaid, the state's implicit guarantee is good enough for the loans to be considered current.

In the past, the Chinese government would simply ensure that multilateral inter-company debts between state-owned firms were getting squared off from time to time, and that the banks would write off their exposure to net losers. But in recent times volumes have increased and state-owned corporations have accumulated more net losses than the entire equity of the banking system.

The picture will one day look clearer when all development and priority loans are taken off the books of the four specialized banks and parked into special institutions which will act as a buffer between loss-making state firms and the nation's budget. Steps have just been taken in that direction.

Asset quality remains the main factor affecting the assessment of Bank of China and as long as its status is not modified, it will be necessary to accept that, indeed, a substantial part of its domestic portfolio is made of doubtful loans, enough to potentially wipe out its shareholders funds.

An additional factor is the large amount of guarantees given by Bank of China through its various branches for commercial loans granted by foreign parties to domestic borrowers.

It is impossible to study Bank of China's capital adequacy, as its actual equity is influenced both by huge potential losses and by the active support of the authorities.

Shareholders equity has been growing rapidly in the last few years to reach almost US$ 12 billion and, even with all profits plugged back into the bank, fresh funds were injected on many occasions. The bank is keen on following the requirements of the Basle agreement in order to improve its image internationally. The present leverage of 19 times, although higher than in previous years, remains acceptable (albeit on the high side) by international standards. Bank of China does not publish its BIS ratio. A rough estimate would put that ratio at about 10%, well within guidelines.

At the end of 1993, 28% of BOC's assets were overseas assets, while a startling 68% of domestic assets were classified as foreign exchange assets. Most of the assets denominated in RMB, representing approximately US$ 54 billion, were for local lending. About 51% of customers deposits are gathered in China, of which 56% are in RMB. Individuals hold about 33% of foreign currency deposits gathered in China.

BOC always controls its global assets and liabilities with remarkable skill and maintains good liquidity ratios with Loans-to-Total Deposits not exceeding 60%. The Quasi-Liquid Asset ratio declined significantly in 1993, falling from 34% to 28%, showing BOC's sudden change in strategy, with more fresh loans than fresh deposits recorded during the year. This might be the result of government pressure on large banks to provide funds to state- owned companies on the verge of collapse in order to postpone drastic bankruptcy decisions with their obvious social repercussions.

Bank of China is the second largest bank in China after ICBC and it is one of the four specialized banks, having been trusted for many years with the lion's share of the country's foreign exchange and international activities.

BOC is the oldest bank in the PRC with its history being able to be traced back to 1905 when the Jing Dynasty established the Da Jing Bank. In January 1912, the bank was re-organized and named Bank of China by Dr. Sun Yat Sen with its headquarters being situated in Shanghai. Before the Central Bank was setup in the PRC in 1928, BOC basically took the role on top of its commercial banking function. After the Communists had risen to power, all banks in the country were unified into one, the People's Bank of China, and BOC basically acted as the international department with its name being maintained externally. Since March 1979, BOC has been separated from the People's Bank of China to become a specialized bank.

The bank's domestic network has grown dramatically in the last two years, jumping from 4,813 branches in 1991 to 6,183 in 1992 and 8,894 in 1993. Most of the expansion was in small savings offices which represent 68% of the total. Domestic staff has reached 156,000 at the end of 1993, having jumped 36% in the year. Another 19,000 staff are employed in 474 offices abroad, many of which are in Hong Kong and Macau in BOC's sister banks. Technically, BOC only owns six of the sister banks but it has a mandate to control most of the PRC-owned banks in Hong Kong and Macau.

Overseas operations have experienced strong growth in recent years, with total overseas assets topping US$ 100 billion for the first time in 1993. The bank has expanded its existing operations in Paris, London, Luxembourg, Frankfurt and New York, and has opened branches and representative offices in Tokyo, Osaka, Los Angeles, Moscow, Cayman, Panama and Sydney in the last few years. 1993 has seen the bank open full branches in both Toronto and Rome. It is present in Thailand, Korea, Scotland, Canada, Cayman Islands, Panama and Kazakhstan.

Despite new competitors, the BOC remains the major Chinese player on international markets and leads China's efforts in borrowing funds overseas. For obvious reasons, Bank of China will have to play a significant role in Hong Kong after 1997, and already today no important decision regarding the banking sector in Hong Kong can be taken without consultations with Bank of China.

Foreign trade and foreign exchange remain Bank of China's forte, although its near-monopoly position in foreign exchange transactions is now being challenged by newcomers such as CITIC Industrial Bank, the Agricultural Bank and the Industrial Bank. But BOC's domestic portfolio also includes infrastructure, construction and industrial credits. It is the bank's wishes to play an increasing role in the financing of joint ventures in China, if only because it would be the only way to keep foreign banks interested in contributing their share. The bank has recently started offering housing loans. Total transaction value on its 1.14 million credit cards has reached close to US$ 21 billion in 1993. Services such as its innovative phone call banking option have also been extended.

OWNERSHIP

The Bank of China was established by the government with some private injections. Since the nationalization when the Communists rose to power, BOC has become wholly owned by the Chinese State and is as such a sovereign risk. While still largely autonomous, the bank falls under the authority of the People's Bank of China, which acts as the central bank.

Profitability 1991-93

PROFITABILITY

Selected Indicators
(%)

	FY93	FY92	FY91
Return on Average Assets	0.79	1.01	1.08
Return on Equity	14.17	16.18	15.59
NIM	1.11	0.92	1.05

PROFITABILITY

* Bank of China is more profitable than the other three specialized banks of China, but it is important to realize that the figures cannot be trusted until the matter of its non- performing loans is settled. Published profits have declined in absolute terms in 1993, and BOC posted a Return on Average Assets ratio of 0.79%, down from 1.08% in 1991 and 1.01% in 1992. The profits of Bank of China are the result from roughly three activities: the very profitable operations in Hong Kong and Singapore, the near monopoly in foreign exchange transactions in the PRC, and the unprofitable domestic operations. Bank of China discloses many more P&L details than any bank operating mostly in Hong Kong, but it is still difficult to assess the contribution of each of the components of its income. Bank of China's Loans- to-Total Deposits ratio is 60% and its Loans-to-Customers Deposits ratio at 87% is comfortable, but its net interest margin is a low 1.11%, even if it is an improvement over the 1992 ratio. It is however an indication that a huge proportion of the bank's portfolio may be non-performing.

* Clearly the bank's net margins are dragged down by its domestic operations. The very high interest margins enjoyed in Hong Kong by the consolidated subsidiaries and by Bank of China's branch might account for two-thirds of the net interest income, leaving the interest margins generated by domestic operations and foreign operations outside Hong Kong at a much lower level. It shows that the bank cannot control its domestic lending and borrowing rates and must survive on whatever the monetary authorities will allow.

* In 1993, non-lending income represented a hefty 0.79% of average assets (0.76% in 1992), which is highly unusual. But Bank of China has a near monopoly on import and export credits, which could generate high fees, and on foreign exchange transactions. The bank also handles the PRC's foreign reserves (approximately US$ 20 billion) and the foreign exchange holdings of state-owned firms (about US$ 30 billion). Now that

individuals are encouraged to maintain foreign exchange funds with local banks, BOC had about US$ 9 billion in such deposits at the end of 1993.

* On the expenditure side, the bank has only one entry for taxes, bad debt provisioning, depreciation and other expenses. This level of disclosure is much better than in Singapore or in Hong Kong, but the bank refuses to reveal more details. It can be safely assumed that a large part of the "other expenses" is meant to cover bad loans. This represented only about 0.6% of the portfolio every year until 1992, but it jumped to 1% of the portfolio in 1993. This provisioning strategy is of course unrealistic and therefore BOC's income figures are very artificial.

* To the extent that other commercial banks might receive permission to compete with Bank of China for non-lending business, the bank might see its profitability erode further. On the other hand, Bank of China in a not-too-distant future is poised to take over many of the invisible but profitable rewards of taking over HSBC's role as HK quasi-central bank. Furthermore, if and when the PRC authorities succeed in transferring policy loans from specialized banks to development banks, BOC will enjoy much improved interest margins.

ASSET QUALITY

* Bank of China is unwilling to comment on the quality of its portfolio. All PRC banks are secretive about that problem, except to claim that it is under control. This may well not be the case, but the banks themselves cannot be blamed for their predicament.

* Chinese banks are said to be threatened by rising bad debts as in the past unprofitable state corporations were able to get bank loans. Lending to badly managed state companies is part of BOC's duties. In such cases, loans are never considered as bad. The official line is that, even if the loans cannot be repaid, the state's implicit guarantee is good enough for the loans to be considered current. Bank of China operates in a country which has its own rules and where state banks are simply a specialized arm of the Ministry of Finance. It is as if customer deposits were financing the state deficit and loans were government subsidies. In most cases, bank loans constitute at least 80% of the resources of state firms.

* In the past, the Chinese government would simply ensure that multilateral inter-company debts between state-owned firms were getting squared from time to time, and that the banks would write off their exposure to net losers. But in recent times volumes have increased and state-owned corporations have accumulated more net losses than the entire equity of the banking system. It is impossible to assess what banks like BOC should provision to meet its share of the losses, but the matter is in fact irrelevant because China does not follow western accounting principles.

* The picture will one day look clear when all development and priority loans are taken off the books of the four specialized banks and parked into special institutions which will act as a buffer between loss-making state firms and the nation's budget. Steps have just been taken in that direction.

* Asset quality remains the main factor affecting the assessment of Bank of China. While the bank is acting like any capitalist financial institution in Hong Kong, Singapore, Tokyo, Australia, Europe and the USA, it still has huge assets on the PRC domestic market. Fortunately many loans are granted to joint-ventures with foreign partners, and to Chinese firms involved in foreign trade. Such loans could be of acceptable quality. But as long as Bank of China's status is not modified, it will be necessary to accept that, indeed, a substantial part of its domestic portfolio is made of doubtful loans.

* An additional factor is the amount of guarantees given by Bank of China through its various branches for commercial loans granted by foreign parties to domestic borrowers. The guarantee total is in the region of US$30 billion, against the background of US$107 billion in recorded loans and US$12 billion in shareholders' equity. This is extremely high by any standards.

Balance Sheet/Capital 1991-93

BALANCE SHEET/CAPITAL

Selected Indicators
(%)

	FY93	FY92	FY91
Equity / Assets	5.11	5.57	6.04
Equity / Loans	11.16	12.40	12.43

BALANCE SHEET/CAPITAL

* Bank of China does not reveal details about the distribution of its profits but this is not important. Whether dividends were paid or not, shareholders equity has been growing rapidly in the last few years and, even with all profits plugged back into the bank, fresh funds were injected on many occasions. The paid-up capital remained unchanged in 1990 but it grew 20% in 1991 and 67% in 1992, mostly through the capitalization of reserves. No change was recorded in 1993. This brought equity to a level of almost US$12 billion. Asset growth slowed down since 1991 and so did equity growth. It is clear that BOC has made the effort to support its expansion with adequate equity. The bank is keen on following the requirements of the Basle agreement in order to improve its image internationally. Bank of China does not publish its BIS ratio. A rough estimate would put that ratio at about 10%, well within guidelines. It is perhaps necessary to mention here that the bank may or may not follow international accounting practices, and that there might be uncertainties about the valuation of some assets.

* At the end of 1993, 28% of BOC's assets were overseas assets, while a startling 68% of domestic assets were classified as foreign

exchange assets. Most of the assets denominated in RMB, representing approximately US$ 54 billion, were local lending.

* About 51% of customers deposits are deposits gathered in China, of which 56% are in RMB. Individuals hold about 33% of foreign currency deposits gathered in China.

* Bank of China's accounts do not include the roughly US$20 billion of foreign reserves it handles on behalf of the People's Bank. But the published accounts show very substantial interbank borrowing and lending, most of it with foreign banks. Domestic interbank transactions are small and, on the liabilities side, they are included in customers' deposits.

* Bank of China is one very few large banks to keep substantial amounts in foreign currency in non-interbank accounts on both sides of the balance sheet. Such a situation makes asset/liability management more difficult than it would be in local currency.

* BOC always controls its global assets and liabilities with remarkable skill and maintains good liquidity ratios with Loans-to-Total Deposits not exceeding 60%. The Quasi-Liquid Asset ratio declined significantly in 1993, falling from 34% to 28%, showing BOC's sudden change in strategy, with more fresh loans than fresh deposits recorded during the year. This might be the result of government pressure on large banks to provide funds to state- owned companies on the verge of collapse in order to postpone drastic bankruptcy decisions with their obvious social repercussions.