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2014

2014 Q2

China's banking sector: Performance of listed banks and hot topics

KPMG Huazhen (Special General Partnership)

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Contents

Introduction

China's Banking Sector: Performance of Listed Banks and Hot Topics is a KPMG publication that covers the important topics and performance indicators of China's banking industry. It provides in-depth but accessible analyses of the hot issues to help you understand their impact and the future direction of the banking sector. It also gathers considerable data to analyse the financial position of China's listed banks. We believe our professional experience will help you better understand the current situation of the banking sector.

This issue (2014 Q2) presents the financial position and business performance of the listed banks for the second quarter of 2014 to help you better understand their current situation. The publication also focuses on current hot topics, including insights on new interbank regulations, the present situation of non-performing loans (NPLs) and distressed assets, private banks, business transformation of regional banks, the Foreign Account Tax Compliance Act, small online loans, and commercial factoring and its impact on traditional banking. We have also invited Zhou Guangyou, deputy professor from the School of Economics of Fudan University, and Luo Sumei, postdoctoral scholar from the Institute of Shanghai International Financial Centre of SHUFE to provide insights on the motives, mechanisms and risks of capital flows in Free Trade Zones from an academic perspective.

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01 2014 Q2 economy and finance

Q2 data analysis

In 2014 Q2, China's year-on-year GDP growth reached 7.5%, the economy gradually stabilised, and the rate of economic growth for the first half-year remained within a reasonable range.

Overall, in Q2, manufacturing demand improved and consumer prices remained basically stable; the real estate market showed signs of adjustment — national real estate investment increased compare to the same period last year, but commercial housing sales declined; the total volume of import and export trade increased by 3.4%; and domestic demand continued to provide the impetus for economic growth.

- Q2 GDP growth slowdown: According to preliminary calculations, China's GDP was RMB 26.9044 trillion as at the end of 2014 Jun, representing a year-on-year increase of 7.5 percent at comparable prices. GDP growth was slightly up by 0.1 percentage points over 2014 Q1. In terms of the performance of different industry sectors, the added values of the primary sector, the secondary sector and the tertiary sector amounted to RMB 1.9812 trillion, RMB 12.3871 trillion and RMB 12.5361 trillion, respectively, representing year-on-year increases of 3.9, 7.4 and 8.0 percent.

- Accelerating growth in imports and exports: In 2014 Q2, import and export value amounted to USD 1.0556 trillion, representing a year-on-year increase of 3.4 percent; trade balance (exports minus imports) was USD 85.97 billion, representing a year-on-year increase of 29.7 percent.

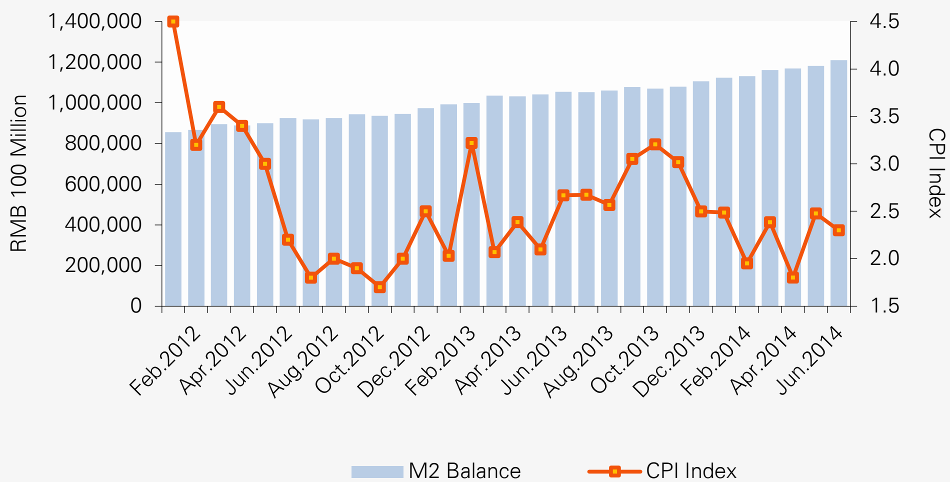
- Steady growth in consumption: Total retail sales of consumer goods reached RMB 6.2117 trillion in 2014 Q2, a nominal increase of 12.3 percent (10.7 percent in real terms).

Overview of key macroeconomic indicators	Unit	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2
GDP	Compare to same period last year（%）	8.1	7.6	7.4	7.9	7.7	7.5	7.8	7.7	7.4	7.5
CPI	Compare to same period last year（%）	3.6	2.2	1.9	2.5	2.1	2.7	3.1	2.5	2.3	2.2
PPI	Compare to same period last year（%）	-0.03	-2.1	-3.6	-1.9	-1.9	-2.7	-1.3	-1.4	-2.0	-1.5
Industrial added value	Compare to same period last year（%）	11.9	9.5	9.2	10.3	8.9	8.9	10.2	9.7	8.7	8.9
Total retail sales of consumer goods	Compare to same period last year（%）	15.2	13.7	14.2	15.2	12.4	13.3	13.3	13.6	12.0	12.3
Fixed asset investment	Compare to same period last year（%）	20.9	20.4	20.5	20.6	20.9	20.1	20.2	19.6	17.6	17.3
Exports	Compare to same period last year（%）	8.9	11.3	9.9	14.1	10.0	3.8	-0.3	4.3	-3.4	5.0
Imports	Compare to same period last year（%）	5.3	6.3	2.4	6.0	14.1	5.0	7.4	8.3	1.6	1.5
Trade surplus	100 Million dollars	317.3	251.5	276.6	316.2	430.7	657.2	152.0	256.4	167.4	859.7
M2	Compare to same period last year（%）	12.9	13.6	14.8	13.8	15.7	14.0	14.2	13.6	12.1	14.7
RMB loan growth	Compare to same period last year（%）	15.7	16.0	16.3	15.0	14.9	14.2	14.3	14.1	13.9	14.0

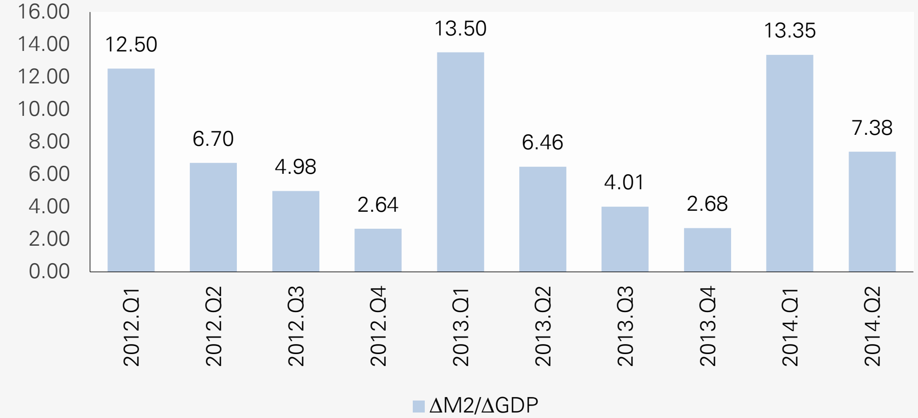
Source：Wind Info

Monetary expansion and national economic output

Money supply and rate of inflation

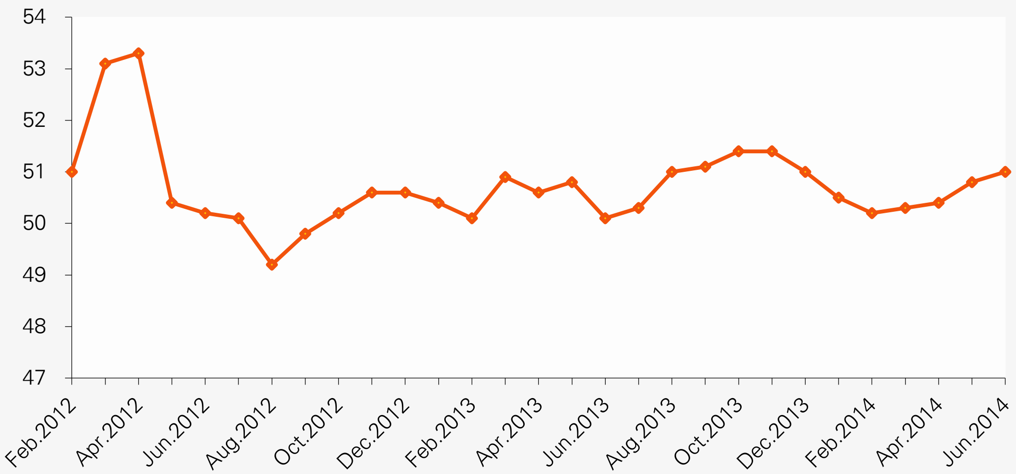


Velocity of money

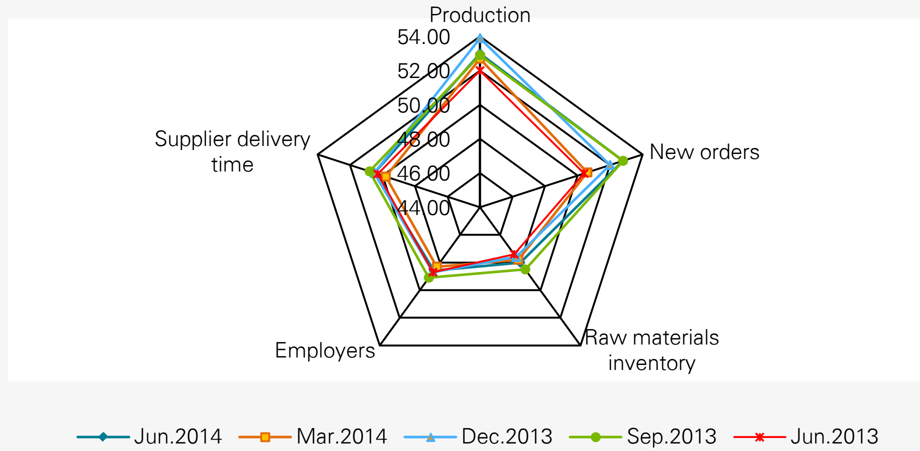


- The CPI growth rate was 2.2 percent in 2014 Q2. The urban CPI grew by 2.3 percent and the rural CPI by 2.0 percent.
- Specifically, food prices increased by 3.4 percent YoY; prices for tobacco, liquor and articles decreased by 0.6 percent; clothing prices increased by 2.5 percent; prices for household equipment and maintenance services rose by 1.2 percent; prices for medical and personal care products rose by 1.3 percent; prices for transportation and communication climbed by 0.4 percent; prices for entertainment and educational products and services rose by 2.0 percent; and house prices increased by 2.3 percent.
- As at the end of June 2014, the broad money (M2) balance was RMB 120.96 trillion, representing a year-on-year increase of 14.7 percent; the RMB loan balance was 77.63 trillion, a year-on-year increase of 14.0 percent; and the RMB deposit balance was 113.61 trillion, a year-on-year increase of 12.6 percent. As at the end of June 2014, the RMB loan increment was 5.74 trillion, representing a year-on-year increase of RMB 0.66 trillion; and the RMB deposit increment was 9.23 trillion, representing a year-on-year increase of 0.14 trillion, which indicates steady growth in RMB deposits.
- At the end of June 2014, the narrow money (M1) balance was RMB 34.15 trillion, representing a year-on-year increase of 8.9 percent; and the balance of currency in circulation (M0) was RMB 5.70 trillion, representing a year-on-year increase of 5.3 percent. As at the end of June 2014, total social financing was 10.60 trillion, representing a year-on-year increase of RMB 0.4175 trillion.
- Compared to 2013, the ratio of new broad money to economic added value remained relatively high in 2014 Q2, indicating that the efficiency of new money was still inadequate.

China Purchasing Managers Index (PMI)

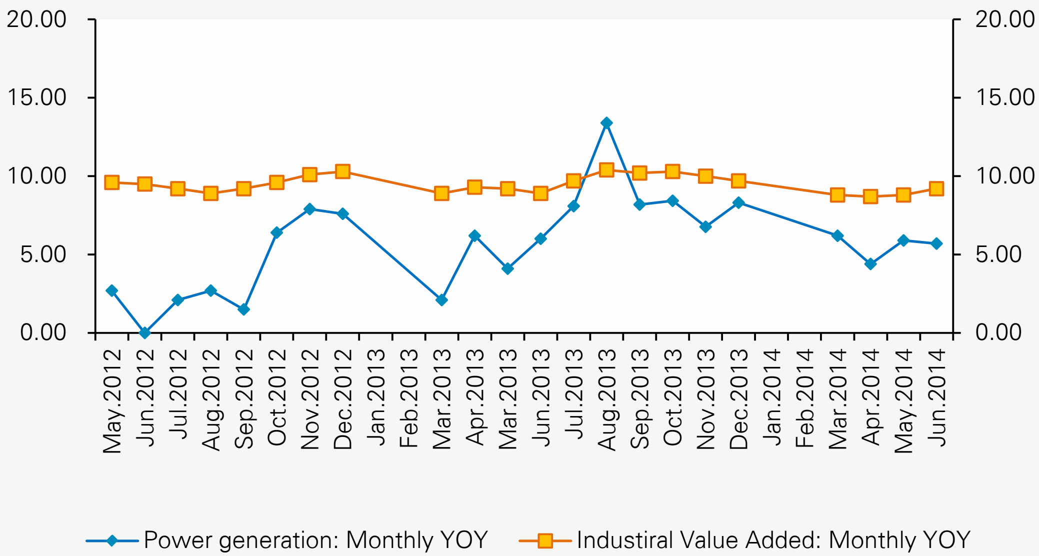


Sub-index under China PMI

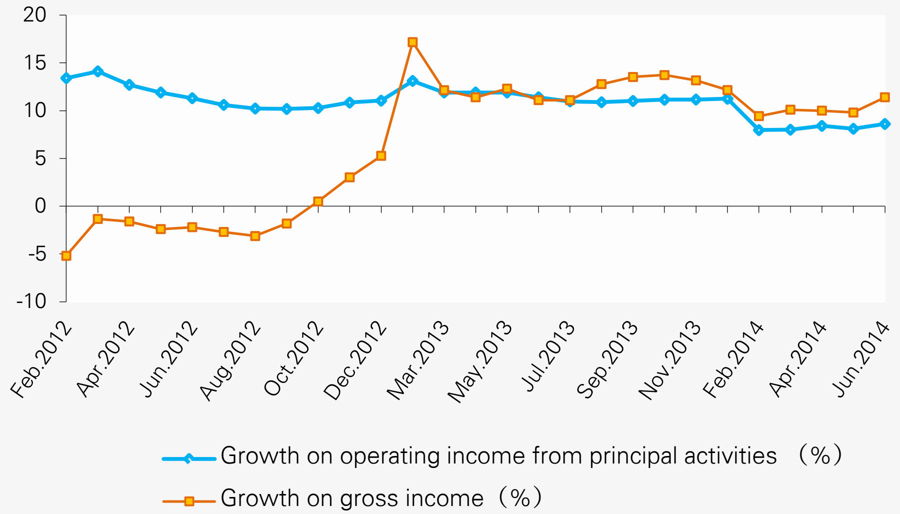


- In general, the national economy ran as normal in 2014 Q2, with positive progress in economic restructuring and upgrading. However, the results also indicate that the economic environment is still complex and changeable, and that the domestic economy is still subject to a certain level of downward pressure.
- In June 2014, China's manufacturing PMI was 51.0 percent, a slight increase of 0.2 percentage points compared to the previous month and the continued rebound since 2014 Q1, indicating smooth growth of China's manufacturing sector; specifically, the PMI of large enterprises was 51.5 percent, 0.6 percentage points higher than in the previous month, and remained above the break-even mark; the PMI of medium-sized enterprises was 51.1 percent, 0.3 percentage points lower than in the previous month; and the PMI of small enterprises was 48.4 percent, 0.4 percentage points lower than in the previous month, and the second lowest point since January 2014, but still below the break-even mark.
- The fresh order index was 52.8 percent, 0.5 percentage points higher than in the previous month and still above the break-even mark, reflecting the rebound of manufacturing market demand. The production index was 53.0 percent, 0.2 percentage points higher than in the previous month, and remained above the break-even mark, signifying the continuous growth of domestic production and the solidification of the positive development trend of large and medium-sized enterprises. The business activities expectation index was 54.8 percent, 1.4 percentage points lower than in the previous month, and had remained on a downward trend for three consecutive months, indicating manufacturers' negative outlook for business activities for the next three months.

Industrial production



YoY growth of accumulative operating income from principal activities and total profit

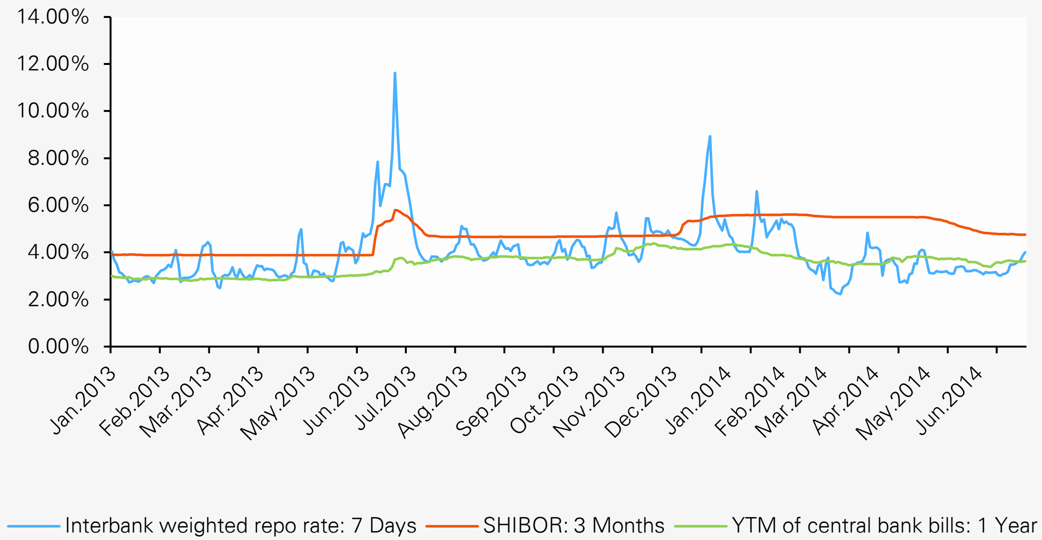


Sources: Wind Info and National Bureau of Statistics of China

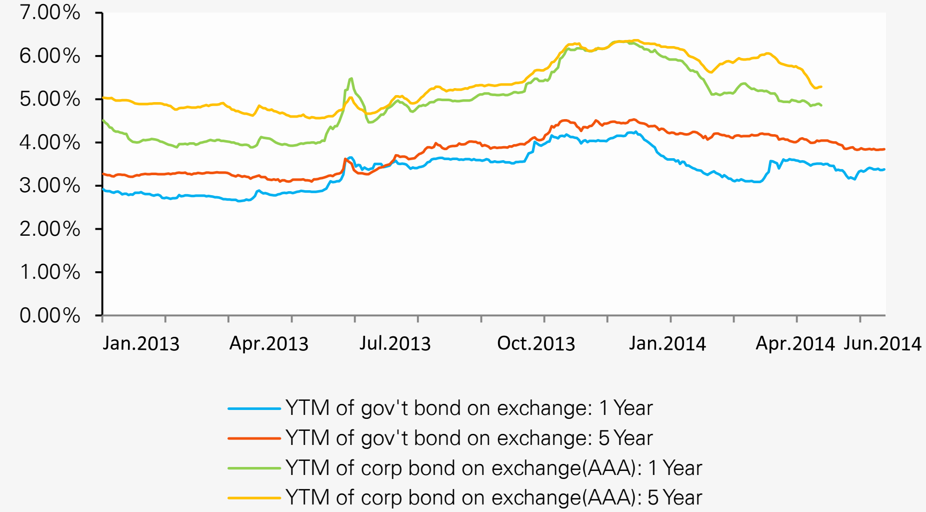
- In June 2014, the added value of the above-scale industry grew by 9.2 percent year on year at comparable prices and the rate of increase was 0.3 percentage points higher than in the same period last year. State-owned and state-holding enterprises, collective enterprises, joint-stock enterprises, and foreign-invested, Hong Kong, Macau and Taiwan invested enterprises grew by 7.3 percent, 3.3 percent, 10.8 percent and 7.4 percent, respectively.
- As for specific industries, the mining industry, the manufacturing industry and the production and supply of electricity, heat, gas and water grew by 7.9 percent, 9.8 percent and 4.7 percent year-on-year, respectively. In terms of regions, the eastern region grew by 9.0 percent year-on-year, the central region by 8.1 percent and the western region 11.7 percent. The current period inventory of above-scale industrial enterprises stood at 97.5 percent in June 2014 , remaining unchanged from that during the corresponding period last year.
- As at the end of June 2014, the operating income from principal activities of above-scale industrial enterprises was RMB 51.44978 trillion, representing a year-on-year increase of 8.6 percent; the cost of operating income from principal activities was RMB 44.21398 trillion, representing a year-on-year increase of 9.0 percent; the increase in cost was slightly higher than that in income; above-scale industrial enterprises realised profits of RMB 2.86498 trillion, an increase of 11.4 percent year-on-year; and profit from principal activities amounted to RMB 2.6722 trillion, representing an increase of 10.8 percent year-on-year.
- As at June 2014, the mining industry realised profits of RMB 340.05 billion, representing a year-on-year decrease of 14.3 percent; the manufacturing industry gained profits of RMB 2.30108 trillion, representing a year-on-year increase of 14.8 percent; and the production and supply of electricity, heat, gas and water achieved profits of RMB 223.85 billion, representing a year-on-year increase of 23.2 percent.

Dynamics of money and bond market interest rates

Money market rate



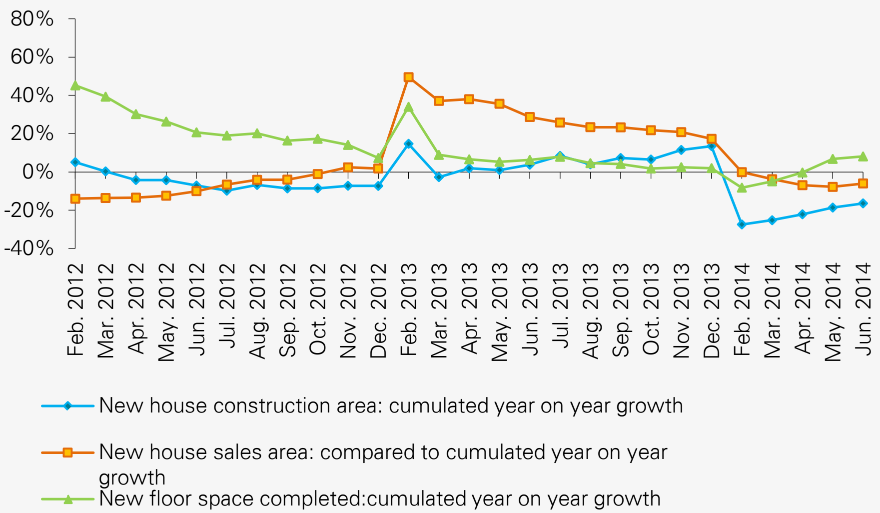
Bond yield



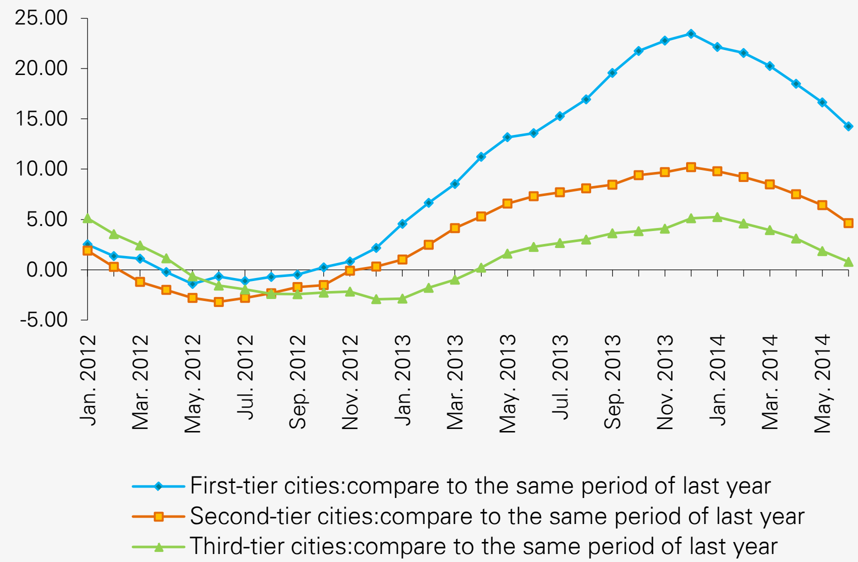
Source: Wind Info

- The yield to maturity of one-year central bank bills was19 percentage points higher in 2014 Q2 than during the corresponding period last year; at the end of June, the above-mentioned yield to maturity was 3.6 percent, 0.83 percentage points higher than at the end of June in the previous year.
- In 2014 Q2, the RMB/USD exchange rate remained stable, and trading was active with lower single day fluctuations. Direct trading was launched between the RMB and the New Zealand dollar and active transactions took place.
- By the end of June, the overnight SHIBOR rate, one-week SHIBOR rate and one-month SHIBOR rate fell by 22 basis points, 111 basis points and 91 basis points, respectively, as compared to the rates at the beginning of the year, dropping to 2.91, 3.87 and 5.00 percent, respectively. Multiple factors, such as continued monetary easing, weak economic fundamentals and the fund allocation demand of entities at the beginning of the year contributed to the recovery of the bond market. The overall treasury yield curve has moved down from that as at the beginning of the year. At the end of June, the yield to maturity of three-year and seven-year treasury bonds in the inter-bank market were 3.78 and 3.99 percent, down 67 basis points and 63 basis points, respectively, from the beginning of the year.
- In 2014 Q2, after three consecutive seasons of decline in 2013, the inter-bank bond market finally had the opportunity to stage a revival. With the anticipated improvement of funding and reinforced regulatory examination of non-standard investment, the money started to flow back into the bond market.
- Market funding faced some extremely challenging circumstances last June and at the end of last year. Just before the 2014 spring festival, People's Bank of China conducted a number of reserve operations to relax the funding market, such as executing reverse repurchases one week before the spring festival. As a result, the overall funding situation at the time of the spring festival was smooth and steady. With the subsequent money backflow, inter-bank funding was fully relaxed, reflected by the short-term interest rate declining to the lowest point in several years and the interest rate of the inter-bank seven-day pledge-style repo remaining at around 3.4 percent in June. Overall, the funding situation was looser than in 2013 Q4, which was also a key driving force in the decline of bond yields in Q2.

Growth of saleable area, and floor space completed and under construction



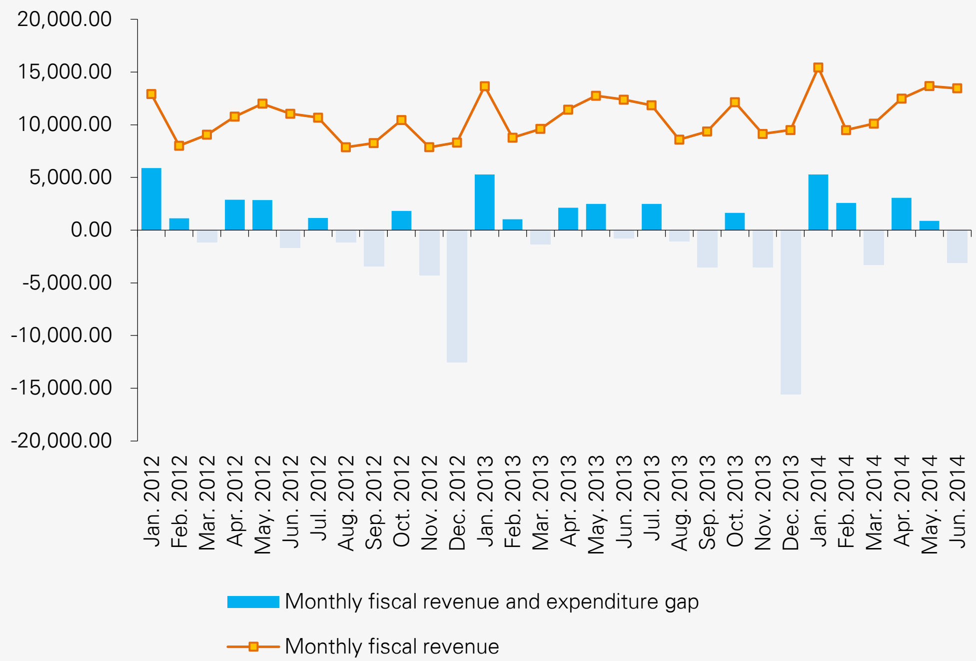
Housing price indices of 100 cities



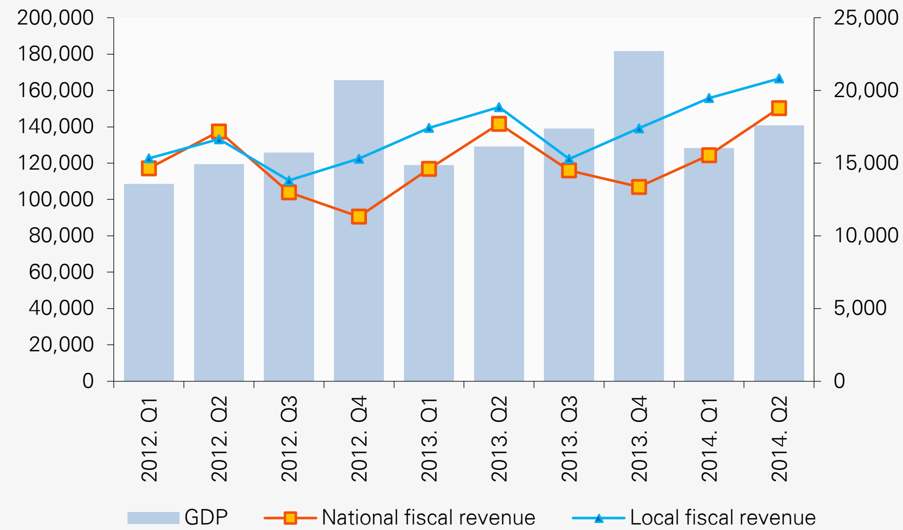
Source: Wind Info

- As at the end of June 2014, national real estate investment amounted to RMB 4.2019 trillion, representing a nominal year-on-year increase of 14.1 percent. Residential housing investment grew by 13.7 percent. The new floor space under construction was 801,260,000 square metres, representing a year-on-year decrease of 16.4 percent; and the new construction area for residential housing fell by 19.8 percent.
- The saleable area of commodity housing was 483,650,000 square metres, representing a year-on-year decrease of 6.0 percent, among which the saleable area for residences fell by 7.8 percent; the total sales of commodity housing reached RMB 3.1133 trillion, representing a year-on-year decrease of 6.7 percent, among which residential housing sales dropped by 9.2 percent; and the land purchase area of the real estate developers reached 148,070,000 square metres, representing a year-on-year decrease of 5.8 percent.
- At the end of June, the available-for-sale area of commodity housing was 544,280,000 square metres, representing a year-on-year increase of 24.5 percent.
- In 2014 Q2, the growth of sales of commodity and residential housing slowed down compared to that during the same period last year, but its absolute level was still at a historic high. The high level of the available-for-sale area resulted in a major decline in new floor space under construction. In addition, the slowdown in saleable area growth led to diversification in the supply and demand balance in different cities. The short supply situation in popular cities therefore began to ease and oversupply risk began to emerge in third- and fourth-tier cities, and even in second-tier cities. Price rises for newly built commodity housing in 100 cities gradually shrank, while those in first-tier cities still led the market.
- Affected by the high cardinal number of the previous year, the sales growth of both commodity and residential housing declined in Q2 compared to that during the corresponding period last year, but its absolute level was still at a historic high.

Monthly fiscal balances (RMB 100 million)

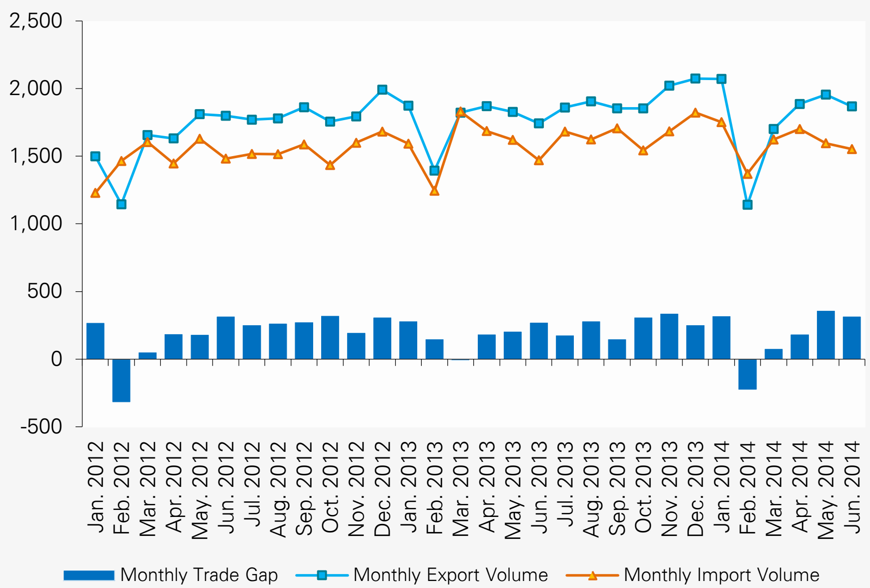


Fiscal revenue and GDP (RMB 100 million)

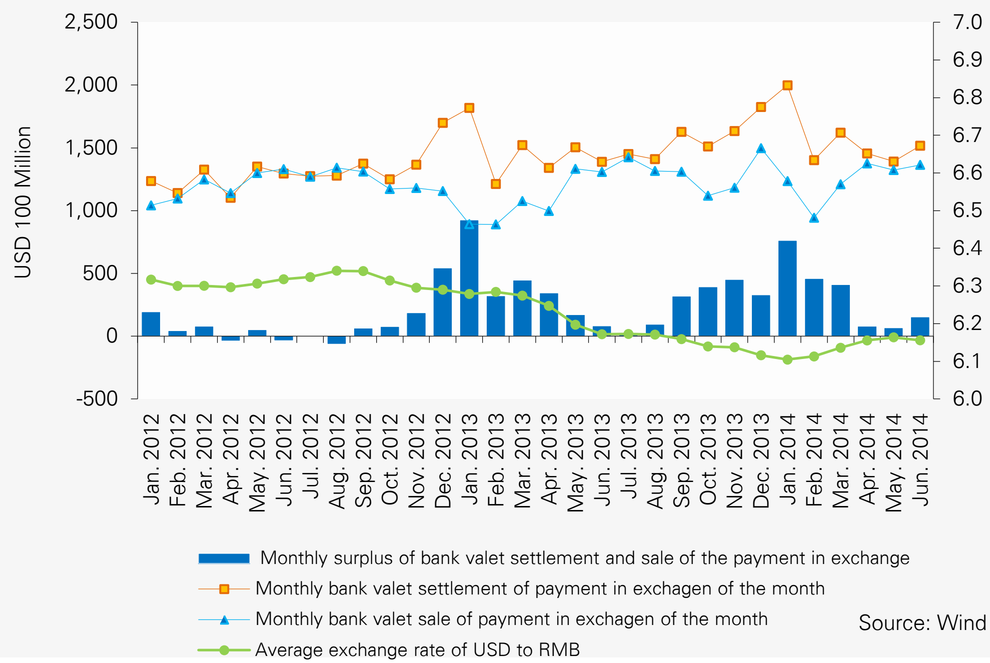


- In 2014 Q2, national fiscal revenue amounted to RMB 3.9612 trillion, representing a year-on-year increase of RMB 305.6 billion, or 8.4 percent: central fiscal revenue reached RMB 1.8783 trillion, representing a year-on-year increase of 6.1 percent, while local fiscal revenue totalled RMB 2.0829 trillion, representing a year-on-year increase of 10.5 percent.
- National fiscal expenditure in 2014 Q2 amounted to RMB 3.8722 trillion, representing a year-on-year increase of RMB 604.4 billion, or 18.5 percent: central fiscal expenditure totalled RMB 642.7 billion, representing a year-on-year increase of 16.3 percent, while local fiscal expenditure reached RMB 3.2295 trillion, representing a year-on-year increase of 19.0 percent.
- National fiscal revenue amounted to RMB 7.4638 trillion in the first six months of 2014, representing an increase of 8.8 percent, or a year-on-year increase of 1.3 percentage points: central fiscal revenue reached RMB 3.4327 trillion, a year-on-year increase of 6.2 percent, while local fiscal revenue totalled RMB 4.0311 trillion, a year-on-year increase of 11.1 percent. Among the fiscal revenue, RMB 6.4269 trillion came from tax revenue, a year-on-year increase of 8.5 percent. The low growth in revenue in the first half of 2014 was mainly due to a decrease in value-added tax and an increase in export tax rebates, despite sustainable growth in the domestic economy. Among local fiscal revenue, the growth of eastern China was higher than that recorded in central China, while the growth of central China was higher than that of western China.

Import and export trade (USD 100 million)



Bank valet exchange settlement and sale and exchange rate



Source: Wind Info

- In 2014 Q2, the value of imports and exports amounted to USD 1.0556 trillion, representing a year-on-year increase of 3.4 percent.
- The value of exports was USD 570.8 billion, representing a year-on-year increase of 5.0 percent; the value of imports was USD 484.8 billion, representing a year-on-year increase of 1.5 percent; and the trade surplus was USD 85.97 billion.
- In June, the value of imports and exports was USD 342 billion, representing a year-on-year increase of 6.5 percent: the value of exports was USD 186.8 billion, representing a year-on-year increase of 7.3 percent; and the value of imports was USD 155.2 billion, representing a year-on-year increase of 5.6 percent.

- In 2014 Q2, bank valet exchange settlement and sales added up to USD 436.3 billion and USD 406.4 billion, respectively. Thus, the valet exchange settlement and sales surplus added up to USD 29.9 billion.
- In 2014 Q2, the exchange rate of the RMB against the USD gradually depreciated compared to that in 2014 Q1, with the monthly average exchange rate of the USD against the RMB rising from 6.1358 to 6.1557.

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Analysis of 2014 Q2 financial data of listed banks

Condition of assets - Asset scale analysis

In 2014, the growth of the real economy has slowed down and fluctuations in bulk commodity prices has intensified, resulting in great uncertainties in the economic environment; certain traders have resorted to trading methods, such as transit trade and related party transactions, to trick the banks into offering them more loans, as well as the Qingdao port incident, which indicating that some companies repeatedly pledged their warehouse warrants for the bank loans, implying elevated risks for the banking industry; in addition, loans to industries with excess capacity, as well as jointly guaranteed and mutually guaranteed loans, further increased the credit risks of the banks.

In response, the banks took a number of steps: they reinforced the examination of potential risks; they exercised more prudence in granting credit facilities; they monitored the amount and use of capital lending more closely; they recalled loans ahead of time due to asset security considerations; and they applied more proactive risk management for risky assets. All these measures have resulted in a slowdown in the growth of credit asset scale and an adjustment of the asset structure of listed banks in the first half of 2014.

Compared to the end of 2013, the overall asset scale of listed banks increased in the first half of 2014. Asset structure changed where the credit asset scale increased, but its proportion in overall asset scale fell and YoY growth slowed significantly. Due from banks and other financial institutions as well as investment in securities expanded.

Source: The banks' 2013 annual reports & 2014 semiannual reports, KPMG China research

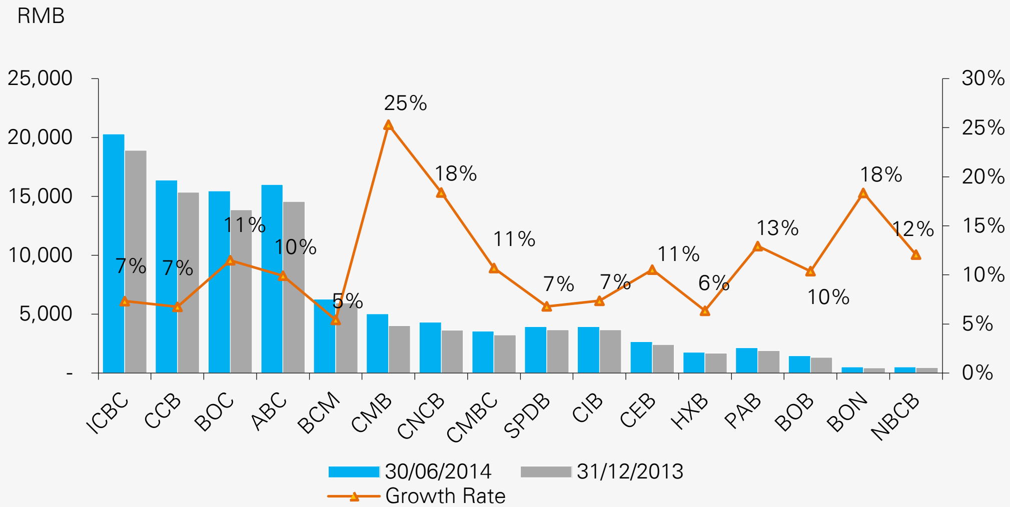
Condition of assets - Asset quality analysis

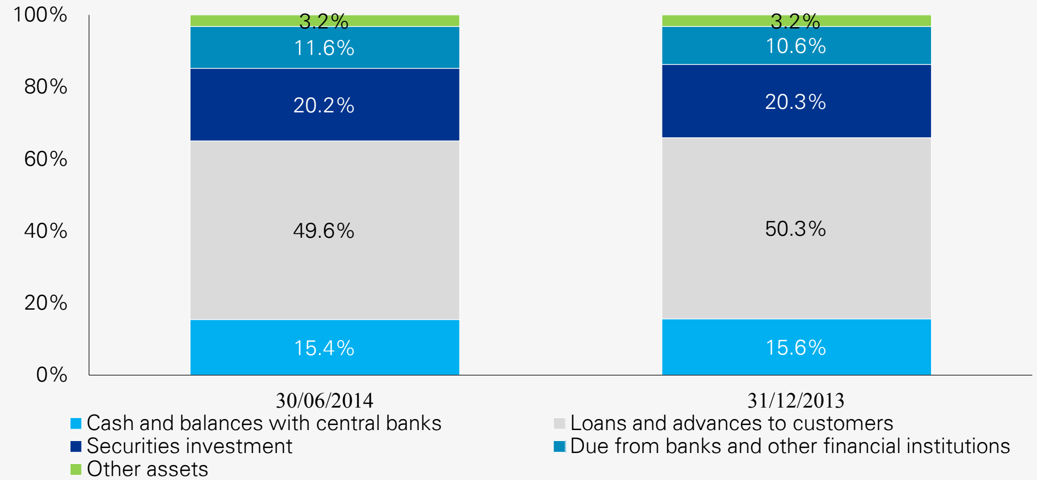
The downside risk for the credit asset quality of listed banks continued in the first half of 2014, due to the following factors: the slowdown in the growth of the macro economy and insufficient demand and confidence in the market; the continuous exposure to corporate credit risks, reflected by the centralized repayment of local government debts, increased default risk of financing platforms, the potential break in the capital chain of small and micro businesses due to lack of orders, and the contra flow pressure facing small and medium property developers, especially those in the third or fourth tier cities.

In the first half of 2014, the non-performing loan(NPL) amount of the listed banks increased in line with a rising NPL ratio. However, because the increased amount of loan loss provision was lower than that of the NPL, the allowance to NPL ratio fell. The overdue loan amount rose, with increased YoY growth in the overdue loan ratio. Due to the slowdown of China's economy, the increased risk exposure in certain industries, the advancement of interest rate liberalisation and financial disintermediation, and cross industry competition from internet finance, the listed banks will continue to face pressure in the management and control of asset quality, as well as intensified inter-bank competition.

Source: The banks’ 2013 annual reports & 2014 semiannual reports, KPMG China research

Condition of assets – Asset scale and structure





In the first half of 2014, the scale of the total assets of the listed banks increased, resulting from the expansion of the scale of credit assets and due from banks and other financial institutions.

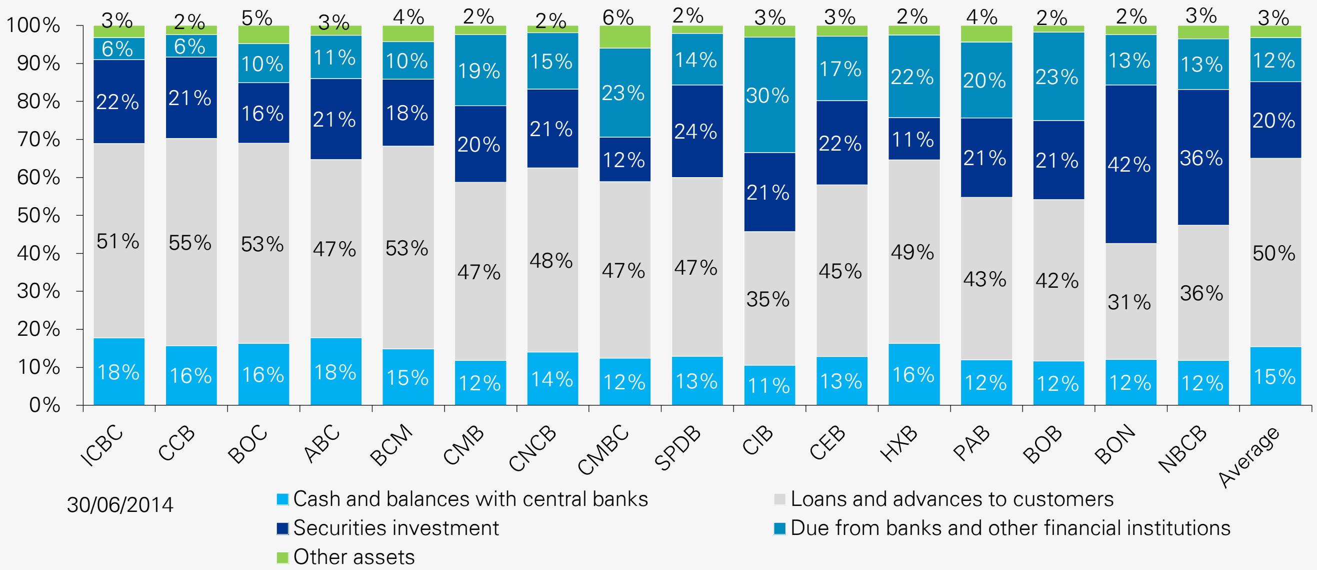
Compared to five major state-owned banks, some of the shareholding commercial banks experienced more active expansion. CMB enjoyed the biggest growth in asset scale, achieving an increase of up to 25% compared with the end of last year, while both CNCB and BON recorded an increase of 18%.

While total asset scale expanded in the first half of 2014, the asset structure of listed banks changed compared with the end of last year: the ratio of loans and advances to customers was down by nearly 1%; the ratio of due from banks and other financial institutions increased by 1%; and the ratio of securities investments remained the same as at the end of last year.

Affected by the slowdown of the real economy and the increase of credit risk, the listed banks took the initiative in mitigating risks through measures such as raising the threshold, cutting lending and controlling credit scale for industries or areas with higher risk. At the same time, they tried to lower their risk exposures by adjusting capital lending direction and optimising their asset structure.

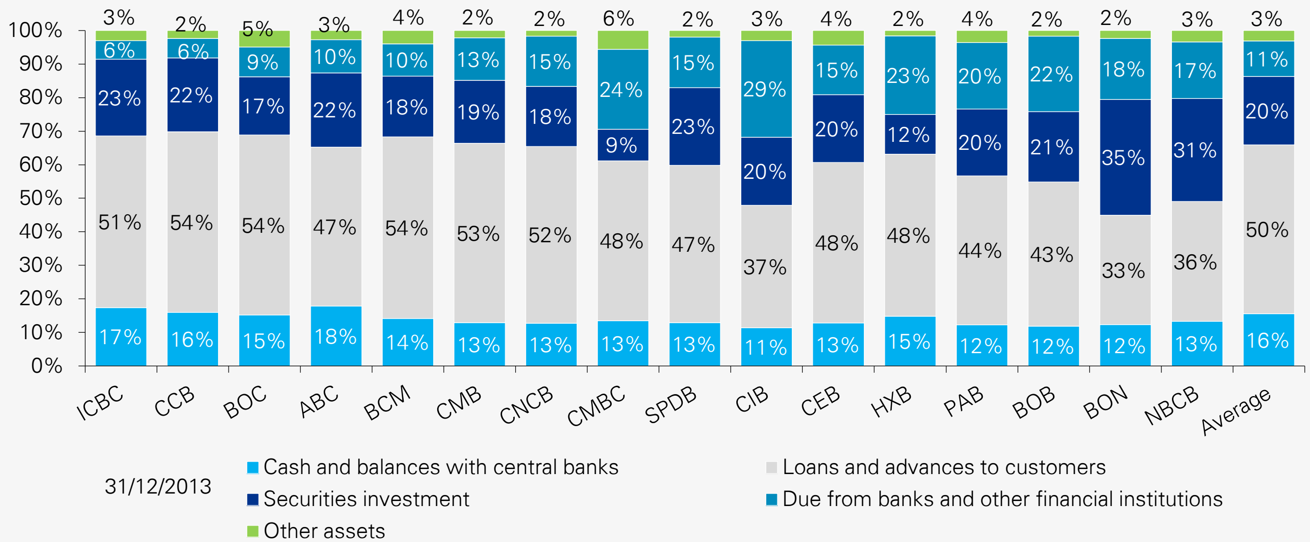
Source: The banks' 2013 annual reports & 2014 semiannual reports, KPMG China research

Condition of assets – Asset structure



Compared with the end of 2013, the average ratio of loans and advances to customers of the 16 banks fell by 1%, with 12 of them experiencing a decrease in their loans and advances ratio;

The average securities investment ratio of the 16 banks remained basically flat with that as at the end of 2013. 10 of the 16 banks had increased securities investment ratios, while those of the other six banks fell.



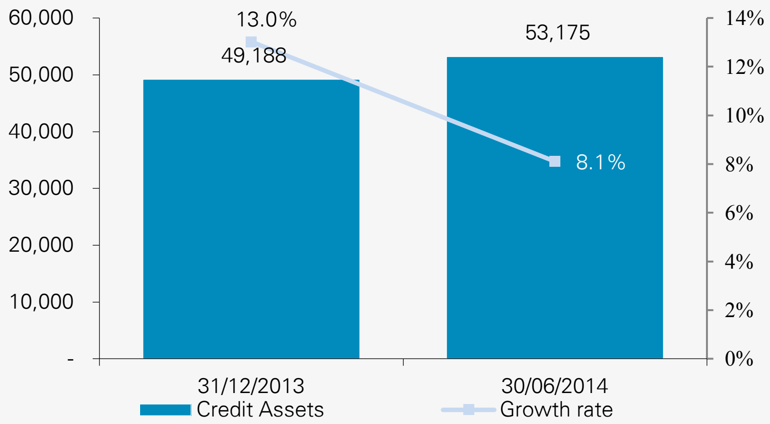
In the first half of 2014, the banking industry remained supportive of the development of the real economy and pushed forward the optimisation of loan structure by regulating total loans and adjusting loan structure.

Moreover, due to the elevation of credit risk, all commercial banks carried out adjustments to their asset structure to a varying extent. In the first half of 2014, the commercial banks oriented more of their capital to due from banks and other financial institutions as well as securities investment in order to gain higher investment performance and mitigate credit risk.

Source: The banks' 2013 annual reports & 2014 semiannual reports, KPMG China research

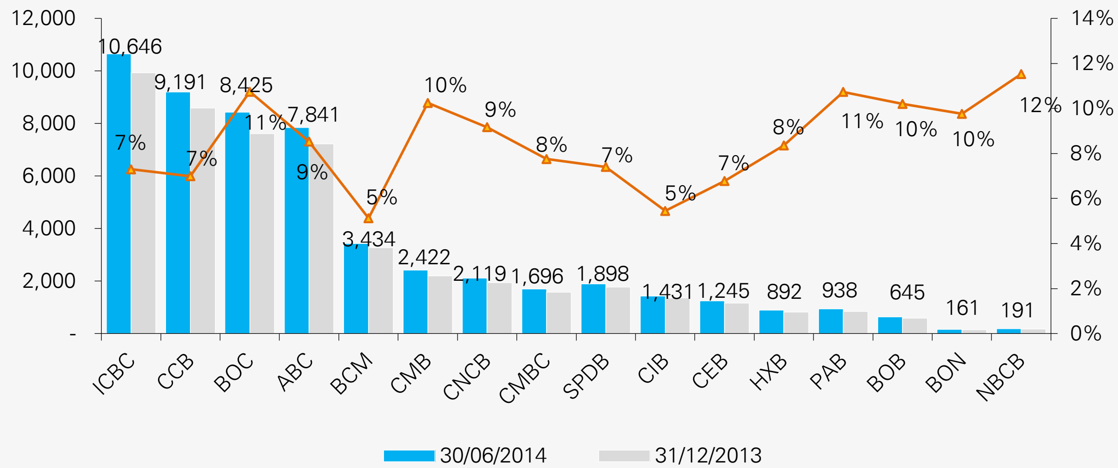
Credit Assets

RMB billion



Credit Assets

RMB billion



In the first half of 2014, the total scale of the credit assets of the listed banks was RMB 53.18 trillion. The rate of growth slowed significantly to 8.1%.

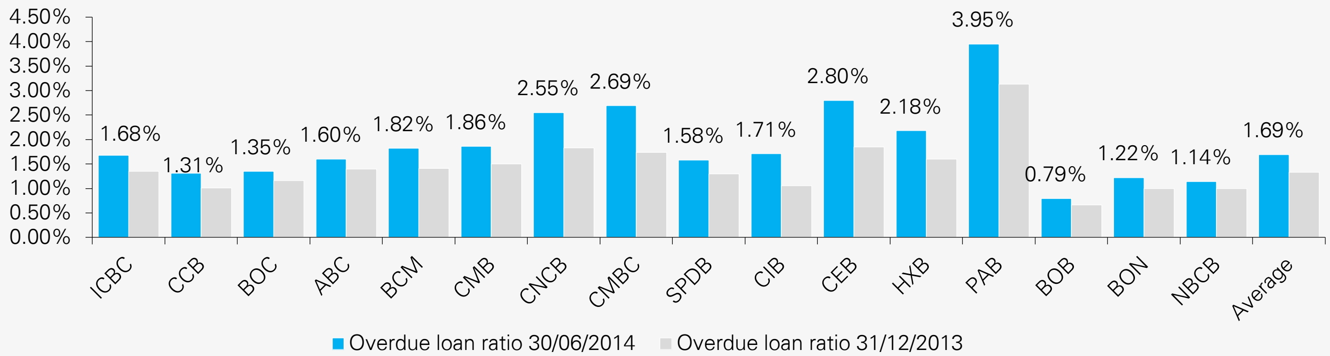
Following the Qingdao Port incident, some companies repeatedly pledged their warehouse warrants for the bank loans; certain traders have tricked the banks into offering them more loans with trade methods, such as transit trade, in 2014. The banks have also been faced with elevated risks from loans to industries with excess capacity and guarantee circles. These problems have forced the banks to tighten the amount and structure of their capital lending in order to reinforce risk management.

In the first half of 2014, the growth rate of the credit assets of the listed banks were showed the opposite trend to their total scale.

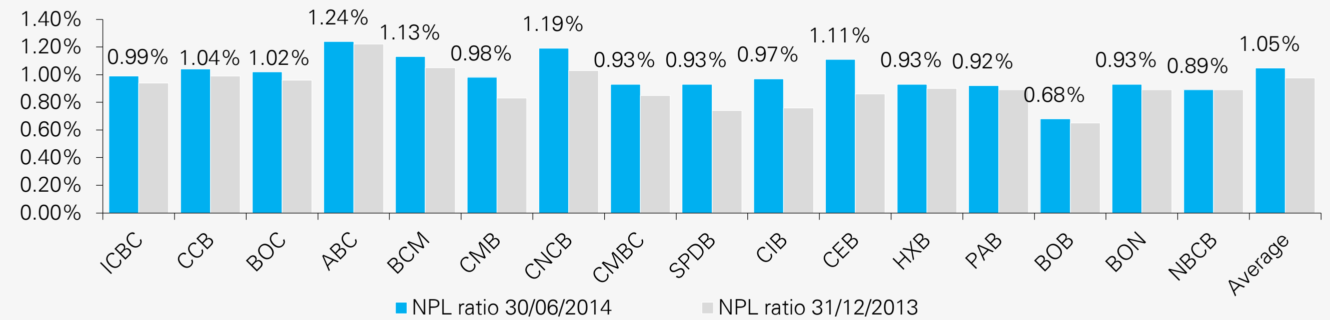
Some of the banks with a smaller credit asset scale recorded a higher than average growth rate. Their growth was driven by the following factors: increased financing support to small and micro enterprises; expanding the scale of consumer loans and credit card loans; and financial innovation on loans through cooperation with key industries.

Source: The banks' 2013 annual reports & 2014 semiannual reports, KPMG China research

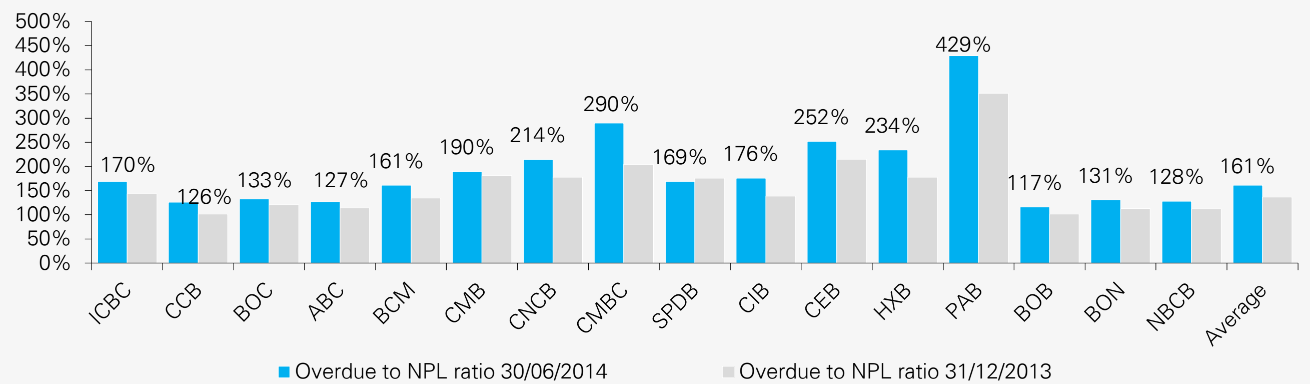
Overdue loan ratio (overdue loan/total loan)



NPL ratio (NPL/total loan)



Overdue to NPL ratio(Overdue loan/NPL)



Source: The banks' 2013 annual reports & 2014 semiannual reports, KPMG China research

In the first half of 2014, the overall credit asset quality of the listed banks declined due to the following reasons: risks from industries with excess capacity spread upstream and downstream in the industry chain; non-performing loans increased in risky industries such as real estate and steel trading; risks were amplified by mutual guarantee and joint guarantee accelerating the growth of overdue loans; private small and medium enterprises experienced insufficient turnover and operational difficulties caused by the economic slump and weak demand at home and abroad.

In the first half of 2014, the scale of the overdue loans of the listed banks further increased by 37% compared with that as at the end of 2013.

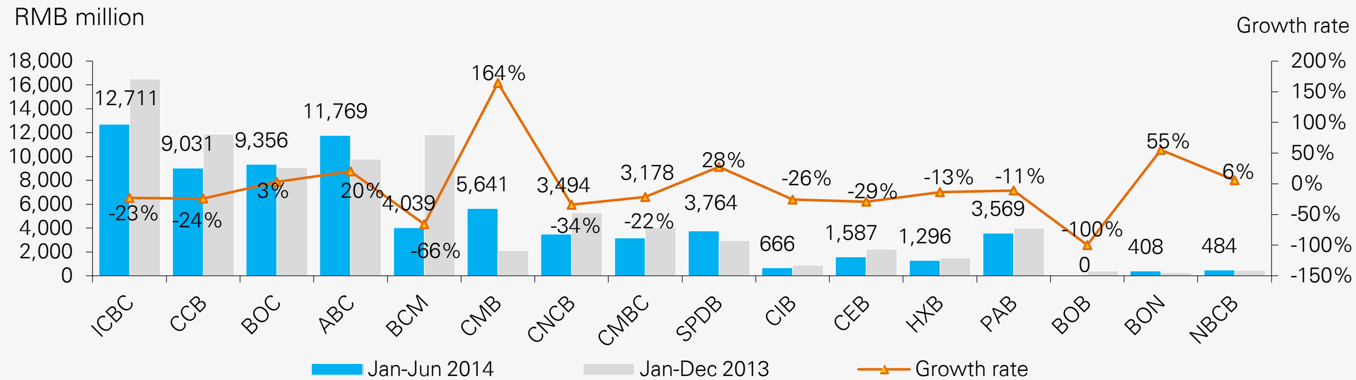
In the first half of 2014, the NPL ratios of the listed banks increased compared with those as at the end of 2013, with an average NPL ratio of 1.05% (2013: 0.98%). The total NPL amount increased by 16%, which growth rate is higher than the same period of last year.

In the first half of 2014, the overdue to NPL ratio of the listed banks increased compared with those as at the end of 2013, with an average overdue to NPL ratio of 161% (2013:137%).

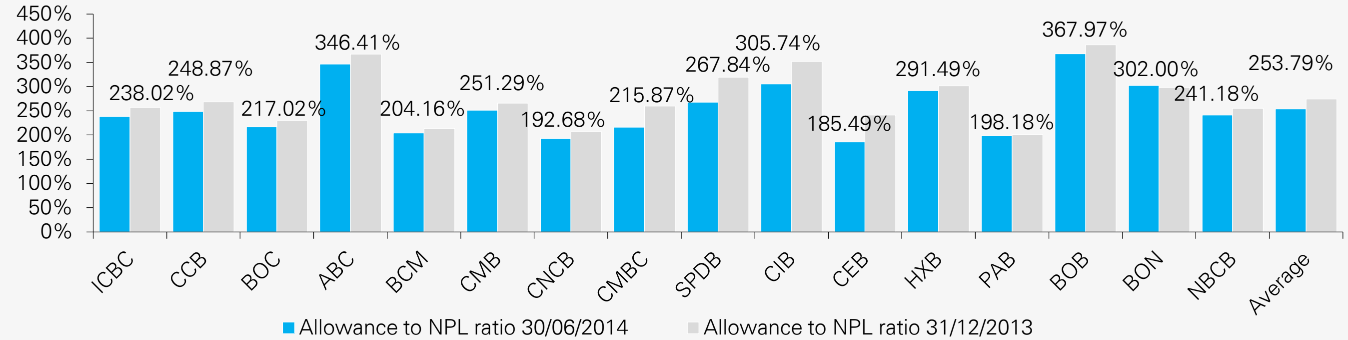
PAB had the highest overdue to NPL ratio for the current period, of over 429%; its newly added overdue loans were mainly loans to mutually guaranteed and joint guaranteed enterprises in the Yangtze River Delta region, most of which were pledged.

Condition of assets – Loan quality(continued)

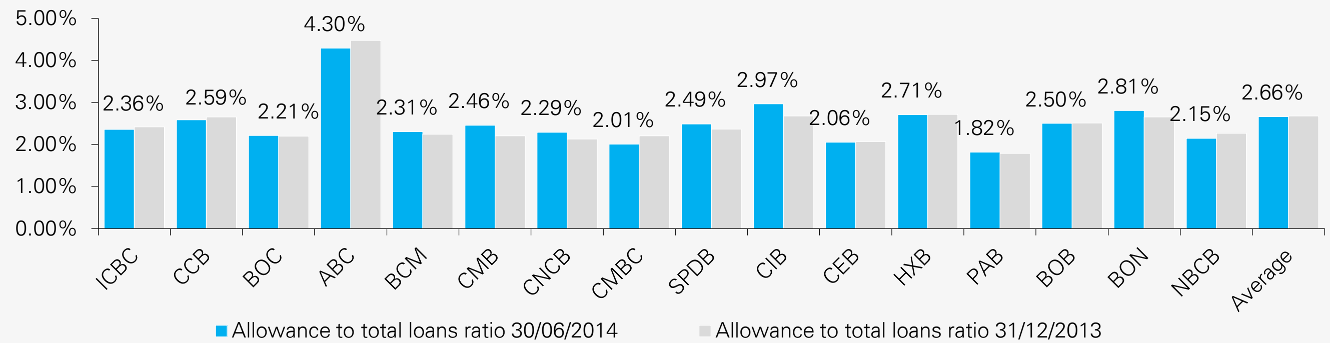
Write-off loans



Allowance to NPL ratio



Allowance to total loans ratio



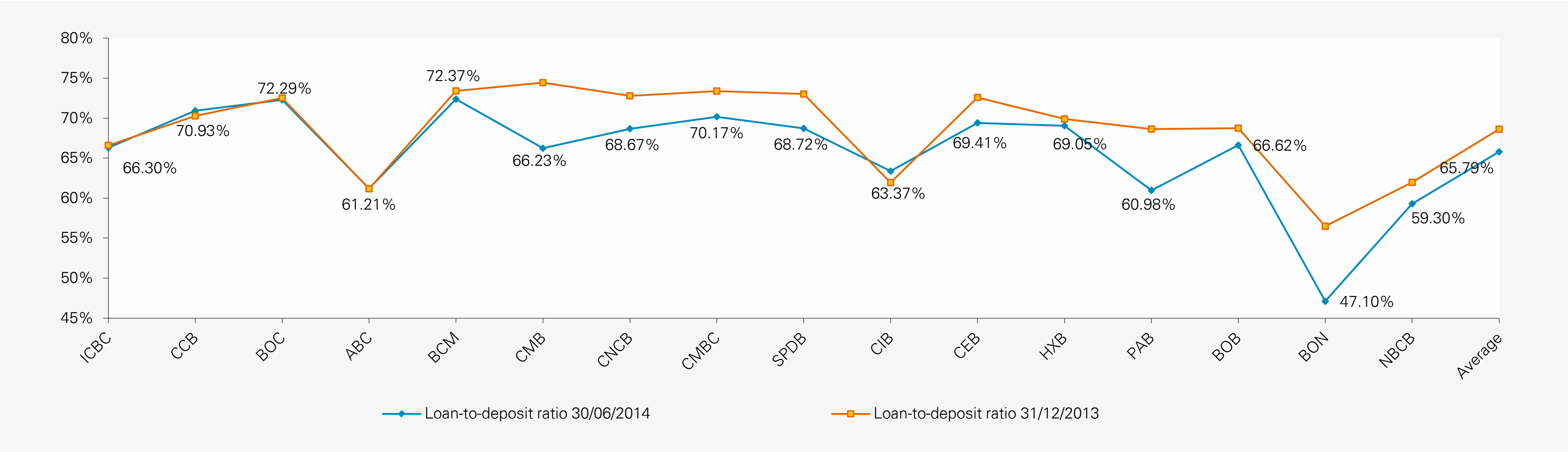
Source: The banks' 2013 annual reports & 2014 semiannual reports, KPMG China research

In the first half of 2014, credit asset quality continued to face downside risks. In order to uncover risks, expedite risk asset disposal, increase the capital adequacy ratio, prevent high allowances for NPL and high NPL ratios, and lighten the burden for sustainable development, the listed banks reinforced write-offs of loans. The write-offs of some of the listed banks in the first half of 2014 exceeded their write-offs for the whole year of 2013.

In the first half of 2014, even though the overall allowance for NPL was sufficient, the increase of the NPL balance lowered the allowance to NPL ratios of the listed banks, with the exception of BON. The allowance to NPL ratios of CMBC, SPDB, CIB and CEB were dragged down significantly by the increase of their NPL ratios.

As for the allowance to total loans ratios, all listed banks, except PAB, had high ratios of 2%–2.7%. 6 of the 16 banks met CBRC's requirement that the allowance to total loans ratio should be at least 2.5% before 2016.

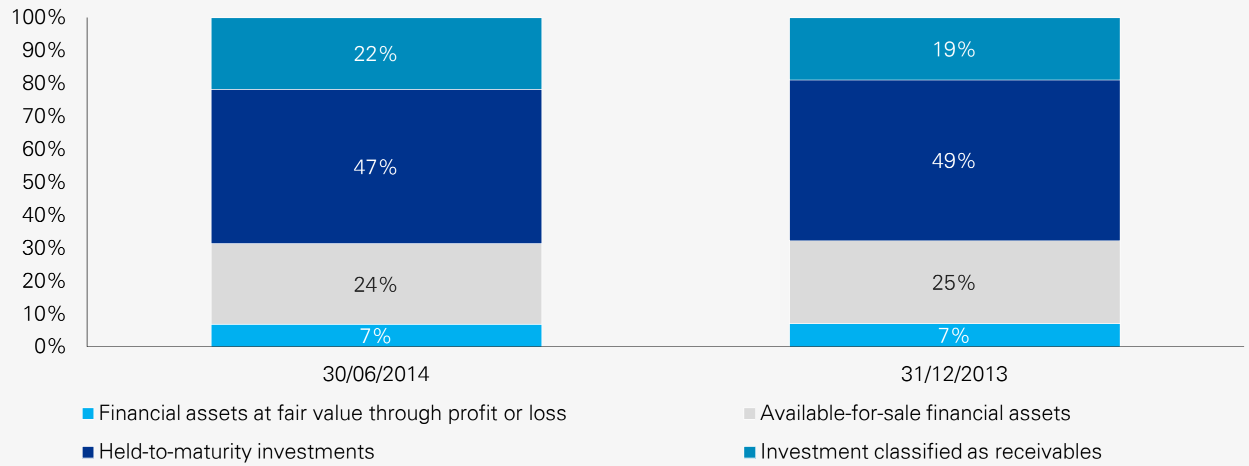
Condition of assets – Loan-to-deposit ratio

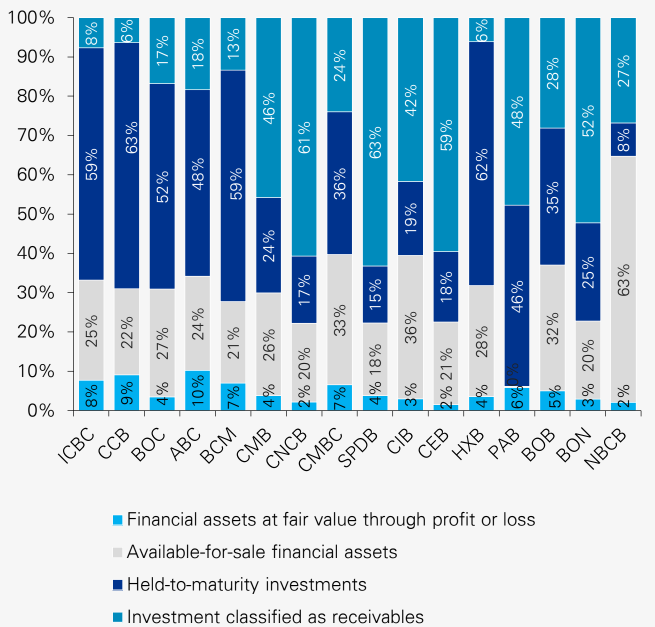


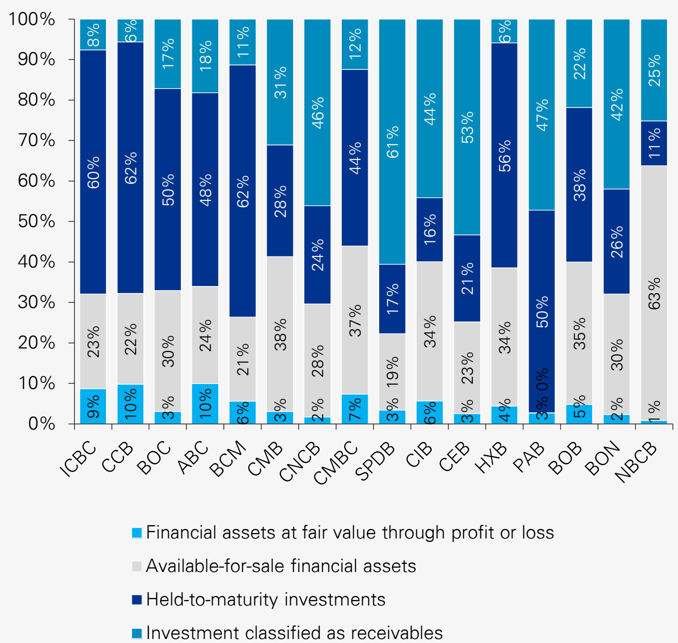
In the first half of 2014, most of the listed banks experienced a decrease in their loan-to-deposit ratio compared with that as at the end of last year. On the one hand, the banks continued to operate based on the concept that deposits should be the foundation of a bank and reinforced deposit taking by issuing high yield wealth management products; on the other hand, the banks more prudently controlled their credit scale due to the YoY decline of credit asset quality. In addition, because the CBRC adjusted the calibre for calculating commercial banks' loan-to-deposit ratios, certain commercial banks with a higher ratio of small and micro businesses loans, and of loans related to San Nong (agriculture, farming and rural areas), benefited from the policy that these types of loans were to be removed from the calculation calibre of the loan-to-deposit ratio, resulting in a significant drop in their loan-to-deposit ratios.

Source: The banks’ 2013 annual reports & 2014 semiannual reports, KPMG China research

Condition of assets – Securities investment







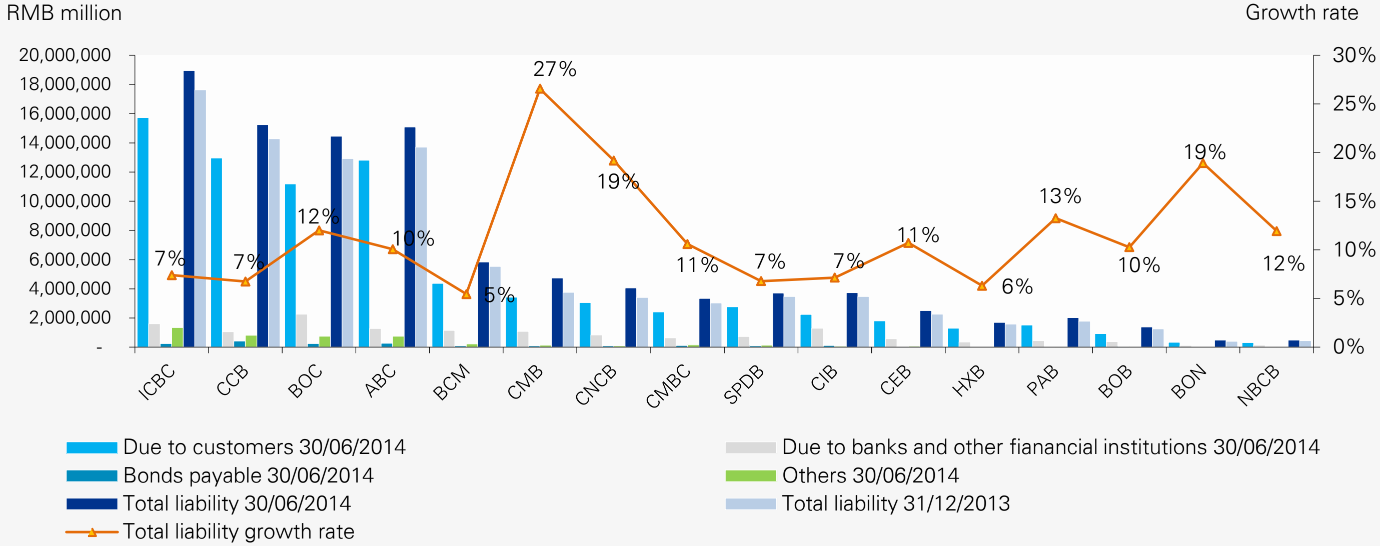
Source: The banks' 2013 annual reports & 2014 semiannual reports, KPMG China research

In the first half of 2014, the listed banks increased the scale of their securities investment as a proportion of overall asset structure by 9% on average compared with that as at the end of last year.

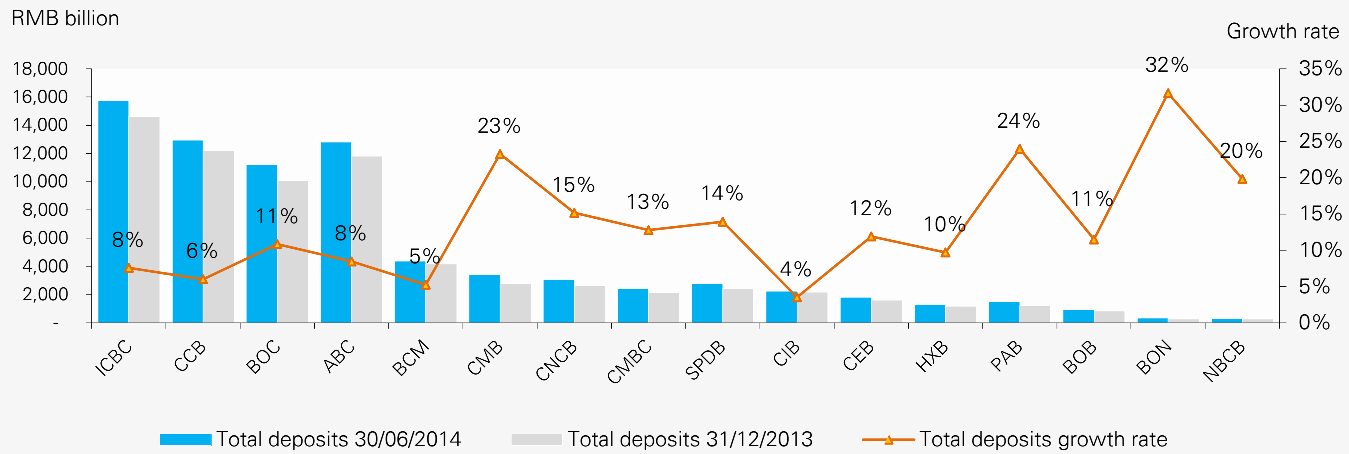
As for general securities investment structures, the listed banks moderately increased the ratio of investment classified as receivables according to their demand of assets/liabilities configuration and operational performance improvement in order to gain higher investment portfolios and performance levels than those from ordinary bonds.

In the first half of 2014, the securities investment structures of the listed banks differed. The five state-owned banks still held a high percentage of held-to-maturity investments, while other commercial banks increased the proportion of investment classified as receivables to varying degrees.

Condition of liabilities – Liability structure



In the first half of 2014, the growth trends of the total liabilities were the same as that of the total assets of the listed banks, with an average increase of 10 percent compared to that as at the end of 2013. This was mainly because the banks enhanced their deposit taking scale. Customer deposits and due to banks and other financial institutions experienced a steady rise. CMB, CNCB and BON recorded the highest increases. Furthermore, customer deposits was still the major component of liabilities.



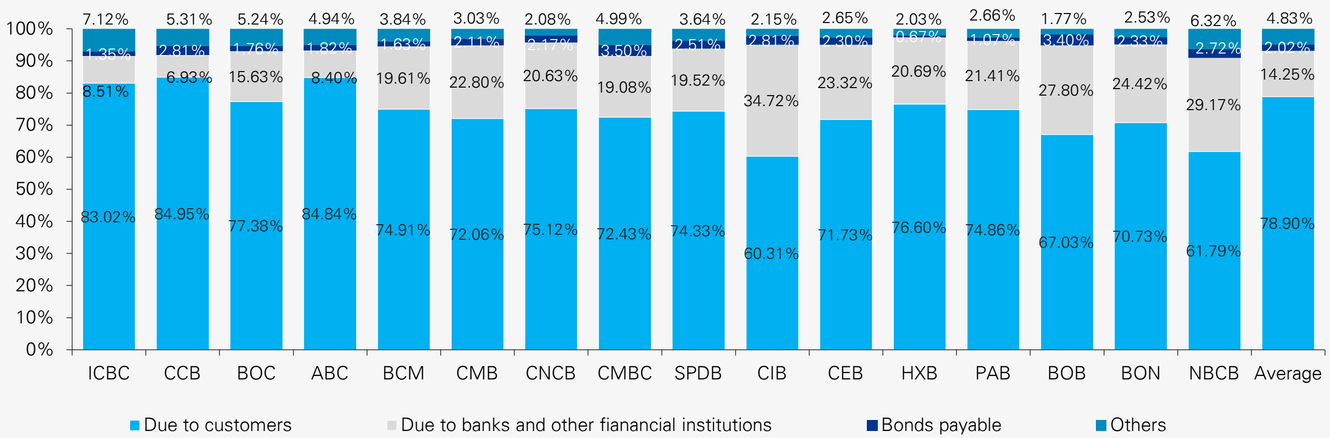
In the first half of 2014, the total scale of deposits of the listed banks was RMB 77.13 trillion, 10% more than that at the end of the last year. BON recorded the highest rate of increase at 32 percent, mainly due to issuing of the wealth management products with high rates of return.

CIB experienced the lowest increase of 4%, mainly due to the fact that current deposits were continuously affected by internet financing, resulting in a limited increase in deposits. BOCOM also recorded a low increase of 5%, mainly because it reduced issuing of the management products with high cost.

Source: The banks' 2013 annual reports & 2014 semiannual reports, KPMG China research

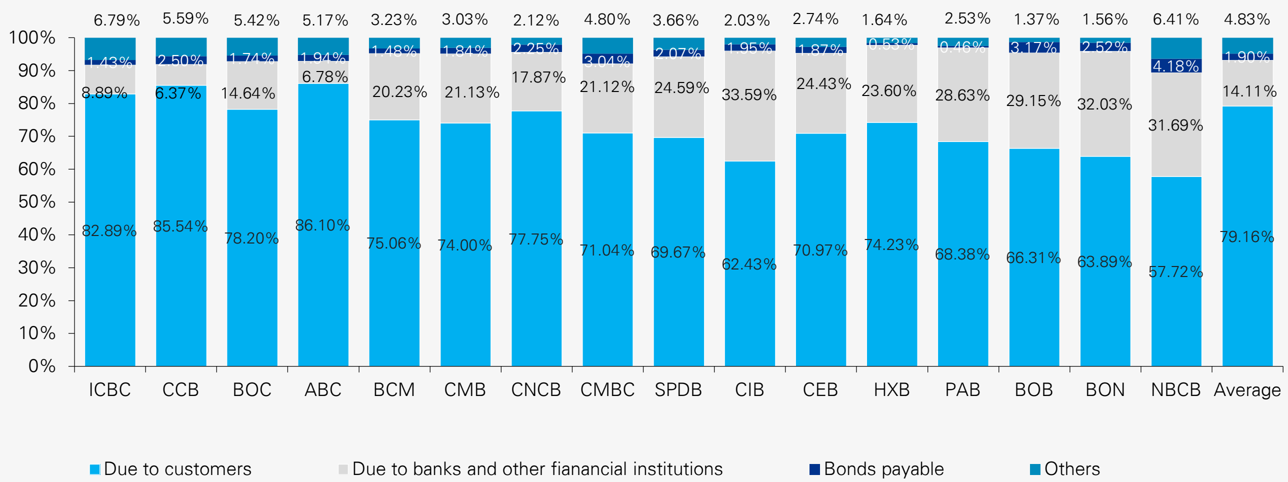
Condition of liabilities – Liability structure(continued)

Liability structure



In the first half of 2014, customer deposits were the major component of the liabilities of the listed banks. The big five state-owned banks had higher rates, with ICBC, CCB and ABC each recording a rate of over 80%, reflecting their advantages in attracting deposits. Shareholding commercial banks and city commercial banks organised sources of funds based on the needs of resource allocation. Comparatively, they had a higher proportion of due to banks and other institutions than the big five state-owned banks. CIB had a rate of 34.72%, mainly caused by the significant increase in repurchase agreements during this period.

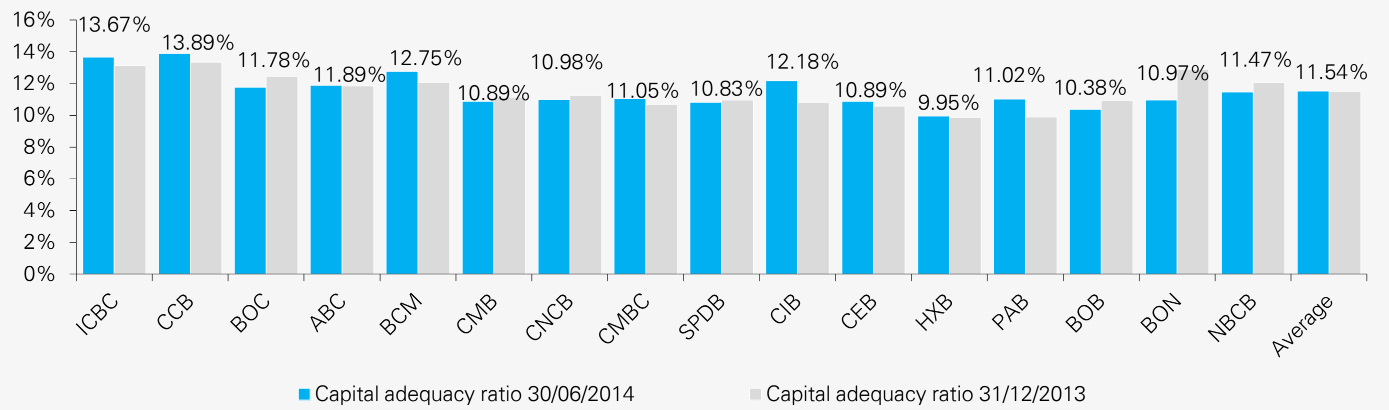
Liability structure



In the first half of 2014, the liability structure of the listed banks remained basically unchanged. ICBC, CCB and ABC maintained the highest rates of customer deposits and CIB had the highest ratio of amounts due to banks and other financial institutions. BON and PAB had significant changes to its liability structure, with the condensing of high cost liabilities from banks and other financial institutions as well as the expansion of low cost customer deposits. As a result, the liability structure improved and net interest margin uplifted.

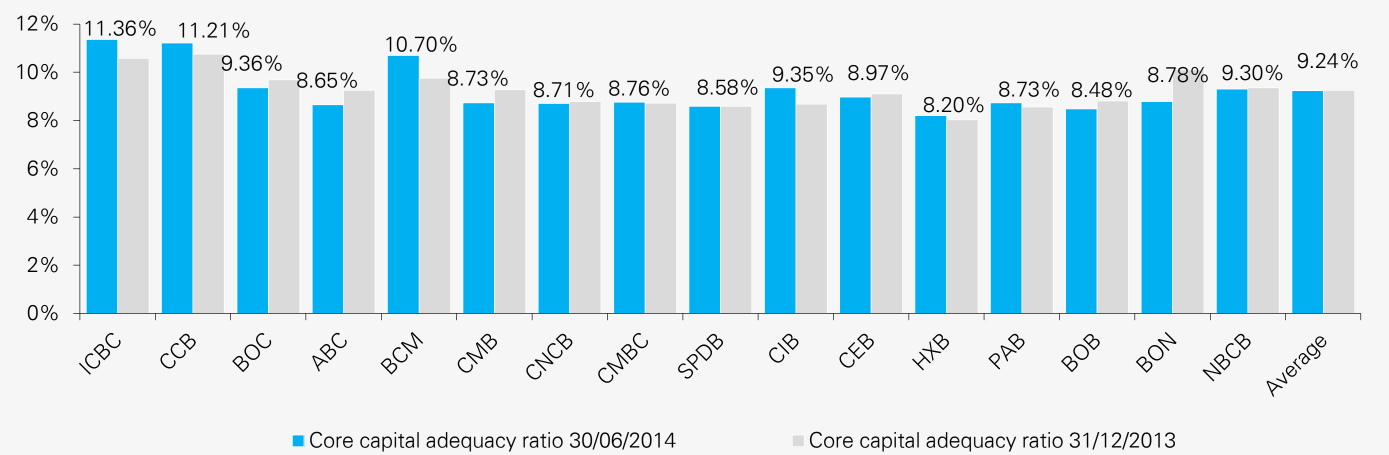
Source: The banks' 2013 annual reports & 2014 semiannual reports, KPMG China research

Risk management – Capital adequacy ratio and core capital adequacy ratio



As at 30 June 2014, the capital adequacy ratios of the listed banks remained at 11.54%, up 0.04% compared with that as at the end of 2013. The banks adjusted the ratio based on their own circumstances to meet regulatory indicators, while taking the optimisation of equity holders' interest into account and maintaining a reasonable capital leverage structure.

CIB experienced the highest increase of 1.35%, while PAB saw an increase of 1.12%, with both increases resulting from the secondary capital bond issued during the first half year to supplement secondary capital.



As at 30 June 2014, the average core capital adequacy ratio of listed banks was 9.24%, down by 0.01% compared to the end of prior year.

BON saw the highest decrease of 1.32%, mainly caused by the significant increase in the total amount of risk assets, particularly credit risk weighted assets.

Source: The banks' 2013 annual reports & 2014 semiannual reports, KPMG China research

Profitability - Profitability analysis

During the first half of 2014, the profitability of the listed banks decreased compared to that during the corresponding period of last year. The main reasons were as follows:

- The listed banks' average net interest margin went down and the growth of net interest income slowed due to the gradual implementation of interest rate liberalisation, the rise in the average cost for interest-bearing liabilities and the decline in the average yield for interest-bearing assets;

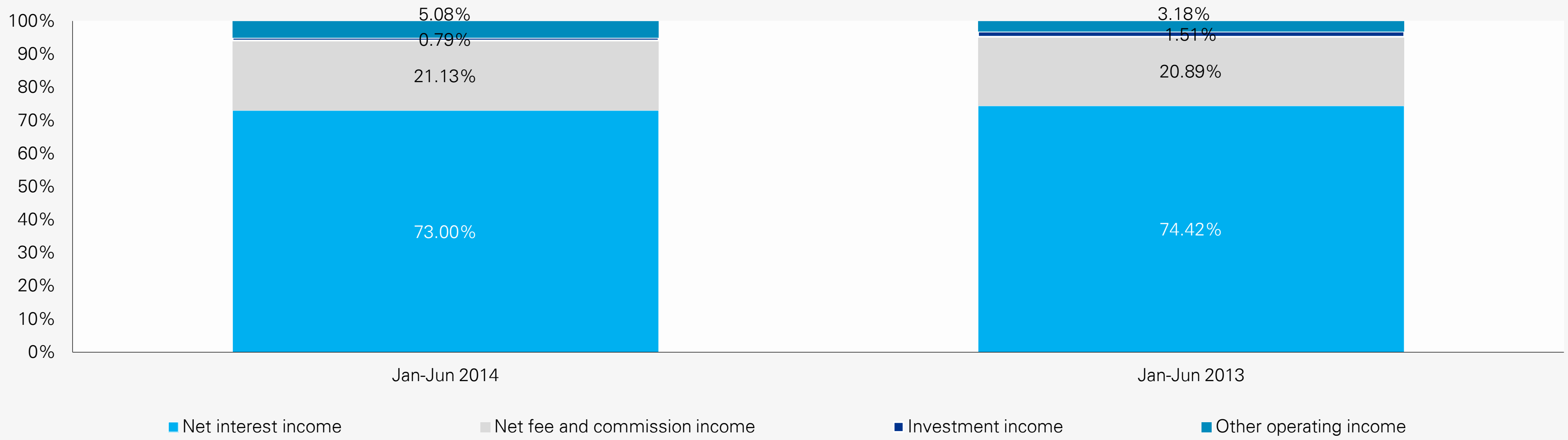
- The banks' asset quality decreased, overdue and non-performing loans increased significantly, and the provisioning pressure for impairment loss increased as a result of the slowdown in the macro economy and the enlargement of credit risk;

- The regulators have strengthened inspection on service charges from banking financial institutions in order to reduce unreasonable charges for banking services, as well as illegal charging behavior, such as intentionally or objectively increasing the financing burden of enterprises, which has also limited the increase of traditional commission fee. Therefore, the listed banks have had to expand the intermediate business income channel through financial innovation;

- The expansion of business, as well as the establishment of new outlets and marketing channels, led to an increase in financial R&D and operating expenses, which brought bigger profitability pressures to the banks.

Source: The banks' 2013 annual reports & 2014 semiannual reports, KPMG China research

Profitability – Operating income and income structure analysis



The total operating income of the listed banks increased by 15% year-on-year in the first half of 2014.

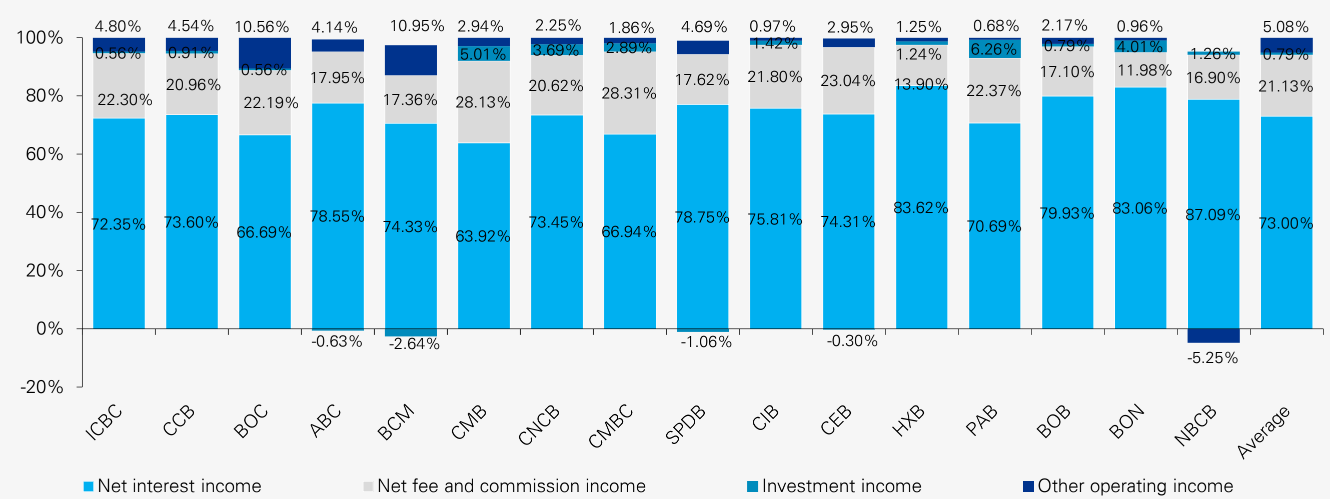
Components of operating income in the first half of 2014 :

- Net interest income accounted for 73.00% on average, down 1.42 percentage points year-on-year;
- Net fee and commission income accounted for 21.13% on average, increasing by 0.24 percentage points compared to the same period in the previous year;
- Investment income accounted for 0.79% on average, decreasing by 0.72 percentage points compared to the same period in the previous year;
- Other operating income accounted for 5.08% on average, an increase of 1.90 percentage points compared to the same period in the previous year. Other operating income mainly consists of gains from changes in fair value, exchange gains, and other income.

Source: The banks' 2013 annual reports & 2014 semiannual reports, KPMG China research

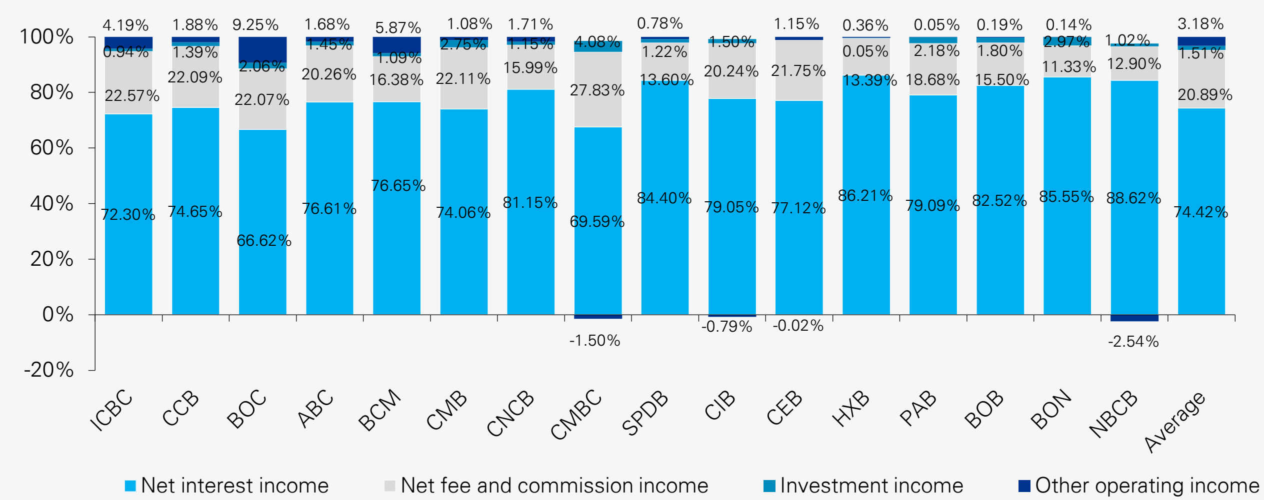
Profitability - Operating income and income structure analysis (continued)

2014 H1 operating income structure



During the first half of 2014, the net interest income of the listed banks accounted for 73.00% on average, while net fee and commission income and investment income accounted for 21.13% and 0.79%, respectively. Net interest income was the main source of operating revenue for the banks.

2013 H1 operating income structure



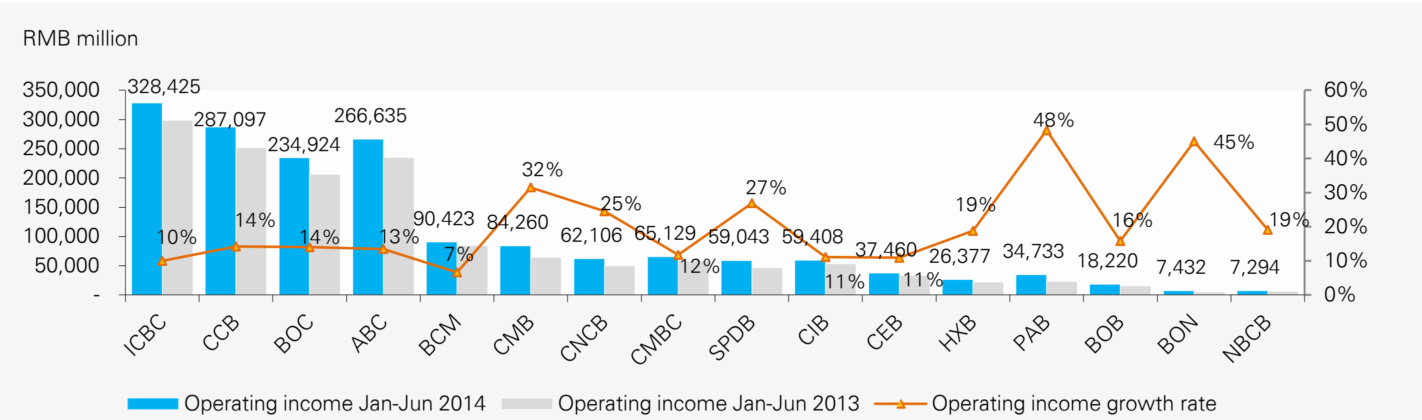
Compared to the first half of 2013, the average ratio of net interest income of the listed banks lessened, mainly due to the narrowing net interest margin under the influence of interest rate liberalisation.

During the first half of 2014, the average ratio of net fee and commission income for the listed banks increased, mainly due to the increase in income sourced from intermediate business, which was driven by financial innovation.

During the first half of 2014, other operating income of BOC and BOCOM, who had the higher ratio than other listed banks, increased a lot compared to the same period in the previous year, mainly contributed by the increase in gains from changes in fair value.

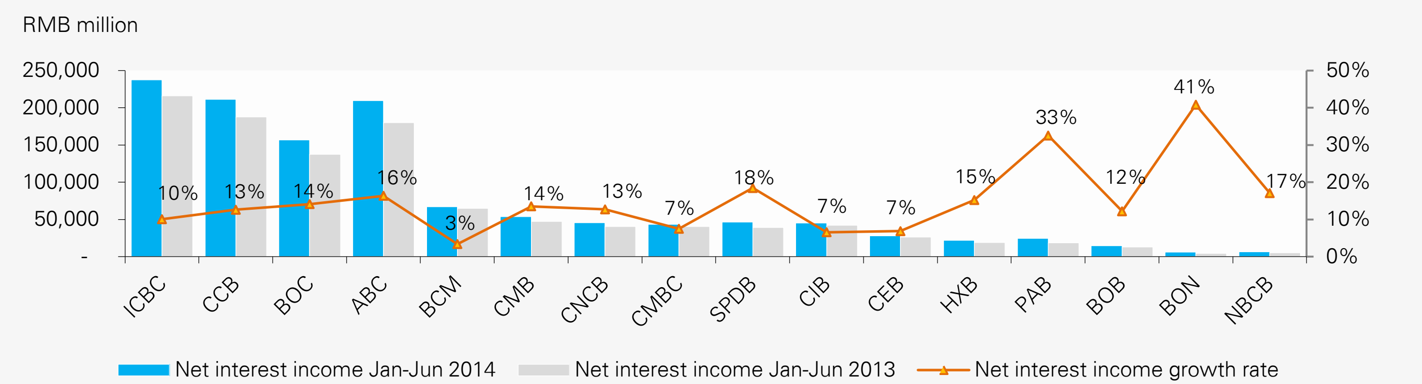
Source: The banks' 2013 annual reports & 2014 semiannual reports, KPMG China research

Profitability- Operating income and income structure analysis (continued)

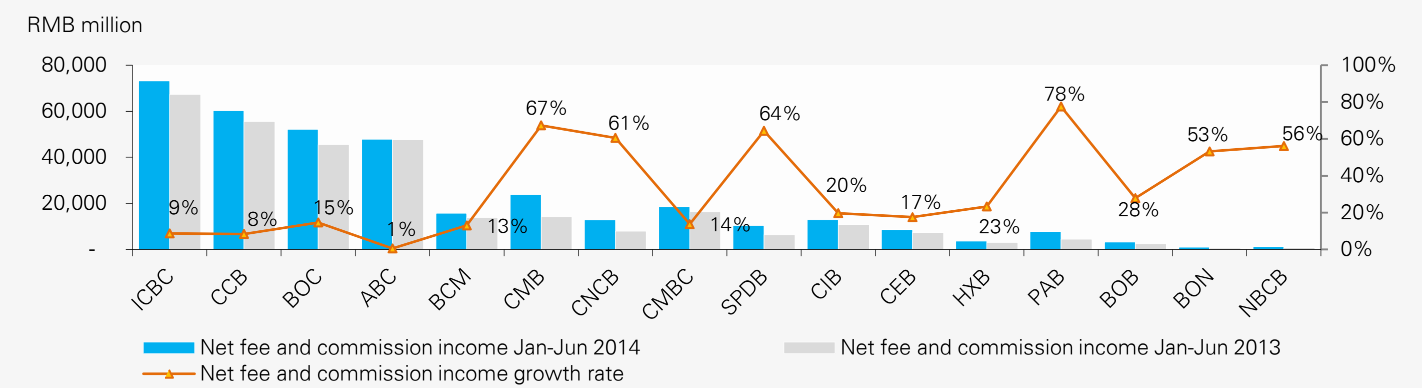


During the first half of 2014, all the listed banks experienced an increase in operating income, caused by the rise in the increase of net interest income and net commission income.

PAB and BON enjoyed an increase of over 40% due to the expansion of interest-bearing assets.



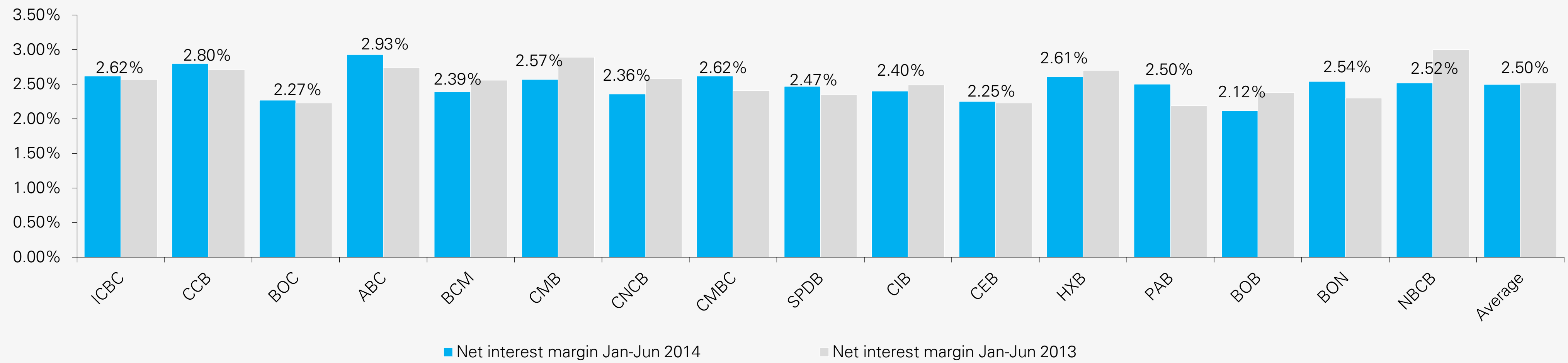
During the first half of 2014, all the listed banks experienced an increase in net interest income compared to the corresponding period in 2013. In the context of accelerating interest rate liberalisation and the narrowing of net interest margin, the increase in net interest income was mainly derived from the continual growth of interest-bearing assets.



During the first half of 2014, all the listed banks experienced an increase in net commission income compared to that in the corresponding period of the prior year. Though influenced by narrowing market interest margins, the banks proactively adjusted income structure and increased commission income by promoting financial innovation through exerting their comprehensive finance advantages, driving the significant income increase in the investment banking business, bank cards and custody business.

Source: The banks' 2013 annual reports & 2014 semiannual reports, KPMG China research

Net interest margin



During the first half of 2014, the listed banks experienced an decrease of 0.02 percentage points in average net interest margin compared with that during the corresponding period of the previous year. 7 out of 16 listed banks experienced a drop in their net interest margin.

BON recorded the biggest drop of 0.48 percentage points. This was mainly due to a narrowing of its net interest margin resulting from the reduction of loan interest rates and repricing of loans, as well as interest rate liberalisation.

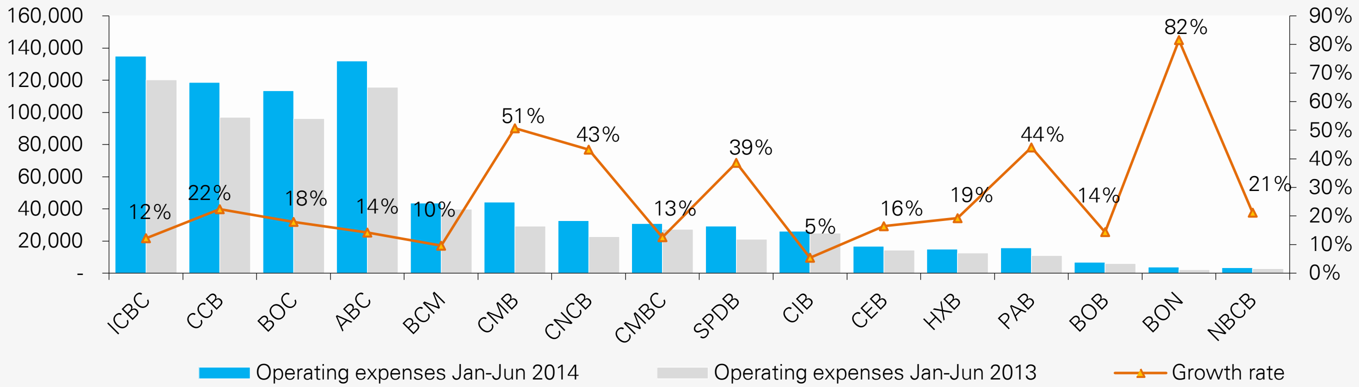
CMB experienced the second biggest drop of 0.32 percentage points. This was mainly due to a year-on-year increase in the average cost rate of interest-bearing liabilities amounting to 0.53 percentage points, with the average yield of interest-bearing assets increasing by only 0.18 percentage points year-on-year, which resulted in a decrease of the net interest margin.

While the commercial banks, as evidenced by PAB, improved their rates of resource utilisation through continuously optimising the interest-bearing structure and adjusting pricing strategy, their net interest margins increased under the circumstances of the narrowing of market interest margin.

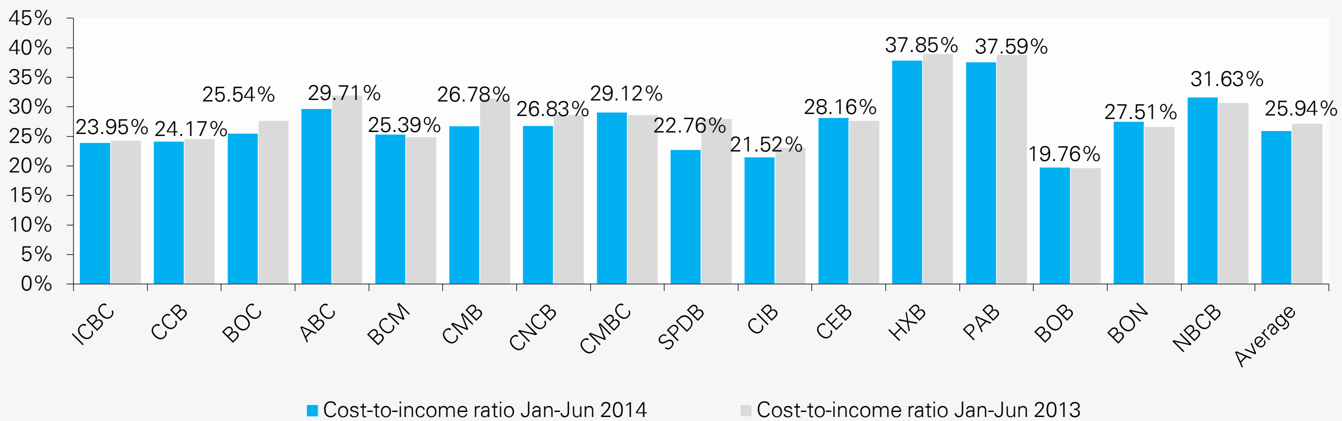
Source: The banks' 2013 annual reports & 2014 semiannual reports, KPMG China research

Profitability – Cost control – Cost-to-income ratio

Operating expenses



Cost-to-income ratio



The operating costs of all the listed banks increased in the first half of 2014. The expansion of business scale and the establishment of new outlets drove the steady increase in the banks' operating costs.

BON, CMB and PAB experienced the highest increases rates of 82%, 51% and 44%, respectively. The main reason was that the increased loan loss provision which caused by the decrease in asset quality contributed to the increase of operating costs.

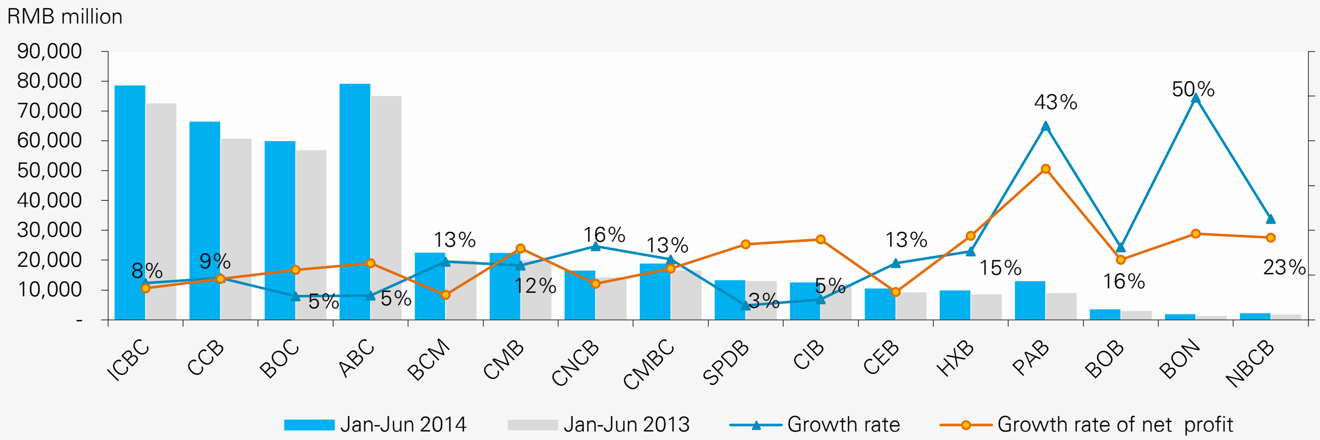
During the first half of 2014, several banks experienced a decrease in their cost-to-income ratios, thanks to efficient cost control, refinement of operating expenses, and the comprehensive effect of asset structure optimization and rapid growth of intermediary business. SPDB experienced the sharpest decrease of 5.23 percentage points.

Nevertheless, considering the increasingly rigorous external regulation, as well as the listed banks' demand to remain competitive through continual innovation with respect to their products and services going forward, whether the low cost-to-income ratio can be sustained or not will be a key challenge facing the listed banks' profitability.

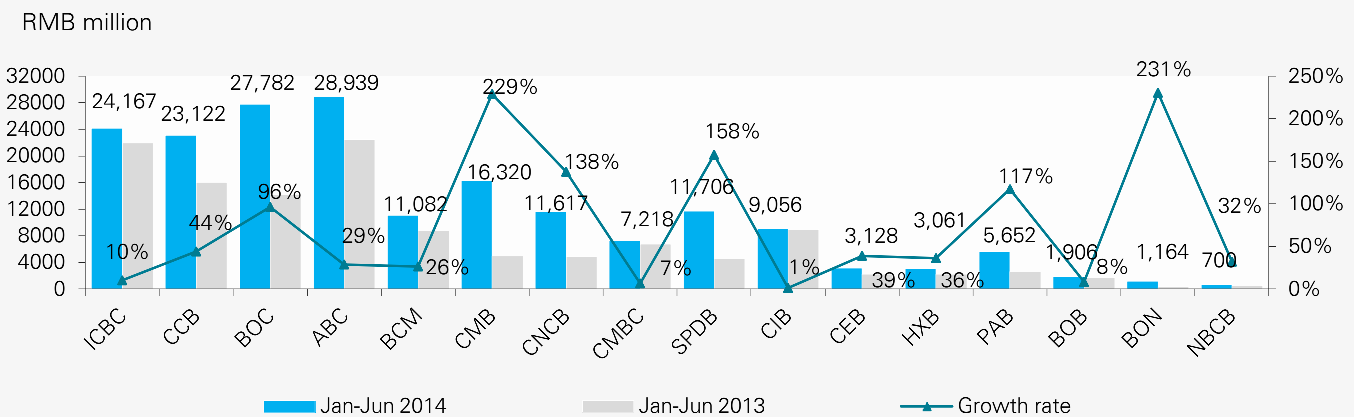
Source: The banks' 2013 annual reports & 2014 semiannual reports, KPMG China research

Profitability – Cost control – General and administrative expenses and impairment losses

General and administrative expenses



Impairment losses



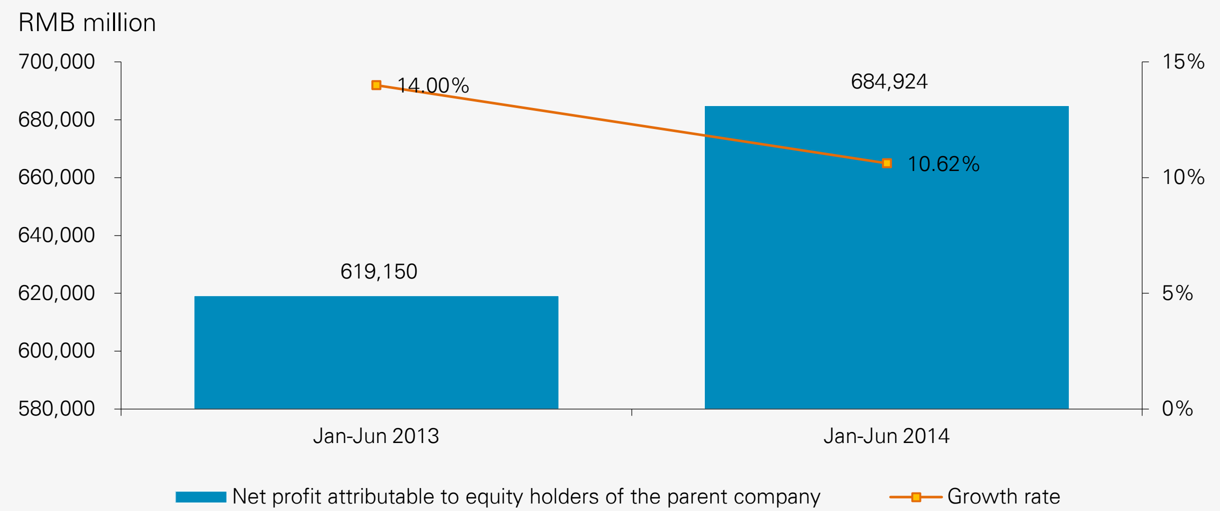
Overall, the listed banks saw an average increase in general and administrative expenses of 9% during the first half of 2014. BON (50%) and PAB (43%) experienced the highest increase rates among all the banks. This was mainly due to expansion in business scale and the establishment of new outlets.

In the first half of 2014, the banking industry increased loan loss provision for credit assets as a result of the build-up of downward economic pressure and a decrease in asset quality. The impairment losses increased significantly, to 51% on average, compared to 19% for the same period in the previous year.

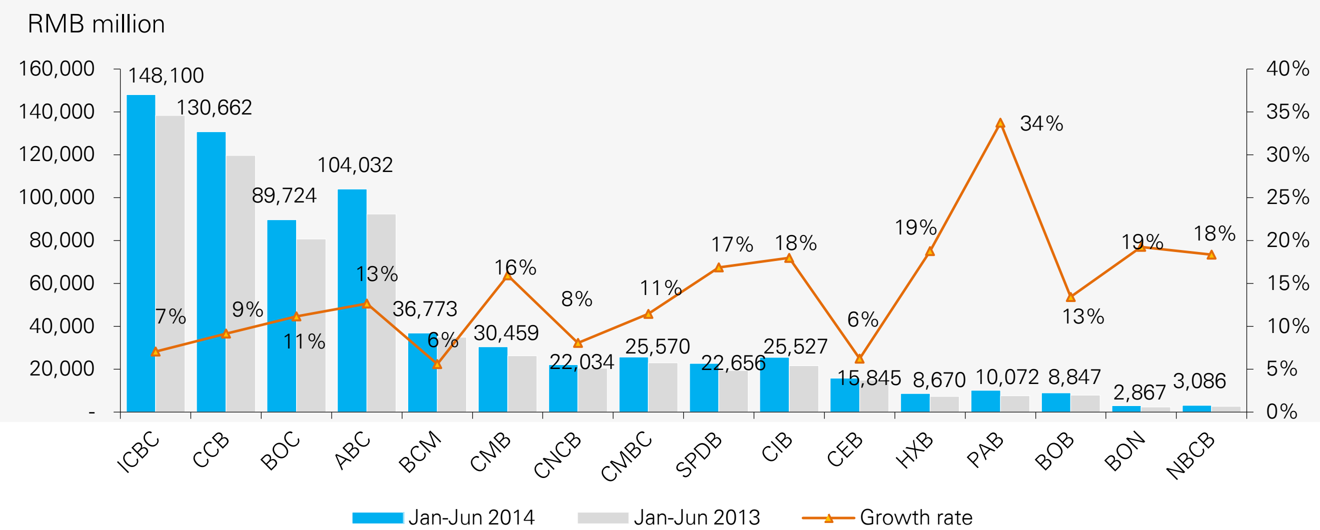
BON and CMB experienced the highest rise in impairment losses, recording increases of 231% and 229%, respectively, due to the sharp decrease in asset quality.

Source: The banks' 2013 annual reports & 2014 semiannual reports, KPMG China research

Profitability – Net profit attributable to equity holders of parent company



In the first half of 2014, net profit attributable to equity holders of the parent company experienced an increase while the growth rate was obviously slower than that during the same period in 2013, falling from 14.00% to 10.62%.

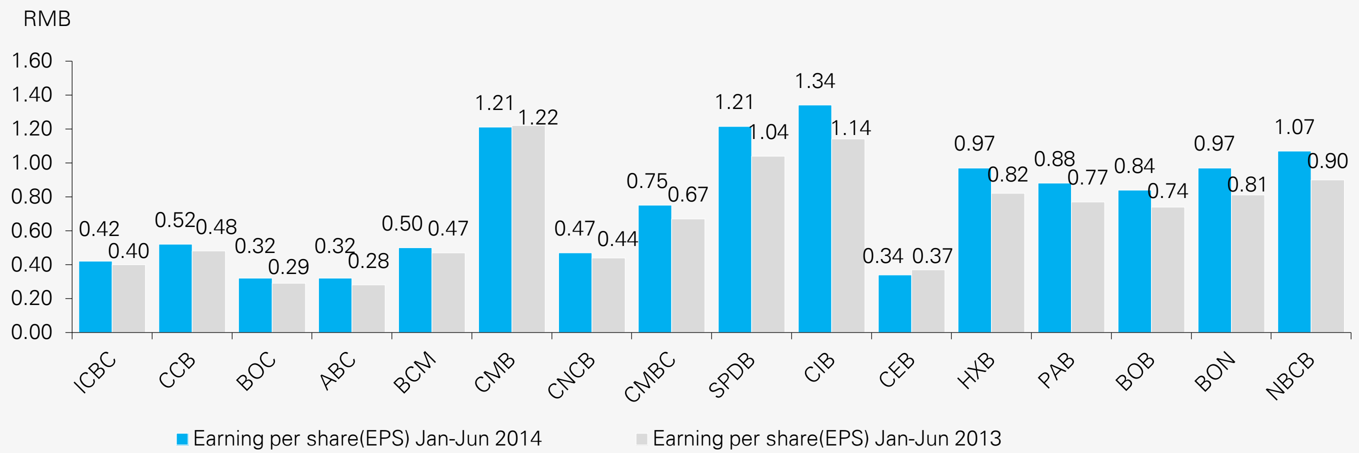


In the first half of 2014, net profit attributable to equity holders of the parent company of the listed banks maintained a double-digit average increase (10.62%), mainly due to the increase in net interest income (12.56%).

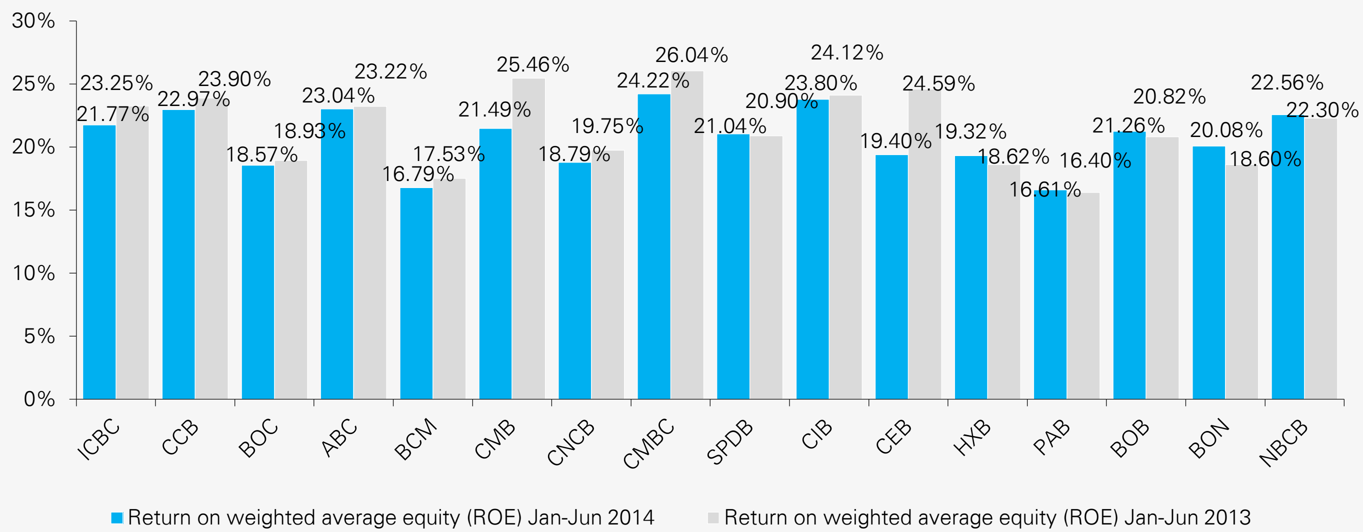
PAB had the highest rate of increase at 34%. Both HXB and BON achieved growth rates of 19%.

Source: The banks' 2013 annual reports & 2014 semiannual reports, KPMG China research

Profitability – Financial performance indicator



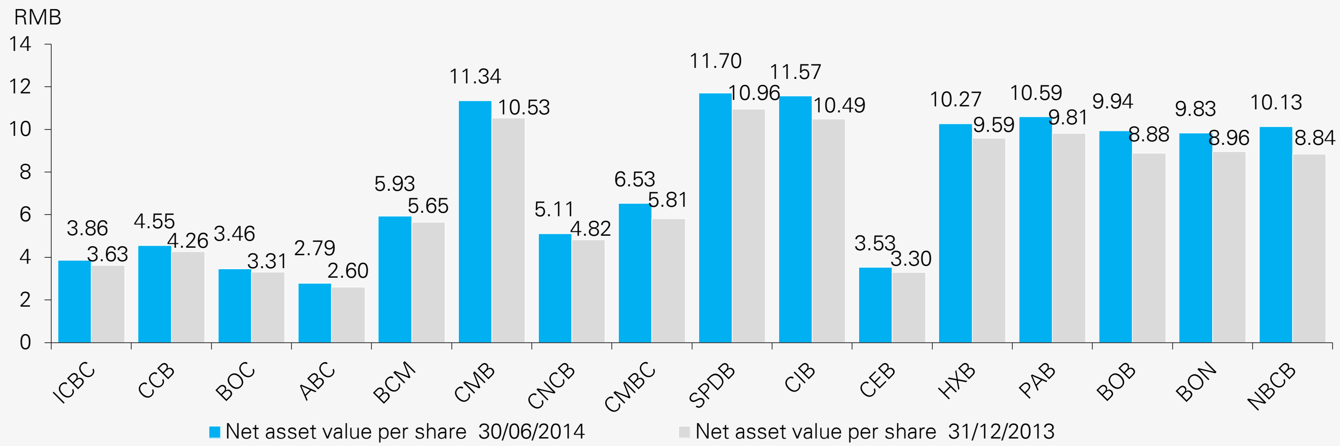
In the first half of 2014, the listed banks experienced rising earning per share (EPS), which was caused by higher income from banking business expansion. However, the increasing trend was weaker than that during the corresponding period in 2013 as a result of influences from the overall market.



In the first half of 2014, the return on weighted average equity (ROE) of the listed banks decreased by 0.79% compared to that during the corresponding period in the previous year, mainly due to the slackening increase in net profit, while net assets continued to increase in line with the expansion of banking business, which resulted in the slight drop of ROE. CEB and CMB had a higher rate of decrease at 5.19 percentage points and 3.97 percentage points, respectively.

Source: The banks' 2013 annual reports & 2014 semiannual reports, KPMG China research

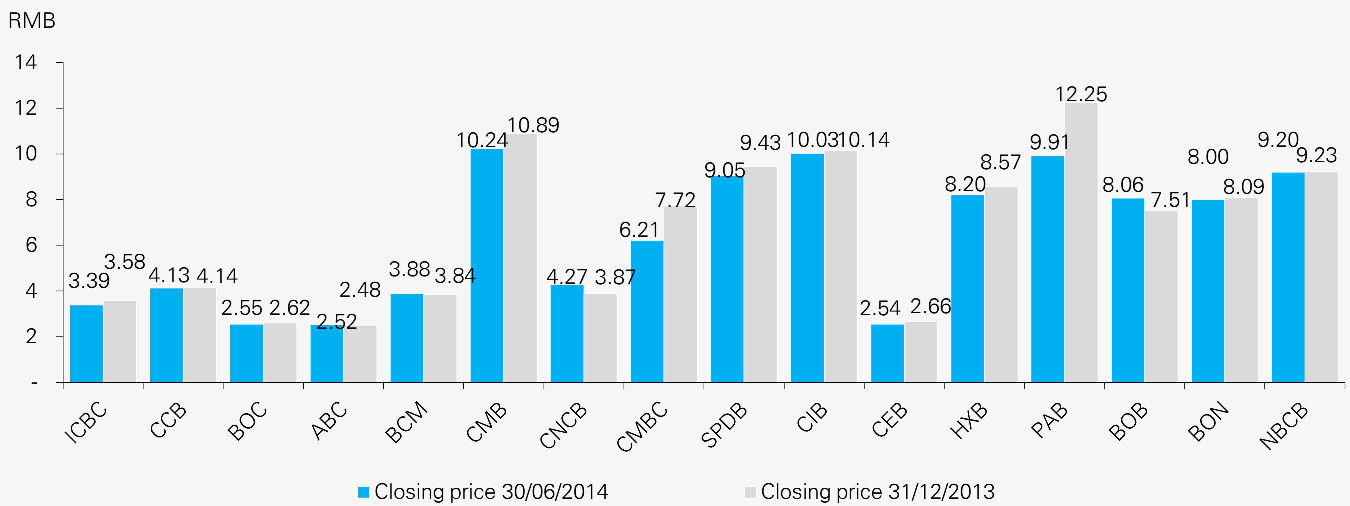
Profitability – Financial performance indicator(continued)



In the first half of 2014, the net asset value per share of all the listed banks recorded a slower rate of increase compared with that during the corresponding period in 2013.

SPDB had the highest net asset value per share at RMB 11.70, an increase of RMB 0.74 over the previous year.

In contrast, NBCB achieved the highest amount of increase (RMB 1.29).



Investors clearly had a lack of confidence as the macro economy slowed down and the stock market remained sluggish.

12 out of 16 listed banks experienced a drop in their share price in the first half of 2014 compared with that during the corresponding period in 2013, while only 4 banks recorded a rise.

Impacted by the downward economy and the decrease in the asset quality of the banking industry, some of the banks with a higher proportion of credit assets from small and micro businesses faced much more pressure. For instance, CMBC suffered a drop in share price of 20%, followed closely by PAB with a drop of 19%. This was mainly resulted from the cash dividend distribution and capital reserve transferred to equity in the first half of 2014 .

Source: The banks' 2013 annual reports & 2014 semiannual reports, KPMG China research

03

Hot topics

Overview of interbank regulations:

2002 In November 2002, PBOC announced the *Interim Measures on Managing RMB Interbank Borrowing (Exposure Draft).*

2007 In July 2007, PBOC announced the *Management Measures on Interbank Lending*.

2009 In December 2009, CBRC announced the *Notice on Further Governance of Cooperation Between Banks and Trust Companies*.

2011 In June 2011, CBRC's Supervision Department of Non-bank Financial Institutions announced the *Notice on Regulating Net Capital and the Conversion of Financial Statements for Cooperative Business between Banks and Trust Companies and the Sales of Trust Products by Trust Companies*.

In September 2011, China Banking Association announced the *Regulations on Bill Business of China Banking Industry.*

2012 In May 2012, MOF announced the *Reply on Accounting Treatment for the Interbank Payment Business of Financial Institutions*.

In August 2012, CBRC announced the *Notice on Managing the Interbank Payment Business*.

2013 In June 2013, the credit crunch crisis emphasised the importance of monitoring interbank business. The mismatch in maturity terms of interbank business has led to liquidity risk.

In November 2013, financial regulators convened a second meeting on how to coordinate interbank regulation and concluded that interbank business should be monitored according to business type.

In December 2013, PBOC announced the *Interim Measures on Interbank Deposit Manage*ment.

2014 In April 2014, PBOC announced the *Report on the Stability of China's Financial Industry*. The report states that: a) interbank business is not subject to regulatory and supervisory requirements at the macro level since 1) it is not required to meet the required reserve ratio; 2) it requires less capital and provision; 3) it is not subject to a deposit to loan ratio; and 4) it creates synergy for counterparties; b) interbank business allows banking peers to borrow short term interbank money at lower cost for reinvesting in assets with long maturity term and high yield. The mismatch in maturity terms of assets comes with potential liquidity risk; c) some interbank business has low transparency in terms of account auditing, making it more difficult to monitor and control risk; and d) the increased correlation in funding of financial institutions has transformed interbank business into a more complicated multi-tier structure. This leads to artificial growth in the overall asset size of financial institutions and increases the possibility of cross risks.

On 16 May 2014, China's five prominent regulatory bodies jointly announced Article 127. To complement Article 127, CBRC required interbank business to be operated under a dedicated department with the announcement of Article 140, while PBOC required all interbank business to be centrally managed and approved by its head office with the announcement of Article 178. Together, the Articles form a preliminary regulatory framework for the interbank business of financial institutions.

Innovative models for interbank business:

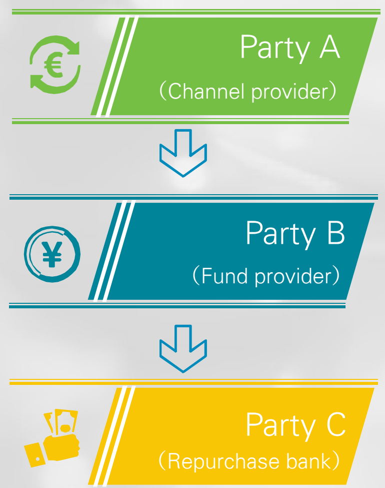
The interbank business of commercial banks offers innovative products. It involves many participating entities with variable structures. Interbank business with underlying assets, such as beneficiary rights and brokerage asset management plans, may include (but is not limited to) the following business models:

1. Direct investment in a beneficiary right or brokerage asset management plan

Commercial banks invest in a beneficiary right and brokerage asset management plan directly.

2. Tri-party repurchase involving only a beneficiary right or brokerage asset management plan

Party A (channel provider) establishes a trust scheme with underlying assets as loans with a trust company, with Party A as the holder of the trust scheme. Party A and Party B (fund provider) secure a transfer agreement to transfer the trust beneficiary right to Party B, with Party B as the beneficiary of the trust scheme. Meanwhile, Party B and Party C secure a repurchase agreement, pursuant to which Party B shall transfer the trust scheme to Party C before the maturity date of the trust loan. In the case of any credit events prescribed in the agreement happening to the underlying entrusted loan, Party B has the right to request Party C to early repurchase the trust beneficiary right unconditionally and irrevocably.



3. Provision of guarantee or underwriting for other entities investing in a beneficiary right or brokerage asset management plan

Party B invests in a beneficiary right or brokerage asset management plan directly. Party A provides guarantee or underwriting to Party B's investment to reduce its credit risk.

4. Secure forward purchase agreement with other entities and forward purchase of a beneficiary right or brokerage asset management plan

Party B invests in a beneficiary right or brokerage asset management plan directly. Party A and Party B sign a forward purchase agreement, pursuant to which Party A agrees the forward purchase of the beneficiary right and brokerage asset management plan held by Party B.

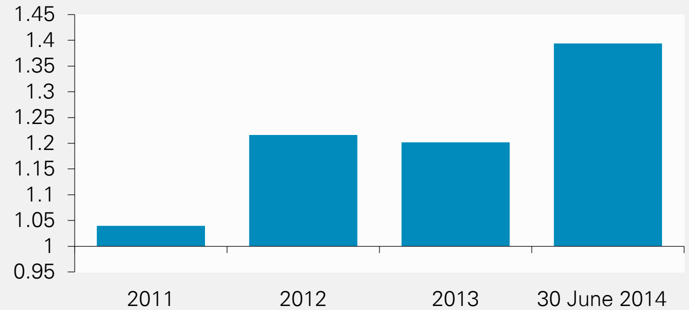
Hot topics: Insights on new interbank regulations (continued)

On 16 May 2014, PBOC announced the *Notice from PBOC, CBRC, CSRC, CIRC and SAFE on the Governance of the Interbank Business of Financial Institutions* ("Article 127") on its official website. On the same date, CRBC announced a *Notice on Governing the Management of Interbank Business of Commercial Banks* ("Article 140") on its official website to complement Article 127. The two Articles lay down a foundation for a preliminary regulatory framework for the interbank business of financial institutions. This could help resolve some serious problems, including the uncontrolled development of interbank business, the circumvention of regulations, the increasing mismatch in maturity terms and the low transparency in information disclosure. The regulatory framework for interbank business includes the following key components:

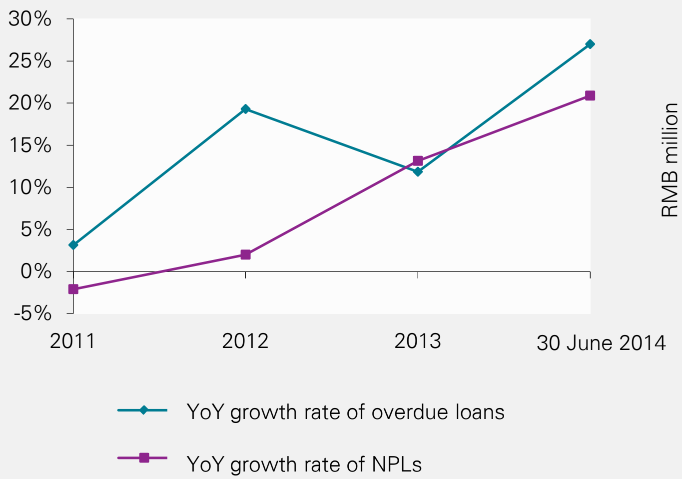
	Regulatory framework for interbank business	Impact analysis
Business management	Govern the scope of interbank business; further clarify the reach of interbank business; manage interbank business according to business type; set up a dedicated department for interbank business to deal with both business operations and centralised management of credit and authorisation.	The biggest challenge encountered by commercial banks is how to integrate previously scattered operations and management into a dedicated department for interbank business.
Account auditing	Clarify the requirements on the use of accounts, accounting treatments and provisions.	To govern the scope of interbank business, Article 127 proposes specific requirements on the use and audit of accounts with reference to the existing definition of interbank business. This will slow down the development of innovative business, such as tri-party or multi-party repurchase. Meanwhile, non-standardised asset investment may come under greater pressure with regards to impairment provision in accordance with the principle of substance over form.
Risk management	Build a risk management system in line with the level of business complexity owing to the importance of managing the liquidity risk of interbank business; govern the risk measurement and capital provision of interbank business according to the principle of substance over form.	Regulations on account auditing help achieve better risk measurement and provision of capital. The misuse of capital utilisation can be basically identified with appropriate regulations. Some banks will face more pressure with regards to the expansion of risky assets and the increase of capital requirements in accordance with the principle of substance over form.
Internal control	Establish an internal control system in line with business development with a comprehensive setup of front, middle and back end support to enhance internal supervision and accountability.	Set up a dedicated department for interbank business. The key to successfully running an interbank business lies in the revamp of internal procedures and controls.
Regulatory indicators	Propose two quotas at the regulatory level, i.e. limits on the interbank borrowing and lending of one single financial institution.	To resolve the issues of significant mismatch in maturity terms and increasing liquidity risk, Article 127 proposes two quotas at the regulatory level in order to build a first line of defence for managing liquidity risk by stabilising and diversifying the sources of capital. Some banks that over rely on interbank financing will be subject to more pressure on adjustment of their liability structures. In addition, commercial banks should also step up the second and third lines of defence in terms of the quality of current assets, contingency plans and stress testing to truly resolve the potential liquidity risk.
Business direction	Encourage asset securitisation and interbank deposit businesses to enhance the proactiveness, standardisation and transparency of asset and liability management.	Under current regulatory policies, commercial banks are encouraged to focus on the asset-backed securitisation and interbank deposit businesses. They will encounter long term problems regarding how to enhance the level of transparency of interbank business and their debt capacity as the liberalisation of interest rates progresses.

Under the regulatory framework of interbank business, the following compliance procedures should be followed: a) obtain an accurate understanding of each regulatory requirement; b) restructure deposit business, perform differential analysis and formulate improvement proposals in terms of business model, versions of contracts, accounting treatment, risk measurement, provision for capital, mismatch in maturity terms, credit risk and buffering arrangements; c) assess whether the current operation and management of interbank business should be adjusted, enhance authorisation and credit management and promote a systematic approach to business management and risk monitoring; and d) formulate the future strategy of interbank business. The banking industry should formulate their business plans from a high level of asset and liability management to bring synergy effects to interbank and other lines of business, such as fund business.

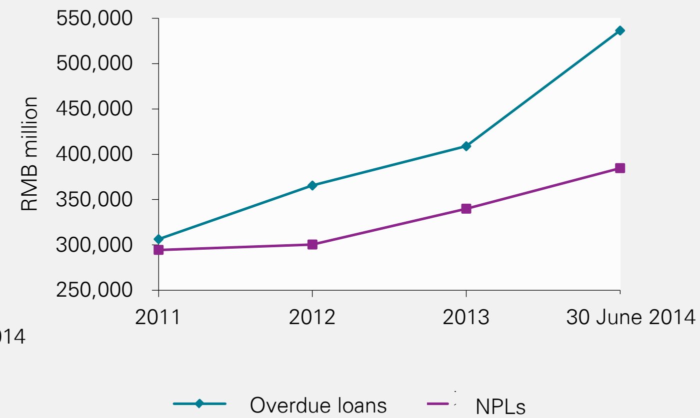
Overdue loans/NPLs ratio



Growth rate



Increasing overdue loans and NPLs



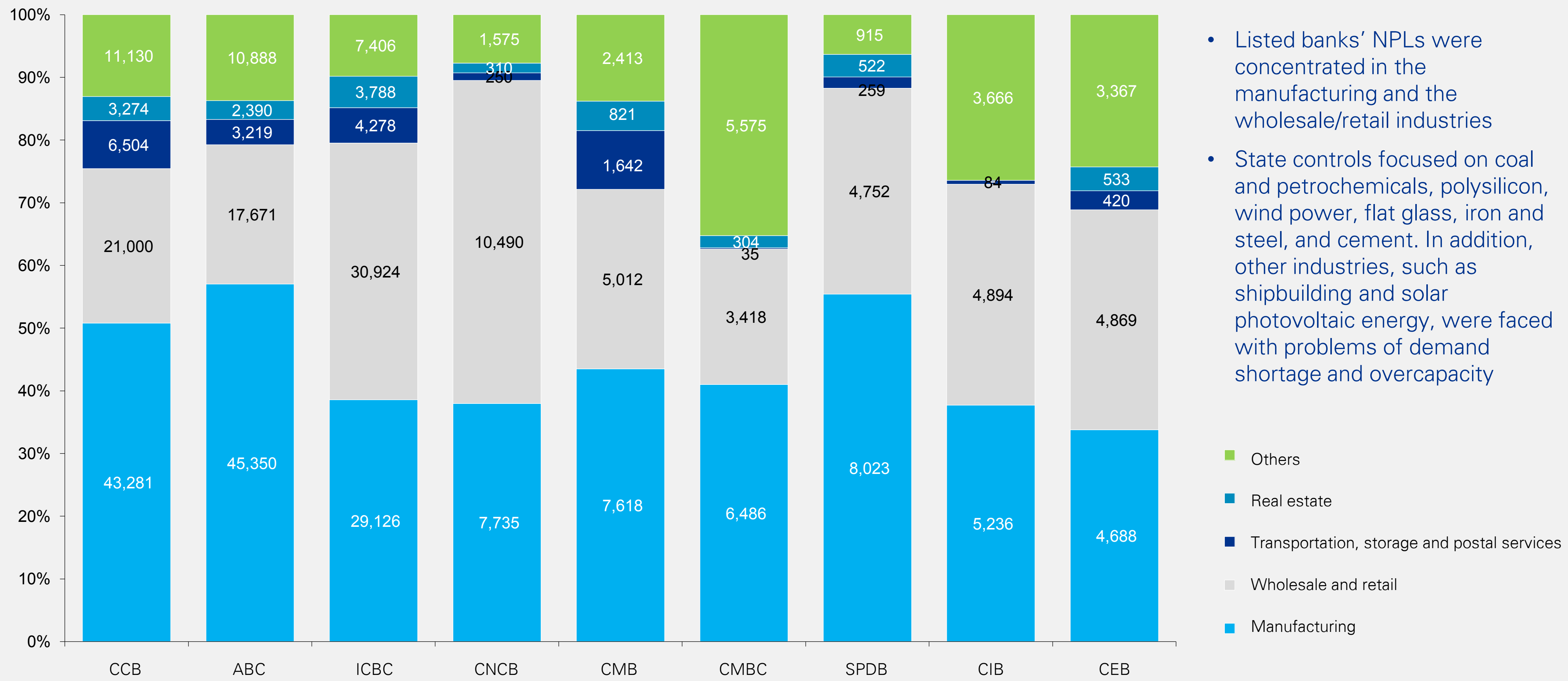
Deteriorating conditions for overdue loans and NPLs of the Big Four banks

- There has been a distinctive increase in the overdue loans and NPLs of the Big Four Banks in recent years
- The apparently higher ratio of overdue loans to NPLs and the widening gap between overdue loans and NPLs from 2011 onwards suggest growing pressure on the banks regarding NPLs and distressed asset resolution
- As at 30 June 2014, the average NPL ratio of the Big Four Banks was 1.07%, surpassing the alert level of 1% set by regulators, with the overdue loan ratio also reaching 1.49%
- Future loan quality is expected to further worsen amid the economic slowdown

Source: Banks' annual and semiannual reports

Warning signals from respective industries

NPLs of nine listed banks by industry (as at 30 June 2014)



- Listed banks' NPLs were concentrated in the manufacturing and the wholesale/retail industries
- State controls focused on coal and petrochemicals, polysilicon, wind power, flat glass, iron and steel, and cement. In addition, other industries, such as shipbuilding and solar photovoltaic energy, were faced with problems of demand shortage and overcapacity

Note:
- *Other listed banks' information disclosures are not comparable*
- *In order of NPL balance*

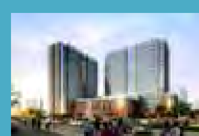
Source: Nine listed banks' 2014 semiannual reports

Warning signals from respective industries (continued)

Industries	Main reasons for NPLs
Manufacturing	Some manufacturing industries (e.g. iron and steel, cement, electrolytic aluminium, and shipbuilding) experienced severe overcapacity and suffered from material losses due to high inventory and low prices.
Wholesale and retail	Affected by market saturation, cost increases and the impact of e-commerce, as well as macroeconomic factors both within and outside of corporations, the average profit margin of the national retail industry was only approximately 1%.
Transportation, storage and postal services	Despite the rapid development of China's transportation industry, logistics and transportation enterprises experienced more difficult operating conditions, with continuously falling net profit prompted by increasingly intense competition in external prices and rising operating costs.
Real estate	China's macroeconomic controls over the real estate sector caused the industry-wide transaction volume to continue to drop. This situation, coupled with factors such as weak confidence among home buyers, higher inventory, falling gross profit margins, and housing defaults (specific to some regions), resulted in cash flow problems for some developers.

Real estate sub-sectors with higher NPL risk exposures in China

Commercial properties



Residential properties

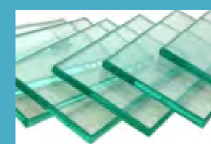
Manufacturing sectors subject to higher credit risk

Iron and steel

Shipbuilding

Cement

Flat glass



Electrolytic aluminium

Photovoltaics

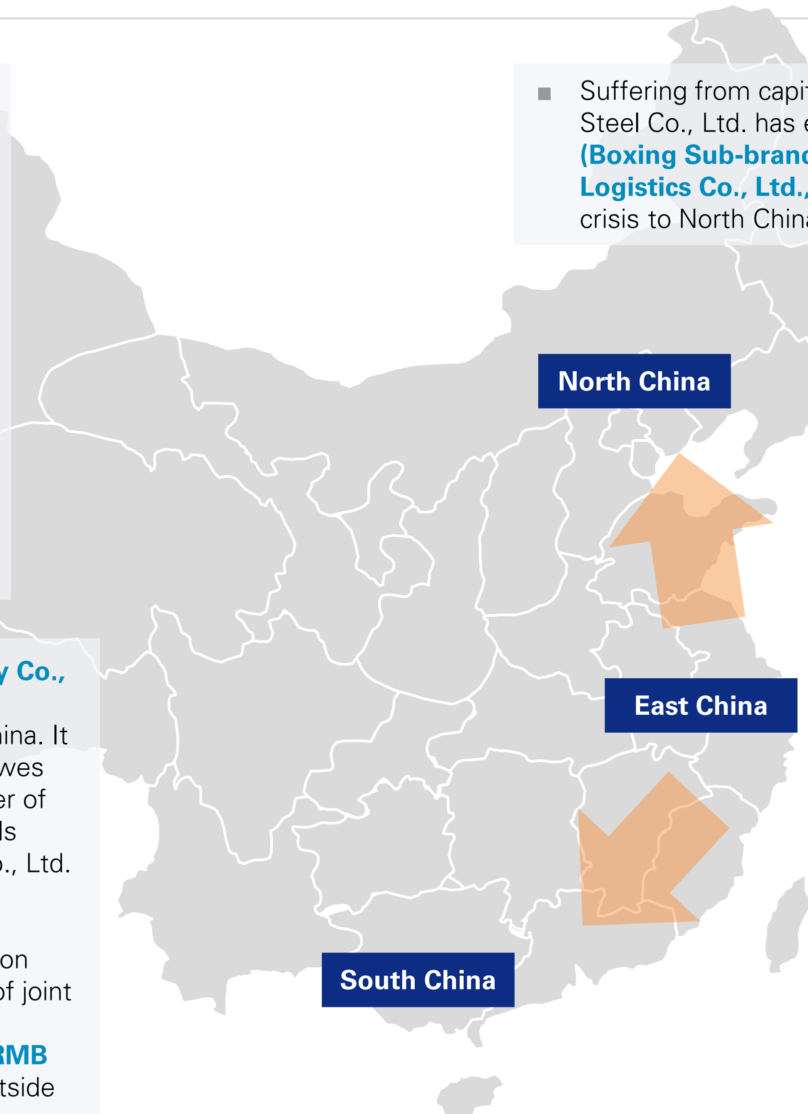
Wind power equipment

Further analysis of the steel trading industry is provided on the next page.

Default cases emerged in East China in 2013 — now they are also reported in South China and North China. We can trace this rash of defaults by studying the changing trends in the overcapacity-stricken steel trading industry.

- Steel trading loans are too concentrated, with a steel trading loan balance of **more than RMB 150 billion** in Shanghai.
- Since 2013, the NPL loans of the steel trading industry have been concentrated in Shanghai. The loans involve industry leaders Xiao Jiashou and Zhou Huarui from Zhouning, Fujian province. Steel trading enterprises founded by natives of Zhouning account **for over 70% of the market** in Shanghai. Massive loans and the **joint/mutual guarantee financing model** have triggered the current steel loan crisis in the city.
- Throughout 2013, banks stepped up their efforts in NPL recovery, litigation and collection for the steel trading industry.

- Suffering from capital chain rupture, Shandong Bojin Iron and Steel Co., Ltd. has experienced debt disputes with **CCB (Boxing Sub-branch) and Shandong Huaxing Metal Logistics Co., Ltd.,** signifying the spread of the steel trading crisis to North China.



- In February 2014, **Guangdong Smith Home Heavy Industry Co., Ltd. (GSMHI)** encountered sudden difficulties, signifying the spread of the steel trading crisis from East China to South China. It has been estimated that GSMHI's Chairman, He Jianhong, owes debts amounting to RMB 3.5 billion to six banks and a number of established firms (including state-owned Guangdong Materials Group Corp. and Hong Kong-listed China Packaging Group Co., Ltd. (HKEx:00572)).
- **Lecong Town, Shunde District,** Foshan City is the largest iron and steel market in South China, with an enormous amount of joint guarantee financing. The off- and on-balance sheet loans of Foshan's iron and steel industry have been estimated to **be RMB 70 billion.** This, coupled with banks' and private financing outside Foshan, means the region's total steel trading loans have been estimated to amount to as much as **RMB 100 billion**.

- In addition to the separate outbreak of debt disputes involving leading steel traders in the Shanghai and Lecong iron and steel markets since the Chinese 2014 Spring Festival, several debt disputes have also arisen in **Boxing County in Shandong Province**. Boxing County, known as "the Home of the Steel Coating Industry", is China's largest coated steel plate, sheet and coil production and processing base and trading hub.

Reasons for a rapid surge in NPLs and distressed assets

Given continued structural problems regarding the low transparency of the financial market, NPLs and distressed assets will inevitably grow amid the economic slowdown.

From a macro perspective, commercial banks are exposed to the following major risks:

1 Slowing economic growth and overcapacity

Following the RMB 4 trillion market stimulus measures enforced by China between 2008 and 2009, the nation's economic growth was largely spurred by local investments. As a result of slowing economic expansion, China could no longer depend on infrastructure investment, but instead needed to pursue more balanced economic strategies. However, excessive infrastructure investment in the early period led to falling investment demand and overcapacity in several key industries, such as coal and petrochemicals, polysilicon, wind power, flat glass, iron and steel, and cement, which were the focus of the state's macroeconomic controls. Furthermore, risks specific to industries with overcapacity began to spread to upstream and downstream sectors, while trade financing risk also spread from steel trading to other bulk commodity trading.

2 Shadow banking and default risks associated with trust products

Given the long-outstanding issue of shadow banking, default risk might arise from mature wealth management products, due to failure to redeem them by the due date, which may in turn trigger a financial crisis. Notwithstanding the previous resolution of the case of China Credit Trust Co., Ltd., it is anticipated that the government will not tolerate non-resolution of the relevant issue. Even though banks will not directly reimburse investors for their losses, the former will suffer from unimaginable losses on defaults by a large number of enterprises as part of a ripple effect due to a liquidity crunch.

3 Debt risk from local debts

In recent years, local government debts have accelerated growth. As local government borrowings are primarily used for infrastructure investments, they will not generate any income for a number of years. Banks have to bear risk from any mismatch between mid- to long-term loans and investment maturities. The local government platforms below the city level have single economic structures and relatively limited management capabilities, and consequently their risk exposures are comparatively higher. The capital requirements of large projects have also resulted in an over-reliance of bank assets on local governments and the strategic industries supported in particular localities. Moreover, many local governments have provided some subsidies for strategic industrial land or tax. Once enterprises fail in this respect, local governments and banks will suffer accordingly.

Countermeasures of commercial banks

Phase 1: Pre-approval controls

Phase 2: Post-approval management

Risk alerts	Risk controls
1. Understanding of borrowers' industry situations and detailed operating conditions	Banks should probe and study the effects of the state's economic control policies on industries (especially industries with overcapacity or high risks, such as steel trading, textiles, real estate and iron and steel) specific to borrowers. More frequent on-site visits should be made to borrowers for the purposes of in-depth study of their production conditions and scales, as well as the collection of their financial statements, in order to perform detailed data analyses of their repayment ability and profitability.
2. Collateral coverage	Some loans are secured by low collateral coverage. Banks are advised to impose more stringent requirements for, and enhance management of, collateral coverage of loans.
3. Discount risk from collaterals with higher initial valuation	Banks should step up valuation review at the time of loan origination by engaging a qualified and established valuation agency to judge whether the estimated value is reasonable according to the market value analysis.
4. Collateral registration	Banks should strictly supervise collateral registration in order to ensure no legal flaws in collateral contract completion or processing formalities in a bid to prevent collateral contracts from becoming void due to negligence, completion errors or invalid registration.
5 Review of guarantors' qualifications and mastery of asset information	Banks should file, and keep track of, guarantors' qualifications and their assets to prevent them from exaggerating their guarantee abilities or transferring their assets.

Countermeasures of commercial banks (continued)

Phase 1: Pre-approval controls

Phase 2: Post-approval management

Risk alerts	Risk controls
1. Timely mastery of borrowers' current operating status, financing scale, and loan purposes	Loan officers should regularly visit borrowers, inspect their production, and understand their genuine financing needs, without indiscriminate loan extension or tightening of loan limits. It is crucial to keep track of borrowers' loan use to see if their loan application is strictly in line with the purposes set out at the time of loan origination. This initiative aims to prevent them from blindly increasing investment risks and engaging in private lending without the knowledge of banks.
2. Ability to seal up and preserve collaterals in a timely manner to safeguard banks' rights	Some borrowers' collaterals are first pledged to banks which have the first right to collaterals. However, banks cannot take the initiative to dispose of collaterals because they have to wait for their turn to seal them up. In the case of private lending, courts are inclined to take into account private borrowers' interest, thus undermining banks' interest to some extent. Banks should closely monitor borrowers and their collaterals, and to take immediate resolution measures to resolve any loan risks identified.
3. Ability to obtain clues on borrowers' and guarantors' other properties and to protect the banks' rights of recourse	Banks should obtain clues on borrowers' and guarantors' other properties through multiple channels, and provide courts with a checklist of property clues for sealing-up purposes to safeguard their rights of recourse and their first right to collaterals.
4. Budgets and strategies for overall recovery/fast realisation of loans	Both the risk management departments and the special assets resolution departments of banks are advised to conduct periodic assessments and communication, as well as analyses and judgement of distressed assets under valuation and disposal approaches. This will serve to minimise cases in which banks play a passive role when assets have become non-performing and will allow them to recover loans under the principle of maximisation.

During its executive meeting on 19 June 2013, the State Council proposed the establishment of private banks, financial leasing companies and consumer finance companies that are established by private funds and are risk-bearing, which was in line with its economic policies on structural adjustment and transition with support from the financial industry. In July 2013, the Office of the State Council announced the *Guidance on Structural Adjustment and Transition of the Economy with Support from the Financial Industry* to propose the establishment of financial institutions that are operated by private funds and are risk-bearing, such as private banks. In November 2013, the third plenary session of the 18th Central Committee of the Chinese Communist Party proposed to allow the legal establishment of financial institutions, such as small to medium banks, with qualified private funds.

Regulatory trends of Chinese private banks:

Decisive market role

- Instead of working for the shareholder of initiator, private banks should: a) establish a formal, comprehensive organisational structure; b) design a practical business process and self-regulatory mechanism; c) introduce scientific and prudent risk management strategies and procedures; d) enhance internal audit and due diligence procedures; e) conduct independent and genuine financial business.

Specialised and differentiated business

- Private banks should focus on offering small and micro businesses, local communities and internet financing since the Chinese government will restrict the business types and regions of private banks. In order to better protect themselves, private banks should enhance their current financial systems and monitor borrowings from local citizens. This will also demonstrate their capabilities in terms of self management and business operations.

Self-bearing of risk and revenue

- The Chinese government will require private banks to prepare "living wills". The *Management Measures on Supervising Pilot Private Banks (Exposure Draft)* also requires a commitment to providing additional capital from the banks' shareholders, who are obliged to provide financial assistance and commit to liability for liquidity risk. Shareholders are liable for any remaining risk after their banks have used up their capital to bear liquidity risk. They are required to settle claims from depositors to prevent the legal entitlements of consumers, depositors and taxpayers from being exploited in case of the failure of the banking operation.

Supervision of shareholders' activities

- Any connected transactions between the regulated banks and their shareholders should be governed under current laws and regulations. This aims to prevent moral risk and to stop speculative activities involving private capital. The Chinese government will focus on the shareholders' capability in providing sustainable funding and risk tolerance. It will also prevent any significant connected loans between pilot banks and their shareholders to prevent those banks from becoming the financing tools of their shareholders, as were the cases in Taiwan.

Application of pilot private banks

During the press conference of the second session of the 12th National People's Congress held on 11 March 2014, CBRC's Chairman, Shang Fulin, announced that the first five private banks have commenced the pilot programs. Ten private enterprises, including Alibaba and Tencent, have participated in pilot operations across Tianjin, Shanghai, Zhejiang and Guangdong.

Although only five private banks have been included in the first batch of pilot programs, over 90 banks have been pre-approved by the State Administration for Industry and Commerce, reflecting the enthusiasm of the market for the establishment of private banks.

During the National Banking Supervisory and Regulatory Work Conference for the first half of 2014, held on 25 July 2014, CBRC's Chairman, Shang Fulin, announced that CBRC has recently approved the preparatory work for the establishment of three private banks. The three banks are: Webank in Qianhai District of Shenzhen, Guangdong Province, initiated by Tencent, Baiyeyuan Group and Li Ye Group; Wenzhou Civil and Commercial Bank in Wenzhou, Zhejiang Province, initiated by Chint Group and Huafeng Group; and Tianjin GoldCity Bank in Tianjin Municipality, initiated by Huabei Group and Maigou Group.

Business model

The choice of business model is critical for private banks with regards to seizing their target market, maintaining their competitiveness and differentiating themselves amid fierce competition. This is also the first strategic issue that a private enterprise should consider before tapping into the private banking industry.

The five current pilot banks will focus on providing specialised and differentiated services to small local communities. They can complement the multi-tier hierarchy of banking financial services.

The pilot banks have their own distinctive development strategies and market positioning, all aiming to provide efficient and differentiated financial services to support the real economy.

Backgrounds of five current pilot banks

Name of initiators	Region	Business model	Description	Principal business of initiators
Alibaba+ Wanxiang	Zhejiang	Small deposit and small loan business	Set out upper ceilings for deposits and loans from one single entity	Alibaba: e-commerce, online payment, B2B online trading platform and cloud computing Wanxiang: manufacture of auto components
Tencent+ Baiyeyuan+ Li Ye Group	Guangdong	Large deposit and small loan business	Set out lower ceiling for deposits (i.e. only take in a minimum amount of deposits) and upper ceiling for loans from one single entity	Tencent: IM software, networking game, portal and other value-added products Baiyeyuan: venture capital Li Ye Group: financial and real estate investment, including finance, manufacturing of power equipment, energy, mining, chemicals, biomedicine and real estate
JuneYao+Fosun Group	Shanghai	Deposit and loan business in designated regions	Limited scope of business and regions	JuneYao: aviation transport and marketing Fosun Group: investment holding
Chint Group+Huafeng Group	Wenzhou, Zhejiang	Deposit and loan business in designated regions	Limited scope of business and regions	Chint Group: low-voltage electrical appliances Huafeng Group: manufacture of polyurethane, real estate, logistics and finance business
Huabei Group +Maigou Group	Tianjin	Deposit and loan business from corporate customers	Only serve corporate customers, not individual customers	Huabei Group: investment in copper production, real estate and industrial park project Maigou Group: commercial logistics, commercial retail and financial investment

Opportunities and challenges of private banks

	Opportunities	Challenges
Business opportunities, regulatory trends and industry competition	**Innovative business model brings opportunities** As expected by regulators, the specialised and differentiated service provided by private banks brings them new business opportunities, including the acquisition of target customers through an internet platform and the innovation of services. Owing to required reserve ratio and loan to deposit ratio requirements, traditional commercial banks prefer investing their money in large enterprises, government financing platforms and real estate during the liberalisation of interest rates. Private banks will strive to meet the loan demand from middle-, small- and micro-enterprises to complement the business area untouched by commercial banks.	**Regulatory trends and competition in the banking industry** The launch of an innovative business model is always accompanied by the issues of how to identify and manage the underlying risks and how the regulators will response. The successful operation of specialised business by private banks, such as acquiring cross-regional customers through an internet platform, is highly related to the level of business innovation and the regulatory response. The previous high growth model of the banking industry is no longer sustainable. In the coming years, more financial resources will flow, in various forms, to small enterprises that have previously been neglected. Traditional commercial banks have noticed this changing trend and leveraged their advantages in capital, technology and staffing to transform their business to the transition of network nodes and the establishment of P2P platforms. This creates an entry barrier for new market entrants.
Strategic opportunities and challenges of risk management	**Reduce the difficulty and high cost of obtaining financing encountered by middle-, small- and micro-enterprises** The establishment of private banks is designed to reduce the difficulty and high cost of obtaining financing encountered by middle-, small- and micro-enterprises. Despite the variance in their operational models, the first batch of private banks approved for operation are all aimed at reviving the sluggish real economy.	**Credit risk management of middle-, small- and micro-markets** Private banks will face the same dilemma as traditional commercial banks during the development of middle-, small- and micro-markets. In addition to the lower credibility of financial statements provided by middle-, small- and micro-enterprises, private banks also encounter other new challenges in risk management — in particular, the new credit risk arising from the combined effect of traditional credit risk and network platforms.
Strength of shareholders and regulatory challenges from connected transactions	**Obtain technological and staffing advantages and easy entry to target markets by utilising the strength of shareholders** When choosing other initial investors, the lead investor of private banks will consider various factors, including: whether a shareholder has an investment or management background in financial industry; whether it can provide technical and staffing support to private banks; and whether the industry has a significant number of middle-, small- and micro-enterprises that have capital demands. This could allow private banks to secure more customers through cross-sales.	**Shareholder relationships and connected transactions** Finding a way to handle shareholder relationships and connected transactions will be another challenge posed to private banks. Shareholders should acknowledge their rights and obligations during the preparation and operation of private banks, i.e. they have to absorb risk and should not regard private banks as their own financing tools for making profits.

Challenges encountered during the course of preparation

Apart from the challenges arising during the operation and development of private banks, completing preparations within six months after CBRC's approval is another challenging issue. Current challenges encountered include:

- **Establishment and segregation of duties of the preparation team**

  The critical factors for the successful completion of high quality preparations on schedule will lie in the composition and segregation of duties of preparation team and the clarification of engagement and detailed planning at each stage.

- **Establishment of internal control and risk management systems and operational procedures**

  Private banks should set up a sophisticated internal control system and related procedures for all of its intended businesses to meet the requirements of risk management and actual business operations. They are required to build an internal control system with corresponding operational procedures that can fulfill both the requirements of laws and regulations and best banking practice within a limited timeframe.

- **Establishment of information technology system**

  The banking industry imposes comparatively high demands with regards to the security and stability of information systems. Private banks are required to build an information system and infrastructure, a team of IT professionals and the management process for daily IT operations within a short period of time.

- **Staffing**

  The establishment of a private bank requires a team of professionals with extensive banking experience to ensure seamless operations in the future. Although private enterprises that are planning the establishment of private banks already invest in banking and other non-banking financial institutions to a varying extent, such as shareholding of commercial banks in city and rural areas, and that of securities fund companies, and the establishment of guarantee, small loan and financial leasing companies and private equity investment funds, it is also critical for private banks to recruit and prepare a team of banking professionals with hands-on experience to ensure successful business operations.

Private banks will become a major component in China's financial system. They will serve the financing demand of middle-, small- and micro-enterprises to complement comprehensive services for the entire financial sector.

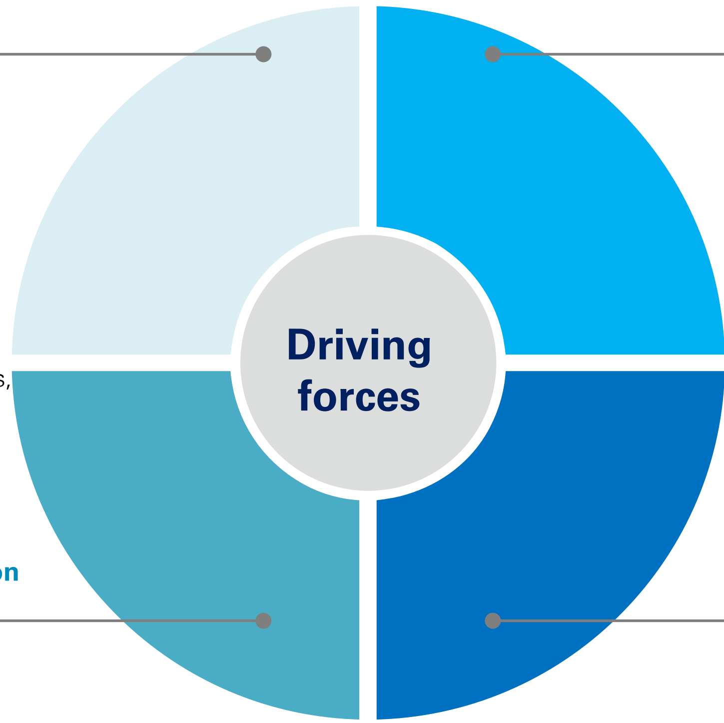
During the period of the 12th Five-Year Plan, strategic adjustments to economic structure and substantive changes in economic development have become the mainstream of macroeconomic development. Economic structural adjustment, financial disintermediation, interest rate liberalisation and macro prudential regulation are significant factors that are directly driving the transformation of the banks.

Financial disintermediation provides external driving force to deepen transformation

- The increase in the range of investment products and channels is providing more options for idle social funds — wealth management products, security funds, bonds, stocks, precious metal and private equity funds have become feasible alternatives to bank deposits, which will greatly affect the deposit-taking efforts of the banks.
- With the development of the capital market, eligible enterprises can raise funds either by issuing debt instruments, including short-term financing bills, medium term notes, and super and short-term notes, or by issuing shares in the main board market, the SME board or GEM. They can even do so by issuing wealth management products through trust companies, which, to some extent, will weaken the financial intermediation of the banks.

Intrinsic pressure of deepening transformation brought by interest rate liberalisation

- With the realisation of interest rate liberalisation, the deposit interest rate will see an obvious rise in line with the increase in the banks' cost of capital. At the same time, the loan interest rate will not necessarily experience the same increase because of factors like market competition. Thus net interest margin will decrease, resulting in a downturn in business performance, and the existing profit model oriented towards net interest margin will be affected.
- Banks with sufficient capital and a large market share will inflict a heavy impact on the market interest rate through their deposit and loan interest rate, which will undermine the independent pricing ability of small and medium banks. As a result, small and medium banks will feel a bigger impact during the initial stages of interest rate liberalisation.



Economic structural adjustments lay foundation for deeper market transformation

- Economic structural adjustments lay the foundation for banks to deepen market transformation, while also providing important opportunities for the development of various businesses. Primarily, retail business has strong potential for major development resulting from the expansion of domestic demand — savings deposits, consumer credit and personal finance, in particular, are likely to provide banks with immense opportunities. Industrial restructuring will also furnish a variety of market opportunities for corporate business.

Macro prudential regulation further drives the transformation of banks

- Continual enhancements to capital regulation will further limit the development of traditional credit.
- Some of the direct financing businesses driven by the banking system will experience changes.
- In the short and medium term, the regulatory environment will not be easy for investment banking.
- In sectors such as asset management, trusts and private placements, banks must integrate business platforms and resources, and carry out operational innovation, before obtaining new business opportunities and development.

Changes in external environment impose higher demands on regional banks

Under the new situation, vested business development and operational management models will face growing challenges. To achieve sustainable development, commercial banks may focus on aspects such as **business model, business structure, customer service, risk control and value creation**, in order to be well-prepared for the emerging challenges.

Transformation of operation and management model

- On the policy level, the process of interest rate liberalisation will be further promoted; more intense horizontal competition will be felt; and the growth of banks' net interest income will be further narrowed down
- The banks' expansion will be further constrained by stronger regulation of the capital adequacy ratio. Currently, the banking industry is confronted with huge capital pressure. Under the circumstances of limited financing capacity in the capital market, banks will be highly constrained by capital during their future efforts at expansion.

→

- Organic and intensive growth
- Introduce more refined management means and techniques, optimal organisation management structure, advanced corporate governance structure, etc.

Adjustment of business structure and scale

- Traditional profit models will lead to imbalanced business and income structures in the banking industry:
  - Income from lending projects occupies a high proportion; due to low costs and controllable risks, big enterprises will become the key arena for the banks
  - Income from interest margin accounts for an absolute proportion of the banks' income

→

- Enhance and focus on the financing of SMEs, vigorously develop retail banking business, and improve individual proportion
- Focus on business comprehensive income, promote the development of intermediate business, and gradually improve the proportion of non-interest income
- Expand financial market, investment banking, asset management and other financial services beyond the traditional businesses

Enhancement of customer service

- With the convergence of existing customer services, customers will require banks to provide more comprehensive, convenient and efficient financial services, rather than adhere to traditional business. They also will pay more attention to the varying levels of value brought by different banks.

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- Recognise that products and channels are concrete carriers and approaches for banks to meet their customers' demands. The continual improvement of products and channels can satisfy and constantly bolster customers' demands in a more effective manner.

Balance among risks, profits and capital

- As commercial banks share the profit-seeking nature of general enterprises, they are characterised by inherent risk fragility. Thus, any operational activity that produces profits will incur the risk that uncertainties inherent in the internal and external environment and banking operations may jeopardize the sustainable development of commercial banks.

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- Strike a balance among income, risk and capital to locate the best bonding point.

Value creation challenges

- Improving value creation in business operations, as well as satisfying customers, shareholders and society at large through value returns, still represents an important challenge.

→

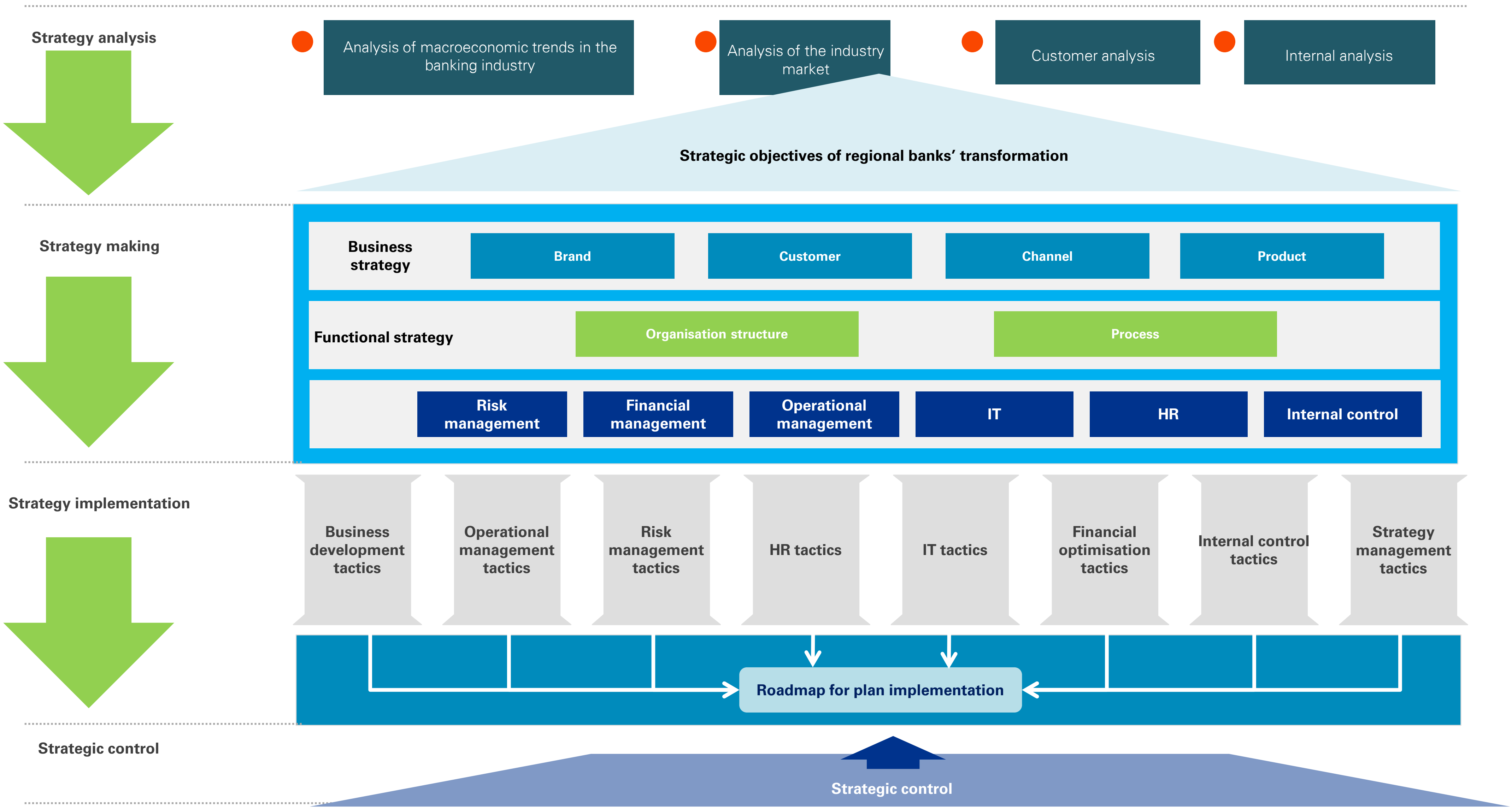
- Achieve a successful balance with regards to:
  - short-term and long-term benefits
  - benefits to banks and social benefits
  - shareholders, customers and employees
  - management system and corporate culture

Banks should establish long-term survival and the development of “value management” as their ultimate goal and abandon the inherent idea of ov eremphasized scale increasing. They should set up and continuously improve development strategies, market targets, management frameworks, assessment systems and corporate culture from the perspective of steadily enhancing capital return, so as to facilitate sustainable growth of the banks’ value.

To avoid intense convergence, the banks can base on their business strengths and strategic positioning to upgrade previously marginalised businesses with broad prospects to mainstream services, so as to establish their own specialties and advantages to differentiate themselves from others.

- **Adjust light capital in business structure**
- **Strengthen replenishment of organic capital**
- **Optimise equity structure**
- **Replace scale drivers with technological ones**
- **Vigorously develop intermediate businesses**

Business transformation is systemised and highly interconnected. Banks should first put solid plans in place for deploying and carrying out their bank-wide transformation strategies from a whole to parts.



On 26 June 2014 (early hours of 27 June 2014, Beijing time), China reached an "agreement in substance" with the United States for a Model 1 intergovernmental agreement (IGA) under the U.S. Foreign Account Tax Compliance Act (FATCA), according to the updates from the U.S. Treasury Department's official website. **For the financial institutions in China, FATCA touched on Chinese ground**.

After the official signing and operation of the IGA between China and the U.S., the related regulatory bodies in China are expected to further introduce relevant supporting rules and guidance to standardise and specify the compliance of financial institutions within China that are affected by FATCA. **At that time, FATCA will become a necessary local compliance for China's financial institutions to follow.** Under the Model 1 IGA framework, financial institutions within China (defined as Foreign Financial Institutions (FFIs) in FATCA) will only need to report the required information for U.S. accounts to China's competent regulators and not directly to the U.S. Internal Revenue Service (IRS). The regulators will be responsible for exchanging information with the IRS.

Although China has not yet signed up to the IGA, the overall framework for China's implementation of FATCA, as well as the timeline, is now clear. Financial institutions within China have begun to **prepare for FATCA compliance, which mainly includes**:

- Estimating whether the institutions and entities within the group are affected by FATCA in order to establish a compliance plan, and making preparations to register on the IRS website in order to obtain a Global Intermediary Identification Number (GIIN);
- Establishing a FATCA compliance policy with service conditions, and clarifying the existing customer account opening and identification process
- Revising the existing customer forms (e.g. account opening application, terms and conditions), and obtaining relevant additional information and authorisation from customers to conform with the requirements of FATCA
- Establishing an initiative for recognising and classifying existing customers
- Upgrading information systems based on the revised business process and FATCA compliance; and
- Conducting business training and providing business guidance to customer service staff

Glossary

What is FATCA?

Foreign Account Tax Compliance Act (FATCA), signed into law by President Obama in January 2013, is designed to enhance the transparency of foreign financial accounts held by U.S. persons. FATCA requires foreign financial institutions to report information related to the ownership of financial accounts by U.S. persons. FATCA also requires non-compliant foreign financial institutions to levy a 30% withholding tax on specific income from the U.S.

In addition, Chinese financial institutions that have looked abroad and established branches in other countries and regions should pay particular attention to the implementation of FATCA in each country. Different countries carry out FATCA according to the requirements in each jurisdictions — Hong Kong SAR, for example, as an independent jurisdiction, will sign up to the Model 2 IGA with the U.S., which means financial institutions in Hong Kong will be subject to different FATCA requirements as compared to the ones applicable in Mainland China. Under the Model 2 IGA, the government of the jurisdiction will amend the existing laws and regulations, so that the FFIs can report associated information directly to the IRS in accordance with FATCA and fulfill other FATCA compliance obligations.

From a broader perspective, the Organisation for Economic Co-operation and Development (OECD) recently released a new global standard for automatic exchange of financial account information between governments. After its release, on 6 May 2014, 34 OECD member countries, as well as another 13 countries, including China, issued a joint declaration that they will implement the new standard. Though OECD did not specify a timeline for implementation, the new global standard will further increase the compliance cost for the financial institutions. In this context, China's financial institutions should consider the impact of the new standard, as well as how to establish a connection between the new standard and FATCA compliance, and should ensure that they are well prepared for various aspects, such as talents and IT, when planning and carrying out FATCA compliance.

FATCA went into effect on 17 January 2013 and was updated successively in 2014. China's financial institutions are expected to implement the related requirements from 1 January 2015.

FATCA requires financial institutions to follow new compliance and reporting requirements, including identification and reporting of specific foreign financial accounts held by specific U.S. persons.

FATCA ensures its implementation by withholding taxes from U.S. specific income on payments to non-compliant foreign financial institutions and persons who do not cooperate.

- According to the definition of the *China Financial Stability Report 2014* issued by the central bank, small online loans refer to the granting of non-P2P small credit loans to customers on the e-commerce platform by Internet companies through their small lending companies.
- The information on platform users that e-commerce companies have amassed over the years provides a solid basis for the development of small lending business. Small online loan providers use the transaction and cash flow data accumulated on the e-commerce platform and the online payment platform to assess borrowers' credit status and grant convenient short-term small loans through online approval. Ali Finance's small loan division is a typical example.
- The small loan business of Alibaba ("Ali Microcredit" (阿里小贷)) is a separate business unit of Alibaba. Alibaba Finance ("Ali Finance") provides purely credit loans to Alibaba members, featuring online operation, speedy approval and absence of collateral and guarantee.
- In addition, Sunning Appliance has set up a small loan company with its overseas subsidiary, taking advantage of its sound logistics, warehousing and data processing ability. The applications of Baidu and Jingdong for setting up small lending companies are initially approved by the regulators.

Development of Ali Microcredit

2002

Launch of the "Cheng Xin Tong" business, which targeted the domestic trade of its members, and engagement of a third party to assess the registered members and accumulate information on shops

2007

Launch of loan products, e.g. "E-channel" and "Yi Rong Tong", with CCB and ICBC to serve small and medium e-commerce companies

2010 and 2011

Establishment of Zhejiang Alibaba Microfinance Limited and Chongqing Alibaba Microfinance Limited to provide loans to e-commerce companies on Taobao and Alibaba

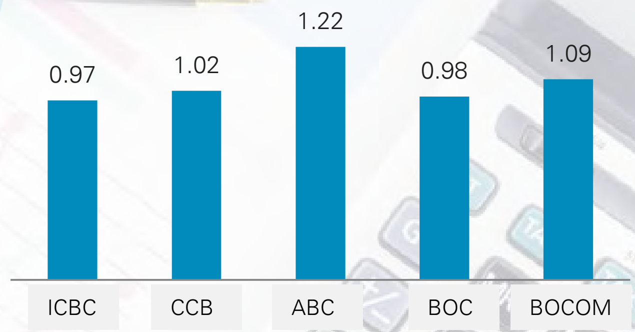
2013

Participation in securitisation projects to expand funding sources and financing size

Ali Microcredit model

- Ali Microcredit mainly provides purchase order loans and credit loans to shops on the Alibaba, Taobao and Tianmao platforms.
- The lending interest rate of Ali Microcredit is accrued on a day to day basis. A purchase order loan for shops on Taobao and Tianmao platforms is capped at RMB 1 million for as long as 60 days bearing a daily interest rate of 0.05%. A credit loan for shops on the Taobao and Tianmao platforms is capped at RMB 1 million for a loan period of 3 months, 6 months or 12 months, and the daily interest rate ranges from 0.05% to 0.06%. Ali credit loans are capped at RMB 20,000 to RMB 1 million for a loan period of 12 months and the lowest daily interest rate is 0.05%. The lowest daily interest rate of 0.05% would translate into an annual interest rate of approximately 18% for Alibaba customers. In addition, The "Zui Hua Suan" specific loan program also provides specific credit loans to qualified shops which win bids on "Zui Hua Suan".
- As at the end of 2013, a total of 642,000 customers were granted loans, and the new loans in 2013 amounted to RMB 100 billion. As at March 2014, Ali Microcredit had provided loans totaling more than RMB 190 billion to over 700,000 micro and small-sized enterprises (MSEs). The non-performance ratio is below 1%.

Non-performing loan ratios of big five state-owned banks in the first quarter of 2014



Sources: First quarter 2014 reports of the banks; KPMG studies

Big data analysis and loan risk controls of various Ali platforms at different stages

Pre-grant review

Credit application	Credit review	Onsite investigation	Approval
• Qualified companies and individuals fill in the application forms online	• The data regarding the applicant's behaviour on online platforms and its credit data, as well as any external data, are entered into the assessment model and processed using the big data processing technology to accurately assess and analyse its operating status, creditability and repayment ability. This is used to approve the loan application and determine the credit limit, interest rate and loan period	• Ali Finance authorises and commissions a third-party professional institution to conduct onsite investigation at the applicant's business premises to communicate with it face to face in order to understand its operating status	• Ali Finance uses the information on its platform database to analyse the applicant's operations and approve loan applications after considering onsite investigation results

Post-disbursement management

Conclusion of contract	Loan withdrawal and repayment	Collection of overdue loans and renewal management
• A contract should be signed within 15 days after approval. If the contract is not signed within the valid period, the applicant can only re-apply after 3 months • A loan contract usually includes the issuance of a bank card for the legal entity as a precondition	• The loan is disbursed to the designated bank card • The borrower's fund flow, information flow and logistics are monitored through the big data of various platforms to provide warnings of any potential risk • The lender sends payment reminders to the borrower via SMS and email five days in advance of, as well as the day before, each monthly repayment date	• Monitor the borrower's post-loan operations, emphasise credit review, and impose restrictions on a defaulting customer or close its online shop and inform online customers about the potential risk of conducting business with the shop

Advantages vs. risks

Advantages and features

- Small online loans are granted based on the borrower's credit status and no collateral or guarantee is required. This new type of lending is more convenient than the traditional one. Against the backdrop of "big data", funds can be arranged, borrowed and repaid quickly, thus greatly enhancing the efficiency of the lending business.
- The approval of bank loans requires the provision of lots of information, including financial information and asset statements for analysis. Such requirements may not meet the needs or suit the characteristics of MSEs. In addition, banks require a lot of manpower and resources to complete the review process, resulting in higher costs. Small online loans are reviewed using the big data, which means lower costs compared with the traditional reviewing method used by banks. Such review process are therefore more appropriate for MSEs.
- Traditionally, lenders are exposed to the risk of default of the borrower, depreciation of collaterals and the burden of post-loan monitoring. As for small online loans, the online activities, trading volume, online credit rating and financial healthiness of the operations of the borrower are assessed to better gauge its funding needs and repayment time. Compared with traditional bank loans, small online loans can further mitigate credit risk.

Limitations and risks

- The advantage of big data in Internet finance is restricted to platform customers. For customers not using the platform, it is difficult to solve the problem of asymmetric information in Internet finance. Therefore, it is difficult to extend small online loans to areas beyond the e-commerce platform.
- Various aspects of the borrower's repayment ability should be considered in assessing its creditability. In general, the data used in approving small online loans are limited to online behaviour records and credit data of the corresponding platforms, which are not as comprehensive as those used by traditional banks in reviewing loan applications. Potential credit risk is neglected to some extent due to the lack of a comprehensive picture of the borrower's offline behaviour.
- In small online loans, the lender uses big data processing to review the borrower. However, as the indicators used are relatively fixed, the prospective borrowers may grasp the rules, thus weakening the risk monitoring ability of data analyses.

Insight and reflection for traditional banking

- The traditional banking sector needs to pinpoint the demand of customers. The advantage of small online loans is that lenders and borrowers are linked directly on the Internet or using mobile communication technology. Amid the changing operating models of commercial banks in China, the eventual goal is finding a way to provide the most convenient and highest quality services according to customer type and respond rapidly to meet customers' changing needs.
- The traditional banking sector needs to free itself from the shackles of traditional concepts and seek to cooperate with third-party ratings agencies or software development companies. This will allow it to improve its credit approval procedures and business processes and fully integrate with new technologies, such as the Internet, thus cultivating a new ecological network to enhance efficiency and meet new development needs.
- The traditional banking sector needs to enhance its ability to analyse credit information. Its credit management depends largely on the operating condition or repayment records available. Given the weak credit awareness in society, the traditional banking sector conducts relatively little analysis on non-structural data (e.g. integrity) due to the banks' lack of analytical capability and professional knowledge in this respect. Therefore, the traditional banking sector needs to cultivate core competence in the big data era, especially the ability to integrate and analyse customers' social information.

Development, regulation and business scale of commercial factoring

Development

The factoring business originated from the wool spinning industry in England in the 14th century. In the second half of the 19th century, booming international trade greatly boosted the economic development and import demand of America's east coast and gave rise to the modern factoring industry. Nowadays, almost each industry benefits from the factoring business. At present, the European market has the largest factoring business volume in the world, occupying a global market share of 59% in 2012, while the factoring business in Asia has enjoyed rapid growth, achieving a global market share of 28% in 2012 to establish itself as the world's second largest factoring market, of which China's factoring business occupies 16% market share.

Prior to 2012, the development of the commercial factoring business in China was hindered by such limitations as the credit environment and credit risk management, as well as market models and regulations. However, from 2012 on, due to increasing market demand and the implementation of relevant laws and regulations, China's commercial factoring market has experienced vigorous growth.

Regulation

The Ministry of Commerce issued *Circular on Works Related to the Trial of Commercial Factoring Business* [Shangzihan (2012) No. 419] in June 2012. In November and December of the same year, Shanghai and Tianjin issued their own administrative measures for the trial of commercial factoring business, which was followed by the official launch of the trial in Pudong district and Binhai district. In order to enhance the management of the commercial factoring industry, the Ministry of Commerce issued *Circular on Improving Administrative Works for the Commercial Factoring Industry* [ShangBanZhiHan(2013)No. 718] in 2013, which lay down the foundations for the healthy development of the commercial factoring industry under the supervision and regulation of the government authority. With the expansion of the trial, Guangzhou, Shenzhen, Chongqing and Su'nan were successively added to the list of participants. In order to facilitate the business development of the Shanghai Pilot Free Trade Zone, the Shanghai Pilot Free Trade Zone Administration released *Provisional Administrative Measures for Commercial Factoring Business in China (Shanghai) Pilot Free Trade Zone* [Zhong(Hu)ZhiMaoGuan(2014)No.26] in February 2014, thereby enforcing more effective regulation of the establishment and management of factoring companies in the Pilot Free Trade Zone.

Business scale

Statistics showed that up to December 31, 2013, the number of registered commercial factoring companies nationwide was 284, including 56 in Shanghai, 96 in Tianjin and 107 in Shenzhen. The registered capital of the commercial factoring companies amounted to over RMB 29 billion, with 130 companies holding capital of RMB 50-100 million and seventy companies holding less than RMB 50 million. The commercial factoring industry employed nearly 10,000 people by the end of 2013.

Currently, the international and domestic factoring business volume in China is about RMB 2.83 trillion, among which the domestic factoring business volume amounts to RMB 2.24 trillion, occupying 79% of the total volume.

Comparison and impact on traditional banking

Comparison and advantages

The factoring business, which is based on the premise of the creditor transferring its accounts receivable, offers comprehensive service packages that combine corporate credit management, account receivable collection and management, and bad debt guarantee and financing, thereby improving the efficiency of the capital turnover and reducing operation costs. Bank factoring, on the other hand, focuses on the financing function, with the bank examining the applicant's credit status and requiring a sufficient pledge to back up the deal. In addition, the factoring deal will take up a portion of the applicant's credit line in the bank. As a result, bank factoring is more suited to large enterprises with sufficient pledges and risk tolerance, while small and medium enterprises will have a hard time satisfying the banks' requirements.

Compared to bank factoring, which focuses on financing, commercial factoring specialises in providing comprehensive services, such as investigation, management, clearing and financing for a specific industry or business area, thereby delivering more tailor-made services to its clients. Furthermore, compared to bank factoring, commercial factoring emphasises the quality of account receivables, buyer credibility and the quality of the product instead of the credit position of the applicant, with the goal of delivering unsecured lending and achieving the shift of all bad debt risk.

In summary, commercial factoring has many advantages, such as lower threshold, simple processing procedures, lower commission charge rates, more flexible and customised solutions and, in most cases, no requirement for pledges. Commercial factoring is therefore more favorable to small and medium enterprises.

Impact on traditional banking

Up till now, bank factoring business volume still occupies a dominant share of the total factoring market. Although domestic commercial factoring companies boomed from 2012, and have secured a place in the financial market, they are still far from posing threats to the significant position of traditional banking in the short term. However, considering that commercial factoring companies meet the demands of customers of various types and scale, we may conclude that the banks are yet to adjust their product structures quickly enough to accommodate the financing needs of different customers.

In the meantime, some large financial institutions have begun to set up their own factoring subsidiaries. These factoring subsidiaries can access their parent companies' vast customer resources and credit records and deliver targeted factoring services to different types of customers, representing an inherent advantage over factoring companies founded by non-financial institutions.

In the short term, while bank financing brings higher costs, commercial factoring companies effectively satisfy the need of small and medium enterprises for account receivable collection and quick financing. As a result, commercial factoring does not necessarily compete with traditional banking directly, but successfully fills the gap in the financial market. In the long run, however, with the implementation of relevant laws and regulations and the development and refinement of the financial market, commercial factoring companies will gradually be able to win over a portion of the banks' market share. Therefore, in the long run, the banks need to be alert and innovative in order to keep its current market shares.

Risks, bottleneck and response

Risks and bottleneck of commercial factoring

Commercial factoring and traditional banking share a similar risk profile. The existing risks facing commercial factoring companies can be categorised as follows:

- Credit risk: The primary repayment source for the commercial factoring business is the buyer's timely payment as per the payment terms set out in the contract. In the case of significant operational loss, bankruptcy or discontinuation of business, the buyer may fail to settle the payment as agreed;
- False transaction background: The processing procedures of commercial factoring are relatively simple. The borrower may use forged or altered invoices or false contracts, etc., to obtain credit from a commercial factoring company. If the commercial factoring company does not exercise the prudence needed to uncover potential fraud, the granted payment will be lost;
- Absence of payment monitoring: If a commercial factoring company does not closely monitor the use of an advance payment made to a customer, the customer may put it into the capital market, instead of using it for production and operational activities, such as materials purchases, etc.;
- Risk of repeated pledge of creditor's right: According to the *Measures for the Registration of Pledge Receivables* issued by People's Bank of China, when multiple pledge rights are set up with the same account receivable, the pledgee will gain and exercise the pledge rights according to the order in which they were registered. The Property Law also specifies that the pledged receivables are not transferable without the consent of the pledgee and should remain void even when they have been registered as a pledge again. As a result, the account receivables may be pledged repeatedly and thus cannot be recovered;
- Operational risk under relevant laws and regulations: According to *Provisional Administrative Measures for Commercial Factoring Business in China (Shanghai) Pilot Free Trade Zone*, commercial factoring companies can obtain financing through legal channels, such as borrowing from banks or non-bank financial institutions and shareholders, as well as issuance of bonds and refactoring. In order to mitigate risk and ensure operational security, commercial factoring companies should develop an effective credit risk management platform and maintain risk assets within 10 times the sum of net assets. That is to say, the operational and asset scale of the commercial factoring companies should meet the requirements of relevant laws and regulations;
- The potential bottleneck: Because the risk assets of commercial factoring companies should not exceed 10 times the sum of their net assets, their business volume relies heavily on their net assets. At present, most commercial factoring companies are backed by parent companies with great financial strength and their capital resource is paid-in capital. However, with the expansion of business scale and market demand, and sustained capital injection, the credit lines granted by the banks and the issuance of corporate bonds will become the key factors for their sustainable development.

Risks, bottleneck and response (Continued)

Response

In order to cope effectively with the above-mentioned risks, the following measures are recommended:

- Select customers prudently: Commercial factoring companies should choose customers with stronger performance capabilities and better credit rating through rigorous examination of the transaction record of the contracting parties. Commercial factoring companies must conduct rigorous credit investigations to evaluate the credit rating of customers and decide whether or not the customers are eligible for the factoring service;
- Reinforce examination before granting payment: Commercial factoring companies should reinforce examination of relevant transaction backgrounds and the authenticity of contracts. The examination should focus on the terms of the commodity trading contract, such as descriptions of commodities, contract value, terms of payment, payment date and delivery date, etc. Commercial factoring companies should also examine the authenticity of invoices to see if their contents are consistent with the commodity trading contracts and shipping documents and if the issuance dates are correct in order to prevent fraudulent conduct, such as cancellation of invoices or conspiracy by the contracting parties to return the goods after issuing invoices;
- Registration of pledge/transfer of creditor's rights: According to *Provisional Administrative Measures for Commercial Factoring Business in China (Shanghai) Pilot Free Trade Zone*, commercial factoring companies should register in the pledge receivables registration and notice system of People's Bank of China credit registry centre. Furthermore, they should register every transferred receivable during the factoring operation and receive a initial registration voucher in return. If the receivable is to be altered or cancelled, the commercial factoring company should register the alteration/cancellation in the system accordingly and obtain the registration voucher in return. Therefore, relevant laws have required that the transfer of receivables shall be subject to registration or alteration procedures. Enforcing such laws can effectively prevent repeated pledging/transferring of receivables to help ensure the collection of the granted payment;
- Collection of receivables: The collection of receivables is an essential part of the commercial factoring business, thus commercial factoring companies should appropriately manage their collection approaches towards debtors. The collection of receivables is of course the final reflection of all previous prudent measures and the recovery of payment from payers with better credit standing is likely to be easier. However, the factoring companies will inevitably need to deal with non-performing receivables when integration and packaging of non-performing receivables for sale, or even legal action, as well as other possible steps, are deemed to be necessary;
- Business expansion: The risk assets of a commercial factoring company should not exceed 10 times the sum of its net assets, so commercial factoring companies need to establish good standing in order to facilitate financing from financial institutions such as banks. In addition, sustained capital injection from parent companies and allocating retained earnings to paid-in capital are common methods used by commercial factoring companies to expand their business.

Brief on column profile

In the "Academic insights" column, we invite finance academics to provide expert views and analyses of, and comments on, the current hot topics and latest developments in the banking sector.

Motives, mechanisms and risks of capital flows in Free Trade Zones (FTZs)

By Zhou Guangyou and Luo Sumei

Financial liberalisation is a main feature of China (Shanghai) Pilot Free Trade Zone. The *Opinions of the People's Bank of China on Providing Financial Support for the Development of China (Shanghai) Pilot Free Trade Zone*, issued in December 2013, spells out the four key elements of financial liberalisation — namely, cross-border Renminbi (RMB) application, RMB convertibility under the capital account, interest rate liberalisation and the administration of foreign exchange. In implementing financial liberalisation, the FTZs will witness large capital inflows and outflows and abnormal capital flows amid relaxed capital controls. If effective preventive measures are not put in place to deal with this situation, financial risk will arise with material implications for China's financial market and real economy. In this regard, there is a pressing and imperative need to analyse the motives, mechanisms and risks of capital flows in the FTZs amid financial liberalisation and to take forward-looking preventive measures accordingly.

I. Motives of capital flows in the FTZs

As the FTZs take on a pioneering role in China's new round of reform and opening up initiatives, and in financial liberalisation in particular, they will become capital hubs and also "buffer zones" or "transit points" for capital flows at home and abroad. Capital flows in the FTZs are not fully identical with those in a country or a region (e.g. Hong Kong or Singapore) undergoing territory-wide financial liberalisation.

Generally speaking, capital flows are two-directional, and there are motives for inflows and outflows. In terms of global capital inflows, there are four key motives: First is the motive to practise arbitrage by taking advantage of anticipated RMB appreciation. As China has long implemented a managed floating exchange rate system, the RMB exchange rate is considered to be significantly undervalued, prompting large capital inflows through various channels from outside China amid persistent market expectation of RMB revaluation. Second is the motive to practise arbitrage by taking advantage of high domestic interest rates. Likewise, China has unduly widening deposit and loan spreads, with interest rates apparently higher than those of foreign market economies. This trend of rate disparity has become even more distinct in the wake of the 2008 global financial crisis, which will inevitably attract more global capital inflows for arbitrage purposes. This results in a double motive for practising arbitrage. Third is the motive to generate investment income by taking advantage of China's rapidly growing economy. Since the reform and opening up, the Chinese economy has seen accelerated expansion with higher investment returns. This has in turn lured large flows of foreign direct investment (FDI) into the country to benefit from domestic economic growth. Fourth is the motive to avoid risks by taking advantage of China's steady economy. Against the backdrop of a decades-long process of reform and opening up, China has become well-known for its economic stability. During the onset of several global financial crises, China was subject to limited impacts without going through any economic crises itself. This was particularly the case when enormous amounts of global capital flowed into China through a variety of channels in the wake of the US's subprime mortgage crisis.

In light of higher domestic interest rates and market expectation of RMB appreciation, China has seen markedly more capital inflows than outflows, while the motives for Chinese capital outflows are totally different to those for global capital inflows. In terms of Chinese capital outflows, there are three key motives: First is the motive to generate FDI income. In line with increased national economic strength, some sizable, financially strong and globally competitive enterprises have emerged in China in an attempt to compete with their foreign market peers for income generation through FDI in other countries. Second is the motive to implement "Go Global Strategies". Over the past few years, China has adopted these strategies to help Chinese enterprises play a leading role in the international division of labour, enhance their global competitiveness, develop themselves into more capable multinational corporations, lessen RMB revaluation pressure, overcome trade barriers, reduce trade surpluses, improve economic and trade relationships with related countries, and study foreign advanced technology. These initiatives are also strategically important for promoting FDI, containing the balance of payments surplus and undue foreign exchange reserve growth, achieving an even balance of payments and, finally, upgrading the balance of payments structure. (See article by Li Dongyang and Zhou Xueren, 2007.) In implementing these strategies, there will inevitably be massive Chinese capital outflows. Third is the motive to attain national strategic interests. Prompted by its rapid foreign exchange reserve growth, China has diversified its foreign exchange allocation and begun investment at the national strategic level in recent years, with the objective of preserving and enlarging its foreign exchange reserves and maintaining its national interests.

Following financial liberalisation in the FTZs, the motives for capital flows in the FTZs are largely the same as those for global capital inflows into China. Capital flows in the FTZs are relatively free, compared with foreign capital flows. In terms of capital flow modes, global capital inflows into China are mainly in the form of FDI, Qualified Foreign Institutional Investor (QFII) funds and hot money, while global capital inflows into the FTZs also comprise large arbitrage capital. Furthermore, the motives for Chinese capital outflows now are consistent with those prior to financial liberalisation. However, the Chinese capital outflows will become significantly larger because of relaxed capital outflow controls, whereas foreign capital outflows are dependent on the need for long-term capital and profit reflux and the motive to practise arbitrage with the use of short-term capital.

II. Mechanisms of capital flows in the FTZs

For better illustration, we use Chart 1 on the right to discuss capital flow mechanisms in the FTZs under financial liberalisation.

As can be seen in Chart 1, domestic and foreign capital flows are within a triangular cycle upon the establishment of the FTZs. That is to say, the FTZs have become major capital hubs and also "buffer zones" for domestic and foreign capital inflows and outflows. They are also "capital pools" for adjusting domestic and foreign capital flows. They serve dual purposes as follows: First, domestically, they can change flow paths of some speculative, high risk capital by allowing risk capital (which was previously subject to stringent approvals or controls for respective channels before flowing into China) to "bypass" such channels and flow into the FTZs. After undergoing the "precipitation" or "filtering" process in the FTZs, the said risk capital re-flows into the Chinese territory, thus mitigating the risk of direct global capital inflows into China. In this respect, the FTZs may also be seen as "firewalls" to prevent financial risk arising from massive global capital inflows. Moreover, there are more options for Chinese capital outflows in the form of outbound direct investment (ODI). Chinese capital may directly flow out to foreign countries or re-flow out overseas after being "buffered" in the FTZs. The main difference between these two options lies in the fact that the latter option has less outflow restrictions and more accessible outflow channels than the former one. Second, globally, the FTZs provide more channels for global capital to flow into China. Global capital may therefore flow into China through conventional channels existing prior to the establishment of the FTZs and new channels of flowing into the FTZs before re-flowing into the Chinese territory. As global capital is subject to stricter controls when flowing through conventional channels, there will be large inflows of capital (and global idle capital and short-term arbitrage capital in particular) into the FTZs upon their establishment. Nonetheless, the FTZs have created new channels for freer domestic and foreign capital flows.

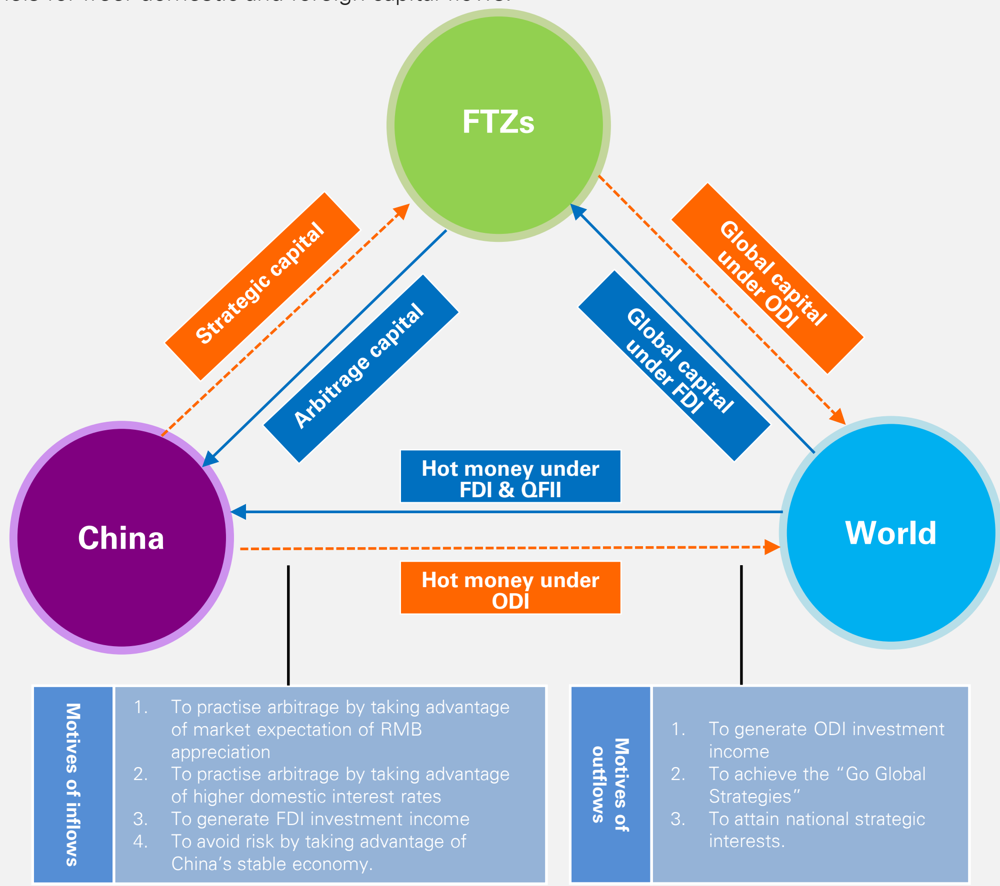


Chart 1 Capital flows in the FTZs under financial liberalisation

III. Risks of capital flows in the FTZs

While FTZs have a promising future under financial liberalisation, China cannot afford to ignore associated risks arising from capital inflows and outflows. The risks include not only risks existing prior to financial liberalisation, but also new ones arising from financial liberalisation in the FTZs. In view of this, the FTZs are exposed to more complicated capital flow risks amid financial liberalisation.

1. Risk from abnormal, short-term global capital flows

Short-term capital flows are mainly characterised by fast inflows and outflows for arbitrage purposes. Amid financial liberalisation, the FTZs enable free, short-term capital inflows and outflows. A large volume of capital inflows within a short period of time will affect the stability of China's financial market and exchange rates, and create financial asset bubbles in the domestic stock and property markets. This will also sharply increase Chinese foreign exchange reserves. The higher proportion of foreign exchange will passively boost money supply, which will, in turn, lead to the risk of inflation, thus undermining the independence of the central bank's monetary policy. Following massive capital inflows, short-term capital will flow from emerging countries back to developed countries, due to phased tapering of quantitative easing by western countries, volatile international financial markets, and investors' needs for risk aversion. Rapid capital flight in a short space of time will cause an abrupt halt or reversal of capital inflows, making it difficult to maintain the stability of RMB exchange rates. This will end with financial market turmoil amid a monetary crisis, and even a financial crisis similar to the one that occurred in Southeast Asia in 1997.

2. Risk from long-term global capital flows

As far as developing countries (including China) are concerned, risk from short-term capital inflows is obvious. In view of China's relatively weak financial regulatory capability and increasing financial liberalisation, long-term global capital inflows and associated risks cannot be ignored. Long-term global capital flows enter China mainly in the form of securities investment, international lending and direct investment. When excessive global loan capital inflows cause an abundance of domestic capital, commercial banks will always blindly expand loans without stringent financial regulation, thus increasing risks in the banking system. Any subsequent capital reflux or reversal will give rise to insufficient liquidity, jeopardising the stability of the financial system. Large global capital inflows into Chinese stock markets will exacerbate stock market volatility, create economic bubbles, and undermine financial market stability. When massive global capital flows into China in the form of FDI, the nature of long-term global capital will shift to short-term investment, leading to bubbles in the Chinese financial market. Immense FDI channelled into certain industries will contribute to over-capacity. In the case of slowing export growth and dwindling foreign exchange reserves, global capital will also seize opportunities to flow back, impacting on the host countries.

3. Special financial risk of the FTZs under financial liberalisation

Apart from the conventional risk of cross-border capital flows, financial risk specific to the FTZs under financial liberalisation will add a new, unique element to the risk matrix. The FTZ-specific risk will not only heighten conventional financial risk, but also make it more uncertain. In this regard, we have to pay greater attention to the FTZ-specific risk. For the time being, the risk in question is chiefly the capital flow risk under the dual interest rate and exchange rate systems inside and outside the FTZs. Under the dual interest rate system (an asymmetric system) inside and outside the FTZs, there will be interest spreads inside and outside the FTZs in China. At the inception of financial liberalisation of the FTZs in particular, there will be wider interest spreads, with the spread inside the FTZs narrower than that outside. Against this backdrop, enormous amounts of global arbitrage capital will flow into the FTZs by any means available, and subsequently into Chinese territory through the FTZs, for arbitrage purposes. Without strict regulatory and control measures, there will be a large and continuous influx of capital into China, simply to take advantage of tiny gaps for capital flows in the FTZs and China's domestic territory. On the one hand, large capital inflows into stock and property markets will generate asset bubbles and impact financial markets. On the other hand, they will increase domestic capital supply and change the demand and supply of capital. As a result, supply will exceed demand in respect of capital while interest spreads will narrow. The inevitable result will be that the central bank will fail to maintain, and be forced to abandon, official interest rates, which will entail interest rate liberalisation. Achieving interest rate liberalisation in this way will, however, affect China's financial system. Moreover, when the interest rates in the FTZs or outside China are higher than those in China's domestic territory due to the narrowing of the domestic interest spreads, capital will flow out of China, thus making interest rates highly volatile. Likewise, enormous amounts of global capital will flow into the FTZs and China's domestic territory for exchange rate arbitrage purposes amid the expectation of RMB appreciation. This will finally result in further RMB revaluation, while adversely affecting Chinese exports and causing unstable RMB exchange rates and uneven balance of payments. However, once the expectation of RMB appreciation diminishes, it will trigger rapid flight of large capital out of China, impacting China's financial market and undermining its financial security.

IV. Conclusion

In terms of direction, global capital flows comprise inflows and outflows, both of which will bring risks and gains to capital receiving/draining countries. To fully leverage the positive role of global capital and prevent capital flow risk, it is crucial to strike a balance between risks and gains. As part of China's financial reform, the financial liberalisation of the FTZs is a bold attempt. Despite a variety of risk exposures likely to arise from the said financial liberalisation, this does not mean that China should hesitate to press forward with the FTZ financial reform. On the contrary, China should make a courageous attempt to take full advantage of the pilot FTZ programme and achieve continuous improvements through trial and error. Efforts should also be made to strike a relative balance between financial liberalisation and risk management, in a bid to acquire experience in this area that will benefit the nation. Of course, China should also prevent undue financial risk by implementing financial liberalisation in a reasonable and orderly manner, with proper relationships between various projects under liberalisation. Abnormal capital flows should be subject to monitoring, advance warning and controls to prevent influx of arbitrage capital. China should fully leverage the capital buffer role of the FTZs for the purposes of early risk prevention and elimination. There should be a good balance between liberalisation and regulation with proper capital flow controls. And finally, supporting systems should be put in place to prevent financial arbitrage under the dual exchange rate and interest rate regimes inside and outside the FTZs.

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04

Appendix: 2014 Q2 financial data of listed banks

Net profit attributable to equity holders of the parent company

RMB million	2014 H1	2013 H1	Growth rate
ICBC	148,100	138,347	7%
CCB	130,662	119,711	9%
BOC	89,724	80,721	11%
ABC	104,032	92,352	13%
BCM	36,773	34,827	6%
CMB	30,459	26,271	16%
CNCB	22,034	20,391	8%
CMBC	25,570	22,945	11%
SPDB	22,656	19,386	17%
CIB	25,527	21,638	18%
CEB	15,845	14,917	6%
HXB	8,670	7,300	19%
PAB	10,072	7,531	34%
BOB	8,847	7,801	13%
BON	2,867	2,404	19%
NBCB	3,086	2,608	18%
Total	684,924	619,150	11%

Source: The banks' 2013, 2013 H1& 2014 H1 report, KPMG China research

Financial performance indicator

	Return on weighted average equity		Basic earnings per share (in RMB)		Net asset value per share (in RMB)	
	2014 H1	2013 H1	2014 H1	2013 H1	30/06/2014	31/12/2013
ICBC	21.77%	23.25%	0.42	0.40	3.86	3.63
CCB	22.97%	23.90%	0.52	0.48	4.55	4.26
BOC	18.57%	18.93%	0.32	0.29	3.46	3.31
ABC	23.04%	23.22%	0.32	0.28	2.79	2.60
BCM	16.79%	17.53%	0.50	0.47	5.93	5.65
CMB	21.49%	25.46%	1.21	1.22	11.34	10.53
CNCB	18.79%	19.75%	0.47	0.44	5.11	4.82
CMBC	24.22%	26.04%	0.75	0.67	6.53	5.81
SPDB	21.04%	20.90%	1.22	1.04	11.70	10.96
CIB	23.80%	24.12%	1.34	1.14	11.57	10.49
CEB	19.40%	24.59%	0.34	0.37	3.53	3.30
HXB	19.32%	18.62%	0.97	0.82	10.27	9.59
PAB	16.61%	16.40%	0.88	0.77	10.59	9.81
BOB	21.26%	20.82%	0.84	0.74	9.94	8.88
BON	20.08%	18.60%	0.97	0.81	9.83	8.96
NBCB	22.56%	22.30%	1.07	0.90	10.13	8.84

Source: The banks' 2013, 2013 H1& 2014 H1 report, KPMG China research

Net interest margin

	2014 H1	2013 H1
ICBC	2.62%	2.57%
CCB	2.80%	2.71%
BOC	2.27%	2.23%
ABC	2.93%	2.74%
BCM	2.39%	2.56%
CMB	2.57%	2.89%
CNCB	2.36%	2.58%
CMBC	2.62%	2.41%
SPDB	2.47%	2.35%
CIB	2.40%	2.49%
CEB	2.25%	2.23%
HXB	2.61%	2.70%
PAB	2.50%	2.19%
BOB	2.12%	2.38%
BON	2.54%	2.30%
NBCB	2.52%	3.00%
Average	2.50%	2.52%

Source: The banks' 2013, 2013 H1& 2014 H1 report, KPMG China research

Average yield on loans and average cost on deposits

	Average yield on loans		Average cost on deposits	
	2014 H1	2013 H1	2014 H1	2013 H1
ICBC	5.80%	5.81%	2.05%	1.96%
CCB	5.83%	5.84%	1.90%	1.91%
BOC	5.18%	5.16%	2.01%	1.86%
ABC	6.01%	6.01%	1.81%	1.75%
BCM	6.24%	6.09%	2.34%	2.08%
CMB	6.08%	6.10%	2.03%	1.85%
CNCB	6.31%	6.16%	2.47%	2.15%
CMBC	6.92%	6.98%	2.36%	2.29%
SPDB	6.38%	Not disclosed	2.40%	Not disclosed
CIB	6.53%	6.16%	2.37%	2.17%
CEB	6.31%	6.19%	2.75%	2.41%
HXB	6.61%	Not disclosed	2.21%	Not disclosed
PAB	7.51%	6.60%	2.55%	2.40%
BOB	6.18%	Not disclosed	2.29%	Not disclosed
BON	6.90%	Not disclosed	2.39%	Not disclosed
NBCB	7.06%	7.13%	2.14%	2.10%
Average	6.37%	6.19%	2.25%	2.08%

Source: The banks' 2013, 2013 H1& 2014 H1 report, KPMG China research

Operating income

RMB(million)	Net interest income	Net fee and commission income	Investment income	Other operating income	Operating income
2014 H1	1,218,367	352,692	13,192	84,716	1,668,967
2013 H1	1,082,370	303,896	22,010	46,188	1,454,464

	Net interest income			Net fee and commission income			Investment income			Other operating income			Operating income		
RMB million	2014 H1	2013 H1	Growth rate	2014 H1	2013 H1	Growth rate	2014 H1	2013 H1	Growth rate	2014 H1	2013 H1	Growth rate	2014 H1	2013 H1	Growth rate
ICBC	237,607	215,889	10%	73,228	67,382	9%	1,827	2,816	-35%	15,763	12,520	26%	328,425	298,607	10%
CCB	211,292	187,660	13%	60,180	55,524	8%	2,601	3,502	-26%	13,024	4,715	176%	287,097	251,401	14%
BOC	156,675	137,288	14%	52,131	45,481	15%	1,314	4,253	-69%	24,804	19,062	30%	234,924	206,084	14%
ABC	209,438	180,002	16%	47,848	47,597	1%	(1,693)	3,414	-150%	11,042	3,945	180%	266,635	234,958	13%
BCM	67,211	65,008	3%	15,701	13,895	13%	(2,390)	928	-358%	9,901	4,981	99%	90,423	84,812	7%
CMB	53,858	47,441	14%	23,702	14,164	67%	4,222	1,763	139%	2,478	689	260%	84,260	64,057	32%
CNCB	45,614	40,474	13%	12,807	7,977	61%	2,290	574	299%	1,395	853	64%	62,106	49,878	25%
CMBC	43,600	40,564	7%	18,438	16,222	14%	1,880	2,380	-21%	1,211	(877)	-238%	65,129	58,289	12%
SPDB	46,498	39,262	18%	10,401	6,327	64%	(624)	568	-210%	2,768	361	667%	59,043	46,518	27%
CIB	45,036	42,261	7%	12,948	10,820	20%	846	803	5%	578	(420)	-238%	59,408	53,464	11%
CEB	27,838	26,054	7%	8,632	7,349	17%	(114)	(8)	1325%	1,104	387	185%	37,460	33,782	11%
HXB	22,056	19,145	15%	3,666	2,973	23%	326	10	3160%	329	79	316%	26,377	22,207	19%
PAB	24,554	18,528	33%	7,771	4,376	78%	2,173	510	326%	235	12	1858%	34,733	23,426	48%
BOB	14,564	12,983	12%	3,116	2,438	28%	144	283	-49%	396	30	1220%	18,220	15,734	16%
BON	6,173	4,384	41%	890	581	53%	298	152	96%	71	7	914%	7,432	5,124	45%
NBCB	6,353	5,427	17%	1,233	790	56%	92	62	48%	(383)	(156)	146%	7,295	6,123	19%
Total	1,218,367	1,082,370	13%	352,692	303,896	16%	13,192	22,010	-40%	84,716	46,188	83%	1,668,967	1,454,464	15%

Source: The banks' 2013, 2013 H1& 2014 H1 report, KPMG China research

Operating income structure

	Net interest income %		Net fee and commission income %		Investment income %		Other operating income %	
	2014 H1	2013 H1	2014 H1	2013 H1	2014 H1	2013 H1	2014 H1	2013 H1
ICBC	72.35%	72.30%	22.30%	22.57%	0.56%	0.94%	4.80%	4.19%
CCB	73.60%	74.65%	20.96%	22.09%	0.91%	1.39%	4.54%	1.88%
BOC	66.69%	66.62%	22.19%	22.07%	0.56%	2.06%	10.56%	9.25%
ABC	78.55%	76.61%	17.95%	20.26%	-0.63%	1.45%	4.14%	1.68%
BCM	74.33%	76.65%	17.36%	16.38%	-2.64%	1.09%	10.95%	5.87%
CMB	63.92%	74.06%	28.13%	22.11%	5.01%	2.75%	2.94%	1.08%
CNCB	73.45%	81.15%	20.62%	15.99%	3.69%	1.15%	2.25%	1.71%
CMBC	66.94%	69.59%	28.31%	27.83%	2.89%	4.08%	1.86%	-1.50%
SPDB	78.75%	84.40%	17.62%	13.60%	-1.06%	1.22%	4.69%	0.78%
CIB	75.81%	79.05%	21.80%	20.24%	1.42%	1.50%	0.97%	-0.79%
CEB	74.31%	77.12%	23.04%	21.75%	-0.30%	-0.02%	2.95%	1.15%
HXB	83.62%	86.21%	13.90%	13.39%	1.24%	0.05%	1.25%	0.36%
PAB	70.69%	79.09%	22.37%	18.68%	6.26%	2.18%	0.68%	0.05%
BOB	79.93%	82.51%	17.10%	15.49%	0.79%	1.80%	2.17%	0.19%
BON	83.06%	85.55%	11.98%	11.33%	4.01%	2.97%	0.96%	0.14%
NBCB	87.09%	88.62%	16.90%	12.90%	1.26%	1.02%	-5.25%	-2.54%
Average	73.00%	74.42%	21.13%	20.89%	0.79%	1.51%	5.08%	3.18%

Source: The banks' 2013, 2013 H1& 2014 H1 report, KPMG China research

Intermediate business income ratio

	2014 H1	2013 H1
ICBC	24.17%	24.28%
CCB	21.54%	22.67%
BOC	23.66%	23.52%
ABC	18.92%	21.16%
BCM	19.15%	18.33%
CMB	30.07%	23.55%
CNCB	21.73%	17.20%
CMBC	31.14%	29.88%
SPDB	18.30%	14.32%
CIB	22.78%	21.05%
CEB	24.71%	22.69%
HXB	15.32%	14.36%
PAB	25.74%	20.88%
BOB	18.06%	17.14%
BON	12.84%	11.93%
NBCB	18.18%	14.19%
Average	21.64%	19.82%

Source: The banks' 2013, 2013 H1& 2014 H1 report, KPMG China research

Operating expenses

RMB million	2014 H1	2013 H1	Growth rate
ICBC	134,919	120,214	12%
CCB	118,554	96,878	22%
BOC	113,495	96,235	18%
ABC	132,042	115,618	14%
BCM	43,605	39,783	10%
CMB	44,245	29,364	51%
CNCB	32,627	22,783	43%
CMBC	30,801	27,357	13%
SPDB	29,286	21,131	39%
CIB	26,163	24,823	5%
CEB	16,749	14,386	16%
HXB	14,876	12,476	19%
PAB	15,736	10,930	44%
BOB	6,824	5,966	14%
BON	3,844	2,117	82%
NBCB	3,437	2,837	21%
Total	767,203	642,897	19%

Source: The banks’ 2013, 2013 H1& 2014 H1 report, KPMG China research

General and administrative expenses

RMB million	2014 H1	2013 H1	Growth rate
ICBC	78,674	72,698	8%
CCB	66,588	60,879	9%
BOC	60,010	57,014	5%
ABC	79,229	75,158	5%
BCM	22,620	20,022	13%
CMB	22,561	20,122	12%
CNCB	16,660	14,306	16%
CMBC	18,966	16,714	13%
SPDB	13,437	13,021	3%
CIB	12,650	12,095	5%
CEB	10,547	9,360	13%
HXB	9,985	8,661	15%
PAB	13,055	9,106	43%
BOB	3,601	3,099	16%
BON	2,044	1,366	50%
NBCB	2,307	1,883	23%
Total	432,934	395,504	9%

Source: The banks’ 2013, 2013 H1& 2014 H1 report, KPMG China research

Cost-to-income ratio

	2014 H1	2013 H1	Growth rate
ICBC	23.95%	24.35%	-2%
CCB	24.17%	24.62%	-2%
BOC	25.54%	27.67%	-8%
ABC	29.71%	31.99%	-7%
BCM	25.39%	24.92%	2%
CMB	26.78%	31.41%	-15%
CNCB	26.83%	28.68%	-6%
CMBC	29.12%	28.67%	2%
SPDB	22.76%	27.99%	-19%
CIB	21.52%	23.16%	-7%
CEB	28.16%	27.71%	2%
HXB	37.85%	39.00%	-3%
PAB	37.59%	38.87%	-3%
BOB	19.76%	19.70%	0%
BON	27.51%	26.66%	3%
NBCB	31.63%	30.74%	3%
Average	25.94%	27.19%	-5%

Source: The banks' 2013, 2013 H1& 2014 H1 report, KPMG China research

Impairment losses

RMB million	2014 H1	2013 H1	Growth rate
ICBC	24,167	21,941	10%
CCB	23,122	16,054	44%
BOC	27,782	14,142	96%
ABC	28,939	22,471	29%
BCM	11,082	8,764	26%
CMB	16,320	4,959	229%
CNCB	11,617	4,889	138%
CMBC	7,218	6,772	7%
SPDB	11,706	4,543	158%
CIB	9,056	8,949	1%
CEB	3,128	2,250	39%
HXB	3,061	2,245	36%
PAB	5,652	2,602	117%
BOB	1,906	1,761	8%
BON	1,164	352	231%
NBCB	700	530	32%
Total	186,620	123,224	51%

Source: The banks' 2013, 2013 H1& 2014 H1 report, KPMG China research

Total assets

	Cash and balances with central bank		Loans and advances to customers		Securities investment		Due from banks and other financial institutions		Other assets		Total assets	
RMB million	31/06/2014	31/12/2013	31/06/2014	31/12/2013	31/06/2014	31/12/2013	31/06/2014	31/12/2013	31/06/2014	31/12/2013	31/06/2014	31/12/2013
ICBC	3,607,404	3,294,007	10,394,435	9,681,415	4,476,040	4,322,244	1,182,732	1,049,887	643,066	570,199	20,303,677	18,917,752
CCB	2,578,036	2,475,001	8,952,511	8,361,361	3,511,470	3,414,617	958,417	754,798	399,356	357,433	16,399,790	15,363,210
BOC	2,387,651	2,114,340	8,238,260	7,439,742	2,487,978	2,403,631	1,610,816	1,233,133	744,391	683,453	15,469,096	13,874,299
ABC	2,851,344	2,603,802	7,503,254	6,902,522	3,411,571	3,220,098	1,821,949	1,443,385	418,494	392,295	16,006,612	14,562,102
BCM	932,763	896,556	3,354,657	3,193,063	1,108,234	1,069,821	622,708	566,429	265,574	235,068	6,283,936	5,960,937
CMB	593,971	517,239	2,362,544	2,148,330	1,012,877	756,830	943,037	505,802	120,693	88,198	5,033,122	4,016,399
CNCB	597,719	496,476	2,070,500	1,899,921	928,446	643,985	632,226	540,792	82,296	60,019	4,311,187	3,641,193
CMBC	442,434	433,802	1,662,137	1,539,447	417,547	304,736	837,988	767,335	211,345	180,890	3,571,451	3,226,210
SPDB	507,149	476,342	1,851,119	1,725,745	956,440	850,707	534,380	556,083	81,129	71,248	3,930,217	3,680,125
CIB	416,033	422,871	1,388,553	1,320,682	824,774	752,259	1,195,818	1,071,026	123,022	110,597	3,948,200	3,677,435
CEB	340,394	312,643	1,219,616	1,142,138	587,222	493,057	447,361	360,626	74,985	106,622	2,669,578	2,415,086
HXB	293,345	262,227	867,735	800,726	199,091	194,671	391,801	389,257	26,588	25,566	1,778,560	1,672,447
PAB	259,604	229,924	921,048	832,127	431,234	391,211	430,960	370,847	93,629	67,632	2,136,475	1,891,741
BOB	172,679	170,687	626,884	568,852	306,873	276,904	344,048	297,976	25,122	22,344	1,475,606	1,336,763
BON	62,120	49,594	156,778	143,058	214,584	151,364	68,005	79,870	12,246	10,172	513,733	434,058
NBCB	61,877	62,195	186,810	167,302	187,368	143,568	69,878	79,050	18,296	15,657	524,229	467,772
Total	16,104,523	14,817,706	51,756,841	47,866,431	21,061,749	19,389,703	12,092,124	10,066,296	3,340,232	2,997,393	104,355,469	95,137,529

Source: The banks' 2013, 2013 H1& 2014 H1 report, KPMG China research

Total asset structure

	Cash and balances with central bank %		Loans and advances to customers %		Securities investment %		Due from banks and other financial institutions %		Other assets %	
	31/06/2014	31/12/2013	31/06/2014	31/12/2013	31/06/2014	31/12/2013	31/06/2014	31/12/2013	31/06/2014	31/12/2013
ICBC	17.77%	17.41%	51.19%	51.18%	22.05%	22.85%	5.83%	5.55%	3.17%	3.01%
CCB	15.72%	16.11%	54.59%	54.42%	21.41%	22.23%	5.84%	4.91%	2.44%	2.33%
BOC	15.43%	15.24%	53.26%	53.62%	16.08%	17.32%	10.41%	8.89%	4.81%	4.93%
ABC	17.81%	17.88%	46.88%	47.40%	21.31%	22.11%	11.38%	9.91%	2.61%	2.69%
BCM	14.84%	15.04%	53.38%	53.57%	17.64%	17.95%	9.91%	9.50%	4.23%	3.94%
CMB	11.80%	12.88%	46.94%	53.49%	20.12%	18.84%	18.74%	12.59%	2.40%	2.20%
CNCB	13.86%	13.63%	48.03%	52.18%	21.54%	17.69%	14.66%	14.85%	1.91%	1.65%
CMBC	12.39%	13.45%	46.54%	47.72%	11.69%	9.45%	23.46%	23.78%	5.92%	5.61%
SPDB	12.90%	12.94%	47.10%	46.89%	24.34%	23.12%	13.60%	15.11%	2.06%	1.94%
CIB	10.54%	11.50%	35.17%	35.91%	20.89%	20.46%	30.29%	29.12%	3.12%	3.01%
CEB	12.75%	12.95%	45.69%	47.29%	22.00%	20.42%	16.76%	14.93%	2.81%	4.41%
HXB	16.49%	15.68%	48.79%	47.88%	11.19%	11.64%	22.03%	23.27%	1.49%	1.53%
PAB	12.15%	12.15%	43.11%	43.99%	20.18%	20.68%	20.17%	19.60%	4.38%	3.58%
BOB	11.70%	12.77%	42.48%	42.55%	20.80%	20.71%	23.32%	22.29%	1.70%	1.67%
BON	12.09%	11.43%	30.52%	32.96%	41.77%	34.87%	13.24%	18.40%	2.38%	2.34%
NBCB	11.80%	13.30%	35.64%	35.77%	35.74%	30.69%	13.33%	16.90%	3.49%	3.35%
Average	15.43%	15.58%	49.60%	50.31%	20.18%	20.38%	11.59%	10.58%	3.20%	3.15%

Source: The banks' 2013, 2013 H1& 2014 H1 report, KPMG China research

Scale of loan

RMB million	30/06/2014	31/12/2013	Growth rate
ICBC	10,646,115	9,922,374	7%
CCB	9,190,601	8,590,057	7%
BOC	8,424,595	7,607,791	11%
ABC	7,840,907	7,224,713	9%
BCM	3,433,769	3,266,368	5%
CMB	2,422,092	2,197,094	10%
CNCB	2,119,144	1,941,175	9%
CMBC	1,696,283	1,574,263	8%
SPDB	1,898,344	1,767,494	7%
CIB	1,430,974	1,357,057	5%
CEB	1,245,356	1,166,310	7%
HXB	891,952	823,169	8%
PAB	938,227	847,289	11%
BOB	644,509	584,862	10%
BON	161,302	146,961	10%
NBCB	190,918	171,190	12%
Total	53,175,088	49,188,167	8%

Source: The banks' 2013, 2013 H1& 2014 H1 report, KPMG China research

Loan quality

	NPL ratio		Allowance to NPL		Allowance to total loans ratio	
	30/06/2014	31/12/2013	30/06/2014	31/12/2013	30/06/2014	31/12/2013
ICBC	0.99%	0.94%	238.02%	257.19%	2.36%	2.42%
CCB	1.04%	0.99%	248.87%	268.22%	2.59%	2.66%
BOC	1.02%	0.96%	217.02%	229.35%	2.21%	2.20%
ABC	1.24%	1.22%	346.41%	367.04%	4.30%	4.48%
BCM	1.13%	1.05%	204.16%	213.65%	2.31%	2.24%
CMB	0.98%	0.83%	251.29%	266.00%	2.46%	2.21%
CNCB	1.19%	1.03%	192.68%	206.62%	2.29%	2.13%
CMBC	0.93%	0.85%	215.87%	259.74%	2.01%	2.21%
SPDB	0.93%	0.74%	267.84%	319.65%	2.49%	2.37%
CIB	0.97%	0.76%	305.74%	352.10%	2.97%	2.68%
CEB	1.11%	0.86%	185.49%	241.02%	2.06%	2.07%
HXB	0.93%	0.90%	291.49%	301.53%	2.71%	2.71%
PAB	0.92%	0.89%	198.18%	201.06%	1.82%	1.79%
BOB	0.68%	0.65%	367.97%	385.91%	2.50%	2.51%
BON	0.93%	0.89%	302.00%	298.51%	2.81%	2.66%
NBCB	0.89%	0.89%	241.18%	254.88%	2.15%	2.27%
Average	1.05%	0.98%	253.79%	274.58%	2.66%	2.68%

Source: The banks' 2013, 2013 H1& 2014 H1 report, KPMG China research

Loan structure

	Normal loans %		Special mention loans %		NPLs %	
	30/06/2014	31/12/2013	30/06/2014	31/12/2013	30/06/2014	31/12/2013
ICBC	96.84%	97.08%	2.17%	1.98%	0.99%	0.94%
CCB	96.56%	96.62%	2.40%	2.38%	1.04%	0.99%
BOC	96.70%	96.55%	2.28%	2.49%	1.02%	0.96%
ABC	95.13%	94.96%	3.63%	3.82%	1.24%	1.22%
BCM	96.70%	97.14%	2.17%	1.81%	1.13%	1.05%
CMB	97.78%	98.05%	1.24%	1.12%	0.98%	0.83%
CNCB	97.02%	97.78%	1.79%	1.19%	1.19%	1.03%
CMBC	97.50%	97.85%	1.56%	1.29%	0.93%	0.85%
SPDB	97.58%	98.03%	1.49%	1.23%	0.93%	0.74%
CIB	97.87%	98.60%	1.16%	0.64%	0.97%	0.76%
CEB	96.92%	97.78%	1.97%	1.36%	1.11%	0.86%
HXB	97.29%	97.60%	1.77%	1.49%	0.93%	0.90%
PAB	96.38%	96.98%	2.70%	2.13%	0.92%	0.89%
BOB	98.11%	98.10%	1.21%	1.25%	0.68%	0.65%
BON	97.00%	96.97%	2.07%	2.14%	0.93%	0.89%
NBCB	97.65%	98.05%	1.46%	1.06%	0.89%	0.89%
Average	96.99%	97.34%	1.99%	1.74%	1.01%	0.92%

Source: The banks' 2013, 2013 H1& 2014 H1 report, KPMG China research

Overdue loans ratio

	30/06/2014	31/12/2013
ICBC	1.68%	1.35%
CCB	1.31%	1.01%
BOC	1.35%	1.08%
ABC	1.57%	1.39%
BCM	1.82%	1.41%
CMB	1.86%	1.50%
CNCB	2.55%	1.83%
CMBC	2.69%	1.74%
SPDB	1.58%	1.30%
CIB	1.71%	1.06%
CEB	2.80%	1.85%
HXB	2.18%	1.60%
PAB	3.95%	3.13%
BOB	0.79%	0.66%
BON	1.22%	1.00%
NBCB	1.14%	1.00%
Average	1.69%	1.32%

Source: The banks' 2013, 2013 H1& 2014 H1 report, KPMG China research

Impairment losses on loans

RMB million	2014 H1	2013 H1	Growth rate
ICBC	23,988	21,927	9%
CCB	21,286	16,067	32%
BOC	27,502	13,883	98%
ABC	27,085	22,211	22%
BCM	10,159	8,469	20%
CMB	16,345	4,975	229%
CNCB	10,914	4,719	131%
CMBC	6,805	6,802	0%
SPDB	10,426	4,399	137%
CIB	8,571	7,867	9%
CEB	3,280	2,266	45%
HXB	3,053	2,219	38%
PAB	5,294	2,564	106%
BOB	1,625	1,760	-8%
BON	1,040	374	178%
NBCB	700	530	32%
Total	178,073	121,032	47%

Source: The banks' 2013, 2013 H1& 2014 H1 report, KPMG China research

Securities investment structure

	Financial assets at fair value through profit or loss		Available-for-sale financial assets		Held-to-maturity investments		Investment classified as receivables		Total	
RMB million	30/06/2014	31/12/2013	30/06/2014	31/12/2013	30/06/2014	31/12/2013	30/06/2014	31/12/2013	30/06/2014	31/12/2013
ICBC	386,592	372,556	1,128,582	1,000,800	2,621,864	2,624,400	339,002	324,488	4,476,040	4,322,244
CCB	324,072	364,050	774,800	760,292	2,220,584	2,100,538	192,014	189,737	3,511,470	3,414,617
BOC	87,240	75,200	682,646	701,196	1,300,033	1,210,531	418,059	416,704	2,487,978	2,403,631
ABC	351,373	322,882	826,749	781,311	1,636,625	1,523,815	596,824	592,090	3,411,571	3,220,098
BCM	77,619	59,083	229,447	220,397	653,404	670,615	147,764	119,726	1,108,234	1,069,821
CMB	38,932	23,223	267,608	289,265	237,705	208,927	468,632	235,415	1,012,877	756,830
CNCB	20,033	11,018	185,935	177,960	158,781	154,849	563,697	300,158	928,446	643,985
CMBC	27,396	22,262	138,383	111,532	151,799	133,124	99,969	37,818	417,547	304,736
SPDB	36,118	28,627	176,791	160,593	138,731	146,253	604,800	515,234	956,440	850,707
CIB	24,899	42,295	300,997	263,681	154,852	117,655	344,026	328,628	824,774	752,259
CEB	9,061	12,490	127,680	111,948	104,209	105,920	346,272	262,699	587,222	493,057
HXB	7,008	8,699	56,325	65,134	123,488	109,265	12,270	11,573	199,091	194,671
PAB	25,217	10,421	1,287	467	198,848	195,667	205,882	184,656	431,234	391,211
BOB	15,468	13,221	99,197	96,431	108,040	107,381	84,168	59,871	306,873	276,904
BON	6,209	3,455	42,602	45,063	53,643	39,319	112,130	63,527	214,584	151,364
NBCB	3,965	1,179	117,333	90,355	15,811	15,950	50,261	36,084	187,370	143,568
Total	1,441,202	1,370,661	5,156,362	4,876,425	9,878,417	9,464,209	4,585,770	3,678,408	21,061,751	19,389,703

Source: The banks’ 2013, 2013 H1& 2014 H1 report, KPMG China research

Liabilities

	Deposits from customers		Liabilities from banks and other financial institutions		Debt certificates issued		Other liabilities		Total	
RMB million	30/06/2014	31/12/2013	30/06/2014	31/12/2013	30/06/2014	31/12/2013	30/06/2014	31/12/2013	30/06/2014	31/12/2013
ICBC	15,728,332	14,620,825	1,612,057	1,568,559	255,640	253,018	1,348,145	1,196,887	18,944,174	17,639,289
CCB	12,956,956	12,223,037	1,057,553	909,885	428,524	357,540	809,745	798,419	15,252,778	14,288,881
BOC	11,190,569	10,097,786	2,260,116	1,890,889	254,102	224,704	757,853	699,443	14,462,640	12,912,822
ABC	12,809,504	11,811,411	1,267,762	930,504	275,358	266,261	746,251	709,389	15,098,875	13,717,565
BCM	4,375,920	4,157,833	1,145,695	1,120,692	95,378	82,238	224,397	178,690	5,841,390	5,539,453
CMB	3,420,748	2,775,276	1,082,314	792,478	99,981	68,936	143,715	113,753	4,746,758	3,750,443
CNCB	3,053,213	2,651,678	838,691	609,568	88,086	76,869	84,499	72,353	4,064,489	3,410,468
CMBC	2,420,577	2,146,689	637,712	638,244	117,078	91,968	166,785	145,022	3,342,152	3,021,923
SPDB	2,756,783	2,419,696	723,912	854,055	93,016	71,970	135,187	127,177	3,708,898	3,472,898
CIB	2,246,522	2,170,345	1,293,484	1,167,597	104,853	67,901	80,085	70,421	3,724,944	3,476,264
CEB	1,796,282	1,605,278	584,136	552,585	57,625	42,247	66,304	61,924	2,504,347	2,262,034
HXB	1,291,794	1,177,592	349,008	374,408	11,378	8,400	34,302	26,028	1,686,482	1,586,428
PAB	1,508,904	1,217,002	431,463	509,471	21,605	8,102	53,563	45,085	2,015,535	1,779,660
BOB	930,262	834,480	385,773	366,848	47,252	39,898	24,589	17,232	1,387,876	1,258,458
BON	342,494	260,149	118,249	130,412	11,269	10,278	12,245	6,362	484,257	407,201
NBCB	305,884	255,278	144,382	140,142	13,472	18,466	31,270	28,364	495,008	442,250

Source: The banks' 2013, 2013 H1& 2014 H1 report, KPMG China research

Liability structure

	Deposits from customers %		Liabilities from banks and other financial institutions %		Debt certificates issued %		Other liabilities %	
	30/06/2014	31/12/2013	30/06/2014	31/12/2013	30/06/2014	31/12/2013	30/06/2014	31/12/2013
ICBC	83.02%	82.89%	8.51%	8.89%	1.35%	1.43%	7.12%	6.79%
CCB	84.95%	85.54%	6.93%	6.37%	2.81%	2.50%	5.31%	5.59%
BOC	77.38%	78.20%	15.63%	14.64%	1.76%	1.74%	5.24%	5.42%
ABC	84.84%	86.10%	8.40%	6.78%	1.82%	1.94%	4.94%	5.17%
BCM	74.91%	75.06%	19.61%	20.23%	1.63%	1.48%	3.84%	3.23%
CMB	72.06%	74.00%	22.80%	21.13%	2.11%	1.84%	3.03%	3.03%
CNCB	75.12%	77.75%	20.63%	17.87%	2.17%	2.25%	2.08%	2.12%
CMBC	72.43%	71.04%	19.08%	21.12%	3.50%	3.04%	4.99%	4.80%
SPDB	74.33%	69.67%	19.52%	24.59%	2.51%	2.07%	3.64%	3.66%
CIB	60.31%	62.43%	34.72%	33.59%	2.81%	1.95%	2.15%	2.03%
CEB	71.73%	70.97%	23.32%	24.43%	2.30%	1.87%	2.65%	2.74%
HXB	76.60%	74.23%	20.69%	23.60%	0.67%	0.53%	2.03%	1.64%
PAB	74.86%	68.38%	21.41%	28.63%	1.07%	0.46%	2.66%	2.53%
BOB	67.03%	66.31%	27.80%	29.15%	3.40%	3.17%	1.77%	1.37%
BON	70.73%	63.89%	24.42%	32.03%	2.33%	2.52%	2.53%	1.56%
NBCB	61.79%	57.72%	29.17%	31.69%	2.72%	4.18%	6.32%	6.41%
Average	78.90%	79.16%	14.25%	14.11%	2.02%	1.90%	4.83%	4.83%

Source: The banks' 2013, 2013 H1& 2014 H1 report, KPMG China research

Loan-to-deposit ratio

	30/06/2014	31/12/2013
ICBC	66.30%	66.60%
CCB	70.93%	70.28%
BOC	72.29%	72.52%
ABC	61.21%	61.17%
BCM	72.37%	73.40%
CMB	66.23%	74.44%
CNCB	68.67%	72.79%
CMBC	70.17%	73.39%
SPDB	68.72%	73.01%
CIB	63.37%	61.95%
CEB	69.41%	72.59%
HXB	69.05%	69.90%
PAB	60.98%	68.64%
BOB	66.62%	68.74%
BON	47.10%	56.49%
NBCB	59.30%	61.97%
Average	65.79%	68.62%

Source: The banks' 2013, 2013 H1& 2014 H1 report, KPMG China research

Capital adequacy ratio and core capital adequacy ratio

	Capital adequacy ratio		Core capital adequacy ratio	
	30/06/2014	31/12/2013	30/06/2014	31/12/2013
ICBC	13.67%	13.12%	11.36%	10.57%
CCB	13.89%	13.34%	11.21%	10.75%
BOC	11.78%	12.46%	9.36%	9.69%
ABC	11.89%	11.86%	8.65%	9.25%
BCM	12.75%	12.08%	10.70%	9.76%
CMB	10.89%	11.14%	8.73%	9.27%
CNCB	10.98%	11.24%	8.71%	8.78%
CMBC	11.05%	10.69%	8.76%	8.72%
SPDB	10.83%	10.97%	8.58%	8.58%
CIB	12.18%	10.83%	9.35%	8.68%
CEB	10.89%	10.57%	8.97%	9.11%
HXB	9.95%	9.88%	8.20%	8.03%
PAB	11.02%	9.90%	8.73%	8.56%
BOB	10.38%	10.94%	8.48%	8.81%
BON	10.97%	12.90%	8.78%	10.10%
NBCB	11.47%	12.06%	9.30%	9.35%
Average	11.54%	11.50%	9.24%	9.25%

Source: The banks' 2013, 2013 H1& 2014 H1 report, KPMG China research

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cutting through complexity