China’s key risk is financial, and growing

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2016 bonanza year over: Growing financial risk pushing State Council/PBoC towards more restrain: cost of funding rising

Source: Natixis, Bloomberg
Better externally: capital outflows stabilizing although not yet totally out of the woods

Source: Natixis, SAFE
But with increasing risks in the financial sector: shrinking conventional interbank market and more bank-to-bank financing through non-standard collateral

Interbank Activities (Quarterly, RMB tr)

Conventional and unconventional interbank assets (% of total assets)

Source: Natixis, WIND

Related Research:
Natixis China Banking Monitor 2016: From lending to investing in order to survive (Annual Report, Executive Summary)
Also increasing recourse to non-collateralized market funding, specially non-negotiable certificates of deposit (NCD) but at a higher cost.

Outstanding NCD by Issuer

- CCB: RMB 4,012 bn, 10% of Total Liabilities
- JSCB: RMB 3,756 bn, 5% of Total Liabilities
- SOCB: RMB 99 bn, 0% of Total Liabilities

Source: Natixis, WIND  N.B. Data as of 5 Apr 2017

Funding Cost of Different Instruments
(6M, monthly average, %)

- NCD
- SHIBOR
- MLF

Source: Natixis, WIND

Related Research:
Chinese banks liquidity problem: Regulation and lack of collateral as key culprits
Liquidity not an issue for big five, only for city commercial banks and some joint stock commercial banks, but some have the size of a G-SIFIs!

Source: Natixis, WIND  N.B. Listed banks included
Beyond liquidity, banks’ profitability and solvency worsening

**Profitability (%)**

- Return on Equity
- Return on Assets (rhs)

**NPL Coverage Ratio (%)**

- NPL Coverage Ratio
- Adjusted NPL Coverage Ratio

*Adjusted NPL Coverage Ratio is calculated as NPL Provision / (NPL + SML)

Source: Natixis, CEIC, WIND

Related Research:

China Banks in 2017: No rebound in sight, rising risks for smaller banks
Banks still capable of meeting regulatory requirements, but no organic capital being created.
Asset quality improved thanks to the caving out of doubtful loans through debt-to-equity swaps but credit still growing fast so hard to see an improvement in medium term

Debt to Equity Swap (RMB bn)

Debt-to-Equity Swap by Industry

Source: Natixis NB Based on swap announced date

*Some announcements do not have a clear breakdown of several deals, and this includes coal, steel, chemicals, metals.
Source: Natixis

Related Research:
Debt-to-equity swaps continue at full speed with deferred consequences
All in all

**China’s real economy doing better but financial risks remain**

- External risk stemming from capital outflows easing but...
- Domestic financial risks growing
  - Bank liquidity more immediately but also solvency in the medium term
  - Also increasing risks from shadow banking
    - P2P lending and also entrusted loans
    - And massive securitization as a way to clean up banks

**Chinese authorities recent tougher line on financial risk is welcome but hard to maintain. The ball is already too big**

- If government gets tougher on moral hazard and losses are allowed, massive capital outflows could resume again
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