PRICEWATERHOUSECOOPERS
普 华 永 道

中国银行业协会
CHINA BANKING ASSOCIATION

# CHINESE BANKERS SURVEY 2010

# 中国银行家调查报告

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〔English translation for reference only.〕

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责任校对：孙　蕊
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# Preface

Enclosed is the Chinese Bankers Survey Report for 2010, jointly presented by the PricewaterhouseCoopers (PwC) and China Banking Association (CBA).

This survey endeavours to:

1. gain insights into the strategies, opportunities, and challenges of the Chinese banking industry in the post-crisis era from the standpoint of Chinese bankers;
2. share the views and recommendations of Chinese bankers on areas such as reform, liberalisation, and business development, amid the regulatory oversight of the Chinese banking industry;
3. promote mutual understanding and dialogue between the regulatory authorities, domestic and overseas market participants, and the Chinese banking industry specialists.

This survey targeted the senior management of both the head offices and branches of Chinese banks. It was primarily conducted between April and June of 2010 through electronic questionnaires, with 752 valid responses received from participating banks. In addition, the project team conducted face-to-face interviews with 70 senior banking executives, which included Board Chairmen, Presidents, Vice Presidents and department heads. We would like to take this opportunity to extend our sincere thanks to the respondents for their time and effort in making this survey possible. We are confident this report will provide readers with a comprehensive understanding of the professional opinions of senior management in the banking industry.

In the post-crisis era, given the uncertainties in the U.S. economic recovery and the effect of the European sovereign debt crisis in the euro region, bankers have differing views on the future direction of the Chinese economy. Quite a few respondents believe that the Chinese economy faces considerable growth uncertainty, making it difficult to forecast its future direction. Seeing that their conclusions are the result of close interaction with the business community, their responses reflect the complexity and blue-sky potential of the Chinese economic landscape, as well as present and future trends.

A majority of bankers endorsed the Chinese government's macro-control policies instituted since 2009, praising, in particular, the effectiveness of its monetary policies. However, considering an environment where the overall global economic recovery remains uncertain, and where general economic trends are still difficult to forecast, China faces many difficult decisions in determining its macro-economic policy.

Chinese banks commonly believe that the "transformation of the economic development model" and "adjustments to the industrial structure" are the two external changes most deserving of attention. Accordingly, "transformation" is a top strategic priority that banks believe they must adopt when responding to the changes to their environment, shifting from an old model that favours expansion in operational scale, to an intensive growth model that pursues cost-effectiveness, pricing power and capital savings. In addition, financial disintermediation, change of customer base and market expansion are also among the main priorities.

The bankers hold the view that the local government-backed financing platform debt situation cannot be ignored as these loans are long term, large in scope and their sustained commercial profitability is difficult to determine. However, the bankers believe the risks associated with local government backed financing platform loans are manageable for the most part. The challenge is in attempting to understand the overall debt situation of the local governments. As the real estate market faces significant uncertainties, most bankers are of the view that short term risks in the industry are rising, in particular, the risk of a chain reaction on real estate development loans, a situation that warrants serious attention.

The survey reveals that bankers tend to focus on achieving a balance among risk management, business growth, and risk-adjusted profitability. At the same time, most respondents do not predict a sharp rise in non-performing loans in the foreseeable future, demonstrating their confidence that these risks can be managed.

Increasing investments in IT is now a common point of consensus among bankers, as they are part of plans to accelerate improvements to their IT infrastructure. However, given the various stages of IT construction amongst the banks, development priorities in this area tend to vary considerably from one to the other.

The China Banking Regulatory Commission's regulatory policies received widespread endorsement from the bankers, while the professionalism, independence and effectiveness of the banking regulation have also been fully affirmed by survey respondents. According to bankers, the introduction of innovative regulatory measures after the financial crisis, including countercyclical capital regulatory requirements and the introduction of leverage ratio regulatory standards, provides a good model for the Chinese banking industry.

The launch of the bank commercialisation reforms in 1994 gave rise to a large number of Chinese bankers with vast market experience and strong management capabilities in China According to the survey, bankers say the top quality standards are strategy management and the ability to develop business With the acceleration in the transformation of the Chinese banking industry, bankers believe the ability to innovate, adopt a global outlook and seek and expand financial services demands in the market place will need to be improved

In our effort to keep relevant stakeholders continuously informed on the latest developments and trends in the Chinese banking industry, this project will be a regular fixture in the future, with follow-up surveys We look forward to hearing your feedback on this report, and suggestions on topics to be included in future surveys on China's banking industry For further information, please contact the PwC Financial Services, China Banking Association, or the project leader

**Wu Weijun, David**
**China Financial Services Domestic Market Leader**
**PricewaterhouseCoopers**

**Yang Zaiping**
**Executive Vice President**
**China Banking Association**

**Ba Shusong**
**Project Leader**

**October 2010, Beijing**

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# Executive Summary

After experiencing the large supply of credit which allowed China to overcome the global financial crisis, the Chinese banking industry faced a series of significant external environment and government policy changes, including changes to the economic development model, adjustments to the industrial structure, an escalation in the removal of financial intermediaries (financial disintermediation) and, an even greater reinforcement of capital restrictions. These changes and turn-arounds were both rapid and far-reaching, going beyond the expectations of many in the banking industry. With this new reality, Chinese bankers began to take a step back to look at ways to maintain sustainable development, keep pace in their competitive environment and take the initiative for change. *The Chinese Bankers Survey 2010* captures the observations, analyses and research of banking experts in the post-crisis era.

## The economic situation

Due to uncertainties in the U.S. economic recovery and the long-term effects of the European sovereign debt crisis in the euro region, a majority of bankers argue that global economic recovery is still uncertain.

The views of bankers on the development of the Chinese economy in 2010 differ markedly: 40% of them believe there are a relatively large number of uncertain factors to economic growth, making the forecasting of growth trends difficult, while 29% believe the economy in 2010 will maintain its rapid growth and the economic recovery will gradually stabilise. The survey results underlie the complexity of China's economic situation in 2010.

The assessments by these banking professionals are the direct result of their close interaction with the business community. They suggest that limits placed on local government-backed financing platform loans and mortgage loans will result in intermittent shortages of loan demand among clients. Only 25% of bankers agree with the statement that "Enterprises' operations are good and their profitability is being improved consistently."

## Overall economic policy

Overall, the bankers have a relatively positive assessment of China's macro-control policies implemented from 2009 onwards, especially on the extent of China's monetary policies, and praise the foresight and effectiveness of China's fiscal policies.

In contrast, China's industrial policies scored relatively low marks amongst the respondents, which can be viewed as a response to the impact of frequent changes in these policies.

Bankers also have recommendations for China's taxation policies in the banking sector. 72% say the conceptual framework behind taxation in the Chinese banking industry attaches too much importance on fiscal revenue, and not enough on addressing the development needs of the industry. 57% point out that the current tax structure in the Chinese banking sector relies too much on business taxes, which serves to hinder the development of the financial services industry and the flow of capital.

## Transformation strategy

After the trials of the economic crisis, the external operating environment of the Chinese banking industry underwent a profound change. Bankers group these changes into four categories: transformation in the economic development model, reinforcement of capital restraints, acceleration of financial disintermediation, and intense competition among industry peers.

Some of these factors are results of changes that are gradual and cumulative, while others have been abrupt and drastic. They overlap and converge on one another, subjecting banks to unprecedented constraints.

"Transformation" has become the main coping strategy for banks in this new environment, transforming the bank's development model from that of large-scale expansion to an intensive growth model that stresses financial cost, pricing power and capital conservation. Some joint-stock commercial banks have already begun to adopt and implement this "transformation" strategy at a fast pace, whereas large commercial banks have been slightly more hesitant and relatively undetermined.

The transformational orientation proposed by the bankers is all-encompassing and far-reaching, including:

- Transforming the customer bases from a model of largely servicing large enterprises to that of servicing customer segments that best complement the bank's service advantages, with more attention to be paid to small and medium enterprises (SMEs);
- Shifting the business structure from a traditional credit business to increased emphasis on the development of the intermediary and high-end retail business;
- Evolving the scope of business from traditional banking to more integrated financial services operations;
- Expanding business space from the city to the countryside, while taking on a more global scope.

## Adjustment in credit portfolio structure

Bankers first directed their attentions to the big picture of the transformation of the economic development model. When assessing "the change in the external environment that deserves the most attention," 88% of bankers would choose "transformation of the model of economic development and the industrial structure adjustment."

The bankers have adjusted their credit portfolio structures to meet the needs of this transformation. Amongst those industries chiefly supported by credit investments in 2010, strategic emerging industries advocated by the Chinese government such as alternative energy and high-class equipment manufacturing rank among the top, while other industries directly affected by domestic demand, such as logistics, agriculture, health care and education, are also main targets for credit investment. Industries that require high energy consumption such as non-ferrous metal, steel, and cement rank near the bottom.

75% of the bankers say that they would "limit credit investment to businesses that are at overcapacity, are high polluting or are high energy consuming." The bankers argue that they will insist on these adjustments in spite of their potential influence on asset quality.

## Financial disintermediation

According to the bankers, the rapid development of the Chinese market in corporate debt financing instruments and the venture capital market has led to accelerating financial disintermediation, greatly affecting the total supply and demand as well as the structure of the bank's credit business. More than half of all bankers believe that the "diversification in corporate financing" is a factor in the transformation of the external environment that deserves immediate attention.

In reality, the investment banking business of Chinese commercial banks has gradually expanded to include such services as bond underwriting, financial consulting, bank-trust cooperation, treasury management, extension of credit for merger and acquisition, and syndication of loans. This expansion of investment banking services, with the exception of equity underwriting, has had a great impact on securities companies. The bankers believe that the development of such services as investment banking is one of the countermeasures that will help them cope with the effects of financial disintermediation. When asked about the "Fields of financial innovation in the banking industry that are most pressing," innovation in investment banking ranked first (accounting for 56% of responses). The bankers believe that the development of such services as investment banking can provide their corporate clients with more integrated financial services, which will help reduce their financial service costs and increase customer loyalty. However bankers believe that the conflicting risk profiles and incentive mechanisms between commercial and investment banking have not yet been effectively resolved.

Bankers also suggest stepping up the level of integration of services outside of traditional banking. Only 19% of interviewees say that they would rule out integrating their operations at the moment. The integrated operations of the banking industry are still at their early stages in terms of investment returns, and industry synergies have yet to be fully realised. The bankers say that the lack of interdisciplinary talent among senior management and the challenges in acquiring the proper licenses are the main hurdles for further operational integration.

When asked to choose a field of business for expansion of integrated operations, 46% of interviewees chose the insurance sector, far surpassing those who picked other fields.

## Transformation of customer bases

The traditional pursuit of large clients in the Chinese banking industry has led to lack of distinctiveness in industry competition, and price competition in assets and liabilities business has intensified. When asked about "The biggest operational challenge in 2010s," 79% of the bankers put both "increasingly fierce horizontal competition" and "increased pressure on attracting customer deposit" at the top.

In terms of corporate performance, bankers are showing increasing interest in SME-related financial services. More than 50% of bankers say that they see SME-related financial service as a new area for profit growth and a crucial strategic pillar, implying that, instead of merely reacting to government calls, banks have started to actively develop financial services for SMEs on their own.

As for personal finance, increasing importance is placed on finding customers with the greatest value to the bank. When assessing the priorities of personal financial service in the coming three years, wealth management has risen from third place in 2009 to first, while private banking has also risen in the rankings.

The bankers believe that the development potential for private banking in China is relatively high, but rife with challenges. In particular, against the backdrop of a segregated financial services framework and a yet-to-be-established process based banking system, overcoming interdepartmental silo limitations, integrating banking products across bank departments, subsidiaries and external resources, and establishing differentiated banking service process, will prove to be a challenge.

In contrast with wealth management services, the ranking for personal residential mortgage loans has dropped from first place in 2009 to fifth, which can be attributed to the increasing effects of government's macro-control policies on real estate in the second half of 2009. Some bankers believe that given the available interest rate discounts to mortgage loans, if these loans reach a certain percentage of the lending portfolio, full-speed development in this area will have a negative impact on the improvement of loan prices across the bank.

## Room for business growth

The Chinese banking industry was once centralised in urban areas. However, given the Chinese government's efforts to resolve the three main issues of "farmers, countryside and agriculture" and the promotion of its urbanisation strategies, the bankers have increased their level of attention on rural finance. 52% of the bankers say that they have begun vigorously developing rural financial services and have identified this business as an area for future growth.

Globalisation is another expansionary objective in the Chinese banking industry. Over two-thirds of the bankers believe that the Chinese banking industry must seize the presently favourable conditions in going global. These favourable conditions include the acceleration in the pace of overseas expansion for Chinese businesses, the introduction of the Renminbi's globalisation strategy and the business space as a result of the deleveraging of the banking industry in the developed world.

The bankers believe that the surrounding Asian countries are the preferred target regions for the globalisation strategy of China's banking industry. While the biggest challenge for the "going global" strategy is still the lack of accurate and detailed knowledge and understanding of the overseas environment and investment policies, protectionist tendencies of foreign governments should not be overlooked either.

Along with room for geographical expansion, over 80% of bankers believe that expansion into the e-banking sector (Internet banking, phone banking and mobile banking) is now taking on increasing importance. Not only does e-banking feature lower-cost and higher-efficiency advantages compared with that of traditional branch banking, it also offers a platform for product innovation.

## Real estate

The real estate-related business takes up a relatively large percentage of Chinese banking industry assets. After the Chinese government unveiled new and stricter mortgage lending policies in mid-April of 2010, the influence of these policies on the banking industry has been the subject of much attention. When asked "What business factors give you the pressure?" 75% of the bankers picked "the relatively high degree of uncertainty in the direction of the real estate market."

The bankers believe that, due to limited land resources and progressive urbanisation, housing prices will continue to rise steadily over the long term, but short-term risks are building, with the risk of the chain reaction on real estate development loans needing particular attention. 88% of the bankers believe that the main risk to the real estate industry in 2010 is the chain reaction of tightening credit policy pressure on real estate industry.

## Local government-backed financing platforms

According to bankers, loan risk is currently manageable for the most part, mainly because local government-backed debt is currently invested in the economically more developed eastern region. Not only do most of the loans in this region have the credit backing of local authorities, the central government and related regulatory departments have also increased regulatory oversight on government-backed debt.

However, certain risks carried by local government-backed debt cannot be taken lightly. Some bankers believe that the chief risks associated with local government-backed debt is that these governments tend to "undertake borrowings from and establish credit facilities with a number of banks" making it difficult for banks to obtain a clear picture of the overall credit situation.

47% of the bankers believe that local government-backed debt carries relatively high loan risk, mainly due to the long investment period and large scale of projects involved, making it difficult to realise sustained commercial profitability of the projects. In particular, risks have been exacerbated by the increasingly rapid growth of government-backed loans by financially vulnerable municipal, county level and western regional governments, insufficient capital and management irregularities in some of the businesses financed by these loans, and an absence of external regulatory oversight and internal corporate governance of these platforms. Further, the banks lack standardised lending regulations for the financing platforms supported by local government.

## Risk management

62% of the bankers believe that tightening the requirements of risk management and knowledge of business risks would be conducive to the healthy development of the sector. Chinese bankers have collectively begun to pay much attention to striking a balance between risk management and business growth, while focusing also on the level of risk-adjusted returns.

71% of the bankers believe China may face a concentrated rise in non-performing loans in the future. In comparison with the 2009 survey results, the forecasted date for potential emergence of a high number of non-performing loans has been pushed back. This can be mainly attributed to the fact that, in comparison with 2009, China's overall economic growth and climate in 2010 have been trending favourably. The bankers across the board believe that non-performing loan rates will generally remain at low levels over the next three years.

Optimising risk management mechanisms is the key to improving the ability to identify risks and controls. According to the survey results, 48% of the bankers believe that the organisational structure for future risk management should move towards a merging of risk management and internal controls. 54% of bankers point out that they have already established and are in the process of optimizing their organisational structures for internal controls.

Among the bankers, credit risk is still considered the biggest and most serious of all risks, while concern over compliance risk is also rising. The concern over compliance may be due to the frequent introduction of new regulations by the central government as well as the substantial changes in industry policies since 2009.

45% of the bankers believe that raising the level of quantitative risk analysis should be the main focus of implementing the New Basel Capital Accord. Compared with the 2009 survey results, the importance attached to fundamental data quality supervision has declined markedly. This might imply that, with the dates for the pre-assessment of commercial banks in their implementation of the New Basel Capital Accord fast approaching, the related commercial banks have already completed their Phase I work, with noticeable improvement to the issues related to lack of data.

## Corporate governance

Overall, the bankers are relatively satisfied with their banks' corporate governance, and give top marks to "sound social responsibility," suggesting that the fulfilment of social responsibility is universally accepted. In comparison, they feel that there is still much room for improvement when it comes to the incentive and supervisory mechanisms behind corporate governance. 60% of bankers consider the policy to limit the management salary is reasonable and necessary in the financial sector, but the