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PRODUCT AND SERVICE DIFFERENTIATION AS COMPETITIVE ADVANTAGES IN CHINA'S CORPORATE LENDING AND LOAN SYNDICATION BUSINESSES

ASIAN BANKER RESEARCH SURVEY ON CORPORATE LENDING AND LOAN SYNDICATION IN BANKS IN CHINA 2014

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Foreword

How Product and Service Differentiation Can Help Chinese Banks

In spite of the slowdown faced by China, the economy is expected to grow at a healthy rate of 7.4% this year. However, there remains an overall concern about the amount of non-performing loans (NPLs) sitting on the balance sheets of Chinese banks. The NPLs have been growing, leaving Chinese banks cautious in offering credit in the market. The banks struggle to find a balance between meeting regulatory capital and reserves requirements and the need to increase credit growth in the overall interest of the economy.

To remain competitive and profitable, Chinese banks need to be more innovative in offering products to their customers. Banks across the globe have utilised technology to grow their business in challenging environments as currently faced by banks in China.

Large global banks have consciously moved away from diverse systems, spreadsheets and manual work. Instead, they embrace technology to consolidate their loan books under one system. The benefits reaped by these banks are multifold. Operationally, consolidation has delivered efficiency by removing manual interventions and allowing the business to get a real-time view of their lending portfolio without depending on multiple applications. This, in turn, allows them to serve customers more efficiently. Banks are also in a better position to launch new products to remain competitive. On the regulatory side, a bank is much better equipped to manage credit risk and meet requirements for capital and reserves due to better understanding of their lending book as well as exposures that they carry on a particular customer. This also leads to better liquidity management and avoids loss of opportunity.

Leading loan servicing solutions have helped global banks achieve the aforementioned benefits (enable revenue growth, increase operational efficiencies while reducing the overall risk) to manage complex lending, which ranges from large syndicated loans to bilateral loans. Banks have seen increases of more than 100% in their syndicated lending businesses after implementing leading loan solutions.

Amit Chopra, Syndicated and Commercial Lending Specialist – Misys

Product and Service Differentiation as Competitive Advantages in China's Corporate Lending and Loan Syndication Businesses

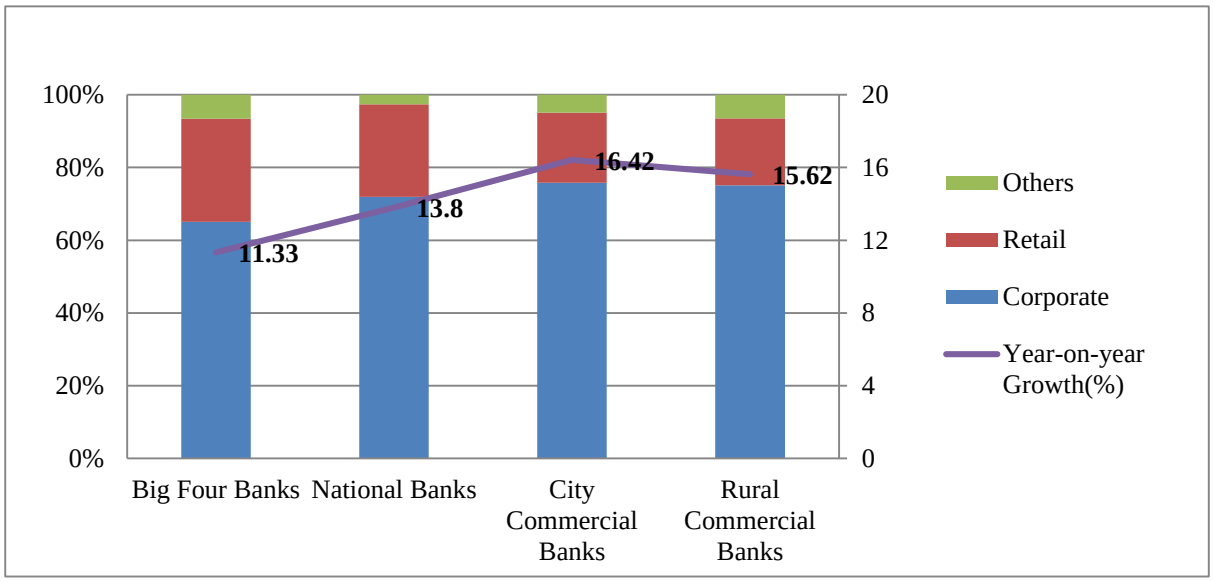
1. Introduction

As competition increases within the corporate lending and loan syndication landscape in China's banking sector, banks will need to compete on better products and services to draw and retain clients. But first, a deeper understanding of the business needs to be gained. The following is an overview of the corporate lending business in China today.

1.1 Size of the corporate lending business in China

The following overall business profile gives an idea of how Chinese banks' balance sheets are dominated by corporate lending and how city commercial banks are growing fastest year-on-year.

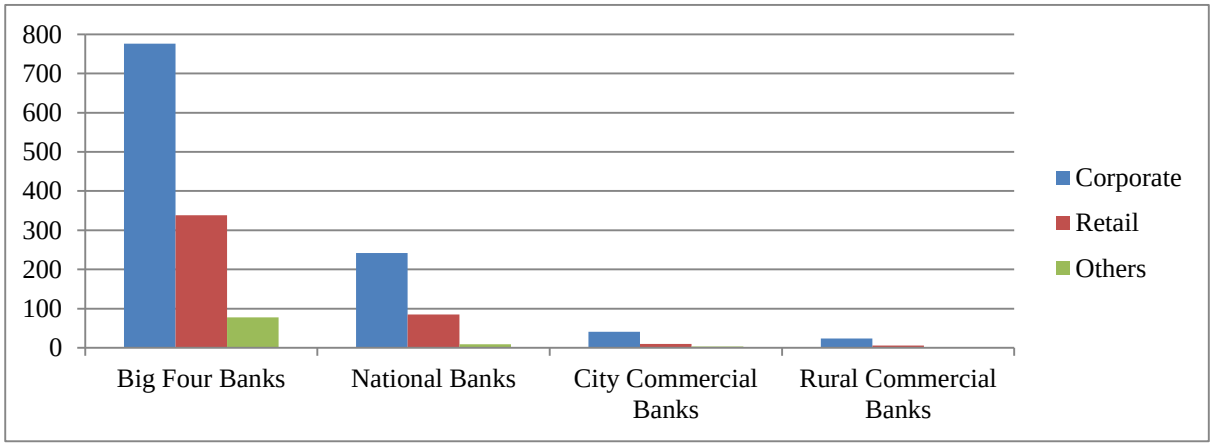
Total Asset Size Breakdown by Corporate/Retail/Others of Selected Categories of Chinese Banks and Year-on-Year Growth of Corporate Loans (%)



Source: Asian Banker Research

The subsequent figure illustrates how the big four banks lead in corporate lending by average deal amounts.

Lending Business of the Largest Chinese Banks in each Category by Asset Size ($b)



Source: Asian Banker Research

The Big Four banks – Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), Agricultural Bank of China (ABC) and Bank of China (BOC) – are suppliers of funds to the manufacturing sector as well as to infrastructure projects. They also offer retail and wholesale banking services to farmers. The development banks – China Development Bank, Export Import Bank of China and the Agricultural Development Bank of China – finance economic, trade development and state-invested projects. The national banks tend to have their own industry specialisations for corporate lending. The 140 city commercial banks set up from 1995 to 2009 support the regional economies. The rural commercial banks are focused on community-level lending to small farmers and SMEs.

1.2 Key developments in corporate lending in China

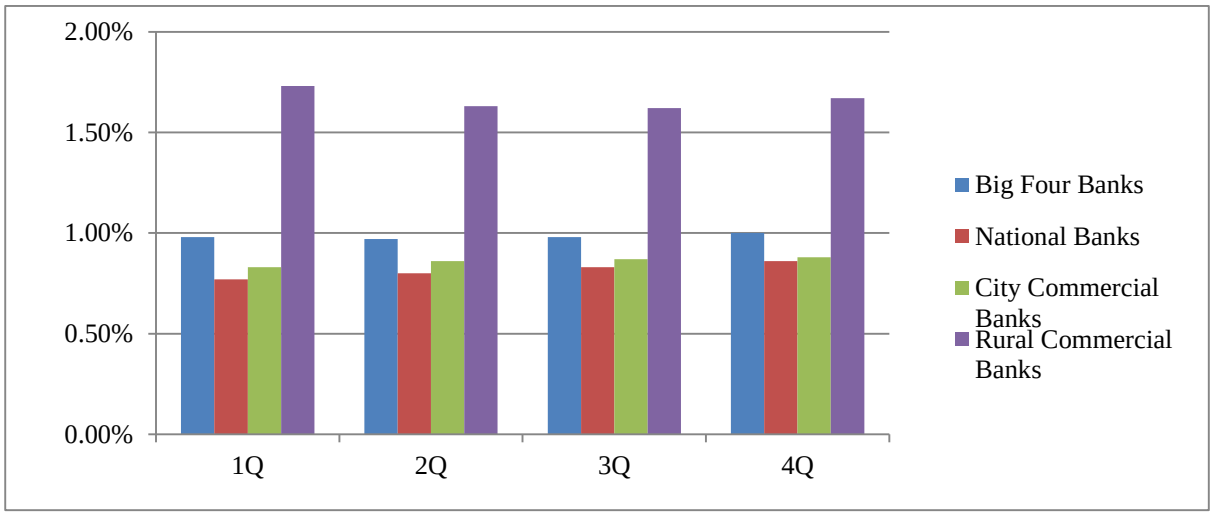
The People's Bank of China (PBOC) allowed financial institutions to set their own loan rates at the beginning of July 2013. This led to squeezing of deposit and loan spreads, narrowing of profits and increasing credit risk. By the end of 2013, the balance and average rate of non-performing loans of listed banks rose. Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), Agricultural Bank of China (ABC), Bank of China (BOC), and Bank of Communications (BoCom) reported a total of CNY374.32b ($60b) of Non Performing Loans last year. The amount is up from CNY327.48b ($52.5b) reported in 2012. The five state owned banks wrote off their books a total of CNY63.92b ($10.5b) Non Performing Loans in 2013. The amount is 2.5 times the CNY25.29b ($4.1b) in problem loans they erased from their books in 2012. Thus, banks increased their efforts to build more robust credit risk management frameworks.

The PBOC credit information centre system operates in the country's 31 provinces and five cities with independent planning and has credit sub-centres. It is the world's largest and most comprehensive collection of financial credit information database of domestic credit activities. Enterprise and individual credit files are maintained separately. The system has been widely used in credit risk management in financial institutions to effectively solve the problem of information asymmetry and improve

the convenience of public financing to create more financing opportunities and promote the development of the credit market.

The PBOC encourages banks to diversify their portfolios by increasing loans to the private sector. So, the culture for competition will improve when banks compete for SMEs rather than SOEs. Meanwhile, corporate lending NPLs are tightly managed.

Chinese Banks Corporate Lending NPLs in 2013 (%)



Source: Asian Banker Research

Recent GDP has slowed to the lowest in 10 years in order to facilitate the transformation of the country's economy. However, there are still capital and liquidity constraints. Basel III liquidity coverage ratio (LCR) tightened with China setting higher-than-required limits. Capital adequacy ratio (CAR) increased and risk-weighted assets (RWA) computations are more stringent. ICBC, CCB, ABC, BOC and Bank of Communications reported a total of CNY374.32 billion ($60 billion) of NPLs last year.

2. Assessment of the corporate lending business – What it will take to succeed in the corporate lending business today

2.1 The true lending cost

Basel III compliance – The ability to know the true lending cost is important because the banks that are profitable are those that understand, then factor in, the real costs of giving loans to organisations.

2.2 The ability to say "no"

Better risk management through better internal process, data consolidation and the ability to say "no" – The banks that are not affected by high NPLs are those that did not extend loans to weak institutions. A well-structured loan facility with access to clearly defined parameters/KPIs for all loan officers to pre-qualify and sort out applications is highly recommended. Chinese banks tend to have a top-down approach to loan approvals. Facilities that include loan approval criteria in the loan system will

help staff to deal with clients categorically, rather than have senior management overrides.

2.3 Client relationship and servicing skills

Strong information system in support of client relationship and servicing skills – Our interviews suggest that most Chinese banks use basic or generic banking and loan management by customer numbers, not by customer information. They do not have client-centric systems to monitor the total corporate relationship. This includes the capability to aggregate and correlate all information from other systems of all products and services provided to the corporate clients in one database so that the banks can pass on good pricing because the clients' total relationship holding costs with the banks are known.

2.4 Scalability to serve growing clients

Faster lending decision-making and scalability to serve growing clients – This refers to the ability to cost-effectively handle new requirements when there is a spike in volume while hosting thousands of concurrent loan participants from numerous places who service transactions in several currencies – quarterly as well as year-end closing, for instance.

3. Conclusion

According to information gathered in our survey, China Domestic Syndicated Lending reached $724b showing 21% increase from 2012. Hence, a good processing infrastructure is important. Our interviews suggest that in order to achieve goals in time to market and customised services to cope with fierce competition, national banks that have strategic mindsets frequently modify their systems and these open up requirements for agile technologies that cover entire lending procedures as well as consolidation of information.

The core and lending systems of the city commercial banks are sufficient to meet the needs of current businesses, but the capabilities and capacities are limited when productions expand. The China Banking Regulatory Commission (CBRC) emphasised the importance of risk management as well as serving SMEs, so banks possibly will leverage technology to help them mitigate risks while achieving growth. There are requirements for flexible systems for the diverse demands of dissimilar SME businesses. There is also a need for advanced risk management and security features in each step of the lending business process. The rural commercial banks tend to be particularly localised players with a handful of core corporate clients each. So, requirements for a centralised corporate lending business exist – since branches tend to be too small to handle corporate lending processes.

There is active support for the legitimate demands for credit and funding intended for key national projects. There also exists opportunities in all kinds of medium investments and financing projects. This provides good opportunities for the development of syndicated loans while improving standardisation levels and the scale of the deals will continue to expand. This sets China in a period of strategic opportunities for innovative syndicated lending business mechanisms. Innovative products will bring in modern Operating Models in the field of syndicated lending management. It will also be good to gain familiarity with existing international lending practice and processes in organising sophisticated syndicated business operations to help reduce challenges and avoid operational risks. Banks globally are looking at specialized lending systems for better efficiency as a best practice rather than relying on their core banking technology.

Performance monitoring of existing loan origination and procedures could show the big banks whether or not they really meet demands. Small banks will benefit from alternative solutions to control costs to help them avoid significant technology spend.

Finally, there is a differentiation between being big and being a leader in domestic as well as international syndicated lending. The biggest banks by asset size are not automatically the only ones at the top. Players who maintain strategic innovative mindsets instead of just following the leader are the ones that will win in this big business.

The China Banking Association's (CBA) Loan Syndications and Trading Association platform

Founded in 2006, the committee developed a professional syndicated loan transaction services system dubbed Loanlinks. It incorporates and regulates its 61 member banks' loan syndication origination. It has in excess of 700 registered users, 550 institutions, covers 40 projects being set up and boasts 30 successful projects through the system with a total of $4.267 billion and is situated in 22 provinces and cities nationwide.

It intends to promote interbank cooperation (since excessive competition among banking institutions lead to loss), construct a working mechanism, promote the syndicated loan market development, improve liquidity, enhance the bargaining power of banks, prevent and divert credit risk, carry out portfolio management in banks, standardise operations, encourage orderly competition, safeguard the syndicated loan market order, innovate, develop talent and construct a transaction service system.

The transaction service system is the sole structure that supports cross-banking syndicated loan deals. It serves as a bridge between the market players and the CBRC. In addition, it has a rigorous standard on syndicated loans trading from the regulatory unit. All its 61 member banks have to use this platform to coordinate cross-banking syndicated loans. The platform will support syndicated loans trade as well. Building of this platform is outsourced to third-party companies. Tsinghua Tongfang developed the first phase. The China Government Securities Depository Trust and Clearing Company Limited, also known as Chinabond, is developing the second phase.

- **How the banks are expected to cooperate, differentiate and compete**

  The syndicated loan market development can take place faster by means of the platform.

  However, issues raised by participants of the CBA Loan Syndications and Trading Association are:

  - Pricing of syndicated loans depend highly on the bargaining power of the leading bank.
  - After negotiation with clients, it decides the price range and other participants will decide whether to accept – based on their own profit-risk level.
  - Prices depend on competitive capability of each participant although syndicated loans are highly standardized.
  - How will they differentiate themselves from the competition? If they enter the system, will competition not be at risk?

  We believe that the system is a safety measure to distribute credit risk, protect liquidity of the banks and keep up orderly collaboration in the syndicated credit marketplace. This is as opposed to damaging rivalry that leads to harm, rising NPLs and write-offs as well as economic slowdown. This will provide good opportunities for the development of the syndicated loan businesses of banks through active participation in projects through the system including constructing the working mechanism to enhance their bargaining powers. The winning banks are ones that have full visibility into their exposures, cash flows and profitability as well as cost-efficiently service deals.

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