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AMTD 尚乘
Equity Research

China Rural Banks

Sector report

New urbanization, new growth engine

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A top-down + bottom-up study on rural banks

Not much has been written on rural banks in China, given their relatively small sizes and low publicity. But, they are in fact as a whole not that small, with a 12-13% share of banking system assets. This is slightly bigger than that of Industrial and Commercial Bank of China (ICBC). In this report, we look at the macro level data as well as bottom-up financial data of rural banks, in an attempt to provide better insight on their performance trends, challenges they are facing and future opportunities.

Rural banks target local small & micro enterprises and rural lending

To differentiate from other types of banks, rural banks target on loans to small & micro enterprises and rural lending. Financial inclusion in these two segments have been on the top reform agenda of Chinese government. Favorable policies and improving financial infrastructure on rural lending and lending to small & micro enterprises support the fast balance sheet expansion of rural banks in recent years. We expect this trend to continue in the next few years.

Opportunities arise from the new-type urbanization plan

The opportunities arising from the new urbanization plan for rural banks include: 1) financing demand for urban infrastructure projects in the form of bank loans as well bond financing; 2) developer loans in the new sub-cities and towns; 3) financing demand for industry upgrade along with the urbanization; 4) housing mortgage demand by rural migrants; 5) personal consumption loans by the rural migrants; and 6) wealth management service demand.

Branch productivity, intermediary businesses and risk pricing have room to improve

We find out that rural banks have lower branch productivity compared to other banks. Rural banks tend to have lower revenue contribution from intermediary business. With on-going urbanization and financial disintermediation, rural banks should focus on product innovation and diversification. Improving risk management system with accumulation of credit data give the rural banks good potential to improve their loan risk pricing capability thus risk-adjusted returns on loans.

Profitability diverges; reflecting different operating efficiency

We take a closer look at the operating data of the top 15 rural banks in China. While rural banks in general have lower profitability than other banks, their performance diverged in recent years. Some leading rural banks have demonstrated much stronger risk pricing, fee generating capabilities and cost efficiency.

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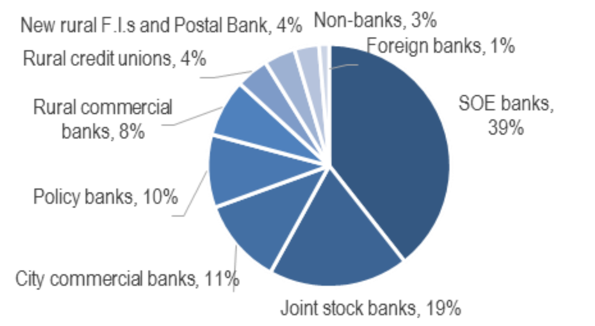
Supporting policies led fast growth

A less explored banking segment

Not much has been written on rural banks, given their relatively small sizes and low publicity with only a few being listed on the stock exchanges. But, they are in fact as a whole not that small, with a 12-13% share of banking system assets. This is slightly bigger than that of Industrial and Commercial Bank of China (ICBC).

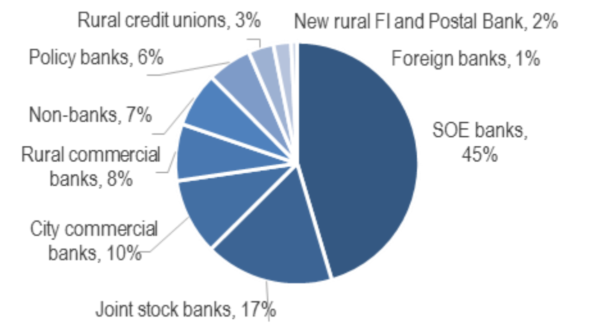
Rural banks include rural commercial banks, rural credit unions and rural cooperatives. Rural commercial banks in China were formed from restructuring and mergers between small rural credit unions in an attempt to improve their corporate governance and operating efficiency. Their sizes in general are much bigger than that of rural credit unions. There were 859 rural commercial banks in China as of 2015. They accounted for 8% of banking system assets as of 2016. There were around 1,200 rural credit unions still yet to be restructured into rural commercial banks as of 2016. They accounted for another 4% of banking system assets.

Figure 1: China banking system asset market share (2015)



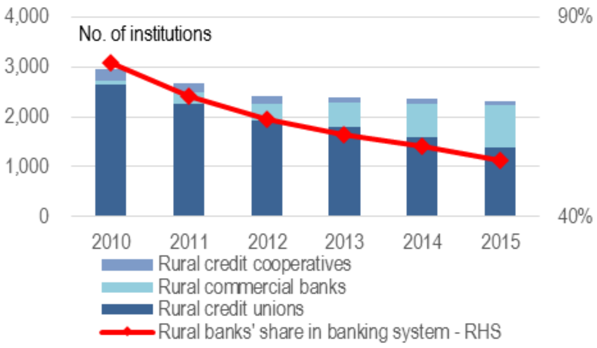
Source: PBOC, CBRC

Figure 2: China banking system net profit market share (2015)



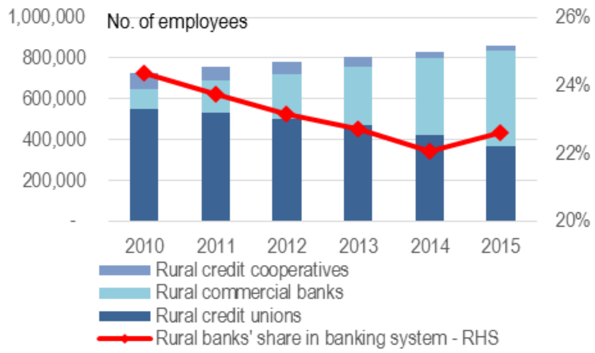
Source: PBOC, CBRC

Figure 3: Rural banks account for 54% of banking institutions



Source: PBOC, CBRC

Figure 4: Rural banks account for 23% of banking employees

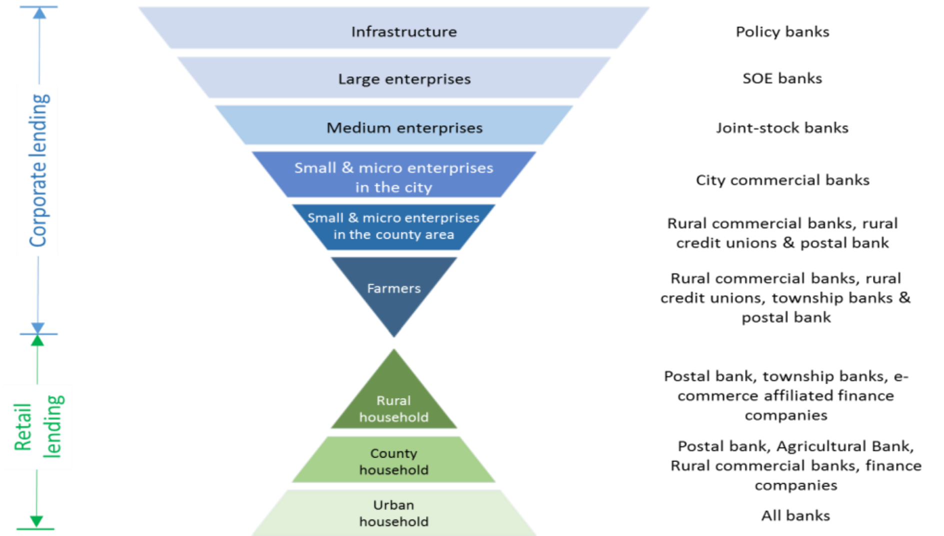


Source: PBOC, CBRC

Rural banks target local small & micro enterprises and rural lending

Rural banks' major shareholders include local governments, local corporates and individuals including farmers and employees. They are regionally focused and mainly serve small & micro enterprises and private businesses in less developed cities and in the county area. They also dominate the lending to agriculture industry, and the rural areas. Since the first rural commercial banks were established in 2001, the rural commercial banks have gone a long way in enhancing their internal control, improving their risk management system and operating efficiency.

Figure 5: Lending market segmentation (2015)

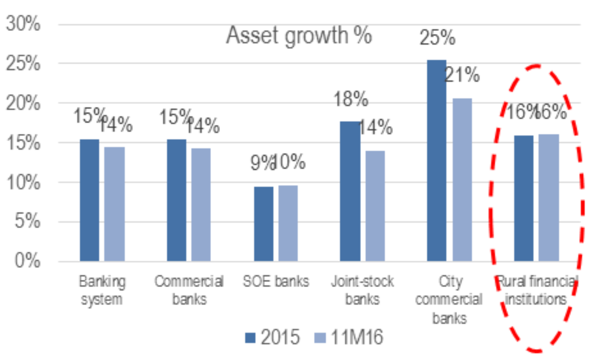


Source: PBOC, CBRC

Strong asset growth

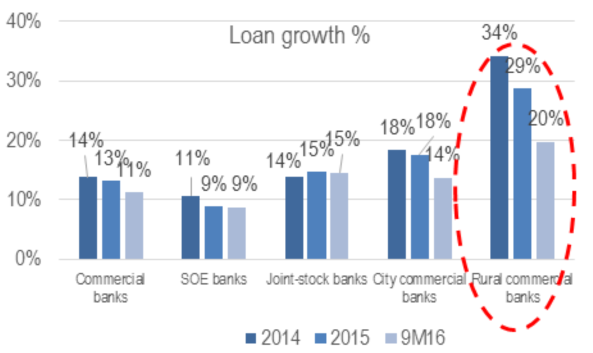
Due to supporting policies to rural lending and SME lending, rural banks have maintained relatively fast loan growth in recent years. In 2015/11M16, their total assets grew by 16%/16%, vs SOE banks at 9%/10%. However, their asset growth is much slower than that of city commercial banks, due to relatively aggressive growth strategy of city commercial banks in interbank assets and investment receivables in their pursuit of short-term profit growth. Rural commercial banks' loans grew by 20% in 9M16 vs 29% in 2015 and 34% in 2014. However, this loan growth could be partially inflated due to formation of new rural commercial banks from rural credit unions.

Figure 6: Rural financial institutions maintained relatively fast asset growth



Source: PBOC, CBRC

Figure 7: Rural commercial banks loan growth



Source: PBOC, CBRC; Note: Rural commercial banks' loan growth may be inflated by formation of new rural commercial banks from rural credit unions.

Supporting policies to promote financial service to rural area and to SMEs

In order to further improve the accessibility of banking services to county/rural area and to SMEs, a series of favorable measures were carries out by Chinese government. These include a lower required reserve ratio for rural banks, lower business tax/VAT rates for rural loans and lower investment threshold for township banks etc. In addition, many policies are carried out aiming to support the development of the agriculture industry, rural household, county economy and push forward the new-type urbanization.

The Central Rural Work Conference held at end of 2016 put the supply-side reform of agriculture industry in the center of rural policies. The policy highlights of this conference include improving the economics of scale of agriculture industry, boosting the rural household income, and pushing forward the new type of urbanization.

The Opinions on Intensifying Reform and Innovation to Accelerate the Modernization of Agriculture (关于加大改革创新力度加快农业现代化建设的若干意见) issued by the State Council in February 2015 specify the requirements on promoting the reform of rural financial systems and driving financial resources to further lean towards Sannong (rural area, agriculture, farmers) issues. The Opinions require that commercial banks ensure the continuous increase in total amount of agriculture-related loans and also no decline in the proportion of agriculture-related loans to total loans, optimize the structure of agriculture-related loans and encourage various commercial banks to introduce financial services for Sannong.

The Number One Document issued by China Central Government in 2016—Opinions on Implementation of New Development Philosophy and Accelerating Modernization of Agriculture to Build a Well-off Society (关于落实发展新理念加快农业现代化实现全面小康目标的若干意见) encourages financial institutions focusing directly on the issue of providing financial services to county areas and transferring financial resources in favour of county area economic growth in order to build up a multi-level, wide-coverage and sustainable rural financial service system, develop rural inclusive finance, lower financing costs and fully activate the rural financial service system.

Preferential policies to promote banking services for small and micro enterprises

The Chinese regulators, including the State Council, PBOC and CBRC, have been guiding the banking industry with policies encouraging the provision of financing to small and micro enterprises.

The so-called “three no-lower targets” policy stipulates that banking financial institutions shall ensure that (i) the growth rate of loans to small and micro enterprises shall not be lower than the average loan growth rate; (ii) the growth rate of total loans to small and micro enterprises shall not be lower than that of the same period of the preceding year; and (iii) the loan approval rate of small and micro enterprises shall not be lower than that of the preceding year. Other policies include:

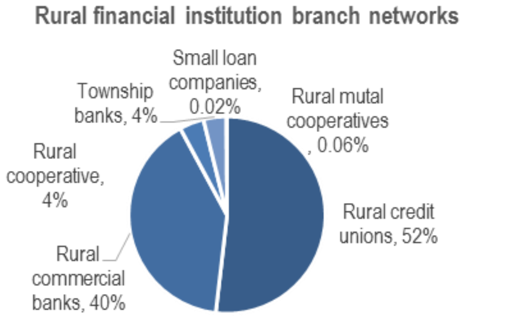
- The RMB statutory deposit reserve requirement ratio for commercial banks with loans to small and micro enterprises exceeding a certain level would be 1 percentage point lower than otherwise required.
- Lending to qualified small and micro enterprises enjoys a relatively lower credit risk weighting of 75%, compared to 100% for normal corporate loans.
- PBOC offers special central bank discount quota in order to increase lending to small and micro enterprises, usually at lower interest rates. When the special scheme was announced in 2014 the loan quota was 50 billion RMB nationally; in 2015 another 50 billion RMB quota was added.
- Approved commercial banks can issue financial bonds to fund their lending to small and micro enterprises.
- Commercial banks are encouraged to set up special business units (SBUs) to provide flexible and effective financial services to small businesses and optimize loan-granting process.
- For commercial banks with credit to small and micro enterprises surpassing a required level, certain restrictions on their outlet expansion would be relaxed.

Competitive landscape in rural lending

There are different layers of players in rural lending in China.

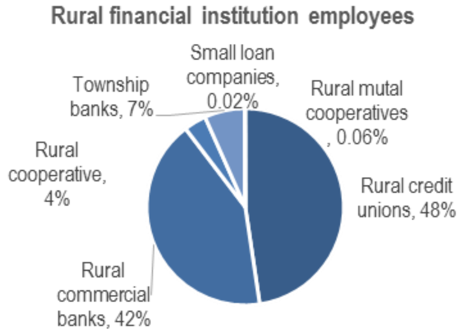
- Rural banks including rural commercial banks, rural credit unions, rural cooperatives. They are the largest group of lenders to farmers and agriculture industry, with the biggest branch networks in the rural areas.
- New types of rural financial institutions: Township banks, small loan companies and rural mutual cooperatives. These institutions are formed with lower investment threshold since 2006 under a series of favorable policies issued by PBOC and CBRC. They tend to focus on small amount of lending in rural areas.
- Policy banks such as China Agricultural Development Bank, China Development bank. These banks focus on infrastructure lending to the rural areas, normally carried out with policy missions rather than on commercial terms.
- Large SOE banks such as Agricultural Bank of China and China Postal Bank also have significant lending to the rural areas due to their large branch networks in the rural/county areas.

Figure 8: Rural financial institutions branch network breakdowns – rural credit unions and rural commercial banks account for 92% of branches



Source: PBOC, CBRC

Figure 9: Rural financial institutions employees

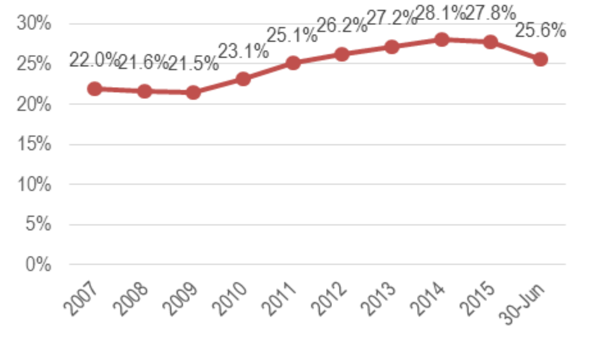


Source: PBOC, CBRC

Rural banks dominate rural lending market

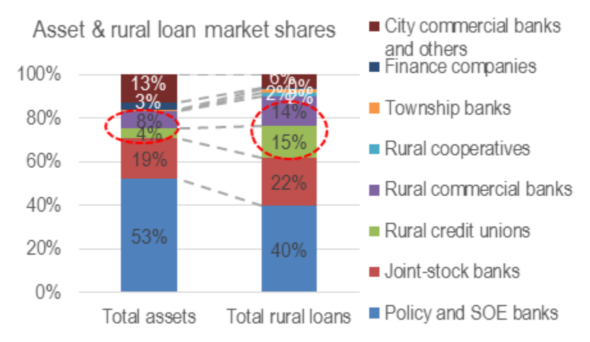
PBOC's definition of rural loans include loans to agriculture industry, loans to farmers and loans to the rural/county areas but not to agriculture industry or farmers. Due to supporting policies and fast development of the county/rural areas in recent years, rural loans as a share of total banking system loans gradually climbed to 25.6% at Jun-16, from 22.0% in 2007. Policy banks and SOE banks are still the major type of lenders of rural loans due to their large balance sheet. Rural commercial banks and rural credit unions are the second largest group of lenders of rural loans. They accounted for 29% of banking system rural loans as of 2014, while their assets only accounted for 12% of banking system assets.

Figure 10: Rural loans as % of total loans – China banking system



Source: PBOC, CBRC

Figure 11: Rural commercial banks and rural credit unions are very important source of supply of rural loans, 2014



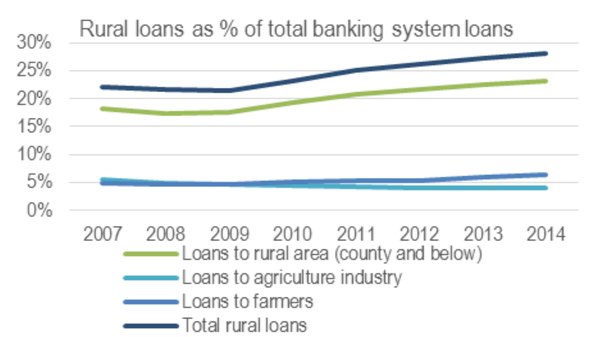
Source: PBOC, CBRC

Rural lending not so "rural"

For the banking industry as a whole, loans to agriculture industry and to farmers' shares in banking system loans remained stable from 2007 to 2014 at 5-6%. On the other hand, loans to rural areas as % of total loans gradually climbed from 18% in 2007 to 23% in 2014. We believe this still reflected a lack of willingness for the banks to lend to farmers and agriculture industry due to the volatile nature of agriculture industry and also due to lack of credit history or collaterals of farmers. Loans to rural areas on the other hand, mainly include loans to SMEs at the county level not necessarily related to agriculture industry which are still the preferred borrowers by commercial banks.

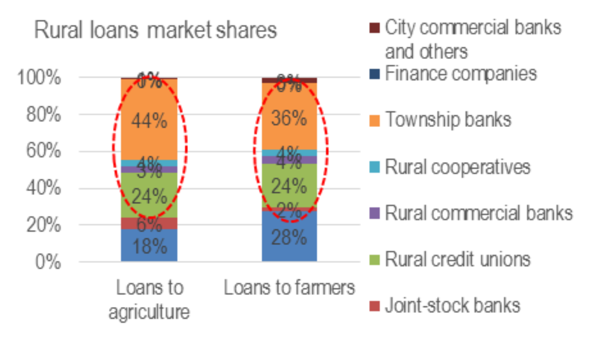
Rural banks are still the largest group of lenders to agriculture industry and farmers. Their market share in loans to agriculture industry was 75% and market share in loans to farmers was 67% in 2014. Notably rural credit unions and township banks are the largest lenders to agriculture industry and farmers. However, loans to farmers and agriculture industry as % of their total loans remained low at 17%.

Figure 12: Rural loans include loans to agriculture industry, loans to farmers and loans to the rural areas



Source: PBOC, CBRC

Figure 13: Rural banks are the largest group of lenders to farmers and agriculture industry



Source: PBOC, CBRC

Operational comparison with other types of banks

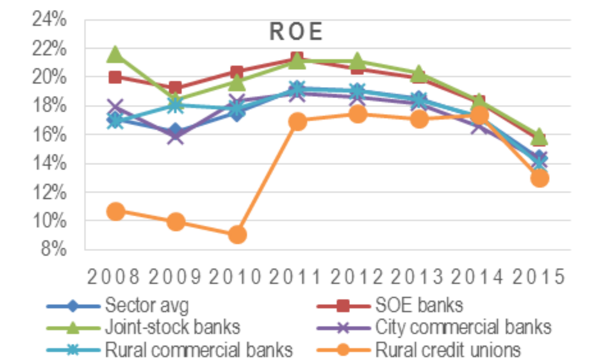
ROE at similar level as city commercial banks

Rural commercial banks' ROEs have been similar to that of city commercial banks. Compared to national banks such as SOE banks and joint-stock banks, rural commercial banks in general have relatively weak ROEs. We believe this is attributable to a smaller fee income business, lower operating efficiency and their lower balance sheet leverage.

In terms of ROA, rural commercial banks had maintained the highest ROA in the sector before 2015. However, they experienced a big drop in ROA in 2015. This is likely due to the impact of interest rate liberalization which posed bigger pressure on rural banks' funding costs which were lagging behind. Also rural banks may have experienced bigger asset quality pressure in 2015 as demonstrated by their faster increase in NPL ratio (Figure 27).

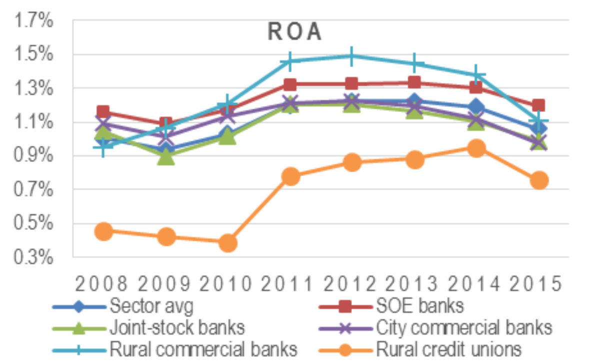
On the other hand, rural credit unions' ROEs and ROAs have been at the bottom of the banking system. This is likely due to their weaker corporate governance and risk management system.

Figure 14: Rural commercial banks' ROE have been in line with that of city commercial banks, but lower than that of SOE and joint-stock banks



Source: PBOC, CBRC

Figure 15: Rural commercial banks maintained the highest ROA, until 2015 when rural commercial banks' ROA more than that of other types of banks



Source: PBOC, CBRC

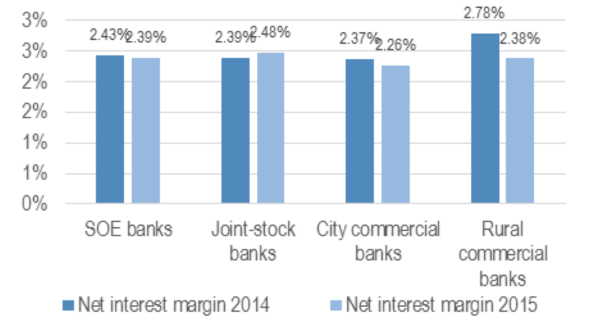
We aggregate the financial data of leading banks including 5 SOE banks, 3 national joint-stock banks, 16 city commercial banks and 15 rural commercial banks. Rural commercial banks' ROE was only slightly lower than that of the other three categories. However, their ROA in 2015 was only lower than that of SOE banks, but higher than that of joint-stock banks and city commercial banks.

Net interest margin under pressure in the near term

Rural commercial banks' net interest margin in 2015 was similar to that of SOE banks, higher than city commercial banks but lower than joint-stock banks. This may also be restricted by their relatively low LDR and lower allocation to higher yielding assets such as loans and investment receivables. However, as loan growth each year is still under strict supervision in a quasi-quota system, it is unlikely that we see rural commercial banks' LDR to pick up in the near future. Due to poor disclosures of unlisted rural commercial banks in their annual reports, we calculate their asset yield and funding cost over simple average of assets.

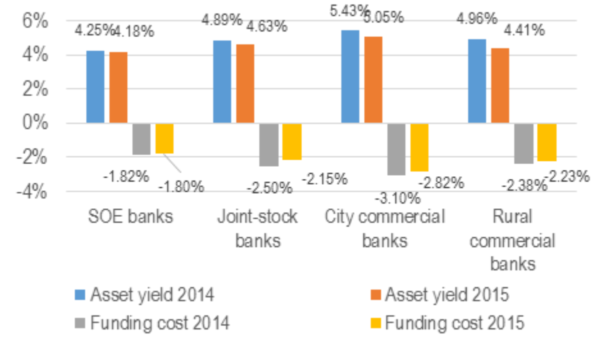
In 2015, rural commercial banks' average net interest margin (net interest income divided by average assets) dropped by 40bps, much faster than other banks (Figure 16). This was driven by a bigger drop of asset yield. We believe this was likely because a bigger portion of rural commercial banks' loans are short-term loans to SMEs which have bigger interest rate elasticity during the rate cuts during 2014-2015, therefore were repriced aggressively lower.

Figure 16: Rural commercial banks experienced the biggest NIM pressure in 2015



Source: Company annual reports

Figure 17: Asset yield vs funding cost

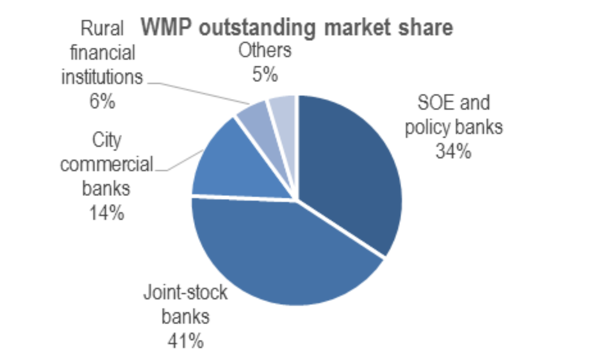


Source: Company annual reports

Rural banks' wealth management products are lagging behind

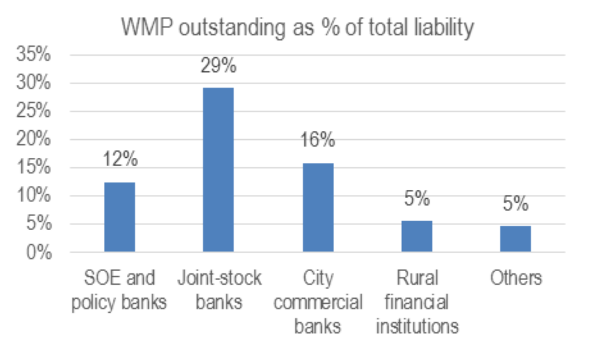
As of June 2016, rural banks outstanding wealth management products were Rmb 1.4 trn, only 5% of their total liability. This compares to 12% for SOE banks and 29% for national joint-stock banks. Further development of their wealth management products can on one hand increase their fee income, but on the other hand pose pressure on their deposit cost. However, we believe increasing origination of WMP by rural banks are an unavoidable trend and banks with good products can enjoy better stickiness of their retail customers.

Figure 18: Rural banks market share in WMP is small (Jun-2016)



Source: Chinabond.com

Figure 19: Rural banks WMP as % of total liability is low



Source: Chinabond.com, CBRC

Weakness in fee income business

In general, rural commercial banks tend to rely more on the traditional deposit – lending spread business with a smaller fee income business. As a result, rural commercial banks' non-interest income expressed as a % of revenue was only slightly higher than that of city commercial banks but much lower than SOE banks and joint-stock banks.

We believe the low revenue contribution from fee income businesses are attributable to relatively low demand for capital market service, relatively low awareness of wealth management products and lack of attractiveness of bank cards issued by rural banks at the moment. However, this is also one of the key areas for improvement.

Figure 20: Key profitability ratio comparison across different types of banks

2015	Net interest income to avg assets	Non-interest income to revenue	Revenue to avg asset	Cost-income ratio	Credit cost as % of avg loans	LDR	ROA	ROE	Asset to equity (x)
SOE banks	2.39%	24%	3.13%	37%	0.83%	74%	1.17%	15.8%	13.4
Joint-stock banks	2.48%	31%	3.57%	34%	1.98%	79%	1.02%	15.8%	15.5
City commercial banks	2.26%	16%	2.69%	34%	1.41%	63%	0.98%	15.9%	16.3
Rural commercial banks	2.38%	17%	2.88%	39%	1.08%	55%	1.03%	15.4%	14.9

Source: Company annual reports

Loan book mix – Higher exposures to small & micro enterprises

Compared to other types of banks, rural commercial banks' retail loans account for a much smaller portion in total loans. On the other hand, they had higher exposures to corporate loans as well as discounted bills in 2015.

Corporate loans- Higher exposures to SMEs & micro enterprises

The corporate lending of rural commercial banks has showed clear preference over local SMEs & micro enterprises. This is reflected in their higher exposures to manufacturing, wholesale & retail, and service sectors. They are the leading force of loans to agricultural industry. Township banks owned by rural commercial banks and city commercial banks are the biggest lenders to farmers. This is how rural commercial banks differentiate themselves from city commercial banks and other national banks. As a result, we would see higher exposures to manufacturing industry, wholesale &retail and service industry where SMEs and micro enterprises have high presence. Their loan book's industry mix is also closely related to the industry structure of local economy.

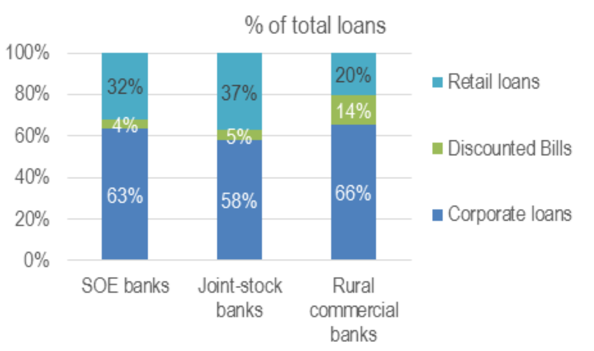
Discounted bills

Rural commercial banks in general have higher discounted bills on their balance sheet. Discounted bill business is an important part of their treasury business. Due to tightening of the rules on discounted bills by CBRC, many banks have shifted their reverse repo assets backed by discounted bills into buy-out discounted bills which are properly counted for in loan quota management and capital charges. As a result, we observed a sudden increase in discounted bills in 2015-2016 with a shrinking balance in reserve repos.

Retail loans

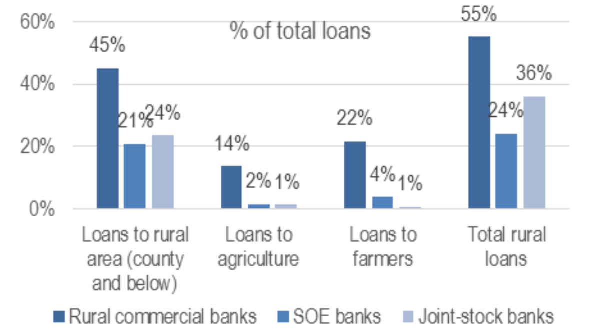
Rural commercial banks tend to have smaller exposures in retail loans due to relatively weak mortgage demand, credit card usage. However, their loans to personal business/farmers as a share in total loans are much bigger than that of SOE banks and joint-stock banks. With the new urbanization and settlement of home-coming migrant workers, we see huge growth potential for the mortgage demand. It is vital for the rural banks to seize such opportunities.

Figure 21: Loan book mix comparison (2015) – Rural banks have much lower portion in retail loans



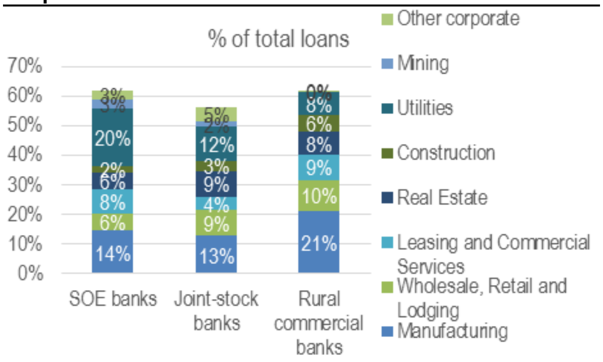
Source: Company annual reports

Figure 22: Rural commercial banks still have high exposures to loans to farmers and agriculture (2014)



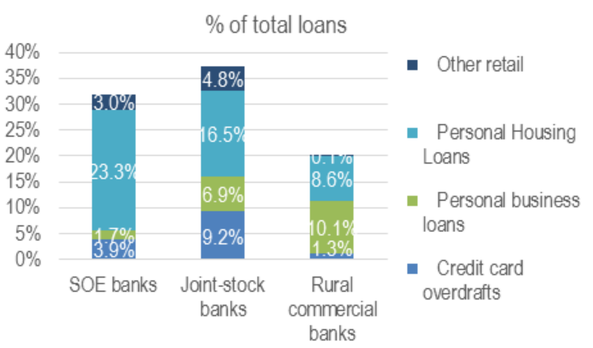
Source: PBOC, CBRC

Figure 23: Corporate loan mix (% of total loans, 2015) – Rural commercial banks have significant higher exposures to SMEs



Source: Company annual reports

Figure 24: Retail loan mix (% of total loans, 2015) – Rural commercial banks have smaller exposure in retail loans



Source: PBOC, CBRC

Branch productivity has room to improve

Operating efficiency is the weak link of rural commercial banks. Rural commercial banks in general have higher cost-income ratio. This is due to more of their branches are spread out in less developed rural area with less population and wealth density.

Low branch productivity

If we look at branch productivity, rural commercial banks asset per branch in 2015, was only 25-30% of that of city commercial banks and joint-stock banks, 62% of that of SOE banks. On the other hand, rural commercial banks are not able to keep their operating cost per branch proportionately lower. This is likely because rural commercial banks are mainly lending to SMEs in county areas, which is much more labor-intensive than lending to larger enterprises. In addition, the top 15 rural commercial banks are mainly located in more developed regions where labor cost and leasing cost are still relatively high. As a result, rural commercial banks cost-income ratio in 2015 was on average 39%, 5 percentage point higher than that of joint-stock banks and city commercial banks.

Figure 25: Branch productivity comparison across different types of banks

2015, Rmb m	Asset per branch	Loans per branch	Deposits per branch	Number of employees per branch	Revenue per branch	PPOP per branch	Operating cost per branch	Profit per branch
SOE banks	1,386	726	966	26	40	25	15	15
Joint-stock banks	3,432	1,683	2,182	42	111	73	38	32
City commercial banks	3,045	1,055	1,813	31	72	48	24	26
Rural commercial banks	853	399	618	14	24	15	9	8

Source: Company annual reports

Employee productivity

Employee productivity shows a slightly different picture. As rural banks branches operate on a leaner basis with much smaller number of employees per branch, their asset per employee in 2015 was even higher than that of SOE banks, and was round 67-77% of that of joint-stock banks and city commercial banks. To our surprise, rural commercial banks staff cost per employee was 36% higher than that of SOE banks, similar to that of city commercial banks and only 15% lower than that of joint-stock banks. This also explains why rural commercial banks have higher cost-to-income ratio – in order to compete for talents, they are willing to offer competitive pays. In a way, it also shows that the majority of rural commercial banks' business are probably not so "rural".

Figure 26: Employee productivity comparison across different types of banks

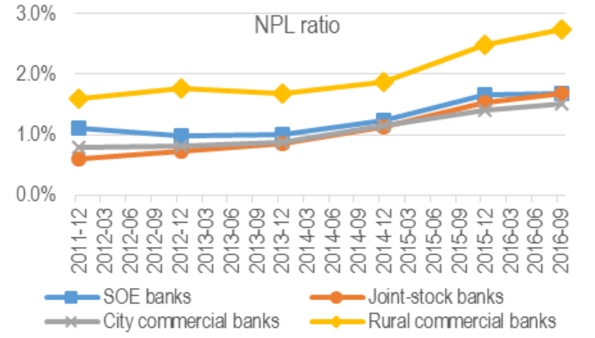
2015, Rmb m	Asset per employee	Loans per employee	Deposits per employee	Revenue per employee	Staff cost per employee	Operating cost per employee	PPOP per employee	Profit per employee
SOE banks	53	28	37	1.54	0.25	0.58	0.96	0.57
Joint-stock banks	81	40	52	2.61	0.40	0.89	1.72	0.74
City commercial banks	95	33	56	2.24	0.33	0.75	1.49	0.83
Rural commercial banks	63	29	46	1.73	0.34	0.66	1.07	0.59

Source: Company annual reports

Asset quality

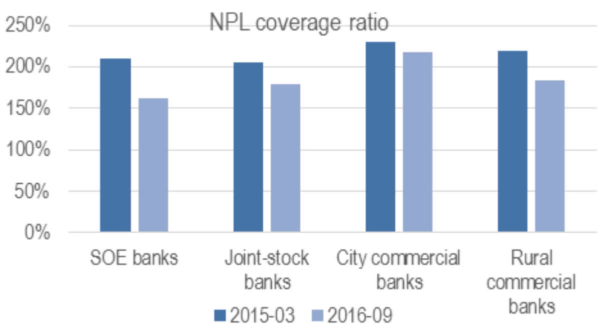
Due to historical legacy, rural commercial banks' NPL ratios have been higher than other banks. During 2015-2016, their NPL ratio experienced faster increase than other banks. We believe this is likely because SMEs and micro enterprises are more vulnerable in an economic downturn. Also their legacy lending may have also played a role. In addition, their internal control and risk management may need to be strengthened further.

Figure 27: Rural banks NPL ratio climbing faster than other banks



Source: WIND

Figure 28: Rural commercial banks' NPL coverage ratio remained relatively high levels



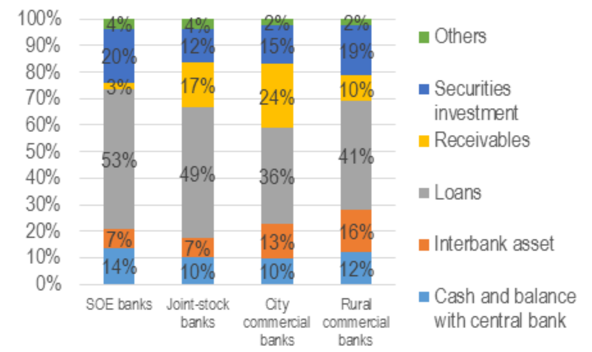
Source: PBOC, CBRC

Balance sheet mix relatively conservative

Rural commercial banks' asset mix is characterized as low allocation in loans, relatively high allocation to interbank assets and small allocation to investment receivables. Constrained by their low LDR and supervision on loan growth, rural commercial banks allocate their excess liquidity into securities investment and interbank assets. Their allocation to investment receivables which normally include quasi-loan assets (also known as non-standard assets) is relatively low compared to joint-stock banks and city commercial banks.

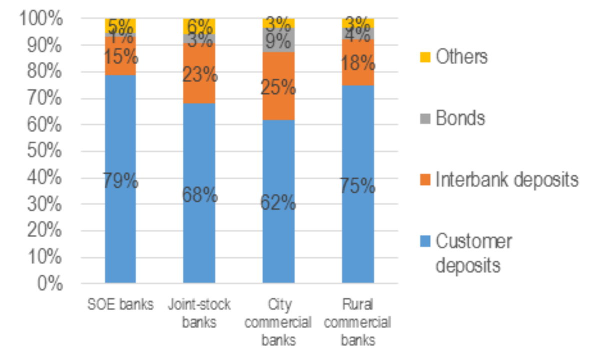
On the liability side, rural commercial banks tend to rely more on deposits. Customer deposits accounted for 75% of rural commercial banks' liability, similar to that of SOE banks, much higher than that of joint-stock banks and city commercial banks.

Figure 29: Asset mix comparison 2015



Source: Company annual reports

Figure 30: Liability mix comparison 2015



Source: Company annual reports

New urbanization, new growth

China central government's new-type urbanization plan focuses on the proper settlement of rural population in new sub-cities/towns and improving their social benefit and standard of life. The opportunities embedded in this new urbanization plan provide rural banks opportunities to boost their branch productivities, fee income and retail banking business.

Opportunities for corporate banking

1. **Urban infrastructure projects:** The new-urbanization plan revolves around the settlement of rural population in the sub-cities/towns. China has a rural population of 900 million currently. The urbanization plan will involve expansion of existing sub-cities/towns as well as formation of new sub-cities/towns. This will create the need for more infrastructure and utilities service which cannot be simply covered by fiscal budget. The funding gap can be filled in by bank loans as well as infrastructure bonds. This implies growth potential for bank loans as well as investment banking business. Example of the new projects include roads, water/gas/electricity supply, solid waste treatment etc.
2. **Developer loans:** Some of the rural migrants will have the capability and demand for housing, which creates a huge demand for properties in lower-tier cities and sub-cities/towns and growth opportunities for developers. This will include financing demand for urban reconstruction, social housing construction, etc.
3. **Industry upgrade:** With the settlement of rural migrants, existing industries are facing growing demand for better quality, high value-added products and services. As a result, they may need to upgrade their production facilities and equipment to produce better products and provide better services. This includes the modernization of the agriculture industry; the upgrade of tertiary industry including financial services, leisure & entertainment, logistics, etc; the manufacturing industry moving up the value chain.
4. **Small & micro enterprises and personal businesses:** The rural migrants may seek employment or start their own business in the new city/town. As a result, we may see a growing number of small & micro enterprises and personal businesses started along with the urbanization progress. They may need working capital or loans to purchase equipment from the banks.

Opportunities for retail banking

1. **Payment services:** With better availability of merchants and products and increasing popularity of e-commerce in the rural area, the consumption pattern of rural migrants should change into a more urbanized life style. As a result, their use of bank cards and internet payment service should increase. This provides big growth potential for the banks' payment business.
2. **Personal consumption loans:** The rural migrants may also have the need for unsecured consumption loans with the upgrade in their consumption pattern.
3. **Wealth management services:** Currently, bank deposits are still the primary form to stock wealth for the rural household. However, rural household could gradually accept wealth management products issued by banks that they are familiar with. This gives the rural banks opportunities to expand their wealth management fee income and better retain their rural retail customers. Currently, WMP outstanding for rural banks only account for 5% of their total liability, much lower than that of other banks.
4. **Housing mortgage:** Rural migrants with stable income will have financing demand for their housing purchase in the new city/town.

Opportunities and challenges

Opportunities

Improving financial infrastructure for rural lending and small&micro lending

Financial inclusion especially in the rural area and among small & micro enterprises has been put at the top of the reform agenda by policy makers. As e-commerce and internet finance gained ground in the rural area, the credit culture and awareness of financial service is gradually improving. This paves the way for future growth for payment business, wealth management business as well as lending business in the rural area. For small&micro enterprise lending, improved financing infrastructure including centralized credit data, public registration and disclosure of receivables and financial leasing assets is essential to improve funding availability to small & micro enterprises.

Improving rural household income

In recent years, the developing economy and favorable government policies continuously introduced in China have provided county/rural area with major opportunities for household income growth. This provides growth potential in personal consumption loans, payment business and wealth management business, etc.

Scale-up of agriculture industry

With the better implementation of land transfer policy, and scale-up of agricultural land usage, increasing number of relatively large companies in the agriculture industry are formed every year. Compared to farmers or family farm, these larger companies may have better operating efficiency, more invested capital, better management to weather the volatilities in the agriculture industry. This essentially translates into more quality borrowers for the rural banks.

Improve branch productivity by leveraging on e-banking and "smart" outlets

Rural banks have been struggling with low branch productivity in the rural areas. However, the county/rural area is where their strength lies in and should remain their target market. Especially with the rising household income and industrial upgrade in county/rural area. Going forward, they can improve their branch productivity by introducing more outlets equipped with e-banking service with less staff. They can also promote their online banking with more rural households are familiar with the use of internet services. In addition, new communities are forming along with the urbanization, this generate the need for community banking outlets that are designed for the financial needs within the communities.

Challenges

Clear market positioning is needed

Currently, lending to farmers and agricultural industry only account for a small portion of rural banks' loan book. Due to lack of collaterals from farmers, low agriculture insurance coverage, rural banks are unable to significantly increase their rural lending. Instead, they tend to focus on SMEs and micro enterprises in the county area or even in the cities. This in a way, puts rural commercial banks in direct competition with city commercial banks, national joint-stock banks and private capital banks.

Challenges introduced by deposit disintermediation

Rural banks have enjoyed relatively low deposit funding cost due to their wide branch networks in the rural area, and low awareness of wealth management products/internet finance products of rural household. However, this is changing and rural banks' deposit costs are quickly catching up. The rural banks are lagging behind in their wealth management product origination.

Loan risk pricing needs to improve

Rural banks' asset yield experienced relatively fast contraction during the rate cut period during 2014-15, with rising asset quality pressures. We believe there is room for the rural banks to improve their risk pricing of loans in order to improve their risk-adjusted returns on loans.

Reliance on traditional lending business is unsustainable

In general, rural banks' revenue contribution from fee income business is still very small. They still rely heavily on the traditional lending business. However, the financing market in China is quickly shifting from indirect financing (bank lending) to direct financing (capital market financing). Rural banks need to build their capital market underwriting capability as well as investment capability in order to take advantage of this trend.

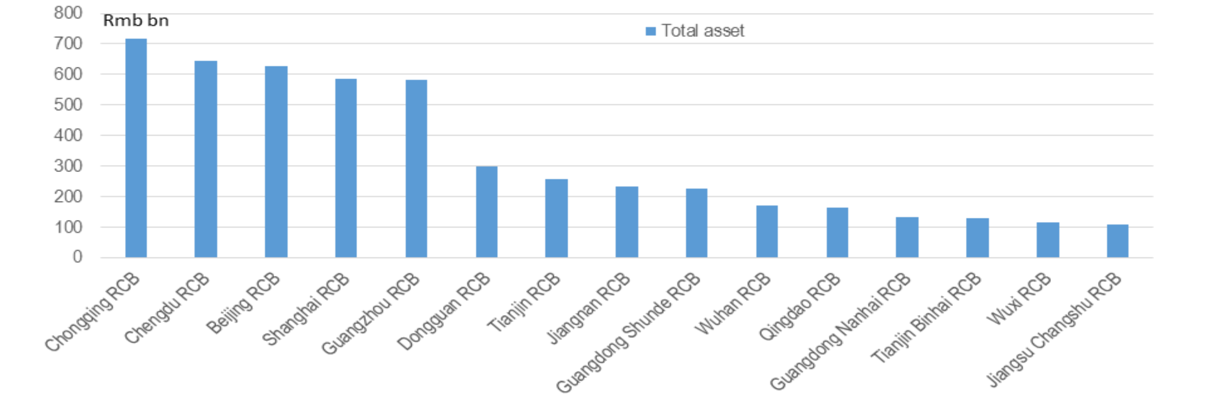
Top 15 rural commercial banks in China

Leading rural commercial banks in China – profitability diverged

Only two rural commercial banks namely Chongqing Rural Commercial Bank (CQRCB) and Jiangyin Rural Commercial Bank (JRCB) are listed on the stock exchanges currently. Only with these two banks, we are able to obtain up-to-date financial information in 2016. For the other banks, our data is based on annual reports that are publicly available on the banks' websites. We listed the top 15 rural commercial banks in China, ranked by total assets in 2015. The top five rural commercial banks had similar ROE in 2015 at around 15%. However, from No.6 – No.15, their ROE varied ranging from below 10% (Tianjin Binhai RCB) to as high as 24% (Dongguan RCB).

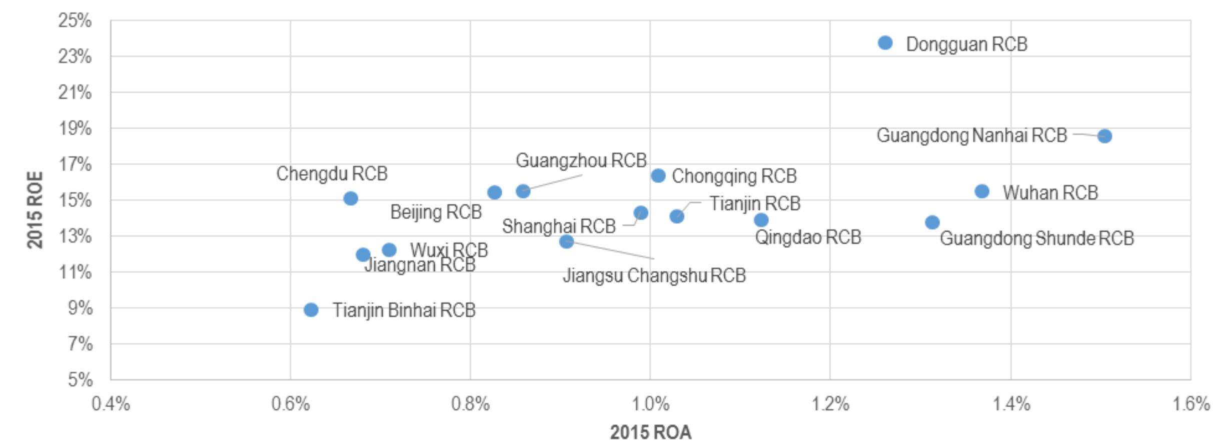
The ROAs showed more variance ranging from 0.6% - 1.5% with banks in Guangdong showing the highest ROA. We will explore the drivers behind this divergence later.

Figure 31: Top 15 rural commercial banks in China, ranked by total assets (2015)



Source: Company annual reports

Figure 32: Top 15 rural commercial banks in China, ROA vs ROE (2015)



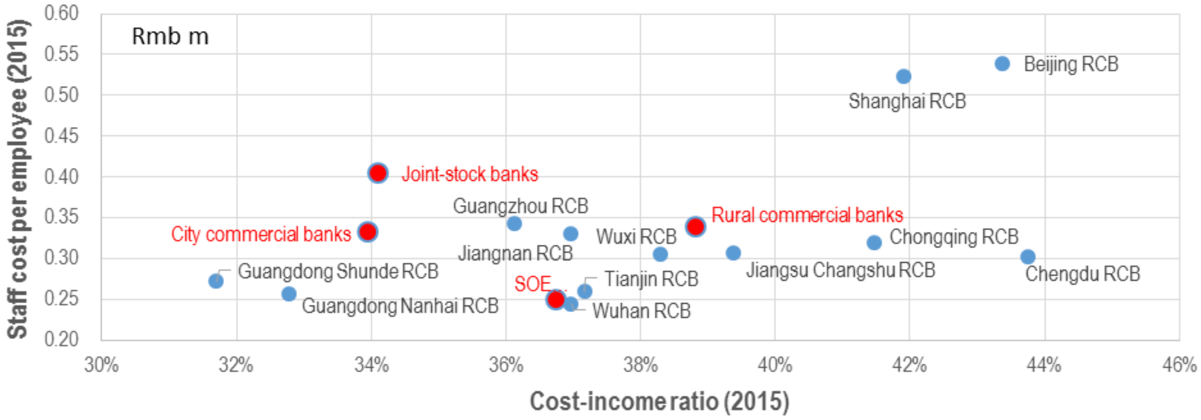
Source: Company annual reports

Productivity and cost efficiency

Staff cost normally account for 50-60% of operating cost for a bank. Therefore, staff cost is an important determinant in a bank's cost efficiency. Naturally banks that operate in more developed regions tend to have higher cost-income ratio. However, a bank's branch productivity as measured by asset per branch or revenue per branch is also an important determinant of a bank's operating efficiency. We can see that rural commercial banks and city commercial banks have very similar staff cost per employee, however, rural commercial banks on average have 39% cost-income ratio vs only 34% for city commercial banks.

Except for Shanghai RCB and Beijing RCB, most of the top 15 rural commercial banks have average staff cost per employee at Rmb 0.25-0.35 million in 2015. However, their cost-income ratio ranged from 32% - 44%. Branch productivity is an more important driver for cost-income ratio.

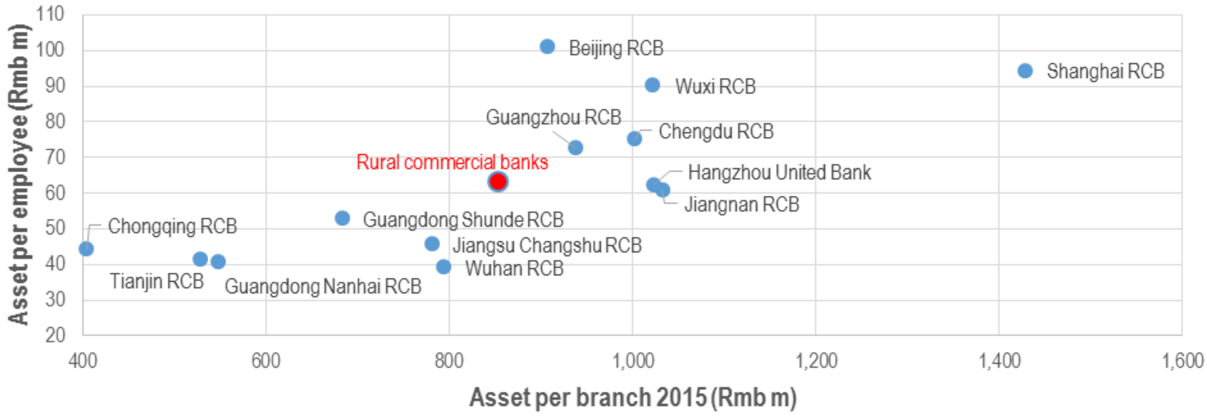
Figure 33: Cost-income ratio vs staff cost per employee



Source: Company annual reports

The branch productivity and employee productivity are very different for individual rural banks. Their asset per branch ranged from Rmb 400m to Rmb 1,400m in 2015. Asset per employee ranged from Rmb 40m to Rmb 100m.

Figure 34: Asset per branch vs asset per employee (2015)

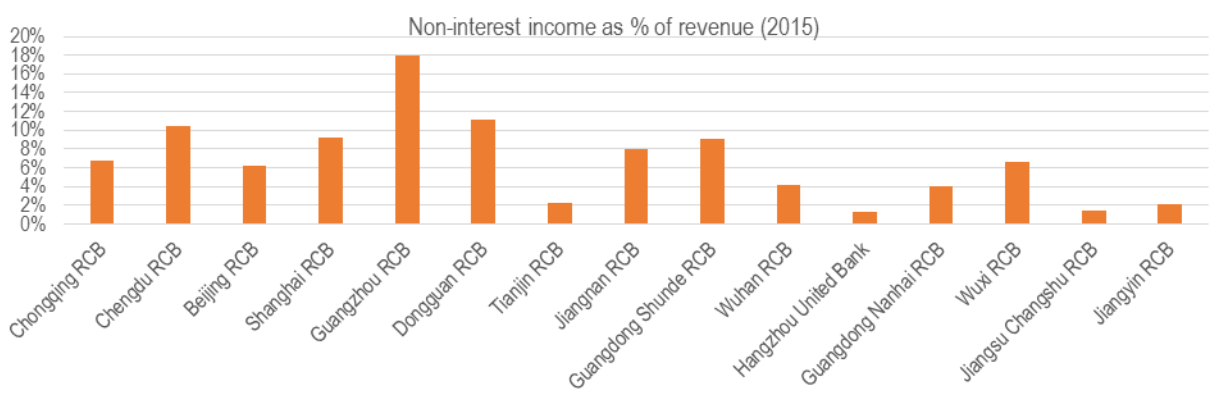


Source: Company annual reports

Intermediary business

In general, rural banks tend to have lower revenue contribution from fee income business. However, some rural banks in Guangdong, Beijing and Shanghai tend to have higher revenue contribution. We believe this is attributable to more direct financing thus higher investment banking fees, and a better developed wealth management product (WMP) market thus higher fee income from WMPs.

Figure 35: Asset per branch vs asset per employee (Rmb m)

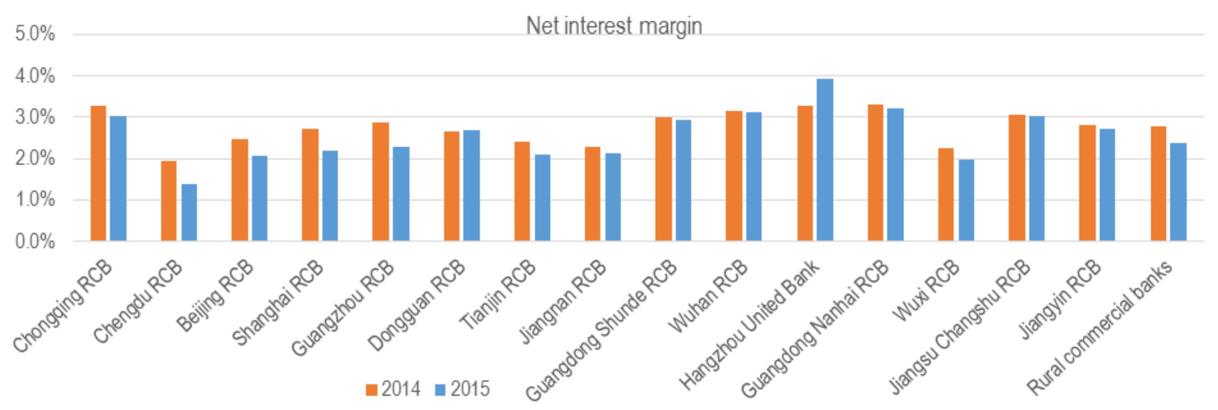


Source: Company annual reports

Net interest margin (NIM) trend

The absolute level of net interest margins as well as their performance also differentiate some rural banks. For example, Chongqing RCB's NIMs have stayed at relatively high levels and experienced only a relatively small contraction in 2015. In comparison, Chengdu RCB's NIM have been at the lower end in the industry and experience a big drop in 2015. This reflects a bank's asset pricing capability and the capability to source stable and low cost funding.

Figure 36: Net interest margin trend also differentiated

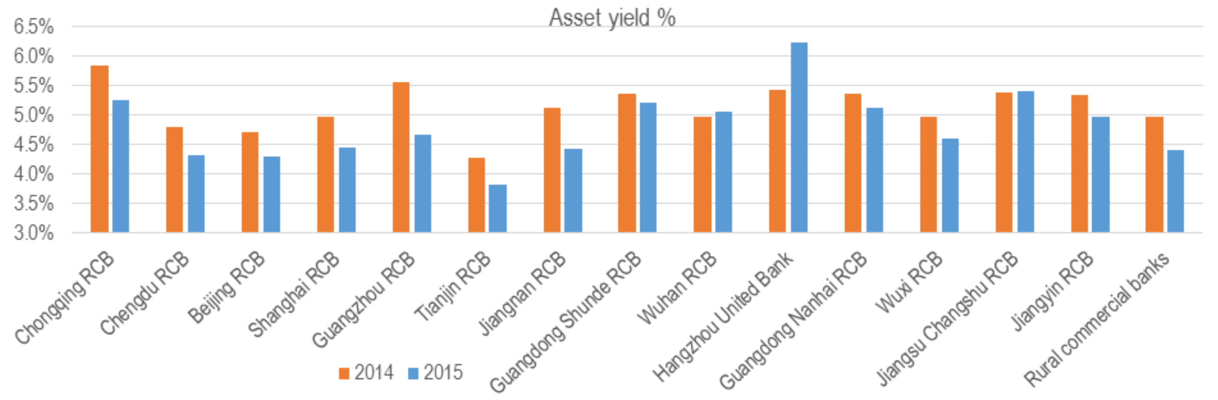


Source: Company annual reports; Note: Net interest margin is calculated as net interest income divided by simple average of total assets.

Asset pricing

Rural banks' asset yield experience more downward pressure than other banks in 2015. However, some rural banks' asset yield was more resilient than others. This could be driven by a faster re-pricing of loans or a shift in asset allocation towards thinner spread assets.

Figure 37: Asset yield trend

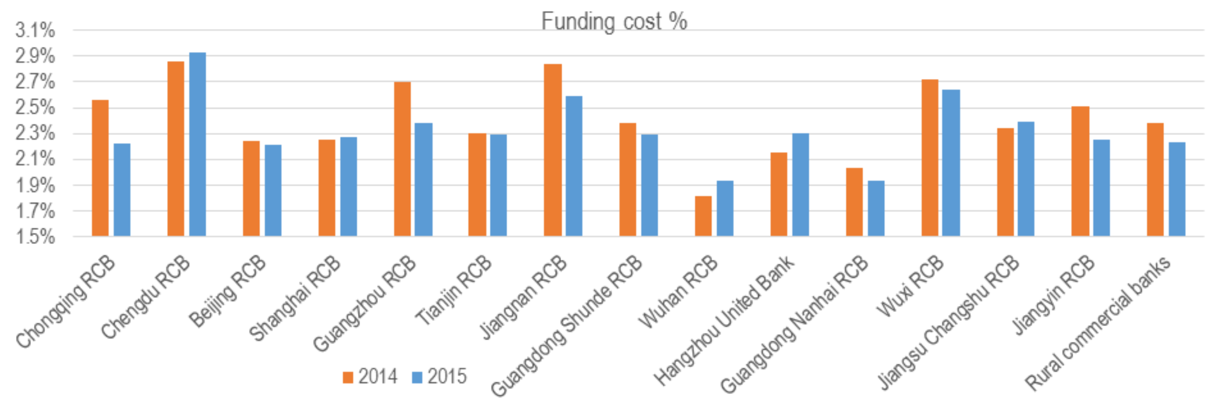


Source: Company annual reports; Note: Asset yield is calculated as gross interest income divided by simple average of total assets.

Funding cost

In general, rural banks' average funding cost is little unchanged or slightly moved lower in 2015. The absolute level of funding costs is an important driver of a bank's NIM. Banks with higher funding cost tend to have lower NIMs, vice versa. For example, Chengdu RCB and Jiangsu RCB have funding cost at the high end in the sector, as a result, their NIMs are also at the lower end in the sector. In contrast, Wuhan RCB and Guangdong Nanhai RCB have much lower funding costs, thus higher NIMs.

Figure 38: Funding cost trend

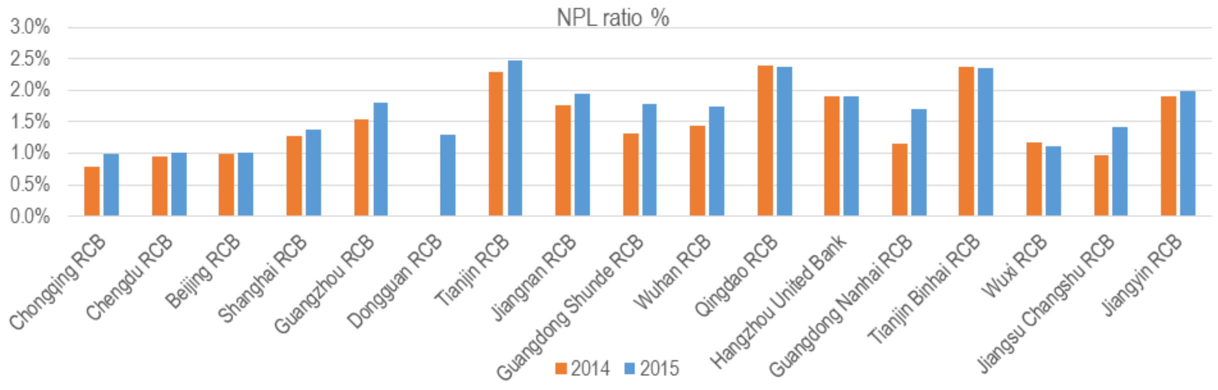


Source: Company annual reports; Note: Funding cost is calculated as gross interest expense divided by simple average of total assets.

Asset quality

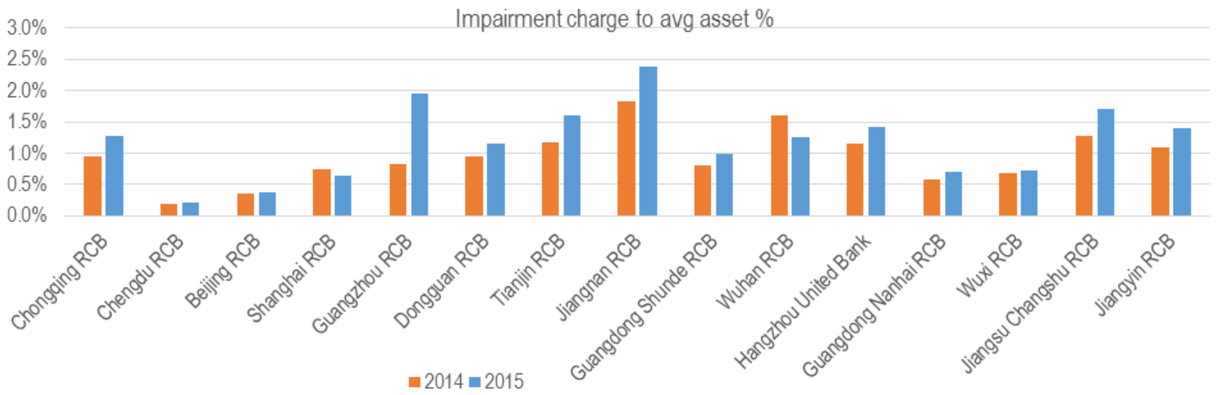
Similar to other banks, rural banks experience a rise in NPL ratio and impairment charges in 2015. Their NPL ratio as of 2015 ranged from 1.0% to 2.5%. Asset quality trend is also a very important performance differentiator. However, a bank's provisioning level as measured by impairment charges to total assets ratio could vary according to a bank's asset quality trend, sufficiency of provision allowance, strength of pre-provisioning profit, as well as expectation of future asset quality trend.

Figure 39: NPL ratios trending up



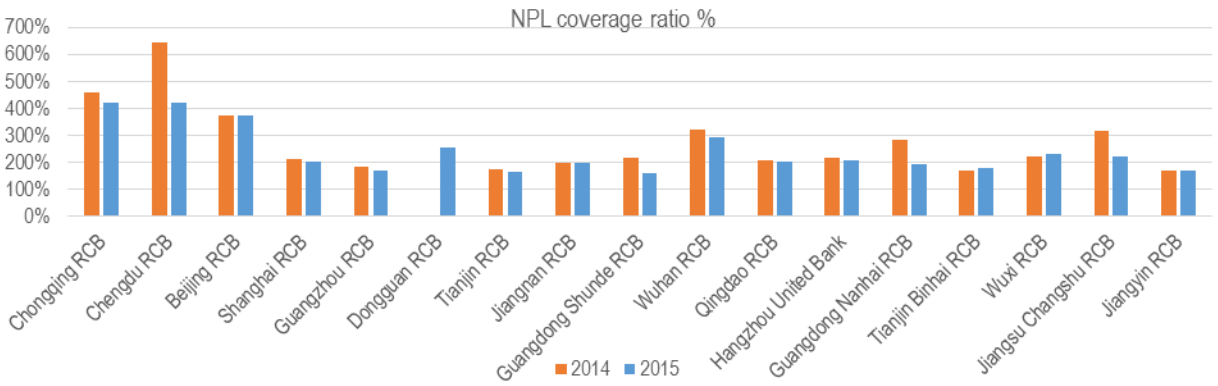
Source: Company annual reports

Figure 40: Impairment charge levels are very different across different banks



Source: Company annual reports; Note: Impairment charges include bad debt charge on loans as well as other assets such as securities investment and interbank assets.

Figure 41: NPL coverage ratio relatively high

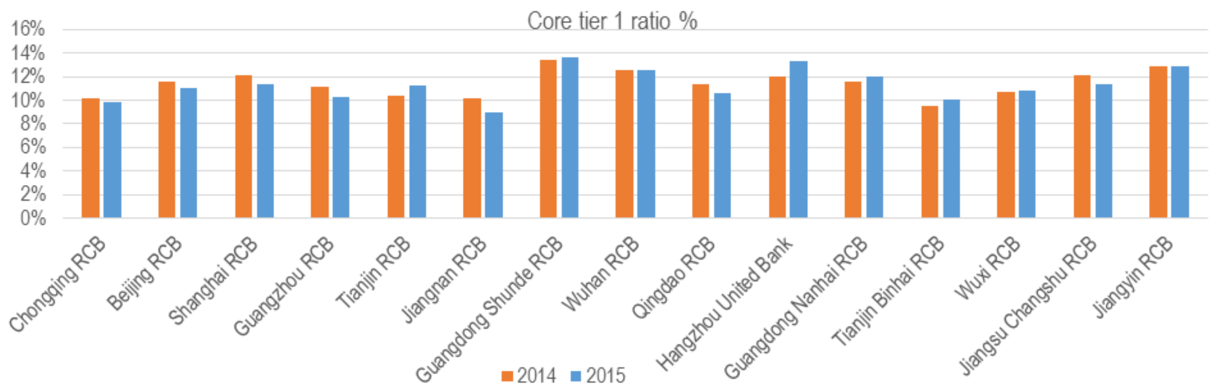


Source: Company annual reports

Capital adequacy

Rural banks in general have higher capital ratios. Most of them had core tier ratio above 10% as of 2015. We believe this is to prepare for their higher asset growth. This is also attributable to their lower LDR ratio and a lower capital charge on small & micro enterprise lending.

Figure 42: Core tier 1 ratio of rural banks are normally high



Source: Company annual reports

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