Challenges Facing the Banking Sector in a Low-Interest-Rate Environment

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Abstract: *Recently, the China Finance 40 Forum and the China Center for International Economic Exchanges jointly held the 6th Bund Summit. During the event, CF40 and Japan's Nomura Research Institute, they co-hosted the CF40-NRI Financial Roundtable, a closed-door seminar.*

Japanese experts emphasized the need to differentiate between the types of challenges facing financial institutions, such as banks. When structural problems in the banking sector are minimal and their profitability remains strong, issues with the balance sheet can be resolved in a timely manner. Currently, while the balance sheets of Japanese banks are relatively sound, they are grappling with declining profitability due to structural changes of economy. Regional banks, in particular, are facing even greater difficulties.

Chinese experts suggested that the banking sector in China should pursue internationalization and diversification to navigate the challenges posed by a low-interest-rate environment. Currently, small and medium-sized local banks are facing increasing competition from larger banks, and they lack the capacity for internationalization and diversified operations, posing significant challenges.

However, simple mergers among banks will not solve these issues. A functional categorization of banks is needed, along with the development of more refined financial licenses to promote differentiation and diversification in the sector. At the same time, efforts should continue to advance the full convertibility of the RMB, so as to support the international operations of banks.

I. The Continued Profitability of Commercial Banks is Critical to Maintaining the Stability of the Banking Sector

Tomoko Amaya, former vice minister for International Affairs at Financial Services Agency of Japan, believed that when the stability of the banking sector is challenged, two key questions must be clarified:

First, is the banking sector facing primarily balance sheet issues or profit statement issues? Balance sheet problems are mostly related to asset quality and capital adequacy, while profit statement problems are mainly concerned with a bank's operations and profitability models.

Second, are these issues cyclical or structural in nature? Cyclical issues may be temporary, whereas structural problems stem from changes in demographics, economic structure, and the competitive landscape of the industry, which in turn diminish a bank's profitability.

If the banking sector faces fewer structural challenges and retains strong profitability, balance sheet issues can be resolved, allowing the industry to recover from cyclical impacts in a relatively short period of time. This is crucial for maintaining banking stability. Amaya cited the example of the 2008 global financial crisis, where although some banks in Europe and the U.S. suffered massive losses, others with higher profit margins were able to quickly clean up their balance sheets and restore capital through profits or fundraising in a relatively short period. Robust profitability provided an alternative solution to balance sheet problems.

However, thirty years ago, when Japan's banking sector faced issues with non-performing assets, many believed these were cyclical problems, leading to an optimistic outlook on future profitability. This mindset resulted in the prolonged existence of non-performing assets and a worsening of balance sheet issues.

Amaya stressed that in previous discussions on banking sector stability, there was a tendency to focus on balance sheet issues such as capital adequacy and asset quality. However, it is equally important to recognize the significance of commercial banks' profitability, as it empowers banks to actively address non-performing assets and recover from losses.

II. Japan's Banking Sector Faces Structural Challenges, with Regional Banks in a More Difficult Position

Tomoko Amaya pointed out that while Japan's banking sector currently has relatively healthy balance sheets, it mainly faces income statement issues such as declining profitability due to structural changes. These structural changes include a shrinking business volume caused by an aging population, as well as increased external competition driven by the development of financial technology.

However, the management layers of Japanese banks has been slow to respond to these changes, failing to adjust their business models in a timely manner. Amaya believed that most of Japan's banking management lacks the motivation to plan for the bank's long-term future. They are content with current profit levels and reluctant to confront potential challenges ahead. Moreover, bank shareholders have not exerted sufficient pressure on management to push for business model improvements. This has resulted in a lack of progress in updating commercial banks' profit models, even as Japan's economic structural changes accelerate.

Amaya further noted that regional banks are in an even more difficult position under these circumstances. First, regional banks are under greater pressure from structural changes such as an aging population and the shrinking of local economies.

Second, compared to larger banks, regional banks have fewer options for innovation and expanding into new business areas, making it harder for them to diversify their profit streams.

Third, regional banks face a dilemma. On the one hand, they are expected to support local economies by providing credit; on the other hand, they must maintain their own financial health, preventing excessive accumulation of bad debts that could undermine the bank's stability. To overcome this challenge, regional banks need to collaborate with local businesses, governments, and communities to find win-win solutions that balance economic development with bank profitability, so as to create shared value and ensure long-term sustainable growth.

III. In a Low-Interest-Rate Environment, China's Banking Sector Should Accelerate Internationalization and Diversification

As nominal interest rates in China continue to decline, the net interest margin and return on assets for the banking sector have also been steadily decreasing. Chinese experts generally believe that to address the challenges posed by a low-interest-rate environment, the Chinese banking sector should accelerate its strategies for internationalization and diversification.

Regarding internationalization, Chinese experts suggested that domestic banks should align their efforts with the trend of increasing outbound investment by Chinese enterprises, providing greater support for companies venturing abroad. Additionally, these banks should offer more diverse and convenient financing and payment services for foreign enterprises investing in China.

In terms of diversification, some Chinese experts proposed moderately relaxing restrictions on banks' direct equity investment activities, encouraging banks to engage in equity investments in technology and innovation sectors. Currently, small and medium-sized technology enterprises in China often struggle to secure bank loans, as startup tech companies typically lack sufficient revenue and profits to meet the lending criteria set by banks, making it challenging to fulfill their funding needs. However, other experts argued that commercial banks already have various channels to conduct equity investment through their subsidiaries, and there is no need to grant special permissions for direct equity investments by commercial banks.

IV. China's Small and Medium-Sized Banks Face Greater Challenges, so Simple Consolidation is Not the Optimal Strategy

Chinese experts pointed out that in the low-interest-rate environment, local small and medium-sized banks in China are facing intensified competition from larger banks, along with a lack of capabilities for internationalization and diversification, resulting in even greater challenges. Currently, the low-interest-rate environment is prompting large domestic banks to extend their services to smaller clients to maintain their revenue and profit scales. This intensifies the competition faced by local small and medium-sized banks, coupled with the limited capability of small and medium-sized banks to carry out international and diversified business, resulting in more severe challenges.

Given the difficulties facing small and medium-sized banks, some believe that the banking sector in China may need to undergo a round of consolidation, significantly reducing the number of banks.

In response, Tomoko Amaya argued that, based on Japan's experience, consolidation among banks does not fundamentally resolve the challenges the banking sector faces. She believed that any consolidations should stem from actual business needs. If consolidation can leverage economies of scale to achieve operational goals, then it is necessary. However, if the consolidation is merely aimed at addressing issues like non-performing assets, the outcome may simply be to delay the emergence of problems.

Moreover, other Chinese experts have pointed out that the issues in the Chinese banking sector are not solely due to an excess number of banks, but also because too many banks are engaged in homogeneous business operations. This results in overlaps in services between large and small banks, as well as between local banks and those from outside the region, leading to a relative surplus of banks.

Therefore, simple consolidation may not be the fundamental solution to this problem. Instead, attention should be directed toward two aspects: first, categorizing the functions of different banks to encourage them to focus on specific regions and sectors; second, improving the governance structures of small and medium-sized banks. Currently, significant interference from major shareholders or local governments in the operations of these banks needs to be addressed to support their future development.

V. Policy Considerations

First, advancing structural economic reforms is fundamental to maintaining the profitability of banks and the stability of the banking sector. Tomoko Amaya argued that the sustainability of banking operations depends on the sustainability of economic development. The extent to which Japan's banking sector can resolve structural issues such as declining profitability largely hinges on the success of Japan's economic structural reforms. If economic reforms make progress and productivity improves, the profitability of the banking sector will likewise increase.

Second, it is essential to strengthen the dialogue mechanism between financial regulatory authorities and the management of banks, promoting faster responses from the banking sector to structural changes and improving their profit models. Amaya suggested that as structural changes of economy accelerate and the banking sector is slow to respond, financial regulatory authorities should engage in dialogue with management to clearly and specifically highlight the issues, thereby enhancing their awareness and sense of urgency regarding these problems.

Third, there could be a need to refine China's financial licenses to promote differentiation and diversification within the banking sector. Some Chinese experts believe that the current high degree of homogeneity in domestic banking operations has led to a relative surplus of banks. It may be necessary to develop more diversified financial licenses to encourage banks to focus on their respective strengths. For instance, certain small banks might specialize in green finance, while others may focus on innovative payment platforms. This would facilitate both differentiation and diversification in the banking sector, allowing all financial institutions to play unique roles in the real economy.

Fourth, efforts should continue to promote the free convertibility of RMB, facilitating the international operations of the banking sector. Chinese experts argued that the free convertibility of RMB would make currency exchanges in cross-border trade and investment more convenient, encouraging commercial banks to offer a richer array of cross-border financial services. Given China's independent monetary policy and a well-established exchange rate management mechanism, there are conditions to further promote the free convertibility of RMB, which would help banks expand their international operations.