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Determinants of Bank Profitability in a Developing Economy: Empirical Evidence from the China Banking Sector

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Abstract

The Chinese banking sector has undergone noteworthy financial reforms, which significantly metamorphosed the banking system. This article seeks to examine the determinants of the profitability of the Chinese banking sector. The empirical analysis is confined to the four State Owned Commercial Banks (SOCBs) and the 12 Joint Stock Commercial Banks (JSCBs) during the postreform period of 2000–2007. The empirical findings of this study suggest that size, credit risk, and capitalization are positively related to the profitability of China banks, whereas liquidity, overhead costs, and network embeddedness have negative impacts. However, the impact of liquidity is not uniform across bank types. We find that the SOCBs with higher level of liquidity tend to be relatively more profitable, which could be vindicated by the significant amount of

lending to the State Owned Enterprises. The impact of economic growth and inflation are always positive whether we examine the SOCB or the JSCB.

KEYWORDS:

bank profitability

multivariate regression analysis

China

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Notes

1. As part of China's World Trade Organisation (WTO) commitment to further liberalized the banking sector and to give the foreign banks completely open access to the China financial markets by year-end 2006.

2. Bank of Communications was made a State Owned Commercial Bank (SOCB) from Joint Stock Commercial Bank by CBRC in 2007.

3. In 2004, the CBRC announced that CCBs are allowed to expand to other cities if their financial performance ratios such as NPLs and Capital Adequacy Radio (CAR) exceed the average performance of the JSCBs. The move is applauded as this will enable the CCBs to expand their operations and develop economies of scale. Since then, there have been eight CCBs granted approval from CBRC for cross city/provincial operations.

4. Stiroh (2004) suggested that greater reliance on noninterest income, particularly trading revenue, is associated with lower risk-adjusted profits and higher risk, whereas Stiroh and Rumble (2006) found that diversification benefits of the U.S. financial holding companies are offset by the increased exposure to noninterest activities, which are

much more volatile but not necessarily more profitable than interest generating activities.

5. The recapitalization exercise started in December 2003 with a capital injection of US$22.5bn each into Bank of China (BOC) and China Construction Bank (CCB) by the central bank, the People's Bank of China (PBOC). The PBC transferred the funds from its international reserves to a newly created entity, the Central Huijin Investment Company (Central Huijin), which acts as the holding company for the government's shares in BOC and CCB. A similar exercise was conducted in April 2005 with Industrial and Commercial Bank of China (ICBC) for a sum of US$15bn. As in the previous cases, Central Huijin is the shareholder of government's shares in the ICBC.