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Chinese banks show resilience to the global banking turmoil, despite domestic headwinds

by NUS-CRI Market Monitoring Team

- **NUS-CRI Agg PD of Chinese banks remains relatively flat above the BB- upper bound since the beginning of the US banking crisis**
- **NUS-CRI Agg Forward 1-year PD suggests a mixed outlook for Chinese banks as PBOC continues its expansionary monetary policy amidst slow economic recovery**

Though the impact of the US banking crisis has been felt widely across the globe, China-domiciled banks (Chinese banks) have remained relatively immune to it. The triggers which sparked the US banking crisis may not pose a threat to Chinese banks in the current environment as the People's Bank of China (PBOC) follows an expansionary monetary policy that stands in stark contrast to its global peers. As seen in Figure 1a, the NUS-CRI aggregate (median) 1-year Probability of Default (Agg PD) of publicly-listed Chinese banks, though elevated as compared to Jan 2022, has remained relatively flat above the BB- upper bound since the beginning of the US banking crisis. The Agg PD of Chinese banks climbed higher in 2022 as the property sector crisis and the COVID-19 restrictions led to declining loan growth and deterioration in asset quality. However, with the abandonment of the Zero-COVID policy in Dec 2022, policy-driven efforts to stimulate economic growth, and disposal of distressed assets, the credit health has improved (see Figure 1b).

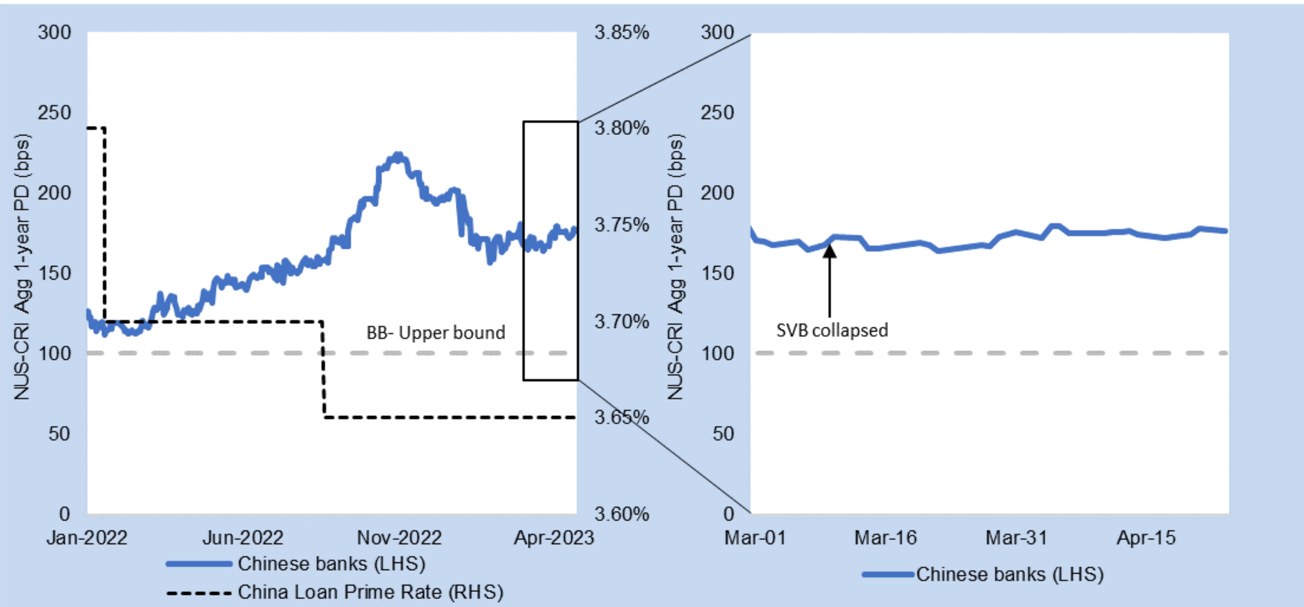

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Chinese banks, with reference to PDiR2.0[1] bounds; PBOC Loan Prime Rate. Figure 1b (RHS): NUS-CRI Agg (median) 1-year PD for Chinese banks, with reference to PDiR2.0 bounds. *Source: NUS-CRI, Trading Economics*

Although China's economic growth is expected to rebound by the end of 2023, the latest release of data for inflation in Mar 2023 showed the consumer price index increasing by 0.7% YoY, with the producer price index decreasing by 2.5% YoY, prompting the PBOC to prioritize credit extension and monetary policy easing to boost domestic economic growth and consumption. Further, the contraction in the manufacturing data on Apr 2022 indicated a slowdown in demand, underlining the fact that China's economic recovery has yet to gather steam. To support the economy, the PBOC asked banks to step up lending, especially to small businesses, infrastructure projects, and the embattled property sector. From a profitability perspective, Chinese banks experienced a slowdown in the most recent quarter, with Q1 2023 profit growth around 6 percentage points slower than in 2022. The sector's net interest margins have come under pressure (see Table 1) as lenders are

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

pushed to offer lower borrowing rates to businesses as well as to individuals seeking home loans, in a bid to stimulate the economy. Consequently, as borrowing costs declined, banks saw an increase in prepayments on mortgage loans which heaped additional pressure on banks' margins. However, despite margin pressures, the banks' profitability remains supported by a strong recovery in credit growth. The PBOC has undertaken a slew of steps to improve bank liquidity and stimulate loan growth. Steps such as the reduction of the loan prime rate and the reserve requirement ratio in conjunction with China's re-opening may have contributed to an improvement in the 2023 YTD credit growth.[2] (see Figure 2a).

Fundamental Indicators	Q1 2022	Q2 2022	Q3 2022	Q4 2022
Net Interest Margin	1.97%	1.94%	1.94%	1.91%
Non-performing Loan Ratio	1.69%	1.67%	1.66%	1.63%
Provision Coverage Ratio	200.70%	203.78%	205.54%	205.85%
Tier 1 Capital Adequacy	12.25%	12.08%	12.21%	12.30%

Table 1: Financial ratios of Chinese banks. *Source: China Banking and Insurance Regulatory Commission*

The banking sector's asset quality also seems to have stabilized despite the drag from the property market crisis (see Table 1). The banks have employed various measures to clean up their balance sheets in order to prevent gross deterioration of their asset quality metrics. As per data reported by regulators, banks sold approximately USD 392bn worth of non-performing loans (NPL), and most of the loans were acquired by China's state-owned asset management companies. Additionally, Chinese banks are using securitization to resolve bad debts on their balance sheets. However, with a slow recovery in demand, the risks in the property sector continue to pose a threat to banks' asset quality. At the same time, in line with China's push for "common prosperity", banks have increased lending to the small business segment accruing the credit risk in the current environment. The asset quality of China's regional banks, which are more exposed to small business loans as well as loans of highly-indebted local governments, maybe the most vulnerable in the sector. The increasing provisioning coverage ratio of the sector may be indicative of expectations of an increase in distressed loans. (see Table 1).

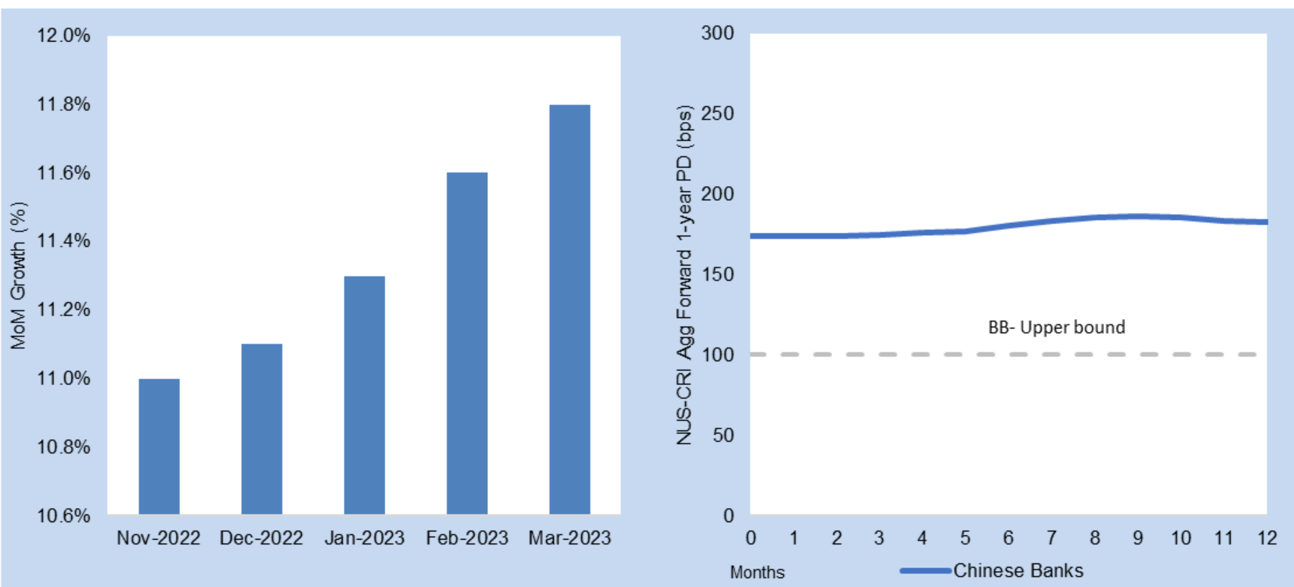

Figure 2a (LHS): MoM growth in China outstanding yuan loans; Figure 2b (RHS): NUS-CRI Agg (median) Forward[3] 1-year PD for the Chinese banks with reference to PDiR2.0 bounds. *Source: Trading Economics, NUS-CRI.*

Going forward, the well-capitalized nature of the banking sector in conjunction with policy intervention may lend support to the sector's credit health and prevent further deterioration (see Figure 2b). Nevertheless, despite a new loan record high of USD 1.54tn, both the domestic demand and export demand remain weak. While providing a temporary lifeline to struggling enterprises, an overflow of credit can also result in obsolete production and unviable projects, ultimately leading to market inefficiency. Given the current context of slowing economic growth and weak demand, such market inefficiencies could potentially increase the banks' NPL in the long run, as indicated by the elevated Forward PD in Figure 2a.

[2] The outstanding Chinese yuan loans registered a growth of 11.8% YoY on Mar 23, the fastest growth since Oct 2021.
[3] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months

Credit News

First Republic Bank is seized, sold to JPMorgan in second-largest U.S. bank failure

May 01. Regulators seized First Republic Bank, the second-largest bank to fail in U.S. history, as it lost USD 100bn in deposits in March due to a wrong-way bet on interest rates, which was accelerated by ultralow interest rates and a pandemic savings boom. JPMorgan Chase & Co. bought most of First Republic's assets, including about USD173bn in loans and USD 30bn in securities, and will assume all of its $92bn in deposits. As part of the agreement, the Federal Deposit Insurance Corp. will share losses with JPMorgan on First Republic's loans. The agency estimated that its insurance fund would take a hit of USD 13bn in the deal. (WSJ)

US companies in distress turn to debt exchanges to dodge bankruptcy

Apr 27. US companies are increasingly turning to debt restructurings to avoid bankruptcy, but many are still ending up in court. Almost 75% of corporate debt defaults in the US last year were out-of-court "distressed exchanges", where a company offers creditors assets worth less than their original bonds or loans, according to Moody's. The "re-default" rate for companies involved in these exchanges is 47%. Private equity-owned companies are particularly likely to resort to distressed exchanges, and S&P predicts the US junk-grade default rate will reach 4% by December, up from 2.5% in March. (FT)

Junk bonds shake off recession worries

Apr 28. Despite signs of slowing growth, demand for junk bonds remains steady among investors. The yield on these bonds has fallen by one percentage point since last month's market turmoil caused by bank distress, indicating a lack of worry about below-investment-grade companies defaulting on payments. Junk-bond spreads have also decreased, hovering between 4.4 percentage points and 4.6 percentage points in the second half of April. This is a far cry from the spreads above 8 percentage points during recessions. However, some newly issued junk bonds have underperformed this month, and there are concerns about the eroding confidence of triple-C and below-rated bonds. (WSJ)

Sun starts to set on once-hot sunbelt office markets

Apr 25. Office markets in Sunbelt cities, including Miami, Phoenix, Austin, and Nashville, are showing signs of slowing growth as they face the economic uncertainty caused by the pandemic and a shift to remote work. Although many companies are still relocating to Sunbelt cities, vacancy rates remain higher than pre-pandemic levels, and sublease inventory is increasing. While average asking rents in Sunbelt hubs continue to rise, rent increases in most large Sunbelt markets have slowed in the past two quarters. This slowdown in growth could lead to a retrenchment in Sunbelt markets as the supply of new office spaces increases while demand declines. (WSJ)

Hedge funds retreat from bets against Italian bonds

Apr 29. Hedge funds have decided to cut their losses on Italian government bonds after the country surprisingly delivered strong returns despite its high level of debt. The value of bonds that investors had borrowed to bet on the prices falling has dropped by 40% over the last month. Previously, short positions reached a high of €46bn in November 2022 when there were concerns over Italy's reliance on gas imports and the appointment of a right-wing Prime Minister. However, a warm winter and lack of confrontation with Brussels have contributed to a 3.4% increase in the ICE Bank of America index of Italian government debt in 2023, which is higher than the ECB's growth estimate for the wider Eurozone. (FT)

Retail investors flock to join Credit Suisse bondholder lawsuit (FT)

China Evergrande faces over 1,300 lawsuits totaling USD 45bn (Nikkei Asia)

Adani pays back USD 200mn Holcim Debt, seeks loan extension (Bloomberg)

Regulatory Updates

German debt reduction demands would be 'straitjacket' on EU, officials warn

Apr 29. German Finance Minister Christian Lindner has faced opposition from Brussels and other EU member states after calling for tough debt reduction targets to be included in EU fiscal rules. Lindner proposed that heavily indebted countries should reduce their debt-to-GDP ratios by 1% per year, while countries with less onerous debts should reduce them by 0.5% per year. Some EU officials have dismissed the proposals as incompatible with efforts to create a more flexible system adapted to member states' individual needs. The European Commission has unveiled draft legislation seeking to introduce reforms to the EU's Stability and Growth Pact. (FT)

Fed plans broad revamp of bank oversight after SVB failure

Apr 29. The Federal Reserve released a report on its supervision of Silicon Valley Bank (SVB) prior to its collapse in March, concluding that there were weaknesses in regulation and supervision. While SVB's own mismanagement was responsible for its downfall, the Fed's oversight of the bank was inadequate, and regulatory standards were too low, the report stated. The Fed has promised tougher supervision and stricter rules for banks and will re-examine how it supervises and regulates liquidity risk, beginning with the risks of uninsured deposits. Increased capital and liquidity requirements could have bolstered SVB's resilience. (Nikkei Asia)

ECB backs Commission proposal for individual EU debt reduction paths (Reuters)

Bank of England forecasts £100bn payment from Treasury by 2033 over QE losses (FT)

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