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Chinese commercial banks shaken by policy rate cuts and structural weakness in domestic real estate

by Lee Wei Qi

- **NUS-CRI Agg (median) 1-year PD reflects increasing credit risk as a reflection of worsening sentiments and structural issues underpinning the economy**
- **Stress tests using BuDA suggest that easing credit conditions in monetary and real estate markets need not translate into positive credit pass-throughs**

Against market expectations, the People's Bank of China (PBOC) has taken steps to reduce the cost of financing across different credit facilities. These forms of selective policy easing are geared to boost sentiments amongst consumers and businesses, as well as easing funding conditions for financial institutions, especially those impacted by the fallout of the ongoing crisis in the real estate sector. Last year, NUS-CRI noted an improved operating environment for Chinese commercial banks while recognizing the potential systemic threat posed by the domestic real estate market. Today, referencing NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) in Figure 1a, the trend has reversed. The deterioration of the industry's credit outlook as of the beginning of next year can be exhibited by the increasing trend of NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[1]) time series in Figure 1b.

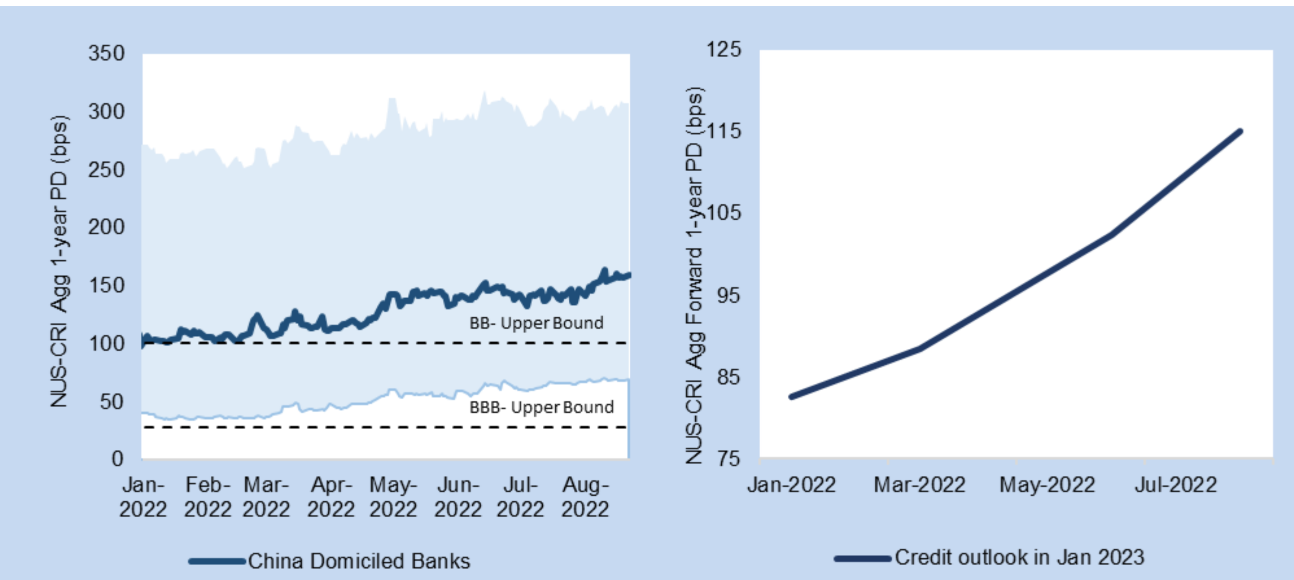

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Chinese commercial banks from Jan-2022 to Aug-2022 with the interquartile range of the industry, with reference to PDiR2.0 bounds[2]. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD time series for Chinese commercial banks based on information from different historical months. *Source: NUS-CRI*

Recent macroeconomic statistics have been less than upbeat as the Chinese government remains steadfast in its stance toward reopening. Currently, 31 cities, which contribute up to 18% of the country's economic activity, remain under full or partial lockdowns. Officials and market participants have been increasingly leaning towards the potential case that the nation could miss its economic growth target. Consumption and production data have been lackluster as well. In Jul-2022, retail sales ticked up by 2.7% YoY while industrial production rose by 3.8%, both missing consensus estimates. As the risks of COVID-19 curbs and a distressed property market continue

[1] 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.

[2] 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.

to linger, bad loans have increased by almost CNY 107bn in H1 2022. Ahead of these, the Chinese commercial banks have rushed to raise debt over the past few quarters (See Figure 2a). While capital raising does provide some buffer, downside for banks remains as the PBOC has engaged in selective easing across its reserve requirement ratio, one year lending rate and five year loan prime rates. Furthermore, the market is expecting another two more 10 bps cuts in PBOC policy rates for the remainder of 2022.

Using NUS-CRI Bottom-up Default Analysis toolkit (BuDA[3]), the impact of future easing in monetary policy and the resultant intended consequence on funding conditions for the property sector can be simulated[4]. Despite accounting for a slight improvement in the domestic real estate funding conditions, the aggregate credit risk of Chinese commercial banks increases in line with levels suggested by the stressed PD in Figure 2b. The cuts in key rates drag net interest income and, vis-a-vis, affect the industry's bottom line. In addition, Figure 2b suggests that a slight improvement in funding conditions for the Chinese property space need not translate into positive credit pass throughs. Currently, there are multiple policies in place to encourage local governments and state banks to help developers acquire the funding they need to resume stalled projects. Nonetheless, despite the intervention of China's State Council, losses are still likely as it is difficult to make returns on distressed real estate projects when home purchases and housing rentals are weak. Hence, increasing funding access for the real estate sector could result in an uptick in non-performing assets.

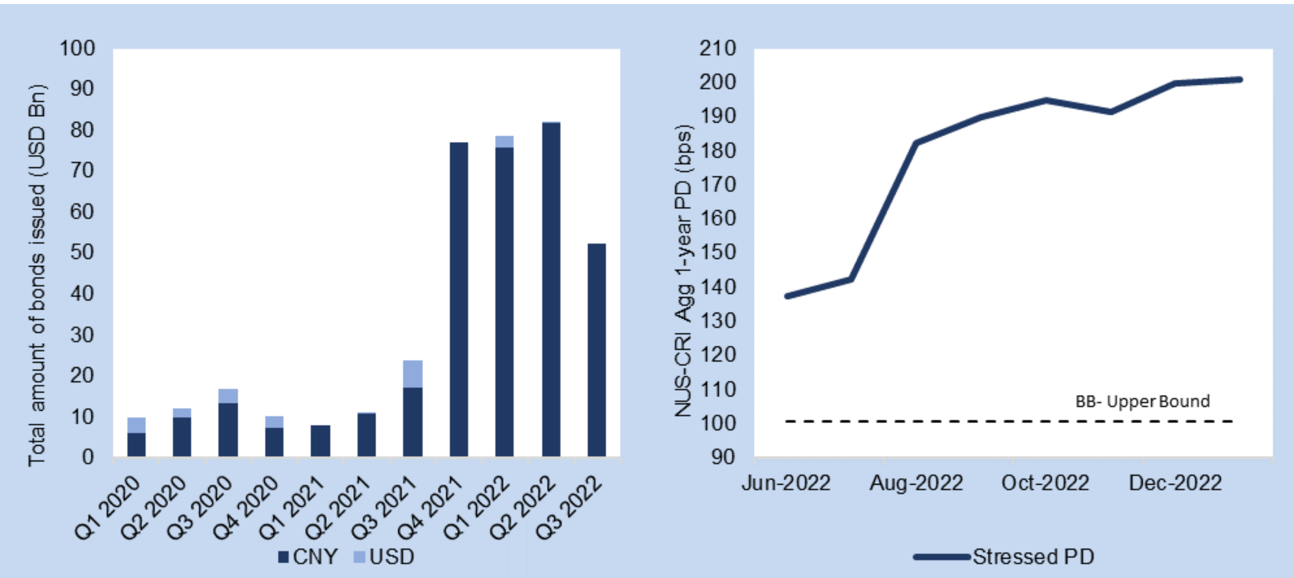

Figure 2a (LHS): Total amount of bonds issued by the Chinese commercial banks every quarter, broken down by currency. Figure 2b (RHS): Stressed NUS-CRI Agg 1-year PD of Chinese commercial banks with reference to PDiR2.0 bounds. *Source: Bloomberg, BuDA v3.4.2*

The Chinese property market accounts for nearly 30% of the nation's total output. As credit risks in the sector continue to linger, real estate remains a prevailing headwind for Chinese commercial banks. In the worst case scenario, the banks could face up to CNY 2.4tn in mortgage losses, corresponding to 6% of total mortgages, which could weigh on asset quality. Moreover, homebuyers, spanning nearly 100 cities and more than 200 unfinished property projects, have been boycotting mortgage payments of late. This could lead to worsening asset quality, increasing non-performing loans and draining provisions.

However, the impact on the credit profiles of the Chinese commercial banking sector varies across the board as evident by the gap in the interquartile range exhibited in Figure 1a. The major Chinese commercial banks have limited exposure to overdue mortgages on uncompleted housing projects (less than 0.015%). This insulates them from the effect of such factors on asset quality. Conversely, a good proportion of the smaller and regional banks in the less developed municipalities have a relatively larger and concentrated exposure to the distressed developers. In terms of capital buffers, these commercial lenders lag far behind the industry average. Outside of the housing crisis, the rising incidence of bank runs weakens liquidity, and potentially heightens reputational risks amongst these smaller provincial banks.

While the need for funding in the real estate sector is recognized, the extent to which it is done should be managed. It is unlikely for policymakers to substantially ease the curbs they have put in place to deleverage the domestic real estate sector. In response to the tough operating environment, any loosening of underwriting

[3] The Bottom-up Default Analysis (BuDA v3.4.2) is a credit stress testing and scenario analysis toolkit jointly developed by the Credit Research Initiative (CRI) team of National University of Singapore (NUS) and the International Monetary Fund (IMF).
[4] Using BuDA, the stressed scenario factored in potential cuts in key rates by the PBOC for the remainder of 2022 alongside a slight improvement in the Chinese funding conditions index.

standards could come at the cost of further deterioration in asset quality for the Chinese commercial banks. Furthermore, while monetary policy easing is expected to continue to the end of the year, the PBOC does face some constraints when it comes to funding. Aggressive cuts are less plausible ahead of the key regulatory deadlines for the large banks to increase their capital buffers[5].

[5] Recall that China's top four lenders are mandated to hold total loss-absorbing capacity minimal targets of 16% starting 2025 and 18% from 2028.

Credit News

China's bad debt funds are no white knights in property crisis

Aug 27. Many large asset management companies had established heavy lending exposure to the real estate sector during the property sector boom. Although the exposure offered lucrative premiums, the companies are now facing a massive pile of soured loans due to the property sector crisis which has adversely affected their balance sheet. As such their role as a savior in the property crisis has lost significance. For instance, industry giant, Huarong Asset Management Co., had received a bailout last year and is expected to further accumulate a loss of CNY 18.9bn in H1 2022 due to credit impairments. As such, Beijing is considering a possible state-led restructuring of the sector, including state-backed entities' acquisition of distressed asset management companies. (Bloomberg)

US shale could erase debt by 2024, freeing up cash for gas pivot

Aug 25. The global trend of rising oil prices and a shift towards lower capital spending is expected to generate nearly USD 200bn of free cash flow for the US shale producers, paving the way to become debt free by 2024. Capital expenditure is down nearly 60% on gas and oil projects compared to that of 2014, establishing a new trend of capital discipline. Profits in the industry are expected to remain high for the rest of the decade, enabling the US shale producers to invest in a pivot towards natural gas and other low-carbon fuel projects. (Bloomberg)

U.S. bond funds record biggest weekly outflow in eight weeks

Aug 26. As market participants were awaiting the outcome of Federal Reserve Chair Jerome Powell's speech about inflation and further interest rate raises, investors dumped U.S. bond funds, leading to a net outflow of USD 8.81bn. Simultaneously, U.S. high yield funds lost USD 4.72bn in net selling, and safer money market funds reached a net inflow worth USD 11.07bn. In addition, U.S. equity funds had a net weekly outflow of USD 2.19bn, and investors sold U.S. growth funds worth a net USD 3.31bn. (Reuters)

Global bond inflows to emerging Asia signal shift in outlook

Aug 25. Overseas investors significantly increased their purchases of key emerging markets bonds in Asia, especially in anticipation of the possibility of less hawkish comments by Federal Reserve Chair Jerome Powell. Currently, the global funds share of Indonesian government bonds has decreased to 16% as compared to 39% in 2020. Simultaneously, their share in Malaysian government debt has also fallen continuously reaching 23.3%. The region's economic well-being is pressured by inflationary pressures, which have so far affected most emerging Asian markets. At the same time, policymakers in the region are trying to balance the inflation and growth challenges, which contributes to making their debt an attractive investment. (Bloomberg)

Russia set to revive local bond sales after six-month freeze

Aug 24. The Russian government is set to restart the sale of ruble-denominated bonds in Sep-2022, which will probably be followed by the announcement of borrowing plans for the upcoming auctions. These plans were put on hold in Feb-2022 before the Russia-Ukraine war, leaving a significant portion of it unfulfilled. Moreover, after realizing the impact of the sanctions by the US and UK on trade and markets, Russia is also considering debuting the issuance of yuan-denominated notes in the near term. Russia's trade volumes with its Chinese ally have surged during the war, presenting an opportunity for investors. Should the Russian government continue the issuance, these yuan-denominated debts would serve as a benchmark for interested companies in the meantime, as current energy revenues appear sufficient to fully support the government's financing needs. (Bloomberg)

Chinese copper trader Maike seeks government help on cash flow issue (Reuters)

Chinese developers lean on government bond guarantees as doubts persist (WSJ)

IMF warns faster debt relief needed as more nations seek help (BT)

Regulatory Updates

ECB officials warn of 'sacrifice' needed to tame surging inflation

Aug 28. ECB officials stressed the need to bring inflation under control in face of surging inflation and warned that ECB monetary policy is expected to remain tight for an extended period. While inflation is expected to ideally react to the monetary tightening, in the worst case that inflation doesn't return to the target range, central banks would be willing to raise rates even beyond the neutral rate. Such action could potentially result in lower economic growth and a weaker labor market. However, the central banks posit that these sacrifices might be necessary to tame inflation as soon as possible, considering that failure to do so would entail higher costs later. (FT)

Jay Powell says Fed will 'keep at it' in hawkish inflation speech

Aug 27. Jerome Powell's much-anticipated speech at the Jackson Hole symposium saw him reiterating that the Federal Reserve must commit to tightening interest rates to restrain inflation. The Fed Chair warned that the extended period of tightening may result in slower economic growth. Reacting to his hawkish comments, the market witnessed a 0.01 percentage point increase in two-year treasury yields while the yield on 10-year treasury notes remained flat. The US stock market witnessed a sharp fall, with the S&P 500 index falling 3.4%. Powell also indicated that in the coming quarters he foresees a softening of the labor market and deterioration of consumers' disposable incomes. (FT)

Central banks will fail to tame inflation without better fiscal policy, study says (Reuters)

China tightens green bond rules to align them with global norms (Reuters)

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