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Chinese banks in focus: exposure to the property sector and local government debt threaten credit outlook

by Amrita Parab

- **NUS-CRI Agg PD for Chinese banks rises following increased pressure on NIMs and weakened loan growth as demand softens**
- **The elevated NUS-CRI Forward PD suggests that higher exposure to the property sector and local government debt threaten banks' asset quality and capital adequacy**

Chinese banks have been struggling with shrinking margins since they were tasked to support the economy and contain risks from the weak property sector. In 2023, they have the added burden of helping prevent a crisis in the local government debt market, which further weighed on their profits and asset quality. As China's real estate crisis deepens with an increasing number of developers facing financing and liquidity pressures, banks, whose property exposure accounts for nearly 40% of all loans, may be on the path to elevated distress stemming from deteriorating asset quality. As seen from Figure 1a, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) for Chinese banks has gradually elevated over the second half of 2023 and exhibits a higher credit risk as compared to the wider financial sector. In addition, as seen from Figure 1b, the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[1]) suggests that the credit risk of Chinese banks will remain elevated in the coming 12 months pointing to sustained stress from a weak economic environment and a continued adverse impact on bank balance sheets originating from their exposure to the property sector.

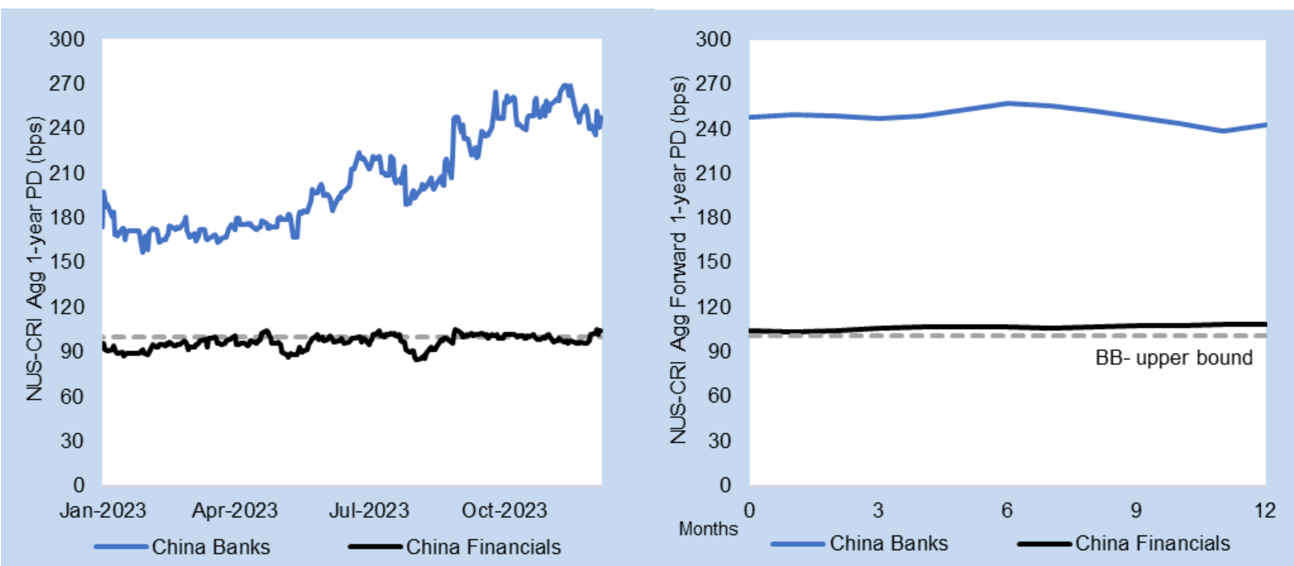

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for China-domiciled banks and financial firms with reference to PDiR2.0 bounds[2]. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for China-domiciled banks and financial firms as of Dec 2023, with reference to PDiR2.0 bounds. *Source: NUS-CRI.*

Chinese banks' profitability has come under pressure as loan growth slumps and banks' net interest margin (NIM) narrows. As seen from Table 1, the NIM for Chinese banks fell to a record low of 1.73% in Q3 2023. The depressed NIM is a result of consecutive rate cuts by the central bank as well as higher funding costs. The loan prime rate cuts undertaken by the central bank have resulted in increased repricing of loans contributing to the contraction of NIMs. Furthermore, the policy push to extend cheaper financing to select sectors such as

[1] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar 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, 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 by 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

infrastructure may have further negatively impacted NIMs. Simultaneous to narrowing margins, loan growth has also been showing signs of slowing down since mid-2023. Although the economy's loan growth in Oct-2023 remained steady as compared to the previous month, the majority of the growth was contributed by government issuances as opposed to demand from businesses and individuals. The ongoing property sector crisis and weak consumer confidence continue to weigh on China's economy and are expected to keep loan demand soft in the coming quarters.

	Q4 2022	Q1 2023	Q2 2023	Q3 2023
Net Interest margin (%)	1.91	1.74	1.74	1.73
Non - performing loans (%)	1.63	1.62	1.62	1.61
Capital adequacy ratio (%)	15.17	14.86	14.66	14.77

Table 1: Key financial ratios of Chinese banks. *Source: Bloomberg, CBIRC*

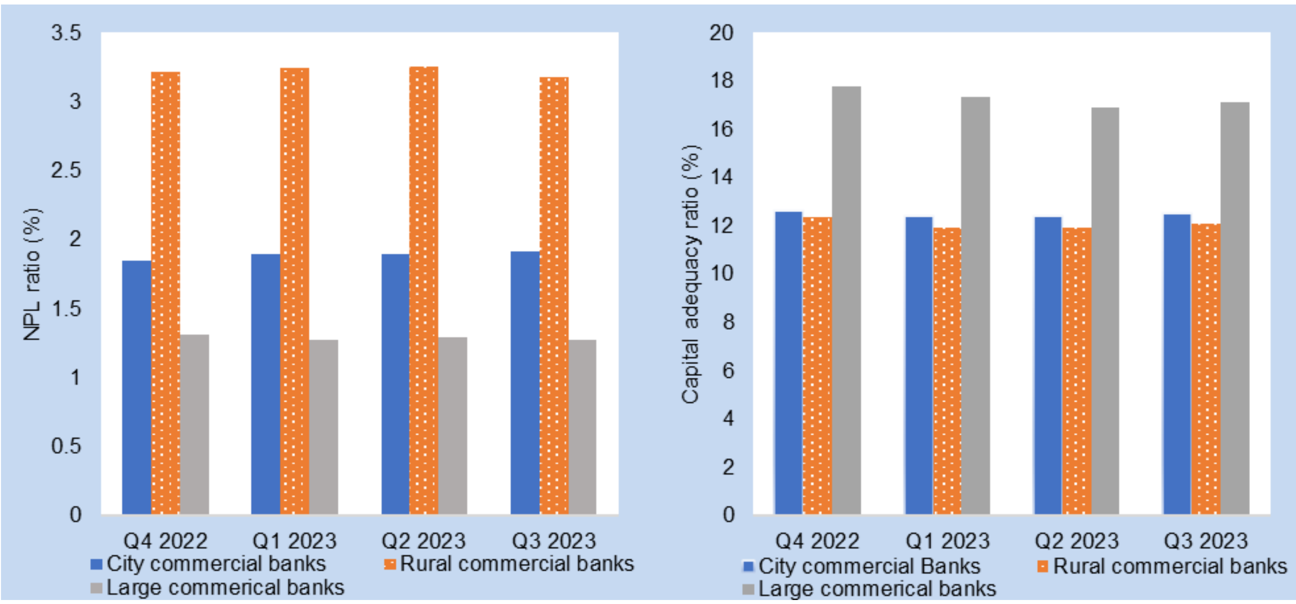

Figure 2a (LHS): Quarterly non-performing loan ratio of Chinese banks by type of institution; Figure 2b (RHS): Quarterly capital adequacy ratio of Chinese banks by type of institution. *Source: Bloomberg, CBIRC*

The asset quality of Chinese banks remains under threat, raising concerns regarding their credit health in the near term. Although banks have managed to keep their NPL ratio stable over the past year, the risk of increased bad loans looms, particularly from their involvement in the property sector. Additionally, banks are being pushed to lend to embattled developers and rollover loans made to the troubled local governments as part of a government effort to prevent an economy-wide contagion of the crisis. Regional banks are at the greatest risk. These smaller banks, considered as the most vulnerable group, face challenges due to the non-diversified nature of their operations. Less transparent governance and a lack of strict regulatory control as compared to their larger peers add to their vulnerability. Regional banks also have higher exposure to local government debt and also to lower-tier local governments which have seen a higher deterioration in their credit health. As a result, Chinese regional banks have reported a greater deterioration in asset quality as compared to their larger peers. (see figure 2a) Similarly, while the capital buffers of larger commercial banks remain healthy, the comparatively thinner capital buffers of regional banks may deteriorate further should non-performing loans rise, necessitating recapitalization. Local governments in China have already raised USD 21.05bn YTD, as of Nov-2023 in an effort to recapitalize small and medium-sized banks. These efforts further result in the ballooning of local government debt at a time when they are struggling to meet their obligations, potentially worsening the local government debt crisis, and raising concerns of spillover risks to the wider economy and in turn the banking sector, as seen from figure 1b.

Credit News

China’s colossal hidden-debt problem is coming to a head

Dec 05. China is grappling with a looming financial crisis as cities and provinces face a massive hidden debt crisis estimated between USD 7tn to USD 11tn. Local governments borrowed extensively for infrastructure projects, leading to unsustainable debt levels, exacerbated by slowing economic growth and deflationary pressures. Authorities are attempting to address the issue by swapping hidden debt for explicit government debt. Concerns mount as defaults could trigger a nationwide crisis, impacting China's banking system. Moody's downgrade reflects heightened risks. Local governments are urged to issue special refinancing bonds, with around USD 200bn raised so far, but experts emphasize the need for more extensive debt swaps to address the crisis. (WSJ)

Banks mask lending to polluters with PR greenwash, ECB blog says

Dec 06. Eurozone banks that vocally address climate change are major backers of polluting industries, using public relations tactics to obscure their support, according to a blog post by four economists associated with the European Central Bank (ECB). The ECB has struggled to compel banks to disclose climate risks, threatening increased capital requirements. The blog asserts that banks projecting environmental consciousness paradoxically lend more to "brown" industries, highlighting a lack of incentives for policy change. This is particularly evident in funding smaller polluters, escaping public scrutiny. Banks are hesitant to disrupt client relationships, perpetuating support for polluters and hindering the transition to cleaner technologies. (Reuters)

Companies rush to take advantage of sharp drop in borrowing costs

Dec 07. Companies in the US and Europe are rushing to issue debt, capitalizing on the lowest borrowing costs in months amid a global bond market rally. In November alone, corporate borrowers issued USD 246bn worth of investment-grade and junk bonds, a 57% increase from October. This surge in issuance is attributed to a shift in investor sentiment anticipating US and European interest rate cuts in H1 2024. Lower yields and increased risk appetite have contributed to a favorable backdrop for companies to borrow. Despite concerns about potential market shifts, the rush to borrow is driven by favorable conditions and looming refinancing needs. (FT)

China's hidden debt spurs warnings of more Moody's downgrades

Dec 07. Moody's Investors Service has hinted at possible credit rating downgrades for numerous Chinese government-backed entities, including those supporting infrastructure development and state-owned banks, as well as the regions of Hong Kong and Macao. This follows Moody's recent downgrade of China's sovereign credit rating outlook, reflecting concerns over local governments' handling of increasing hidden debt during a prolonged property downturn. Moody's has placed the ratings of 26 Chinese local government financing vehicles on review for a downgrade, signaling growing apprehension about the ability of local governments to manage their mounting debt. The outlooks for eight state-owned banks were also changed to negative. (Nikkei Asia)

Japan consumer lenders brace for bad debt on 'revenge spending'

Dec 11. Japan's consumer finance industry faces rising bad loan risks and increased funding costs as a surge in new customers seeks post-pandemic "revenge spending." Provisions for loan losses at Acom, Aiful, and SMBC Consumer Finance grew about 30% to approximately JPY 120bn for H1 FY2023. The lenders gained over 600,000 new customers, driven by mobile apps lowering borrowing barriers. While these lenders report manageable risks, concerns arise as outstanding loan balances per customer decline, and borrowers with five or more loans increase. Funding costs rose amid expectations of the Bank of Japan's move away from an ultraloose stance, impacting borrowing costs. (Nikkei Asia)

US commercial mortgage distress rises in November on office woes -KBRA (Reuters)

Wanda's billionaire founder sells film unit as debt pressure builds (BT)

Chinese investors drive rally in local government dollar bonds (FT)

Regulatory Updates

Central banks prepare to rebuff investors over path of interest rates

Dec 11. Central banks, including the US Federal Reserve, the European Central Bank (ECB), and the Bank of England, are set to challenge investor expectations of imminent interest rate cuts amid strong employment figures. Investors have been speculating that these central banks would ease monetary policy early in the new year to address falling inflation readings. However, recent robust employment data may prompt central banks to resist these expectations, with the Fed, ECB, and BoE signaling a need for clearer evidence of labor market weakening before considering rate cuts. ECB and BoE meetings this week aim to counter market rate-cutting narratives. (FT)

Japan bond liquidity worse under easing, BOJ review finds

Dec 06. The Bank of Japan (BOJ) revealed that liquidity in the Japanese bond market has generally deteriorated due to a decade-long extreme monetary easing policy. Reports highlight that three adjustments to the BOJ's yield curve control policy since Dec-2022 have alleviated some side effects. However, the market's view on interest rates has diverged from the tolerance band under yield curve control, impacting liquidity indicators and causing distortions in the yield curve. The review, involving outside voices for the first time, reflects a broader assessment of Japan's monetary policy, which aims to combat deflation and spur consumer price growth. (Nikkei Asia)

Bank of Canada keeps rates unchanged, cites progress on cooling inflation (WSJ)

China proposes trading cost cuts for mutual funds, to regulate commissions (Reuters)

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Contributing Editors: Chenye Wang