Weekly Credit Brief Jan 25 - Jan 31 2022

# Policy-driven economic recovery paves the way to improve credit outlook for Chinese Banks

by Amrita Parab

- **The NUS-CRI Agg PD of Chinese Banks increased in the second half of 2021, as the property crisis and an economic slowdown threatened banks' profitability and asset quality**
- **Going forward, the NUS CRI Agg Forward PD shows an improvement in credit outlook, as fiscal and monetary policy tools may revive loan growth and improve asset quality**

To combat a slowdown in the economy and stimulate credit growth, in Jan 2022, the People's Bank of China (PBOC) lowered the one-year loan prime rate by 10bps to 3.7% and the five-year rate by 5bps to 4.6%. With most global central banks pursuing a tighter monetary policy in the face of heightened headline inflation risk amongst the developed markets, PBOC's actions are brought into focus as they continue to diverge from those of its global peers. Consequent to the rate cut, Chinese banks lowered their borrowing rates for a second consecutive month in order to stimulate credit growth, as the wider economy faced a slowdown due to a drop in consumer spending and the ongoing crisis in China's real estate sector. Concurrent with these challenges, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) of Chinese Banks (See Figure 1a) showcases an increase in credit risk in H2 2021. On the other hand, the NUS-CRI Aggregate (median) Forward 1-year PD (Forward PD[1]) of Chinese Banks (See Figure 1b) reflects a gradual improvement in credit outlook in the short-to-medium term as the above mentioned government-support measures poise Chinese banks to benefit from improved asset quality and a revival in loan growth as the Chinese government rejuvenates the economy.

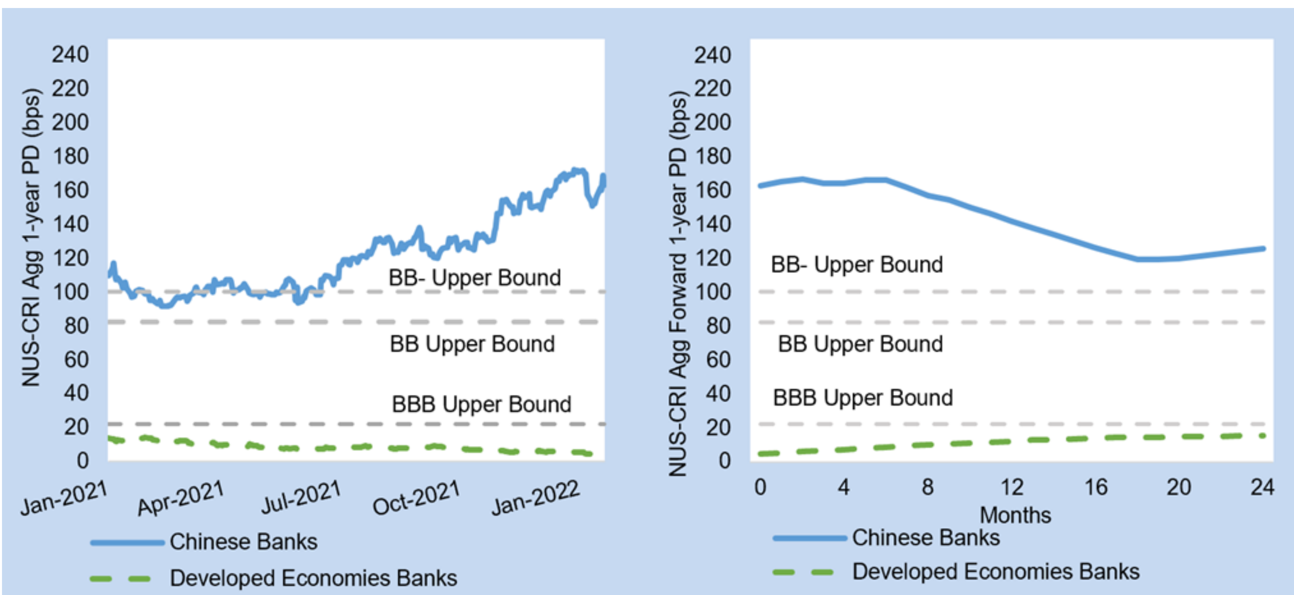


Figure 1a (LHS): NUS-CRI Agg 1-year PD for the Chinese Banks and Developed Economies' banks from Jan-2021 to Jan-2022 with reference to PDiR2.0 bounds[2]. Figure 1b (RHS): NUS-CRI Forward PD for Chinese Banks and Developed Economies' banks as of Jan-2022 with reference to PDiR2.0 bounds. *Source: NUS-CRI*

As major central banks around the world tighten monetary policy in an effort to control inflation, PBOC's stance to reduce rates is not too surprising. Given that the Chinese economy's headline inflation levels have been below their official target of 3% throughout 2021, inflation concerns, that are beginning to dictate rate movements for central banks in developed markets, are not at the forefront of risks faced by China. On the contrary, PBOC's

[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 1 year plus 6 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 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.

policy response to the current economic slowdown may prove to be marginally positive for Chinese banks' credit outlook, especially as the industry may benefit from a short-term reprieve in its declining loan growth (See Figure 2a) that may revive wider economic growth in the short-to-medium term.

For context, heightened omicron-related COVID-19 restrictions nearing the end of 2021, among a plethora of additional financing-related challenges, have already hampered business operations for Chinese corporates and household consumption across China. Resultantly, the slowdown, which prompted PBOC to cut loan prime rates, has continued to pressure banks' net interest margin (NIM) since the start of 2021 (See Table 1). As Chinese corporates remain reluctant to borrow and increase capital expenditures, the PBOC's policy may not completely catalyze loan demand, and at the same time, may further pressurize Chinese banks' NIMs. However, the rate-cut may provide the necessary signal to companies that the Chinese government may be willing to adopt further favorable policies to jump-start the economy in the short term.

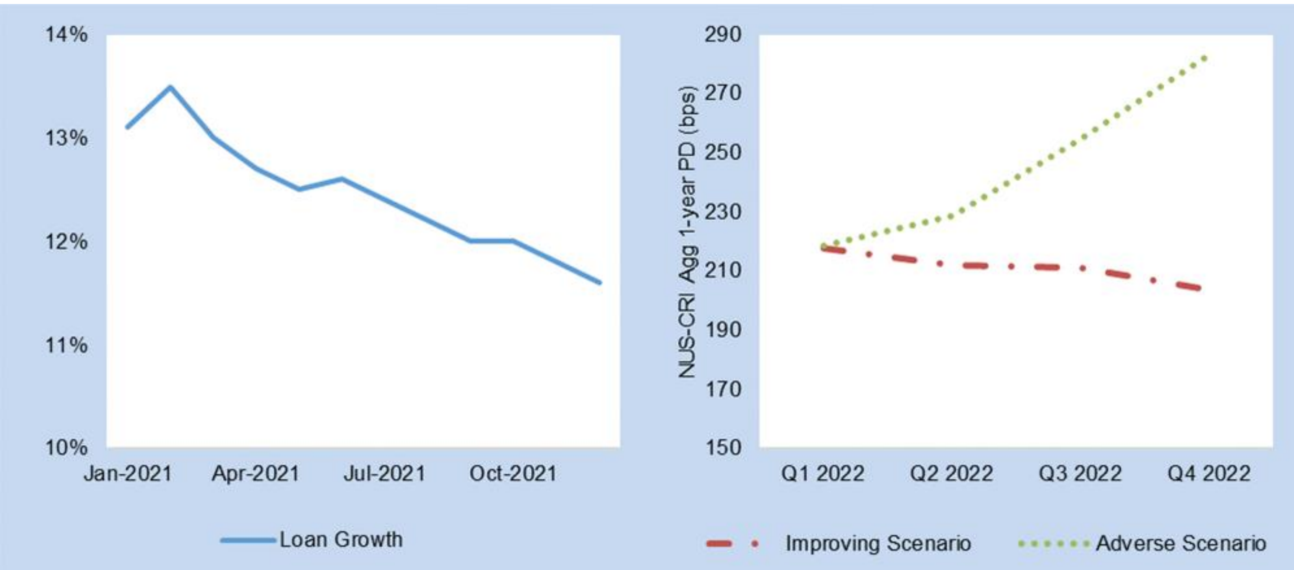


Figure 2a (LHS): Percentage loan growth rate (YoY) for CNY-denominated loans distributed by Chinese banks Figure 2b (RHS): Agg PD for the Chinese banks simulated under improving and adverse scenarios underpinned by a recovery in house prices and loan growth rate as of the end of Q1-Q4 2022. *Source: Bloomberg, BuDA v3.3.0*

The impact of different scenarios for economic recovery can be simulated by utilizing the Bottom-Up Default Analysis Toolkit (BuDA[3]) developed by NUS-CRI. Figure 2b showcases the simulated Agg PD (median of the stressed portfolio) for Chinese Banks in an improving and adverse macroeconomic environment. The improving scenario is underpinned by growth in loan demand and house prices to levels witnessed near the start of 2021. The adverse scenario is based on the current declining trend witnessed in loan growth and house prices continuing for the next 12 months. Given that the Agg PD under the adverse scenario diverges rapidly from that under the improving scenario post-Q2 2022, continued government intervention that can potentially revitalize the wider economy and improve credit growth conditions in the short term is vital for Chinese banks' credit outlook.

The real estate sector, which contributes a third of China's GDP, has continued to see an increase in defaults since the second half of 2021. As a result, Chinese banks have remained wary and highly selective when financing projects in the cash-strapped sector in an effort to mitigate the credit risk of their loan portfolio, with loans in the sector amounting to close to 27% of the industry's total lending operations. PBOC has thus urged banks to boost real estate lending in Q1 2022 in order to improve the sector's liquidity conditions. The authorities also allowed for new funding sources[4] for property developers in order to provide some breathing room, giving marginal relief from the deleveraging effort brought on by Three Red Line policy restrictions. For Chinese banks, this may be a double-edged sword. Firstly, the new policy may potentially lower NPLs leading to fewer defaults from the property sector, however, resultant increase in real economic productivity is unlikely as the now-accessible funds are most probably going to be used to pay off short-term debt liabilities. At the same time that banks are being pushed to extend credit to stronger developers in order to ring-fence the distressed developers from the rest of the sector, they are also under pressure to keep loan losses contained and mitigate potential fallout and cross defaults across their lending portfolio.

[3] The Bottom-up Default Analysis (BuDA v3.3.0) 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] Access to prepaid escrow accounts that have previously not been tapped are now available to Chinese developers

| | Q4 2020 | Q1 2021 | Q2 2021 | Q3 2021 |
|---|---|---|---|---|
| Net Interest Margin (NIM) | 2.10% | 2.07% | 2.06% | 2.07% |
| NPL ratio | 1.84% | 1.80% | 1.76% | 1.75% |
| Provisioning coverage ratio | 184% | 187% | 193% | 197% |
| Capital adequacy ratio | 14.7% | 14.5% | 14.5% | 14.8% |

Table 1: Key financial metrics for Chinese banks *Source: China Banking and Insurance Regulatory Commission*

Despite their macroeconomic and real-estate industry-specific challenges, Chinese banks may be well poised to face short-term headwinds caused by further stress on their loan portfolios. Should the fallout from the real-estate crisis continue to drive contagion risk in the wider market, the impact of a potential rise in NPLs may be mitigated by the industry's strong provision coverage (Q3 2021: 197%). The impact on the industry's capital position is also going to be limited given its robust capital buffers (As seen from table 1, the industry's capital adequacy ratio is around 14% throughout the first three quarters of 2021, well above the 10.5% minimum capital requirement). The industry's robust financials pave the way for Chinese banks to commence the regulation-mandated credit extension to the economy, which may improve the incumbent operational environment while mitigating potential capital losses.

That being said, loans extended to small businesses represent another source of potential further stress for Chinese banks. MSMEs in the country have been struggling with higher input costs, as well as from the fallout of a new set of COVID-19 pandemic restrictions. Notwithstanding the impact of this economic slowdown on the operational capability of MSMEs, borrowing costs for small businesses also continued to soar in 2021. The difference in borrowing cost between MSMEs and large corporations, which reached its highest level since 2012, was 2.73 percentage points[5]. To contextualize Chinese banks' exposure to this lending segment, the Chinese government has been consistently pushing banks, especially the Big Six[6] banks, to lend to the small business segment since the beginning of the pandemic, while actively encouraging double-digit loan growth over the past two years[7]. A further economic downturn may raise potential NPLs arising from MSMEs for Chinese banks, especially for the rural commercial banks sub-industry that have a higher exposure to their local MSMEs[8].

Going forward, the PBOC and other ministries of the Chinese government are expected to take additional actions to support businesses and revive economic growth, which should alleviate the stress on banks' profitability and further improve their asset quality. The PBOC has pledged that it will continue to use its tools to support the economy and is expected to further cut rates over the first half of 2022. The PBOC has also taken steps to extend its support to small businesses, which may reduce the operational and financing burden on MSMEs, and resultantly mitigate the adverse impact on banks' asset quality. The steps taken by the PBOC are set to be further supported by fiscal policy measures taken by the government. The Chinese government has announced an extension of tax cuts and a reduction of administrative fees for corporations. The government may also step up its spending efforts, especially in the infrastructure industry, to boost demand and stimulate economic recovery. However, with concerns around local provincial governments' debt increasing, it will be a fine balancing act between controlling debt and boosting infrastructure spending. As such, as Chinese corporates remain poised to benefit from an improving operating and financing environment, the Forward PD of the Chinese banking sector showcases a potential reduction in their credit risk, indicating that Chinese banks, especially large commercial banks such as the Big Six, are well placed to navigate this period of uncertainty.

[5] As of Nov-2021, around 4.4mn small companies deregistered since the beginning of 2021, highlighting the stress faced by SMEs.
[6] Big Six comprise of Agricultural Bank of China Ltd (ABOC), China Construction Bank Corp (CCB), Bank of Communications Co Ltd (BOCM), Industrial & Commercial Bank of China Ltd (ICBC), Bank of China Ltd (BOC), and Postal Savings Bank of China Co Ltd (PSBC)
[7] Exposure of Big 6 banks to the small business segment has increased rapidly with ICBC posting a 40.4% growth in June 2021, the largest amongst the Big 6.
[8] Rural commercial banks can already feel the stress arising from this sector as demonstrated by their NPLs rising well above the industry average to around 4% throughout 2021.

## Credit News

### U.S. Government bond yields rise after Fed announcement

**Jan 26.** The yields on US Government bonds rose after the Fed signaled plans to raise interest rates sooner than expected in mid-March to combat inflation. Benchmark 10-year Treasury note yields were up from 1.782% to 1.845%, while the two-year yield closed at its highest level since February 2020 at 1.089%, before further climbing to 1.156% in after-hours trading. The Fed also approved a final round of asset purchases and continued discussing plans to shrink its USD 9tn balance sheet. The expectation of increasing short-term interest rates triggered a rout in the bond market, driving yields to a peak since the start of the pandemic, while the DJIA and S&P 500 saw significant declines in tech companies and cryptocurrencies. Meanwhile, Treasury auctions were met with strong demand from investors, with above-average bidding signaling robust investor appetite for debt. (WSJ)

### Junk loans shine amid market rout

**Jan 26.** The USD 1.3tn market for leveraged loans gained 0.66% so far this year, with loan funds taking in a record USD 2.25bn in the week ended Jan 19, despite fears of rising interest rates driving losses in the stock market and safe debt market. As companies that issue leveraged loans pay floating interest rates, these loans tend to increase in value when rates rise, whereas the prices of bonds that pay the fixed interest payments tend to fall. The strong demand for leveraged loans has driven the price of existing loans up faster than expected. Despite leveraged loans issued by companies with low credit ratings, currently, default rates are near record lows, and rising interest rates remain a concern to investors. (WSJ)

### China's property crisis has investors in green bonds seeing red

**Jan 28**. Before China's property crisis, developers had rushed to issue green bonds, with Chinese real-estate firms selling close to USD 10bn of green bonds in 2021. However, the selloff in China's property-bond market in recent months and a string of defaults in the sector have hammered prices for many of these dollar-denominated green or sustainable bonds. Several of these securities now trade at less than 30 cents on the dollar. The rapidly growing environmental debt markets opened a new funding channel for China's highly leveraged developers, allowing them to tap the market at more attractive yields. However, the picture has changed rapidly in the past few months, as China's property companies have come under increasing financial stress. Several issuers of bonds tied to ESG are among those that have defaulted on their dollar debt, including Kaisa Group Holdings Ltd., which in Dec-2021 failed to repay USD 400mn of 6.5% sustainable bonds issued a year earlier. (WSJ)

### Asia high-yield ETF inflows surge even as performance plummets

**Jan 27.** Asian high-yield exchange-traded funds (ETF) have seen substantial inflows in Q4 2021, although overall returns plummeted in H2 2021. The Asia high-yield bond market has been dominated by US dollar-denominated debt issued by Chinese real estate giants facing a combination of tightening borrowing restrictions and declining home sales. On Sep 23, Evergrande missed interest payment on an offshore bond and triggered turmoil in the Chinese real estate market as several developers reported warnings on delayed bond payments over the past few months. However, this has not stopped global investors from pouring money into Asia's high-yield bond market, with ETFs serving as a convenient and liquid tool. Many investors have been buying into such ETFs in recent months as they see the crisis as an opportunity to enter at a low cost to capture the upside and to diversify away from single bonds. (FT)

### Wall Street's green push exposes new conflicts of interest

**Jan 29.** Financial services firms are spending billions to boost their climate-related operations, with more than USD 3.5bn spent on buying green-ratings companies and data providers over the past two years. Many firms providing ESG ratings are already managing deep conflicts of interest because they are paid by the companies they judge. Now, a new set of potential conflicts arise, as the practice of selling ESG ratings alongside related services such as consulting becomes widespread. Companies may feel pressured to buy ESG services from credit-rating firms to maintain a good relationship and safeguard their credit rating, while credit-rating firms may be more reluctant to downgrade companies that pay them large fees for credit ratings and, now, for ESG services. Additionally, there is an incentive to hand out high ESG scores, as ESG raters typically get most of their income from investment firms that package top-scoring companies to create green-branded products for investors. (WSJ)

**Inter Milan returns to bond market with EUR 415mn debt refinancing** (FT)

**Sri Lanka 'trying all options' to avoid default, says finance minister** (FT)

**Argentina, IMF agree to restructure USD 44bn bailout** (WSJ)

## Regulatory Updates

### Fed's tightening plan upends outlook for treasury's bond sales

**Jan 31.** With the reduction of pandemic-relief spending, the Treasury began scaling back longer-term debt in Nov-2021, forcing dealers to prepare for bigger auction sizes in the future. Asset sales, including three-, 10- and 30-year debt in the coming quarter, are expected to reach USD 110bn, about USD 10bn less than in November. By the end of 2024, the Fed's USD 8.9tn balance sheet is forecasted to be reduced by USD 2.8tn, and about two-thirds of the reduction will come from US Treasuries. Ample liquidity in the money market, which is supported by USD 1.6tn cash parked in the Fed's reverse repo facility, could flow to short-term Treasuries. At the same time, longer-term debt sales are projected to shrink again in May. The sales of Treasury Inflation-Protected Securities are experiencing an expansion. (Bloomberg)

### Turkey's Erdogan vows to continue lowering interest rates

**Jan 29.** Turkey President Recep Tayyip Erdogan has promised to continue cutting interest rates after the Turkish central bank halted a rate-cut cycle this month that trimmed 500 basis points from the benchmark rate since Sep-2021. The lira had plunged to historic lows, and inflation hit a 19-year high after the central bank started the rate-cut cycle in line with Erdogan's demands. Turkey will release January inflation data on Thursday. Annual inflation is expected to surge to 48% according to analyst estimates. (Bloomberg)

**Australia to scrape QE, revise up inflation as rate debate builds** (Bloomberg)

**India to boost spending with near-record debt** (Bloomberg)

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