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Chinese banks' credit profile benefits from improving operating environment despite threats of systemic risk

by Raghav Mathur

- **NUS-CRI PD indicates that Chinese banks' credit profile has improved since the initial shock of the COVID-19 pandemic**
- **The credit improvement happened amidst the improving operating environment and regulatory interventions**
- **Nevertheless, overexposure to the domestic real estate market poses a threat to China's top 6 systemically important banks as measured by the NUS-CRI CriSIB**

China domiciled banks' (Chinese banks) have benefitted from the country's impressive economic recovery since the onset of the COVID-19 pandemic. The improved operating environment has helped to increase domestic loan demand, with CNY-denominated loans increasing by a record CNY 3.58tn in Jan 2021. Chinese banks have also been affected by an increasing emphasis on state-driven regulatory reform that has aided the holistic improvement of the industry's credit profile. The NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) (see Figure 1a) demonstrates the overall improving credit health of Chinese banks. Notwithstanding the improvements, short-term risks are still prevalent as the industry is particularly exposed to exogenous shocks in vulnerable asset classes such as real estate. This, coupled with their high level of 'connectedness' with the wider financial system, points to potential vulnerabilities in some of China's most important banks as ranked by the NUS-CRI Systemically Important Banks (CriSIB[1]).

[1] CriSIB is the ranking of systemic importance for exchange-listed banks around the world. It is dynamic by nature, and it determines a firm's systemic risk by its size and interconnectedness with others. A higher ranking of a firm means it is likely to pose a larger threat to the global (group) financial system. NUS-CRI Systemically Important Banks monthly (January 2021) rankings can be found at the NUS-CRI Website.

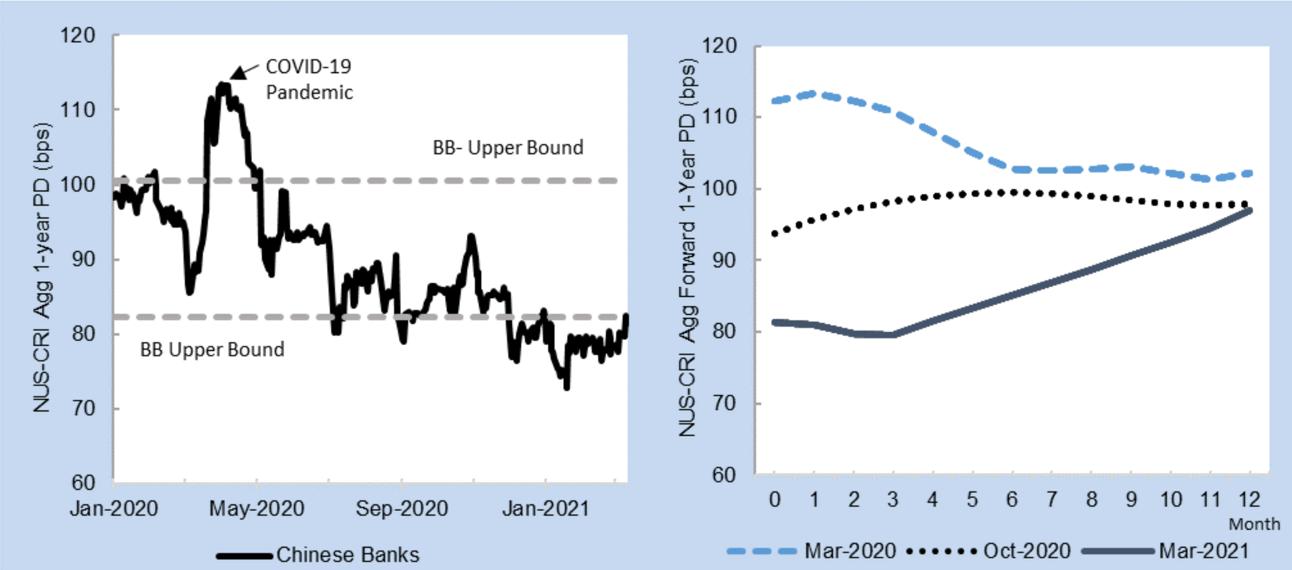

Figure 1a (LHS): NUS-CRI Agg 1-year PD for China domiciled listed banks with reference to PDiR2.0[2]. Figure 1b (RHS): NUS-CRI Agg Forward 1-year PD for Chinese banks based on data feed as of Mar 2020, Oct 2020 and Mar 2021. *Source: NUS-CRI*

From Figure 1a above, we can see that the Agg PD for Chinese banks decreased from 113bps at the end of Mar-2020, to 81bps by mid Mar-2021. Despite the volatility in the Agg PD, the overall trend is downwards, validating the notion that the credit health of Chinese banks has been improving steadily over the past year. This downward trend is not surprising given that China saw a cumulative recovery in GDP growth of 14.6% YoY in the last three quarters of 2020. Simultaneously, the demand for total domestic loans in China increased from CNY 163tn to CNY 174tn, while Non-Performing Loans (NPL)/Total Loan ratio for Chinese banks decreased from 1.91% to 1.84% over the same period. Similarly, the aggregate capital adequacy ratio for Chinese banks has also been increasing since the start of Q2 to the end of the year from 14.2% to 14.7%, increasing the ability of the sector to absorb losses should potential NPLs increase in the near future. The trickle-down effect of improvement in economic performance, and underlying strengthening of the industry's capital position, could help explain the improving credit profile of the industry.

NUS-CRI Aggregate (median) Forward 1-year PD (Forward PD[3]) also demonstrates the improving credit outlook on a YTD basis (Figure 1b). We see that the short-term credit outlook between Mar-2020 and Mar-2021 has diminished by 31bps. The improvement came amidst regulatory interventions to reduce risk in the industry. Concerns regarding overexposure to volatility and potential 'bubble' in property prices has catalysed regulators to impose restrictions on bank lending in the real estate sector both on mortgage loans and loans to property developers.

[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.

[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.

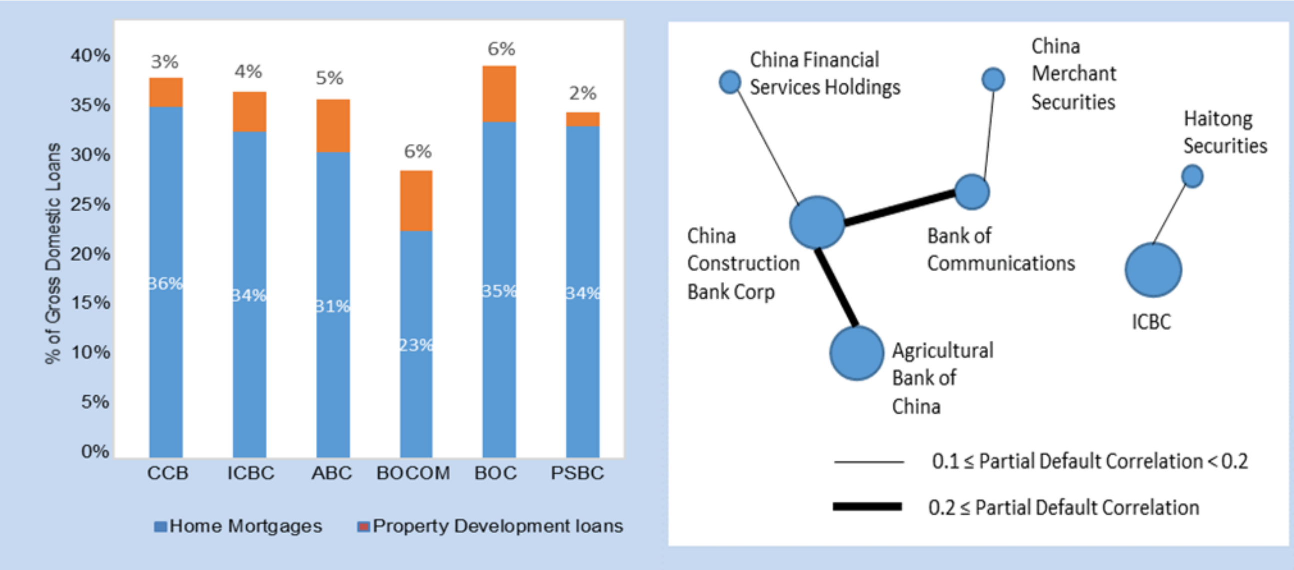

Figure 2a (LHS): % of total domestic loans that are appropriated for Home Mortgages and Property development loans for the 6[4] biggest banks in China. Figure 2b (RHS): Visualisation of the 'connectedness' and size[5] of the top 5 systemically important banks in the world with a partial default correlation of greater than 0.1 when referenced to CriSIB for Jan 2021. *Source: Fitch, NUS-CRI*

Regulators introduced a cap of loans to the real estate sector to 40%, with mortgage lending not exceeding 32.5% for the six biggest commercial banks. Figure 2 illustrates that the 6 biggest banks, 5 of which are the five most systemically important banks in the world according to CriSIB, own 30-40% of loans with exposure to the domestic real estate market. As systemically important banks' asset quality is linked to the health of the domestic real estate sector, any potential shock or excessive volatility may have consequences to the health of the whole financial system in the country[6]. The NUS-CRI CriSIB network links in Figure 2b illustrate that CCB, ABC and BOCOM have strong default links with each other, with a partial default correlation[7] measure of greater than 0.20, indicating that any exogenous negative shock linked to CCB's loan portfolio may have significant ripple effects on both these banks, and thus, may be reflective of heightened risk in the overarching domestic banking network.

[4] CCB = China Construction Bank Corporation, ICBC = Industrial and Commercial bank of China, ABC = Agricultural Bank of China, BOCOM = Bank of Communications, BOC = Bank of China, PSBC = Postal Savings Bank of China. These 6 banks are the biggest and systemically most important in the country.

[5] The size of the bubble is the measure of the total asset size of the banks. CCB = USD 4.16tn; ICBC = USD 5.2tn; ABC = USD 4tn; BOCOM = USD 1.5tn; China Financial Services holdings = USD 709mn; China Merchant Securities = USD 70bn; Haitong Securities = USD 113bn

[6] Though the focus in this article is solely on China domiciled banks, the same sample ranks in the top 5 for systemically important banks in the whole world. Thus, the potential impact of exogenous shocks experienced by these institutions may be profound on the global financial network as well.

[7] Partial default correlations measure only the direct connection between any two banks in terms of their future default likelihoods. For example if default events in Bank A and B are correlated, and Bank B and C are correlated, naturally A and C are going to be correlated as well. But in a partial correlation matrix, the correlation of A and C will be 0. You may find more information here.

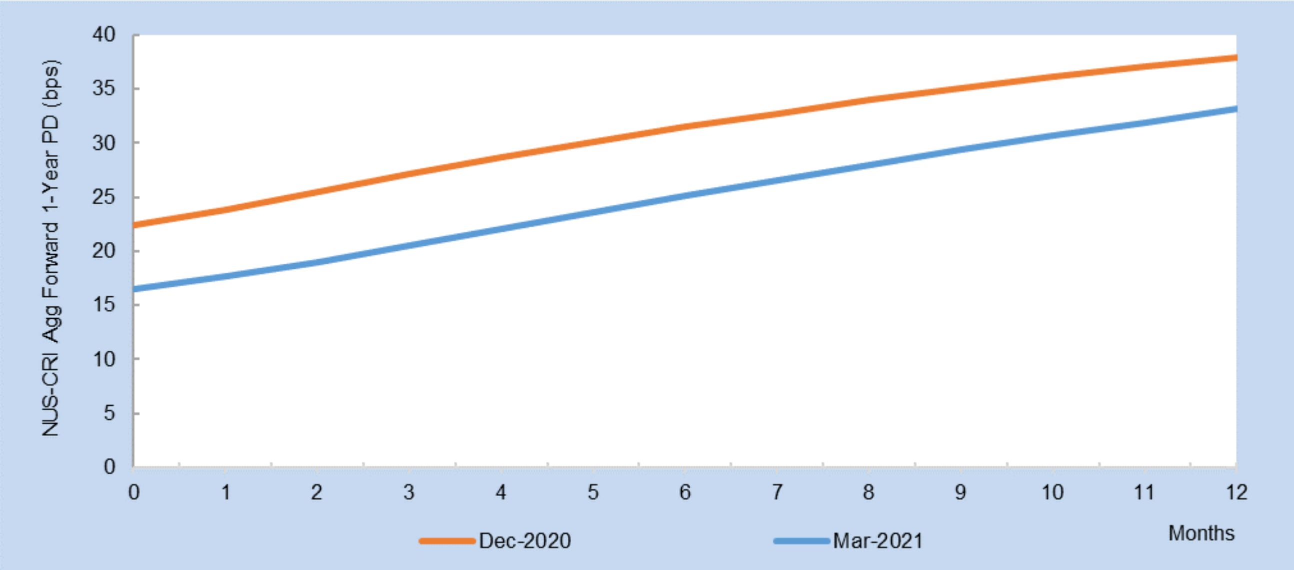

Figure 3: NUS-CRI Agg Forward 1-year PD for the 6 biggest commercial banks on Dec-2020 and Mar-2021 data feed. *Source: NUS-CRI*

Concurrent with the implementation of new regulations mentioned above, the 6 biggest banks have seen their credit outlook improve this year when compared to that at the end of last year. However, the top 6 systemically important Chinese banks still face threats of rising NPLs, like those experienced by ICBC at the start of Mar-2021, which demonstrate a potential risk on these banks' asset quality. Given that the domestic real estate sector has also been under tight scrutiny by regulatory watchdogs due to their highly levered balance sheets, risks of rising defaults in the sector pose a real threat to the balance sheet of these banks. Overall, the credit profile of the whole industry has been improving, though threats of systemic risks pertaining to real estate asset class exposure may still provide some woes in the future.

Credit News

China accelerating bankruptcy process of heavily indebted firms

Mar 13. China is gearing up on crisis management before the 2022 party congress. Recently, the government-tied travel firm, HNA Group, saw over 300 of its companies going into rehabilitation. The procedure allows the business to reconcile its future development with its lenders. As the rehabilitation process termed "chong zheng" is increasingly prevalent, the financials are aligning themselves with the state. This is imperative as the Chinese capital market grows in financial risk. Management has become more important than ever to maintain China's creditworthiness. (Nikkei Asia)

China provinces rush to address 'hidden debt'

Mar 12. This season has recorded an attempt to shore up funding by the Chinese local provinces. This is in response to the onset of the Chinese government's deleveraging attempt. Bond sales under the local government financing vehicles have soared over 75% to CNY 290bn as of Jan 2021. As the recent high-profile defaults of Tsinghua and Yongcheng set in, the formerly comforting implicit government guarantee is very much shaken. As regulators go on to remove liquidity from the financing landscape, defaults are on the rise. (Nikkei Asia)

Europe's first sustainable junk bond draws scrutiny over green impact

Mar 12. A Greek power company recently raised over EUR 650mn via sustainability linked high yield bond issuance. The 5-year paper is issued at a rate of 3.875%. Enjoying the influx of demand, the corporation was able to increase the issuance amount by EUR 150mn. Unlike green bonds, there is no requirement for sustainability linked notes to direct capital to green causes. It is up to the firm's prerogative to set its benchmarks and reach them. The possibility of firms being rewarded for their failure to be on a more environmentally friendly path raised scrutiny from investors. (FT)

American Airlines launches biggest debt deal in industry's history

Mar 11. American Airlines recently issued junk bonds worth USD 6.5bn, in conjunction with USD 3.5bn worth of loans, marking the largest debt issuance ever in the airline industry. This was increased from USD 5bn and USD 2.5bn after investor demand surged. The airline issued two tranches of debt at 5.5% and 5.75%, which were significantly lower than the 11.75% that it issued last year. The issuance will provide the company with a year and a half worth of cash while noting that it will likely burn USD 30mn of cash daily in the first quarter of this year. The deal is collateralized by American's loyalty programme, which boasts a 53% profit margin, above its competitors United and Delta. The proceeds of the loan will be partially used to refinance its government loan obtained last year. (FT)

Banks adopt new debt terms to avoid repeat of Citi's USD 900mn payment mishap

Mar 10. American banks have begun to add legal clauses to prevent funds from being moved by accident and prevent a repeat of the USD 900mn error from Citigroup, which occurred after the bank transferred its own money by accident to creditors. The funds were unable to be recovered following further legal discourse, causing its profits to drop by USD 323mn in the fourth quarter. These clauses are now being added all across Wall Street, which state that funds that are accidentally sent to lenders could be recalled on demand by banks, and typically allows banks to decide as to whether the payment was made by accident. However, it remains to be seen if investors will be willing to return funds in the case of actual accidental payments in the future. (FT)

HSBC toughens stance on fossil fuel funding after shareholder heat (Nikkei Asia)

Norwegian Air makes final restructuring offer to creditors (Reuters)

Higher mortgage rates bring cheer to Canadian banks, but rapid rise could end house party (Reuters)

Regulatory Updates

ECB to boost emergency bond buys to stem yield rise

Mar 11. The ECB has made clear that it will increase its purchases of debt instruments over the next quarter, as it tries to keep interest rates low. It holds almost a trillion euros to serve this goal and has not made any further policy changes, instead choosing to focus on asset purchases to control the economy. The central bank hopes to assure investors regarding its aim to slow the rally in bond yields, which have occurred as a result of tightening supply, rising oil prices as well as increased expected inflation in the US. The move for open market operations was met with divided opinions, as some feel that the increase in yields could be beneficial for the economy. The region is expected to experience marginally higher inflation, coupled with slower growth as a result of the pandemic. (Reuters)

Federal Reserve to close most Covid crisis emergency facilities

Mar 9. The Fed is withdrawing most of its lending facilities. These include the Commercial Paper Funding Facility, the Money Market Mutual Fund Liquidity Facility and the Primary Dealer Credit Facility. The closure leaves only the Paycheck Protection Program Liquidity Facility, which provides funds to financial institutions that originate such loans. Right now, banks and investors are pending the directive of the Fed on the concessions for capital requirements. (FT)

China central bank rolls over CNY 100bn of medium-term loans, keeps rate unchanged for 11th month (Reuters)

Brazil central bank extends reserve requirements to boost liquidity, economic recovery (Reuters)

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