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South Korean and Chinese Banks' credit quality diverges amidst differing tapering stances

by Ng Ziyan Derlyn

- **With contrasting policies enacted by their respective governments, the NUS-CRI Agg PD demonstrates the diverging credit profiles of Chinese banks as compared to their Korean counterparts**
- **The NUS-CRI Agg Forward 1-year PD (Forward PD) demonstrates that the outlook for Korean banks remains stable amidst interest rate hikes, while the outlook for Chinese banks improves**

As the narrative around the world shifts towards reducing bond purchases, raising interest rates, and curbing potential overshooting inflation, this week's issue of NUS-CRI's Weekly Credit Brief focuses on the impact of different monetary policies in the Asian financial landscape. Chinese and South Korean banks[1] see diverging credit profiles arising from the differing government policies enacted to maintain growth and curb inflation respectively in the wake of a resurgence of the pandemic. On one hand, the Chinese government is taking a dovish stance to bolster the economy by cutting banks' reserve requirements. On the other hand, the hawkish move by the Bank of Korea saw interest rates increasing in an attempt to rein in rising debt and inflation. The NUS-CRI 1-year Aggregate (mean) Probability of Default (Agg PD) for Chinese banks is currently peaking at 193bps, surpassing the BB- upper bound according to the PDiR2.0[2]. Meanwhile, the Agg PD for Korean banks displayed a decreasing trend and briefly crossed the BBB- Upper Bound before sitting at 34bps currently (See Figure 1a). It is evident that Chinese banks are facing headwinds in their credit profile, whereas Korean banks are faring better than their peers in terms of credit risk. The NUS-CRI Agg Forward 1-year PD (Forward PD[3]) depicted in Figure 1b further emphasizes the higher credit risks in the short-to-medium term for Chinese banks, compared to the relatively stable outlook for Korean banks. In the long term, Chinese banks experience falling credit risk as the Chinese government aims to curb the build-up of financial risk, while Korean banks see their credit risk stabilizing.

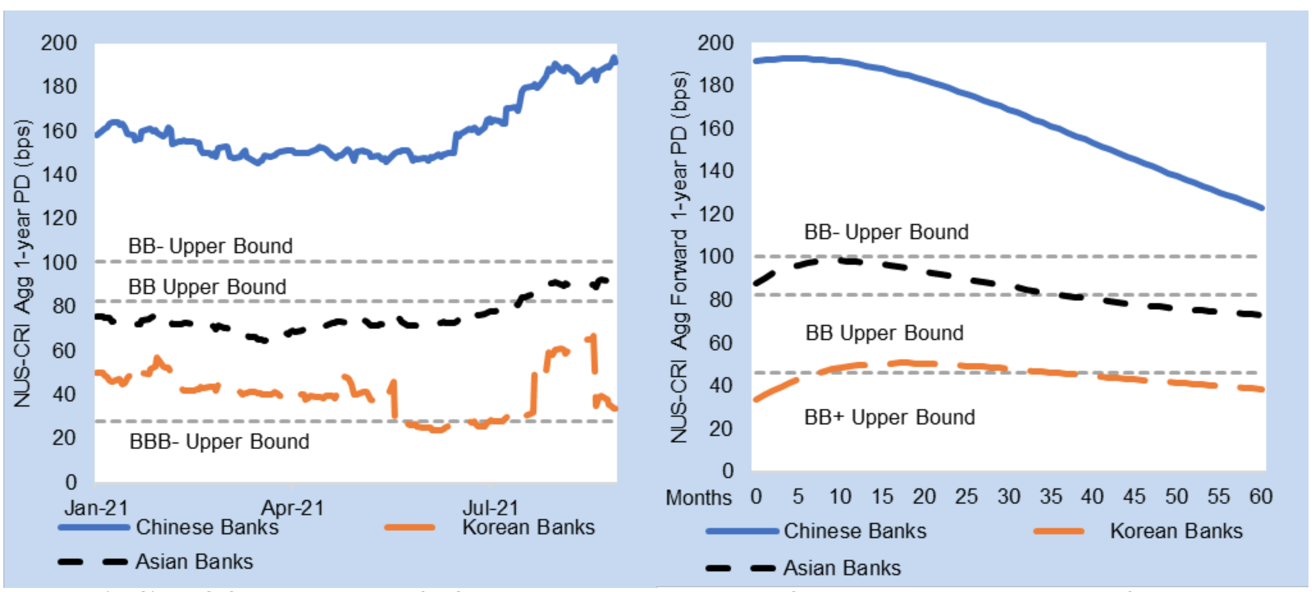

Figure 1a (LHS): NUS-CRI Agg 1-year PD for Chinese, Korean and Asian Banks from Jan-2021 to Aug-2021 with reference to PDiR2.0 bounds. Figure 1b (RHS): NUS-CRI Forward 1-year PD for Chinese, Korean and Asian Banks as of Aug-2021. *Source: NUS-CRI*

[1] NUS-CRI's sample contains 5 active banks domiciled in Korea.

[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, conditional on the firm's survival in the next 6 months.

Chinese banks continue facing a cloudy operating environment. Since 98% of their loans are concentrated within China, Chinese banks' credit health is heavily dependent on the health of the Chinese economy. Recent statistics of industrial, consumption, and investment activities all showed decelerating growth. The Non-manufacturing Purchasing Managers' Index (PMI) of Aug-2021 fell to its second-lowest level ever recorded. After an 18.3% YoY expansion in Q1 2021, the economy grew only 7.9% YoY in Q2 2021, with estimates that the growth may retreat further in the second half. Additionally, Beijing's crackdown on the fastest-growing sectors could stymie bank lending and have a negative impact on credit. Credit growth is expected to slow further, with Beijing asking banks to slow their loan growth in an effort to not overheat its domestic credit markets, as policies are expected to tighten up to 80% of domestic credit demand. To prevent risks in the real estate sector, the government imposed financing curbs on 35% of banks' loan books for mortgages and other property financings. This resulted in the growth of property loans tumbling down to 10.3%, shrinking their mortgage business in Jul-2021. Furthermore, curbs to the already indebted sector could lead to more bad loans in the property sector. However, these curbs aid to prevent a build-up of long-term systemic financial risks in the banking sector that may have overarching implications for the economy in the long term (See Figure 1b).

Meanwhile, Korean banks have a contrasting operating environment. After the benchmark rate had been cut to 0.5% in May-2020, the lowest on record, the Bank of Korea has become the first central bank in a major Asian economy to hike its interest rates. With inflation near a 9-year peak of 2.6% in Aug-2021 and house prices skyrocketing, raising interest rates signals that the government believes that increased household debt and inflation are a greater threat to the economy, compared to the possible economic slowdown caused by the Delta variant. Furthermore, as a residual impact of China's recent regulatory crackdown, there has been an outflow of capital away from Chinese companies into other major Asian markets. Korean companies, in particular, have also benefited from this capital inflow, as higher investor demand helped fuel a record spike in Korean initial public offerings. As such, these companies may be able to gain better access to funds, which will reduce their financing risk as they will be better positioned to meet their obligations to their domestic loan repayments.

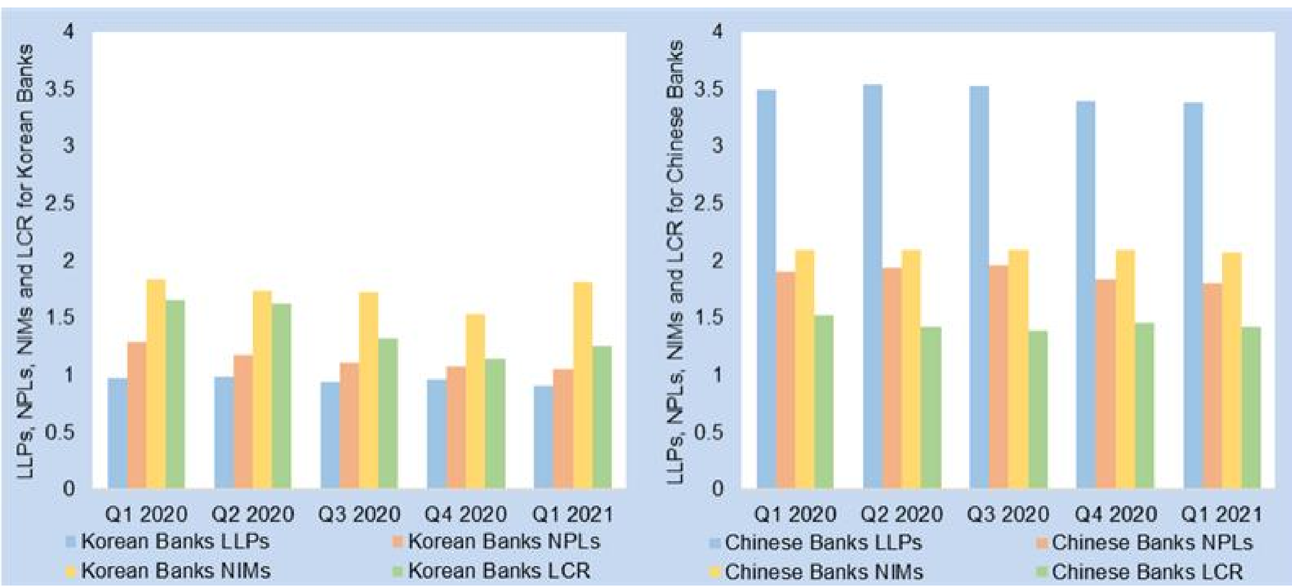

Figure 2a (LHS): Loan Loss Provisions (LLPs), Non-Performing Loans (NPLs), Net Interest Margins (NIMs) and Liquidity Coverage Ratio (LCR) for Korean banks from Q1 2020 to Q1 2021. Figure 2b (RHS): Loan Loss Provisions (LLP), Non-Performing Loans (NPLs), Net Interest Margins (NIMs) and Liquidity Coverage Ratio (LCR) for Chinese banks from Q1 2020 to Q1 2021. *Source: Bloomberg, China Banking and Insurance Regulatory Commission, Financial Statistics Information (Korea)*

In Q4 2020, the Chinese banking industry's bad loan ratio peaked at 1.96%, the highest in six years, pressuring banks' cash flows due to worsening asset quality and lower profitability from loans gone sour. Although the NPL ratio has since dropped to 1.76% as of Jun-2021, Chinese banks are still wary of a rebound in NPLs because of their high exposure to the property sector, with the four most systemically important banks in the world according to CriSIB[4] as of Aug-2021 owning 30-40% of loans that have exposure to the domestic real estate market. Furthermore, the government's ability to resolve increasing debt at other state-owned enterprises puts pressure on Chinese banks. In an event of a bailout, banks would be forced to support these distressed companies, whilst banks, which are the principal lenders and owners of the companies' onshore bonds, would

[4] 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 rankings can be found at the NUS-CRI Website.

be negatively impacted in an event of a default. For example, the possible restructuring of Huarong could see banks extending loans to Huarong to meet its obligations.

On the other hand, Korean banks saw their NPLs dip to 0.95% (See Figure 2a), on the back of a rebounding economy, with the economy in the second quarter growing at the fastest pace annually in ten years. Although Korea has seen a spike in COVID cases amounting from the Delta variant, the economic impact has been cushioned by strong demand for consumer electronics, semiconductors, and automobiles internationally.

As a result of the gloomy economic environment, the Loan Loss Provisions (LLPs) have remained high for Chinese banks, stagnating around 3.4%, higher than Korean banks' Loan Loss Provisions of 1% (See Figure 2a). LLPs for Chinese banks are almost double their NPLs, indicating that Chinese banks have set aside more funds to cover bad loans, as they expect NPLs to increase. This would strain the sector's cash flow generating abilities. In contrast, LLPs for Korean banks are historically low, which signifies stable NPLs, on the back of consistent growth of 4% expected in the economy. Furthermore, as depicted in Table 1, Korean banks have consistently higher capital ratios than their Chinese counterparts, allowing them to weather a potential downturn in the future even if there is a spike in NPLs due to a resurgence of COVID-19 cases.

Tier 1 Capital Ratios	Chinese Banks	Korean Banks
Q1 2020	10.88%	12.00%
Q2 2020	10.47%	12.30%
Q3 2020	10.44%	12.20%
Q4 2020	10.72%	12.80%
Q1 2021	10.63%	13.90%
Q2 2021	10.50%	13.60%

Table 1: Tier 1 Capital Ratios for Chinese and Korean banks from Q1 2020 to Q2 2021. *Source: China Banking and Insurance Regulatory Commission, Bloomberg*

Furthermore, due to low interest rates and mortgage repricing, Chinese banks' Net Interest Margins (NIMs) have been under pressure (See Figure 2b). NIMs for Chinese banks have been falling as a result of US-China trade tensions and the COVID pandemic in Q1 2020. With the government's request for the largest banks to increase the proportion of loans to small and medium enterprises by 30% in 2021 alone, the banks' profitability and asset quality will deteriorate as they lend to riskier businesses at lower interest rates. For example, as of end Jun-2021, Chinese banks loaned CNY 888bn to small and medium-sized firms at a rate of 2.25% through the relending facility[5], lower than the one-year medium-term lending facility. The low-interest-rate environment in China is expected to persist, which continues to threaten the banks' profitability in the months to come.

Meanwhile, South Korea raised its interest rates for the first time since the pandemic struck 18 months ago. The rate hike could reduce the burden on South Korean banks' profitability by lowering the pressure on NIMs. Currently, the Korean banks have been experiencing increasing NIMs since Q4 2020 (See Figure 2a). With rate hikes expected in the next few quarters, Korean banks look poised for their NIMs to increase over the upcoming years. However, this increase in interest rates could make it more difficult for households and corporations to repay their loans, which could lead to a rise in the banks' credit risk over the next year (See Figure 1b).

In an attempt to boost the Chinese economy, the People's Bank of China (PBOC) lowered the reserve requirements for financial institutions by 0.5 percentage points in Jul-2021 to a weighted average of 8.9% which will release around CNY 1tn in long term liquidity. This move will help stabilize banks' funding needs and support their credit growth by saving banks CNY 13bn in interest payments. It lowers the cost of lending which alleviates asset quality concerns, improving the return on released capital by around 2 percentage points. However, it may be insubstantial as it translates to less than 1bps of the banks' total debt cost of CNY 185.5tn as of end Jun-2021. Furthermore, the reserve ratio cuts may be primarily aimed to benefit loans for small businesses, which will only serve to increase risks, as banks are charging lower interests for riskier loans. Currently, Chinese banks' Liquidity Coverage Ratio (LCR) stands at 1.42 as of Q1 2021, which is marginally higher than Korean banks' liquidity coverage ratio of 1.25 (See Figure 2b). This can be attributed to the Korean Financial Services Commission lowering the LCR baseline for both domestic and foreign assets to 85% and 70% respectively in Apr-2021. As such, Korean banks are poised to be more profitable, as they can give out more loans, compared to their Chinese counterparts who have to hold more cash as per the government's requirements.

High funding costs, margin pressure amid low-interest rates, and tighter rules on loans to major business categories such as real estate development have all undermined Chinese banks' profitability. Another cause for

[5] The relending program targets banks to help lend to small and medium enterprises at a lower rate.

concern is the “shadow” products totalling CNY 3tn, which will consume a bulk of the capital for smaller banks if it is moved onto the banks’ balance sheets by end-2021. However, with the benefits of the crackdown only being realized in the longer term, credit risks for Chinese banks have heightened in the short term, but the outlook is stable for the longer term. On the contrary, South Korean banks are poised to benefit from the increased interest rates and are expected to maintain a stable credit profile in the long term.

Credit News

Chinese credit beats Asian peers as Huarong worries recede

Sep 1. China's corporate bond returns attracted investor interest in August as Chinese notes experienced a rebound, in concurrence with total return on corporate dollar debt surging to 1.5%. Following a bailout of China Huarong Asset Management Company, Huarong's notes became top performers in China's dollar debt market in August. China's high yield debt also rallied with returns of 3.1% in August, higher than Chinese investment-grade notes and Asian low-rated peers. Although the rally provides a respite in the near term, risks remain as China's property sector continues to be a source of worry. However, investors also foresee prospective growth in Asia, led by cyclical industries like auto and transportation of China and India. (Bloomberg)

A surprise bond rally sweeps over India as global funds pile in

Sep 6. Following a rise in yields on Indian government 10-year bonds to the highest level since March 2021, foreign investors purchased a total of INR 43.7bn of Indian sovereign bonds since the last week of August, while mutual funds recorded INR 151bn in bond purchases over the past ten trading days. This boost in risk sentiment by foreign investors is likely driven by expectations of low inflation risk, and the assurance that the Fed would be gradual in tapering stimulus. (Bloomberg)

Clock ticks for Evergrande as USD 7.4bn of bonds due 2022

Sep 6. China Evergrande Group needs to raise cash to repay USD 7.4bn of bonds due in 2022. Evergrande's dollar notes plummeted to record lows after it warned of a possible default. With cash and equivalents at a six-year low, its ability to repay short-term debt worsened in H1 2021. Should it be unable to sell assets and extend borrowings successfully, the liquidity problem may worsen, with its onshore bonds downgraded by China's biggest credit rating agency. Its yuan bonds are not accepted as collateral anymore in China's key funding market. Although Chinese regulators have urged Evergrande to address its debt problems, the government remains silent on whether it will provide financial support. Despite Evergrande giving discounts on its properties to raise cash, its contracted sales fell 26% YoY in August. (Bloomberg)

Search for yield leads bond buyers to unrated debt

Sep 5. The average yield for US speculative-grade corporate bonds has plunged as low as 3.53%, more than one percentage point lower than any time before the COVID-19 pandemic. This low-yield environment is particularly challenging for high-yield fixed-income investors as buying the wrong bonds could cause them to lag benchmark returns and contend with drawn-out default-resolution processes. As such, high-yield fund managers have been piling into the lowest-rated speculative-grade debt; with some even looking for yield in smaller, less-liquid bonds that are often unrated by the three major credit rating agencies. Due to the scarcity of potential buyers, owning these less-liquid bonds could be risky as their prices are vulnerable to falling sharply during a market downturn. Nevertheless, such investors believe that the attractiveness of these bonds is justified given that the economy is still at a relatively early stage in the economic cycle. (WSJ)

'Solar bond' demand goes through the roof

Sep 4. The sale of solar bonds, debt issued to finance the purchase of rooftop solar panels by US households, hit a record high of USD 2bn in the first half of 2021, double the amount during the same period in 2020 and 2019. Demand for solar panels is increasing as they reduce dependence on electric grids and help individuals cut their electricity expenditure, amidst unpredictable weather patterns including hurricanes that could cut power suddenly. Solar bonds are popular among investors as borrowers that own homes, have a good credit standing, in addition to meeting investors' ESG targets, back them. Currently, the solar bond market is still relatively small, but with established fund managers like BlackRock Inc. starting to invest, the market is projected to grow substantially in the future. (WSJ)

Divided RBI no reason to flee bond markets, top bank says (Bloomberg)

Taper welcomed by risky emerging bonds with world-beating rally (Bloomberg)

Carlyle to raise USD 1bn debt to acquire Hexaware, mint says (Bloomberg)

Regulatory Updates

ECB weighs slower bond purchases as economy rebounds

Sep 6. With Europe's economy on the path to recovery, the main question faced by the European Central Bank (ECB) is how it should unwind its asset purchase program without adversely affecting economic recovery. Inflation, which has risen to a decade high, is also a formidable concern facing the ECB. The surge in inflation is cause for tension ECB governing council between "hawks" who support a reduction in stimulus and "doves" who want to maintain the incumbent loose monetary stance. With the Eurozone's GDP growth over 2% in Q2 2021 and inflation at 3% as of August, the hawks believe that any delay in response from the ECB may force it to take sudden measures to tighten policy and prevent overheating of the economy. (FT)

China likely to quicken fiscal spending, but policy rate cuts not on the cards

Sep 1. Amid slowing economic recovery, China is likely to accelerate fiscal spending and credit growth. The market anticipates that PBOC will cut banks' reserve requirement ratio again to compensate for liquidity shortages toward the year-end. Meanwhile, market yields are low enough that a rate cut could widen the gap between China and US monetary stances, triggering sharp capital outflows. According to recent economic statistics, the Chinese economy is losing steam and facing more pressure in H2 2021. Investors increasingly expect local governments to accelerate bond issuance to expand credit and stimulate activity, possibly exceeding CNY 1tn in Sep. To offset growing bond issuance and heavy maturities of medium-term loans, analysts expect ample liquidity conditions with a loosening bias throughout the year. Policymakers, however, are also wary of increased two-way yuan volatility considering possible Fed tapering. Economists expect Chinese authorities to move fast to avoid a surge in capital outflows. (Reuters)

Australia faces renewed taper talk as sluggish rebound looms (Bloomberg)

Fed delay on taper past September is all but certain on job data (Bloomberg)

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