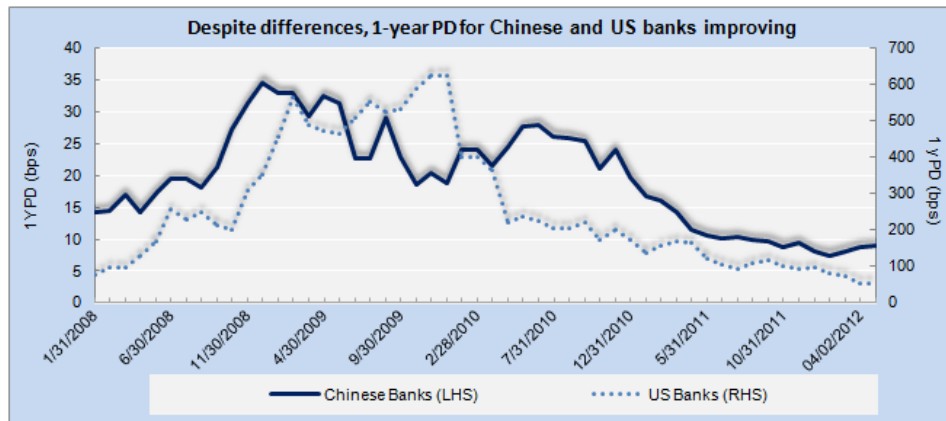


Stories of the Week

Latest earning results reaffirmed a positive trend in Chinese banks' credit outlooks

The credit outlook for the Chinese banking sector continues to show resilience according to RMI CRI data, despite widespread concerns fueled by an economic slowdown, a government clampdown in the property market and deteriorating local government finances. The RMI CRI 1-year probability of default (PD) for Chinese banks fluctuated narrowly in a range between 7 and 9bps during the first quarter of this year and ended at 8.8bps on April 2, continuing the downward trend that began in November 2010.



The latest earnings reporting season for Chinese banks revealed an encouraging picture that defied common market expectations. China's biggest banks, including Industrial & Commercial Bank of China (ICBC), Bank of China (BOC), and China Construction Bank (CCB), posted continuous growth in profits and lending during the financial year ending December 31. Notably, fees earned from bank intermediary services, such as consulting and interbank money transfers, increased at an average pace of 45.7% during 2011, providing strong support for Chinese banks as they diversify away from traditional lending businesses.

However, at the same time, the longevity of Chinese banks' robust business performance may be questionable, given widely-held expectations that a deceleration of the Chinese economy may cause a surge in non-performing loans (NPL). NPL data released alongside Q4 bank earnings dampened the otherwise all-around positive bank results, with the ICBC and BOC reporting a quarterly increase in their NPL ratios of 0.03% and 0.01% respectively, while the NPL ratio at CCB increased by 10% during the same period. Nonetheless, the negative effects of the aforementioned problems on the credit outlook of Chinese banks are largely expected to be mitigated by a range of factors listed below. Interestingly, US banks currently appear to be lagging behind their Chinese counterparts in some of these aspects. Underperformance in these areas is also a potential risk to the credit outlook for the US banking sector, despite a fall in PD during Q1.

Firstly, a heavy government presence and close supervision within the Chinese banking system should overall be a credit positive. Moves by Central Huijin Investment Company, China's sovereign wealth fund, to lower the dividend payout ratio at three of China's largest banks is expected to alleviate capital needs of the banks and preserve their liquidity. The three banks ordered to cut their dividend ratios are ICBC, BOC and CCB. The prudent measure contrasts sharply with the US banking sector, where the Federal Reserve has allowed many large banks to increase dividends and share buybacks, a move that could weaken their cash flows.

In addition, a shift towards fee-generating businesses should shield Chinese banks from a possible acceleration in asset quality deterioration, should concerns about a large wave of defaults materialize. The brighter business prospects of Chinese banks compares favourably with US banks, where reductions in loan loss provisions mainly accounted for the significant profit increases at US banks during 2011. Furthermore, US interest rates are expected to stay low for a prolonged period and impair the lending revenues of US banks.

A return to equities market to capitalize on a strong stock market performance so far this year is expected to give another boost to Chinese banks' credit outlooks. After being deterred from raising capital due to a weakening in market conditions during the second half of last year, Chinese banks are seeing more favourable funding opportunities following a 12% rebound in the Hong Kong stock market so far this year. In March, China MingSheng Banking Corporation raised USD 1.4bn in equity capital in Hong Kong equities markets, and the Bank of Communications is planning to raise USD 9bn in private placements. Other mid-sized Chinese banks are also planning to raise additional capital, according to some market participants. In comparison, US banks have been flocking to repay the government bailout funds they received during the last financial crisis, with the total amount of repayment reaching USD 211.5bn so far, higher than the USD 204.9bn they received under the Troubled Asset Relief Program (TARP).

Sources:

- [ICBC Join Smaller Chinese Rivals in Posting Profit Gains](#) (Bloomberg)
- [China Construction Bank's Net Climbs 25.5%](#) (WSJ)
- [China's bank fees keep rising](#) (China Economic Review)
- [Nonperforming loans tick higher at Chinese banks](#) (Reuters)
- [China Addressing Capital Crunch Facing Banks: Analysts](#) (CNBC)

[Major U.S. bank dividend actions Friday](#) (WSJ)

[US banks have most profitable year since 2006](#) (ChinaPost)

[Minsheng Bank Seeks To Raise Up To US\\$1.46 Bln As China Banks Tap Equity Markets Again](#) (WSJ)

[Banks Repaid Fed Bailout With Other Fed Money: Government Report](#) (The Huffington Post)

In the News

Financial holding company to leverage its capital base

Mar 27. In the 2012-13 Union Budget, the Government of India mapped out a bank recapitalization plan in which a financial holding company (FHC) will be set up to help the government inject around INR 4tn of capital into state-backed banks over eight years. The FHC will be able to leverage its balance sheet to provide crucial funds to meet banks' rising capital needs as non-performing assets grow. The plan will help reduce the government's budget burden at a time when the government budgetary deficit is projected to remain high in the coming years. ([Financial Express](#))

OECD urges eurozone rescue fund boost to EUR 1tn

Mar 27. Angelo Gurría, the Secretary-General of the OECD, called for the eurozone bailout funds to be doubled to EUR 1tr on March 27, in order to increase the credibility of government commitments while market confidence remains weak. The proposal was followed by an agreement between eurozone finance ministers on March 30 to increase the combined size of the European Financial Stability Facility and European Stability Mechanism to EUR 700bn. ([BBC](#), [Reuters](#))

BBA to launch crackdown on LIBOR rates

Mar 28. The British Bankers' Association (BBA) has launched an examination into the process used to determine LIBOR, with the main aim to propose appropriate reforms and tighten controls on the rate setting process. Banks involved in setting LIBOR have attracted investigations from a number of global regulators over alleged rate manipulations during the last Financial Crisis. The BBA will engage with a number of global financial regulators and banks in the study, and aims to release a reform proposal by the middle of 2012. ([FT](#))

Indian court blocks Fitch downgrade

Mar 28. Fitch Ratings announced March 27 that an Indian high court had ordered it to stop publishing credit rating updates for SREI Infrastructure Finance, effectively blocking a downgrade Fitch was said to be planning. The move is allegedly linked to a long dispute between the SREI and Fitch over the rating agency's decision in March 2011 to place the company on Negative Watch. Fitch has maintained a AA-rating on SREI since 2002. The court decision, which is the first such move in India, reflects the increasing concern about the quality of the service provided by the credit rating agency industry. ([International Financing Review](#))

Recent developments in Chinese credit markets

Mar 30. Sino-Forest filed for bankruptcy protection in Canada on March 30, two months after it avoided default in January when the company's creditors waived the right to force the company into bankruptcy. Sino-Forest announced that ownership of the company would effectively transfer to the company's creditors if a buyer cannot be found. Meanwhile, Shandong Helong Co Ltd emerged as a potential candidate for the first ever default in China's nascent corporate debt market, after uncertainty over government bailouts and bank credit lines complicated its ability to repay CNY 400mn of commercial paper maturing on April 15. ([FT](#), [Reuters](#))