Credit gap between the six largest and other commercial banks in China to further diverge in future

by Yao Xuan

The COVID-19-induced economic slowdown in China has plunged China domiciled banks' profits at the fastest pace in a decade. On top of the dampened earnings, the sector has seen rising proportions of non-performing loans (NPL) and the depletion of capital buffers. As the country continues to deal with the aftermath of the nation-wide lockdown, NPLs are expected to increase in the near future. This can be concerning in light of the rising competition from Financial Technology (FinTech) companies. The implications of the aforementioned factors, however, will not be homogenous across all the Chinese banks. In the next few years, China's six biggest commercial banks[1] (Big Six) are projected to have a relatively more stable credit outlook, while the other commercial banks (Other Banks) face a deteriorating credit outlook. Relative to the Big Six, Other Banks have lower Capital Adequacy Ratios (CAR), which make them more susceptible to policy changes and macroeconomic shocks. The account above is corroborated by the NUS-CRI Aggregate (Median) Forward 1-year Probability of Default (Forward PD[2]) (Figure 1) which suggests that the present difference (60bps) in credit outlook across the Big Six and the Other Banks will continue to widen.

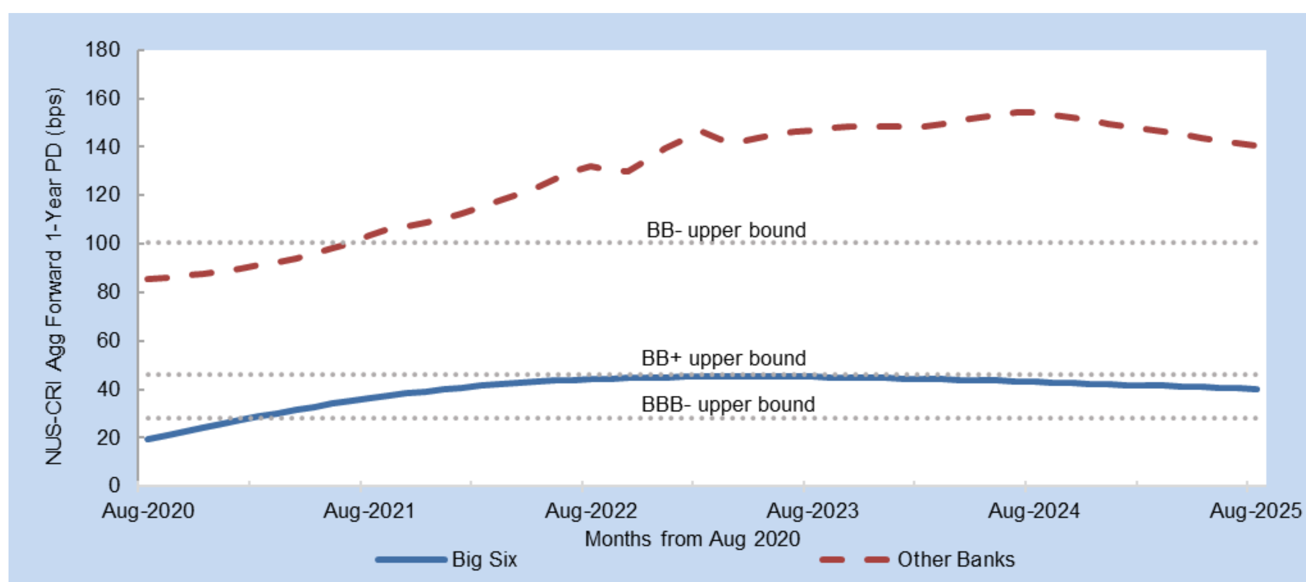

Figure 1: NUS-CRI Agg Forward 1-Year PD of Big Six and Other Banks based on data feed as of Aug 2020 with reference to the PDiR2.0[3]
Source: NUS-CRI

The pandemic induced economic slowdown has had a detrimental effect on the industry. This has inevitably caused a decline in the quality of the banks' portfolios. To ease financial pressures of the affected industries,

[1] 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).
[2] 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.
[3] 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.

the People's Bank of China (PBOC) has cut interest rates and relaxed the credit criteria for companies to attain funding. As banks are encouraged to provide liquidity to struggling businesses, we have seen a rise in non-performing loans along with a depletion of capital strength. However, compared to the Big Six which have relatively well-diversified portfolios, Other Banks remained more vulnerable due to their larger exposure to heavily affected industries such as manufacturing, wholesale, retail, and transportation sectors. Furthermore, a larger portion of Other Banks' borrowers consisted of Mid-Sized Enterprises (MSEs) with high yield loans. In Q2 2020, the Big Six accounted for only 31.04% of total MSE loans while their assets accounted for almost 50% of the total assets of all commercial banks. This observation indicates that the MSEs represents a smaller proportion of the Big Six's overall loan books. The pressure of the pandemic on commercial banks will continue to persist in the future as the commercial banks have made loan extension arrangements for a large number of MSEs in accordance with regulatory requirements. With larger and well-diversified loan portfolios, the Big Six are better positioned to navigate the troubled waters.

Furthermore, the NPL ratios of Big Six are lower than those of the Other Banks. As of Aug 2020, Big Six have an average NPL ratio of 1.45% compared to Other banks, with average NPL ratio of 2.47%. Moreover, their CARs are also higher, with the Big Six having a CAR ratio of 16.14% and Other banks having a CAR ratio ranging between 12.65% and 14.44%. Facing constraints in liquidity, the Chinese banking sector has issued a significant amount of bonds to replenish their capital. The relatively healthier balance sheets have enabled the Big Six to raise funds at a lower cost. In contrast, the cash-strapped small lenders have been issuing very risky bank debt to shore up their capital levels. As of July 2020, 19 banks have sold a grand total of CNY 339.6bn high-yield subordinated perpetual bonds. This seemingly risky approach is not a good sign as some of the smaller banks with weaker risk management capabilities and tighter liquidity may not be able to make interest payments or redeem the debt.

Moving forward, competition from the local and global fintech companies will further increase pressure on Chinese banks. A significant portion of the banking clients and their following card transactions have moved to online platforms such as Alipay and WeChat Pay. Digital payment companies are likely to poach 13% of banks' payments revenue in China. In addition, the wide spectrum of financial services provided by fintech companies continues to threaten other important sources of bank revenues. For example, Ant Finance, a subsidiary of Alibaba, provides services like money market investment (Yu'e Bao), insurance service (ZhongAn), credit rating (Sesame Credit), personal credit line (Ant Micro Loan), and lending (MYbank). As such, the Big Six have invested more funds into FinTech Research and Development (R&D). This would endow them with the competitive edge required to compete with the likes of their FinTech competitors. When ranked according to their investment in FinTech, the top five banks are all from Big Six. In 2019, CCB and ICBC have invested more than CNY 16bn in FinTech R&D. In comparison, most of the Other Banks may not have the financial flexibility to invest in FinTech R&D currently as they navigate the headwinds posed by the on-going crisis. All in all, the divergence of the future credit gap will continue to diverge.

Credit News

Fed could ramp up corporate debt purchases if volatility persist – Citi

Sep 5. The Federal Reserve (Fed) may increase its purchases of corporate bonds if stocks and corporate debt markets incur further weakness following the recent sharp stock sell-off. Investors primarily sold 'high-flying' technology stocks, while investment-grade corporate bond spreads further widened. Analysts are awaiting policy response from the Fed, which could decide to marginally ramp up purchases soon to reassure the market. The Fed has been reducing corporate bond purchases from USD 300mn in May to USD 26mn in August as spreads have tightened and credit markets have recovered. Previously, when stocks dropped 7% in mid-June, the Fed increased bond and ETF purchases by USD 40mn a day. Analysts estimate that if risk-off moves continue into the month, the Fed will intervene again by around USD 100mn in purchases per day. (Reuters)

Risk creeps into municipal bond market, yet prices stay high

Sep 4. The Covid-19 Pandemic has threatened the creditworthiness of the municipal bond market. Nevertheless, prices, as of Sep 2020, are holding up to near pre-pandemic highs. Credit agencies like Moody's have in response revised their outlook on most of the municipal bond sectors. Nevertheless, the market remains positive as very minimal rating actions took place in light of the global economic slowdown. Since May 2020, the market has been poured with inflows. Prices which dipped in Mar 2020 has recovered. (WSJ)

China banks plan USD 29bn in bond sales to replenish capital

Sep 4. In order to restore capital levels that have been depleted by the surge in cheap lending to struggling businesses, Chinese banks are planning to issue a near-record bond sale. Banks have been tasked to ease the financial hardship of consumers and businesses hurt by the pandemic. The authorities have called on them to forgo 1.5tn yuan of profit to provide cheap funding, deferring payments and increasing lending. This has reduced their capital buffers as they take up a record number of non-performing loans. Analysts see this as long term preparation to restore both tier-1 and tier-2 capital. However, falling prices on subordinated notes are providing hints to weak investor demand for these upcoming issues. (Bloomberg)

UOB, DBS debut more Sora-pegged loan products

Sep 3. Singapore banks are introducing more loan products pegged to the Singapore Overnight Rate Average (Sora), helping in the transition into using Sora as the new benchmark interest rate. Sora, which is the average rate of unsecured overnight interbank Singdollar transactions, is a backward-looking rate that provides more stability than forward-looking rates like the Singapore Interbank Offered Rate (Sibor) and the Singapore Swap Offer (SOR). UOB signed a two-year SGD 200mn loan pegged to Sora and Secured Overnight Financing Rate (SOFR). This is part of MAS's larger transition plan into using alternative risk-free rates in Singapore, and to develop robust Sora Markets in the near future. CapitaLand was the first company in Singapore to obtain a 3-year Sora-based loan from OCBC worth SGD 150mn. DBS has also launched a Sora-pegged business property loan, which is tailored for SMEs looking to finance their commercial and industrial properties. Last month, DBS launched the agribusiness industry's first Sora-based loan as well, coupled with a Sora based interest rate swap. (Straits Times)

US corporate bond issuance hits USD 1.919tn in 2020, beating full-year record

Sep 3. The USD 2bn bond from Mizuho, along with the USD 2.5bn deal from Tenet Healthcare, has tipped the overall US corporate bond issuance to a new high. A key catalyst for this rapid recovery from the low prices in Mar 2020 can be attributed to the Fed's pledge to purchase corporate bonds. However, caution should not be thrown into the wind as earnings remain depressed which is concerning for credit especially in light of the surging debt. (FT)

Vodafone idea to raise up to USD 3.4bn (Bloomberg)

Monte dei Paschi risky debt in demand as Italy works to exit bank (Reuters)

Sustained Bank Indonesia support may bolster corporate debt (Bloomberg)

Regulatory Updates

MAS introduces new SGD funding facility for banks, boosts access to liquidity

Sep 3. The Monetary Authority of Singapore (MAS) announced that it will be increasing SGD and USD funding to banks in order to strengthen the sector's resilience and improve funding conditions. This will allow the banks and finance companies an additional source of longer tenor borrowing with more forms of collateral, with domestic systemically important banks now able to pledge residential mortgage loans as collateral. This funding facility will include cash and investment-grade debt securities and be priced above prevailing market rates to serve as a liquidity backstop. (Business Times)

Swedish central bank starts corporate debt buys as part of COVID measures

Sep 1. Sweden's central bank will buy corporate bonds for the first time later this month as part of its quantitative easing program aimed at reducing market rates. This is to ensure the well-functioning of credit markets and reducing the impact of the pandemic on the economy. The existing asset purchase program already covers government debt, local authority bonds, mortgage-backed debt and commercial paper, and will include corporate debt for the first time. The policy will cover non-subordinated corporate bonds issued by companies with credit ratings equivalent to Baa3/BBB- or higher with a remaining maturity of up to five years. The Swedish central bank plans to buy USD 1.16bn of corporate debt over the next 9 months as markets remain relatively fragile. The central bank has also said it was developing ways to include a sustainability assessment in its purchase program. (Reuters)

Fed's Main Street Lending Program open for non-profit borrowers (Bloomberg)

PBOC to promote interbank repo rates in financial products (Regulation Asia)

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