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China Banking Sector

Impact of developers' default is manageable

We think developers default will not cause a systemic risk in banking sector but banks asset quality may be hurt. As a conclusion from our scenario analysis, under our worst scenario (assuming 10% of developers go default), the whole banking sector have sufficient capital as a cushion, but they have to suffer a deterioration on asset quality and they need to sacrifice part of their provision and profit to clean up the balance sheets in next few years.

- **Possibility on systemic risk?** Little possibility on this. Based on our scenario analysis, under our worst/base/best scenario, banks core tier-1 CAR will be 10.17%/10.41%/10.50%, much higher than CBIRC's minimum requirements.
- **How about banks' fundamentals?** Although there is little systemic risk, banks' asset quality will be affected. Under worst scenario, 10% developers default will cause a 59 bp increase on NPL ratio to 2.35% and provision coverage ratio will drop to 143% which is lower than regulators' recommendations of 150%. Under worst scenario, banks have to spend 7%-9% of their profits to clean up the balance sheet in next 5 years.
- **Which one is more defensive?** Postal should be the safe harbor for investors. With a NPL ratio of 0.83% and provision coverage of 421%, Postal should have sufficient cushion for headwind. In addition, only 2.11% of its loan is property loan which is lowest among all the state owned and stock joint banks. With less links to property developers and sufficient cushion on asset quality, negative impacts on Postal is limited.

Peers Comparison Table

Name	Ticker	1H21 NPL ratio	Provision coverage	Loan loss reserve to total loan	Property development loan as % of total loan
Postal	601658.SH/1658.HK	0.83%	421%	3.49%	2.11%
CCB	601939.SH/0939.HK	1.53%	222%	3.41%	4.72%
ICBC	601398.SH/1398.HK	1.54%	192%	2.96%	4.98%
ABC	601288.SH/1288.HK	1.50%	275%	4.12%	5.48%
BoComm	601328.SH/3328.HK	1.60%	149%	2.39%	6.02%
Citic	601998.SH/0998.HK	1.50%	189%	2.84%	6.30%
Hua Xia	600015.SH	1.78%	157%	2.79%	6.91%
CEB	601818.SH/6818.HK	1.36%	184%	2.51%	6.95%
SPDB	600000.SH	1.64%	151%	2.48%	7.28%
CMB	600036.SH/3968.HK	1.01%	439%	4.45%	7.51%
BOC	601988.SH/3988.HK	1.30%	184%	2.74%	7.89%
CIB	601166.SH	1.15%	257%	2.95%	8.67%
CBHB	9668.HK	1.76%	161%	2.82%	9.58%
PAB	000001.SZ	1.08%	260%	2.80%	10.14%
CZ Bank	601916.SH/2016.HK	1.50%	180%	2.71%	13.54%
CMBC	600016.SH/1988.HK	1.80%	143%	2.57%	10.34%

Source: Wind, Company data, CMBIS estimates

NOT RATED

China Banking Sector

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Chinese banks: Impact of Evergrande default manageable

Unlikely to see major systemic turbulence

Among Evergrande's (3333 HK) RMB 572bn interest-bearing borrowings as of end 1H21, we estimate only around RMB 220bn are from domestic banks, while the rest over RMB 350bn are debts to domestic non-bank financial institutions, mostly trusts, and overseas institutions. Given the fully collateralized status of property loans and improved risk management capabilities of banks, we believe the negative impact on Chinese banking sector should be manageable, even if the defaults extend to 10% of property developers in a worst case scenario. Based on our scenario analysis, we think core capital can be hurt but the impact are not significant.

To gauge the potential capital erosion due to defaults of real estate developers, we conducted a scenario analysis based on the following assumptions:

- Investment exposure to real estate developers: Since most of fixed income investments are not backed by collaterals, banks are quite conservative on these investments. Given that most bonds held by banks are issued by government and other high rating borrowers, we assume banks' exposure to property bonds and other real estate investment vehicles are approximately 10% of property loans.

- We assume 30% recovery of principal on property loans and 0% recovery on bond investments. The assumption of 30% recovery ratio is on the conservative front, compared to the market consensus on the recovery ratio of China Fortune Land Development (CFLD). We set bond investment recovery to be zero because it is not collateralized.

- We assume that banks' provision and NPL balance remain unchanged. Thus, all the unrecovered loss will be deducted from core capital.

- The industry average loan loss reserve ratio of banking sector was 3.39% at end-1H21. Therefore, we assume that banks have already taken 3.39% loan loss reserve on the property development loan.

- As feedback from banks, little possibility on mortgage default because borrowers have already pay at least 30% down payment and mortgage default will hurt their personal credit record. No incentive on defaulting the mortgage. Hence, we assume no incremental default on mortgage.

- For the assumption of property loan defaults, we make three scenarios:
    - **Base case scenario**: Evergrande is down but other developers do not default the lending;
    - **Worst case scenario**: We assume 10% of the developers' borrowings (including loan, bonds and other financial vehicles) default;
    - **Best case scenario**: Local government or other institutions bail out Evergrande.

Figure 1: China banking industry: Potential loss on Evergrande case

(RMBbn)	Total exposure	Loan	Other investment
Risk exposure (Evergrande)	220	200	20
Risk exposure (all developers)	13640	12,400	1,240
Recovery of principal	27%	30%	0%

(RMBbn)	Total loss	Provision taken in advance	Capital deducted
Base case (Evergrande bankruptcy)	**160**	**7**	**153**
Worst case (10% default rate)	992	42	950
Best case (Government bail out)	0	-	0

Source: CBIRC, CMBIS

Figure 2: China banking industry: Potential impact on capital adequacy

		1H21	Worst Case Scenario	Base Case Scenario	Best Case Scenario
Balance (RMBbn)					
Potential loss	**资本金损失**	-	**571**	**153**	**0**
Core capital	核心一级资本	*18,528*	17,957	18,375	18,528
Total tier-1 capital	一级资本合计	*21,017*	20,446	20,864	21,017
Total capital	总资本	*25,565*	24,994	25,412	25,565
RWA	加权风险资产	*176,538*	176,538	176,538	176,538
Loan balance	贷款总额	*158,962*	158,962	158,962	158,962
Ratio					
Core tier-1 CAR	**核心资本充足率**	***10.50%***	**10.17%**	**10.41%**	**10.50%**
Tier-1 CAR	一级资本充足率	*11.91%*	11.58%	11.82%	11.91%
CAR	资本充足率	*14.48%*	14.16%	14.39%	14.48%

Source: CBIRC, CMBIS

Under our worst scenario, assuming 10% default rate on all developers' borrowings (including loan, bonds and other financial vehicles), there is a RMB 992bn loss on banking system. With a 3.39% loan loss reserve to total loan ratio in 1H21, we assume RMB 421bn loan loss reserve has already been taken, thus, additional RMB 571bn should be deducted from core capital. The RMB 571bn deduction will lead to 33bps decline of core tier-1 CAR, from 10.5% to 10.17%. Obviously, the loss will hurt banks' profits, but it is unlikely to cause a systemic turbulence in banking system.

Some small banks may face pressures on capital

However, little systemic risk does not imply all the banks are safe. Some regional banks which are short of capital and have high exposure to Evergrande may need to raise fund for capital replenishment. As shown in the table below, banks can issue new shares or capital supplemental instruments which can be converted to ordinary shares, and the fund raised by these instruments can be counted as core tier-1 capital.

The advantage of issuing capital supplemental instruments is obvious, it can help banks lift the capital balance and prepare for headwind. But the disadvantage is clear, too. The instruments issuance is time consuming and it needs to get approval from regulators. Sometimes, banks may not have enough time to wait for the approval. To prevent the systemic risk in financial market, PBOC may jump in and inject “confidence” in the market by providing credit enhancement for small banks. Saving Bank of Jinzhou in 2019 can be a good example. In 2019, when Bank of Jinzhou was facing liquidity risk on interbank market, because of its poor asset quality and capital management, PBOC provided credit enhancement for Bank of Jinzhou by creating Credit Risk Mitigation Warrant (CRMW, 民营企业债券融资支持工具), with this support, the interbank dealers feel confident on Bank of Jinzhou’s negotiable certificates of deposit (NCD, 同业存单), then the tension on its liquidity is solved. The support from PBOC bought time for Bank of Jinzhou and the bank finally find strategic investors to increase the capital.

Figure 3: Chinese banks: Capital supplemental instruments

Core tier-1 capital	Other tier-1 capital	Tier-2 capital
IPO	Preference share	Tier-2 capital supplemental instruments
Secondary offerings	Perpetual bond (become popular since 2019)	
Private placement		
Rights issue		
Convertible bond		
Convertible preference share (have not become popular yet)		

Source: CBIRC, CMBIS

Little systemic risk but banks’ asset quality should be affected

Although troubled Evergrande will not lead to a collapse on banking sector, banks’ profit and asset quality will be hurt. Obviously, with RMB 12.4tn outstanding loan which is lend to property developers in 1H21, increasing default rate will cause a deterioration banks asset quality.

Under our base case scenario, if Evergrande defaults all of its borrowings, banks will lose RMB 160bn, with RMB 7bn write-off by provision net NPL balance will increase RMB 153bn. The increasing NPL balance will lead to 9.6 bps on sector NPL ratio (from 1.76% to 1.85%) and sector provision coverage will drop from 193% to 183%. Net increased NPL balance is equivalent to 13.4% of sector accumulated net profits in 1H21 and 7.4% of estimated sector accumulated net profits in 2021.

Under the worst case scenario, assuming 10% of RMB 12.4tn loan to property developers will go default, after the recovery collection from default loan, banks will still bear a RMB 992bn loss on its property related lending. Even though RMB 42bn write-off by provision, additional RMB 950bn default loan will lead to 59 bps increase on NPL ratio, from 1.76% to 2.35%. Accordingly, provision coverage will drop from 193.2% to 143%. The RMB 950bn loss is equivalent to 83.3% of banks net profit in 1H21 and 45.8% of estimated sector accumulated net profits in 2021.

Figure 4: Impacts on sector asset quality under different scenarios

RMB bn	1H21	Worst Case Scenario	Base Case Scenario	Best Case Scenario
NPL balance	2,791	3,741	2,944	2,791
Provision coverage ratio	193.23%	143.04%	182.94%	193.23%
NPL ratio	1.76%	2.35%	1.85%	1.76%

Source: CBIRC, CMBIS

As we illustrated above, systematic risk is manageable but banks will bear the loss on their lending to Evergrande. The negative impacts on sector CAR is negligible. However, under our worst case scenario, there is a significant increase on NPL ratio. Based on our base case (Evergrande collapsed and no default contagion, the negative impacts on banks asset quality and profits is significant but still manageable. However, under our worst case, banks' balance sheet will be hurt.

How could banks deal with the deteriorating asset quality if the worst case happen?

Usually, Chinese banks need to spend around 3 years to clean their balance sheet after a big "default wave", as we learned from 2 cases in early 2014 (massive default in clean energy industry) and early 2018 (massive default in industries with overcapacity). Without the help from external funding resources, banks need to use their provision to managing NPL and keep a dynamic balance among provision, profits and NPL balance.

Under base case, negative impacts on banks are limited. Banks have sufficient provision to protect their balance sheet. However, if the worst case happens, as we assumed it will cause RMB 950bn additional NPL in the sector and banks may spend 5 years to write-off this RMB 950bn NPL, equivalent to spend RMB 190bn every year in next 5 years. Under worst case scenario, banks have to spend around 7%-9% of its net profits in next 5 years.

In our view, current market correction on banks is overreacted on the default risk. The correction reflects an expectation on "default contagion". The expectation implies much more default on property development loan, meanwhile upstream and downstream of property developers will have a higher default rate as well. But we think the possibility of default contagion is low, govt will jump in and make the default under control.

As we forecast little systemic risk, banks with good fundamentals will outperform. In our view, under current circumstance, banks with high provision, better asset quality and less exposure on property sector (excluding mortgage) should be attractive, giving a low valuation after previous market correction.

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