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S&P Global
China Ratings

Group Support Sustains Credit Quality of Bank-affiliated Leasing Companies in China

June 1, 2020

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Although the COVID-19 pandemic has negative impact on asset quality and profitability of bank-affiliated leasing companies in China, we expect them to maintain stable credit quality thanks to strong support from parent banks and ultimately the government. We believe the sharp revenue shock to financial leasing companies with large exposures to the aviation industry is controllable at the banking group level.

Significant pressure is felt on the asset quality of the companies' aircraft fleets. Distressed cash flows of the aviation industry are hurting the rental revenue of leasing companies in ways of deferrals of lease rentals, possible bankruptcy and return of aircrafts by airlines, restructuring of leases, and lower lease rates in a weak market. As COVID-19 keeps aircrafts on the ground around the world, airlines are forced to request for deferrals in lease payment and a few airlines outside China have filed for bankruptcy. After repossession of aircrafts from a bankrupt airline, revenue will probably be lost as lessors hold on idle aircrafts and try to find new lessees. A silver lining is that, if a bankrupt airline can be reorganized, there is a good chance of the reorganized airlines keeping the leased aircrafts, saving leasing companies the trouble of releasing repossessed aircrafts.

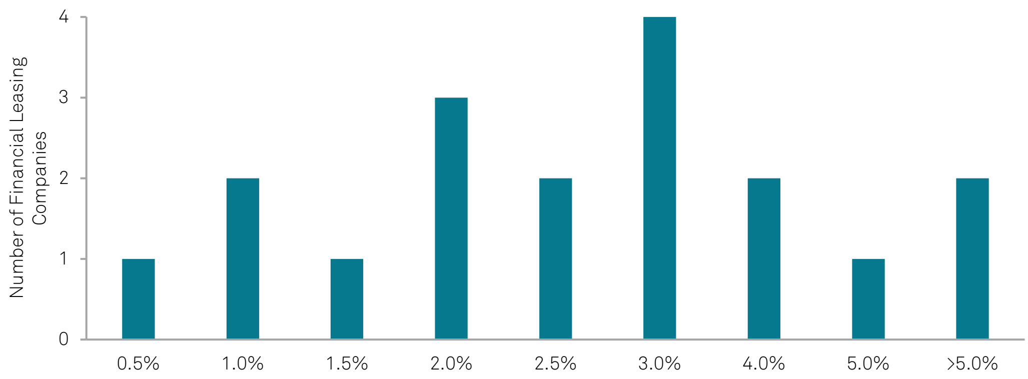
In addition, as the leasing market suffers from low demand, lease rates are likely to fall for repossessed aircrafts and those with leases expiring in 2020 or 2021. If the pandemic has a lasting influence on the market valuation of aircrafts, aircraft portfolios may be under further pressure.

In our opinion, the potential extent of aviation industry -related loss is subject to the development of the pandemic and governments' support to the aviation industry. Given the global nature of aircraft leasing and leasing companies' exposure to international airlines, Chinese financial leasing companies are also facing uncertainty in foreign governments' support to their respective aviation industries.

Although large bank-affiliated leasing companies typically have significant exposure to the aviation industry, the contribution of aircraft fleets to parent banks' total assets is typically small. Therefore, we believe the increase of risk related to aircraft assets is controllable at the group level. The exposure to the aviation industry mainly concentrates in top leasing companies affiliated with China's top banks. The high creditworthiness of the parent banks mitigates the sharp shock caused by the pandemic, in our view.

Chart 1

Distribution of Ratio of Bank-affiliated Financial Leasing Company Assets/Parent Bank's Assets as of End of 2019



Source: Wind, collected and adjusted by S&P Global (China) Ratings.

In addition to aviation leasing, financial leasing portfolios are also under asset quality pressure. In our view, financial leasing asset portfolios have a risk profile similar to the corporate loan portfolios of banks, with exposure typically concentrating in manufacturing, infrastructure and utilities sectors within China.

We believe bad debt pressure of financial leasing portfolios is mitigated by governments' likely support to local government financing vehicles (LGFVs) and businesses in general. In addition, the highly overlapping client bases of banks and their leasing companies lead to positive synergy in risk management and mitigation.

Chart 2

Distribution of Non-performing Ratio of Financial Leasing Assets of Selected Bank-affiliated Financial Leasing Companies as of End of 2019

Source: Wind, collected and adjusted by S&P Global (China) Ratings.

We anticipate the parent banks' incentive and capability to support their leasing subsidiaries to remain stable. We consider the leasing business as integral to their banking groups' strategy to be comprehensive providers of financial products and services. We believe China's banking sector will remain stable thanks to strong government support (see "Government Support Mitigates COVID-19's Pressure On Chinese Banks' Creditworthiness", published on May 20, 2020). Chinese regulation requires parent banks to ensure capital adequacy and liquidity sufficiency of their affiliated leasing companies in times of need.

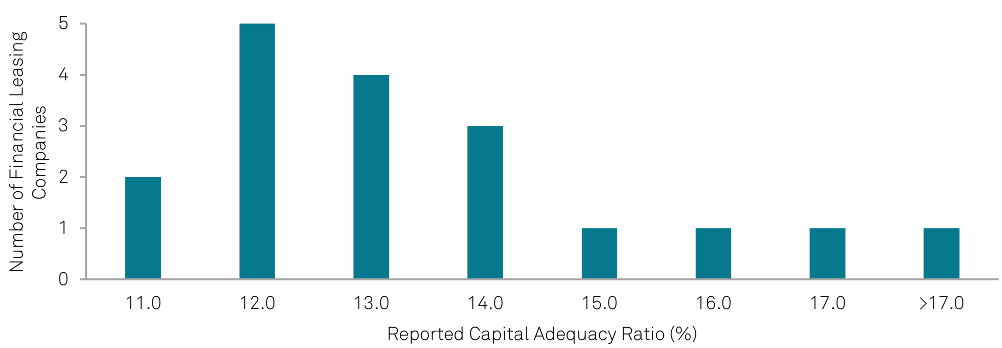
We believe any government support to the banks will also flow to their leasing subsidiaries. Financial leasing companies' forbearance measures for aviation and other hard-hit industries are consistent with government policy of having financial institutions help the real economy through the hard time. As the government prioritizes financial stability in this special period, we expect its incentive to support banks and their affiliated leasing companies to be strong.

We expect the business growth of the financial leasing companies to be slower because aircraft leasing had been an important growing sector before the pandemic and aircraft leasing will probably not see any growth in 2020. Nevertheless, there are other business opportunities related to government-led infrastructure development.

Despite the earnings pressure, we expect the companies' capital level to remain adequate as their parent banks are required by regulation to replenish their capital when necessary. In addition, bank-affiliated leasing companies typically had adequate capital before the pandemic thanks to strong capital injection from parents and good earning capability. In addition, slower growth of operating leases is also likely to reduce capital consumption in 2020.

Chart 3

Distribution of Capital Adequacy Ratio of Selected Bank-Affiliated Financial Leasing Companies as of End of 2019



Source: Wind, collected and adjusted by S&P Global (China) Ratings.

We expect the funding and liquidity profiles of the bank-affiliated leasing companies to remain stable thanks to the ample systemwide liquidity in the inter-bank market and strong liquidity positions of their parent banks. Regulation requires the parent banks to provide liquidity support to their leasing subsidiaries. Due to the forbearance measures given to airlines and other hard-hit customers, the cash inflow of rental payment is reduced. Meanwhile, we expect their cash outflow related to capital spending to be lower than originally planned as aircraft delivery will probably be very few this year.

Our stable outlook for the banking sector and bank-affiliated leasing companies in China is based on our economic forecast of a U-shape recovery in 2020 and 2021. We acknowledge a high degree of uncertainty about the economic recovery from the COVID-19 outbreak for both China and other countries. As the situation evolves, we will update our assumptions and estimates accordingly.

Credit Outlook of Bank-affiliated Financial Leasing Companies in 2020

Risk Factor	Outlook in 2020	Key Points
Business Position	Stable with downward pressure	– Aircraft leasing business is unlikely to grow in 2020. – There are other business opportunities related to government-led infrastructure development.
Capital & Earnings	Stable with downward pressure	– We expect significant downward pressure on profitability due to bad debt pressure and potential loss related to aircraft leasing. – We expect the capital level to remain adequate as parent banks are required by regulation to replenish their leasing subsidiaries' capital when necessary.
Risk Position	Stable with downward pressure	– The risk of aircraft leasing rose sharply as aviation industry is badly hurt by the pandemic. – Financial leasing portfolio is also under bad debt pressure. – The risk is mitigated by on-going support from parent banks for risk management. – The risk is also mitigated by governments' support to aviation industry, LGFVs, and other businesses.
Funding & Liquidity	Stable	– Cash inflow is affected by deferral of rental payments from airlines. – Generally, the parent banks have strong liquidity position to support their leasing subsidiaries. – Parent banks are required by regulation to support the liquidity of affiliated leasing companies in time of need.
Standalone Credit Quality	Stable with downward pressure	– We expect significant pressure on profitability and asset quality in 2020, but we believe the capitalization will generally remain adequate.
Group Support	Stable	– We expect the parent banks' incentive and capability to support their leasing subsidiaries to remain stable and strong. – We believe any government supports to the banks will also flow to the affiliated leasing companies.
Issuer Credit Quality	Stable	– We believe that the credit outlook of bank-affiliated financial leasing companies is the same as their parent banks.

This report does not constitute a rating action.