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S&P Global
China Ratings

Government Support Mitigates COVID-19's Pressure On Chinese Banks' Creditworthiness

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Although the COVID-19 pandemic will hurt asset quality and profitability of banks, the downward pressure is balanced out by strong government commitment to maintain financial stability, S&P Global (China) Ratings said today. We believe the probability of any serious bank credit incident is low in China's capital market this year.

We expect downward pressure on asset quality as the pandemic has caused profound economic disruption. There was a noticeable increase of special-mention loans ("SML") and non-performing loans ("NPL") in the first quarter of 2020, but the bad debt ratio increase was not obvious due to significant loan growth. As of the end of the first quarter, the NPL+SML ratio of the banking sector was 4.88%, 0.11 percentage point higher than the end of 2019.

In our opinion, the lagging effect of NPL classification and the forbearance measures given to some borrowers has thus far contributed to the stability of asset quality metrics in the first quarter, but the pressure will be felt in the second half of the year. The final asset quality impact of COVID-19 is far from certain, highly depending on the continued containment of the pandemic and the progress of economic recovery later this year.

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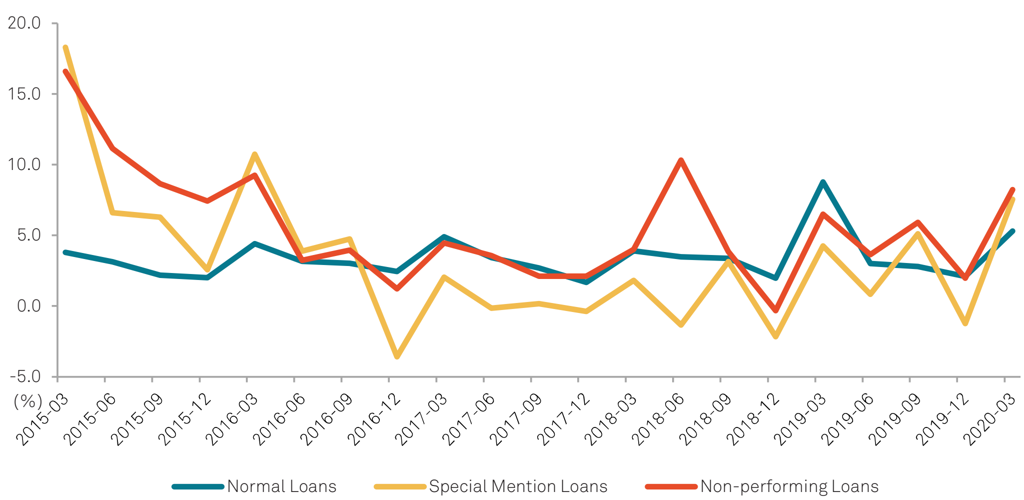
Chart 1

Loan Growth Compared with Last Quarter

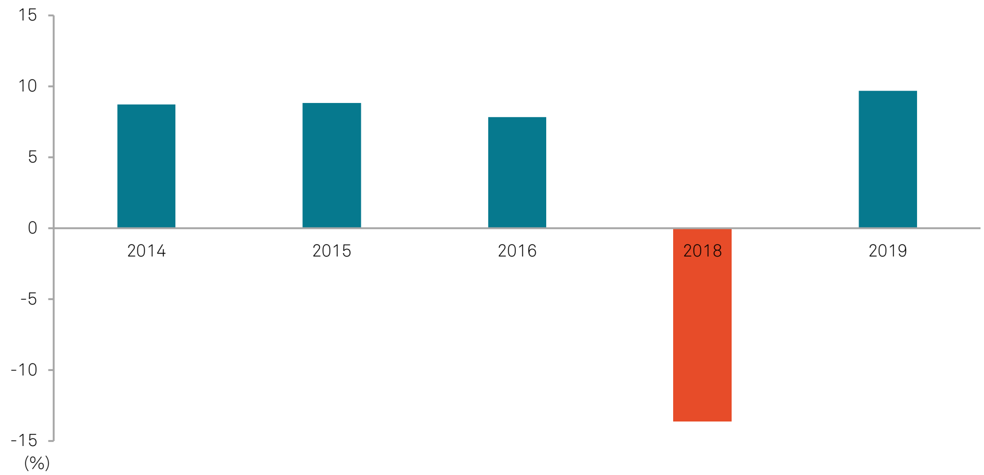


Source: CBIRC, collected and adjusted by S&P Global (China) Ratings.

Recently, the central and local governments have stepped up their efforts to recapitalize troubled banks and clean up their legacy bad debts, which help maintain the financial stability. For example, Hengfeng Bank, Jinzhou Bank and Gansu Bank, who had legacy bad debt problems before, all have received strong government supports and have seen their creditworthiness significantly improved. We believe the probability of another high-profile bank credit incident, like Baoshang Bank takeover, is low in 2020. As the economy is recovering from the pandemic, maintaining financial stability is a top priority for the government. The legacy bad debt problems and undercapitalization trouble of few small and medium-sized banks will probably be solved through government-led recapitalization and bad debt clean-up.

Chart 2

Reported Tier-1 Capital Adequacy Ratio of Hengfeng Bank

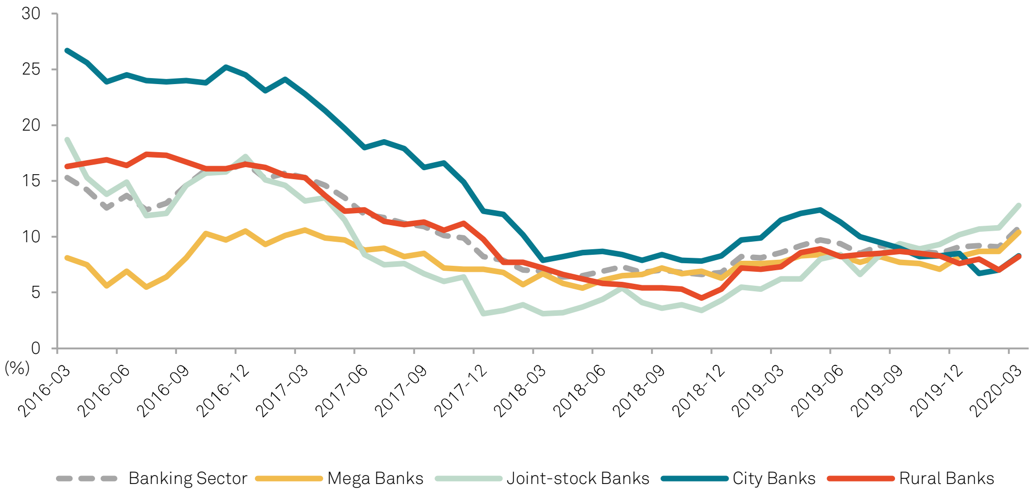


Note: Because the bank didn't publish its 2017annual report, the data in 2017 is not available.
Source: Annual Reports of Hengfeng Bank, collected and adjusted by S&P Global (China) Ratings

We expect fast loan book growth in 2020 as the banking sector pumps credit into the real economy to accelerate the economic recovery. In the first quarter of 2020, the banking sector's total assets grew by 10.8% YoY. The subsector that grew the fastest was joint-stock banks, whose YoY growth was 12.8%. There was a significant increase of loans lent to small and micro businesses. Compared with the end of 2019, the small and micro business loans grew by 7.6% in the first quarter, with mega banks as the main driving force behind this growth.

Chart 3

Banking Sector Asset Growth

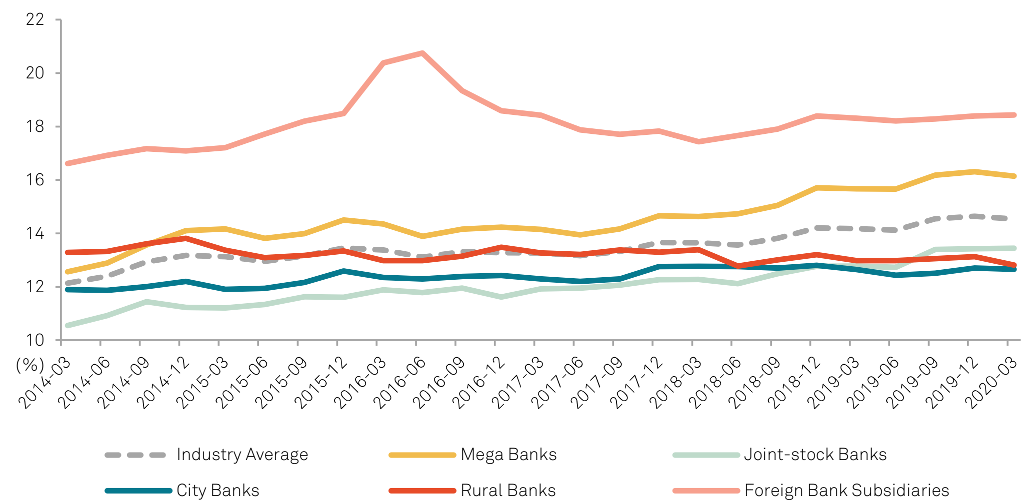


Source: CBIRC, collected and adjusted by S&P Global (China) Ratings.

We expect the capitalization of China's banking sector to remain adequate, despite that the rapid loan book growth and bad debt pressure will negatively weigh on capital position. As of the end of the first quarter, the banking sector has an average reported capital adequacy ratio of 14.53%, 0.11 percentage point lower compared with the end of 2019. Among the different subsectors, city banks had the lowest average capital adequacy ratio of 12.65%, and foreign bank subsidiaries had the highest of 18.43%. The sound capitalization of mega banks and leading joint-stock banks help mitigate the impact of the pandemic.

Chart 4

Reported Capital Adequacy Ratio



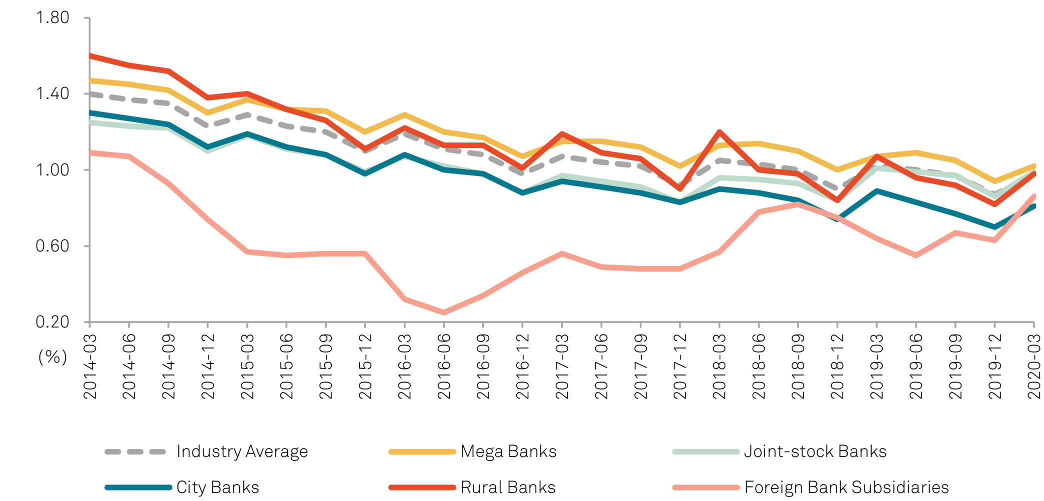
Source: CBIRC, collected and adjusted by S&P Global (China) Ratings.

We expect downward pressure on net interest margin ("NIM") as loan prime rate ("LPR") further drops after the first quarter. The banking sector's average NIM dropped 10 basis points to 2.10% in the first quarter of 2020 compared to the fourth quarter of 2019.

We expect downward pressure on banks' profitability in 2020 due to NIM compression and impairment charge increases. In the first quarter of 2020, the annualized return on assets of the banking sector was 0.98%, only 4 basis points lower than the first quarter of 2019. The city banks had the lowest ROA of 0.81% while the mega banks had the highest of 1.02%. We believe the sound profitability may not be sustainable in the following quarters once higher impairment charges caused by the pandemic are reflected in banks' financial statements later.

Chart 5

Return on Assets (ROA)



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

We expect the funding and liquidity profile of the banking sector to remain stable given sufficient liquidity in the market. As China loosened its monetary policy to deal with the COVID-19 outbreak, the average interest rate of negotiable certificates of deposits issued by banks in the inter-bank market dropped significantly, easing the liquidity and funding cost pressure of medium and small banks.

Chart 6

Coupon Rates of 3-month Negotiable Certificates of Deposits

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

Despite the unprecedented economic shock caused by the pandemic, we expect China's banking sector to maintain a stable credit outlook for the following two reasons. First, the mega banks have stable stand-alone credit quality despite the pandemic while government supports keep a few vulnerable medium and small banks from falling into further trouble. Secondly, according to the economic forecast made by S&P Global, China is expected to go through a u-shape recovery in 2020 and 2021, and we are using this assumption in assessing the credit implications for the banking sector. 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.

This report does not constitute a rating action.

This document is prepared in both English and Chinese. The English translation is for reference only, and the Chinese version will prevail in the event of any inconsistency between the English version and the Chinese version.