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S&P Global
China Ratings

# Chinese Banks' Q2 Performance Remained Stable but COVID-19 Credit Cost Continues to be a Concern

**August 20, 2020**


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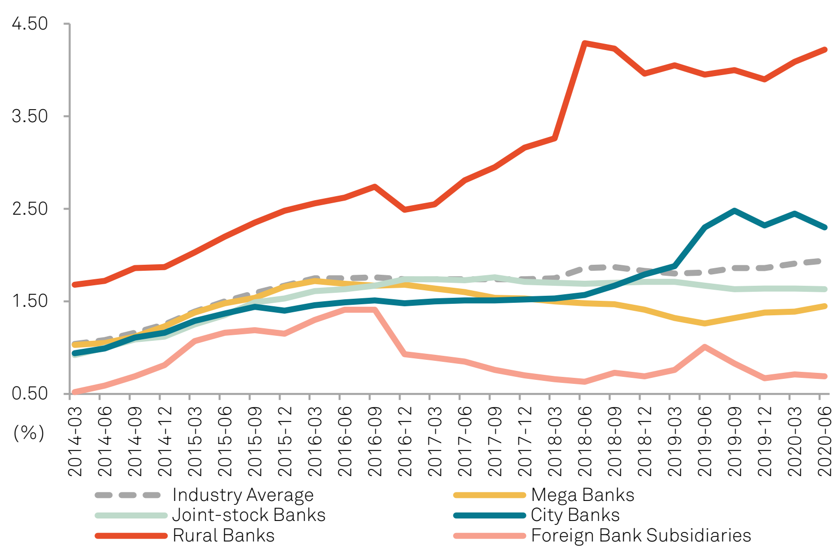
Although China's commercial banking sector delivered stable asset quality performance in the second quarter of 2020, we continue to expect higher pressure on credit cost and profitability going ahead because of COVID-19. Our overall outlook for the sector remains stable as the Chinese economy is recovering, and government support remains strong.

Asset quality metrics in the second quarter remained stable. The industry's non-performing loan ("NPL") ratio increased from 1.91% as of the end of Q1 to 1.94% as of the end of Q2, while the special mention loan ("SML") ratio dropped from 2.97% to 2.75%. As of the end of Q2, the total amount of SML + NPL was RMB 6.6 trillion, down by 0.7% when compared to the end of Q1.

Chart 1

## Non-performing Loan (NPL) Ratios




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

Despite the apparently stable asset quality performance in the first half of the year, we expect the credit cost caused by COVID-19 to increase in the latter half of 2020 and into 2021. The lagging effect of NPL classification and forbearance measures given to small business borrowers have contributed to the stability of asset quality metrics in the first half of 2020. Other reasons include the recovering economy, high growth of new loans, and the writing-off of bad debt.

The final impact of COVID-19 on asset quality is far from certain, and highly dependent on the progress of economic recovery. We believe the government is vigilant and responsive to the potential risks that lie ahead for the banking sector and are taking measures to ensure the stability of the sector. Three major measures being taken include government-led capital injection, improvement of corporate governance and a clean-up of legacy bad debt.

There was a significant increase in loans to micro and small enterprises ("MSE") in the second quarter. MSE loans grew by 9.4% compared to the end ofQ1. Mega banks led MSE loan growth, delivering an increase of 13.6%. We believe this is in line with the government policy of stabilizing employment. However, it is still too early to determine the potential impact of MSE lending on asset quality.

Downward pressure on net interest margins ("NIM") was only marginal in the second quarter. The banking sector's average NIM dropped only 1 basis point to 2.09% in Q2 from Q1. We believe that lower funding costs in the interbank market have mitigated the NIM pressure. Nevertheless, further NIM pressure would continue as the government pushes for lower interest rates for the real economy.

Chart 2

## Net Interest Margin (NIM)

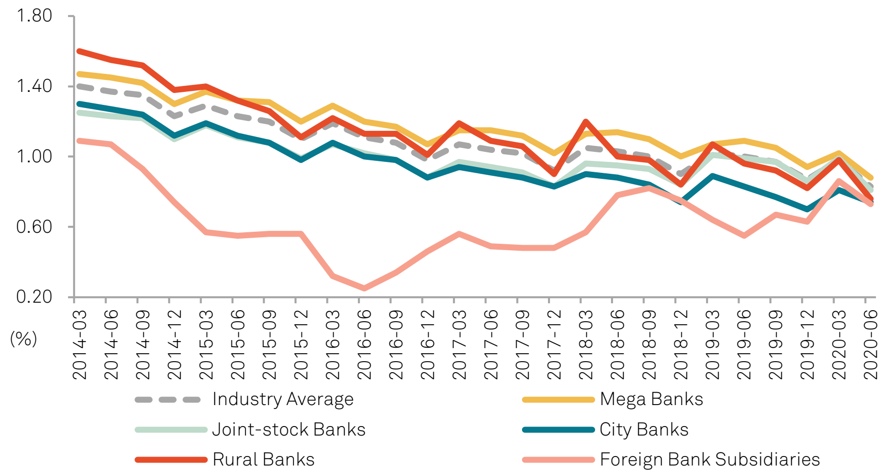

Source: CBIRC, collected and adjusted by S&P Global (China) Ratings.



We have noted downward pressure on banks' profitability in the second quarter, and we expect the pressure to continue into 2021 as it may take years for the credit cost caused by the pandemic to be fully absorbed. In the second quarter of 2020, the annualized return on assets of the banking sector was 0.83%, 15 basis points lower than Q1.

Chart 3

## Return on Assets (ROA)

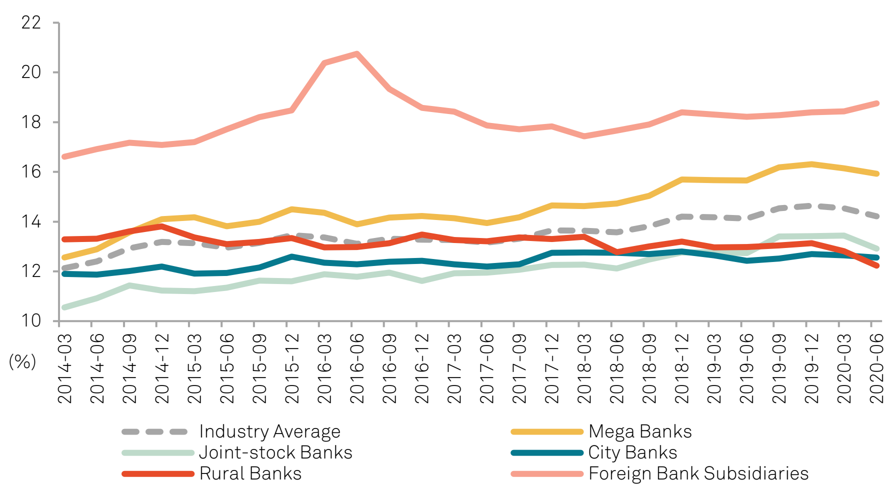



Source: CBIRC, collected and adjusted by S&P Global (China) Ratings.


Steady asset growth and weakened profitability in the second quarter have resulted in lower regulatory capital ratios. The banking sector's total assets grew by 10.8% YoY in the second quarter. As of the end of Q2, the banking sector had an average reported capital adequacy ratio of 14.21%, 0.32 percentage points lower than the end of Q1.

Chart 4

## Reported Capital Adequacy Ratio

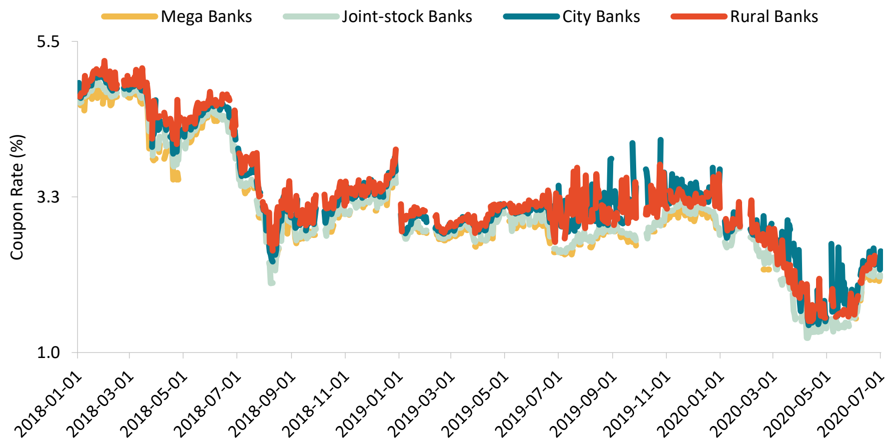



Source: CBIRC, collected and adjusted by S&P Global (China) Ratings.


In the second quarter, the central bank continued to ensure ample systemwide liquidity while keeping interest rates from falling too low. According to the People's Bank of China, it is fully aware of the danger of an extremely low interest rate environment and has moderated the extent of the interest rate drop in the second quarter. Nevertheless, we continue to expect the funding and liquidity profile of the banking sector to remain stable.

Chart 5

## Coupon Rates of 3-month Negotiable Certificates of Deposits




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



Despite lingering uncertainty related to COVID-19, China's economy is progressing steadily on a U-shaped economic recovery trajectory, an assumption which is fundamental to our overall stable outlook of the industry. After GDP growth dropped by 6.8% YoY in Q1, the growth rate bounced back to a positive 3.2% in Q2.

This report does not constitute a rating action.

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