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China Ratings

Mega Banks: Strong Enough to Withstand COVID-19

2020 Outlook for Chinese Mega Banks

April 24, 2020

Key Takeaways

- All Chinese mega banks delivered healthy financial performances in 2019.
- The mega banks' asset quality metrics remained stable and their reserve buffer was strengthened in 2019.
- The COVID-19 outbreak may put pressure on mega banks' asset quality and profitability in 2020, but we expect their overall capitalization to remain solid.

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Overview

Because of their extremely strong business franchise and very close ties with the central government, in our view, the state-owned mega banks typically have the strongest stand-alone credit quality and issuer credit quality among Chinese banks. China has six state-owned mega banks, including Industrial and Commercial Bank of China Limited ("ICBC"), China Construction Bank Corporation ("CCB"), Agricultural Bank of China Limited ("ABC"), Bank of China Limited ("BOC"), Bank of Communications Co., Ltd. ("BoCom") and Postal Savings Bank of China Co., Ltd. ("PSBC", AAA_{spc}/stable). These six banks have about half of the commercial banking market share in China by asset, playing a critical role in overall financial stability in the country. They are directly or indirectly owned by the central government, which views its ownership of these banks as long-term and strategic.

All Chinese mega banks delivered healthy financial performances in 2019, and we believe they are strong enough financially to fight the challenges of the short-term economic disruption caused by the global COVID-19 outbreak, as well as the slowdown in China's economic growth.

2020 Credit Outlook for Chinese Mega Banks

Factor	Outlook	Key Considerations
Business Position	Stable	– Mega banks' market position remains stable. – First quarter growth was affected by COVID-19, but we expect higher growth in the following quarters as China has got the outbreak under control. – We expect the whole year's business growth to be robust as banks provide credit to the real economy and facilitate recovery from the pandemic.
Capital & Earnings	Stable	– We expect pressure on profitability caused by net interest margin ("NIM") compression and impairment charges. – We expect capital to remain stable or improve as the G-SIB banks work on meeting TLAC targets.
Risk Position	Stable with downward pressure	– Mega banks had stable asset quality metrics and improving loan loss reserves as of the end of 2019. – The economic disruption caused by the global COVID-19 outbreak is expected to have an impact on asset quality. As China gets COVID-19 under control, we expect asset quality pressure to be generally manageable. – Generally speaking, most of the large corporate groups, as the most important client base of mega banks, are expected to remain stable despite the outbreak. – Mega banks' retail loan book is dominated by mortgage lending, the debt serving performance of which has been less affected by the outbreak. – We expect small and medium-sized enterprises ("SME") and micro businesses to be hit hard by the pandemic. But mega banks' overall exposure to these sectors is still relatively small.
Funding & Liquidity	Stable	– We expect the mega banks' deposit franchise to remain stable. – We believe mega banks benefit from "flight to quality," so they are very resilient in terms of funding and liquidity.
Indicative Stand-alone Credit Quality	Stable	– Although there may be some downward pressure on asset quality and profitability, the overall stand-alone credit quality of mega banks is expected to remain stable.

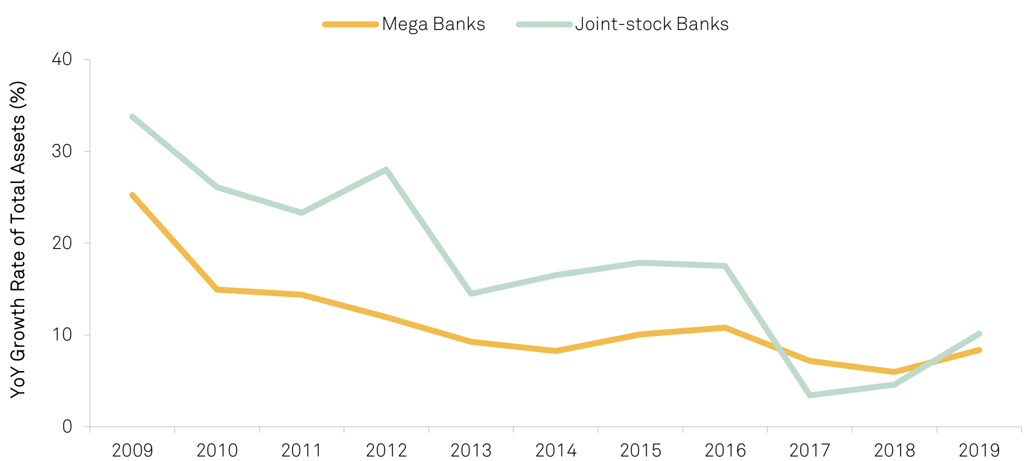
Government Support	Stable	– We expect the mega banks' critical importance level to the central government to remain stable. – We expect the government's willingness and capability to support the mega banks to remain unchanged.
Indicative Issuer Credit Quality	Stable	– We expect mega banks' issuer credit quality to remain stable in 2020.

Business Position

We expect the competitiveness of mega banks to remain stable and unchallenged in the foreseeable future, despite a marginal decrease in market share in recent years. As of the end of 2019, the six mega banks' total market share by asset in the commercial banking industry was 48.7%, 2.9 percentage points lower than the end of the previous year. This was caused by faster growth among other types of banks, in our opinion, particularly joint-stock banks. Compared with joint-stock banks which tend to have more volatile growth, mega banks have a generally more stable growth momentum thanks to their solid business franchise.

Chart 1

YoY Growth Rate of Total Assets



In the past decade, joint-stock banks grew faster than the mega banks, but mega banks' growth was steadier.

Note: PSBC was not categorized as a state-owned mega bank until 2019, so we exclude it in this chart for better comparability.
Sources: CBIRC, public information of banks, collected and adjusted by S&P Global (China) Ratings.
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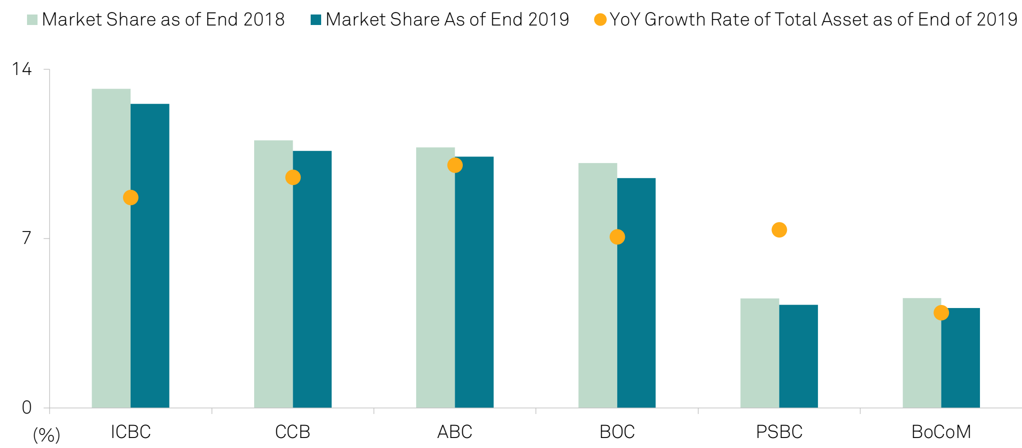
Chart 2

Asset Market Shares and YoY Growth Rates of Total Assets



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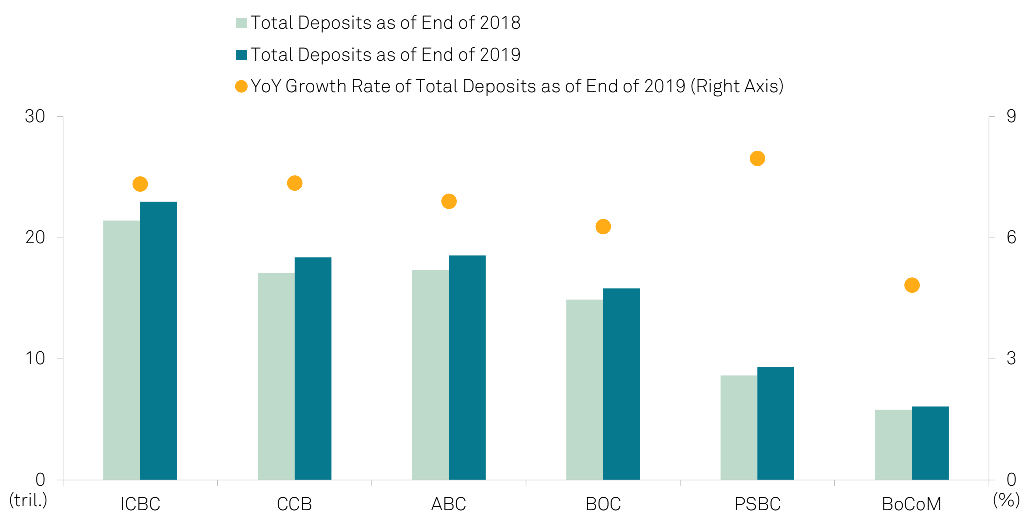
Mega banks' market share saw a mild drop in 2019 because other types of banks grew faster.

Chart 3

Deposit Growth



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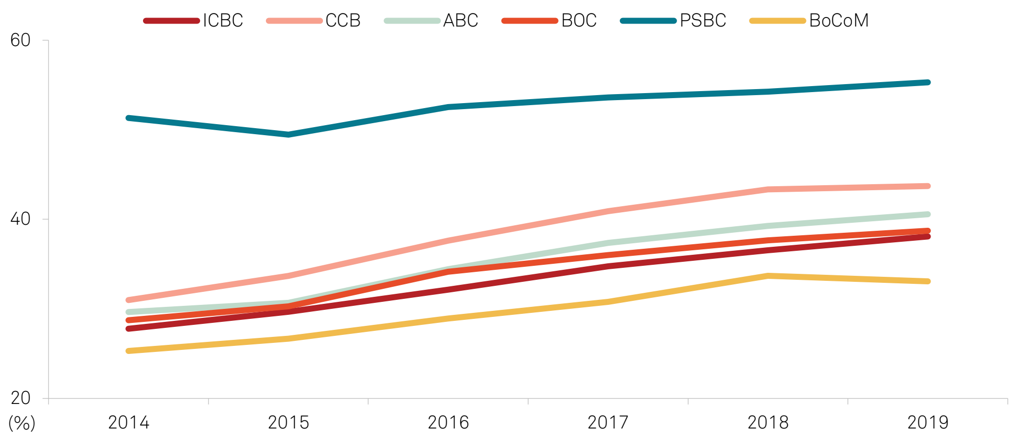
Mega banks maintained their strong deposit business franchise in 2019.

All mega banks have been expanding their retail lending business, particularly mortgage lending. We generally view this trend as positive thanks to the good granularity of retail business and the generally sound asset quality of mortgages in China.

Chart 4

Retail Loans/Gross Customer Loans



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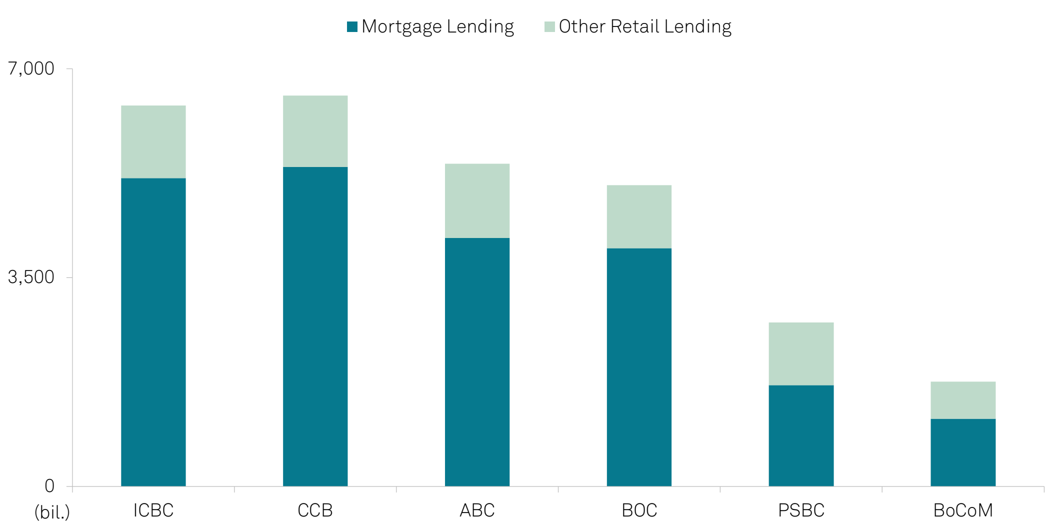
Mega banks have been increasing their retail lending business.

Chart 5

Breakdown of Retail Loan Portfolios as of End of 2019



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Mortgage lending is the dominant component in the retail loan portfolio of mega banks.

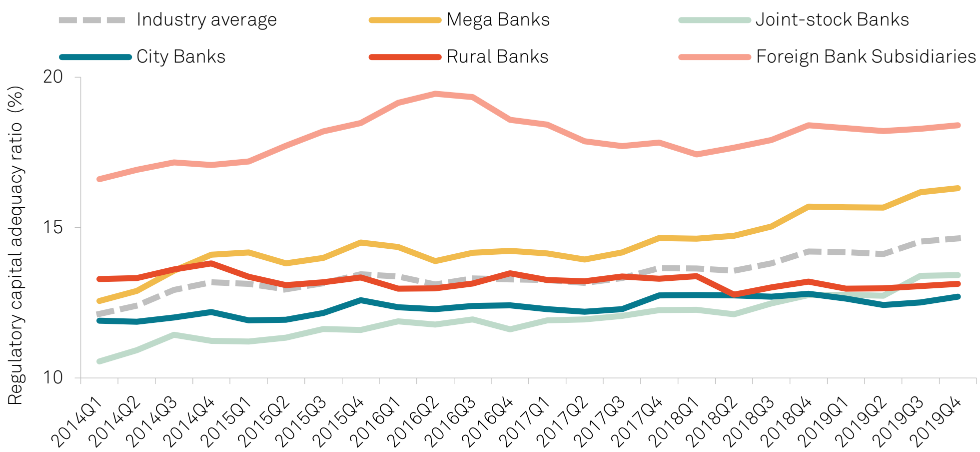
We expect mega banks' full year business growth in 2020 to be robust as the mega banks provide credit to the real economy, facilitating recovery from the pandemic. Growth in the first quarter was disrupted by COVID-19, but with the pandemic generally under control in China since March, we expect business growth to regain momentum in the second and third quarters.

Capital & Earnings

Most mega banks have reported capital ratios above the industry average, due not only to their strong capital and earnings but also their use of an internal rating-based ("IRB") approach for risk-weighted asset ("RWA") calculation. As of the end of 2019, the mega bank group's average reported capital adequacy ratio increased to 16.31%, up by 0.61 percentage points compared to the end of 2018. The improvement of capitalization can be attributed to both good internal capital generation capability and issuance of hybrid bonds.

Chart 6

Reported Capital Adequacy Ratio



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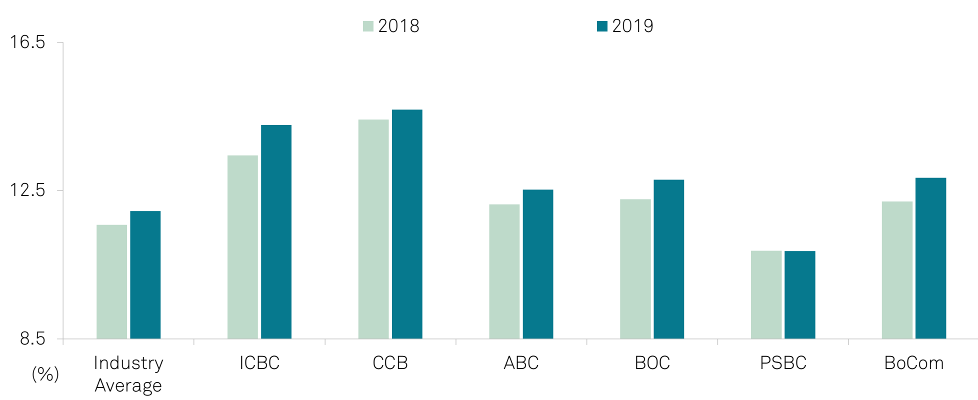
Mega banks have reported regulatory capital adequacy ratios above the industry average.

Chart 7

Reported Tier-1 Capital Adequacy Ratio



Note: except for PSBC, the five other mega banks use IRB approach to calculate RWA; while PSBC uses Standard Approach. Generally speaking, the RWA calculated under IRB approach is lower than the RWA under standard approach.

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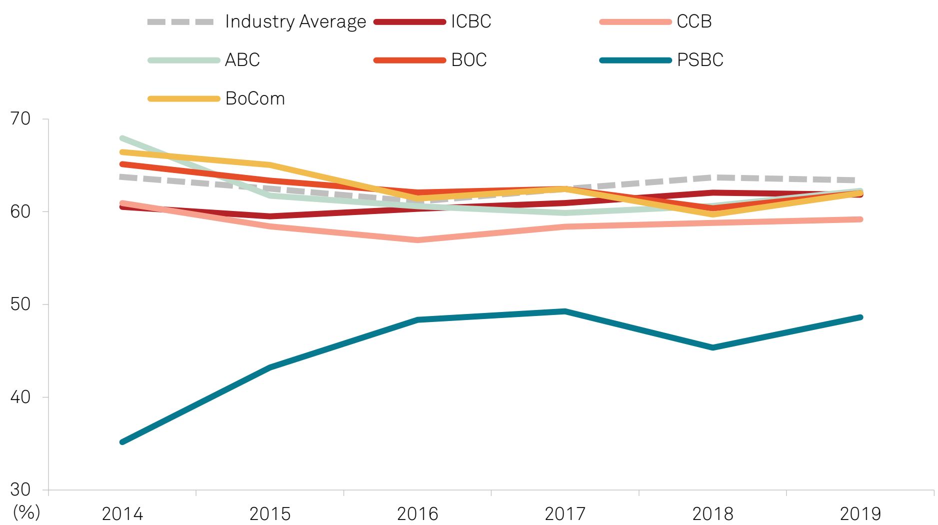
Mega banks improved their reported tier-1 capital adequacy ratios in 2019.

Although the five mega banks (ICBC, CCB, ABC, BOC and BoCom, the "mega five") use their internal credit models to decide the credit risk weights for their RWA calculation, their RWA density (measured by the ratio of RWAs to total assets) converged in 2019, leading to better capitalization comparability among the mega five.

Chart 8

Reported Risk-weighted Assets/Total Assets



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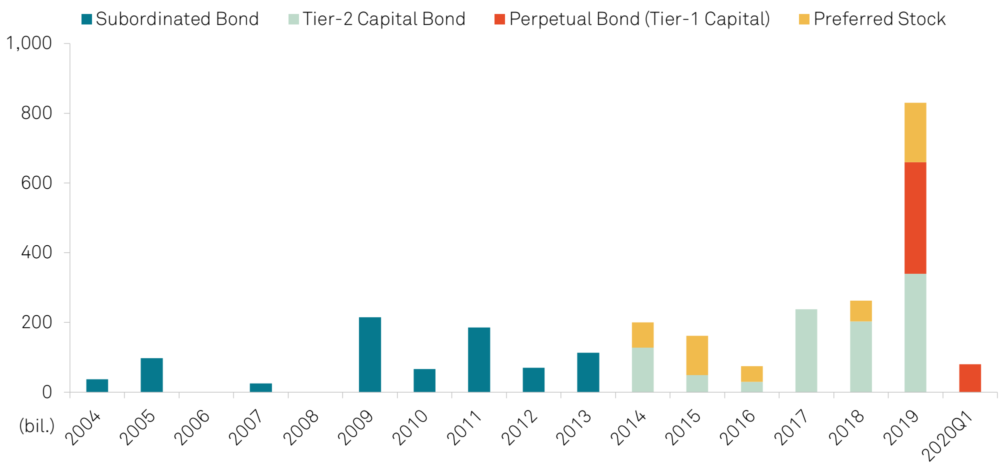
The five mega banks using IRB approach had similar RWA density as of the end of 2019.

In addition to different RWA calculation methods, differences in RWA density may also be explained by variations in business models and asset mixes. The much lower RWA density of PSBC is mainly caused by its distinctive asset mix, because it holds a large portfolio of low-risk bonds, such as treasury bonds, and has a much lower loan-to-deposit ratio compared to the other mega banks.

The high-volume issuance of hybrid bonds and preferred shares in 2019 helped mega banks build up a capital buffer to absorb the impact of COVID 2019. Before 2019, mega banks typically issued tier-2 hybrid bonds, which helped improve total capital adequacy ratio but didn't help tier-1 capitalization. In January 2019, BOC became the first Chinese bank to issue perpetual bonds in the domestic market, which is qualified as additional tier-1 capital under Basel III rules. Since then, perpetual bonds have become an important tool for mega banks to enhance their capitalization.

Chart 9

Hybrid Instruments Issued by Mega Banks in the Domestic Market



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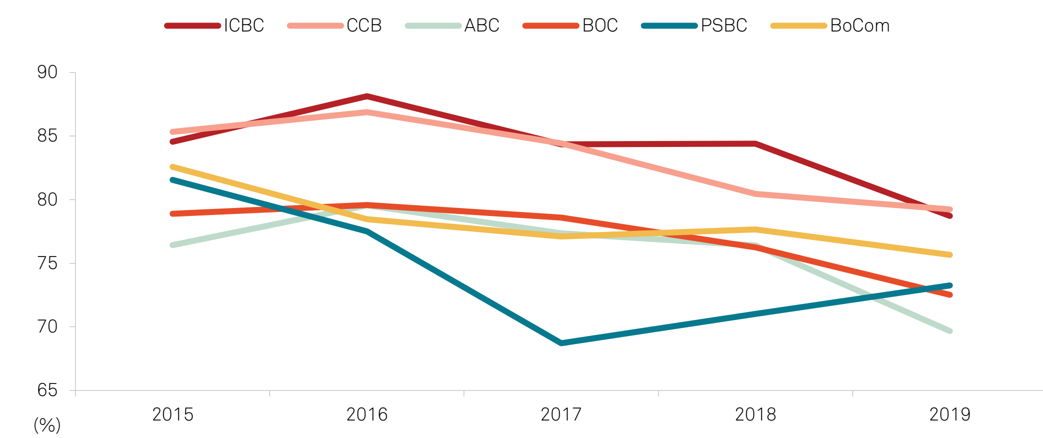
Mega banks significantly increased their issuance of hybrid bonds in 2019.

As more hybrid bonds are issued, mega banks' capital quality (measured by the ratio of core tier-1 capital to total capital) has come under downward pressure. Nevertheless, the mega banks' current capital quality level is consistent with international practices.

Chart 10

Core Tier-1 Capital/Total Capital



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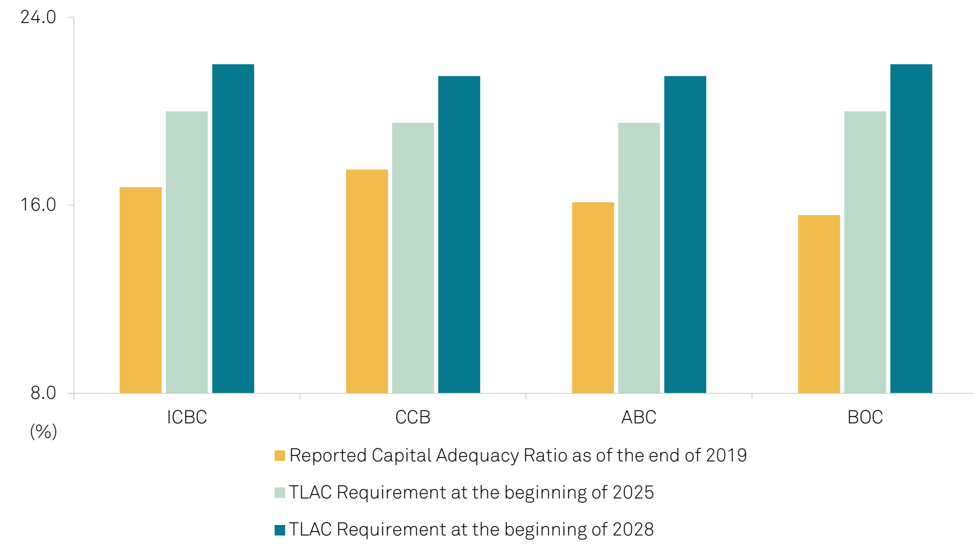
As more hybrid instruments are issued, the capital quality of mega banks has come under downward pressure.

In order to meet the Total Loss-Absorbing Capacity ("TLAC") requirements of the Financial Stability Board in the next decade, China's four global systemically important banks ("G-SIBs", including ICBC, CCB, ABC, and BOC) may need to significantly increase their issuance of equity and hybrid bonds in the foreseeable future, given the material gap between their current capital positions and TLAC requirements.

Chart 11

TLAC Requirements for the Chinese G-SIBs



Sources: China Financial Stability Report 2019 published by PBOC, public information of banks, collected and adjusted by S&P Global (China) Ratings.

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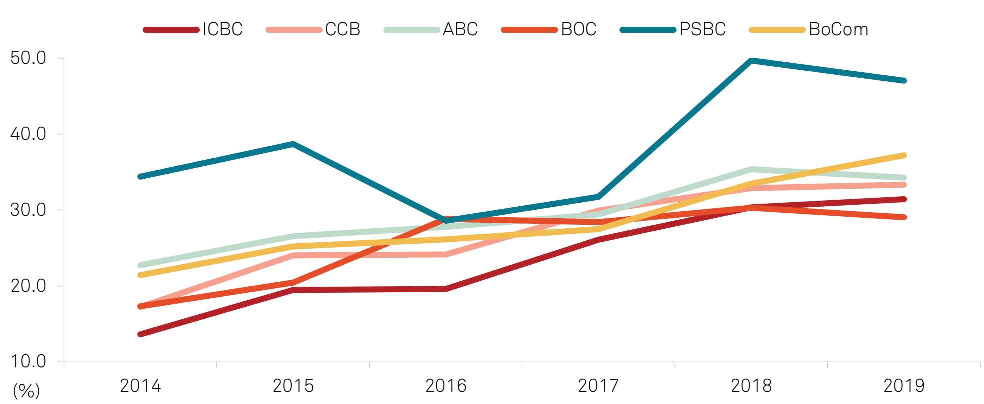
The four G-SIBs face gaps between their current capitalization and their TLAC requirements in the next decade.

Impairment charges have weighed on the profitability of mega banks in recent years, and we expect the pressure to continue in 2020 as COVID-19 brings new challenges to asset quality. Nevertheless, thanks to their strong revenue, we believe the mega banks still have enough financial flexibility to further step up their provisioning in 2020.

Chart 12

New Provisioning/Pre-provisioning Operating Profits



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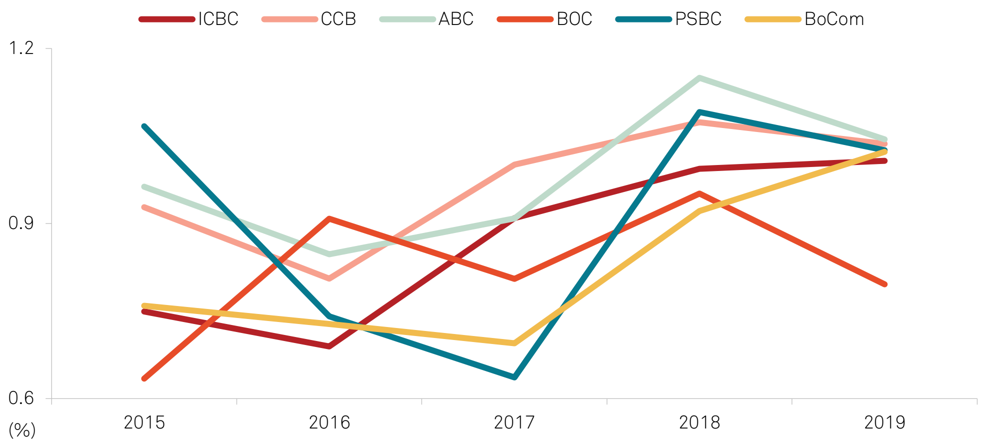
Impairment charges have been weighing on the profitability of mega banks.

Most mega banks have similar credit cost (measured by the ratio of new provisioning to average gross loans). The average credit cost of mega banks was 0.99% in 2019, 0.04 percentage points down compared to 2018.

Chart 13

Loan Provisioning/Average Gross Customer Loans



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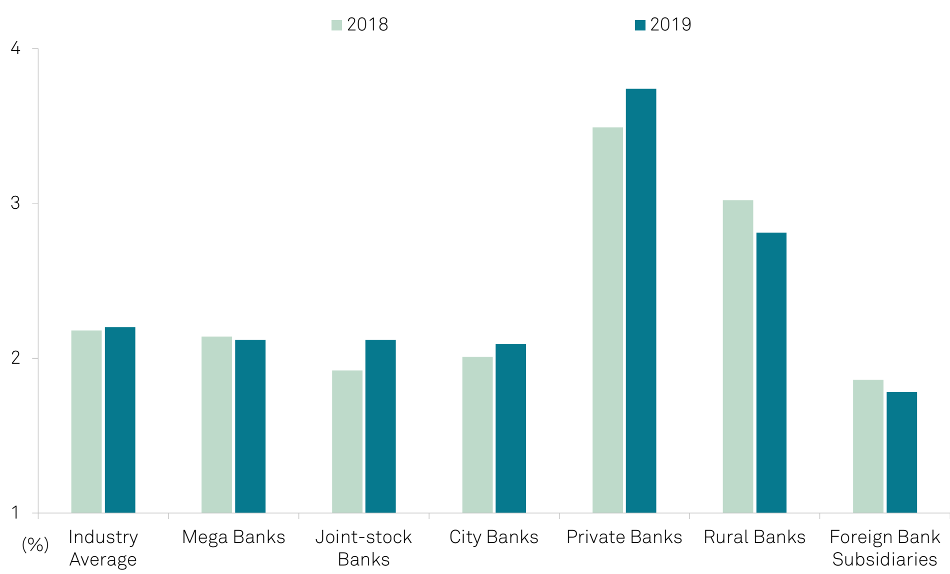
Mega banks' average credit cost was around 1% in 2019.

Most mega banks felt mild NIM compression pressure in 2019. The average NIM of mega banks was 2.10% in 2019, 0.07 percentage points lower than 2018. We expect their NIM to further narrow in 2020, putting pressure on profitability. The NIM compression pressure is mainly caused by the adoption of the loan prime rate and loosened monetary policy. To help the real economy recover from the pandemic, the government intends to keep borrowing costs low in 2020. Meanwhile, to ease banks' NIM pressure, the central bank and regulators are set to prevent an increase in deposit interest rates in 2020.

Chart 14

Net Interest Margin



Sources: CBIRC, collected & adjusted by S&P Global (China) Ratings.
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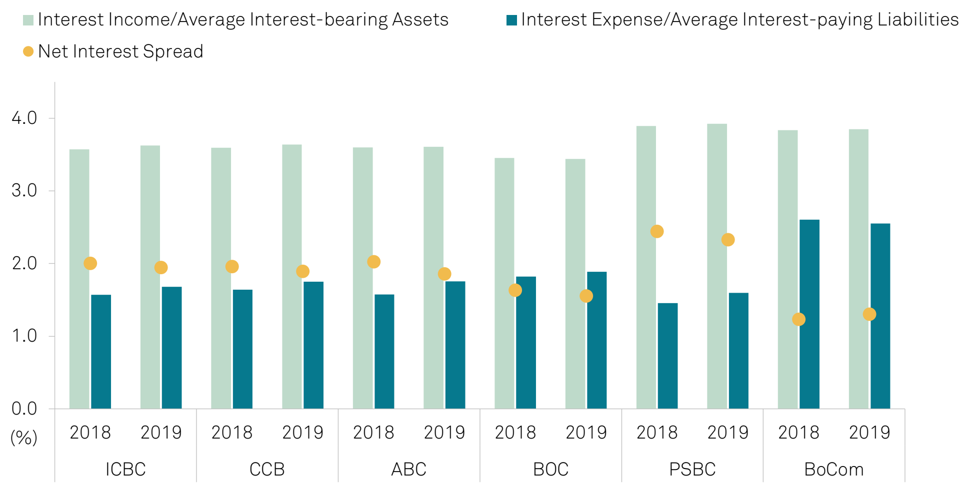
The NIM of mega banks is consistent with the industry average.

Chart 15

Net Interest Spread



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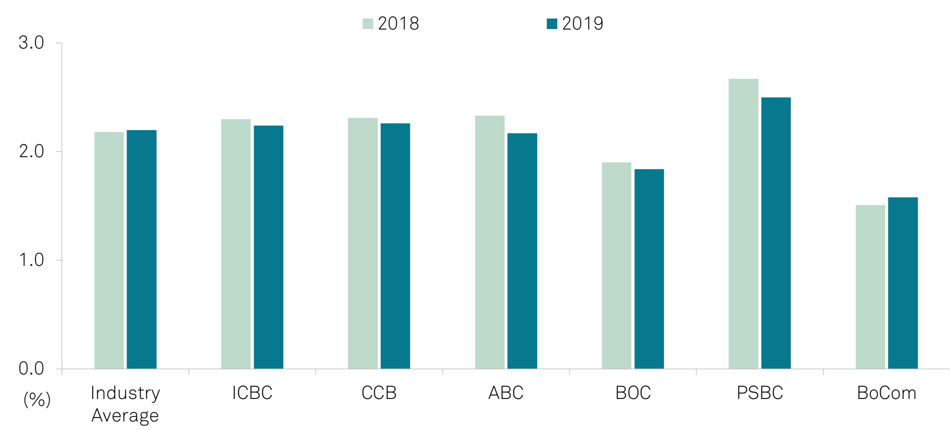
In 2019, most mega banks' credit spread pressure came from rising funding costs while average interest rates on the asset side remained stable.

Chart 16

Reported Net Interest Margin



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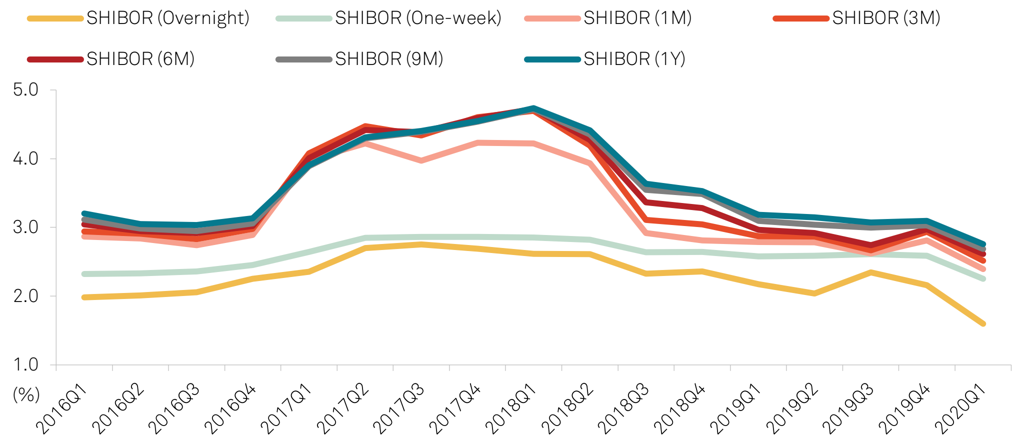
Most mega banks felt mild NIM compression pressure in 2019, only Bocom improved its NIM.

Chart 17

Average SHIBOR Rates



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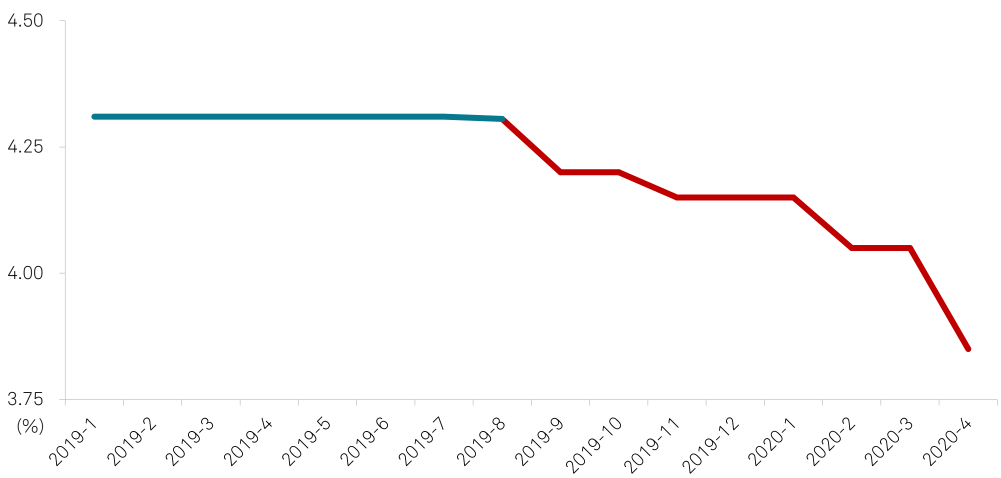
Monetary policy is easing in early 2020 as the central bank looks to counter the impact of COVID-19.

Chart 18

Average 1-Year Loan Prime Rate ("LPR")



Note: PBOC started a new LPR quotation mechanism on August 17, 2019.
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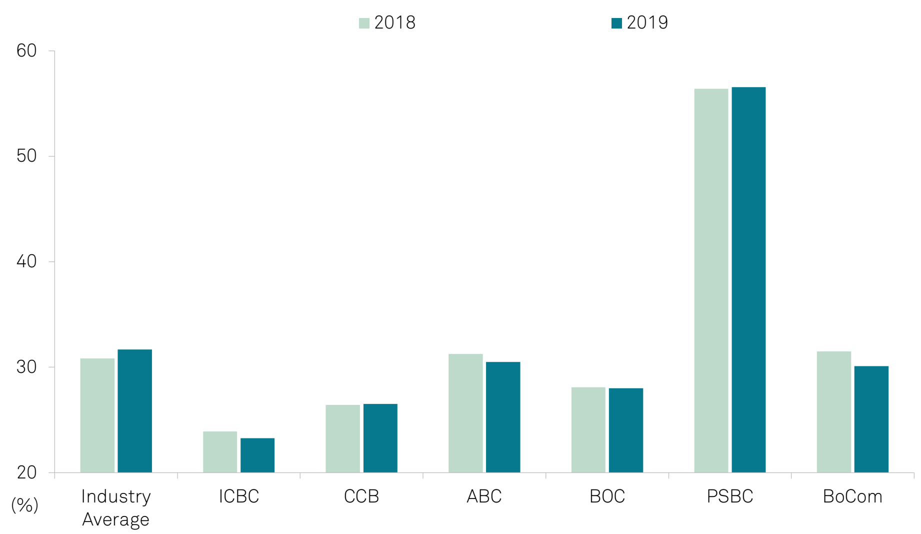
Mega banks face downward pressure on loan yields amid a decrease in the LPR in early 2020.

Most mega banks have low cost-to-income ratios thanks to their large operational scale. Only PSBC has a higher cost-to-income ratio because of the agency fees it needs to pay to China Post Group under its unique "proprietary branch + agency outlet" business model.

Chart 19

Reported Cost-to-income Ratio



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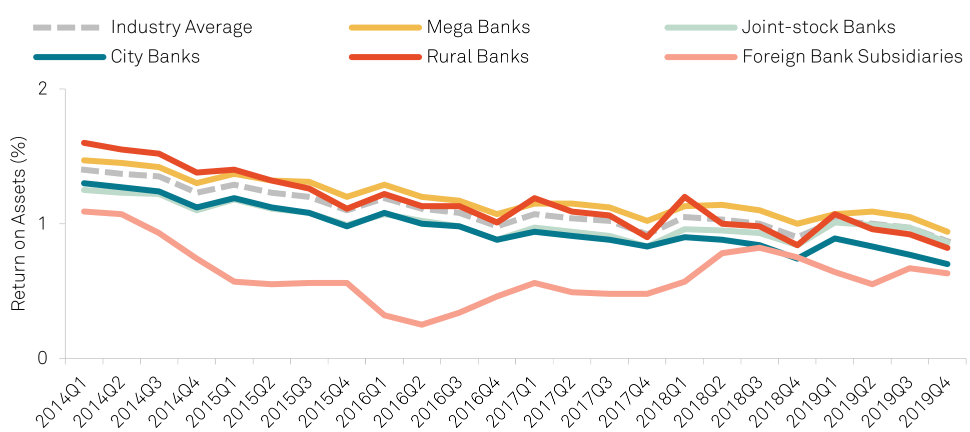
Most mega banks have low cost-to-income ratios thanks to their large operational scale.

Thanks to very strong business franchise and effective management, the mega banks have maintained strong and stable profitability through the years. Their robust retained earnings levels help them to maintain adequate capitalization while keeping a healthy business growth rate.

Chart 20

Return on Assets



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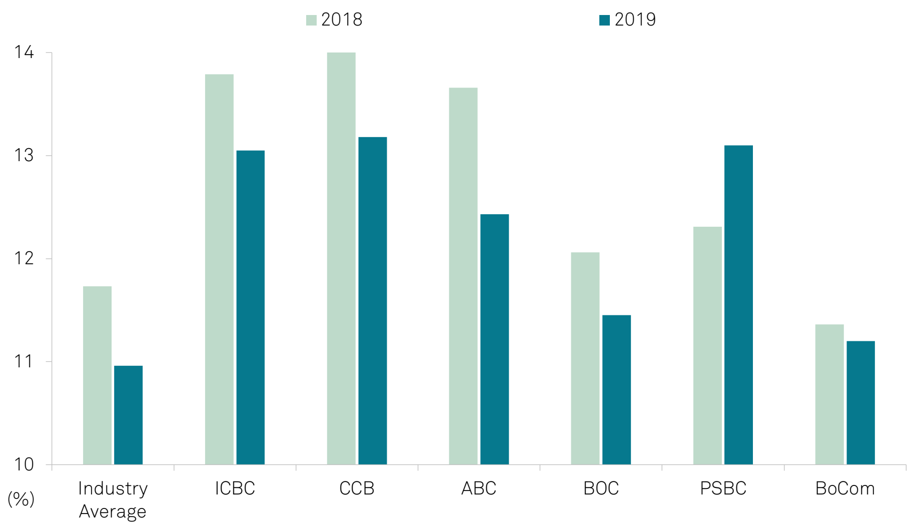
Compared with other types of banks, mega banks have more stable and stronger profitability.

Chart 21

Reported Return on Equity



Mega banks achieved above industry average ROE in 2019.

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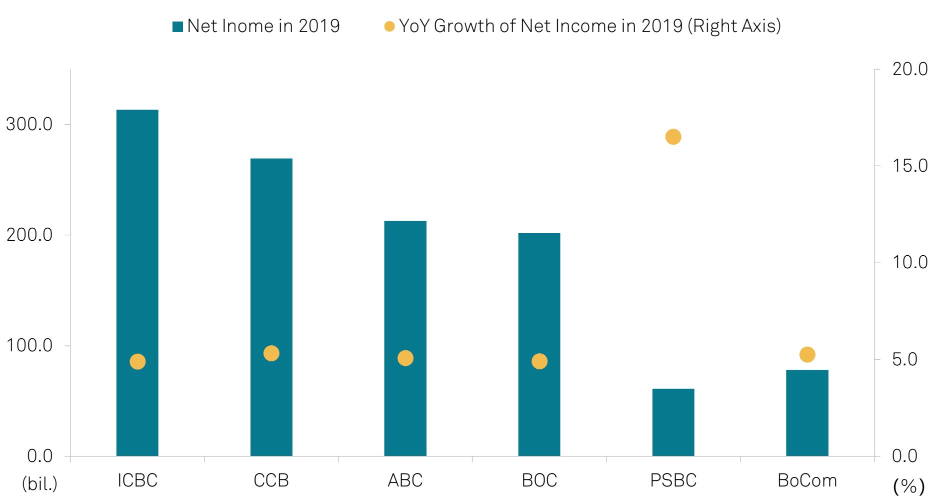
Chart 22

Net Income



Mega banks achieved good net income growth in 2019.

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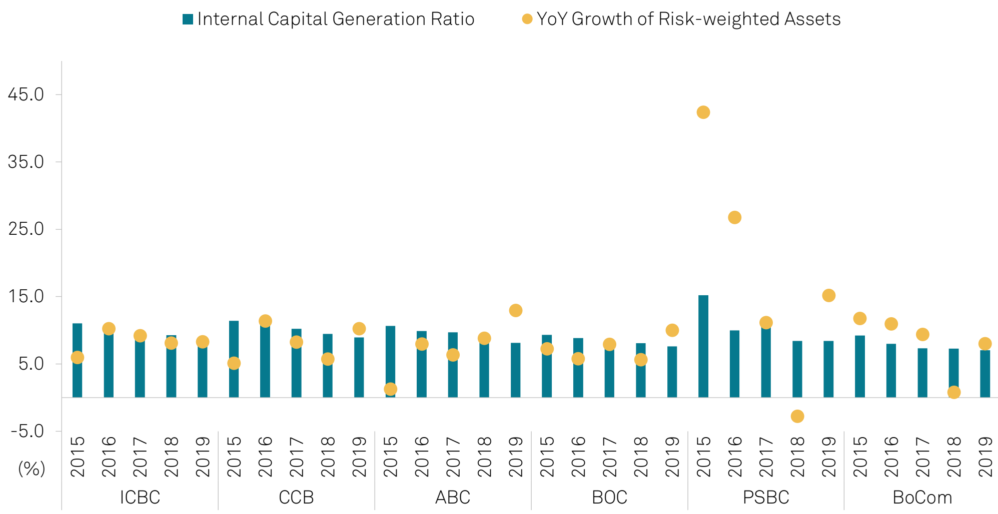
Stable and strong internal capital generation capacity achieved through robust profitability and a stable dividend payout ratio have helped mega banks maintain stable capitalization. Most mega banks have an RWA growth rate roughly consistent with their internal capital generation capacity. PSBC may be an exception because it is still in the stage of rapidly developing its loan book which is capital intensive. Nevertheless, stable capitalization won't be enough for mega banks as regulators expect systemically important banks to achieve higher capital ratios in the next decade.

Chart 23

Internal Capital Generation Capacity



Note: Internal capital generation ratio = (net income – cash dividend)/average total equity.
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Stable and strong internal capital generation capacity helps mega banks to maintain stable capitalization.

The profitability of mega banks is under pressure in 2020 because of narrower NIMs and higher impairment charges in the pandemic period. The extent of the profitability pressure may depend on the duration and severity of the outbreak.

Profitability pressure may lead to slower internal capital generation in 2020 given the rising economic uncertainty. Nevertheless, we expect mega banks' capital position to remain stable or improving capital position as the G-SIBs take measures to meet TLAC requirements.

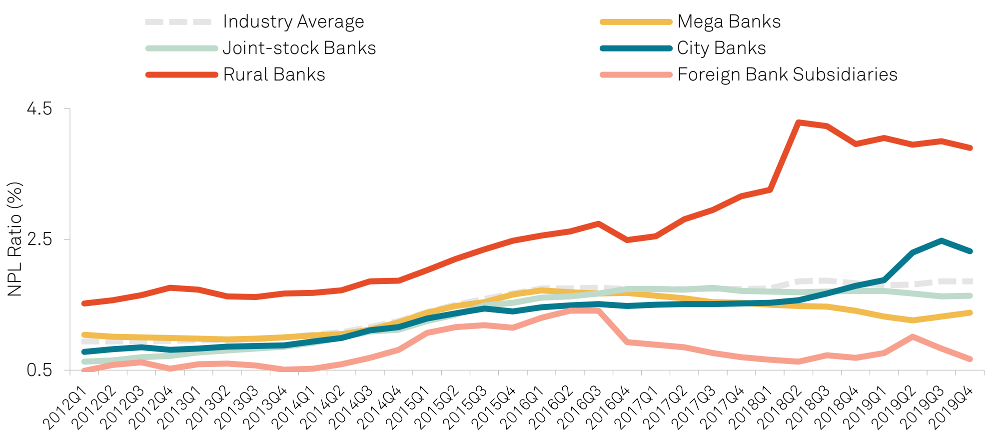
Risk Position

Because of their high market share in the lending business and extensive exposure to the real economy in China, mega banks typically have a risk position in line with the industry average. PSBC is an exception because it has a smaller lending operation and enjoys better asset quality metrics.

The very good diversification of their loan books in terms of both geography and industry helps the mega banks to have a more stable asset quality performance compared with other types of banks. Compared with 2015, which saw significant growth of mega banks' NPLs, 2019 was a more stable year in terms of asset quality control.

Chart 24

Non-performing Loan ("NPL") Ratio



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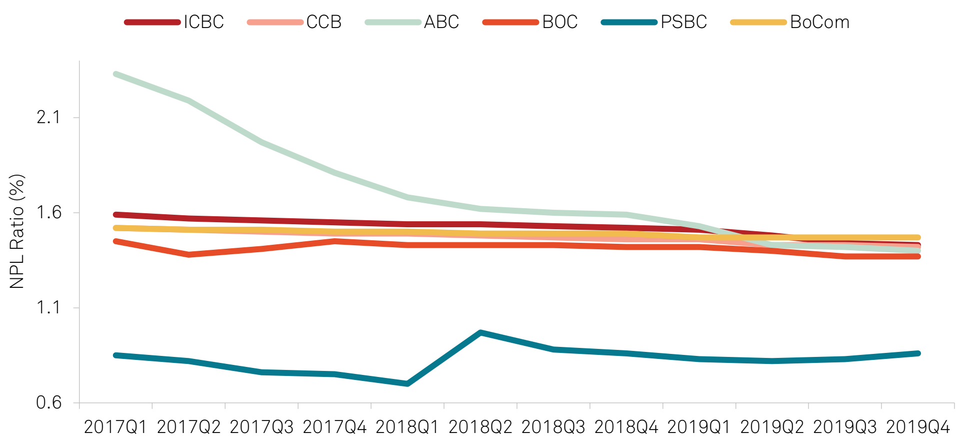
Mega banks' NPL ratio is more stable compared with other types of banks.

Chart 25

NPL Ratio



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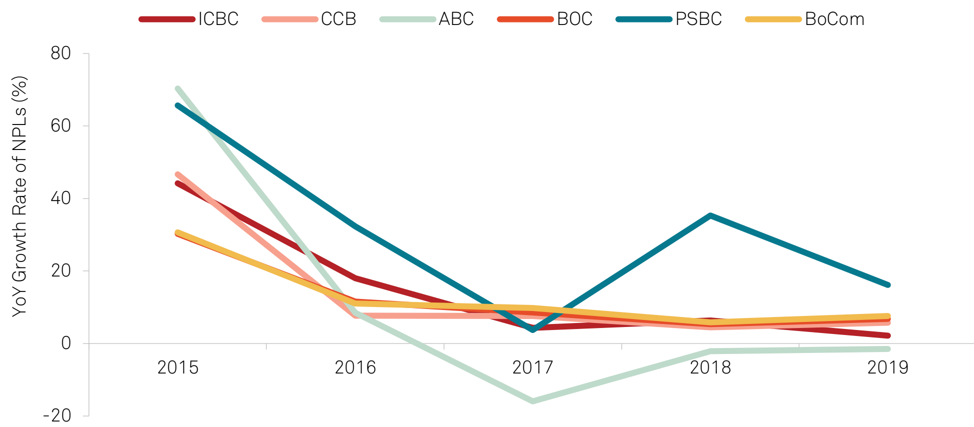
PSBC has better asset quality metrics compared with its mega bank peers.

Chart 26

YoY Growth of NPLs



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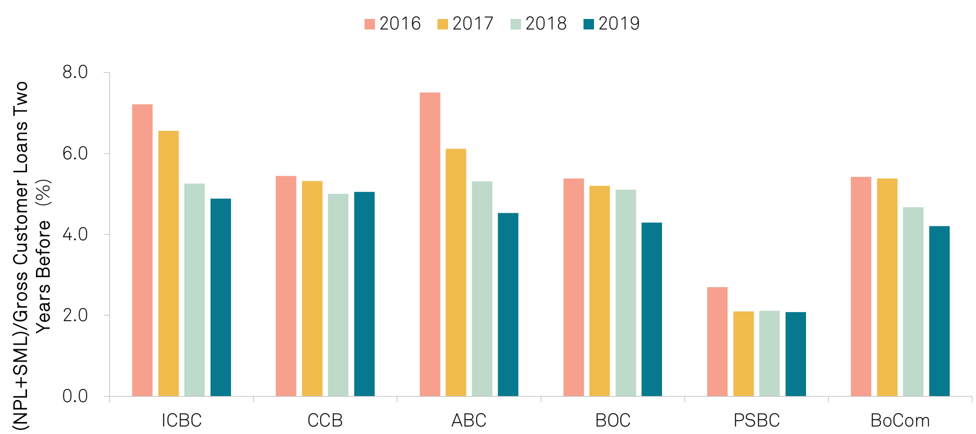
Mega banks' bad debt growth has moderated.

Chart 27

(NPL+SML)/Gross Customer Loans Two Years Before



Note 1: NPL- non-performing loans; SML- special mention loans.

Note 2: (NPL+SML)/Gross Customer Loans Two Years Before as of end of 2019 = (NPL+SML) as of end of 2019/ Gross Customer Loans as of end of 2017, the two-year adjustment on the denominator is to reduce the influence of loan book growth on NPL+SML ratios.

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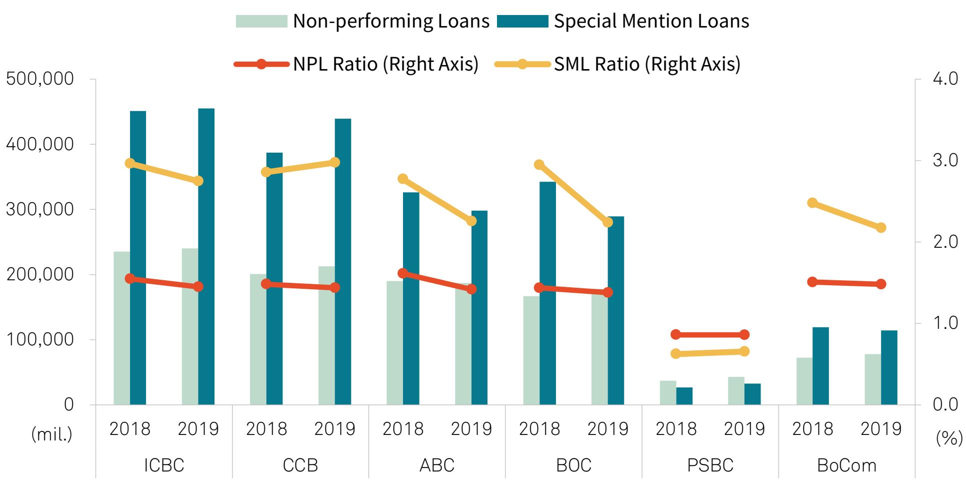
If we exclude the influence of loan book growth on NPL+SML ratios, we see a more significant improvement of asset quality metrics in recent years.

Chart 28

Asset Quality Metrics



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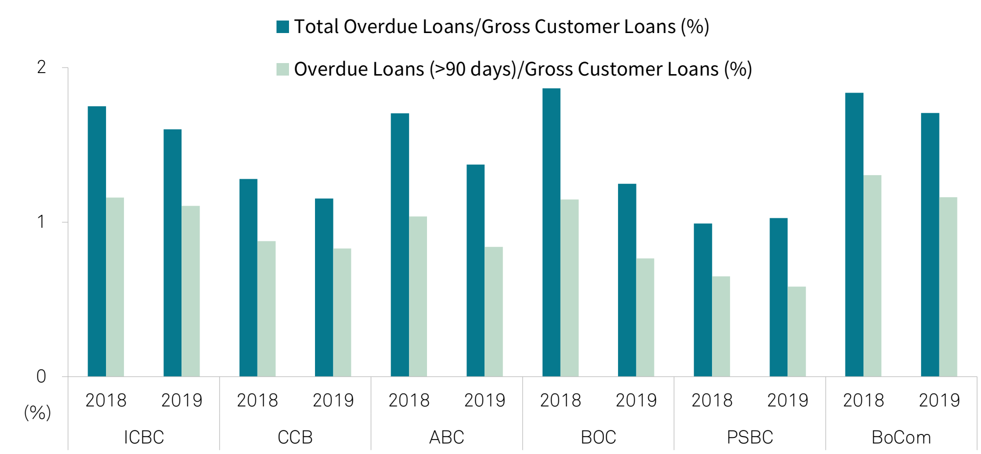
Mega banks' asset quality metrics remained stable in 2019.

Chart 29

Overdue Loans/Gross Customer Loans



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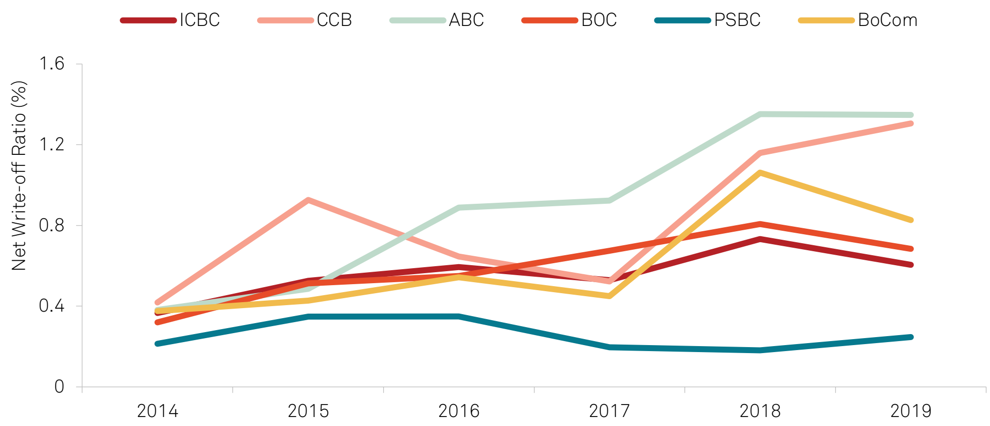
Mega banks' overdue loan ratios decreased in 2019.

Chart 30

Net Write-off Ratio



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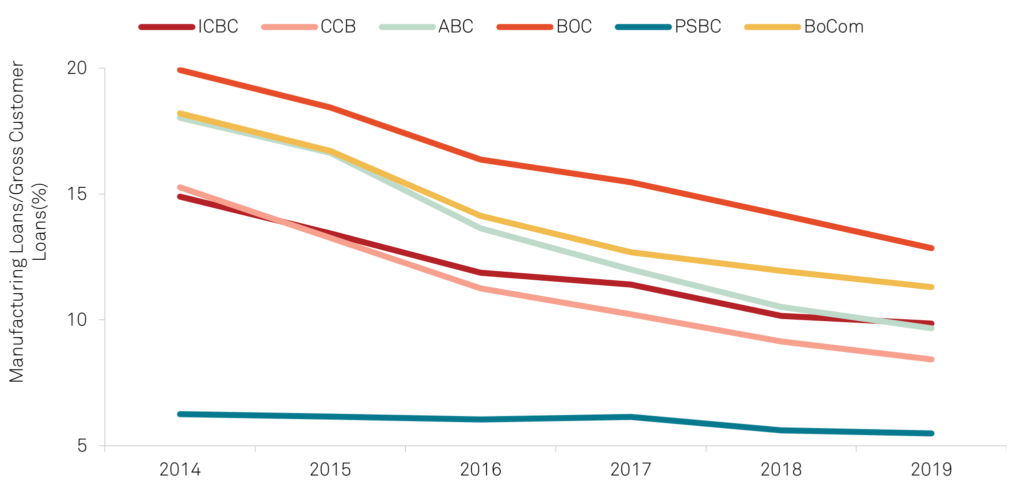
Writing-off has been an effective measure for mega banks to keep their NPL ratios low.

Mega banks have reduced their exposure to the manufacturing sector in recent years as some manufacturing sub-sectors showed high credit risk. As China rebalances its economy, overcapacity and over-leveraging of some manufacturers have led to bad debts and the manufacturing sector has shown higher NPL ratios compared to other sectors. Mega banks have been actively shifting away from high-risk manufacturing sub-sectors and increasing their exposure to retail lending business.

Chart 31

Manufacturing Loans/Gross Customer Loans



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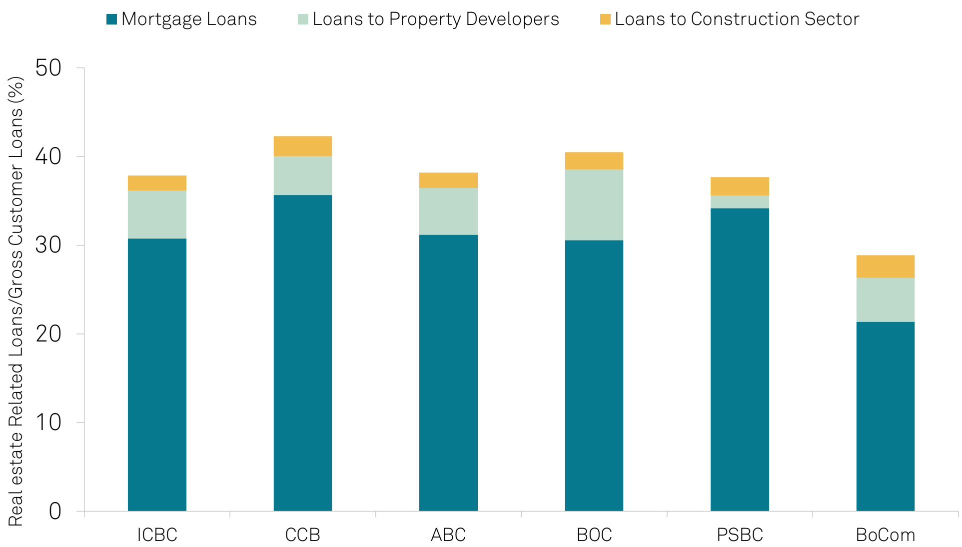
As China's economy rebalances, mega banks have witnessed a decrease of manufacturing loans in their loan books.

Chart 32

Real Estate - Related Loans as of End of 2019



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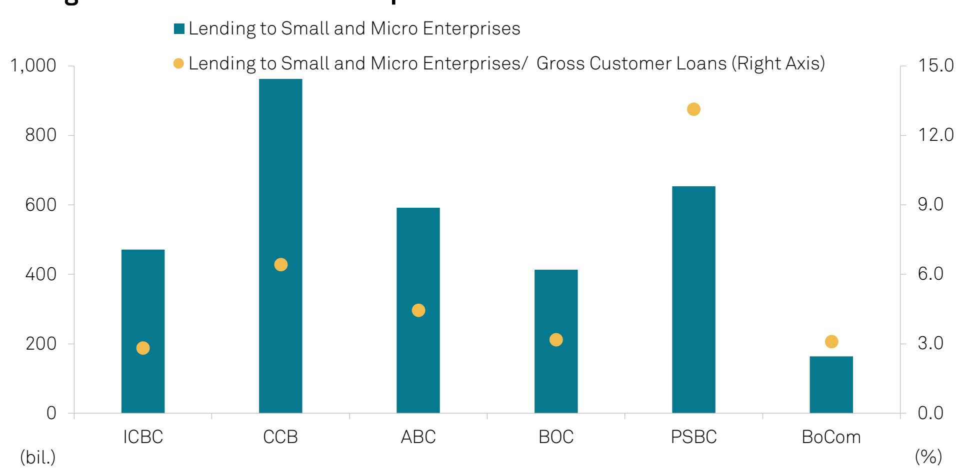
Mega banks have substantial exposure to China's property market, but the risk is mitigated by the good granularity and sound asset quality of mortgage loans in China.

SMEs and micro businesses are generally the most vulnerable borrowers to the pandemic outbreak, but we believe that mega banks' profitability is strong enough to absorb additional credit loss from SMEs and micro businesses caused by COVID-19. The mega banks increased their exposure to small and micro enterprises in 2019 as encouraged by the government but their overall exposure to those smaller borrowers is still limited.

Chart 33

Lending to Small and Micro Enterprises as of End of 2019



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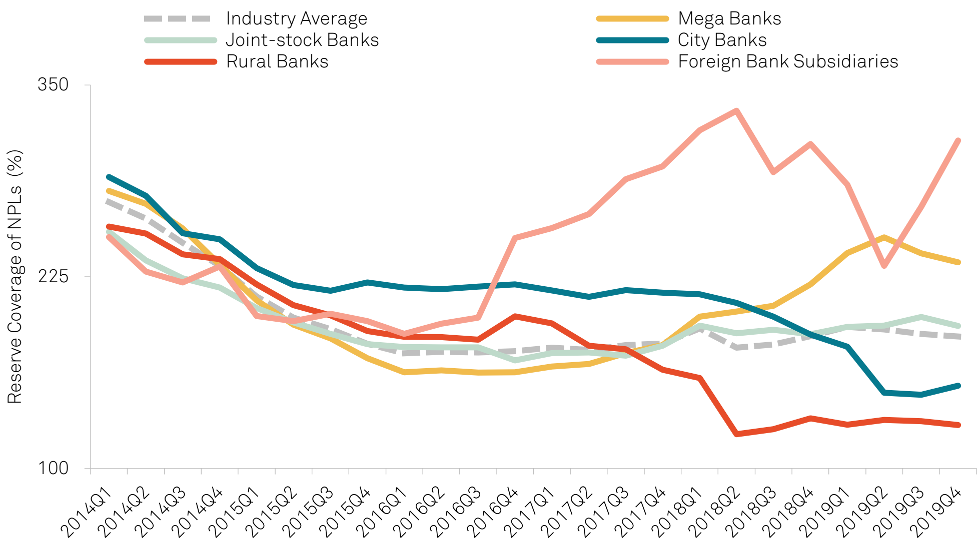
We believe that mega banks' profitability is strong enough to absorb additional credit loss from small and micro enterprise loans caused by COVID-19.

We expect mega banks to have higher asset quality pressure in 2020 owning to the COVID-19 outbreak. The forbearance given to clients hit by COVID 19 may mitigate the rise of reported NPL ratios and special mention loan ("SML") ratios this year, so it will take longer to fully assess the deterioration of underlying asset quality.

Among domestic banks, mega banks generally have the highest reserve coverage of bad debts. In our view, if the pandemic's impact on the economy is worse than our expectations and the industry's bad debt problem worsens, the mega banks are generally in a better position to protect their capital base compared to other types of domestic banks.

Chart 34

Reserve Coverage of NPLs



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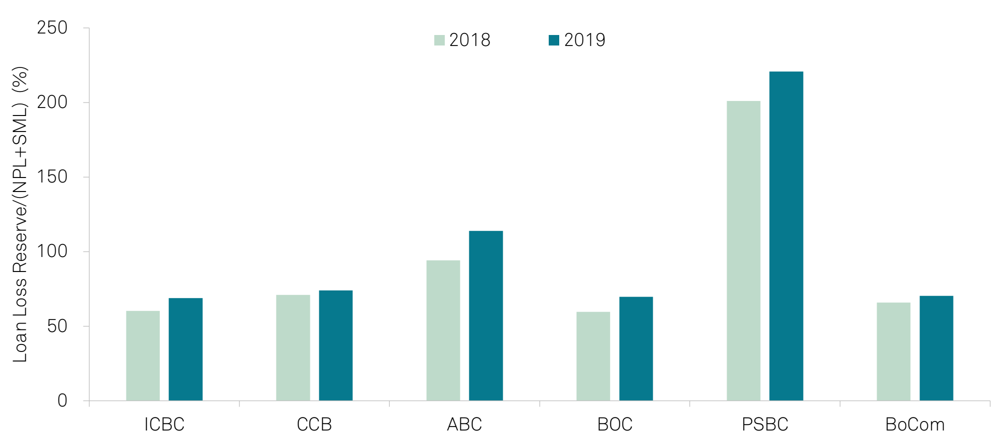
The reserve coverage level has diverged in recent years and mega banks have the best reserve coverage among domestic banks.

Mega banks have improved their reserve coverage over NPL+SML in 2019, giving them a better position to fight against the effects of COVID-19 in 2020.

Chart 35

Loan Loss Reserve/(NPL+SML)



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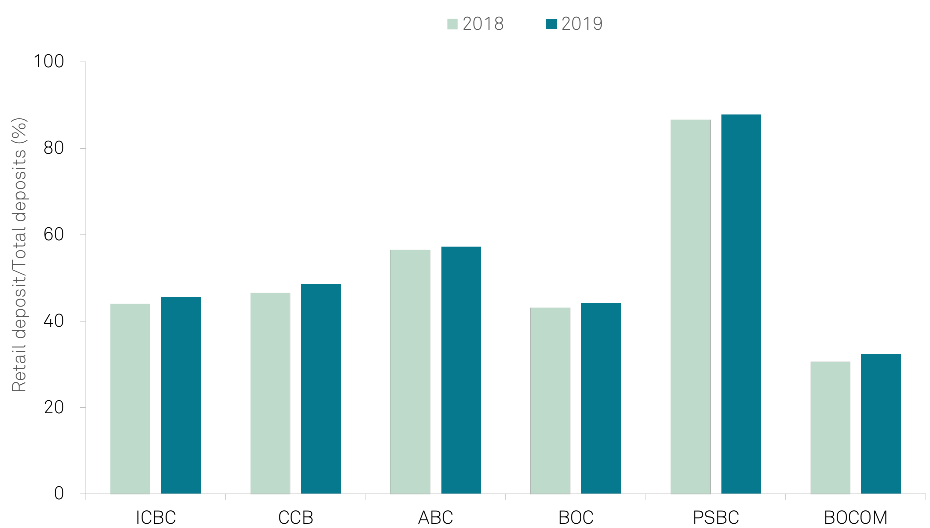
PSBC has a very prudent approach to provisioning.

Funding & Liquidity

Thanks to their extensive network and strong business franchise, mega banks have a very solid and sticky deposit base which leads to a funding structure much more stable than the industry average. The funding and liquidity profile of mega banks has remained stable in 2019 and we don't expect any material change in 2020 and beyond. In addition, these banks typically benefit from a flight to quality, leading to high resilience in their liquidity profile.

Chart 36

Retail Deposits/Gross Customer Deposits



Despite fierce competition for retail deposits, mega banks have maintained their strong retail deposit funding base.

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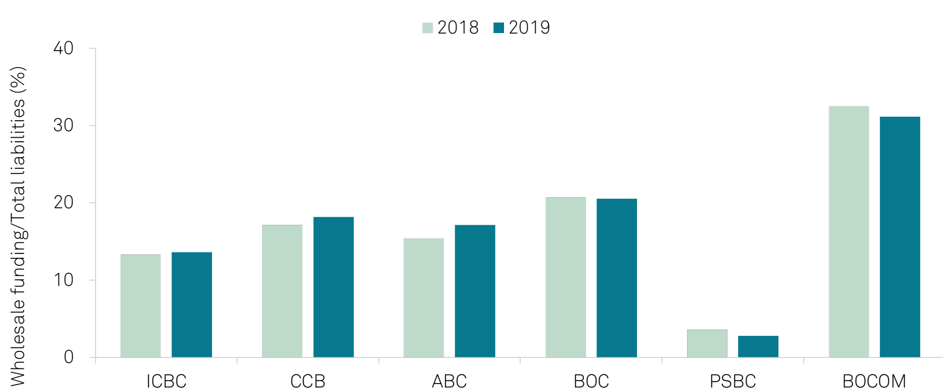
Chart 37

Use of Wholesale Funding



Mega banks' use of wholesale funding remained restrained in 2019.

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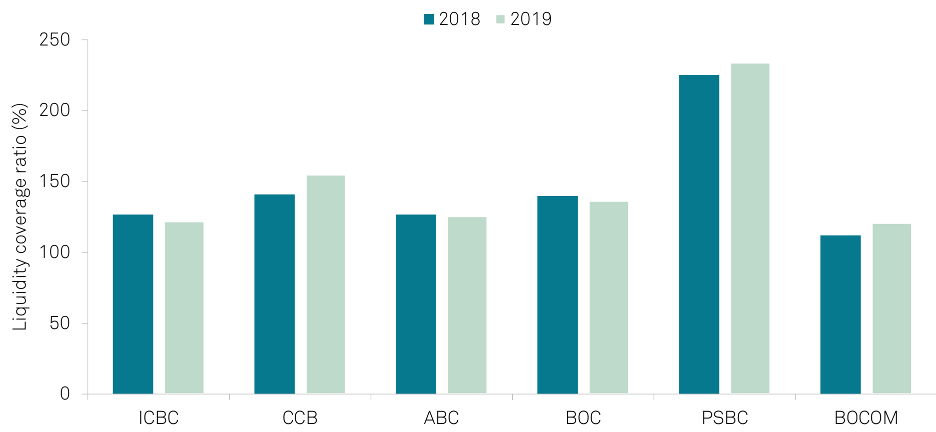
Chart 38

Reported Liquidity Coverage Ratio



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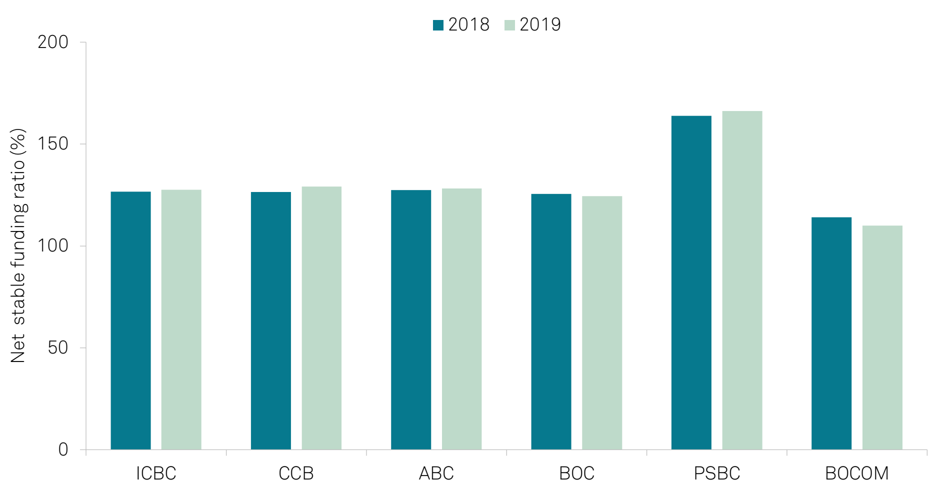
Mega banks maintained stable liquidity coverage ratios in 2019.

Chart 39

Reported Net Stable Funding Ratio



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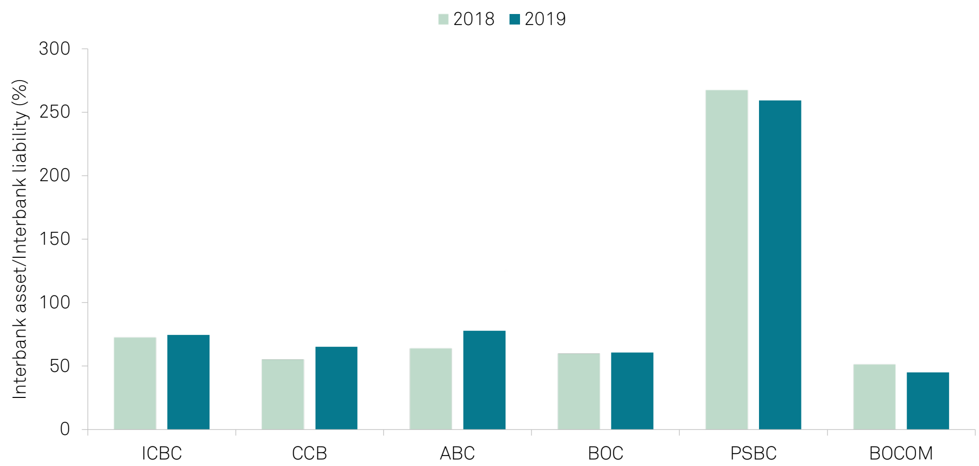
Mega banks kept a stable funding profile in 2019.

Chart 40

Interbank Assets/Interbank Liabilities



Note: Interbank assets include deposits with banks and non-bank financial institutions, placements with banks and non-bank financial institutions and financial assets held under resale agreements. Interbank liabilities include deposits from banks and non-bank financial institutions, placements from banks and non-bank financial institutions, and financial assets sold under repurchase agreements. Financial institution bond and negotiable certificate of deposits are excluded.

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PSBC is a net liquidity provider to other financial institutions thanks to its uniquely strong liquidity position.

This report does not constitute a rating action.

Appendix: Related Methodologies & Research

Methodology Applied:

- S&P Global (China) Ratings Financial Institutions Methodology.

Related Research & Commentary:

- S&P Global (China) Ratings General Considerations on Rating Modifiers and Relative Ranking.
- Diversity Across China's Banking System – A Deep Dive A Study on Credit Quality Differentiation Among Chinese Banks.
- Key Differentiation Factors of Credit Quality of Domestic Banks in China.
- Strong and Steady – Mega Banks as the Pillars of China's Banking Sector

Related Issuer Ratings and Research

- Rating Action: Postal Savings Bank of China Co., Ltd. Assigned "AAA$_{spc}$" Rating; Outlook Stable
- Bulletin: PSBC's 2019 Financial Performance in Line with Expectations

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