

# **Quarterly Snapshot on China's Banking Sector**

**Second Quarter of 2020**

**标普信评**

**S&P Global**

China Ratings

August 2020

# Contents

- **Industry Outlook**
- **Business Position**
- **Capital and Earnings**
- **Risk Position**
- **Funding & Liquidity**
- **Government Influence**
- **Appendix: Related FI Research**

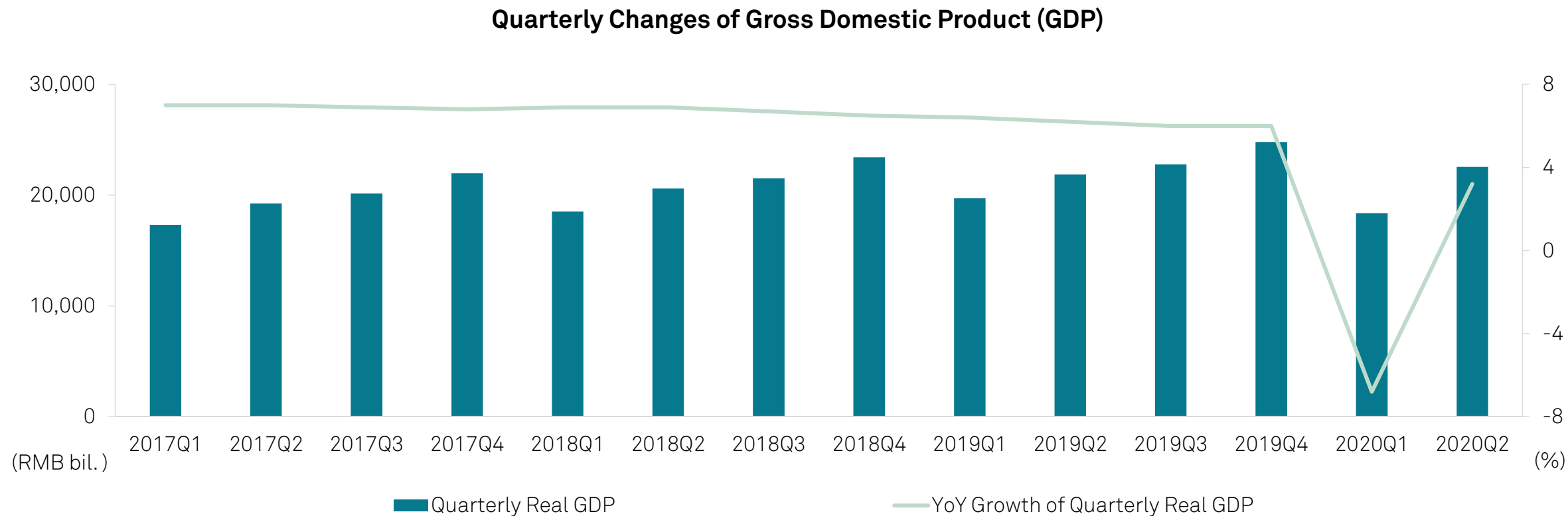
# Industry Outlook

Factor	Outlook	Major Views
Business Position	Stable	<ul style="list-style-type: none"><li>➤ Steady credit growth continues in the second quarter as banks pump loans into the real economy to fight the virus</li></ul>
Capital & Earnings	Stable with downward pressure	<ul style="list-style-type: none"><li>➤ The industry's average capital ratio continued to drop in the second quarter but still remained adequate</li><li>➤ Profitability witnessed a mild drop in the second quarter</li><li>➤ We believe COVID 19's impact on banks' profitability will be felt beyond 2020 after more bad debts are exposed in 2021</li></ul>
Risk Position	Stable with downward pressure	<ul style="list-style-type: none"><li>➤ The second quarter asset quality metrics remained stable</li><li>➤ The economic disruption caused by coronavirus is expected to have a negative impact on asset quality</li><li>➤ In addition to the pandemic, a few small banks are also troubled by legacy bad debts</li></ul>

# Industry Outlook (cont.)

Factor	Outlook	Major Views
Funding & Liquidity	Stable	<ul style="list-style-type: none"> <li>➤ Accommodative monetary policy continued to support ample systemwide liquidity in the second quarter</li> <li>➤ The central bank slightly tightened interbank liquidity in May to prevent excessive leverage buildup in the interbank market</li> </ul>
Stand-alone Credit Quality	Stable with downward pressure	<ul style="list-style-type: none"> <li>➤ Although there is downward pressure on asset quality and profitability, the overall stand-alone credit quality of the sector is expected to remain stable as the mega banks and leading joint-stock banks had good financial health before the pandemic</li> </ul>
Government Influence	Stable	<ul style="list-style-type: none"> <li>➤ We expect the government's willingness to support the banking sector to remain strong to maintain financial stability</li> <li>➤ Regulator is enhancing corporate governance of small banks</li> </ul>
Issuer Credit Quality	Stable	<ul style="list-style-type: none"> <li>➤ Our stable outlook is based on a U-shaped economic recovery for 2020 and 2021</li> </ul>

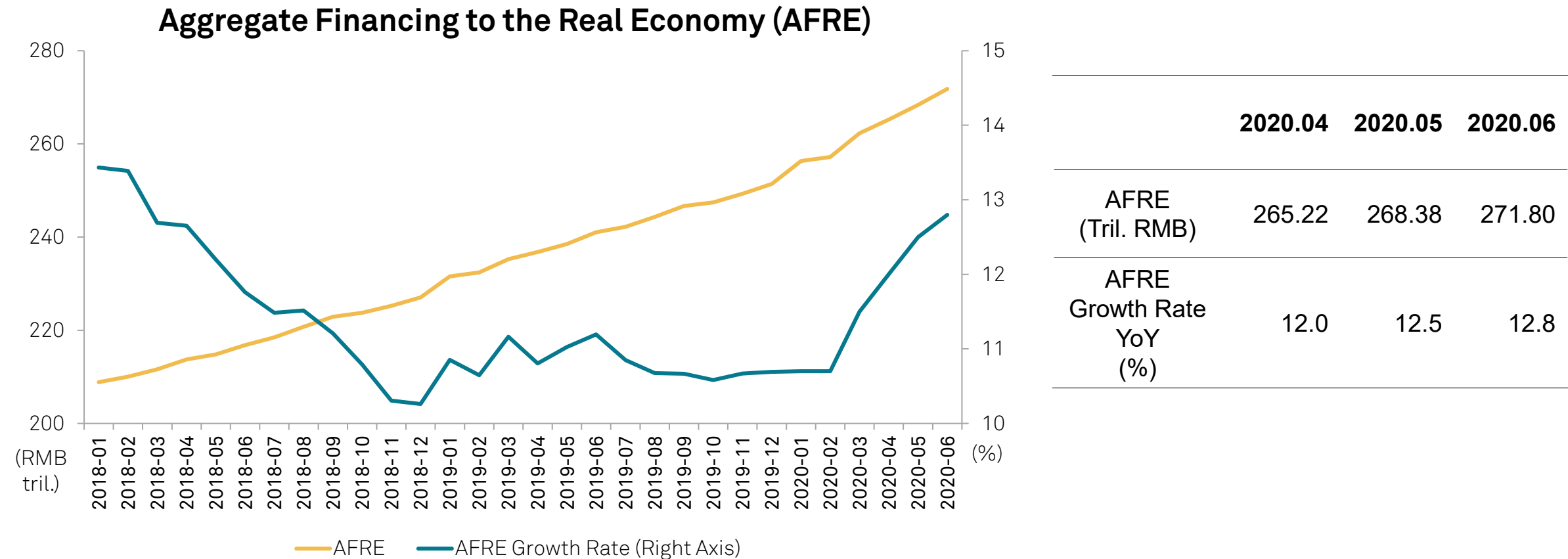
# Despite lingering uncertainty over COVID-19, China is progressing steadily on a U-shaped economic recovery trajectory, in line with our expectations



# Contents

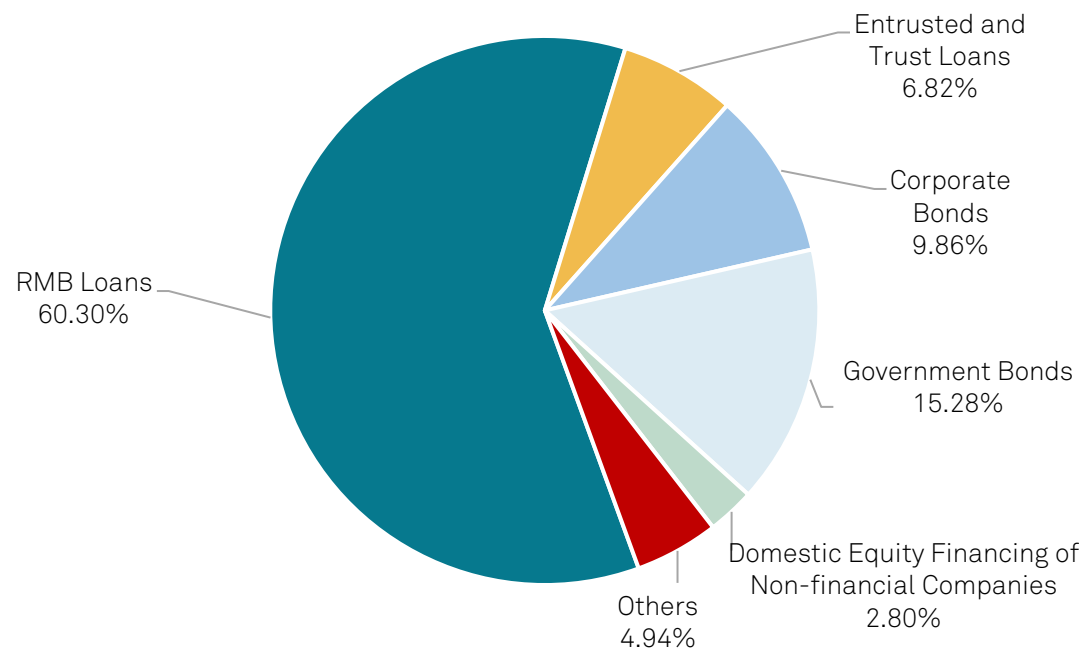
- Industry Outlook
- **Business Position**
- Capital and Earnings
- Risk Position
- Funding & Liquidity
- Government Influence
- Appendix: Related FI Research

# Financing activities continued to accelerate in the second quarter as more credit was pumped into the real economy to promote economic recovery



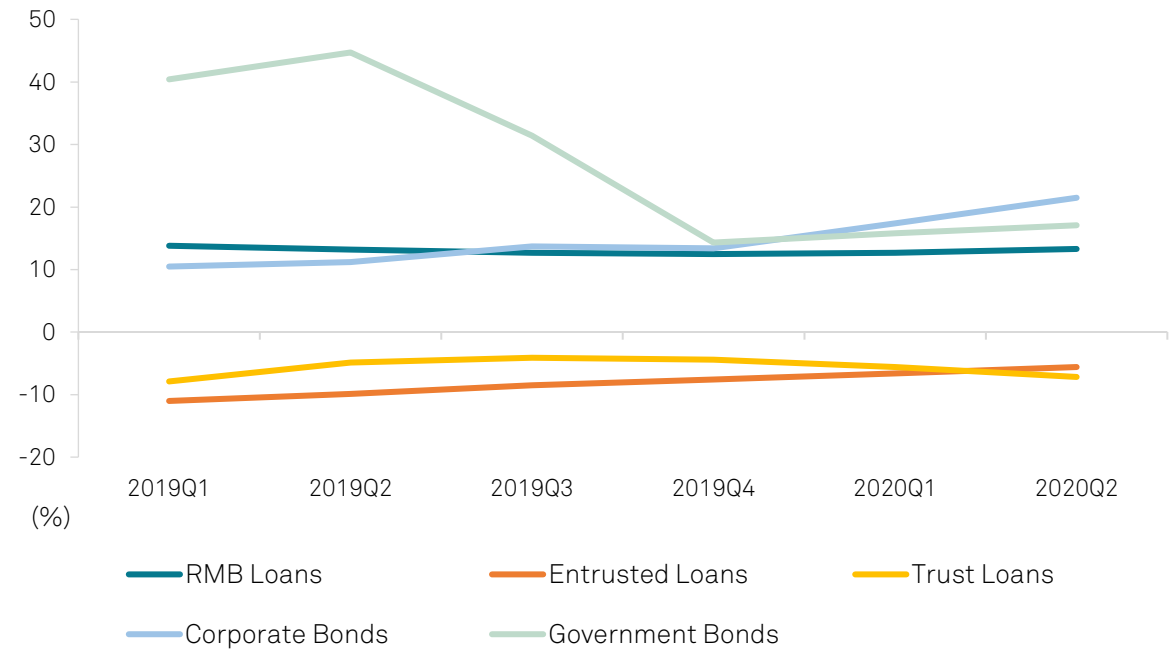
# Banks and the bond market expanded credit to the real economy, while shadow banking activities continued to contract

AFRE Breakdown as of End of 2020 Q2



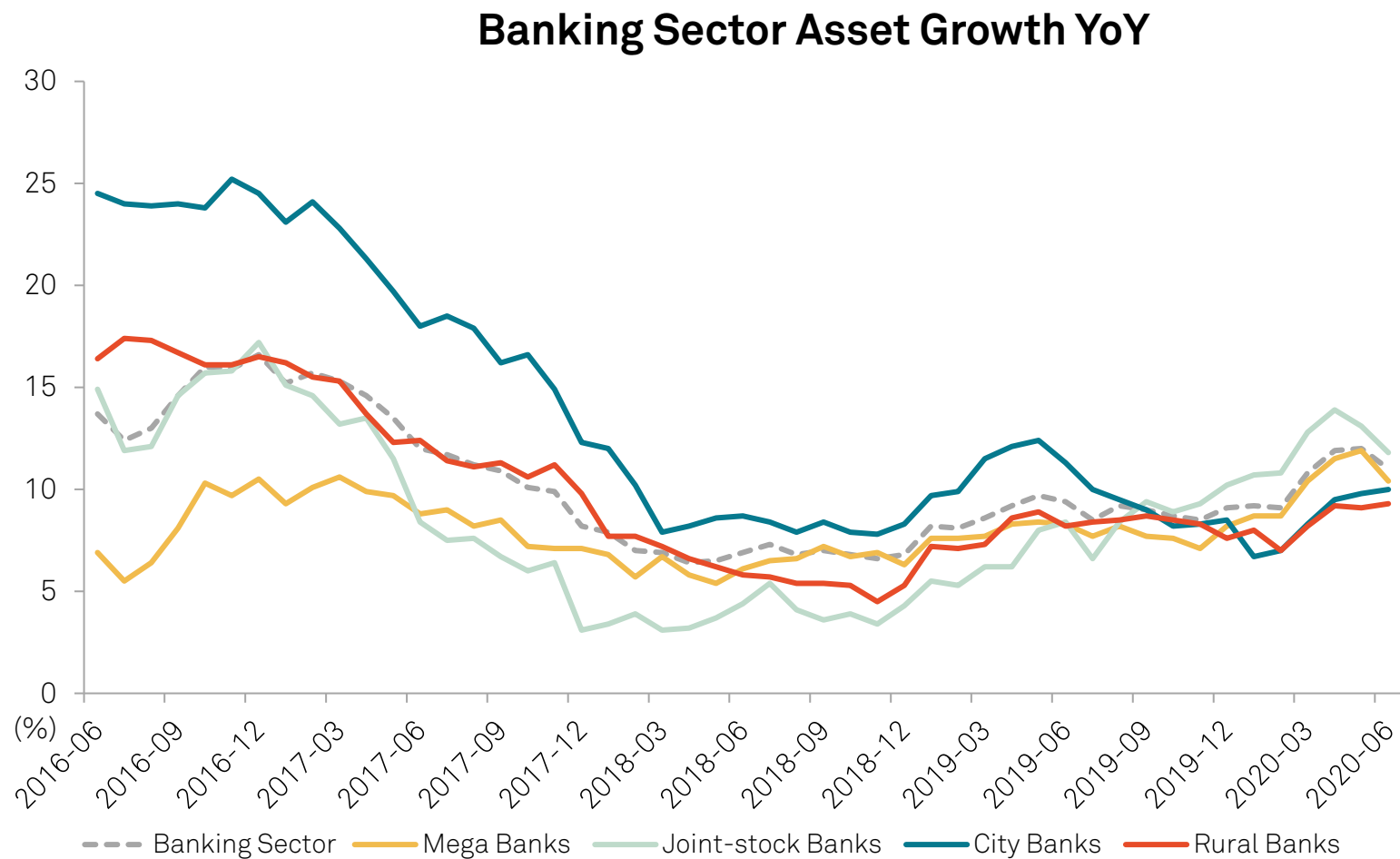
Note: Others include foreign currency loans, undiscounted bank's acceptance bills and other financing instruments.

YoY Growth of Major AFRE Factors



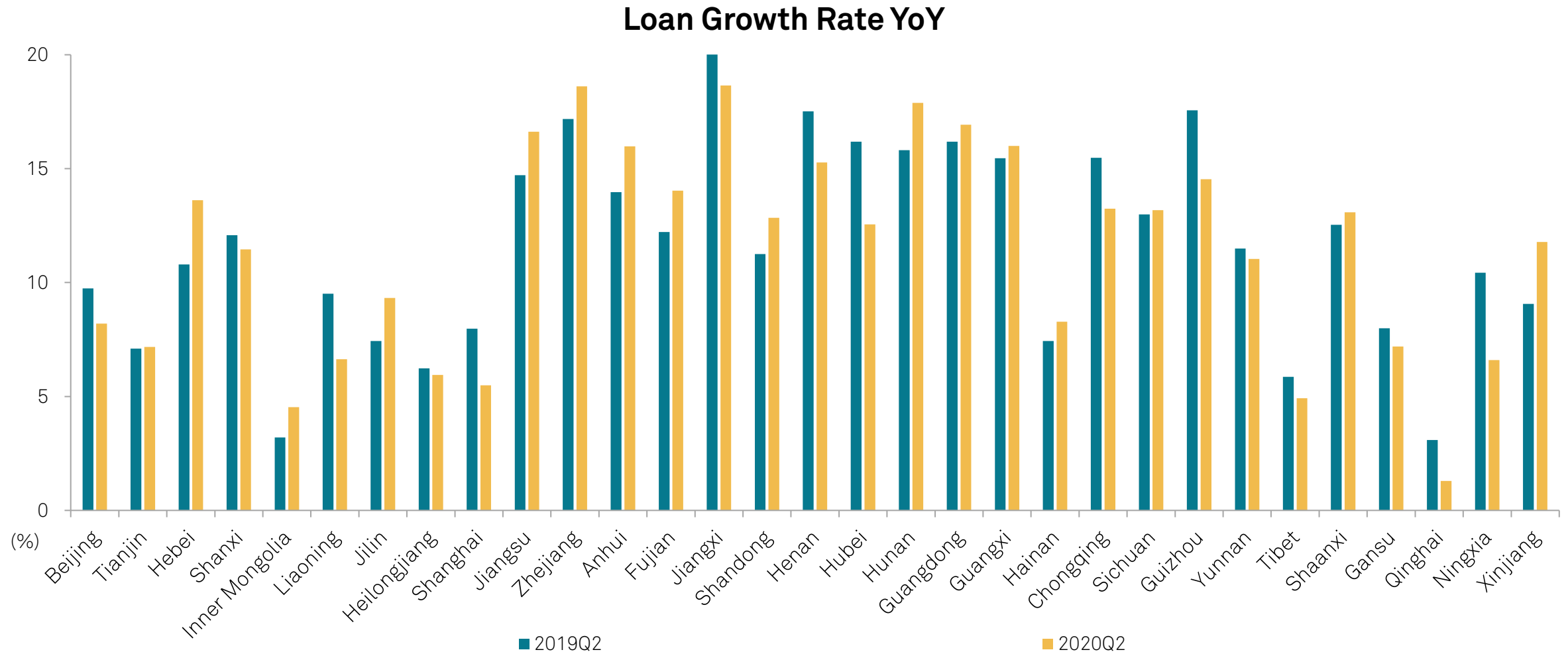


# Regional banks' asset growth accelerated in the second quarter as they increased their lending to small businesses



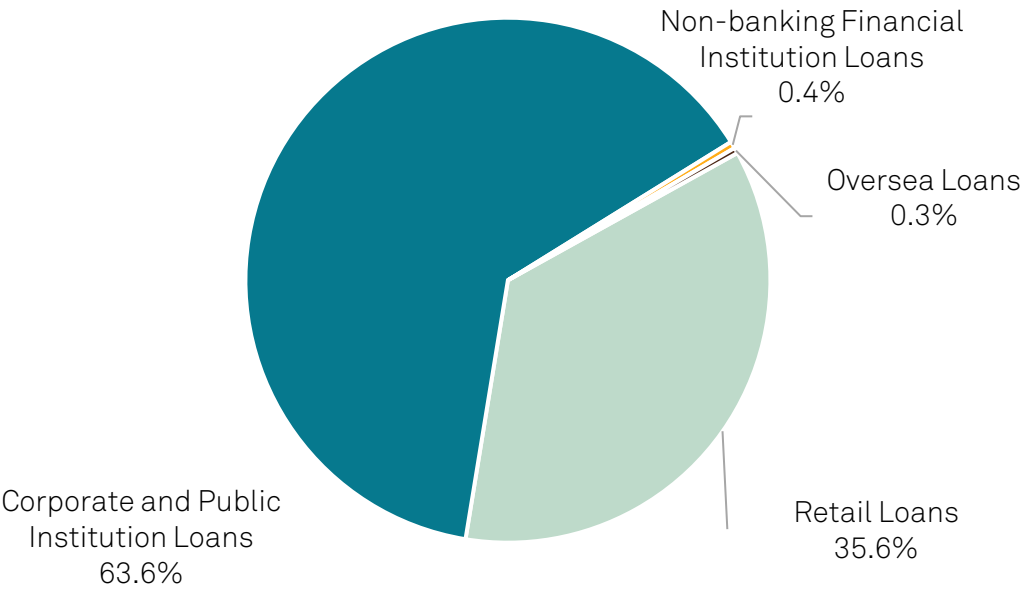
Asset growth YoY (%)	2019 Q4	2020 Q1	2020 Q2
Industry average	9.1	10.7	10.8
Mega banks	8.2	10.3	10.1
Joint-stock banks	10.2	12.8	11.8
City banks	8.5	8.3	10.0
Rural banks	7.6	8.2	9.3

# Loan growth trends varied by region in the second quarter

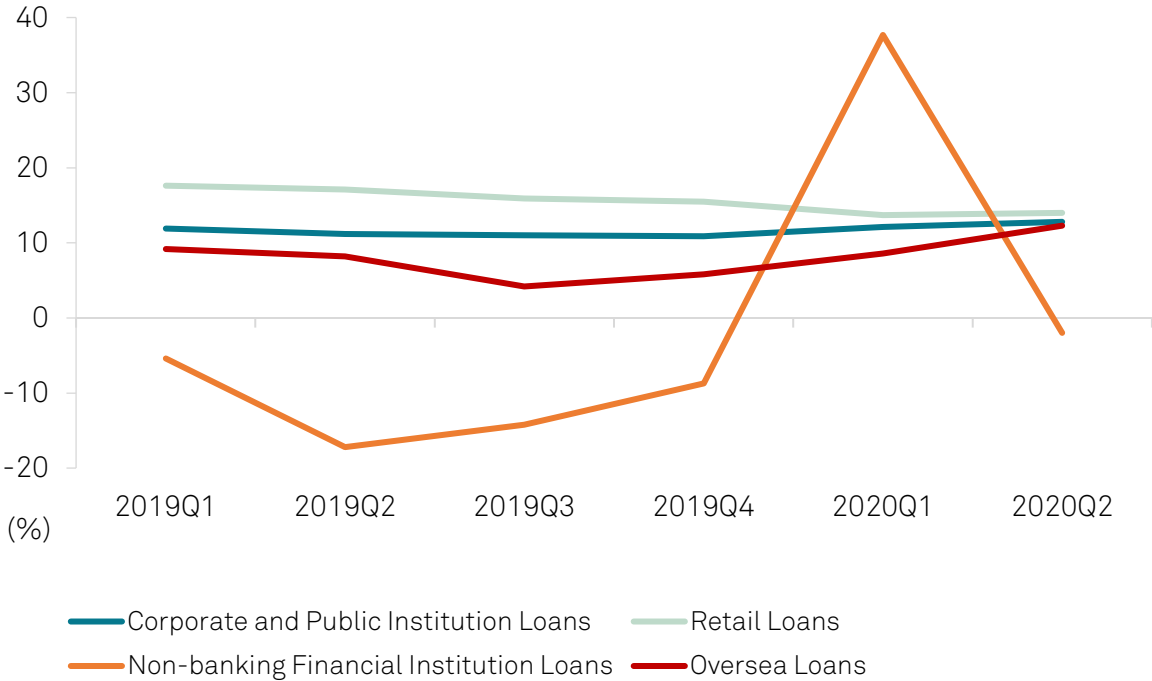


# While lending growth remains stable for corporate and household sectors, loans to non-bank financial institutions contracted in Q2

RMB Loans Breakdown as of the end of 2020 Q2

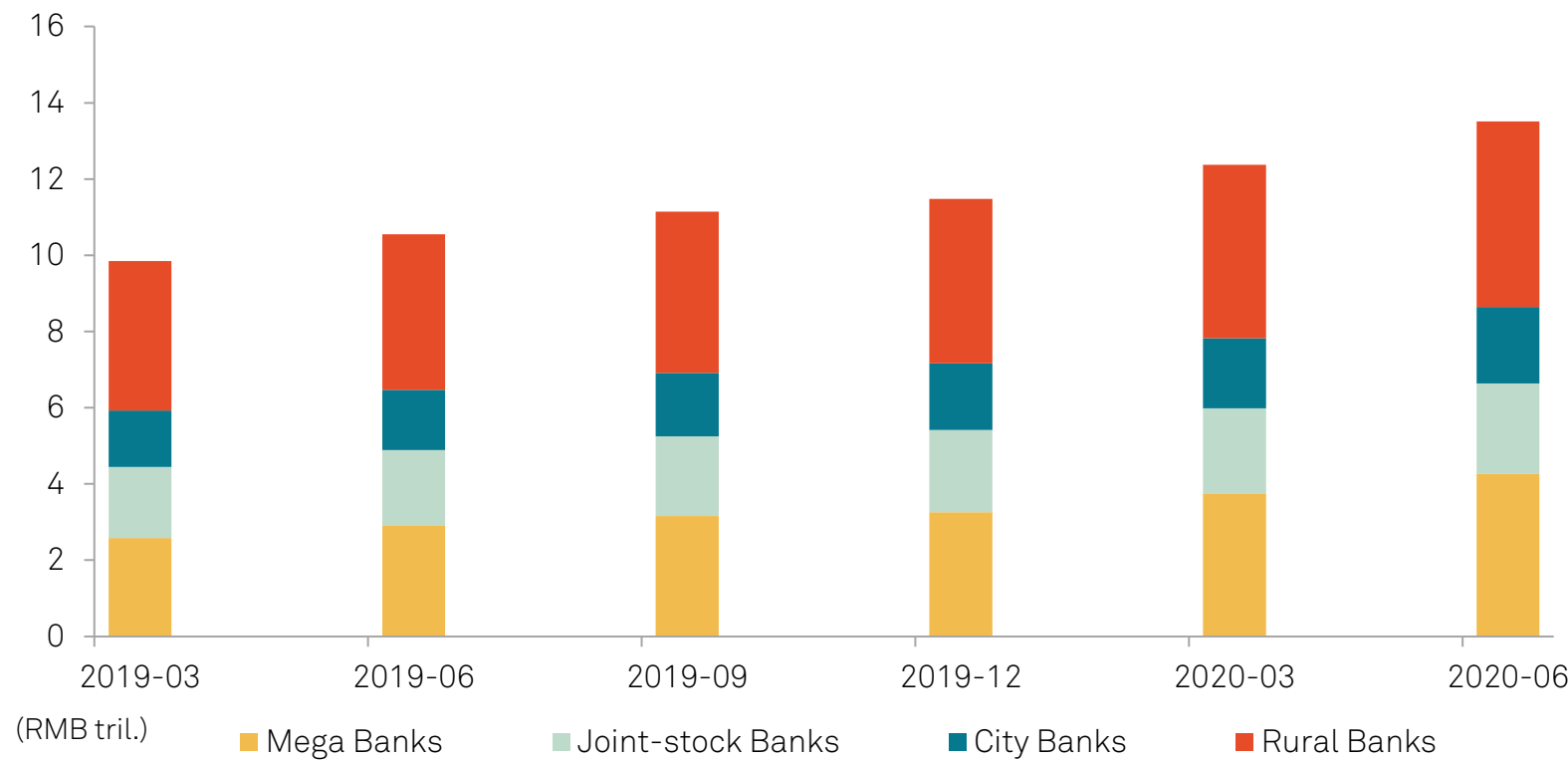


YoY Growth Rate of RMB Loans



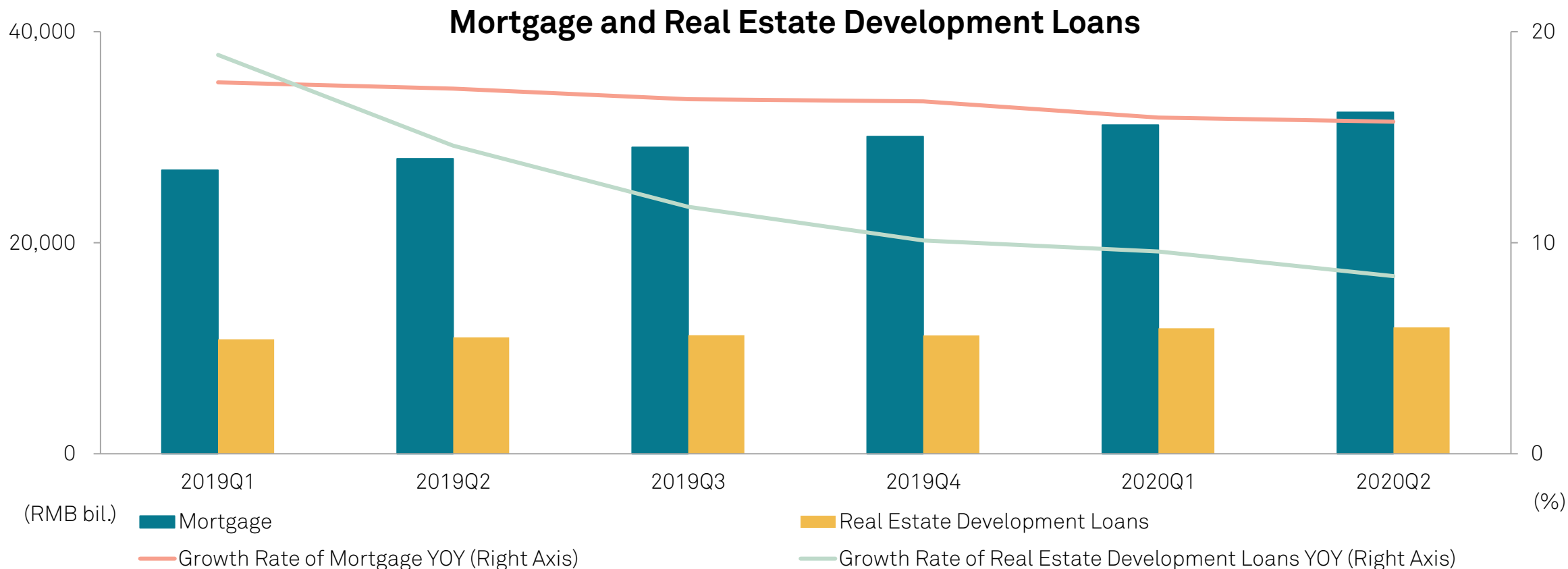
# In the second quarter, the banking sector continued to increase lending to micro and small enterprises (“MSE”), which is in line with the government policy of stabilizing employment

Loans to Micro and Small Enterprises



MSE loan growth compared to the last quarter (%)	2019 Q4	2020 Q1	2020 Q2
Industry average	3.17	7.60	9.37
Mega banks	3.06	15.19	13.59
Joint-stock banks	3.63	3.35	6.38
City banks	4.64	5.66	9.23
Rural banks	2.08	5.24	7.01

# The growth rate of real estate development loans dropped by 1.6 percentage points in the second quarter while mortgage loans maintained stable growth momentum



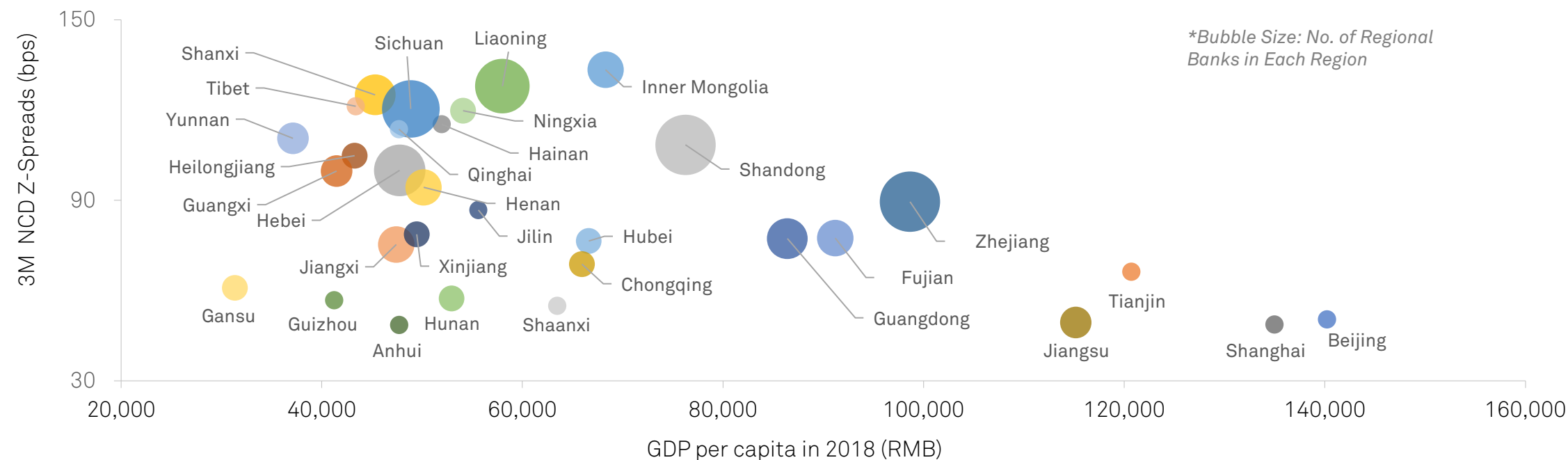
# Fiscal deposits dropped by 4.5% in the first half of 2020 as fiscal revenue decreased and government spending increased

As of end of Q2 2020	Deposits (RMB bil.)	YoY Growth Rate (%)	Breakdown of Deposits (%)
<b>Total Deposits</b>	<b>207,478</b>	<b>10.6</b>	<b>100.00</b>
Deposits of Households	89,632	14.3	43.20
Deposits of Non-financial Companies	64,721	11.4	31.19
Deposits of Government Departments & Organizations	30,825	1.6	14.86
Fiscal Deposits	4,522	(4.5)	2.18
Deposits of Non-banking Financial Institutions	16,502	11.1	7.95
Overseas Deposits	1,276	11.3	0.62

# Recent plans to merge small banks into bigger regional banks would reduce vulnerability in small and mid-sized banks

There are reports on potential merger involving five small city banks in Shanxi Province. Two rural banks in Shaanxi Province are also planning merger. There are also similar proposals in Xuzhou and Sichuan.

Average Z-spreads of 3-month NCDs of City Banks Grouped by Regions



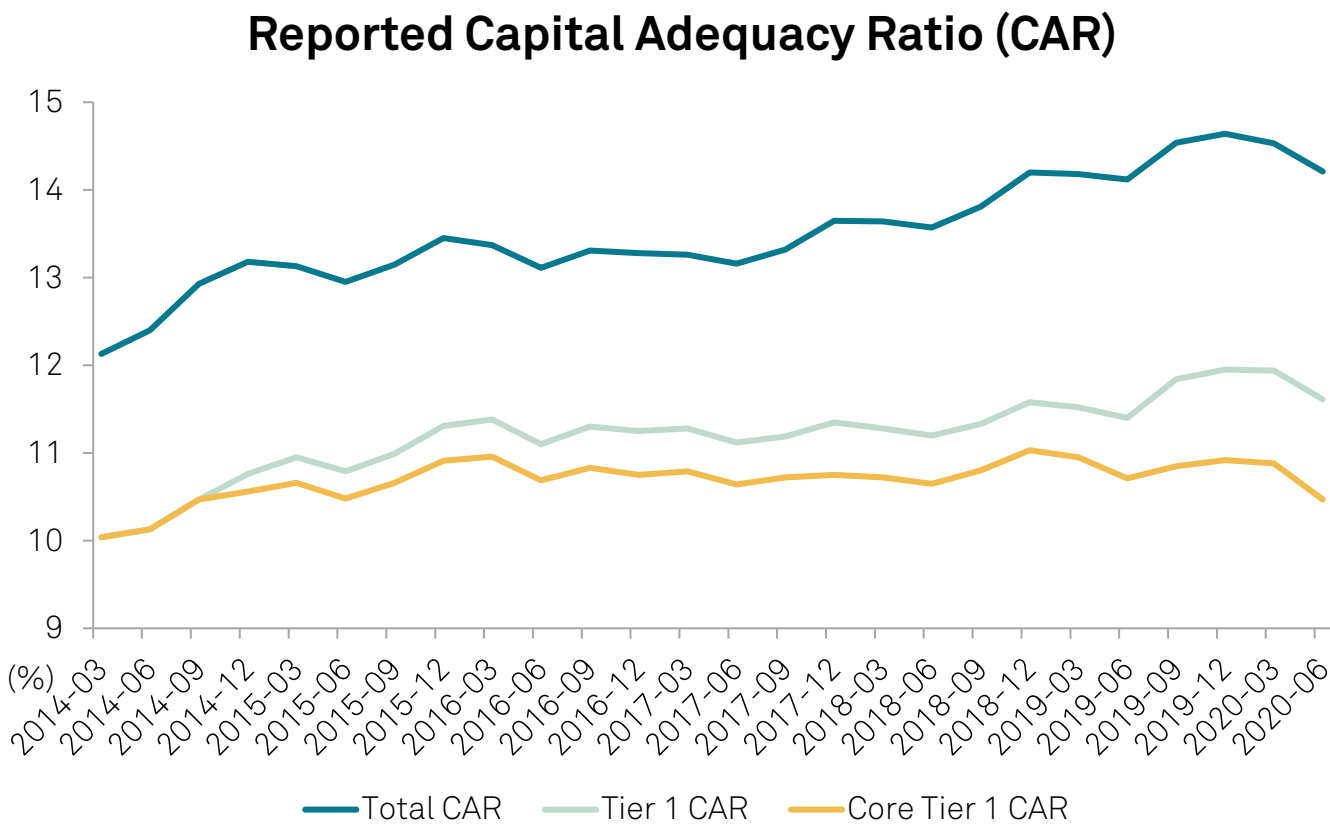
Note: The samples in the chart include 108 city banks that issued 3-month NCD from June 01, 2019 to November 30, 2019.  
Sources: Wind, collected and adjusted by S&P Global (China) Ratings  
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# Contents

- Industry Outlook
- Business Position
- Capital and Earnings**
- Risk Position
- Funding & Liquidity
- Government Influence
- Appendix: Related FI Research

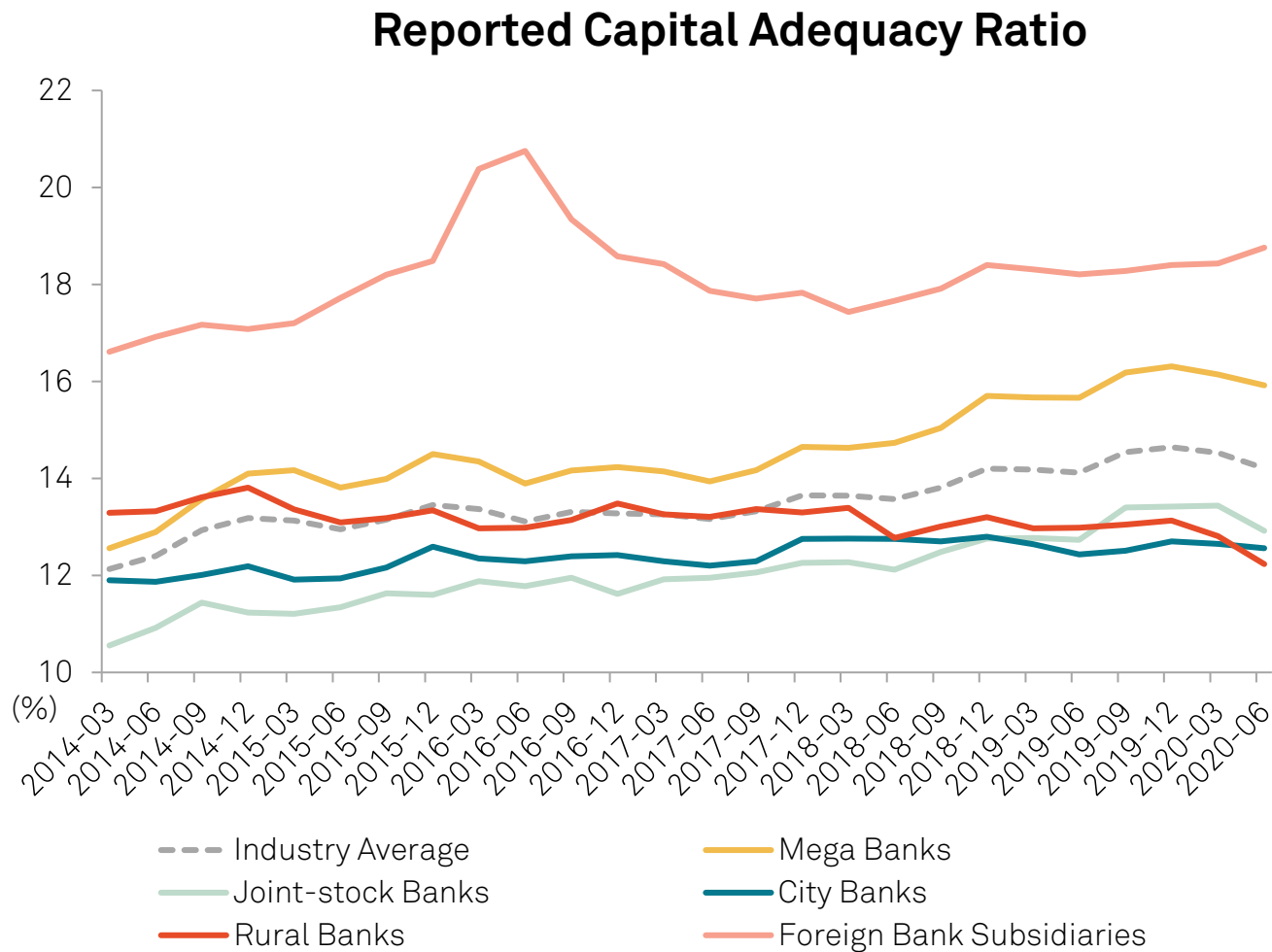


# Capital adequacy ratio and capital quality metrics remained relatively stable in Q2, with total capital adequacy ratio dropping from 14.5% to 14.2%



Capital quality metrics (%)	2019Q4	2020Q1	2020Q2
Core tier-1 capital/Total capital	74.59	74.88	73.68
Tier-1 capital/Total capital	81.63	82.17	81.70
Tier-2 capital/Total capital	18.37	17.83	18.30

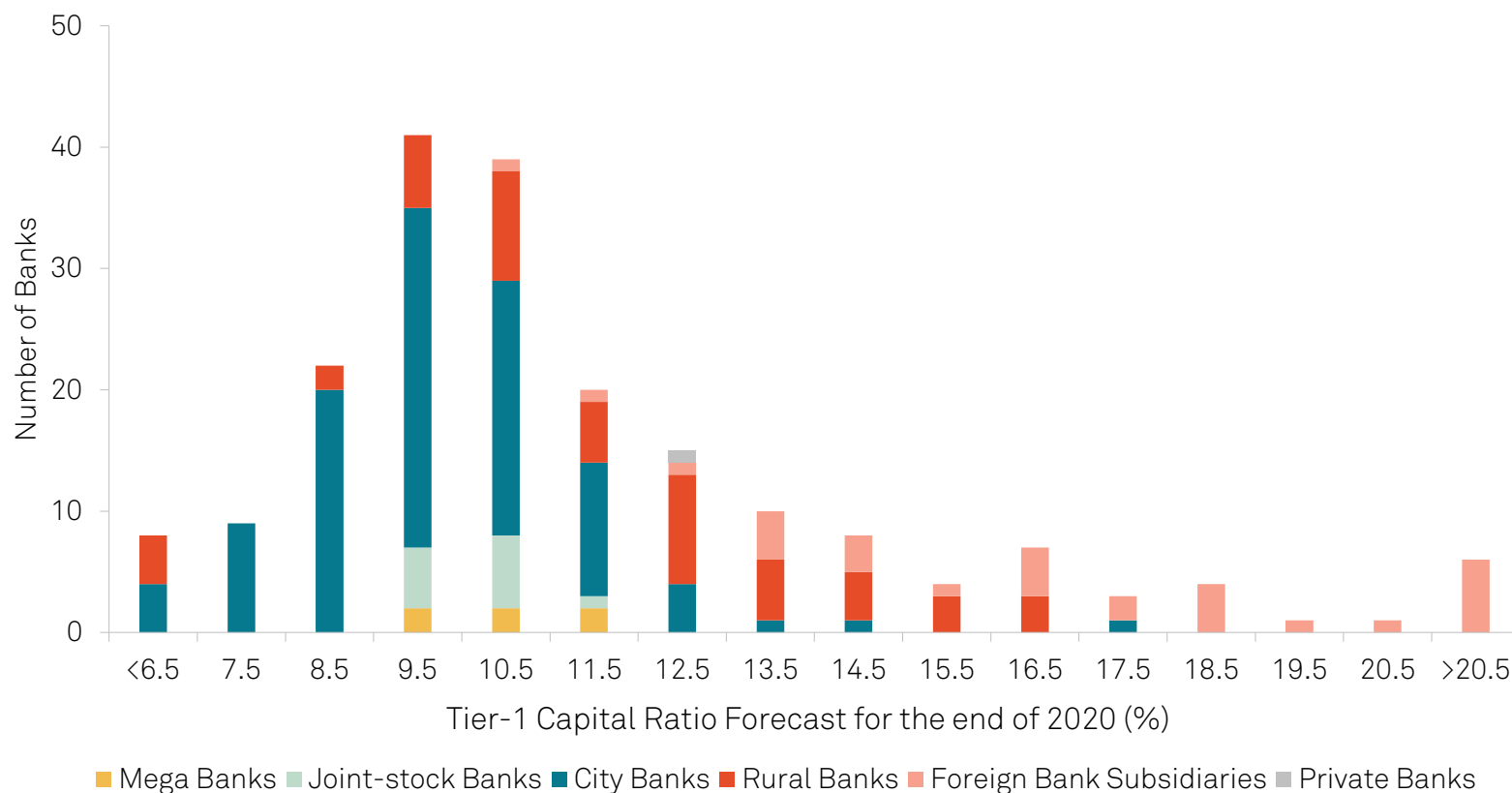
# The banking sector's capital dropped mildly in the second quarter mainly due to rapid loan growth and moderate earnings



CAR (%)	2019Q4	2020Q1	2020Q2
Industry average	14.64	14.53	14.21
Mega banks	16.31	16.14	15.92
Joint-stock banks	13.42	13.44	12.92
City banks	12.70	12.65	12.56
Rural banks	13.13	12.81	12.23
Foreign bank subsidiaries	18.40	18.43	18.76

# We expect most banks' capital to come under mild pressure but still remain adequate in 2020

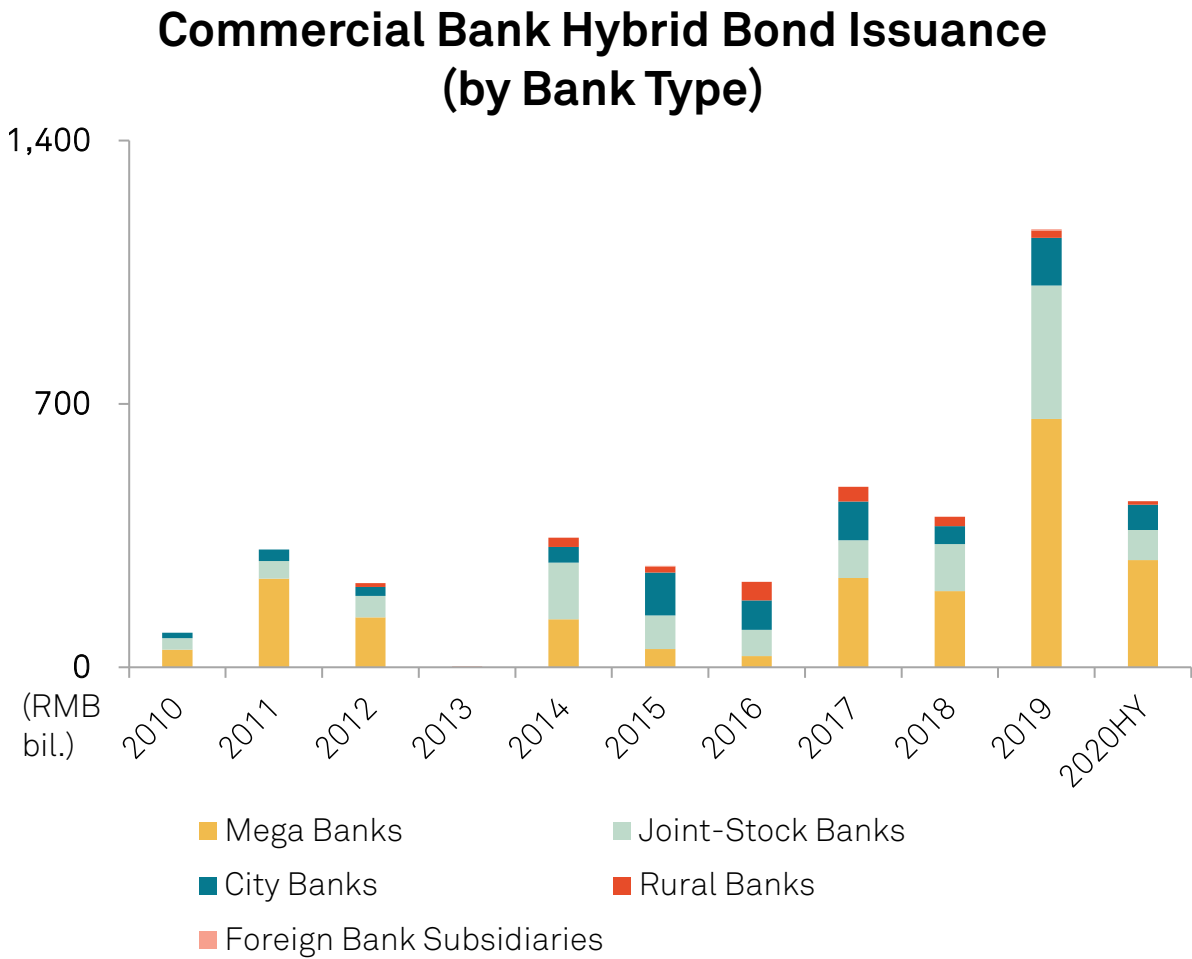
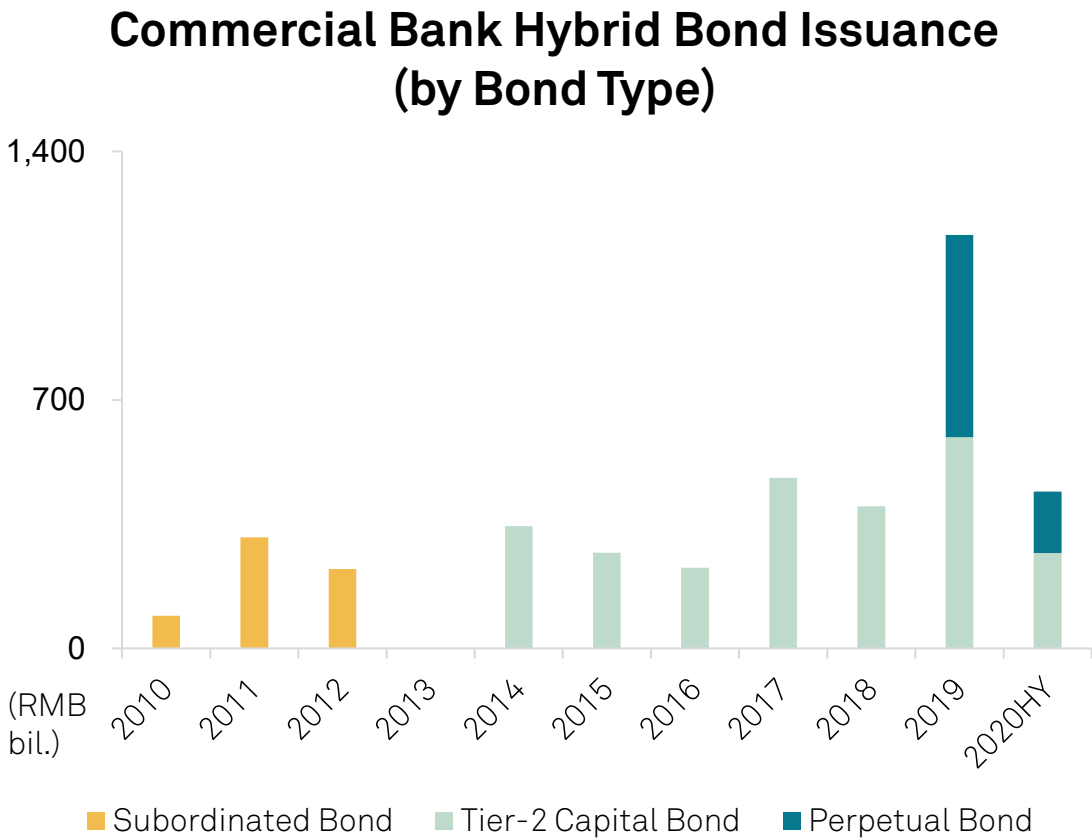
## Tier-1 Capital Adequacy Ratio Forecast in Stress Scenario



The following major assumptions/adjustments are put into our stress scenario analysis:

1. Retained earnings in 2020 is 50% of the previous year.
2. Risk-weighted assets YoY growth is up by 2 percentage points compared to 2019.
3. The implicit capital consumption of off-balance sheet wealth management products is reduced by half by the end of 2020 compared to 2019.
4. The stress analysis doesn't include any capital injection in 2020. After capital injection is considered, there will be less undercapitalized regional banks.
5. Banks using internal rating based approach are adjusted to standard approach.

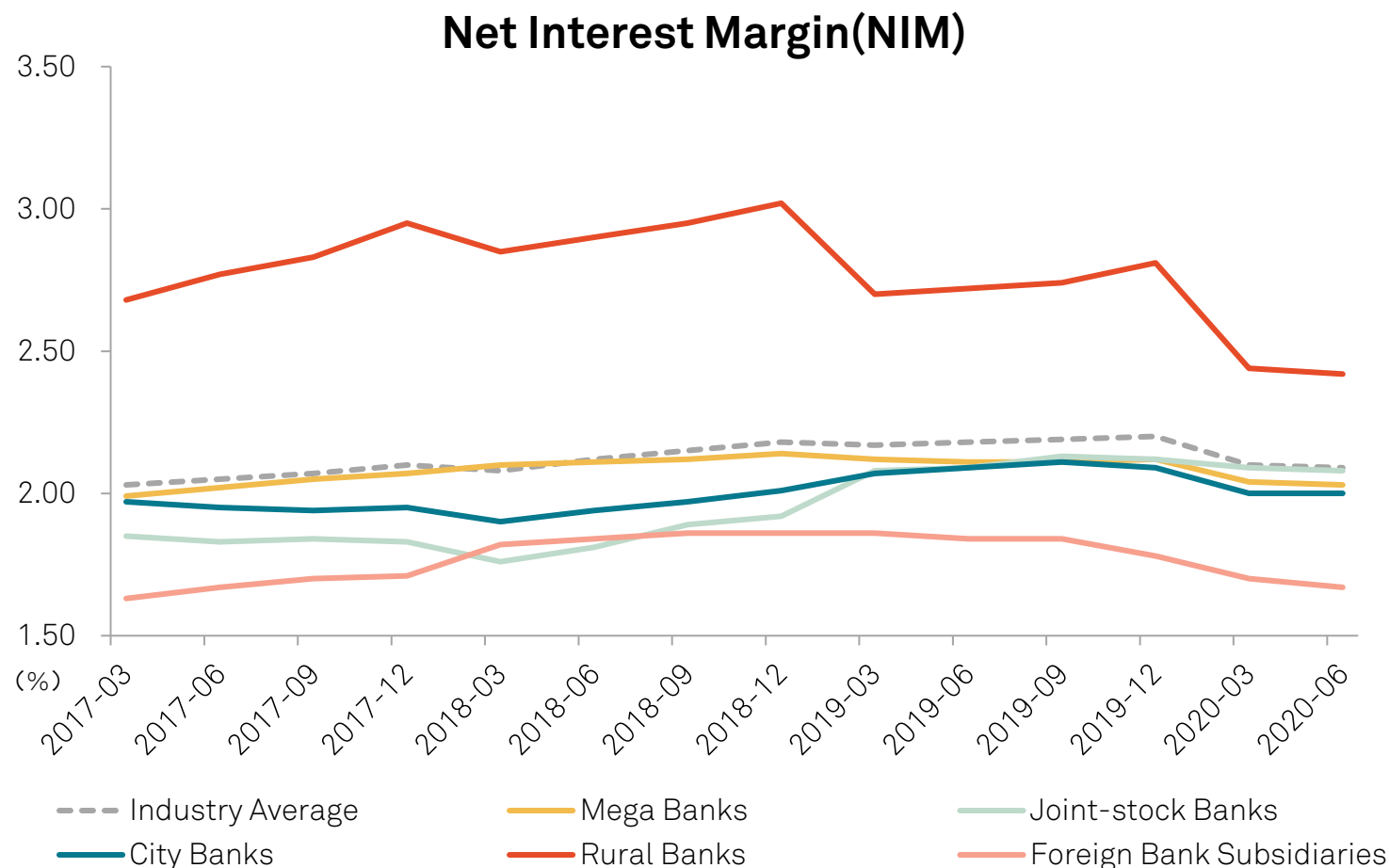
# Hybrid bonds will remain an important source of bank capital buffer in 2020



# The government is helping banks to raise capital

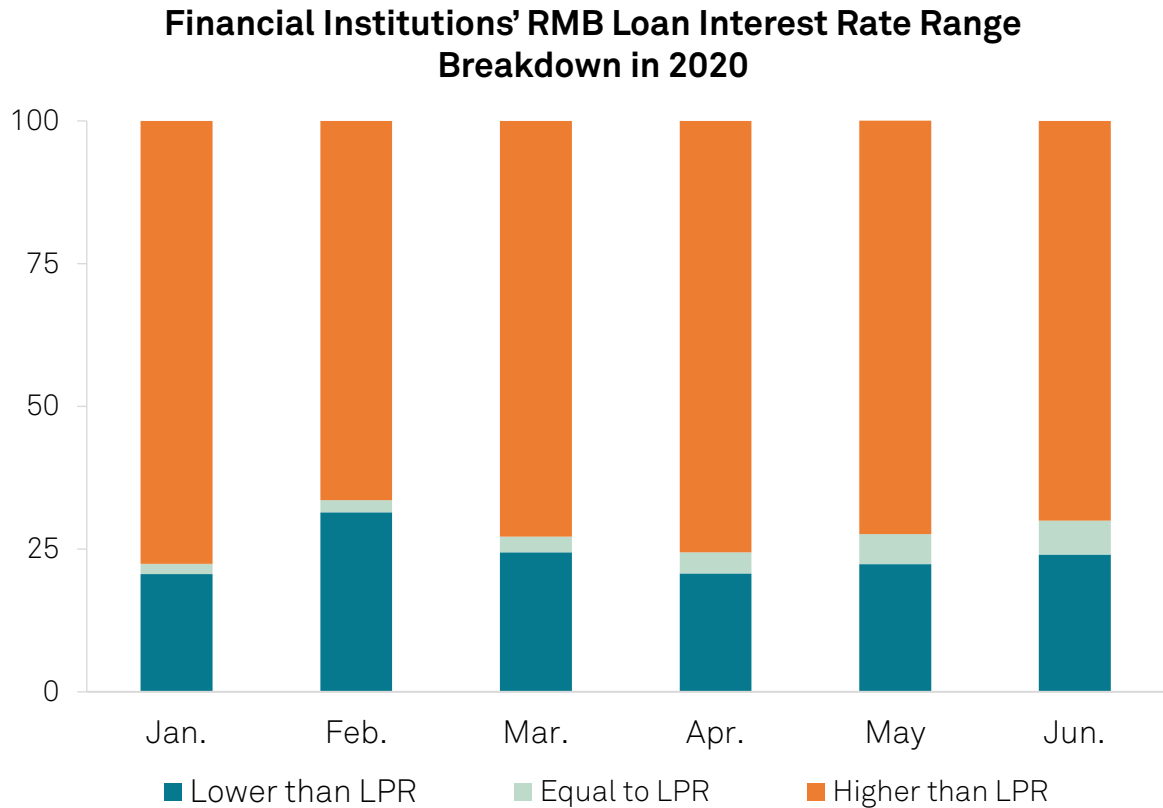
- ❑ The central bank continued to conduct Central Bank Bills Swap (“CBS”) in the first half of 2020. Under this mechanism, primary dealers can swap banks’ perpetual bonds into central bank bills. The objective is to increase the liquidity of banks’ perpetual bonds (particularly small and mid-sized banks). In the first half of 2020, perpetual bonds worth RMB 31 billion were swapped.
- ❑ The China Securities Regulatory Commission has accelerated its approval of equity financing by regional banks via private placement since May 2020. It approved 15 cases in the first seven months of 2020, including 10 rural banks, 4 city banks and 1 village banks.
- ❑ The State Council decided to allow local governments to raise money through local government special bonds to inject capital into regional banks. By the end of July, an earmarked quota of RMB 200 billion was approved for this purpose involving 18 provinces.

# Net interest margin only dropped marginally in the second quarter



NIM (%)	2019Q4	2020Q1	2020Q2
Industry average	2.20	2.10	2.09
Mega banks	2.12	2.04	2.03
Joint-stock banks	2.12	2.09	2.08
City banks	2.09	2.00	2.00
Rural banks	2.81	2.44	2.42
Foreign bank subsidiaries	1.78	1.70	1.67

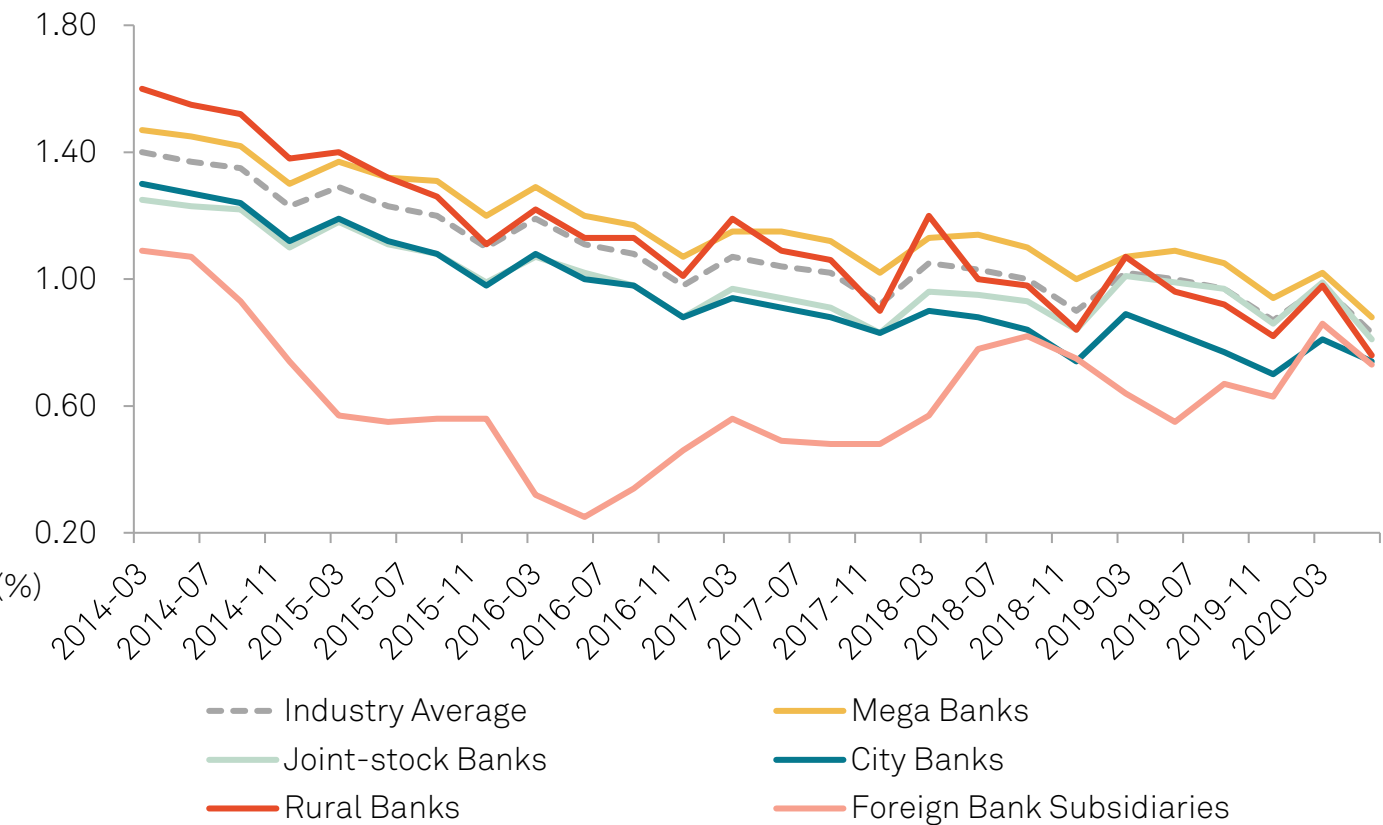
# The percentage of borrower interest rates higher than the loan prime rate (“LPR”) has decreased from 77% as of end of 2019 to 70% as of end of 2020 Q2



Weighted Average Interest Rate in June	(%)	Change from Dec. 2019 (percentage point)	YoY Change (percentage point)
General Loans	5.26	(0.48)	(0.68)
Corporate Loans	4.64	(0.48)	(0.64)
Notes Financing	2.85	(0.41)	(0.79)
Mortgage	5.42	(0.20)	(0.11)

# Compared to the first quarter, earnings pressure became more obvious in the second quarter

Return on Assets (ROA)

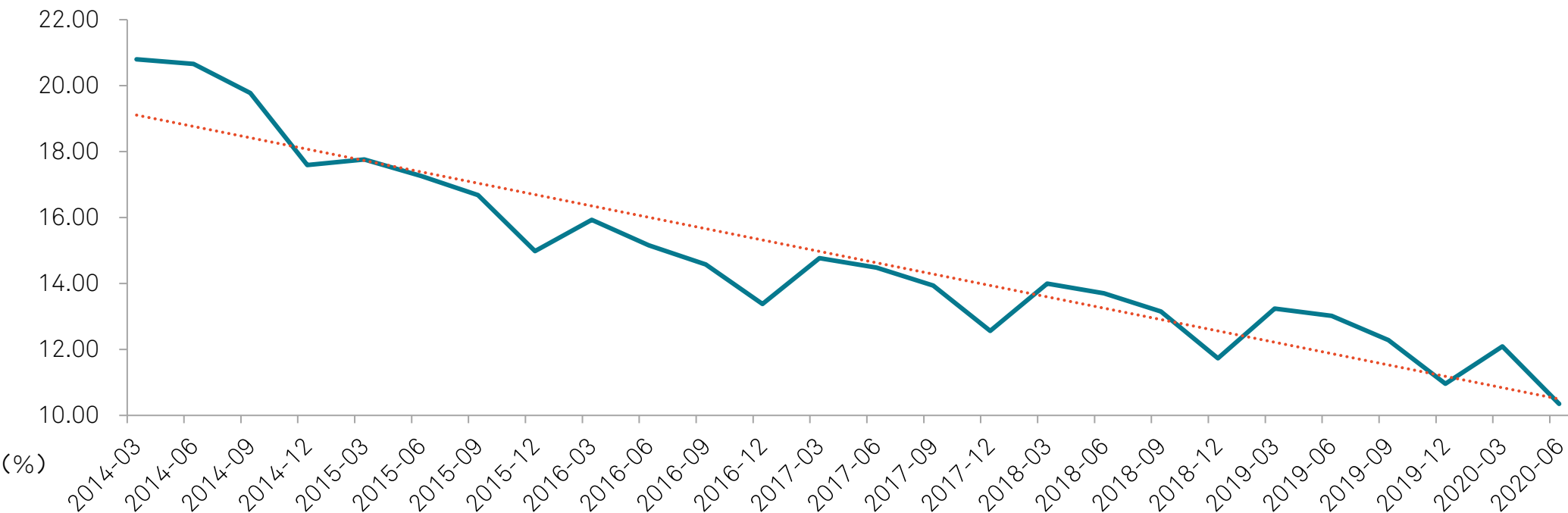


ROA (%)	2019Q1	2020Q1	2020Q2
Industry average	1.02	0.98	0.83
Mega bank	1.07	1.02	0.88
Joint-stock bank	1.01	0.99	0.81
City bank	0.89	0.81	0.74
Rural bank	1.07	0.98	0.76
Foreign bank subsidiaries	0.64	0.86	0.73



**Annualized industry ROE dropped from 12.09% in Q1 to 10.35% in Q2, and we expect the earning pressure to continue into 2021 as banks gradually absorb the credit costs caused by COVID-19**

**Return on Equity (ROE) of the Commercial Banking Industry**



# Contents

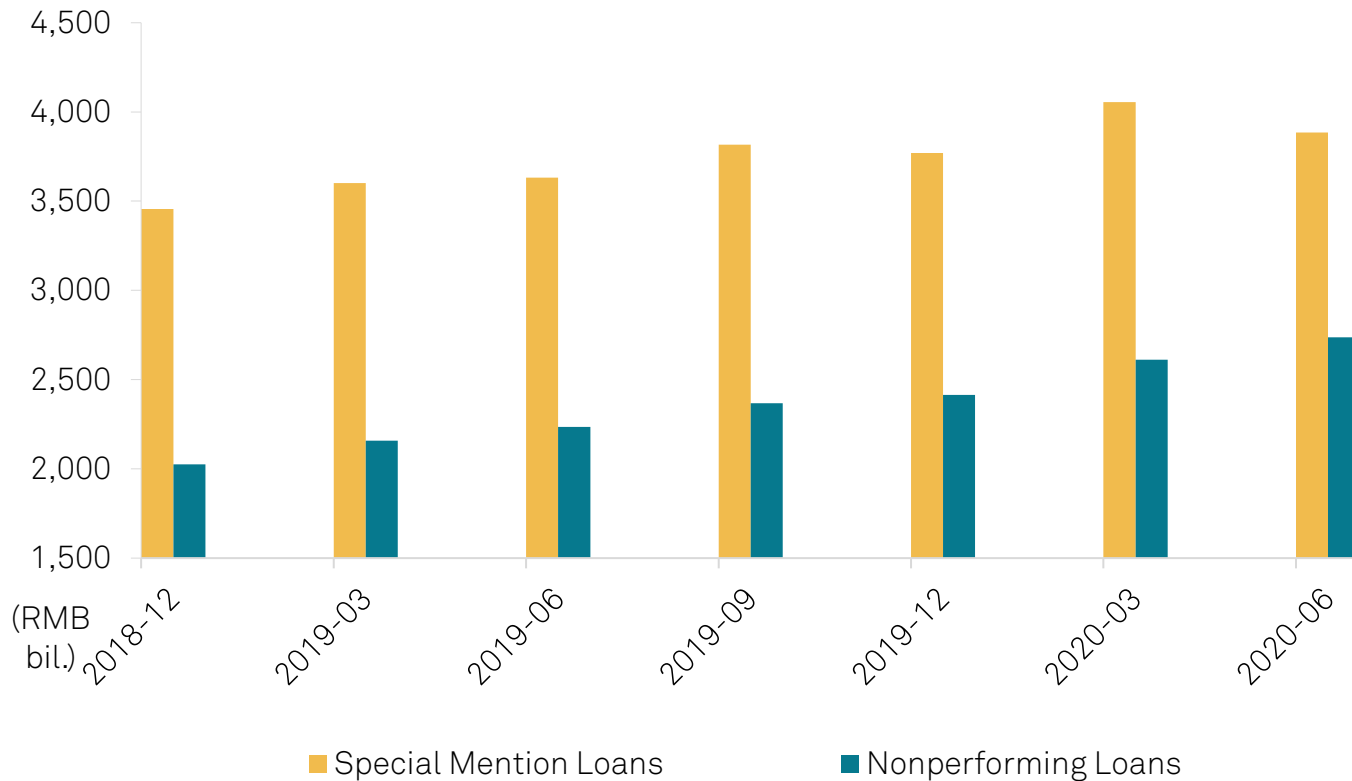
- Industry Outlook
- Business Position
- Capital and Earnings
- Risk Position**
- Funding & Liquidity
- Government Influence
- Appendix: Related FI Research

# COVID 19's impact on asset quality hasn't been fully reflected in the reported numbers of the first half of 2020 due to the lagging effect of non-performing loan (“NPL”) classification

- ❑ The lagging effect of NPL classification and the forbearance measures given to some borrowers have contributed to the stability of asset quality metrics in the first half of 2020. Because banks typically classify loans overdue by 90+ or 60+ days as NPL, the asset quality pressure caused by the pandemic hasn't been fully reflected in the numbers.
- ❑ Other reasons contributing to the stable asset quality metrics include the recovering economy, the fast growth of new loans and writing-off of legacy bad debts.
- ❑ We expect more bad debt pressure in the second half of the year and 2021. The final asset quality impact of COVID-19 is however far from certain and highly dependent on the progress of economic recovery.

# The NPL ratio increased by only 3 bps in Q2, while the special mention loan (“SML”) ratio dropped

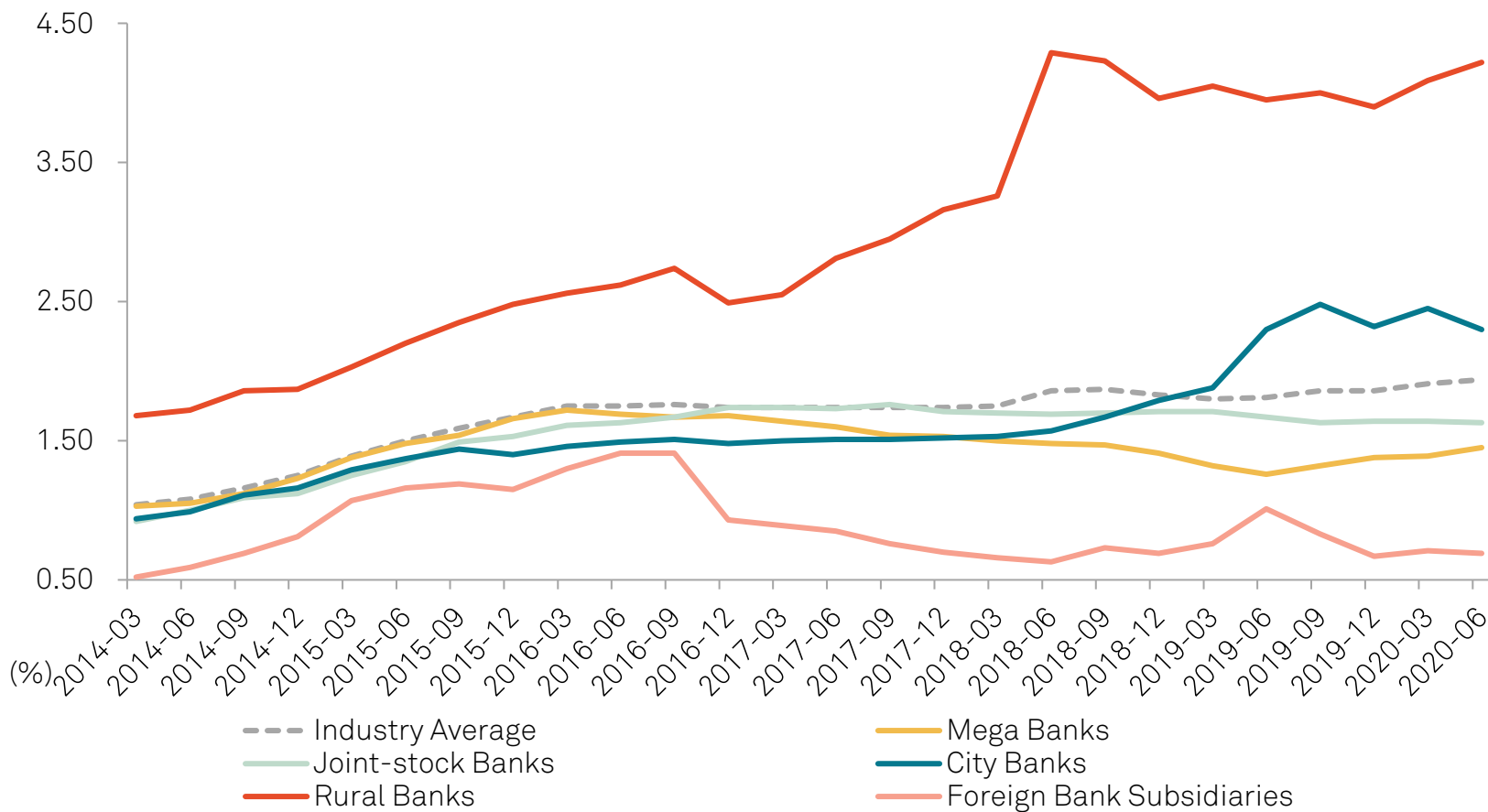
NPL and SML Amounts



Loan Classification (%)	2019 Q4	2020 Q1	2020 Q2
Normal Loans	95.23	95.12	95.31
Special Mention Loans	2.91	2.97	2.75
Non-performing Loans	1.86	1.91	1.94
- Substandard Loans	0.78	0.84	0.92
- Doubtful Loans	0.78	0.78	0.76
- Loss Loans	0.30	0.29	0.27
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>

# Rural banks continue to face the highest bad debt pressure

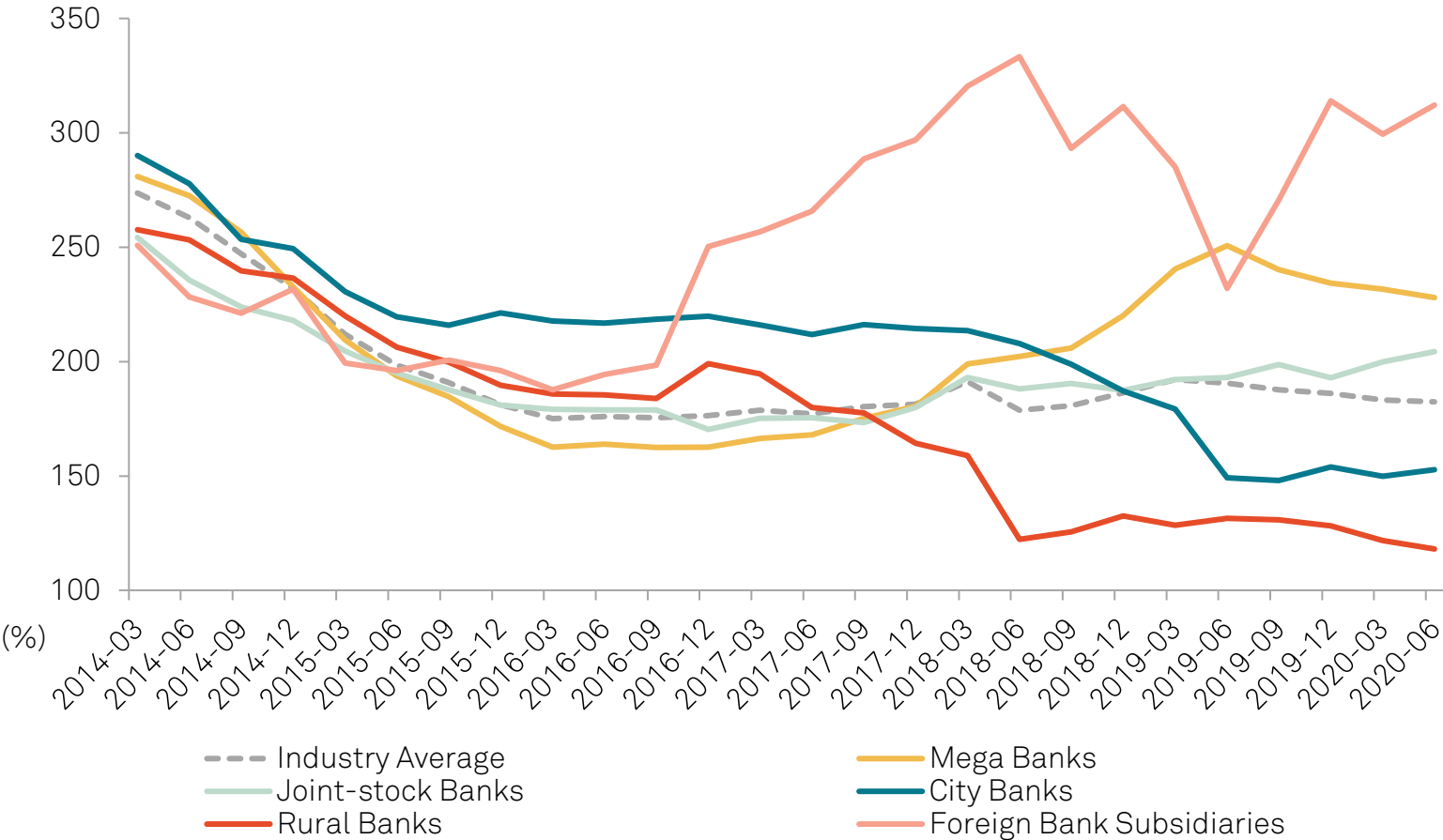
Non-performing Loan (NPL) Ratios



NPL Ratio (%)	2019 Q4	2020 Q1	2020 Q2
Industry average	1.86	1.91	1.94
Mega bank	1.38	1.39	1.45
Joint-stock bank	1.64	1.64	1.63
City bank	2.32	2.45	2.30
Rural bank	3.90	4.09	4.22
Foreign bank subsidiaries	0.67	0.71	0.69

# Due to stable asset quality performance in Q2, reserve coverage metrics also remained generally unchanged

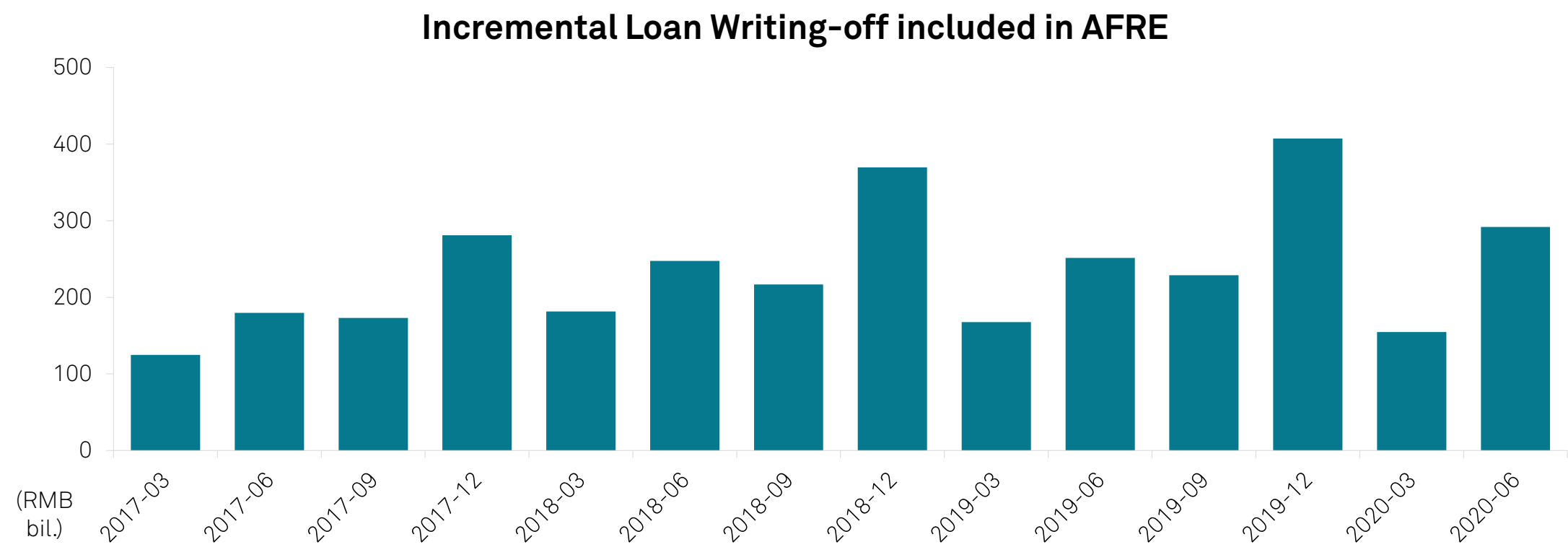
Reserve Coverage Ratios



Reserve Coverage Ratio (%)	2019Q4	2020Q1	2020Q2
Industry average	186.08	183.20	182.40
Mega banks	234.33	231.70	227.97
Joint-stock banks	192.97	199.89	204.33
City banks	153.96	149.89	152.83
Rural banks	128.16	121.76	118.14
Foreign bank subsidiaries	313.90	299.33	312.09

# Writing off loans has become an important way of keeping the NPL ratio low

In the first half of 2020, non-performing loans worth RMB 446.3 billion were written off, up by 6.5% compared to the same period last year.



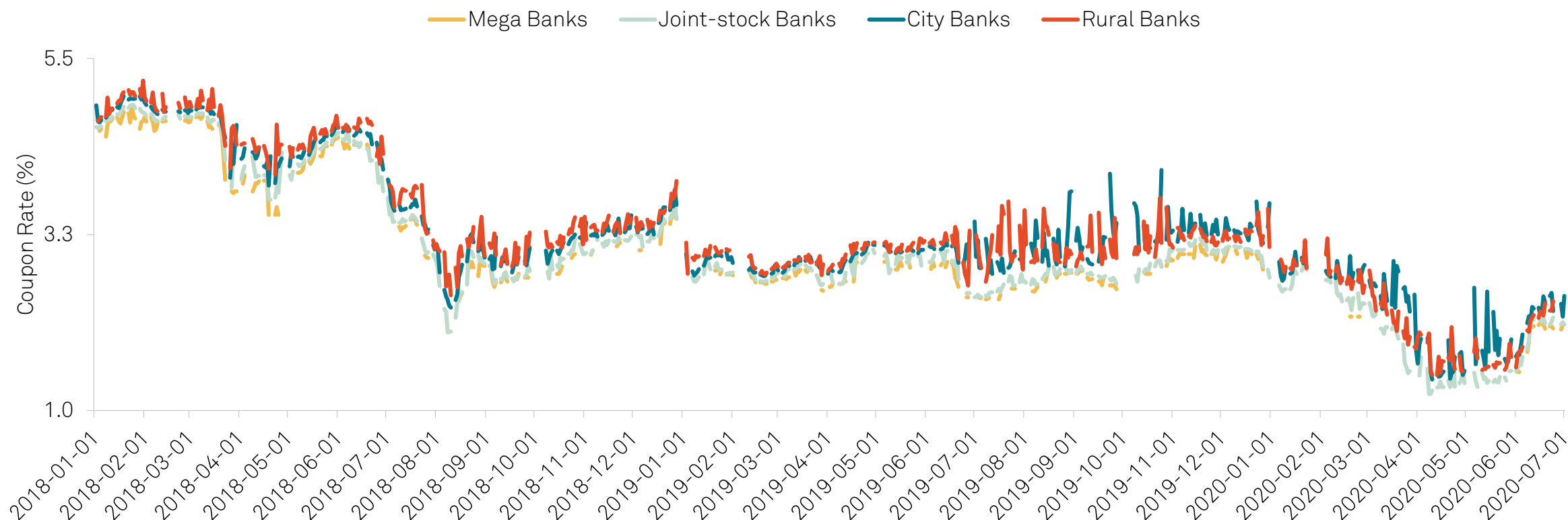
# Contents

- Industry Outlook
- Business Position
- Capital and Earnings
- Risk Position
- Funding & Liquidity**
- Government Influence
- Appendix: Related FI Research



# In the second quarter, the central bank continued to ensure ample systemwide liquidity while keeping interest rates from falling too low

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



# Contents

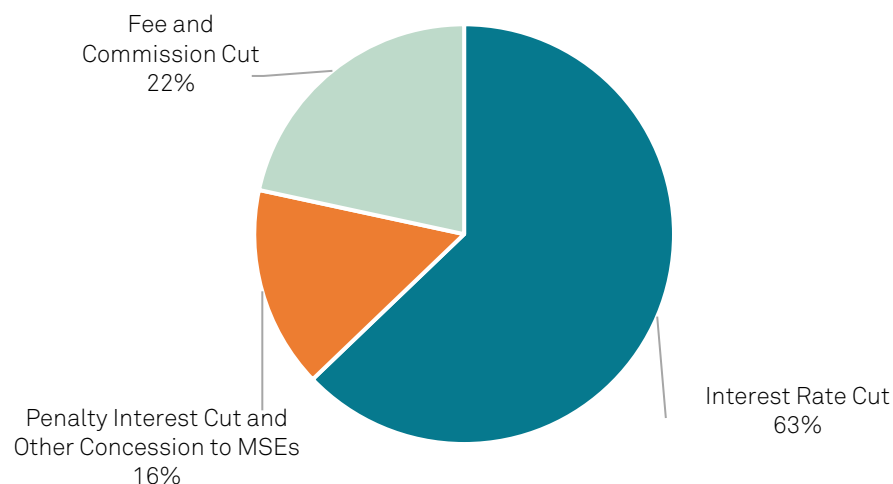
- Industry Outlook
- Business Position
- Capital and Earnings
- Risk Position
- Funding & Liquidity
- Government Influence**
- Appendix: Related FI Research

# The government has urged banks to provide more support to the real economy in the form of interest and fee cuts

## What's Happened

In June, the State Council announced plans for a RMB 1.5 trillion concession from the financial sector to the real economy to support economic recovery from COVID-19. We believe the majority of the concession will come from the banking sector.

RMB 1.5 Trillion Concession Breakdown



## Views of S&P Global (China) Ratings

- ❑ RMB 1.5 trillion concession to the real economy is in line with our expectation of lower earnings for the banking sector. But we don't expect material weakening of bank capitalization due to this concession.
- ❑ Final cost of COVID-19 for banks will be above RMB 1.5 trillion because of the higher credit cost.

# Defusing High-risk Banks – Baoshang Bank

## What's Happened

- ❑ After its banking operations were transferred to Mengshang Bank and Huishang Bank in April 2020, Baoshang Bank will soon file for bankruptcy to liquidate remaining assets.
- ❑ According to PBOC, without government support, the loss to general creditors would be over 40%. With funding from PBOC and Deposit Insurance Fund, retail depositors and most institutional creditors did not suffer any loss. A 10% loss was imposed on wholesale creditors with large exposure to Baoshang Bank. The 10% loss demonstrated the central bank's intention to increase institutional investors' credit risk awareness without crippling those institutions' overall creditworthiness.
- ❑ According to PBOC, individuals implicated in wrongdoings in Baoshang Bank's operations will be held responsible.

## Views of S&P Global (China) Ratings

- ❑ The recent development of Baoshang Bank didn't have a significant impact on the market.
- ❑ PBOC's recent activities are in line with our expectations that the government is trying to balance financial stability with prevention of moral hazard in the financial sector.

# Postponement of New Asset Management Rules Implementation

## What's Happened

- ❑ In July, regulators announced the implementation of New Asset Management Rules would be delayed by one year until the end of 2021, from the end of 2020. Early implementation is still being encouraged.
- ❑ New Asset Management Rules became effective in 2018. After the reforms are completed, banks should no longer have implicit guarantees on wealth management products (WMPs) because WMPs will be valued on a net asset basis.
- ❑ As of the end of 2019, outstanding WMPs were worth RMB 23.4 trillion, 10% of the total assets of China's commercial banking sector. WMPs on a net value basis accounted for 43% of total WMPs outstanding as of the end of 2019.

## Views of S&P Global (China) Ratings

- ❑ The deadline postponement is to mitigate the disruption caused by COVID and to stabilize financing to the real economy. After the postponement, more underlying assets in the WMPs will mature naturally before the new deadline.
- ❑ The regulatory trend of removing banks' implicit guarantees on WMPs and curbing imprudent shadow banking activities remains unchanged.
- ❑ Before the reforms are implemented by the end of 2021, we will continue to consider the potential consumption of capital by off-balance sheet WMPs when we assess banks' capitalization.

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# Regulator's Disclosure of Non-compliant Shareholders is Positive for Banks' Corporate Governance

## What's Happened

- ❑ On July 4, CBIRC disclosed for the first time a list of financial institution shareholders that have breached regulatory rules or laws in their dealings with banks, insurance companies and other finance companies in which they had invested. CBIRC has indicated that it would make such disclosure a regular activity. This is in line with the regulator's efforts in improving banks' corporate governance.
- ❑ CBIRC listed six kinds of non-compliant or illegal activities conducted by the 38 financial institution shareholders , including (1) conducting inappropriate related-party transactions, (2) filing falsified documents with authorities; (3) failing to obtain approval when related shareholders' holdings reached certain regulatory thresholds; (4) investing money derived from illegitimate sources into banks; (5) breaching the single-shareholder shareholding limits; and (6) being involved in criminal activities.

## Views of S&P Global (China) Ratings

- ❑ We believe the mega banks and most joint-stock banks have sustainable corporate governance frameworks in place, and the majority of problems typically concern certain regional banks and small rural credit institutions.
- ❑ We believe inappropriate related-party transactions can become a serious threat to banks' real capital base and overall viability. Although banks routinely disclose their related-party transaction information, the actual extent of related-party transactions would be difficult for outsiders to gauge if a bank shareholder disguised its activities through multiple shell companies or associated companies.

标普信评

S&P Global

China Ratings

# Contents

- Industry Outlook
- Business Position
- Capital and Earnings
- Risk Position
- Funding & Liquidity
- Government Influence
- Appendix: Related FI Research**

# Related Issuer Research

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Credit Rating Report: JPMorgan Chase Bank (China) Company Limited, Feb 24 2020

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Credit Rating Report: Shanghai Rural Commercial Bank Co., Ltd., Jan 14 2020

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Bulletin: SRCB Continues to Maintain Good Asset Quality, April 22 2020

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Credit Rating Report: Postal Savings Bank of China Co., Ltd., Jan 3, 2020

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Bulletin: PSBC's 2019 Financial Performance in Line with Expectations, March 26 2020

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# Related Industry Research

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[New Challenges Arise for Credit Loss Provisioning Under IFRS 9 Amid COVID-19, August 12 2020](#)

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[Regulator's Disclosure of Non-compliant Shareholders is Positive for Banks' Corporate Governance, July 13 2020](#)

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[Risk Differentiation Exists Between Banks' Hybrid Capital Instruments and Senior Bonds, July 1 2020](#)

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[Joint-Stock Banks Capable of Sustaining Lending Growth Under Earning Pressure: A Study on the Credit Quality of Chinese Joint-stock Banks Amid COVID-19, June 15 2020](#)

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[Chinese Mega Banks Reported Good Profitability in the First Quarter but Still Face Uncertainty, May 11 2020](#)

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[Mega Banks: Strong Enough to Withstand COVID-19, April 24 2020](#)

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[City Banks: Indispensable Financiers of China's SMEs, March 24 2020](#)

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[The Role of Rural Banks in China's County Economy -- A Study into the Creditworthiness of China's Rural Banks, March 24 2020](#)

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[Key Differentiation Factors of Credit Quality of Domestic Banks in China, March 3 2020](#)

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[Small but Solid – Foreign Bank Subsidiaries as Niche Players in China's Banking Sector, Feb 26 2020](#)

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[Strong and Steady – Mega Banks as the Pillars of China's Banking Sector, Jan 9 2020](#)

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[Diversity Across China's Banking System – A Deep Dive, Oct 21 2019](#)

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# Criteria and Criteria-Related Commentaries

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Methodology: Financial Institutions

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Commentary: Understanding S&P Global (China) Ratings Financial Institutions Methodology

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Commentary: Understanding S&P Global (China) Ratings Approach To Support

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General Considerations On Rating Modifiers And Relative Ranking

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Commentary: Understanding S&P Global (China) Ratings General Considerations on Rating Modifiers and Relative Ranking Methodology

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S&P Global (China) Ratings – Panda Bond Methodology

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