

SECTOR UPDATE

Banking – China

Limited Impact Of Credit Suisse Crisis On Chinese Financials

China's bank bond market investments do not have overseas AT1 holdings, limiting the potential contagion risk to the Chinese banking system. China's AT1 bonds differ from overseas AT1 bonds mainly on their: a) write-down clauses with specific trigger conditions, while foreign AT1 bonds can have principal write-downs; b) dividend suspension mechanism; and c) higher probability of redemption. Maintain **MARKET WEIGHT**. Our top pick is CMB (3968 HK).

WHAT'S NEW

- **AT1 bond write-offs.** Approximately US\$17b in Credit Suisse's Additional Tier 1 (AT1) bonds were wiped out as part of the transfer to UBS, essentially reducing the burden on its new owner and hitting investors who bought risky instruments. But the controversy around the decision, with bondholders treated more harshly than shareholders, has rippled across the wider \$260b AT1 market. AT1 bonds are subordinated debt instruments that can be counted towards a bank's regulatory capital, meeting the regulatory requirements for Tier 1 capital adequacy, similar to perpetual bonds issued by China banks. AT1 bonds were introduced after the 2008 global financial crisis as an additional layer of protection.
- **Order of write-downs.** AT1 bonds have subordinated characteristics and must have write-down or conversion clauses that immediately result in their being written down or converted to ordinary shares upon a trigger event. Trigger events occur when a commercial bank's core Tier 1 capital adequacy ratio falls below a certain level or when the point of non-viability (PONV) clause is triggered and the regulatory authorities determine that the commercial bank is unable to operate. The Credit Suisse AT1 bonds are write-down bonds, requiring a write-down to occur when a trigger event occurs. The full write-down of Credit Suisse AT1 bonds was led by the Swiss Financial Market Supervisory Authority (FINMA) (AT1 instruments written-off by FINMA), mainly due to the triggering of the PONV event. Under normal repayment order, equity is written off first, followed by AT1. However, in the event of "unsustainable business", the regulator can unilaterally declare a write-down, and in theory, the regulator has the autonomy to do so.
- **Impact on Chinese banking system.** AT1 bonds are similar to China banks' perpetual bonds, with most of them being written down types. Of more than 170 outstanding perpetual bonds, only five are convertible types. China banks are relatively cautious when investing in the bond market, and do not hold overseas AT1 bonds so they will not be affected by overseas bond market fluctuations.
- **China banks' AT1 exposure.** Currently, only state-owned banks, China Merchants Bank and Minsheng Bank, have issued overseas AT1 bonds. According to the data disclosed in ICBC's 2022 interim report, the size of perpetual bonds and preferred stocks overseas are 39.8b yuan and 19.8b yuan respectively, and the size is relatively small (less than 1.5% of net capital). In terms of size, if overseas market issuances are affected in the future, they may choose to return to the China capital market for financing. Using perpetual bonds as an example, the write-down clause in China is triggered when an event makes survival impossible, allowing the issuer to write down part of or the entire bond. This event refers to the earlier of two situations: a) China Banking and Insurance Regulatory Commission (CBIRC) determines that the issuer will not survive if a write-down is not carried out, and b) relevant departments determine that the issuer will not survive if public sector funding or equivalent support is not provided.

PEER COMPARISON

Company	Ticker	Rec	Price @ 21 Mar 23 (LCY)	Target Price (LCY)	Market Cap (LCY b)	Upside/ (Downside) to TP (%)	PE 2023F (x)	PE 2024F (x)	P/B 2023F (x)	P/B 2024F (x)	P/POP 2023F (x)	P/POP 2024F (x)	Yield 2023F (%)	Yield 2024F (%)	ROE 2023F (%)	ROE 2024F (%)
CCB	0939 HK	BUY	5.00	6.24	1,267,152.3	24.8	3.5	3.4	0.4	0.4	2.1	2.0	8.7	9.1	11.8	11.6
CMB	3968 HK	BUY	39.70	62.47	988,500.4	57.4	5.9	5.2	1.0	0.8	4.2	4.0	4.5	5.1	14.8	15.8

Source: Bloomberg, UOB Kay Hian

MARKET WEIGHT

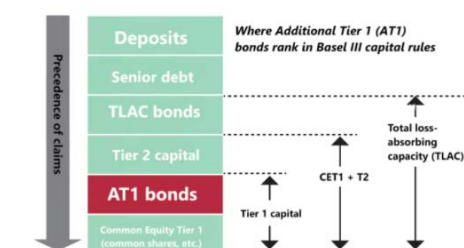
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SECTOR PICKS

Company	Ticker	Rec	Share Price (HK\$)	Target Price (HK\$)
CMB	3968 HK	BUY	39.70	62.47

Source: UOB Kay Hian

AT1 BONDS ARE RISKIER THAN ORDINARY BONDS BECAUSE THEY RANK LOWER IN THE ORDER OF CLAIMS WHEN A FINANCIAL INSTITUTION FAILS.



Source: Nikkei Asia

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ESSENTIALS

- Limited impact on China banks.** Commercial banks in China are expanding their business under strong regulatory supervision, and the probability of banks being "unable to survive trigger events" is extremely low. The risk of write-downs for perpetual bonds is controllable. The impact of the reduction in overseas capital bonds and the increase in risk weight due to new capital regulations may increase the cost and difficulty of issuing new Tier 2 bonds to replace maturing bonds for small- and medium-sized banks. Therefore, more small- and medium-sized banks may choose not to redeem their Tier 2 bonds upon maturity.
- Channel checks on insurance.** AIA has confirmed that it has no exposure to Credit Suisse's AT1 bonds and equities. Its exposure to CS's debt is less than 1% of the total invested assets of US\$216b as of 2022. Similarly, Prudential's overall exposure to CS is considered immaterial. AIA was not on the list of CS AT1 bonds listed by Bloomberg, and Prudential Plc only has US\$2.5b in CS as of Dec 22.
- China AT1 vs foreign AT1 bonds.** Chinese banks' AT1 bonds differ from foreign banks' AT1 bonds on several key points:
 - Chinese AT1 bonds have no write-down clauses. It is only mandatory to convert the bonds into shares under certain trigger conditions. On the other hand, it is common for foreign banks' AT1 bonds to have a principal write-down if a risk event occurs, meaning that investors may not only lose their interest payments but also part of their principal.
 - Chinese banks' AT1 bonds have a dividend suspension mechanism that protects investors by preventing issuers from distributing profits to ordinary stocks or other securities ranked lower than overseas preferred stocks.
 - Chinese banks' AT1 bonds have a higher probability of redemption than foreign banks' AT1 bonds due to the fixed spread over US Treasury bonds used for interest reset, which is typically higher than the market spread at issuance. According to statistics, 64% of Chinese banks' AT1 bonds have a higher agreed spread than the market spread, compared to only 29% of foreign banks' AT1 bonds.

ACTION

- We maintain MARKET WEIGHT on the banking sector.** An economic reopening should have substantial benefits for China's banks but we remain cautiously optimistic as persistent LPR repricing should present challenges to NIM. We prefer high-quality retail banks represented by China Merchants Bank as they offer attractive ROE compared with peers but have been undervalued.
- China Merchants Bank (3968 HK/BUY/Target: HK\$62.47).** China Merchants Bank's retail competitive advantage is still compelling from a long-term perspective, as the bank's profitability has continuously surpassed its peers, and the forward-looking strategic structure has become the key driver of the premium valuation over time. Maintain BUY with a higher target price of HK\$62.47.
- China Construction Bank (939 HK/BUY/Target: HK\$6.24).** We think CCB's valuation and dividend yield will be attractive to long-term investors. Its low valuation and above-average asset quality are good defensive plays. Maintain BUY with a higher target price of HK\$6.24, as we trim our earnings forecast in our Gordon Growth Model to factor in better asset quality outlook.

ASIAN BANK BOND MARKET, OVERALL PERFORMANCE IS MORE STABLE THAN THAT OF OTHER REGIONS' BANKS. AFTER THE EUROPEAN MARKET OPENED IN THE AFTERNOON, THE PRICE OF USD AT1 BONDS CHANGED BETWEEN -0.5% TO -0.2%.

Pricing Date	Issuer	Credit Rating (Moody/S&P/Fitch)	Coupon Rate (%)	Issuance Size (m USD)	----- At Issuance -----		First Redemption Date (Yrs)	Redemption Yield (%)	Purchase Price	G-spread (pt)	Price Change Since 20 Mar Mid Day (pt)
					Issuance Spread (bp)	Yield (%)					
9/16/21	ICBC	Ba1/-	3.20	6,160	236.8	3.20	3.5	5.887	91.60	233	-0.2
11/11/20	Bocom	-/BB+	3.80	2,800	334	3.80	2.7	6.366	93.65	270	-0.2
07/17/20	ICBC	Ba1/-	3.58	2,900	330	3.58	2.5	6.472	93.26	278	-0.4
02/26/20	BOC	Ba1/BB+/BB+	3.60	2,820	244.9	3.60	2.0	6.553	94.57	279	-0.5
09/11/18	BOC (HK)	Baa2/BBB/-	5.90	3,000	303.6	5.90	0.5	7.612	99.21	308	-0.2

Source: Yicai, Bloomberg, UOB Kay Hian

CHINA COMMERCIAL BANK CAPITAL ADEQUACY RATIO (CAR) ABOVE REQUIREMENT

Date	Tier 1 - CAR	Core Tier 1 - CAR	CAR
Mar-21	11.91	10.63	14.51
Jun-21	11.91	10.50	14.48
Sep-21	12.12	10.67	14.80
Dec-21	12.35	10.78	15.13
Mar-22	12.25	10.70	15.02
Jun-22	12.08	10.52	14.87
Sep-22	12.21	10.64	15.09

----- Bank -----				
Date	Rural	Urban	Joint-stock	Large
Mar-21	12.12	12.70	13.47	16.34
Jun-21	12.14	12.91	13.35	16.27
Sep-21	12.46	12.96	13.40	16.84
Dec-21	12.56	13.08	13.82	17.29
Mar-22	12.33	12.82	13.59	17.34
Jun-22	12.25	12.73	13.28	17.26
Sep-22	12.03	12.85	13.54	17.61

Source: WIND, UOB Kay Hian

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