Fixed Income
Credit Commentary

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CMBI Credit Commentary

Asian AT1s Part II – Picks on DM AT1s

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Executive summary

- Further to Asian AT1s part I – Our picks on Chinese G-SIBs AT1s on 12 Oct'22, we turned our focus to AT1s in developed markets (DM) in Asia, i.e. Hong Kong, Singapore, South Korea, and Australia. Our picks in this space are **DBSSP 3.3 PERP**, **UOBSP 3.875 PERP**, and **SHINFN 5.875 PERP** in view of their more balanced risk and return profile, as well as shorter tenor. These AT1s also offer quite competitive yield pick-up (418-1255bps) over their senior bonds recently.

- We note the non-call of Heungkuk Life Insurance and the guidance of Australian Prudential Regulation Authority (APRA) on "uneconomic calls" on capital instruments. That said, we still believe that Asian AT1s, especially those issued by major banks in DMs and Chinese G-SIBs, offer more predictable return, partly because of these banks' comfortable capital adequacy levels. We are more selective in our picks after the recent sharp price movements.

- DBS, UOB and Shinhan Bank are systemic importance banks in their home countries. These three banks' NPL ratios consistently lower than their home peers in each of the year since 2017. Their CET1 ratios are 14.2%, 13.1% and 14.3% respectively at Jun'22, compared with the minimum CET1 ratio requirements (including capital conservation buffer) of 9% in Singapore and 7% in South Korea. DBS, UOB and Shinhan Bank have demonstrated their ability to maintain capital adequacy, even at the trough of last economic cycle around 2008. We view that the chance they become non-viable is remote over the medium term.

Table 1: Snapshot of our picks

	DBSSP 3.3 PERP	UOBSP 3.875 PERP	SHINFN 5.875 PERP
AT1 rating	Baa1	Baa1	Baa3
Year to call	2.3	1.0	0.8
YTC (%)	9.3	9.4	18.1
Price	87.3	95.6	91.6

Source: Bloomberg

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Asian AT1s Part II

High return predictability for Asian DM AT1s despite recent noise

In Part II of our Asia AT1s comments, we focus on AT1s in developed economies in Asia, i.e. Hong Kong, Singapore, South Korea, and Australia. We will discuss the loss absorption framework, history of loss absorption and non-call (if any) of each of the region, followed by our picks. We note the non-call of Heungkuk Life Insurance and the guidance of APRA on "uneconomic calls" on capital instruments. That said, we still believe that the return predictability is high for Asian DMs in general, driven by banks' comfortable capital adequacy levels. We are even more selective after the recent noise. Among those more frequently traded AT1, we selected 8 banks, 2 from each country/region, to facilitate our discussions. They are **BOCHKL, BNKEA, DBSSP, UOBSP, SHINFN, CITNAT, ANZ** and **WSTP**.

Table 2: Summary of key features we compared

	Hong Kong	Singapore	South Korea	Australia
Loss absorption trigger	Discretionary	Discretionary	Discretionary	Mechanical
Loss absorption record	No	No	No	No
AT1s non-call on first call date record	No	No	No	No
Average yield to call (%)	9.6	9.4	15.2	10.2
Average year to call	1.8	1.7	2.4	4.3

Source: Bloomberg

Table 3: List of more frequently traded HK/SG/KR/AU AT1

		Bond rating	Next call date	Yr to call	YTC (%)	Price	Coupon reset (%)	Loss absorption	CET1 ratio trigger
CHIYBK 5.25 PERP	HK	NR	11/29/2022	0.1	14.4	98.9	5yrUST+3.15	Write-down	N/A
CIMWLB 5.72 PERP	HK	NR	3/30/2023	0.4	5.8	99.0	5yrUST+4.13	Write-down	N/A
SHINFN 5.875 PERP	KR	Baa3/-/-	8/13/2023	0.8	18.1	91.6	5yrUST+3.05	Write-down	N/A
BOCHKL 5.9 PERP	HK	Baa2/BBB/-	9/14/2023	0.9	8.0	98.3	5yrUST+3.04	Write-down	N/A
UOBSP 3.875 PERP	SG	Baa1/-/-	10/19/2023	1.0	9.4	95.6	5yrUST+1.79	Write-down	N/A
CINDBK 7.1 PERP	HK	Ba2/-/-	11/6/2023	1.0	6.3	100.5	5yrUST+4.15	Write-down	N/A
CIMWLB 6.5 PERP	HK	Ba1/-/-	1/24/2024	1.2	6.5	99.5	5yrUST+3.95	Write-down	N/A
CITNAT 4.35 PERP	KR	Baa3/BBB-/-	7/2/2024	1.7	14.2	85.9	5yrUST+2.64	Write-down	N/A
BNKEA 5.875 PERP	HK	Ba2/BB/-	9/19/2024	1.9	32.2	65.1	5yrUST+4.26	Write-down	N/A
WOORIB 4.25 PERP	KR	Ba2/BB/-	10/4/2024	1.9	18.6	77.8	5yrUST+2.66	Write-down	N/A
DBSSP 3.3 PERP	SG	Baa1/-/-	2/27/2025	2.3	9.3	87.3	5yrUST+1.92	Write-down	N/A
BOCOHK 3.725 PERP	HK	Ba1/-/-	3/3/2025	2.3	7.2	92.6	5yrUST+2.53	Write-down	N/A
BNKEA 5.825 PERP	HK	Ba2/BB/-	10/21/2025	3.0	25.0	61.5	5yrUST+5.53	Write-down	N/A
ANZ 6.75 PERP	AU	Baa2/BBB-/-	6/15/2026	3.6	8.6	94.3	5yrUST+5.17	Equity conversion	5.125%
MQGAU 6.125 PERP	AU	Ba1/BB+/-	3/8/2027	4.4	11.2	83.0	5yrUST+3.70	Equity conversion	5.125%
WSTP 5 PERP	AU	Baa2/BBB-/-	9/21/2027	4.9	10.8	78.6	5yrUST+2.89	Equity conversion	5.125%
CHIYBK 8 PERP	HK	NR	10/26/2027	4.9	9.8	91.2	5yrUST+3.70	Write-down	N/A

Source: Bloomberg.

Low likelihood of loss absorption

DM banks are generally well-capitalized….

The regulatory of four DMs (Australia, HK, Singapore and South Korea) set minimum common equity T1 (CET1) ratio requirements for banks since 2013 and gradually increased the requirements. Currently, the CET1 ratios required by respective regulators are 3-4% higher than the Basel III requirement of 4.5%, and 2-3% higher than the trigger level commonly set in regions with mechanical loss absorption framework of 5.125%.

We believe that the probability for loss absorption of these AT1s to be triggered over the medium term is very low given the selected banks' profitable track records and ample capital buffer. The 8 selected banks reported successive net income over the past 20 years. These banks also have ample CET1 buffer, the average differential between CET1 ratios at Jun'22 and regional regulatory requirement of banks in HK/SG/KR/AU is 8%/4.7%/7.4%/3.8%, respectively.

Chart 1: HK banks' CET1 ratio buffer

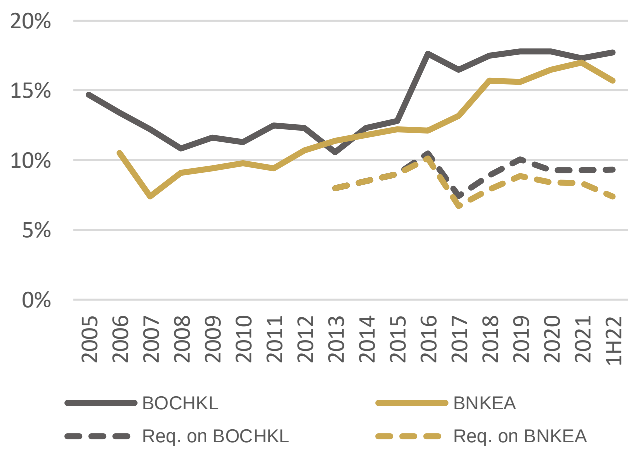
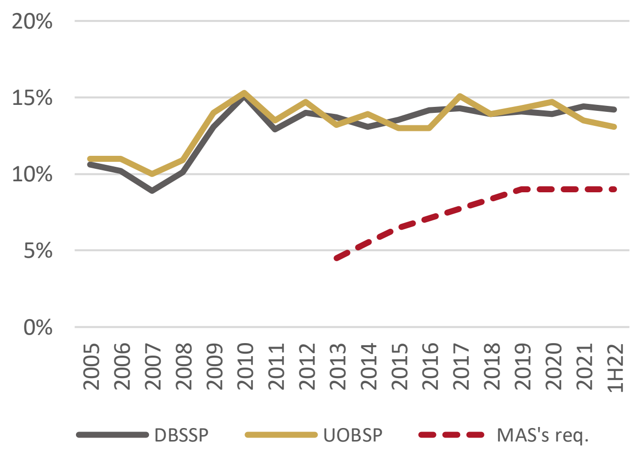
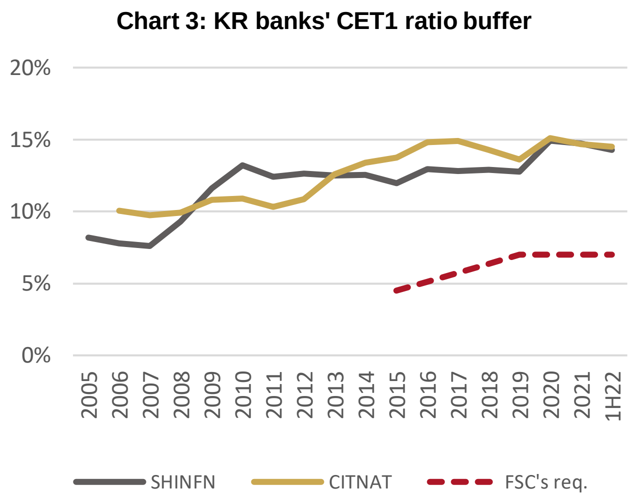
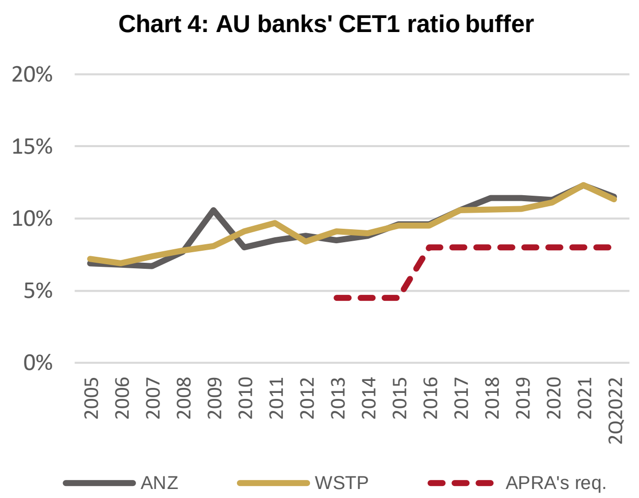


Chart 2: SG banks' CET1 ratio buffer



Note: Hong Kong Monetary Authority (HKMA) has different minimum capital ratio requirements on BOCHK and BNKEA. Source: Bloomberg, HKMA, Monetary Authority of Singapore (MAS).





Note: FSC: Financial Services Commission. Source: Bloomberg, FSC, APRA.

Higher hurdle to absorb loss in KR/HK/SG compared to AU….

We compared the loss absorption trigger clauses of respective regions and detailed in Table 4 below. For South Korea, it will need the regulator to designate bank as insolvent in order to hit the loss absorption trigger. We view the watermark for non-viable is higher than insolvency. Therefore, it reduces the risk of AT1s in South Korea being written down compared to HK/SG/AU. There is no hard CET1 ratio requirement that will trigger the principal write-off.

For Hong Kong and Singapore, the loss absorption under point of non-viability (PONV) is at the discretion of its regulator, and there is no CET1 ratio trigger either. For Australia, the PONV loss absorption is the similar to HK/SG, and on top of that, CET1 ratio trigger at below 5.125% would mechanically trigger the loss absorption.

We believe it is more remote for Korea to write-off the AT1 for loss absorption given its lower watermark of insolvency, followed by Hong Kong and Singapore, and Australian AT1s could be least friendly to investor among these regions, given there is CET1 ratio trigger on top of PONV.

Table 4: Comparison of loss absorption triggers

	Hong Kong	Singapore	South Korea	Australia	China
Loss absorption classification	Discretionary	Discretionary	Discretionary	Mechanical	Discretionary
PONV trigger	Earlier of the HKMA notifying an authorized institution (AI) in writing: (a) in his opinion, a write-off or conversion is necessary, without which the AI would become nonviable; or (b) a decision has been made by the government body, a government officer or other relevant regulatory body with the authority to make such a decision, that a public sector injection of capital or equivalent support is necessary, without which the AI would become non-viable.	Earlier of: (a) the MAS notifying the bank in writing that the MAS is of the opinion that a write-off or conversion is necessary, without which the bank would become non-viable; and (b) the MAS's decision to make a public sector injection of capital, or equivalent support, without which the bank would have become non-viable, as determined by the MAS.	Designation of the bank as an "insolvent financial institution" pursuant to the Act on the Structural Improvement of the Financial Industry of Korea	Earlier of: (a) the issuance of a notice in writing by APRA to the authorized deposit-taking institution (ADI) that conversion or write-off of capital instruments is necessary because, without it, APRA considers that the ADI would become non-viable; or (b) a determination by APRA, notified to the ADI in writing, that without a public sector injection of capital, or equivalent support, the ADI would become non-viable.	Earlier of: (a) CBIRC determined it would become non-viable without a write-down or conversion of capital; or (b) Relevant authority decided that a public sector injection of ca pital or equivalent su pport is necessary, wi thout which it would b ecome non-viable CBIRC's approval is required to convert preference shares into ordinary shares.
CET1 ratio trigger	N/A	N/A	N/A	CET1 ratio fall below 5.125%	CET1 ratio fall below 5.125%
Dividend stopper	Yes	Yes	Yes	Yes	Yes

Source: HKMA, MAS, Financial Services Commission (FSC), APRA, CBIRC.

…. no loss absorption so far for DM AT1s

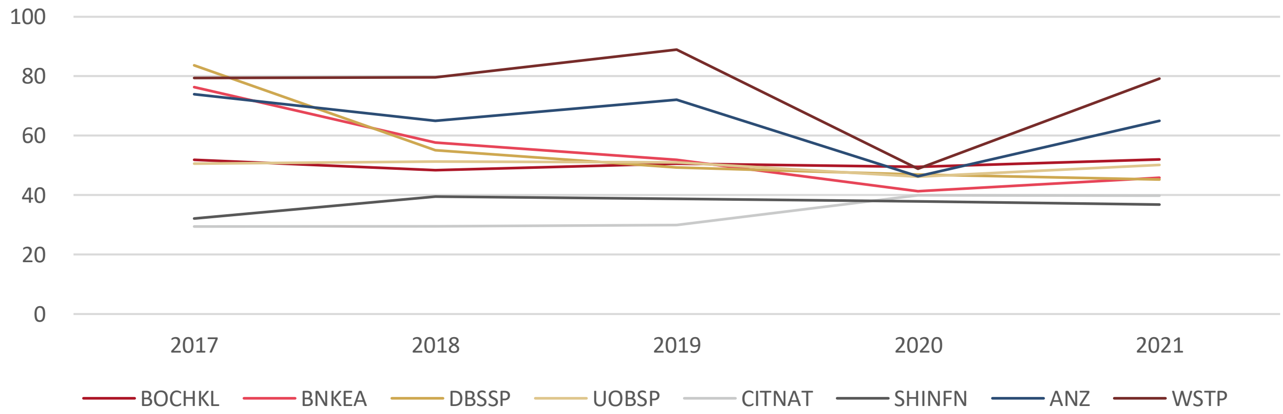
So far, there is no loss absorption for holders of AT1s in HK/SG/KR/AU. This is attributable to the robust capital adequacy and resilient operating performance of banks in these developed economies. Additionally, the stringent regulatory requirements on banks' capital and liquidity help maintain the banking system stability, and keep AT1s far from the point of loss absorption.

Low likelihood of distribution cancellation

There is no distribution cancellation history in HK/SG/KR/AU. All selected banks' AT1s have distribution stopper clauses, which restrict these banks from paying ordinary share dividend if they elect to cancel distribution on the AT1s. That means cancellation of AT1s' distributions will derail years of dividend payout record and have negative impact on their reputation. Specifically, our picks DBS and UOB have explicit dividend policy to provide sustainable dividends. Therefore, we consider the probability that these banks elects to cancel distribution is low.

The selected banks in the four regions have years of profitability record throughout the economic cycles, we see the chance of cancellation of distribution on AT1 to absorb loss is low in near future. See the dividend payout ratios of these banks in Chart 5 below.

Chart 5: Dividend payout ratio (%)



Source: Bloomberg.

Low non-call risk

No non-call of AT1s in HK/SG/KR/AU so far…

In Asian context, the reputational risk of non-call is high. Woori Bank, one of the four largest commercial banks in South Korea in terms of total assets, announced in Feb'09 they would not call on its lower tier 2 bonds (first call date in Mar'09). It was the first non-call event in Asia, and Woori's bonds plunged after the news. The bank subsequently issued new bond to exchange the above in Jul'09 concerning the market reaction. Recalled that ICICI's non-call incident in 2011, the issuer first chose not to call its 3 T2 bonds issued in 2006 on the first call dates in 2011, and proposed to exchange three bonds with new bonds due 2020. ICICI made an U-turn on the decision after the negative market reaction and called the 3 T2 bonds on the first call dates.

…. Heungkuk's non-call on perps is more of idiosyncratic

On 2 Nov'22, Heungkuk Life Insurance announced that it would not call its USD500mn HUKLFI 4.475 PERP on the first call date (9 Nov'22), after the failure to tap the market. The non-call shocked the market as it is the first non-call of USD capital bonds from South Korean financial institutions since 2009. HUKLFI 4.475 PERP dropped 13.7pts immediately after the news and dragged down other AT1 in the market. Nonetheless, Heungkuk is the 8th largest insurer in Korea with a market share (premium income) of only 4%. We consider the non-call more of an "idiosyncratic" event than of a change of attitude or sharply deteriorated operating environment major banks facing in Korea.

APRA's guidance on "uneconomic" calls may increase the non-call risk in Australia

In the letter issued by APRA on 2 Nov'22, Australian banks are required to provide analysis to demonstrate the cost of issuing the replacement AT1/ Tier 2 instrument is equal to or less than the cost of keeping the existing instrument outstanding. The authority believes that solely based on exercising calls to limit reputational damage would undermine the permanence and quality of capital. ANZ 6.75 PERP/MQGAU 6.125 PERP/WSTP 5 PERP will be callable in 26-27, the APRA's stance may lower the chance of AT1 being called on first call dates if the rate hike persists.

Our picks are DBSSP 3.3 PERP, UOBSP 3.875 PERP and SHINFN 5.875 PERP

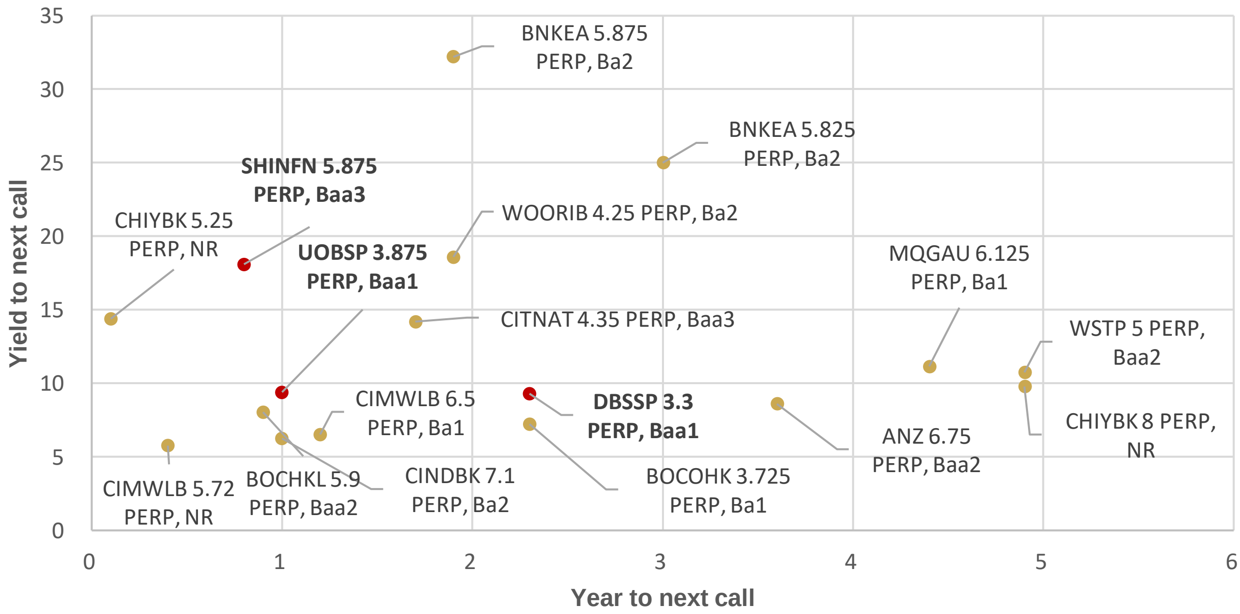
As discussed in our Part I comments, the return predictability of AT1s are subject to 1) likelihood of loss absorption; 2) likelihood of cancellation of non-cumulative distribution; and 3) likelihood of call, especially on the first call dates. In these regards, Asia DM AT1s offer higher return predictability compared with its global peers. Our picks in this space are **DBSSP 3.3 PERP**, **UOBSP 3.875 PERP**, and **SHINFN 5.875 PERP** in view of their more balanced risk and return profile, as well as shorter tenor. These AT1s also offer quite competitive yield pick-up (418-1255bps) over their senior bonds recently.

The non-call of Heungkuk perps will raise questions on ability and willingness to call for financial institutions, especially those of South Korean issuers. We would argue that Heungkuk, rated Baa1 by Moody's, is the 8th largest insurer in South Korea with a market share of premium income of only 4%. Its non-call decision should be issuer-specific. Shinhan Bank, rated 2 notches higher at A1 by Moody's, is backed by Shinhan Financial Group with notably stronger ability to call its AT1s

More balanced risk return profile with shorter tenor

As of 4 Nov'22, DBSSP 3.3 PERP, UOBSP 3.875 PERP and SHINFN 5.875 PERP are trading at decent yield to next call of 9.3%, 9.4% and 18.1%, respectively with relatively short tenor, especially compared with that of AU peers. Additionally, we believe that the return predictability of our picks is high given the low likelihood of loss absorption, distribution cancellation and low risk of non-call on the first call dates.

Chart 6: More frequently traded Asian AT1 YTC



Source: Bloomberg

DBS, UOB and Shinhan Bank are systemic importance banks in their home countries

These 3 banks' NPL ratios have been consistently lower than those of their domestic peers. As shown in charts 2-3, DBS, UOB and Shinhan Bank have demonstrated their ability to maintain capital adequacy, even at the trough of economic cycle around 2008. We view that the chance they become non-viable is remote over the medium term. See Appendix 1.

From the profitability point of view, these 3 banks have a higher than average net interest margin most of the time since 2017. This helps strengthen the banks' capacity to manage the payout of shares dividend and AT1s' distributions.

Chart 7: NPL ratio of our picks are below industry average (%)

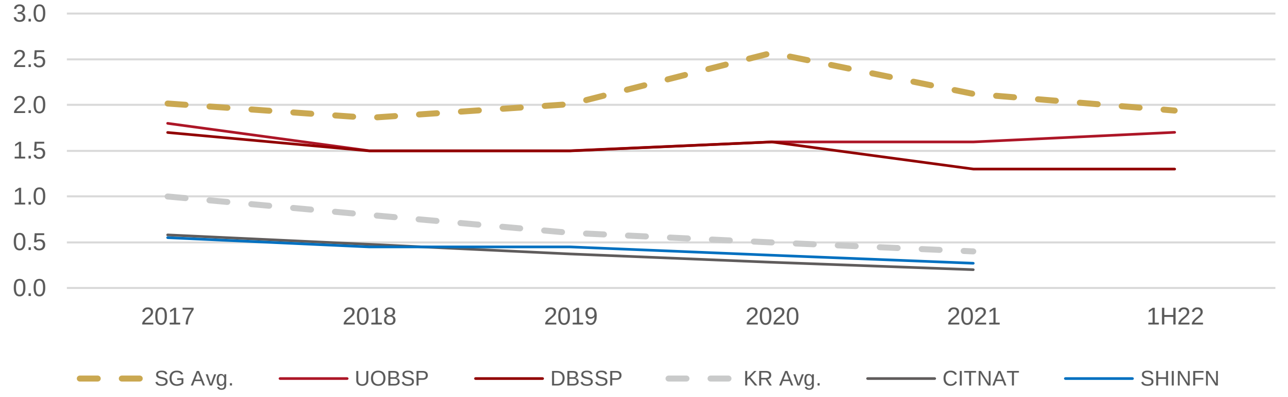


Chart 8: DBS and UOB net interest margin (%)

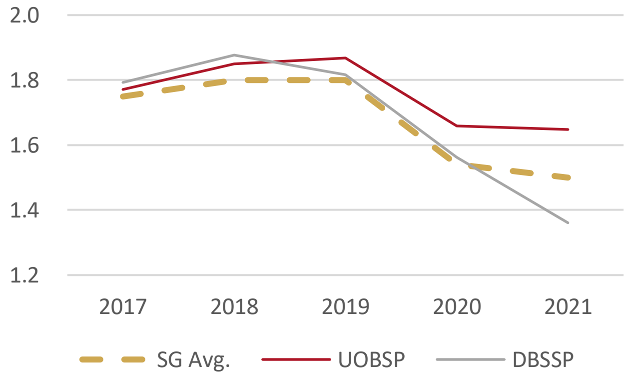
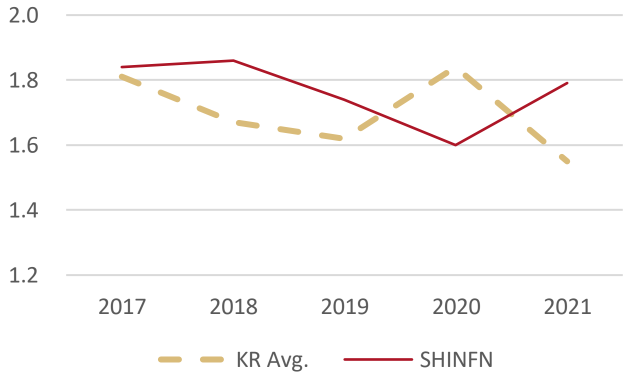


Chart 9: Shinhan Bank's net interest spread (%)



Source: Bloomberg, CEIC.

Convictions on BNKEAs are not strong despite YTC above 30%...

We exclude BNKEAs from our picks regardless its high YTC. The asset quality and profitability are weakening over the years. ROAA and ROAE both show deteriorating trend since 2017, despite a slight improvement in 2021. The annualized ROAE and ROAE for 1H22 are the lowest in past five years.

We are also concerned with BNKEA's China exposures, especially in the property sector. It accounted for 35.7% of total loan book at Jun'22. The bank maintains 35-40% level in past few years, and it is highest among its peers in Hong Kong.

The property turmoil in mainland China hurts BNKEA's asset quality. 5.4% of total property development loans were impaired at Jun'22, increased significantly from 1.3% at Dec'21. The loan provision also increased by more than a double for the same period. The CET1/Tier1 ratios at Jun'22 deteriorated 1-2% to 15.7%/17.7%, from 17.0%/19.8% at Dec'21.

We see that BNKEA's earning will continue under pressure in coming 1-2 years. In its China's book, stage 3 loans represented 1.45% of total China book at Jun'22. We expect stage 3 loans to increase in 2022E and 2023E amid the property developer are struggling with short of liquidity, which in turns, stress on the bank's thin profit level in coming foreseeable horizon.

…. with weakening profitability and asset quality over the years

Chart 10: ROAA and ROAE are falling

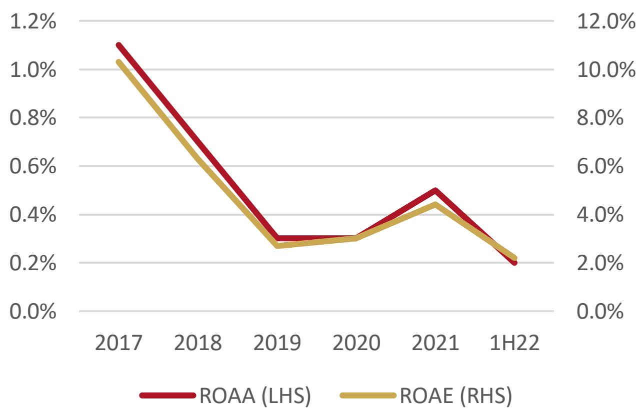
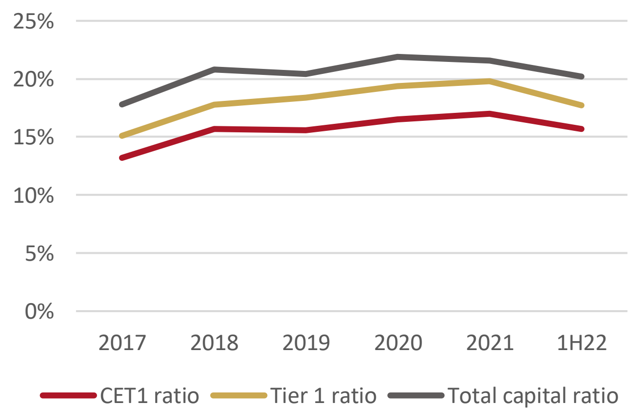
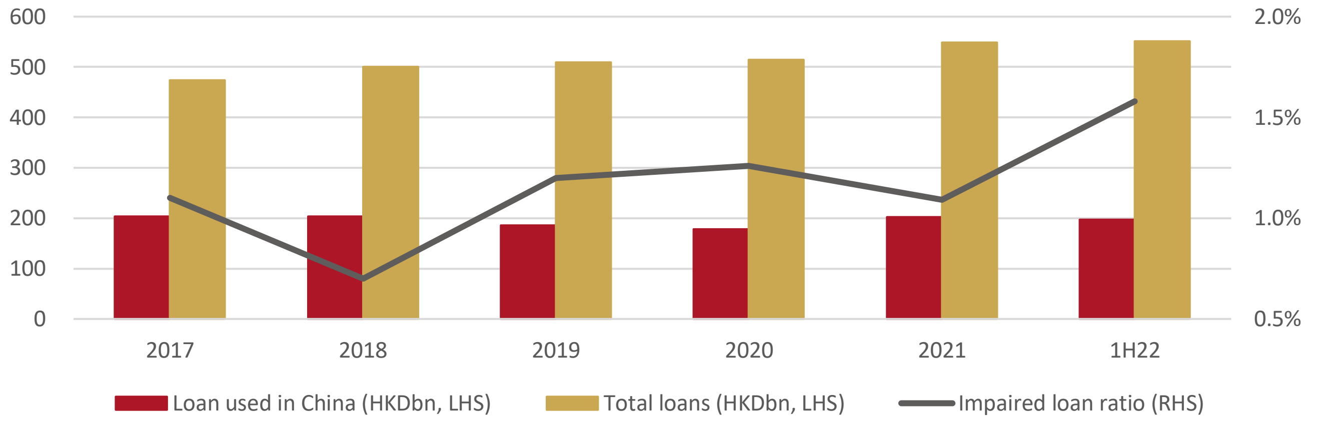


Chart 11: Solid capital ratios, albeit drop in 1H22



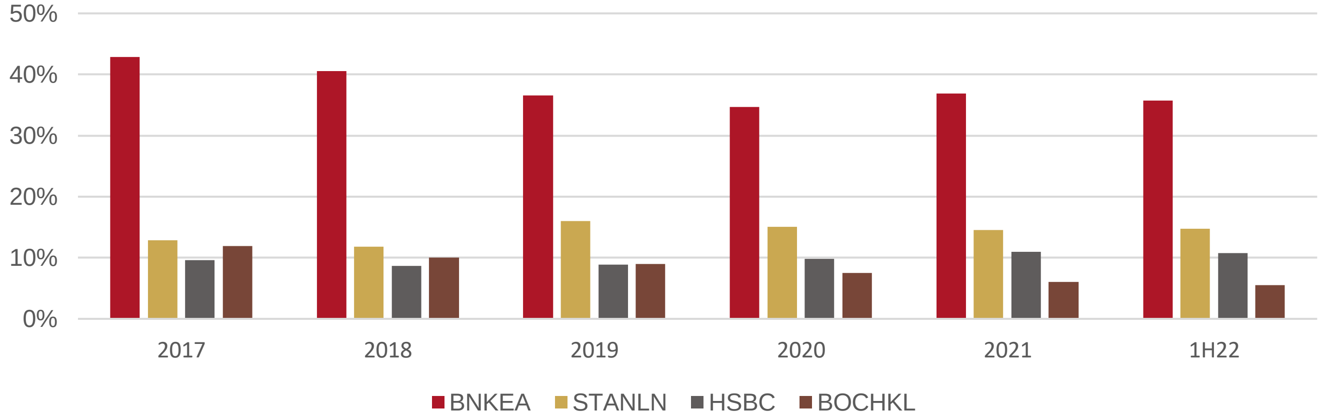
Source: Company's fillings.

Chart 12: Impaired loan ratios are rising



Source: Company's fillings.

Chart 13: BNKEA's China loan exposures are substantial compared to its local peers



Source: Companies' fillings.

Yield differential over senior bonds is quite decent

As shown in Charts 14-16 below, the yield differential between our picks and their senior unsecured bonds with similar tenor is widening recently. As of 4 Nov'22, the yield differential of DBSSP 3.3 PERP, UOBSP 3.875 PERP, SHINFN 5.875 PERP are 418bps, 428bps and 1255bps, widened 134bps, 252bps and 964bps over the past 3 months, respectively. The widening yield differential, in our view, offers better entry opportunities for our AT1 picks.

Chart 14: DBSSP 3.3 PERP

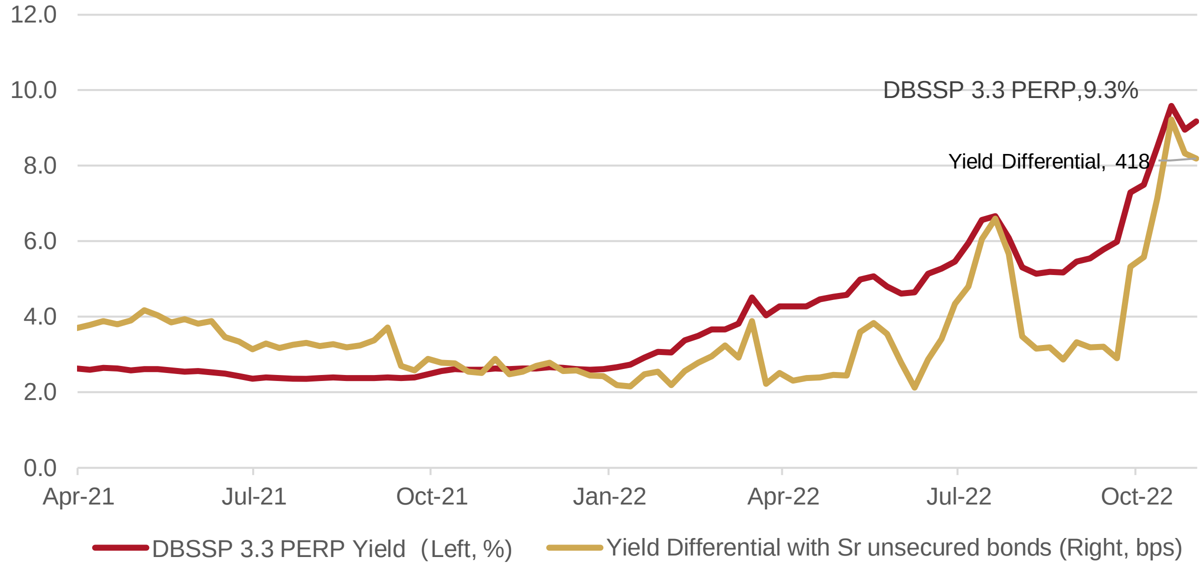


Chart 15: UOBSP 3.875 PERP

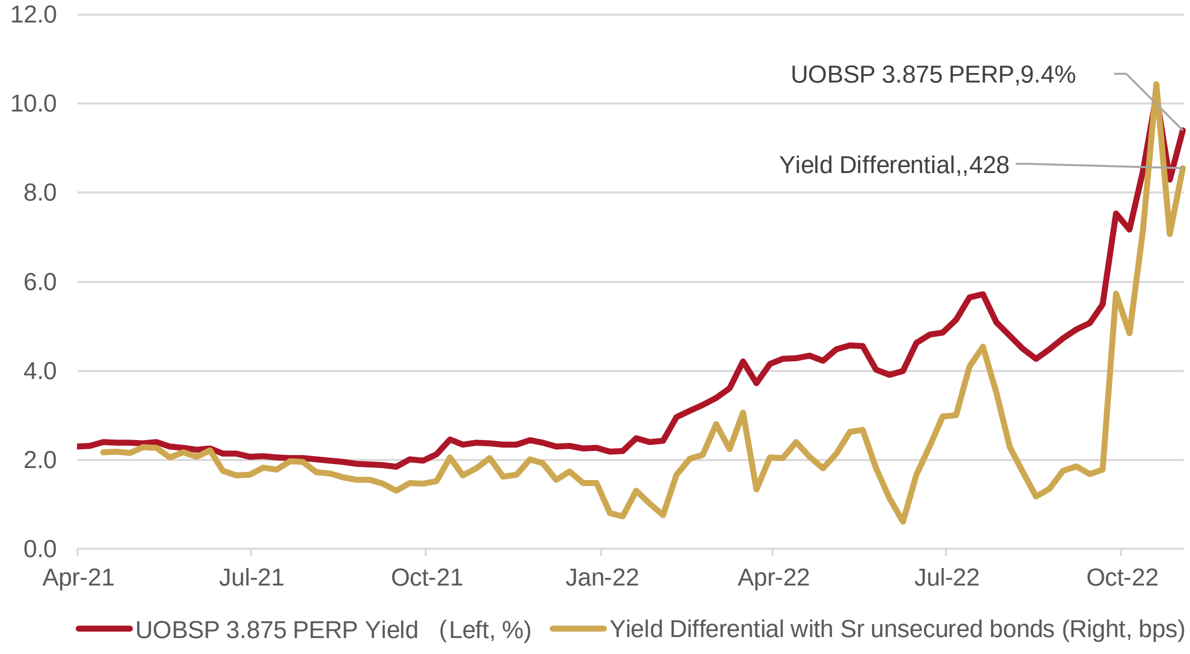
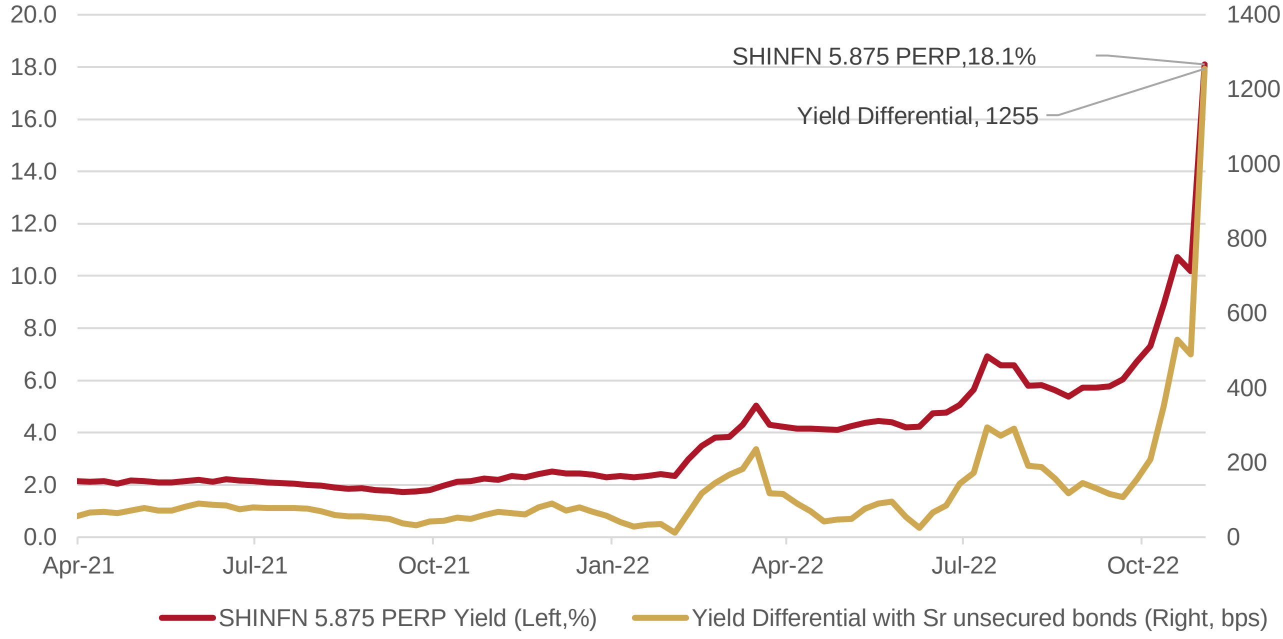


Chart 16:SHINFN 5.875 PERP



Source: Bloomberg

Appendix 1: Credit metrics of our picks

1H2022	DBSSP	UOBSP	SHINFN
Credit ratings (M/S/F)			
Issuer rating	Aa1/AA-/AA-	Aa1/AA-/AA-	Aa3/A+/A
Outlook	Stable	Stable/Stable/Neg.	Stable
Standalone rating	a1/a/-	a1/a/aa-	a3/a-/a
Senior unsecured rating	Aa1/AA-/	Aa1/AA-/AA-	Aa3/A+/A
AT1 rating	Baa1/-/-	Baa1/-/-	Baa3/-/-
Key credit metrics			
ROA	1.0%	0.9%	0.8%
ROE	13.4%	10.1%	12.3%
Net interest margin (NIM)	1.6%	1.7%	1.6%
CET 1 ratio	14.2%	13.1%	14.3%
Tier 1 ratio	14.9%	14.0%	15.1%
Total capital ratio	16.7%	16.4%	18.0%
NPL ratio	1.3%	1.7%	0.1%
Loan-to-deposit ratio	80.4%	89.8%	96.9%

Source: Bloomberg, Companies' filling.

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