

CMBI Credit Commentary

Asian AT1s Part I – Our picks on Chinese G-SIBs AT1s

Buy BCHINA 3.6 PERP and ICBCAS 3.58 PERP within China G-SIBs

In Part I of our Asia AT1s comments, we focus our discussions on China AT1 and our rationale on why we believe that China AT1s, especially those of China G-SIBs, offer more predictable return.

To start with, 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 being called, especially on the first call dates.

So far, there is no precedent on the principal of the AT1s of Chinese G-SIBs being written down or converted into equity. There is also no precedent for Chinese G-SIBs to cancel distribution, and all of the Chinese AT1s were called on their respective first call dates. Please see Table 1 for examples of loss absorption or non-call of European AT1s.

While AT1s in Europe offer better YTC, we would argue that Asian AT1s, especially Chinese G-SIBs' AT1s, offer more predictable return because of their lower likelihood of loss absorption, higher certainty of being called on the first call dates and scheduled distributions.

Amongst China G-SIBs' AT1s, our picks are **BCHINA 3.6 PERP (callable Mar'25)** and **ICBCAS 3.58 PERP (callable Sep'25)** in view of their higher YTC, relatively shorter-tenor and better trading liquidity. These AT1s also offer decent yield pick-up (81-98bps) over their senior bonds.

Table 1: Loss absorption/ non-call of European AT1s

Year	Ticker	Bank	Country	Treatment	Principal amount
2017	SANTAN	Banco Popular Español, S.A.	Spain	Equity conversion	EUR1.35bn
2017	NDB	BremerLB	Germany	Coupon skip	-
2019	SANTAN	Banco Santander	Spain	Not to call on first call date	EUR1.5bn
2020	YESIN	Yes Bank	India	Written-down	INR8,415 crores
2020	DB	Deutsche Bank AG	Germany	Not to call on first call date	USD1.25bn
2021	HVB	UniCredit	Italy	Coupon skip	-

Note: Banco Popular Español, S.A. was acquired by Banco Santander in 2017.

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Chart 1: Selected China G-SIBs' AT1 YTC

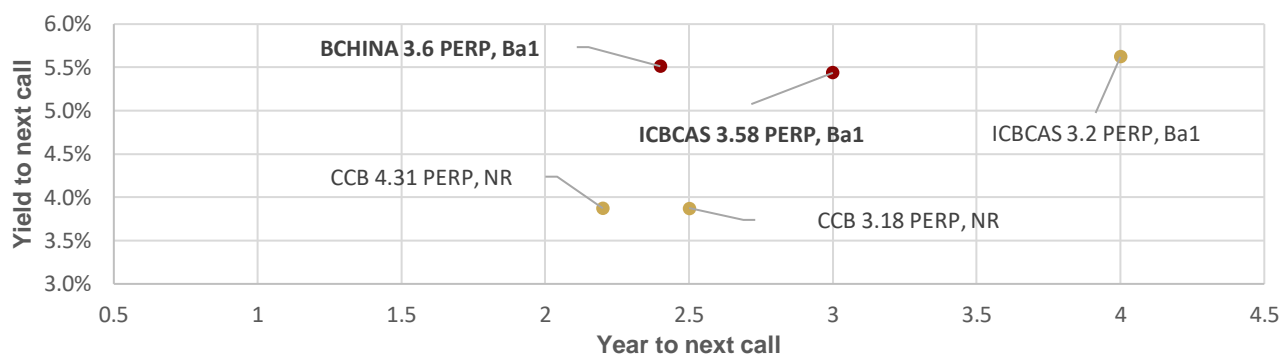
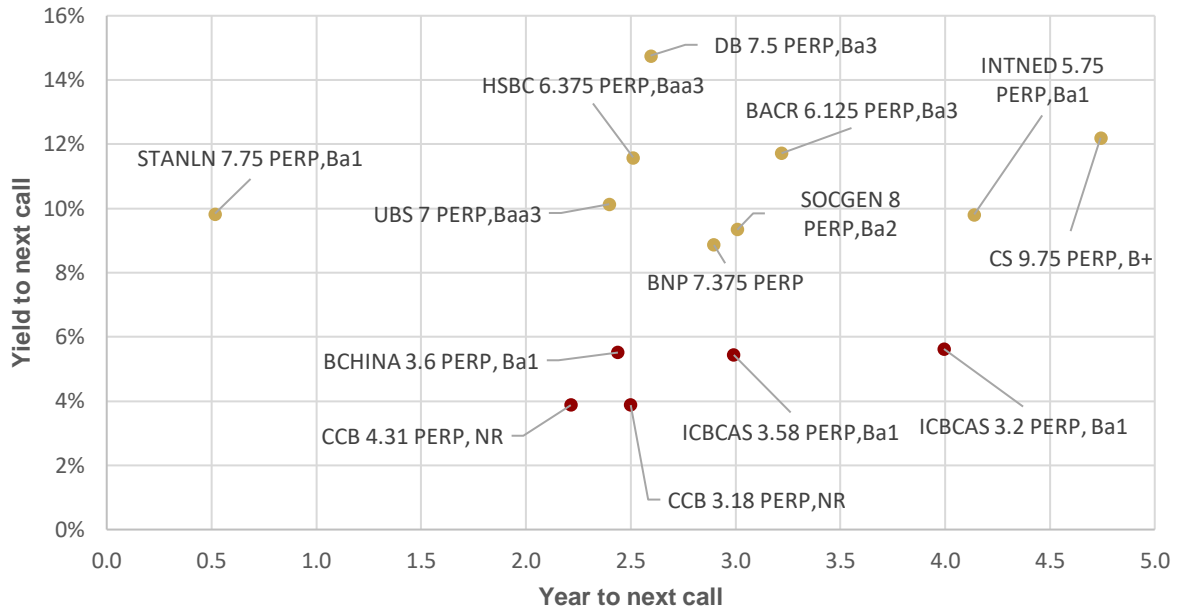


Table 2: List of outstanding offshore AT1 issued by Chinese banks and subsidiaries

	Bond rating	Next call date	Yr to call	YTC	Coupon reset	Loss absorption trigger	CET1 ratio trigger	Loss absorption	Price
China G-SIBs									
BCHINA 3.6 PERP	Ba1	3/4/2025	2.4	5.5	5yUST+2.449%	Mechanical	5.125%	Equity conversion	96.4
BOCHKL 5.9 PERP	Baa2	9/14/2023	1	5.7	5yUST+3.036%	Discretionary	--	Principal write-down	100.7
CCB 4.7 PERP	NR	12/29/2022	0.3	-1.1	5yUST+2.550%	Discretionary	--	Principal write-down	100.3
CCB 4.31 PERP	NR	12/13/2024	2.2	3.9	5yUST+2.974%	Discretionary	--	Principal write-down	99.7
CCB 3.18 PERP	NR	3/26/2025	2.5	3.9	5yUST+2.450%	Discretionary	--	Principal write-down	97.2
ICBCAS 4.9 PERP	NR	3/21/2023	0.5	4.9	5yUST+2.250%	Discretionary	--	Principal write-down	99.9
ICBCAS 3.58 PERP	Ba1	9/23/2025	3	5.4	5yUST+3.300%	Discretionary	--	Equity conversion	95.7
ICBCAS 3.2 PERP	Ba1	9/24/2026	4	5.4	5yUST+2.368%	Discretionary	--	Principal write-down	93
Joint-stock commercial banks									
BOCOHK 3.725 PERP	Ba1	3/3/2025	2.4	5.5	5yUST+2.525%	Discretionary	--	Principal write-down	96.9
BOCOM 3.8 PERP	NR	11/18/2025	3.1	5.5	5yUST+3.345%	Discretionary	--	Principal write-down	96.2
CHINAM 4.4 PERP	NR	10/25/2022	0.1	6.4	5yUST+2.443%	Mechanical	5.125%	Equity conversion	99.5
CIMWLB 5.85 PERP	NR	12/29/2022	0.2	4.3	5yUST+4.130%	Discretionary	--	Principal write-down	99.3
CIMWLB 5.72 PERP	NR	3/30/2023	0.5	5.2	5yUST+4.130%	Discretionary	--	Principal write-down	99.3
CIMWLB 6.5 PERP	Ba1	1/24/2024	1.3	5.7	5yUST+3.948%	Discretionary	--	Principal write-down	101.3
CINDBK 7.1 PERP	Ba2	11/6/2023	1.1	5.6	5yUST+4.151%	Discretionary	--	Principal write-down	101.9
CINDBK 3.25 PERP	Ba2	7/29/2026	3.8	6.3	5yUST+2.530%	Discretionary	--	Principal write-down	91.3
CINDBK 4.8 PERP	Ba2	4/22/2027	4.6	6.2	5yUST+2.104%	Discretionary	--	Principal write-down	96.1
City and rural commercial banks									
BOCHON 5.4 PERP	NR	12/20/2022	0.2	5.5	5yUST+3.210%	Mechanical	5.125%	Equity conversion	99.6
CBZHZH 5.5 PERP	NR	10/18/2027	5.1	7.7	5yUST+3.567%	Mechanical	5.125%	Equity conversion	99.6
GZHRCB 5.9 PERP	NR	6/20/2024	1.7	8.8	5yUST+4.036%	Mechanical	5.125%	Equity conversion	94.8
JZCITY 5.5 PERP	NR	10/27/2022	0.1	9.1	5yUST+3.486%	Mechanical	5.125%	Equity conversion	97.6
ZHYUBK 5.6 PERP	NR	11/21/2023	1.2	22.8	5yUST+2.606%	Mechanical	5.125%	Equity conversion	83.2

Note: China G-SIBs: ICBC, CCB, AGRBK, BCHINA. For issuance with mechanical trigger, it has going concern trigger on top of non-viability trigger, the equity conversion still subject to CBIRC's discretionary decision. See Table 3 for going concern trigger and non-viability trigger events.

Chart 2: Selected G-SIBs AT1s comparison



Note: Red dots are China AT1s

Chinese AT1s: Lower but more predictable return

Loss absorption resulting from PONV is remote over the medium term....

Chart 3: CET1 ratios of China G-SIBs

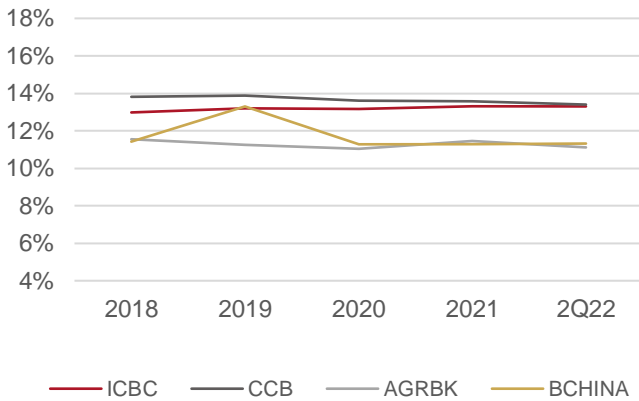
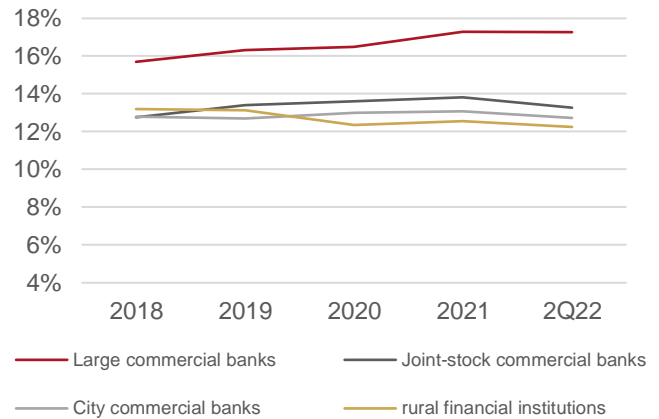


Chart 4: Capital adequacy ratio of Chinese banks



Note: Large commercial banks include China G-SIBs, POSABK (since 2019) and BOCOM. Source: CBIRC, Companies' report.

Based on more solid fundamental of China G-SIBs, ample capital buffer and our expectation of their continued profit generation, we see the probability of these banks become non-viable is remote. See Appendix 1 for the credit highlights of our picks.

The loss absorption trigger for principal write-down or equity conversion for AT1s varies. In Hong Kong, South Korea and Singapore, the point of non-viability (PONV) triggers will be determined at their regulators' discretion; while in India and Thailand, the loss absorption of AT1s will be triggered either regulators consider the banks would become non-viable, or mechanically after banks' CET1 ratios fall below the threshold (6.125% in India and 5.125% in Thailand). China's loss absorption is more of a hybrid of both but more inclined to the regimes of Hong Kong, South Korea and Singapore, in our view, as even for AT1s with a CET1 trigger of 5.125%, the consent from CBIRC is required for executing the equity conversion. That said, whether CBRIC will override the loss absorption for AT1s with CET1 falling below the threshold remains untested.

.... no loss absorption by AT1 for Chinese banks historically

Up to now, there is no principal write-down or equity conversion for Chinese AT1s, both offshore or onshore. So far, only Baoshang Bank, a city commercial bank based Inner Mongolia, was concluded non-viable by CBIRC in 2019 and the bank's onshore Tier 2 capital bond (the bank's only hybrid bond issuance) were written down.

Low likelihood of cancellation of AT1 distributions

As of today, no Chinese G-SIB has ever cancelled its distributions on AT1. We expect Chinese G-SIBs to continue to pay their AT1 distributions as scheduled in view of their capital buffer and continued profit generation.

Additionally, the Chinese government requires state-owned banks to maintain the ordinary share dividend payout ratio at c30%. Meanwhile, the dividend stopper clauses of AT1s restrict these banks from paying ordinary share dividend if they elect to cancel distribution on the AT1s. Hence, we believe that the Chinese G-SIBs' AT1s will continue to pay the distributions on AT1s in order to satisfy the dividend policy stipulated by the government.

Within the China AT1 space, the only distribution cancellation was in 2019 when Bank of Jinzhou cancelled the distribution of its AT1 as its capital adequacy ratio fell below the regulatory requirement. After cRMB12.1bn ordinary share injection from state-owned enterprises, the bank resumed the AT1 distribution in 2020. Recalled that the AT1 distribution is non-cumulative; any amount of distribution that has not been fully paid will not be cumulative.

Table 3: Key features of China AT1 capital instruments

	Terms
Tenor	Undated with no fixed maturity date
Distribution	Reset every 5 year, at reference rate + fixed spread Payment is subject to: (i) The Board passed resolution to declare the distribution (ii) The bank has distributable after-tax profit (iii) The bank meet the regulatory required capital adequacy ratios
Dividend stopper	If the bank elects to cancel (in whole or in part) any distribution, the cancellation of such on the Bonds shall be approved at a general meeting of the shareholders. The bank shall not make any distribution or dividend to the holders of ordinary shares of the Issuer, until the distributions scheduled to be paid on any subsequent payment date is paid in full to the bondholders.
Write-off/ mandatory conversion	If a non-viability trigger event occurs, the bank has the right (without any requirement for the consent of the holders) to irrevocably write-off (in whole or in part) the principal amount outstanding, or convert (in whole or in part) the principal into common equity
Non-viability trigger event	(i) CBIRC determined it would become non-viable without a write-down or conversion of capital; or (ii) Relevant authority decided that a public sector injection of capital or equivalent support is necessary, without which it would become non-viable
Going concern trigger event	Common equity tier 1 capital adequacy ratio has fallen to 5.125% or below. CBIRC's approval is required to convert preference shares into ordinary shares.
Redemption	Redeemable at the option of the bank, first call date at 5 years after issuance
Redemption condition	(i) Use the same or better quality capital instrument to replace the principal to be redeemed (ii) The regulatory capital after redemption will remain above the regulatory requirements

Table 4: Dividend payout history of selected China and European banks

Region	Issuer	Credit rating (M/S/F)	CET1 Ratio 1H22 (%)	Dividend Payout Ratio (%)			Avg. AT1 distribution (%)	2021 Dividend Yield (%)
				2019	2020	2021		
CN	BCHINA	A1/A/A	11.3	31.1	32.1	31.6	4.8	6.4
	ICBC	A1/A/A	13.3	30.4	30.8	30.9	3.9	6.1
	CCB	A1/A/A	13.4	30.4	30.7	30.5	4.1	6.0
EU	BACR	A1/A/A+	13.6	21.2	11.4	7.9	6.8	3.9
	BNP	Aa3/A+/A+	12.2	0.0	22.2	54.2	6.0	8.0
	CS	Baa2/BBB/BBB	13.5	19.8	9.0	0.0	6.6	2.5
	DB	A2/A-/BBB+	13.0	0.0	0.0	21.3	6.1	2.4
	HSBC	A3/A-/A+	13.6	101.6	0.0	40.3	6.1	3.0
	INTNED	Baa1/A-/A+	14.7	56.2	18.8	33.5	5.3	6.4
	SOCGEN	A1/A/A-	12.9	0.0	0.0	27.2	6.7	7.5
	STANLN	A3/BBB+/A	13.9	12.0	86.2	19.3	6.0	1.7
	UBS	A3/A-/A+	14.2	61.3	20.0	22.8	5.4	8.0

Note: AGRBK does not have any AT1 issuance.

High likelihood of AT1s being called on the first call dates

We expect Chinese banks, especially G-SIBs, will continue to call their AT1s on the first call dates. So far, all China AT1s, including those issued by non G-SIBs, were called on their first call dates (see Table 5 below).

Our confidence on AT1s being called on the first call dates is also predicated on Huarong's calls (in Sep'21 and Jan'22) on 2 perps totaled USD2bn when Huarong was in mid of financial distress and recapitalization. In 1H22, Huarong posted a net loss of RMB18.9bn, mainly due to unrealized fair value loss of RMB8.8bn on financial assets and credit impairment loss of RMB17.4bn. That said, it announced the call of another perps (HRINTH 4 Perps, o/s USD700mn) on 29 Sep'22 ahead of its first call date on 7 Nov'22.

Table 5: Summary of call history of China offshore AT1s

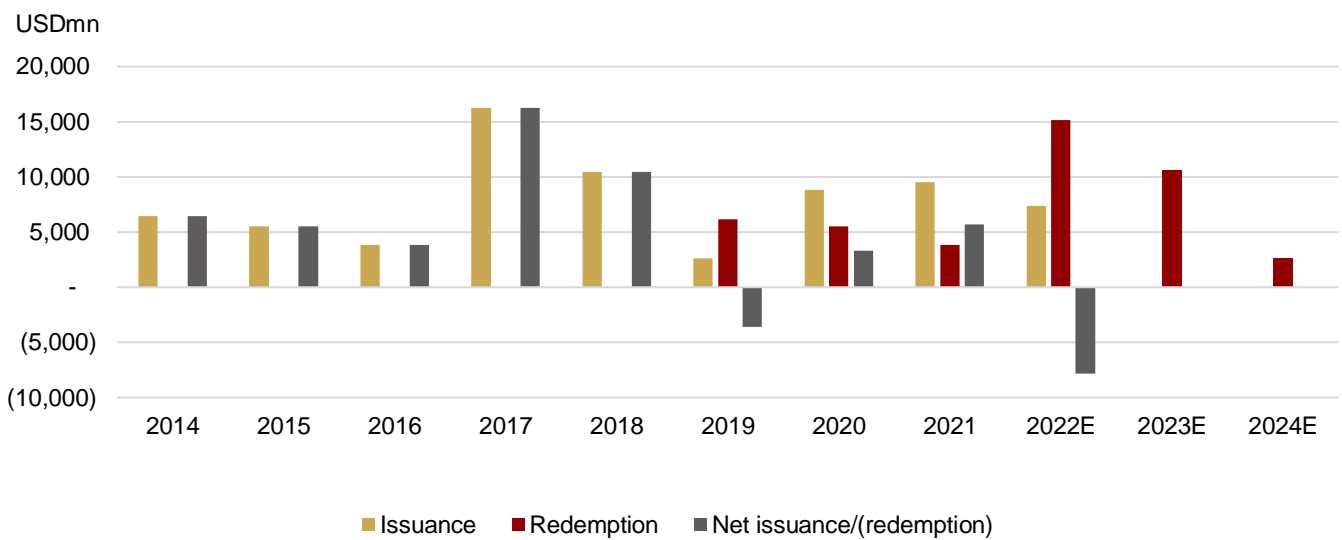
	Issue Date	Called Date	Coupon reset
CINDBK 7.25 PERP	4/22/2014	4/22/2019	5yUST+5.627%
ICBCAS 6 PERP	12/10/2014	12/10/2019	5yUST+4.382%
BOCOM 5 PERP	7/29/2015	7/29/2020	5yUST+3.344%
CCB 4.65 PERP	12/16/2015	12/16/2020	5yUST+2.974%
ICBCAS 4.25 PERP	7/21/2016	7/21/2021	5yUST+3.135%
CINDBK 4.25 PERP	10/11/2016	10/11/2021	5yUST+3.107%
HSBANK 5.5 PERP	11/10/2016	11/10/2021	5yUST+4.231%
CHIMIN 4.95 PERP	12/14/2016	12/14/2021	5yUST+3.147%
ZHESHG 5.45 PERP	3/29/2017	3/29/2022	5yUST+3.517%
CIMWLB 5.2 PERP	4/27/2017	4/28/2022	5yUST+3.130%
QDBANK 5.5 PERP	9/19/2017	9/19/2022	5yUST+3.761%
POSABK 4.5 PERP	9/27/2017	9/27/2022	5yUST+2.634%

.... hence, the average tenor of Chinese AT1s is shorter

For the sake of discussions, we did some number crunching based on Bloomberg data, we found that the average tenor (from issuance to call redemption) of EU banks and EU G-SIBs is 8.8 and 7.8 years, respectively, compared with 5 years of that of China.

Offshore AT1 issuance should be limited

Chart 5: Offshore AT1 issuance and redemption



Note: 2022E's redemption and net redemption include the anticipated redemption of USD4.38bn in 4Q22. 2023E and 2024E reflect potential redemption in 2023 and 2024 based on call dates. The chart includes the offshore AT1s issued and redeemed by all China banks and its subsidiaries.

Due to the sharp interest rate hike, we expect the USD4.38bn outstanding AT1s with first call date in 4Q22 to be called, and hence, we should see a net redemption in China AT1 space for 2022. We also believe that the incentive for Chinese banks to replenish its capital offshore to dwindle, facing RMB depreciation, weak offshore market sentiment and sustained slowing down in outbound investments of Chinese corporations over the coming 1-2 years.

Yield differential over senior bonds off the recent lows

As shown in Chart 6 and 7, the yield differential between BCHINA 3.6 PERP and ICBCAS 3.58 PERP and their respective senior bonds with similar tenor had trended downward until the recent lows of 18.4bps and 35.2bps, respectively. At current levels, BCHINA 3.6 PERP and ICBCAS 3.58 PERP are trading at YTC of 5.5% and 5.4%, representing yield pick-up of 98.2bps and 80.9bps over their senior bonds with similar

tenor. We consider BCHINA 3.6 PERP and ICBCAS 3.58 PERP decent yield pick-up trades over their senior bonds, and the recent price movements offer better entry opportunities.

Chart 6: BCHINA 3.6 PERP

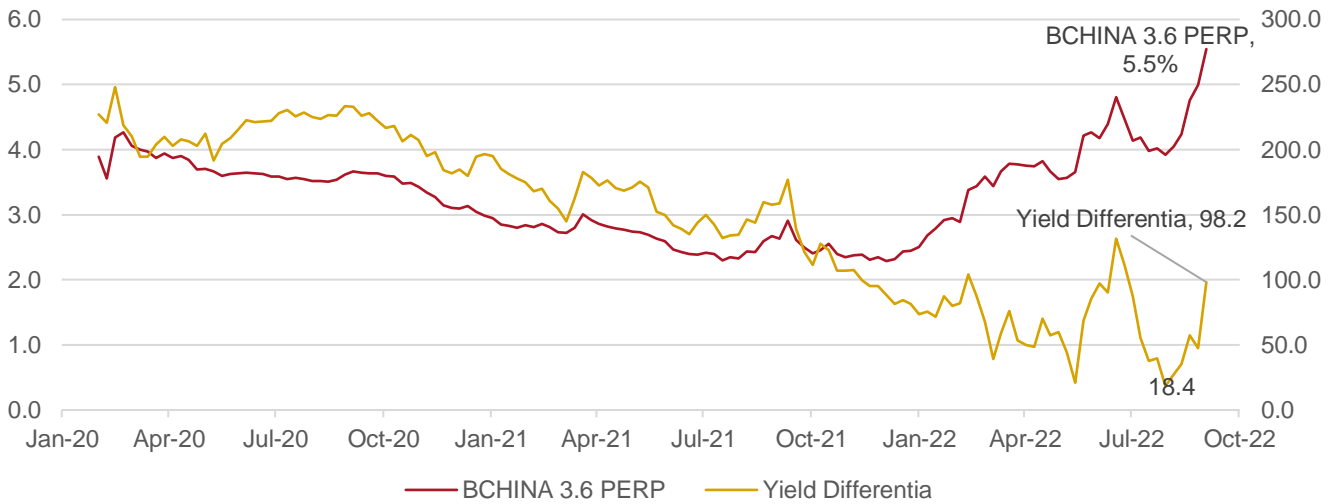


Chart 7: ICBCAS 3.58 PERP



Note: Left axis (%): Yields of AT1 pick; Right axis (bps): Our pick differential with its senior unsecured bonds. Source: Bloomberg

Appendix 1: Credit highlights of our picks

Prefer BOC for its diversified exposures

BOC's asset quality remains stable in 1H22 amid macroeconomic headwinds. The bank's real estate loan only accounted for 5.24% of its Chinese mainland loan book at Jun'22, lower than that of ICBC and ABC. The real estate NPL ratio increased probably due to property liquidity crisis, up 0.6% from Dec'21 to 5.67% in Jun'22, similar to the level of ICBC's.

Residential mortgages NPL ratio also increased, up 9bps to 0.36% in Jun'22. The bank's mortgage portfolio is quite sizeable, 31.1% of Chinese mainland loan book, yet we see the risk is manageable with government-directed effort in supporting the home delivery projects. The spillover effect from the liquidity stress in property market to the bank is limited, in our view.

The overall NPL ratio stood at 1.34% at Jun'22, just 1bp up from Dec'21, remains the lowest among China G-SIBs. BOC's exposure towards the sectors more heavily affected by resurgent of pandemic (such as wholesale and retail trade, catering, and manufacturing) also lower than that of peers. The bank's capital adequacy is well above the regulatory minimum with CET1/Tier1/CAR ratios at 11.33%/13.63%/16.99% in Jun'22, up slightly compared to the levels in Dec'21.

BOC also compares favorably with its peers in terms of its boarder geographical presence. BOCHK, one of the most important offshore subsidiary of BOC, is the second largest bank in Hong Kong by total assets, and it operates a significant network in SEA.

The capital buffer of ICBC is the highest among China G-SIBs

In line with the industry trend, the bank's net interest margin dropped to 2.03% in Jun'22 from 2.11%. Despite the decline in NIM, the bank's CET1/Tier1/CAR ratios increased, at 13.29%/14.90%/18.31% in Jun'22, highest among its China G-SIBs peers. This is mainly due to the slower than total assets growth in risk-weighted assets, and it is also a sign of the bank's more prudent risk appetite in 1H22.

ICBC's NPL ratio at 1.41% is largely stable compared to Dec'21, and is comparable with CCB and ABC. The bank reduced the exposures towards real estate sector in 1H22; corporate side dropped to 5.9% of total loan book in Jun'22 from 6.5% in Dec'21, while residential mortgages to 28.9% from 30.8%.

On the other hand, the bank increased exposures to manufacturing and leasing and commercial services during 1H22, the asset quality of these industries are more hinge on the government policy direction in dealing with the COVID-19. Nonetheless, ICBC is well capitalized to sail through the property storm and the pandemic.

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