

Gauging China's banking sector risk: a new approach

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China's economy has been under unprecedented pressure over the past couple of years. COVID lockdowns left many firms struggling to stay afloat, while the housing market slump severely undermined the ability of many builders to service their debt.

Investors routinely ask what these problems mean for banking sector risk. Specifically, might some banks find it increasingly difficult to meet their obligations and potentially even default?

Assessing the true scale of risk among China's banks and whether it is rising or declining has traditionally been a difficult task. Official nonperforming loan (NPL) data have never been a fair representation of bank asset quality. Moreover, while domestic lenders are backed by the state in some form, only a small handful are backed by the central government. Most get support from local authorities, some of which are less able to ensure their banks remain solvent than others – which further complicates efforts to assess risk.

Somewhat counter-intuitively, we believe that banking sector risk declined in 2022. Our conclusion is based on an unconventional approach – analyzing changes in coupon rates on negotiable certificates of deposit (NCDs) issued by banks. Rather than try to measure risk based on banks' balance sheets, we looked at how banks gauge the risk of lending to each other.

NCDs are short-term bond-like securities with maturities of 1 to 12 months that banks sell in the interbank market. Although the interbank market includes insurance companies, trust companies, and other financial institutions, it's dominated by the banks. Hence, the yield on NCDs primarily reflects the price at which banks are willing to lend to each other.

Banks typically issue NCDs to secure liquidity for periods longer than what's on offer in the repo market. However, unlike repo transactions, NCDs are unsecured – if a borrower defaults, investors don't have recourse to collateral. Instead, they risk having to take a haircut on their investment. That risk is reflected in the coupon rate.

We have no way of knowing how the interbank market collectively determines whether a bank is becoming more or less risky, but it has a proven track record of identifying changes in risk early. NCD price moves signaled problems at Baoshang Bank well in advance of its May 2019 takeover by financial regulators. Since then, banks with particularly high NCD coupons have been involved in state-directed mergers or restructuring.

We calculated the spread of 12-month NCDs above our approximation of the risk-free rate from 2014, when banks first started issuing NCDs, to mid-January 2023.¹ We then used changes in those spreads to draw conclusions about banking system risk.

1 The risk-free rate is the rate at which the market is willing to purchase the debt of institutions that have zero-chance of defaulting. However, China's risk-free financial institutions – the central bank and three policy banks – don't issue NCDs. Instead, we came up with an approximation of the risk-free rate using the coupon rates of NCDs issued by banks with a near-zero chance of default – specifically, China's big six state-owned commercial banks (SOCBs). We also found that most joint stock banks (JSBs) issue NCDs at near identical rates to the SOCBs. Consequently, our approximation of the risk free rate is the monthly average of 12-month NCDs issued by the SOCBs and nine of the 12 JSBs.

We found that for AAA-rated banks that were already perceived by their peers as low risk – basically the majority of China biggest 80 banks who account for about 80% of total banking assets – the spread on their NCDs remained stable against the risk-free rate throughout 2022. However, since May 2019, when Baoshang Bank was taken over, a small number of AAA-rated banks have had to price their NCDs at a significant premium to their peers, a sign that the market perceived them as being increasingly risky. Our analysis found most of those banks saw their NCD spreads narrow in 2022.

On the whole, our calculations reflect greater willingness among Chinese banks to lend to their riskiest peers in 2022, which we interpret as a decline in perceived risk. We believe the overall improvement in the interbank market's perception of bank risk is due to the authorities having identified risky banks and worked to strengthen their balance sheets.

In only one case – that of the Bank of Langfang – did we identify a material widening of NCD spreads in 2022. That change is likely linked to the crisis in the property sector.

We believe that the NCD market gives us unparalleled insight into whether the risks in China's banking system are rising or falling, thereby helping us better anticipate policy changes and identify weaker banks that may require a bailout from the authorities.

A paucity of data

It's been a tough couple of years for China's economy. Service sector firms have struggled under draconian lockdown policies aimed at containing the spread of COVID-19. Meanwhile, state-led efforts to reduce debt levels among property developers have resulted in dozens of defaults.

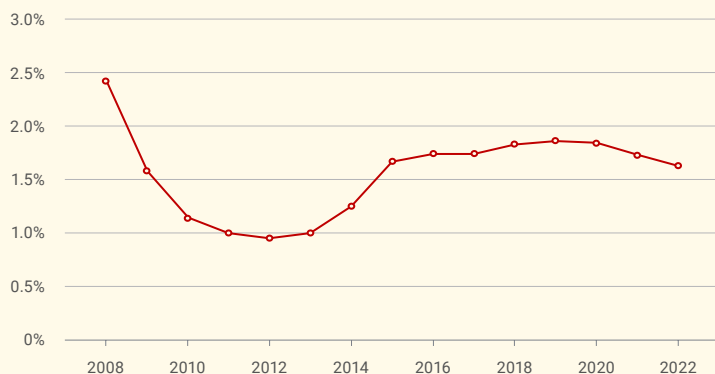
The impact of all of this stress on banks, however, is unclear. It would be reasonable to assume that the quality of banks' assets has deteriorated. But given the unreliability of NPL data it's difficult to accurately gauge the scale of the deterioration, assess whether some banks may require large bailouts, and determine whether market confidence may potentially be shaken.

China's official NPL data suggest that there's nothing to worry about – the overall NPL ratio of the banking sector has, perhaps surprisingly, declined throughout the pandemic [Fig. 1]. But the official data don't capture the full extent of banks' soured assets. Since 2021, regulators have encouraged banks to exercise forbearance in their treatment of the NPLs of small firms, and last year they permitted forbearance on some loans to property developers.

Even without the recent policies explicitly permitting the non-recognition of bad loans, China's official NPL data have never been a fair reflection of the state of banks' distressed debt. At various times lenders have deployed a range of tricks to hide bad assets, thereby reducing the amount of capital they need and lessening the pressure on profits. Currently, banks often don't recognize a loan as being distressed if it is fully backed by collateral. Without reliable NPL data it's impossible to determine whether banks are adequately capitalized or have made sufficient provisions against their bad assets.

Fig. 1 – The banking sector's NPL ratio has remained low for years

NPLs as a share of total outstanding loans



Source: CBIRC, Trivium

However, even if the data were reliable, they would nonetheless give us little insight into financial sector stability because this is only partly based on the health of banks' balance sheets. It is also determined by the willingness and ability of the state to ensure they remain solvent.

The role of the state

In the US, the authorities typically only intervene when a bank is on the brink of collapse, at which point the Federal Deposit Insurance Corporation (FDIC) gets involved. The role of the FDIC is to protect depositors and ensure financial stability, not to rescue the bank, which will typically be restructured and sold to a peer. Occasionally, the US government will rescue a financial institution considered too-big-to-fail – either using state resources or by cajoling private sector firms – in the interests of preserving financial sector stability, but such interventions are rare.

In China, the state, in one form or another, intervenes far earlier. The central government, through the central bank, will step in when large regional banks are on the brink of collapse (as it did with Inner Mongolia's Baoshang Bank and Shandong's Hengfeng Bank).

But increasingly the burden of ensuring that a bank is adequately capitalized falls on lower-level governments, either at provincial, city, or county level. That's because local banks are closely tied to the local political economy. Local authorities derive significant amounts of tax revenue from banks in their jurisdiction and exert significant influence over how they deploy their resources, regardless of whether a lender is controlled by state shareholders. Consequently, problems with local banks usually stem from local political decisions or a failure of local oversight.

Local authorities typically get involved when a bank needs to raise capital but is struggling to do so from the private sector, which in recent years has played only a marginal role in replenishing bank capital. That's partly because banks can only sell new equity at or above their net asset value (NAV) per share – and most banks' shares are worth less

than their NAV, which means the only feasible buyer is the state. As a result, local governments have mobilized local state-owned enterprises and financial institutions, local government financing vehicles, and even government finance bureaus to recapitalize weak banks by buying new equity (see our report from October 29, 2020, "[China's state-led banking sector recap is hitting serious speed bumps](#)").

However, given mounting pressure on local government finances, many authorities have found it increasingly difficult to come up with funding. To ease their burden, the Ministry of Finance (MOF) has, since 2020, issued an annual quota of special purpose bonds (SPBs) that local governments can use to raise funds for replenishing bank capital.

Not all local authorities are equally capable of ensuring the viability of their financial institutions. So, how do we gauge financial sector risk when it's determined not only by the financial health of the banks themselves, but the likelihood that their state sponsor can guarantee a bank's ability to honor its debts?

We posit that the pricing of banks' NCDs provides unique insight into both.

A track record of flagging risk

Starting with Baoshang Bank, NCDs have, over the past few years, repeatedly provided early warning of distress at banks that were eventually restructured.

Baoshang was an AAA-rated city commercial bank based in Inner Mongolia in northern China. In May 2019, the People's Bank of China (PBoC) and the China Banking and Insurance Regulatory Commission (CBIRC) took the lender into conservatorship.

Although the move came as a surprise to most outside observers, the banking sector was already well aware of Baoshang's problems. In August 2018, 10 months before the takeover, investors in China's interbank market started demanding significantly higher coupon rates on NCDs issued by Baoshang – far higher than any other AAA-rated city commercial bank. Its coupon rates came down a little by the time of the takeover but were still way above its peers [Fig. 2].

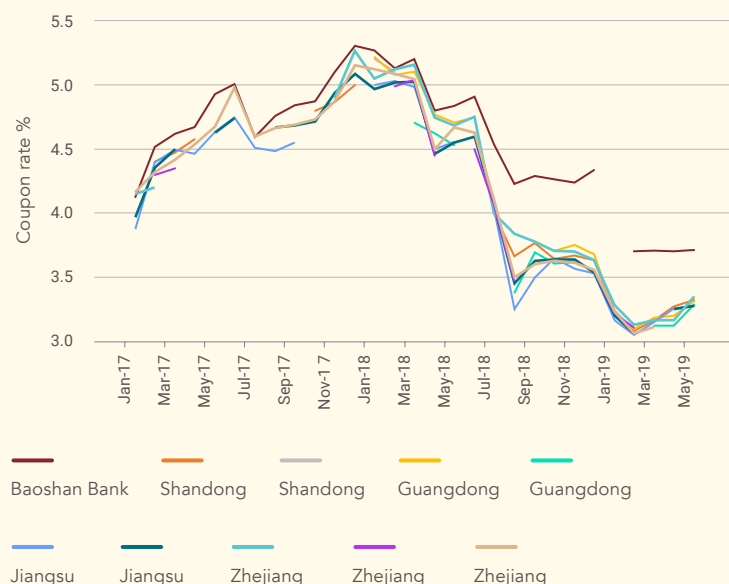
The NCD market not only recognized that there was something wrong with Baoshang almost a year before its takeover, but also recognized that the implicit backing of the Inner Mongolia authorities might be inadequate. Consequently, investors demanded a premium for purchasing the bank's debt.²

² The NCD market's track record of identifying other instances of bank distress around the same time is less clear cut. In December 2019, the central and Shandong-provincial governments launched a RMB 100 billion bailout of Shandong-based Hengfeng Bank. Since mid-2017, when Hengfeng issued its first NCD, the interbank market had demanded higher coupon rates than for other joint stock banks (JSBs). The premium was fairly small, but as a JSB Hengfeng should have been one of China's safest banks.

But by then, the problems at Hengfeng were already well documented. In late 2016, Caixin ran a detailed expose on corruption at the lender, alleging its chairman had surreptitiously taken control of the bank through a web of complex shareholdings. Still, the divergence in NCD pricing between Hengfeng and its peers signaled that the interbank market doubted Hengfeng's problems posed a potential risk to NCD investors.

Fig. 2 – NCDs flagged problems at Baoshang well before its takeover

Coupon rate on Baoshang Bank 12-month NCDs compared with AAA-rated banks from Zhejiang, Jiangsu, and Shandong in the year before the takeover



Source: Wind, Trivium

The Baoshang takeover permanently changed the way investors price risk for NCDs, the primary instrument for unsecured lending between banks. In a major departure from earlier bank bailouts, regulators forced some of Baoshang's creditors to accept haircuts. Very little is known about the exact size of those haircuts, but Bank of Gansu disclosed that authorities guaranteed only 90.7% of what it had lent. By forcing creditors to accept losses, regulators shattered the long-held assumption that the state would fully back the liabilities of all banks. Henceforth, if a bank made an unsecured loan to another bank, there was a risk – however small – that it might not be repaid in full.

Consequently, since the Baoshang takeover, the NCD market has become a reliable barometer of risk. The premium investors demand to buy NCDs from risky banks spiked relative to their peers and has remained high. Our research suggests that the higher coupon rate reflects the risk of a potential haircut.

Bailouts and mergers

There haven't been any formal bank takeovers by the authorities since Baoshang. However, since May 2019, widening spreads on NCD coupon rates have signaled problems at one bank that was eventually bailed out, and at a number of small banks that were eventually merged or taken over by a peer.

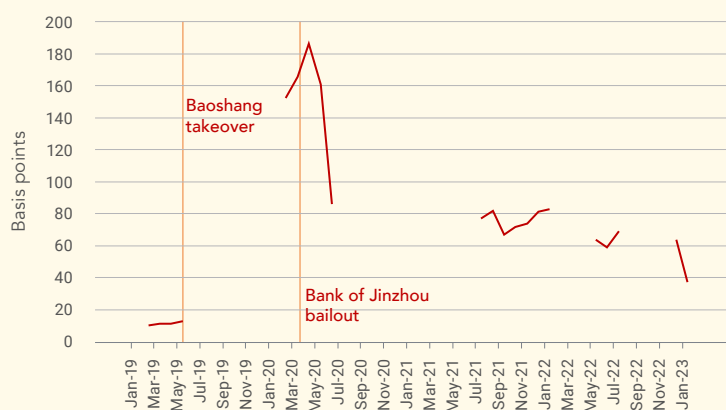
The bailout

In March 2020, the PBoC launched a bailout of Bank of Jinzhou, a CCB based in Liaoning province. That was the second attempt by authorities to stabilize the lender. In July 2019, authorities had tried to shore up the bank when two financial institutions owned by the central government – ICBC and Cinda – took an 18% stake.

At the time of Baoshang's takeover, Bank of Jinzhou's 12-month NCDs were priced in line with most other AAA-rated CCBs, thereby offering no indication that the bank was having difficulties (Jinzhou issued 12-month NCDs in February, March, April, and May with a spread of 11-12 bps above the risk-free rate). It didn't issue another 12-month NCD until February 2020, only weeks before the PBoC bailout. However, the coupon on the February NCDs were issued at a whopping 150 bps premium above the risk-free rate – the single ever biggest spread on NCDs issued by an AAA-rated bank – in what was a clear sign that the market believed Jinzhou to be in serious trouble [Fig. 3].

Fig. 3 – The spread on Bank of Jinzhou NCDs widened significantly immediately before its bailout

Spread on Bank of Jinzhou 12-month NCDs



Source: Wind, Trivium

The mergers

Henan province:

In H1 2022, Zhongyuan Bank took over three Henan-based city commercial banks: Bank of Jiaozuo China Travel Services (CTS), Luoyang Bank, and Pingdingshan Bank. The coupon on NCDs issued by Bank of Jiaozuo CTS and Pingdingshan Bank spiked after the Baoshang takeover. Up until the merger, the spread between both banks' coupon rates and those on 12-month NCDs issued by the safest banks had been among the widest of all issuers (Both Jiaozuo and Pingdingshan were rated AA). The coupon on AA+ rated Luoyang Bank's NCDs was lower than the other two, but still higher than most AA+ rated banks. [Fig. 4.1]

Sichuan province:

In September 2020, regulators approved the creation of a new bank – the Bank of Sichuan – from the merger of Panzhihua City Commercial

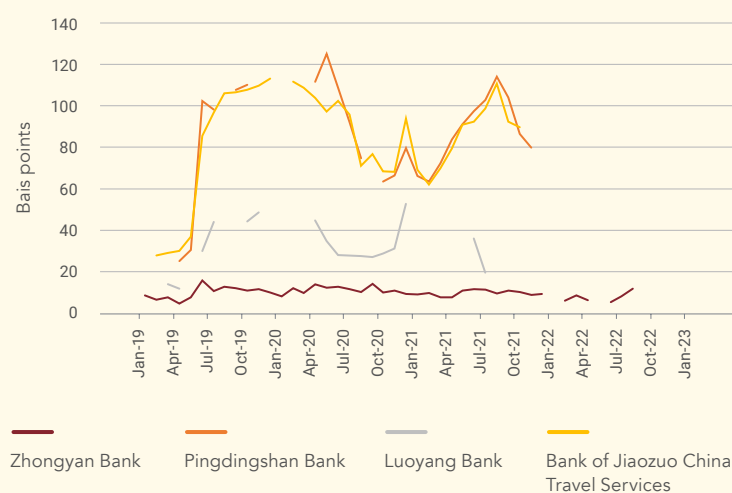
Bank and Liangshan Prefectural Commercial Bank. The spread on Panzhihua's 12-month NCD coupons above our risk-free rate spiked to almost 120 bps – higher than almost any other bank – following Baoshang's takeover. It hasn't issued 12-month NCDs since.

Shanxi province:

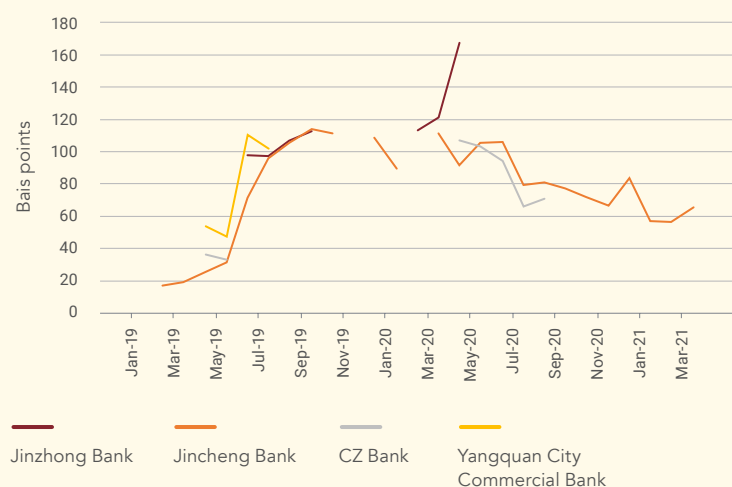
In August 2020, the merger of five Shanxi province-based city commercial banks – Jincheng Bank, Yangquan City Commercial Bank, Jinzhong Bank, CZ Bank, and Datong Bank – was announced. Datong hasn't issued 12-month NCDs, but the coupon spreads of the other four spiked after the Baoshang takeover and remained high until their merger to form Bank of Shanxi. [Fig. 4.2]

Fig. 4 – Banks with exceptionally wide spreads have been targets for provincial mergers

4.1 Spread on 12-month NCD coupons of three banks before Zhongyuan Bank's takeover



4.2 Spread on banks' 12-month NCD coupons before merging to form Bank of Shanxi



Source: Wind, Trivium

Our methodology

Using Wind Financial's database of 180,000 NCDs issued since 2014, we set out to determine what the NCD market can tell us about financial sector risk and how it changed in 2022.

We narrowed our dataset to the 12-month tenor because it is the most commonly issued maturity. It is also the longest maturity and so consideration of default risk plays a greater role in pricing.

We then calculated an approximate risk-free rate for NCDs – i.e. the rate at which risk-free financial institutions issue NCDs – to use as a baseline against which to calculate the spread of all other issuers. Risk-free institutions – like policy banks – don't issue NCDs so we used NCDs issued by institutions with the lowest risk, namely China's six state-owned commercial banks (SOCBs) (ICBC, China Construction Bank, Agricultural Bank of China, Bank of China, China Postal Savings Bank, and Bank of Communications). We also found that most joint stock banks issued NCDs at near identical coupon rates as the SOCBs.

We then calculated our baseline risk-free proxy using the average monthly coupon rate on 12-month NCDs issued by the six SOCBs and nine of the 12 JSBs [Fig. 5]. We excluded three JSBs from our calculation: Zheshang Bank, Hengfeng Bank, and Bohai Bank. All three have consistently issued NCDs with a coupon rate in a range of 10 to 20 basis points (bps) higher than their peers.

Fig. 5 – The risk-free rate

The average coupon rate on 12-months NCDs issued by the six SOCBs and nine of the 12 JSBs



Source: Wind, Trivium

Having established a monthly average of the coupon rate at which China's safest banks were able to issue 12-month NCDs, we then calculated the spread above this base rate for all other banks who issued NCDs. We used the spread as a gauge of risk. When a borrower is perceived as risky, lenders typically demand a higher interest rate as compensation. Hence, it is fair to assume that banks issuing NCDs at higher coupon rates than their peers – that is, at a wider spread – are considered riskier by interbank market investors.

The sample

Hundreds of banks have issued NCDs, but most are small and rated lower than AAA. Individually, their health is irrelevant to the stability of the financial system. Their issuance is more sporadic and some have stopped issuing altogether. Consequently, we narrowed our analysis to focus on AAA-rated banks – 77 in total. AAA-rated CCBs and RCBs are typically the biggest local banks in each province and so are likely to receive the most support from local authorities. Consequently, we believe our sample is sufficiently large to allow us to draw conclusions about the overall stability of the banking sector.

Breakdown of the 77 banks:

- The six SOCBs and 12 JSBs are all AAA-rated.
- The remaining 59 are city commercial banks (CCBs) and rural commercial banks (RCBs).³
- Of China's 31 provinces, 26 have an AAA-rated city or rural commercial bank.
- All but two lenders in our sample are among China's biggest 80 banks⁴ that together account for about 80% of total banking assets.

Given that all the SOCBs and most of the JSBs issue NCDs at the lowest possible coupon rate, our analysis is focused on the CCBs and RCBs.

We found that since the takeover of Baoshang Bank in May 2019:

- Most AAA-rated CCBs and RCBs pay almost identical coupon rates on their 12-month NCDs.
- Of the 59 CCBs and RCBs, 45 typically issue 12-month NCDs within a spread of 20 bps [Fig. 6].
- On occasion the spread of some of the 45 banks moved a little higher, but deviations have been small and short-lived.

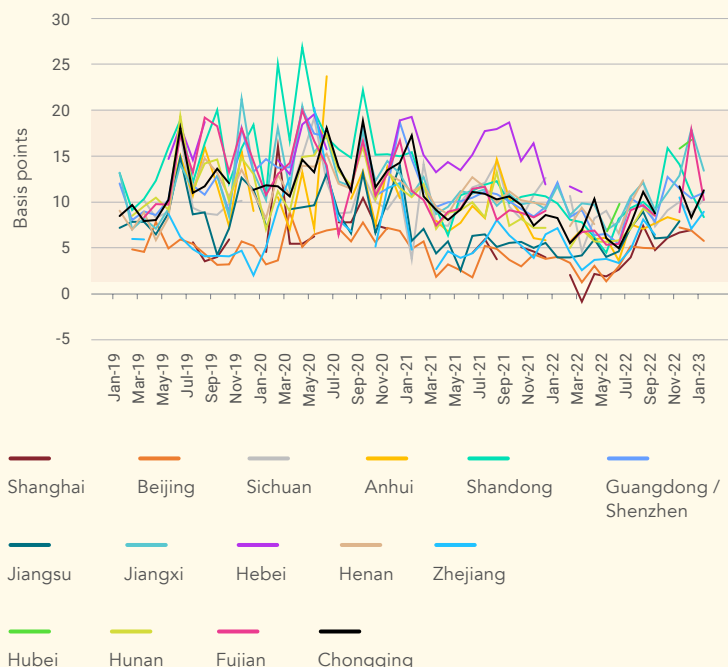
In short, the interbank market perceives no material variation in risk between those 45 banks despite differences in their clientele, capitalization, asset mix, funding structure, and most importantly, location.

³ We have treated Baoshang Bank and its restructured successor, Mengshang Bank, as one bank. We have also treated Huarong Xiangjiang Bank and its successor, Bank of Hunan, as one bank.

⁴ Based on the list of China's 100 strongest banks published by the China Banking Association in 2022. The ranking is based on capital.

Fig. 6 – Average spreads of 45 CCBs and RCBs grouped by province that have mostly traded in line with each other since 2019

Coupon spread on 12-month NCDs of most AAA-rated banks is usually within 20 bps of the risk-free rate



Source: Wind, Trivium

Location, location, location

However, location does matter to the market when it comes to 14 of the other 15 AAA-rated CCBs and RCBs. The province or municipality where the lender is based seems to be a key factor in determining its coupon rates. The coupon rates for this group have at times been significantly higher than their peers [Fig. 7]. Most saw their spreads widen immediately after the takeover of Baoshang.

(For the remaining bank – Huarong Xiangjiang Bank – the location factor does not apply. Its spreads widened suddenly in mid-2021 in response to problems at its state-owned parent company, China Huarong Asset Management Co. The bank has since been spun off and is now call Bank of Hunan. The spreads on its 12-month NCDs are gradually converging with most other CCBs and RCBs.)

Excluding Huarong Xiangjiang, which we regard as an outlier, the 14 banks are located in eight provinces (or provincial level municipalities). Five of the provinces have multiple AAA-rated banks – Liaoning has three, and Tianjin, Guangxi, Guizhou, and Shanxi have two each – and since mid-2019 they have all mostly issued 12-month NCDs at higher coupon rates than their CCB and RCB peers. (Note that Bank of Shanxi data start from 2021 when it was created.)

Fig. 7 – NCD spreads of banks in eight provinces widened after Baoshang Bank takeover

Location of AAA-rated banks that issued 12-month NCDs at a spread wider than their AAA-rated peers immediately following the Baoshang takeover

Province	Triple-A rate CCBs and RCBs
Liaoning	Bank of Dalian, Bank of Jinzhou, Shengjing Bank
Tianjin	Tianjin Rural Commercial Bank, Bank of Tianjin
Guizhou	Bank of Guizhou, Bank of Guiyang
Gansu	Bank of Gansu
Heilongjiang	Harbin Bank
Jilin	Bank of Jilin
Guangxi	Guangxi Beibu Gulf Bank, Bank of Guilin
Shanxi	Jinshang Bank, Bank of Shanxi

Note: For the sake of simplicity we refer to Tianjin – a municipality which is treated as a province for administrative purposes – as a province.

Note: Most of these banks still issue NCDs with a wider spread than their peers. However, in H2 2020 the spreads for Bank of Tianjin and Jinshang Bank declined and now align with most other AAA-rated CCBs and RCBs.

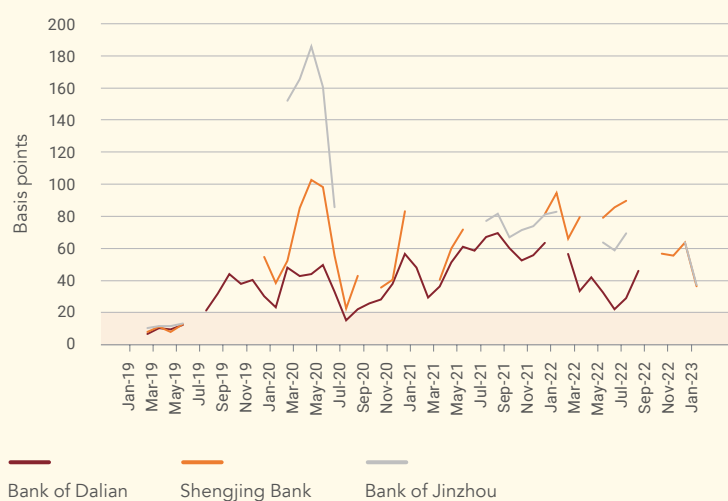
Source: Wind, Trivium

NCD pricing – bringing it all together

NCD pricing suggests that since May 2019, interbank market investors perceive default risk to be binary, that is a bank can either expect a bailout from local authorities with full certainty, or there is at least some doubt about whether local authorities can be relied upon to muster the necessary resources. Banks that can expect adequate government support pay a similar yield on their NCDs. For those that can't, they have to pay a premium which varies between banks in the same province based on the relative health of the issuer. For example, in Liaoning province, Bank of Jinzhou pays a higher premium than Shengjing Bank (which was downgraded from AAA to AA+ in 2021), and they both pay more than Bank of Dalian [Fig. 8].

Fig. 8 – All three AAA-rated CCBs in Liaoning are riskier than most of their peers

Coupon spread on 12-month NCDs issued by Liaoning CCBs



Note: Red shaded area is the range in which low-risk AAA-rated CCBs and RCMs typically issue NCDs.

Source: Wind, Trivium

The ability of a provincial government to backstop its banks seems to be linked to the region's economic strength. The provinces where banks pay a premium on their NCDs are among those with the weakest economies and often have high levels of government debt. In February 2023, credit rating agency Fitch Ratings published a report in which it listed 10 provinces that it believes will have trouble supporting their local government financing vehicles (LGFVs). Fitch's list includes Heilongjiang, Jilin, Liaoning, Guangxi, Guizhou, Gansu, and Tianjin, all of which are on our list of provinces with banks whose NCD coupons have wide spreads. It also includes Yunnan, Qinghai, and Ningxia, three provinces that don't have AAA-rated banks.

Shanxi province wasn't on Fitch's list. However, as we noted in Fig. 5, Jinshang Bank – Shanxi's longest standing AAA-rated bank – has seen its spreads narrow over the last few years, so much so that they've now aligned with most of their CCB and RCB peers. Moreover, newly created Bank of Shanxi issues NCDs with spreads only slightly wider than Jinshang's [Fig. 9]. It's reasonable to assume that improving sentiment toward Shanxi banks is linked to the fact that the province is one of China's top coal-producing regions and strong demand has boosted provincial fiscal revenue.

Fig. 9 – Shanxi's best banks are perceived as being of comparable risk to most of their CCB and RCB peers

Spreads on 12-month NCDs issued by Shanxi's AAA-rated banks



Note: Red shaded area is the range in which low-risk AAA-rated CCBs and RCBs typically issue NCDs.

Source: Wind, Trivium

Did risk rise or fall in 2022?

For most AAA-rated CCBs and RCBs, we found that there was no material change in the spread on their coupon rates in 2022.

However, for most of the riskiest banks in our sample, spreads narrowed, signaling that their peers perceived that the risk of default had diminished. Most notably, Bank of Jilin's spread narrowed significantly in 2022. Guangxi Beibu Gulf Bank, Guilin Bank, Bank of Dalian, and Bank of Gansu saw smaller but nonetheless significant declines [Fig. 10].

This doesn't reflect an improvement in local government finances – problematic banks still trade at a premium to their peers, which wouldn't be the case if the market had confidence that local authorities had the resources to guarantee the liabilities of large banks in their province. Rather, we believe it reflects authorities' concerted efforts to strengthen the balance sheets of risky banks through recapitalization, aggressive NPL disposals, and the winding back of off-balance sheet risks.

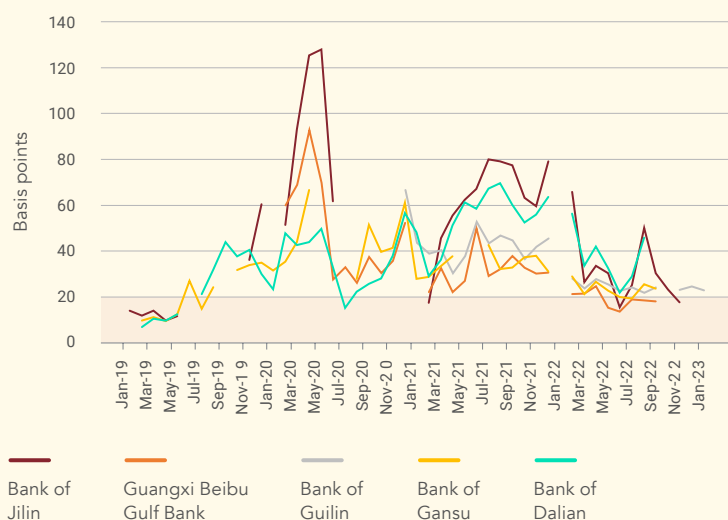
Mergers and restructurings also appear to have prompted NCD buyers to view the banking system as a whole as a safer investment. In 2022, Baoshang's successor – Mengshang Bank – was able to issue NCDs at a much lower coupon rate. In November it issued 12-month NCDs with a 25 bps spread above the risk free rate, a slight premium to its AAA-rated peers.

After its creation from the merger of lower rated, high-spread banks, Bank of Shanxi issued 12-month NCDs in November 2022 with a spread of 19 bps, in line with its low-risk peers. Bank of Sichuan has issued NCDs in line with other AAA-rated CCBs and RCBs.

Hengfeng Bank still issues NCDs at a premium to most other joint stock banks, but the premium has declined. The spread on 12-month NCDs was only 5bps in January 2023, down from 35 bps in November 2019, immediately prior to its bailout.

Fig. 10 – Interbank market perceived banks' default risk to have declined during 2022

Coupon spreads on 12-month NCDs narrowed significantly for some banks



Note: Red shaded area is the range in which low-risk AAA-rated CCBs and RCMs typically issue NCDs.

Source: Wind, Trivium

The outlier - Bank of Langfang

As we noted above, many smaller banks, which have ratings lower than AAA, have stopped issuing NCDs, most notably in Liaoning, where only the province's three AAA-rated banks have issued NCDs since mid-2021. Many of its 11 other city commercial banks had previously been active issuers.

There is only one case where spreads clearly widened over the course of last year – Hebei-based Bank of Langfang. The bank is AA+ rated and so is outside our sample. However, it was China's 82nd largest by capital in 2021 – according to the China Banking Association – and so is comparable in size to some banks in our sample.

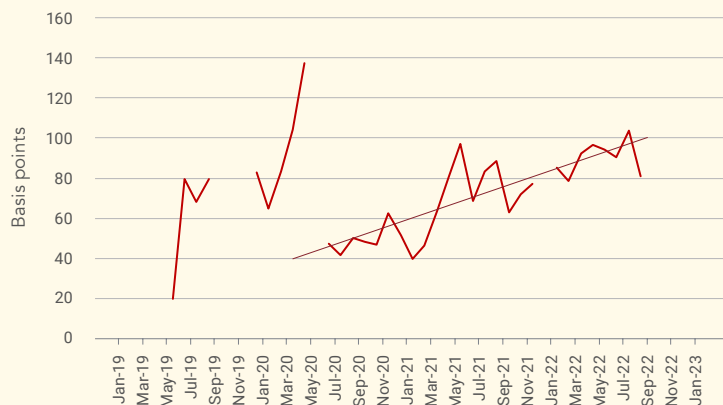
Bank of Langfang

Bank of Langfang's second-largest shareholder is China Fortune Land, a developer headquartered in Langfang city that has been undergoing restructuring since defaulting on its bonds in early 2021. In February that year, the vice governor of Hebei warned that China Fortune's problems posed "a regional systemic risk."

The bank's troubles predate Fortune Land's default – the spread on its NCDs spiked after the takeover of Baoshang Bank. But after a steep decline, the spread roughly doubled in the two years through July 2022, reflecting the problems at Fortune Land [Fig. 11]. Bank of Langfang is the only bank we've identified that has had its NCD pricing adversely affected by the property sector's woes.

Fig. 11 – Coupon spread on Bank of Langfang's 12-month NCDs

Widening spread indicated growing concern over default risk due to lender's links to a property developer



Source: Wind, Trivium

Conclusion

We believe that the best way to gauge changes in banking sector risk is to look at how China's commercial banks price the risk of lending to each other in the NCD market.

Our analysis of the data shows that despite China's worsening economy, banking sector risk declined last year, although the data on their own don't provide insight into what's caused the change in risk or give an indication of the costs involved in containing the risk.

We believe that NCD coupon rate spreads provide us with a valuable tool to track changes in financial sector risk which we can use to assess the success of government policy, anticipate changes in policy, identify banks that are potential targets for state intervention, and detect banks' deteriorating confidence in their peers.