Banks - China

China TLAC: less time left but more needs to be done

Credit Analysis

04 January 2024

Global Emerging Markets | Corporate Credit
Asia | China
Banks

TLAC shortfall: USD316bn/US$780bn by end-2024/27

With the implementation date on 1 Jan. 2025, Chinese banks have one year to raise the total loss-absorbing capacity (TLAC) buffer. We update our TLAC shortfall estimate based on the most updated Global Systemically Important Banks (G-SIBs) list, as well as a faster risk-weighted asset growth witnessed in 2023. The result comes to CNY2.2tn (USD316bn) /CNY5.5tn (USD780bn) by end-2024/27 for the five Chinese banks (the Big 5). Please see Exhibits 1, 2 and 3. This is about 50% higher than our previous estimate, mainly because BOCOM will be added to the G-SIBs list, faster RWA growth and lower capital ratio found in 2023.

USD TLAC bond gross supply: USD15-18bn in 2024

Although the shortfall seems very substantial, we expect to see most of the TLAC bond to be issued in China onshore bond market with cheaper funding cost. The Big 5 also have substantial senior-ranked debt securities outstanding, mainly Certificates of Deposits (CDs), which could be probably replaced by TLAC bonds. We also note that China banks tend to issue new types of instruments in the international market only in the early stage of the implementation. Therefore, in the USD bond market, we expect to see USD15-18bn TLAC bonds from five Chinese banks with G-SIBs tags, which has a maturity of USD13bn for senior bonds. Those senior bonds should be refinanced by TLAC bonds in theory. So, the net supply would be USD2-5bn in total, in our view. Among the major banks, AGRBK has the highest shortfall, followed by CCB.

Credit rating and pricing of new TLAC bonds

We believe the new TLAC bonds from the major banks are likely to be rated as low-A, with the exception of BOCOM at high BBB. It should be generally two notches below that of senior bonds, based on the example of Bank of East Asia (BNKEA) and a Fitch report. In terms of pricing, it is difficult to find effective reference points currently, in our view. Nonetheless, the first deal may be priced at 80-90bp, based on 1) global peers' spread level at 100-120bp; 2) the liquid Chinese tier-2's and senior bonds' trading level of about 80bp and 50bp, respectively; and 3) our assumptions of limited supply of TLAC bonds and strong technical support from Chinese investors for the big Chinese banks.

Updates on the Deposit Insurance Fund

Our TLAC shortfall estimate does not incorporate the Insurance Deposit Fund (the Fund), which could contribute at most 2.5%/3.5% of RWA by end-2024/27, based on the TLAC rules, though the shortfall could be less than 2.5% of the RWA. As of end-2022, the size of the Fund was only CNY55bn (USD7.7bn) vs CNY96bn (USD14bn) at end-2021. This is only 2.4% of the shortfall, as of end-2024. It seems the Fund is unlikely to provide meaningful support for TLAC implementation unless the government has substantial injection into the Fund.

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TLAC shortfall: CNY2.2tn (USD316bn) by end-2024

Our TLAC shortfall estimate is based on the capital adequacy ratio (CAR) at end-Sept. 2023, the TLAC and Basel III requirement of the Big 5, and the assumption of RWA growth based on the compound growth rate from 2017 to 2022, though the first 10 months in 2023 witnessed a higher-than-before growth rate. At end-Sept. 2023, the RWA base needs TLAC coverage is about CNY96tn (USD13.6tn), up 22% YTD, mainly due to the newly added BOCOM into G-SIBs list. While the average CAR decreased about 0.4ppt to about 17% YTD, mainly due the fast growth of the loan book in 2023. The shortfall estimate based on the simple calculation is CNY2.2tn (USD316bn) /CNY5.5tn (USD780bn) by end-2024/27. For more details on single banks, see Exhibits 1 and 2. Our estimate for 2024 is roughly in line with the S&P's estimate but higher than Fitch as it considers a three-year phase-in period of BOCOM. And the variation would be higher for the estimate in 2027, mainly because of the RWA growth rate assumption. (Exhibit 3).

Exhibit 1: TLAC capital shortfall of Chinese banks (I)

The huge RWA base is the key driver of a significant amount of debt instrument needed. While, we think the new capital rule in 2024 could increase the capital ratio by 0.5ppt. Please see our report here: China's new capital rule: Moderately positive for the Big 5 banks.

In CNY bn	CAR as of end-Sep'23	The G-SIB capital buffer	Capital Conservation Buffer	TLAC buffer by end 2024	Total buffer required	Shortfall vs RWA	Shortfall assuming the new capital rule add 0.5ppt.
AGRBK	16.6%	1.5%	2.5%	16.0%	20.0%	3.4%	2.9%
BCHINA	17.3%	1.5%	2.5%	16.0%	20.0%	2.7%	2.2%
CCB	17.6%	1.5%	2.5%	16.0%	20.0%	2.4%	1.9%
ICBCAS	18.8%	1.5%	2.5%	16.0%	20.0%	1.2%	0.7%
BOCOM*	14.7%	1.0%	2.5%	16.0%	19.5%	4.9%	4.4%
Total/Ave.	17.0%					2.9%	2.4%

Source: Company disclosure, BofA Global Research

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Exhibit 2: TLAC capital shortfall of Chinese banks (II)

The shortfall would be CNY2.2tn (USD316bn) by end-2024, and CNY5.5tn (USD780bn) by end-2027.

In CNY bn	RWA Growth rate	RWA by end 2024	TLAC shortfall by end of 2024	TLAC buffer by end 2027	Total buffer required	Shortfall vs RWA by 2027	RWA by 2027	TLAC shortfall by end of 2027
AGRBK	9.5%	24,945	718	18.0%	22.0%	4.9%	32,770	1,599
BCHINA	6.7%	19,969	439	18.0%	22.0%	4.2%	24,262	1,019
CCB	8.9%	24,720	477	18.0%	22.0%	3.9%	31,906	1,254
ICBCAS	6.9%	26,658	189	18.0%	22.0%	2.7%	32,588	883
BOCOM	8.1%	9,708	422	18.0%	21.5%	6.4%	12,277	780
Total/Ave.	8.0%	106,001	2,246			4.4%	133,802	5,535
Total in USD bn		14,930	316				18,845	780

Source: Company disclosure, BofA Global Research

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Exhibit 3: TLAC estimate by rating agencies.

Our shortfall estimate at USD316bn by end-2024 is similar to S&P' calculation.

	End-2024	End-2027	Related reports
Our estimation (CNY tn)	2.2	5.5	
Our estimation (USD bn)	316	780	
S&P(CNY tn)*	2.4		China's New Capital Rules Will Ease Strain On Banks Ahead Of TLAC Rollout (Nov. 2023)
S&P (USD bn)	373		
Moody's (CNY tn)**		3.3	Regulation of noncapital total loss absorbing capacity (TLAC) securities issuance is credit positive (May, 2022)
Moody's (USD bn)		520	
Fitch (CNY tn) ***	1.7	6.3	China Banks Dashboard: November 2023 (Nov. 2023)
Fitch (USD bn)	239	887	

Source: Moody's, Fitch, S&P, BofA Global Research

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Credit rating and pricing of new TLAC bonds

Credit ratings: expect low-A

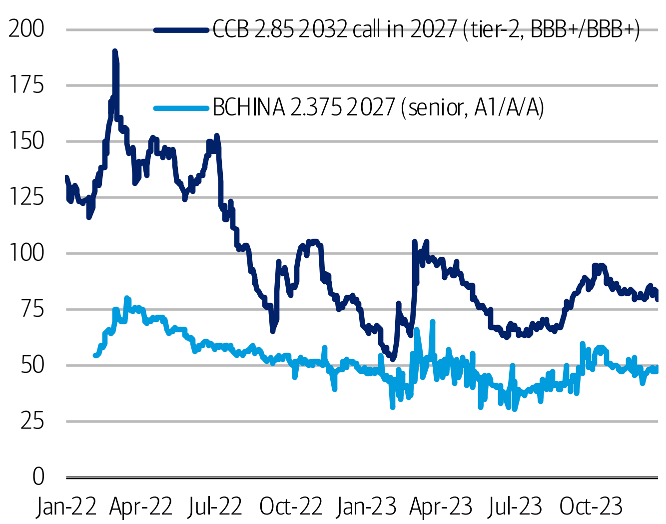
We believe the new TLAC bonds from the Big 5 are likely to be rated low-A, two notches below that of senior rating based on the example of BNKEA. BNKEA TLAC bond is rated at Baa2/BBB by Moody's/S&P, two notches below the issuer credit rating (senior bonds rating) at A3(neg. outlook)/A-. Moreover, BNKEA tier-2 is rated Baa2/BBB- by Moody's/S&P. Fitch does not rate the BNKEA complex, but based on its report, the notching for TLAC would be less than the tier-2 with two notches, meaning one notch lower than IDRs, thus the Fitch rating is likely to be A-.

Discussion on pricing level

Although BNKEA is the first and only USD TLAC bond issuer in emerging Asia market, we found difficult to use it as a reference estimate for the pricing level of China TLAC bonds. Currently, BNKEA TLAC bond trades more than 150bp inside its tier-2 bond currently (Exhibit 6); however, the national banks' most liquid tier-2, i.e., CCB 2.85 2032 (tier-2), is only trading at about 80bp (Exhibit 4). We believe the potential TLAC bond would reprice the tier-2 wider first. In Exhibit 5, we list the low-A rated TLAC bonds in Europe, Japan and the US with credit spread at 100-120bp. We believe China TLAC could trade inside DM peers, given the strong technical support from China investors for the top national banks. The technical support is also evidenced by the very tight pricing level of capital bonds from Big 5. It seems to us the first deals of China TLAC may price at about 80-90bp, based on different references listed here.

Exhibit 4: The pricing of TLAC from Chinese banks

The TLAC bond should be priced between tier-2 and senior bonds. Helped by the strong technical support, the only liquid USD tier-2 bond from CCB currently trades at only about 80bp, and that for 5-year senior is about 50bp. We believe the coming TLAC should re-price the tier-2 wider. And the pricing level of TLAC bond could be at 80-90bp probably...



Source: Bloomberg, Jan. 2, 2024

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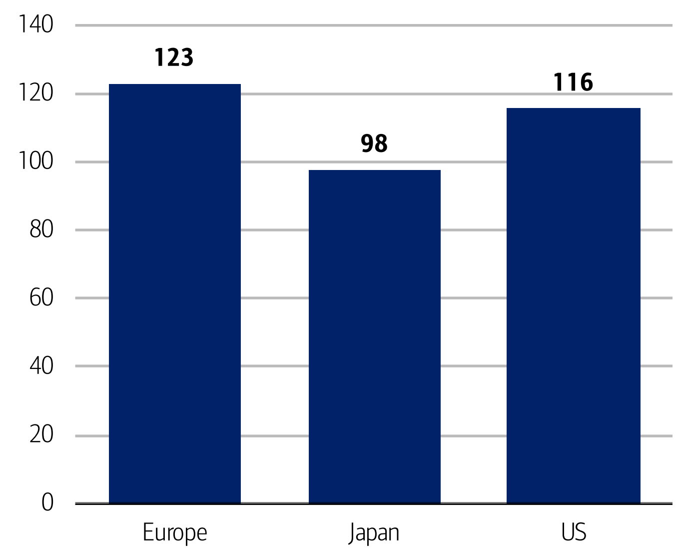
Exhibit 5: Credit spread of global senior non-preferred bonds with low-A rating and duration of 3 years.

... which would be slightly tighter than the developed market peers. This is similar for the spread relations for tier-2 and senior bonds.



Source: Bloomberg, ICE BofA Global Financial Index. As of Jan. 2, 2024

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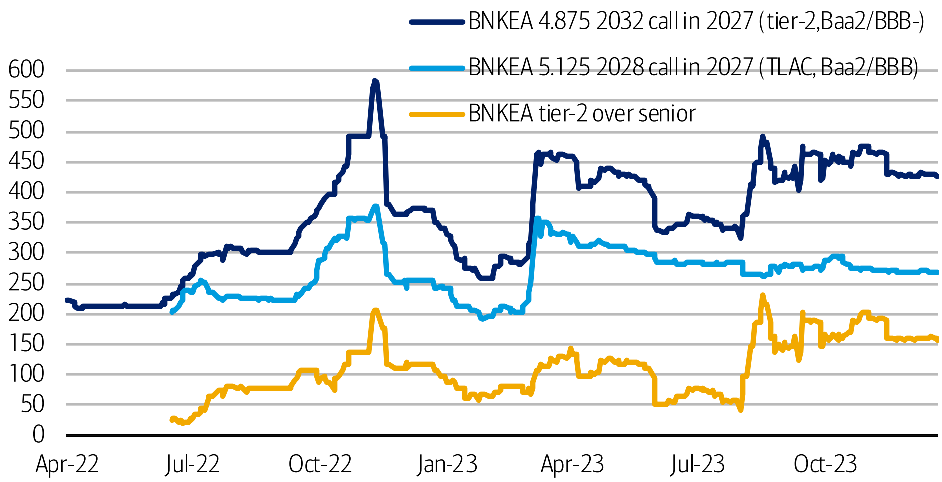
Exhibit 6: BNKEA tier-2 vs BNKEA TLAC bond

The TLAC bond from BNKEA, the only TLAC issuer in EM Asia space, initially was priced 30bp tighter than tier-2 bonds, but now trading more than 150bp tighter than tier-2 due to the sell-off of tier-2.



Source: Bloomberg, Jan. 2, 2024

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Recap of TLAC rule in China

The total loss-absorbing capacity (TLAC) implementation in China has been in the spotlight of the credit market given the large amount of debt securities with bail-in features needed. China offshore investors' concerns were further fueled in Nov 2022, after the deputy governor of the People's Bank of China (PBoC) said the Chinese banks should be encouraged to issue TLAC bonds in offshore markets. To recap the TLAC implementation in China, we summarize the key points here:

1. Five China banks with Global Systemically Important Banks (G-SIBs) tags are eligible for TLAC requirements so far: the Agricultural Bank of China (AGRBK), the Bank of China (BCHINA), China Construction Bank (CCB), the Industrial and Commercial Bank of China (ICBCAS), and Bank of Communications (BOCOM), which just won the G-SIBs title in Nov 2023; no TLAC requirements for the 19 Domestic Systemically Important Banks (D-SIBs) are announced yet.

2. The implementation dates are 1 Jan.'25 and 1 Jan.'28, two years from now for the first step and another three more for the second/final step.

3. TLAC buffer would be a parallel system vs Basel III capital-buffer requirements, meaning assuming a bank has a shortfall of USD300mn to meet the Basel III tier-1 ratio. While it issues USD500mn AT1 capital bond. Then, only USD200mn of the AT1 bond will be counted as TLAC buffer. In another word, it could be only used to fulfill either the TLAC buffer, or the Basel III capital additional tier-1 buffer; but cannot fulfill both at the same time.

4. AGRBK, CCB, BCHINA and ICBCAS are in the Bucket 2 defined by Bank for International Settlements, which required 1.5% additional capital buffer. BOCOM is located in Bucket 1 with 1% buffer required. Considering Basel III and TLAC, the capital thresholds would be 20% for the first four, and 19.5% for BOCOM for the first step.

5. CET1, Tier-1, and Tier-2 capital instruments would be all eligible for TLAC buffer. Non-capital unsecured instruments with loss-absorption features and more than one year to maturity would be eligible for the TLAC buffer as well.

6. The Big 5's contribution to the Deposit Insurance Fund could be eligible for TLAC buffer with maximum contribution at 2.5% of RWA when the TLAC requirement is 16% of RWA, and 3.5% of RWA when the TLAC requirement is 18% of RWA.

Insurance Deposit Fund seems too small to provide meaningful support.
Our TLAC shortfall estimate does not incorporate the Insurance Deposit Fund (the Fund), which could contribute at most 2.5%/3.5% of RWA by end-2024/27, based on the TLAC rules, though the shortfall could be less than 2.5% of the RWA. As of end-2022, the size of the Fund was only CNY55bn (USD7.7bn) vs CNY96bn (USD14bn) at end-2021. This is only 2.4% of the shortfall, as of end-2024. It seems the Fund is unlikely to provide meaningful support for TLAC implementation unless the government has substantial injection into the Fund.

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