CAPITAL INTELLIGENCE

Credit Rating Announcement

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Bank of China's Ratings Affirmed with a Stable Outlook

Capital Intelligence Ratings (CI Ratings or CI) today announced that it has affirmed the Long-Term Foreign Currency Rating (LT FCR) and Short-Term Foreign Currency Rating (ST FCR) of Bank of China (BOC) at 'A' and 'A1', respectively. At the same time, CI Ratings has affirmed BOC's Bank Standalone Rating (BSR) of 'bbb-' and Core Financial Strength (CFS) rating of 'bbb-'. The Outlook for the LT FCR and BSR remains Stable.

Benefiting from the Very High Extraordinary Support Level (ESL), BOC's LT FCR is set four notches above the BSR, a level aligned with CI's internal assessment of sovereign credit risk for China. The ESL reflects the Bank's majority state-ownership and globally systemically important bank (G-SIB) status. The Chinese government has a strong track record of extending assistance to troubled banks in case of need, and ample resources and policy flexibility to support the banking sector as a whole notwithstanding a decline in its fiscal position due to the economic slowdown seen in recent years.

The Bank's BSR is derived from a CFS rating of 'bbb-' and an Operating Environment Risk Anchor (OPERA) of 'bbb-', the latter indicating modest risk. OPERA balances the economy's high competitiveness, a strong external position and large diversified economy against very high macro-financial risks, prolonged weaknesses in the property market that are hampering economic growth, and rising external risk factors in addition to persistent institutional weaknesses. While current official financial ratios of Chinese banking institutions are satisfactory, CI is concerned that the ongoing weaknesses in the property market and increasing financial stress among local government financing vehicles (LGFV) have increased the vulnerability of the Chinese banking sector.

The BSR and CFS rating are driven by the Bank's comfortable liquidity indicators, good loan asset quality metrics, and solid capital ratios. The key challenge facing BOC, in common with the sector, is the modest profitability due to the low interest rate environment. The July interest rate cut will further strain the net interest margin (NIM) while headwinds from the prolonged downturn in the real estate sector and rising financial stress in the LGFV segment will keep impairment charges high. These factors will thus constrain any improvement in profitability metrics in the short term. Additional constraints for the ratings are the high exposure to the weak real estate sector notwithstanding consecutive declines in recent years, and the lack of disclosure on LGFV exposure, in common with peers, which restricts a full assessment of overall asset quality. In this regard, CI continues to draw some degree of comfort from the Bank's consistently good loan and investments quality to date.

BOC's key strength is its size in terms of total assets. It remains among the top four commercial banks in China, with an extensive domestic network and large overseas presence. The Bank has a solid domestic franchise with a diversified banking operation, holding a leadership position in a number of its key businesses such as foreign currency and trade operations. Notwithstanding good loan growth in both 2023 and Q1 24, its balance sheet remains conservatively positioned, with a relatively prudent level of loans in its asset mix at end-Q1 24.

The loan book remains skewed towards the corporate sector, but this exposure is well diversified by economic sector. The large book of residential mortgages constitutes a fairly high concentration in the real estate sector. However, housing loans are generally collateralised and granular in nature. Moreover, the Bank's prudent residential mortgage lending policy mitigates the concentration risk.

Following the trend of the banking sector, the Bank's overall loan asset quality metrics continued to improve in both 2023 and Q1 24. NPL accretions slowed and loans expanded. As a result, BOC's already low NPL ratio improved further and was better than the commercial bank average in 2023. Loan loss reserve coverage was also strengthened in both periods, although it still lags the peer group average at end-Q1 24. Stage 2 loans increased further in 2023 but they represented a still very low proportion of gross loans. This information was not available for Q1 24. Going forward, notwithstanding the elevated credit risk environment, CI anticipates BOC's loan asset quality metrics to remain good given its prudent lending and provisioning policies. We also expect the Bank to continue to generate a reasonable level of operating profit (although this metric has declined in recent years) to meet additional provisioning requirements if needed. Moreover, the solid capital base could also provide an additional buffer. As with its peers, the Bank maintained a sizeable portfolio of financial investments with a large proportion in government bonds. The latter has been rising to a fairly high level in relation to equity.

Another key strength of BOC is its deep customer deposit base which supports good loan-based liquidity ratios. Both loans to deposits and net loans to stable funds ratios were at comfortable levels in recent periods. Notwithstanding a decline, BOC's wholesale borrowings remained slightly higher than those of the other top 3 banks. Refinancing risk however is considered moderate and is mitigated by the Bank's majority government ownership, good liquidity buffer, ready access to the capital markets, alongside its position among the top four commercial banks in China and G-SIB status.

The Bank continued to replenish capital through the issuance of Tier 1 and Tier 2 capital bonds and internally through profit retention in 2023 and Q1 24. Faster growth of RWAs in 2023 led to a drop in both CET1 and Tier 1 ratios, but both ratios improved in Q1 24. The Tier 2 capital bonds issue helped the Bank to maintain a solid total CAR ratio especially at end-Q1 24. The quality of capital remained good with a high proportion of CET1 and Tier 1 capital. Following the trend at its peers, the Bank's internal capital generation rate declined further in 2023 reflecting lower earnings. Despite a conservative dividend payout ratio, the internal capital generation rate remained behind those of its larger peers. Balance sheet leverage inched down marginally and was largely in line with its immediate peers.

BOC's earnings composition reflects its diversified business activities. Corporate banking and personal banking activities are the main contributors to operating income, with treasury activities providing another important source of revenue. Contributions from its investment banking and insurance activities picked up in 2023. The quality of earnings is considered good, reflecting the high proportion of net interest income (NII) and fee-based income. That said, as with its peers and the sector, NII was impacted by the low and declining interest rate environment. However, good expansion of fee-based income and higher gains from investment securities supported the sound growth in operating income in 2023. Almost flat operating costs contributed to operating profit growth, but an increase in impairment charges led to slower growth in net profit in 2023. The Bank's earnings in the first three months were weaker due to a y-o-y contraction of NII, reflecting a further narrowing of net interest margin , a drop in fee-based income and lower gains from investment securities. Consequently, an increase in operating expenses and higher impairment charges led to a y-o-y contraction in operating and net profit, respectively, in Q1 24.

Going forward, we expect NIM to remain under pressure given the recent interest rate cut. While lending prospects are sound, the slower economic growth could constrain loan expansion despite the pickup in Q1 24. The still elevated credit risk environment due to the prolonged downturn in the real estate sector and rising financial stress in the LGFV segment could also keep impairment charges sizeable. CI therefore expects profitability to remain a key challenge for BOC and the banking sector as a whole.

Rating Outlook

The Stable Outlook indicates that the ratings are likely to remain unchanged over the next 12 months. The Outlook balances the challenging operating environment against the Bank's sound financial standing in terms of loan asset quality, liquidity, and capital positions.

Rating Dynamics: Upside Scenario

As the LT FCR is aligned with CI's internal assessment of China's sovereign risk, the Outlook could be revised to Positive and/or the rating revised upwards if there is similar upward revision of CI's internal assessment of the Chinese government's credit strength. This scenario is however remote at this stage. The Outlook on the Bank's BSR could be revised to Positive and/or the rating revised upwards if there is a significant and sustainable improvement in profitability ratios, increased transparency on LGFV exposure, a further strengthening of capital ratios and/or an upward assessment of OPERA.

Rating Dynamics: Downside Scenario

Although not our base case, the Outlook on the LT FCR could be revised to Negative or the ratings lowered by one notch if CI revises downwards its internal assessment of the Chinese government's credit strength or its willingness and ability to support the Bank and/or if there is a downward revision of OPERA. The Outlook on the Bank's BSR could be revised to Negative or the rating lowered by one notch in the next 12 months if the Bank's loan asset quality and profitability weaken substantially.

Ratings

Foreign Currency		Outlook	BSR	Outlook	CFS	ESL	OPERA
LT	ST	LT FC		BSR			
A	A1	Stable	bbb-	Stable	bbb-	Very High	bbb-

Contact

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About the Ratings

The credit ratings have been issued by Capital Intelligence Ratings Ltd, P.O. Box 53585, Limassol 3303, Cyprus.

The following information source was used to prepare the credit ratings: public information. Financial data and metrics have been derived by CI from the rated entity's financial statements for FY2021-23 and Q1 2024. CI may also have relied upon non-public financial information provided by the rated entity and may also have used financial information from credible, independent third-party data providers. CI considers the quality of information available on the rated entity to be satisfactory for the purposes of assigning and maintaining credit ratings. CI does not audit or independently verify information received during the rating process.

The principal methodology used to determine the ratings is the Bank Rating Methodology, dated 3 April 2019 (see www.ciratings.com/page/rating-methodologies/bank-ratings). Information on rating scales and definitions, the time horizon of rating outlooks, and the definition of default can be found at www.ciratings.com/page/our-policies-procedures. Historical performance data, including default rates, are available from a central repository established by ESMA (CEREP) at http://cerep.esma.europa.eu

This rating action follows a scheduled periodic (annual) review of the rated entity. Ratings on the entity were first released in November 1997. The ratings were last updated in September 2023. The ratings and rating outlook were disclosed to the rated entity prior to publication and were not amended following that disclosure.

The ratings have been initiated by CI. The following scheme is therefore applicable in accordance with EU regulatory guidelines.

Unsolicited Credit Rating	
With Rated Entity or Related Third Party Participation:	No
With Access to Internal Documents:	No
With Access to Management:	No

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