

Credit Opinion

13 May 2024

Ratings	
Category	Financial Institution
Domicile	China
Rating Type	Solicited Rating
Long-Term Credit Rating	BBB _g
Outlook	Stable

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Zhejiang Nanxun Rural Commercial Bank Co., Ltd.

Initial credit rating report

CCXAP assigns first-time long-term credit rating of BBB_g to Zhejiang Nanxun Rural Commercial Bank Co., Ltd., with stable outlook.

Summary

The BBB_g long-term credit rating of Zhejiang Nanxun Rural Commercial Bank Co., Ltd. (“NRCB” or the “Bank”) is underpinned by the Bank’s (1) strong market franchise in Nanxun District; (2) limited exposure to market funds and solid deposit base; (3) low level of non-performing loan comparing with its peers; and (4) ongoing operating support from Zhejiang Rural Commercial United Bank (“ZRCB”) in terms of business development, risk management and information system configuration.

However, the rating is constrained by the Bank’s (1) squeezing profitability as a result of the narrowing net interest margin and higher credit costs; (2) asset quality which is sensitive to economic downturns because of its large exposure to small and medium-sized enterprises (“SMEs”) and geographic concentration of loan portfolio; and (3) decreasing capital adequacy ratios resulting from continuous loan portfolio expansion.

The rating also incorporates our assumption that the Bank is likely to receive extraordinary support from ZRCB and the government in times of need, given its (1) moderate position in the financial system of Zhejiang Province, with strong franchise in Nanxun District; and (2) track record of receiving support from ZRCB.

The stable outlook on NRCB’s rating reflects our expectation that the business and financial profile of the Bank will be stable, and the Bank will maintain its important market position in Nanxun District over the next 12 to 18 months.

Rating Drivers

- Strong market franchise in Nanxun District, with an extensive branch network
- Limited exposure to market funds and solid deposit base
- Profitability challenged by the narrowing net interest margin and higher credit costs
- Low level of non-performing loan while asset quality is still sensitive to economic downturns
- Decreasing capital adequacy ratios with continuous asset growth
- Likely to receive extraordinary support from ZRCB and the government in times of need

Rating Sensitivities

What could upgrade the rating?

The rating could be upgraded if (1) the likelihood of receiving government support increases; (2) the Bank's macro profile strengthens, such as higher sovereign rating for China, significant improvement in corporate debt leverage, or better credit condition in China; and (3) the Bank's financial profile improves constantly, such as improved profitability and sustainability or enhanced funding access.

What could downgrade the rating?

The rating could be downgraded if (1) the likelihood of receiving government support declines; (2) the Bank's macro profile weakens, such as lower sovereign rating for China, heightened corporate debt level, or worsened credit condition in China; or (3) the Bank's financial profile deteriorates significantly, such as declined asset quality or severely weakened liquidity.

Key Indicators

	2021FY	2022FY	2023FY
Total Assets (RMB billion)	66.7	76.1	90.8
Total Equity (RMB billion)	6.3	7.0	7.6
Operating Income (RMB billion)	2.0	2.3	2.3
Net Profit (RMB million)	673.7	712.5	741.6
Pre-provision Operating Profit/Average Risk-weighted Assets (%)	2.4	2.5	2.2
Problem Loans/Total Loans (%)	0.5	0.5	0.5
Capital Adequacy Ratio (%)	14.5	14.2	13.5
High Liquid Assets/Total Assets (%)	29.9	30.6	31.7
Market Funding/Total Assets (%)	7.5	6.0	5.9

All ratios and figures are calculated using CCXAP's adjustments.

Source: Bank data, CCXAP research

Corporate Profile

NRCB was established in 2010 based on the shareholding reform of the former Nanxun Rural Credit Union founded in 1996. It is the first rural commercial bank in Zhejiang Province and is positioned to serve the local economy, SMEs, and urban and rural residents. NRCB has a dominant market position and extensive branch network in Nanxun District, Huzhou City, Zhejiang Province. It ranked first for years in the local banking market, with a market share of 44.5% in deposits and 27.8% in loans as of the end of 2023. NRCB also promotes regional expansion through the development of off-site sub-branches and village banks. It has established a total of 14 village banks in Anhui Province and Zhejiang Province, with the shareholding ratios ranging from 35%

to 60%. As of 31 December 2023, NRCB reported total assets of RMB90.8 billion and net assets of RMB7.6 billion.

NRCB is one of the member banks of ZRCB under its monitoring, guidance and supervision. ZRCB is the largest bank in Zhejiang Province, formed under the restructuring of the local rural credit societies in the province in 2022, with a registered capital of approximately RMB5.0 billion.

Exhibit 1. Top 10 shareholders as of 31 December 2023

Shareholder Name	Shareholding Ratio (%)
Huzhou Shixi Livestock Product Processing Co., Ltd.	5.3
Huzhou Shiyou Door Industry Co., Ltd.	5.0
Huzhou Jinlongma Linen Technology Co., Ltd.	5.0
Zhejiang Fugang Group Co., Ltd.	3.0
Huzhou Shuangjie Industrial Co., Ltd.	3.0
Huzhou Xinjiayuan Investment Management Co., Ltd.	1.2
Zhejiang Lintanmuye Technology Co., Ltd.	1.1
Huzhou Yuneng Textile Co., Ltd.	1.0
Huzhou Fornice Imp. & Exp. Co., Ltd.	0.9
Huzhou Youchuang Investment Management Partnership (Limited Partnership)	0.6
Total	26.1

Source: Bank information, CCXAP research

Rating Considerations

Macro Profile

NRCB has substantial footprint in China, particularly in Zhejiang Province. Its macro profile is underpinned by China's (1) robust economy and fiscal strength; (2) high but stabilizing systematic financial leverage; and (3) stable and reliable financial system. China has strong economic fundamentals and institutional strength. It is the second largest economy in the world, with a gross domestic product ("GDP") of USD17.9 trillion in 2023. China has demonstrated long-term stability in its political environment and high efficiency of government.

NRCB's macro profile also incorporates China's high but stabilizing systematic financial leverage, as measured by the domestic credit to private sector to GDP ratio of 185.4% in 2022, representing a YoY increase of 8.1 percentage points. China has a stable and effective financial system, with no material failure in the banking sector over the past 10 years. The Chinese authorities have a good track record in monitoring and regulating the banking sector. In 2022, China proposed the new Financial Stability Law (《金融稳定法》), aiming to mitigate systemic shocks from the failure of smaller banks and curb contagion risk. In 2023, the regulator introduced the new rule on banks' asset risk classification, namely the Measures for the Classification of Financial Asset Risks of Commercial Banks (《商业银行金融资产风险分类办法》), which is expected to strengthen banks' reporting standards and gradually reduce inconsistency in financial asset classification.

Funding conditions for Chinese banks remain favorable and have benefited from a stable deposit base and ample interbank liquidity conditions. Chinese banking assets and liabilities grew robustly in 2023, with a YoY increase of 10.0% and 10.1%, respectively. However, market competition has intensified as banks are adjusting against financial reform and innovation. The lowering interest rate environment in China also pressures banks' profitability, especially for small and medium banks like rural commercial banks in China. The weighted average interest rate of corporate loans was down 0.29 percentage points YoY to 3.88% in 2023, which recorded the lowest level in history.

Rural commercial banks are of unique importance to the financial system, serving most of the population in the rural areas of China. They represent a large proportion of financial institutions in the banking sector, though, in terms of size, they only account for 13.1% of the banking system's total assets as of 31 December 2023. Rural commercial banks have been responsible for supporting China's rural economy since the 1990s, and they are integral to the development of the agricultural sector and county-level economy. They also play a vital role in the government's current development strategy for revitalizing rural economies. Nonetheless, rural commercial banks are facing rising operating pressure given the weakened credit profile of small enterprises during the economic slowdown in China and the tightening bank regulations.

Financial Profile

Strong market franchise in Nanxun District, with an extensive branch network

Nanxun District is located in Huzhou City of Zhejiang Province, with solid economic fundamentals supported by diversified manufacturing industries. Leading industries in the district include elevators, motors, magnet wires, and wooden floors. Nanxun District has cultivated multitude of large-scale enterprises, outstanding private enterprises, as well as listed corporations. Zhejiang Province is the fourth largest province by GRP in China, having higher disposable income per capita compared with other provinces. The credit environment of Zhejiang Province is also better than most of the provinces in China, evidenced by the low level of non-performing loan ratios and stronger profitability in general.

NRCB has a strong market franchise in Nanxun District, with an extensive network of more than 40 sub-branches in the district, covering most of the county and rural areas where other banks do not have large presence, and having close ties with local community. The Bank has a large percentage of corporate loans in urban areas and a larger percentage of retail loans in county and rural areas. It has ranked first for years in the local banking market with a market share of 44.5% in deposit and 27.8% in loan, as of the end of 2023.

The Bank also expands its branch networks to other areas in Zhejiang Province including Huzhou City and Hangzhou City, totaling 10 sub-branches. Additionally, it has 14 village banks in Anhui and Zhejiang Provinces, with shareholding ratios ranging from 30% to 60%, which accounted for around 30% of its total deposits and loans. Cross-regional operations enable the Bank to unearth business growth opportunities and leverage its local reputation and management know-how. NRCB's strong market franchise can help partially mitigate the negative impact of the increasing competition in the banking sector.

With the market positioning of serving "agriculture, rural areas and farmers", we believe that NRCB will maintain its competitive advantage in the banking business for local SMEs, private enterprises and individuals and households.

Limited exposure to market funds and solid deposit base

NRCB is a deposit-funded bank and has limited exposure to market funds over the past five years. The market funds only accounted for 5.9% of the Bank's total assets as of 31 December 2023. Such level was lower than that of most joint-stock commercial banks and city commercial banks.

As of 31 December 2023, NRCB's market funds mainly came from the borrowings from the central bank (43.5% of its total market funds) and debt securities issued (43.9%). It has limited exposure to the interbank or repurchase agreement (repo) business. The low market fund ratio of NRCB means that it is unlikely to be adversely impacted by the level of market fund usage from other financial institutions. The borrowings from the

central bank are the funding to support the refinancing of agricultural individuals and small enterprises, which are expected to be a stable funding source for NRCB under the current policy tendency.

NRCB's deposit base is solid and growing, underpinned by its strong franchise and branch networks in Nanxun District. It has reported double-digit percentage growth in deposits over the past five years. The deposit concentration risk is low as the Bank focuses on retail and SME clients with relatively small deposits. Retail deposits accounted for approximately 74.3% of its total deposits, as of 31 December 2023. However, NRCB is facing more competition in deposits, especially in urban areas where intense rivalry comes from other large state-owned banks with lower funding costs. With a high proportion of fixed deposits (69.2% of its total deposits), we expect NRCB's deposit funding to be more sensitive to interest rate fluctuations, which may drive up deposit costs in order to retain its deposit funding. We consider the deposit cost competition for the Bank is still manageable, supported by its strong local franchise and government's policies to control the competition on deposit pricing.

We also take into account NRCB's maturity mismatch in balance sheet assets and liabilities. As of the end of 2023, on the parent company basis, NRCB's assets due within one year accounted for 54.5% of the total assets, while the liabilities due within one year accounted for 65.6% of its total liabilities, showing certain liquidity maturity gap. Meanwhile, its access to new funding is expected to be weaker than that of its other state-owned and listed bank peers.

Profitability challenged by the narrowing net interest margin and higher credit cost

NRCB's profitability is moderate, driven by its higher loan premium, lower funding cost and outstanding operating cost control. Nevertheless, the Bank's profitability is challenged by the narrowing net interest margin and higher credit costs. In 2023, its pre-provision operating profit/average risk-weighted assets ratio was 2.24%, down from 2.40% in 2021.

NRCB's profitability is derived mainly from its lending business, while its non-lending business scale remains small. Net interest income made up of 93.5% of total revenue on average in the past three years. The Bank's net interest margin has decreased from 3.18% as of end-2021 to 2.66% as of end-2023. Its net interest margin is likely to trend slightly lower because of the loan prime rate reform and lowering loan pricing yields to support the real economy.

NRCB is facing swelling credit costs. It recorded total asset impairment (including lending and non-lending impairments) losses of RMB284.7 million in 2023, which was RMB274.3 million and RMB103.7 million in 2022 and 2021, respectively. The asset impairment/total asset ratio was 0.46% at end-2023, increasing from 0.16% at end-2021. NRCB's return on average assets ("ROA") showed a downward trend, falling from 1.08% in 2021 to 0.89% in 2023.

We expect that the advancement of interest rate liberalization, policy requirements for fee reductions and profit concessions, and intensified peer competition may put further downward pressure on net interest margins, thereby affecting the Bank's profitability stability and sustainability.

Low level of non-performing loan while asset quality is still sensitive to economic downturns

NRCB's non-performing loan ratio has remained low at under 1% over the past five years. As of 31 December 2023, its non-performing loan ratio was at 0.52%, lower than most of its peers. Its special-mentioned loan ratio has also remained low, decreasing from 1.57% at end-2021 to 1.55% at end-2023, though experiencing a slightly increase during 2023. The Bank's low non-performing loan ratio was benefited from its good asset sales

and write-offs. Most of the non-performing loans came from local individual clients in manufacturing and wholesales & retail sectors who have experienced operating difficulties during economic downturn.

NRCB's asset quality is constrained by its relatively high industry and geographical concentration. The majority of the Bank's lending business comes from Huzhou City and Hangzhou City and its customer base is dominated by local manufacturing, wholesale and retail enterprises, which accounted for 44.4% and 18.7% of the total loans, respectively, as of the end of 2023. Some local manufacturers, such as those in the elevator and timber processing segments, may be adversely affected by the weak property market in China. The large exposure to SMEs, who in general have weaker credit profiles, is likely to weigh on the Bank's asset quality during an economic downturn.

Nevertheless, NRCB's high non-performing coverage ratio, decreasing loan exposure to individual customers, and the region's robust economy, are expected to alleviate its asset risk. The Bank has a high non-performing coverage ratio of 581.4% as the end of 2023. The top one customer and the top ten customers accounted for 1.2% and 10.8% of its net capital, respectively, as of the same date. 49.5% of the Bank's loans carry a certain proportion of pledges with tangible or monetary assets, which also reduces credit risk.

We consider the market risk on the Bank's securities and financial investments is relatively low given its prudent investment strategy. The Bank's securities and investments accounted for 19.0% of total assets as of the end of December 2023, with most parts related to government and quasi-government bonds, financial institutions bonds and interbank negotiable certificate of deposits.

We are also aware that the Bank's fast growing loans book at a rate higher than the industry average growth rate could expose the Bank to unseasoned asset risk.

Decreasing capital adequacy ratios with continuous asset growth

As of 31 December 2023, NRCB reported the core tier 1 capital adequacy ratio and the capital adequacy ratio of 10.7% and 13.5%, respectively, as compared to 11.7% and 14.5% at end-2021. The Bank's capitalization ratios are higher than the local regulatory requirements. However, the Bank's capitalization is constrained by its moderating growth in profit retention and fast-growing risk-weighted asset ("RWA") base. Its RWAs increased by 14.4% in 2023 and 16.1% on average from 2020 to 2022. The moderating profitability of the Bank, as seen by its lowering ROA, has weakened its endogenous capital growth, which drives the majority of capital replenishment. NRCB has actively issued perpetual bonds and secondary capital bonds, which, to a certain extent, has alleviated its capital replenishment pressure. For example, in October 2022, the Bank issued a tranche of secondary capital bonds of RMB700 million.

External Support

Likely to receive extraordinary support from ZRCB and the government in times of need

Although NRCB does not have direct nor indirect shareholding from the government, we believe the Bank is likely to receive extraordinary support from ZRCB and the government in times of need, given its (1) moderate position in the financial system of Zhejiang Province, with strong franchise in Nanxun District; and (2) track record of receiving support from ZRCB.

The Zhejiang Provincial Government promoted the establishment of ZRCB based on the former Zhejiang Provincial Rural Credit Cooperatives Union. ZRCB was officially established in 2022 and was composed of all legal person rural credit institutions in Zhejiang Province, with a registered capital of RMB5.0 billion. ZRCB is the largest bank in Zhejiang Province, ranking first in deposits and loans with a low non-performing ratio of less

than 1%. ZRCB is authorized by the Zhejiang Provincial Government to perform management, guidance, coordination, and service functions for its 82 member banks. As one of the key member banks, NRCB undertakes the tasks of rural revitalization and private economic development in Nanxun District, which is of great significance to the stability of the financial system and the development of the local real economy in Nanxun District.

NRCB has received ongoing support from ZRCB in terms of business development, scientific and technological information, risk management, and system construction. ZRCB has organized its member banks across the province to sign mutual assistance agreements, which helps NRCB to obtain timely liquidity support when necessary. The local government also placed deposits on ZRCB, totalling RMB2.2 billion as of 31 December 2023. Given its essential role in Nanxun District, we believe NRCB is likely to receive extraordinary support from ZRCB and the local government in times of need.

Rating Methodology

The methodology used in this rating is the Rating Methodology for [Banks \(November 2021\)](#).

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