Week of 23rd November 2020

What's on our mind this week?

US sanctions 31 Chinese companies

On 12th November President Trump issued an executive order prohibiting any US person or entity from investing in securities (equity or bonds) issued by 31 Chinese companies deemed by the White House administration as having ties to the Chinese military. The list includes some of the largest companies in the country including state owned telecoms, utilities and infrastructure incumbents as well as certain large private technology companies including Hikvision and Huawei. Under the terms of the order, no US entity would be allowed to transact in financial securities of these business groups, including their subsidiaries, except to divest their existing position which they would have to complete within twelve months. The ban takes effect on 11th January 2021.

The news is clearly very troubling for investors in Chinese markets. Admittedly the Trump administration had already banned US Government sponsored funds from holding securities issued by these companies but extending the order to all US persons (including preventing US banks from trading securities issued by these companies) clearly demonstrates the Trump administration's intension to sharply ratchet up pressure on the Chinese Authorities all the way up until the end of the current term in January next year. In this regard we would not be surprised to see further executive orders impacting the Chinese economy and corporate sector, particularly if the president, as we suspect, takes the view that the COVID virus, which he already blames on China, was a key reason for losing his office.

In terms of impact this latest announcement may have on Asian financial markets, there is still a great deal of uncertainty although we have started to see some ripple effects as certain issuers have seen bond prices weaken in anticipation of this liquidity constraint in the future. Clearly there are still many unknowns including what subsidiaries of these entities could be included in the ban, would the actions be challenged in US courts and to what extent an incoming Biden administration might reverse such bans. JP Morgan which manages some of the most widely followed bond indices in the Asian region has taken a conservative approach announcing last week that, until more clarity is known, it

would prevent the addition of any new bond from the sanctioned list (including subsidiaries) although affected issues already in the indices (estimated at 72 securities) would not be automatically removed at this stage. Based on our own internal estimates, companies on the sanctioned list account for approximately 4.1% of our own ADBI Index benchmark. This compares to a 3.5% exposure for the JKC Asia Bond Fund and 0% exposure for the JKC Asian Bond 2023 Fund.

It should be remembered, however, that this is a purely technical impact. The vast majority of the companies on the sanctioned list are Investment Grade companies with strong standalone fundamental credit profiles. US investors tend to have a small exposure to Chinese SOE issuers and so we believe the holding and trading of these issuers can relatively easily be transferred to non-US entities. In this respect we expect the negative impact to be relatively short lived. Nevertheless, this does raise the prospect of further US executive actions on China in the next two months and we will have to remain vigilant on this risk in the near term.

DBS comes to the rescue of Lakshmi Vilas bank

Last week, the Indian government placed Tamil Nadu-based private sector lender Lakshmi Vilas Bank (LVB) under moratorium, capping withdrawals from its customers' accounts at INR 25,000 a month (USD 330). However, depositors were allowed to withdraw more than INR 25,000 with the permission from the Reserve Bank of India (RBI) for medical treatment, payment of higher education and marriage expenses. While this created some initial panic, the news was immediately followed with the announcement of a proposed merger of LVB with Singapore-based DBS Bank's Indian unit, DBS Bank India limited (DBIL), under an RBI-approved plan. The immediate plan for a resolution was very different to earlier cases like the Punjab and Maharashtra Cooperative (PMC) Bank, where depositors’ pain continues or the case of Yes Bank Ltd where depositors had to wait for two weeks to get a rescue plan after the bank went under moratorium. The RBI also took control of LVB’s board due to the serious deterioration of its finances.

It is worth highlighting that the RBI has put LVB under the prompt corrective action framework (PCR) since September 2019. Under this framework, the bank is restricted from lending to corporates and focuses on reducing the concentration of loans to certain

sectors. The bank is also restricted from opening new branches and paying dividends. It was quite clear that RBI has been looking for a suitable acquirer for LVB for the past year during which it received interests from Indiabulls Housing Finance and Clix Capital that eventually didn't go forward. While the reasons for having turned down Indiabulls Housing Finance's offer was not specified, it was widely believed that Indiabulls was not matching the fit and proper criteria for becoming a bank. DBS with its strong parentage, healthy capital position and clean record of governance is a suitable candidate to take over capital-starved Lakshmi Vilas Bank.

The proposed merger of LVB with the local arm of Singapore based DBS Bank appears to have become a model for the RBI to rescue struggling banks. It is a win-win situation for the regulator, for customers and for the acquiring bank as it protects the interests of depositors and helps the acquiring bank to quickly ramp up its presence inorganically while the RBI fixes some issues of the system. DBS currently has over 30 branches in India, while LVB has more than 550, and over 900 ATMs. DBS, which has a market value of about USD 48bn, will inject INR 2,500 crore (USD 330m) into its Indian subsidiary for the proposed merger.

LVB's capital position worsened to the extent that its capital adequacy ratio turned negative at -4.85% on 30th September 2020. DBS India limited (DBIL) before merger has a capital adequacy ratio of 16%. After the proposed merger, the combined entity will have a capital adequacy ratio of 12.5% compared to the regulatory minimum of 9%, without taking into account the additional capital infusion.

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