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He Yuxin
Corporate analyst
yuxin.he@dragonomics.net

China Development Bank: the best bank in China?

If outsiders know China Development Bank (CDB) at all, it is as the financier of China Inc's global investment drive. The unlisted, state-owned policy bank has funded every major Chinese overseas acquisition, from the purchase of oil, copper and iron ore assets by state-owned firms to private car company Geely's takeover of Volvo. It took a 3% stake in one of Britain's biggest banks on the eve of the global financial crisis, financed the global expansion of telecoms champions Huawei and ZTE, and runs China's biggest private equity fund, which focuses on investments in Africa.

Yet those impressive achievements are just a side-show. More than 80% of CDB's balance sheet is in China, where over the past 15 years it has supported virtually every jumbo project, from the Three Gorges Dam to the south-north water diversion project to the Shanghai Expo, as well as financing social programs such as slum upgrades, migrant worker training and disaster relief. It invented the most popular—and, as some increasingly argue, the most perilous—technique for infrastructure finance, under which companies linked to local governments borrow heavily against ever-rising land values. And it has achieved all this while delivering impressive profits and maintaining the lowest non-performing loan ratio of any major Chinese financial institution. The story of China's stunning growth over the past decade is in many ways the surprising story of CDB.

1- A princeling's fresh start

CDB was founded in 1994, along with other two policy banks, Agricultural Development Bank (ADB) and Export-Import Bank. The idea was to concentrate policy-driven lending on infrastructure and social projects in these specialized institutions, leaving the "Big Four" state-owned commercial banks (Bank of China, Industrial and Commercial Bank of China, China Construction Bank, and Agricultural Bank of China) to focus on regular corporate lending. CDB, originally modeled on the World Bank, was meant to focus on "national strategic projects," while ADB and Exim Bank were supposed to subsidize agriculture and exports respectively.

From the start, CDB had tight links to economic planners: it was assembled from six investment companies under the State Planning Commission (the forerunner of today's National Development and Reform Commission or NDRC). Along with the other two policy banks, it ran into severe difficulties within a few years, because policy-driven lending generated high rates of non-performing loans (NPLs).

The bank's turnaround began in 1998 when new premier Zhu Rongji installed 53-year-old Chen Yuan as CDB's governor. Although the job held ministerial rank, the appointment likely came as a disappointment to Chen, whose political pedigree augured bigger things. He was the son of Chen Yun (who was China's second most powerful official, behind only Deng Xiaoping, in the 1980s), and had served as deputy governor of the People's Bank of China (PBC) for a decade. Most had expected him to become the central bank's boss, but after Chen's father died in 1995, Zhu Rongji had a henchman, Dai Xianglong, promoted over him as PBC governor. Three years later Chen got the unenviable consolation prize of running an orphan policy bank with a 33% NPL ratio, and whose customers generally assumed that their loans never needed to be repaid.

From the start, Chen Yuan was more commercially minded than the bosses of China's 'commercial' banks

It was not obvious, at first glance, that Chen was up to the job. Unlike many other "princelings" or children of high officials, he is not obviously arrogant; he speaks in a soft voice and sometimes appears sickly, reminiscent of his low key and valetudinarian—though iron-willed—father. But from the outset, Chen had a very clear bottom line: he wanted to run a real, profitable, self-sustaining bank. That commitment to profit was most unusual: it put Chen well ahead of the chiefs of the so-called "commercial" state banks, who still viewed themselves essentially as agents of government fiscal policy. Continuous commitment to the profit principle over the next decade enabled Chen's supposed "policy" bank, to become a more commercially successful institution than any of its ostensibly commercial state-owned rivals.

2- Building a good bank, against the odds (1998-2002)

Immediately on taking charge, Chen Yuan made several decisive changes in CDB's operations and management that set the bank's course for the next decade. The first problem was funding. As a wholesale bank, CDB had no deposit base. To fund itself it issued bonds, which PBC forced state-owned banks and other saving institutions (notably the postal savings system and rural credit cooperatives) to buy at a fixed rate that ensured CDB a thin margin. The banks hated this system, and agreed to buy CDB's bonds only in exchange for access to PBC's re-lending window at favorable rates.

Chen established a market-based funding mechanism for CDB...

In September 1998, six months after Chen took over, CDB began to issue its bonds through market auctions, enabling buyers to influence the interest rate and issuance volume. By 1999, 97% of CDB's RMB bonds were sold by tender on the interbank market, and CDB issued a US$500m bond off shore. From 1999 to 2001, CDB issued Rmb513 bn in domestic bonds, more than it issued in its first 5 years of existence; at the end of 2009, it had Rmb3.3 trn of bonds outstanding. The establishment of this relatively market-based, wholesale funding mechanism created a crucial difference between CDB and other Chinese banks. Because it had to pay a market rate for funding—about 170-180 basis points higher than the average for state-owned commercial banks—CDB put itself under pressure to identify profitable projects, and put an appropriate price on risk.

..built up skilled staff...

The second task was to build up staff. A key move was the December 1998 acquisition of China Investment Bank (CIB), the badly run investment arm of China Construction Bank (CCB). This gave CDB 20 regional branches, with professional staff, and also brought in new income sources such as foreign exchange and domestic interbank lending. Chen quickly disposed of CIB's retail network and other bad assets by packaging them and auctioning them off to commercial banks.

Figure 1.

China Development Bank key financial data

	Total assets, Rmb bn	Loans outstanding, Rmb bn	Net income, Rmb bn	Return on assets	NPL ratio
1999	686	621	0.7	0.10%	18.7%
2000	808	672	0.8	0.10%	8.8%
2001	890	758	11.0	1.24%	4.3%
2002	1,040	896	12.0	1.15%	2.5%
2003	1,279	1,140	13.0	1.02%	1.9%
2004	1,575	1,410	17.0	1.08%	1.2%
2005	1,899	1,732	23.0	1.31%	0.8%
2006	2,314	2,018	28.0	1.32%	0.7%
2007	2,893	2,272	29.0	1.11%	0.6%
2008	3,821	2,899	21.0	0.62%	1.0%
2009	4,541	3,708	31.9	0.76%	0.9%

Source: CDB, Almanac of China's Finance and Banking

...and eliminated or restructured problem loans

Third was to rid CDB of its legacy problem loans. It participated in the general cleanup of bank balance sheets in 1999, under which Rmb1.4 trn in NPLs were transferred to asset-management companies (AMCs). Through this mechanism CDB off-loaded Rmb100 bn of NPLs, or 60% of its total. To take care of the rest, Chen devised some creative work-outs, which included debt restructuring and debt-for-equity swaps. One case was of great significance for CDB's future lending activity: a Rmb2 bn bad loan to Xiali, a struggling local state-owned car maker in Tianjin. CDB promised to extend a much larger loan (Rmb10-20 bn) to finance urban infrastructure projects in exchange for the city government clearing up the Xiali loan in a way that did not force CDB to take a write-down.

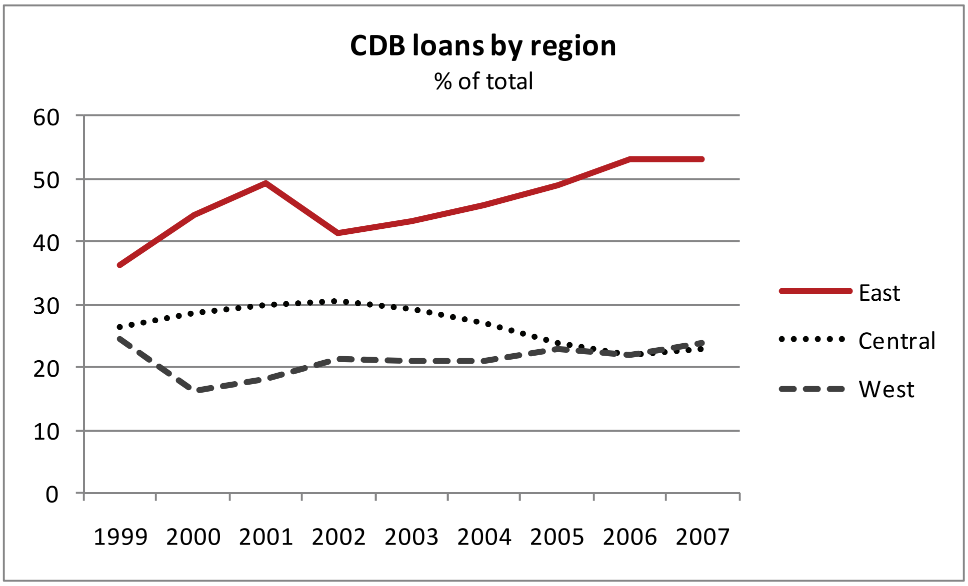
In 1999, CDB pioneered the use of local-government investment companies (LICs) to finance local infrastructure in a more disciplined way

The Xiali case helped inspire the local-government investment corporation (LIC) model, which has attracted attention recently but which CDB pioneered back in the late 1990s, and which is the dominant vehicle for CDB's domestic lending. The basic idea is that a local government sets up a special-purpose company which borrows from CDB. Originally, LIC loans were collateralized by local government fiscal revenues, but later land became the major source of collateral and loan-servicing revenue. LIC borrowing has set off alarm bells because it vastly expanded during the 2009 economic stimulus program (to Rmb7.4 trn by official figures), and because the ability of localities to service these loans increasingly depends on land values which may be inflated. But these problems should not obscure the fact that the LIC model was for many years a highly effective way to finance city infrastructure, and enabled CDB dramatically to reduce its NPL ratio. That ratio plummeted from 33% to 9% between 1998 and 2000, and in recent years has consistently remained under 2%, in significant measure because of the switch to more disciplined LIC lending. It is also important to note that for many years, LIC lending was almost an exclusive preserve of CDB, which by the end of 2005 had signed contracts with LICs in 30 provinces, 348 prefectures and cities, and 906 counties. It was not until 2008 that commercial banks got into the LIC lending game in a big way.

More generally, Chen established the first real loan-quality management system at a major Chinese bank. Six industries and regions were categorized

The government said 'Develop the West,' but CDB focused on developing the more prosperous east

Figure 2.



Source: CDB

CDB's loan review process is the gold standard in Chinese banking

as the riskiest and had their existing credit lines canceled. Every new loan above Rmb100m had to be reviewed by four teams, whose members were chosen at random every six months, in order to minimize the influence of *guanxi* or local relationships. After two rounds of review, the loan required approval by the bank's central loan committee, and finally by Chen himself. Chen frequently vetoed unqualified projects (nearly 100 in 1998-2003) proposed by local governments and national development officials.

At the same time as review boards weeded out bad projects, regional branches scrambled to identify good ones. Such "market-oriented" projects increased to a third of CDB's balance sheet (from zero) in Chen's first year. CDB's focus on projects that would yield a return—as opposed to the welfare projects the bank financed in the pre-Chen years—was reflected in a regional shift: in 2000, CDB's loan in the prosperous east area increased 8 percentage points to 44%, while loans to the west fell 8 pp to 16.4%—even though that year marked the beginning of Beijing's "Develop the West" policy push. The next year, CDB gave Huawei and ZTE, two leading telecoms equipment makers, domestic buyer credit of Rmb15 bn and Rmb7 bn respectively. Those deals antagonized commercial banks, which grumbled that CDB was abandoning its mandate to finance riskier or less profitable projects and encroaching on their turf. The reality was that CDB, despite its policy bank label, was becoming a far more skillful commercial lender than the commercial banks.

Despite its policy lender status, CDB earned better profits on sounder assets than commercial banks

By 2002, CDB was more profitable and had a sounder balance sheet than any other major Chinese bank, commercial or policy. Its NPL ratio of 2% was far lower than those of its policy bank brethren, Exim Bank (5%) and ADB (43%). In 2003, it made the biggest annual tax contribution (Rmb8 bn) of any financial firm.

3- Cashing in on the property boom (2003-06)

Through 2003, CDB mainly financed road, railway and electric power projects, which together accounted for about two-thirds of its loan book. From 2004 onward, its dominant activity was supporting "public infrastructure," which basically meant primary development of urban land, including the construction of basic facilities such as sewers, roads, bridges and

At first, CDB financed roads, railways and power plants, but later switched to supporting basic urban infrastructure

Figure 3

CDB loans by sector

% of total

	2001	2008
Public infrastructure	9.6	28.8
Roads	15.9	20.3
Power	36.7	15.7
Petrochemicals	4.2	4.4
Railways	14.4	3.2
Telecoms	3.3	2.3
Agriculture	-	2.0
Coal	-	1.2
Other	16.1	22.1

Source: CDB

public transport systems. This category alone consumed 36% of CDB's lending in 2004-06, although the proportion fell somewhat in 2007-08. infrastructure finance became CDB's dominant activity. This shift was apparently risky. CDB had previously lent mainly to projects with strong cash flows (or backed by large central subsidies, as in the case of inter-provincial railroads or big hydropower stations). But many of the new public infrastructure projects generated minimal cash flows.

CDB invented the idea of using rising land values to collateralize and service local debt

What made the move into lower-return public infrastructure possible was a switch toward reliance on land sales revenue to service LIC debt. The breakthrough came in 2003, in Tianjin. Early that year, Tianjin's new mayor Dai Xianglong (the man who pipped Chen Yuan to the post to become PBC governor in 1995) announced an ambitious municipal five-year development plan, involving Rbm170 bn in public infrastructure—six times the city's total public infrastructure investment in the prior 14 years combined. Since Tianjin's annual fiscal revenue was just Rmb31 bn, it was far from clear how this gigantic scheme would be financed.

The answer came in April, when CDB granted Tianjin a 15-year, Rmb50 bn credit line for land development and the construction of highways, subways and parks. CDB's own analysis of the deal admitted that the projects themselves would produce no return, but that loan would be serviced through land sales: over the life of the loan, it estimated Tianjin would generate land sales revenue of Rmb74 bn, enough to cover the total principal and interest payments of Rmb72 bn. Tianjin's land sales revenues far exceeded expectation, soaring from an average of Rmb3 bn a year in 2003-06 to Rmb39 bn in 2007, Rmb44 bn in 2008 and an astonishing Rmb73 bn in 2009. Tianjin was an extreme case, but there were others: in 2004, CDB loaned Rmb1.7 bn to Yufu, Chongqing's biggest LIC, to finance the clearance of a prime city-center plot that Yufu then sold at a vast profit. Today, Yufu is known as "Chongqing's Temasek," as it controls Chongqing's biggest land bank and many local financial institutions.

This technique helped local governments, and enabled CDB to more than double in size

The increased reliance on land sales enabled CDB to ramp up its balance sheet rapidly. From 1998 to 2002 its loan balance grew by 15% a year; from 2002-06 average annual growth rose to 23%. Its loan book actually grew faster than that of the "Big Four" commercial banks, in part because the commercial banks were increasingly constrained by the China Banking Regulatory Commission (CBRC), whose regulatory oversight did not extend to CDB. Another reason was CDB's uniquely tight set of relationships with local governments, via the LICs, which enabled it swiftly to execute large-scale loans for major infrastructure projects. As a result, CDB turned a neat trick: it satisfied government's policy goals while at the same time becoming a top-notch commercial lender.

But reliance on land sales revenues tempted local governments into excessive borrowing, and encouraged a corrupt culture of land-price ramping

But this apparent win-win situation concealed three serious consequences. First, the switch to land-based finance encouraged local governments to maximize land income, inflating a property bubble. Second, easy land revenues tempted local governments to borrow excessively—especially from other commercial banks, which had less underwriting skill than CDB. This problem became particularly acute during the 2009 stimulus program, when Beijing actively encouraged banks to lend as much money as possible. According to official figures, LICs had outstanding debt of Rmb7.4 trn by the end of 2009, of which 40% or Rmb3 trn was borrowed in 2009. LIC balance sheets began to look rickety: CDB reckons the average LIC debt-to-asset ratio is 150%, rising to 400% at some weaker LICs. And since in many cases the chief asset is land, the solvency of many LICs could be threatened by a plunge in land values. Finally, the excessive reliance on land created a dangerous political problem, since it strengthened the power of local governments that controlled land sales, without creating any systems of accountability.

Recognizing the problems, regulators in Beijing called for CDB to be reined in

Top officials in Beijing recognized these problems long before the excesses of the stimulus program, and pressure began to mount for CDB to be subjected to the same regulatory oversight as commercial banks. In April 2006, five ministries led by NDRC and the Ministry of Finance issued an urgent notice prohibiting new loans guaranteed by local governments, and specifically naming policy banks like CDB as among the offenders. Three days later, PBC governor Zhou Xiaochuan gave a speech suggesting that the development of a more mature market economy had rendered policy banks' specialized function obsolete. Chen Yuan responded with a speech defending the special role of policy banks. The ground was prepared for a battle royal between regulators who wanted to bring CDB to heel, and Chen, who wanted to preserve the bank's autonomy.

4- The fight against commercialization (2007-09)

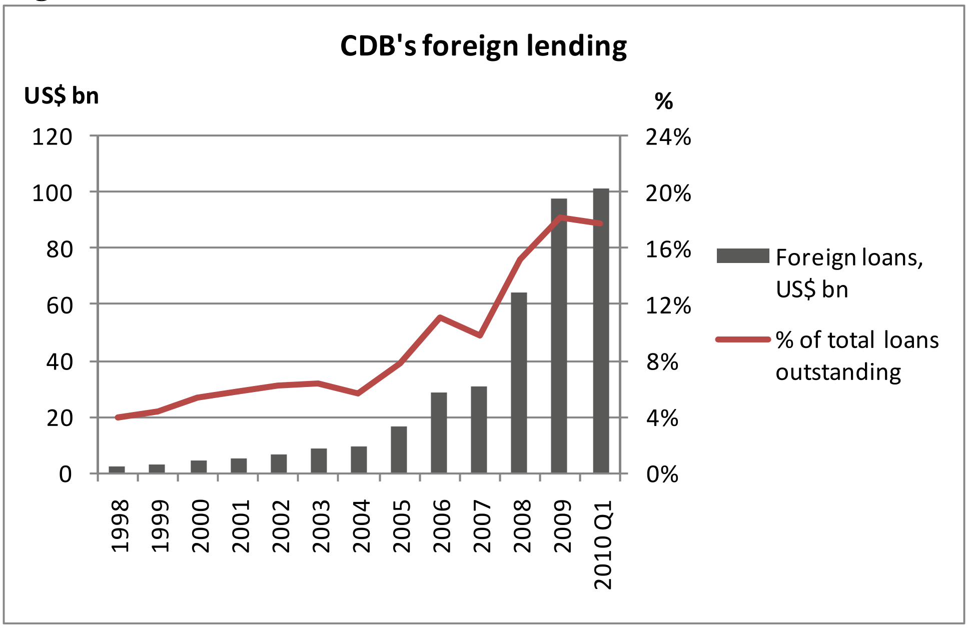
The battle took the form of a two-year effort to convert CDB into a "normal" commercial bank, with the same corporate structure and regulatory obligations as big commercial banks like Bank of China, Industrial and Commercial Bank of China and China Construction Bank. The battle was confusing because regulators never articulated a clear vision of the distinction between commercial and policy banks, and because CDB already operated in a more commercial manner than most Chinese commercial banks. Chen Yuan recognized these contradictions and beat back the effort to bring CDB under the regulatory scrutiny of CBRC, with the result that today CDB is stronger and more independent than ever.

CBRC and Ministry of Finance wanted CDB to become a normal commercial bank, but Chen fought to keep CDB's special status

The fight began in January 2007, when premier Wen Jiabao announced at the annual national finance working committee meeting that policy banks would be converted to commercial banks starting with CDB. The main advocates of this policy were CBRC, which felt it had a right to regulate policy banks, and the Ministry of Finance, which as the nominal shareholder wanted a clearer corporate governance structure and an ability to distinguish better between policy banks' subsidized, quasi-fiscal operations and their commercial ones. PBC, despite governor Zhou's reservations, wound up supporting CDB's

The main tactic was to assert CDB's unique role in financing the expansion of Chinese companies abroad

Figure 4.



Source: CDB

effort to maintain its special status. PBC was won over because the existence of a flexible policy bank that could finance large-scale international investments by Chinese firms dovetailed with its desire to diversify the deployment of China's vast foreign exchange reserve away from low-yielding government securities. (PBC also had fewer regulatory concerns, since as the approval agency for CDB's bond issues it was already in effect the bank's regulator.)

Between 2007 and 2009, CDB's international loan book more than tripled, to US$100 bn

Chen's main line of defense was to produce a new raison d'être for his bank: it would be the financier for Beijing's "going out" policy, under which big state enterprises were encouraged to make large-scale international investments. In 2007, CDB participated in many international syndicated loans and M&A projects, and accelerated bilateral cooperation with African governments and development banks. In July 2007, it spent nearly US$3 bn to buy 3% of Barclays, as the British bank prepared a bid for foundering Dutch lender ABN-AMRO, and announced plans to become Barclays' biggest single shareholder once the acquisition was complete (in the event, the Barclays bid failed).

In 2008, CDB was the major backer of Chinalco's US$14 bn purchase of a 9% stake in global mining giant Rio Tinto, and gave a US$8.1 bn loan to a central Asian natural gas pipeline. In just one year, CDB's foreign loan balance in support of "Going out" projects ballooned to US$40 bn, from US$18 bn in 2007. By the end of 2008 CDB surpassed Bank of China as China's top foreign lender, with a total foreign loan balance (including non-"going out" deals) of US$65bn.

Chen outfoxed CBRC, getting a new capital injection ahead of schedule...

Back home, CBRC pressed ahead with the commercialization plan. It set a timetable for CDB to undergo an audit, dispose of non-performing assets, get a new capital injection, and launch a stock-market listing. In the second half of 2007, the National Audit office began to audit CDB's books.

But Chen was one step ahead of his regulators. CDB was not supposed to get new capital until its books had been audited and its NPLs disposed of, but on 31 December 2007 it got a US$20 bn capital injection from Central Huijin, the subsidiary of sovereign wealth corporation China Investment Corporation

(CIC) that holds the central government's shares in major financial institutions. This new capital enabled CDB to accelerate its policy-driven overseas lending, and strengthen the case against commercialization.

...and by quickly ramping up policy loans under the economic stimulus program

The bureaucratic struggle over CDB's fate intensified in 2008. After its Barclays investment registered a large paper loss, CDB's proposal to buy a big stake in Citibank was rejected by the State Council. But the bank still aggressively financed overseas deals by favored state-owned enterprises. And it got an oddly lucky break when one of its vice-governors was accused of corruption relating to a previous stint at the securities regulator. This forced a re-check of the CDB audit, and delayed the commercialization schedule. At this point the global financial crisis intervened, and in December 2008, as part of its economic stimulus program, the State Council increased its policy lending quota by Rmb100 bn, of which CDB immediately lent out three-quarters.

CDB's overseas policy loans were approved directly by the State Council, not CDB's shareholders or regulators

In the same month, the bank established its new corporate entity, CDB Corporation, and the bank regulator declared that CDB was now a commercial, not a policy bank. But that declaration was empty. The bank regulator still does not exercise oversight over CDB, and Chen used the new corporation to establish a comprehensive financial holding company, with subsidiaries focusing on private equity, investment banking and local infrastructure investment via LICs. And its policy-driven overseas loan book expanded at a breakneck pace, rising 52% in 2009 to US$98 bn—more than triple the level just two years earlier. The bank financed US$35 bn in loan-for-oil deals with Russia and Brazil, and underwrote Chinalco's (ultimately failed) US$20 bn bid to up its stake in Rio Tinto. None of these deals was submitted to either CBRC or CDB's shareholders, Central Huijin and the Ministry of Finance. Instead, they were approved directly by the State Council on account of their strategic significance. Chen had succeeded in making CDB the principal banker to the Chinese state.

5- The future of the barony

So in the end, what exactly is China Development Bank? It is not a commercial bank in the Western sense, but neither is it simply a dumb tool of the State Council's industrial and foreign policies. In some respects, as we have shown, its behavior is more commercial than that of the "commercial" banks, because it pays a market rate of interest for its funds, and consequently assesses its risks more carefully. Despite its policy bank status, CDB's average interest rate on loans is essentially identical to that of the commercial banks.

Does CDB really perform better than the commercial banks? Probably, but it's hard to tell

Yet while CDB clearly outperforms its policy bank brethren (Exim Bank and ADB), rating its performance against the big commercial banks is tricky. True, it pays more for its funds, but its administrative costs are far lower because it does not maintain a big retail branch network and the associated huge staff requirement. Despite this lower administrative cost—and despite the fact that virtually all of its assets are loans, whereas the big commercial banks devote about half their balance sheets to low-yielding government and SOE bonds—CDB's return on assets is significantly lower than that of the commercial banks. This suggests that, for all its underwriting skill, it retains a large non-commercial policy lending function. (Against that, however, is the fact that the apparently strong recent performance of the commercial banks came only after a massive government bailout and recapitalization in 2003-06, whereas CDB's performance over the past decade derived entirely from its own efforts.)

Probably the best way of understanding CDB is to see it as a strong barony in China's quasi-feudal bureaucratic landscape. Its leader vows fealty to the sovereign, but mainly for the purpose of enhancing the power of his own barony: the successful baron must master the delicate task of simultaneously serving the sovereign's policy interests and his own commercial ones. Though technically now a commercial bank, CDB thwarted the main purpose of the commercialization campaign, which was to sever its direct link to the sovereign (the State Council) and subject it to bureaucratic oversight. CDB gives its own interpretation of its new status under the heading of the "Four changes and four no-changes." The four changes are:

Some things change...

1. CDB is now a commercial bank, not a policy bank.

2. It is now a shareholding corporation, rather than a directly-held state owned bank.

3. It has improved corporate governance.

4. It provides diversified services—notably investment banking and private equity investment—on top of its original banking services.

...but others stay the same

The four "no changes" are:

1. It is still state owned.

2. Its primary function is still serving national strategic priorities through medium and long-term credit and investment.

3. It remains a wholesale bank, funding itself from bond issuance and principally financing strategic projects.

4. It remains committed to close cooperation with central and local governments, and with major state-owned enterprises.

The big question is what becomes of CDB after Chen Yuan retires

The key unanswerable question about CDB is whether the barony can retain its unique status after the passage of the baron who built it, Chen Yuan. CDB is largely a creation of his creativity, financial acumen and bureaucratic skill. He has run the bank for 12 years—an unusually long stint for a boss of a major SOE—and is now 65, which is the official retirement age for cadres of his rank. Most analysts reckon he can wangle another five years or so at the helm, but then he will be forced to step down. At least until then, however, CDB is likely to remain a crucial part of most of China's strategic investments, both at home and abroad.

Please see the next page for a detailed financial comparison of China Development Bank and its commercial- and policy-bank peers.

Financial comparison of CDB and other main commercial and policy banks

Figure 5.

CDB compared to commercial bank and policy bank peers

Commercial banks, 2009	Total assets, Rmb bn	Loan balance, Rmb bn	Net income, Rmb bn	Return on assets	NPL ratio	Staff
Industrial and Commercial Bank of China	11,785	5,729	129	1.1%	1.54%	390,000
China Construction Bank	9,623	4,820	107	1.1%	1.50%	302,000
Bank of China	8,752	4,797	85	1.0%	1.52%	263,000
Agricultural Bank of China (2008)	7,014	3,100	51	0.7%	4.32%	442,000
China Development Bank	**4,541**	**3,708**	**30**	**0.8%**	**0.94%**	**6,700**
Policy banks, 2008						
China Development Bank	**3,821**	**2,899**	**21.0**	**0.55%**	**1.0%**	**6,200**
Agricultural Development Bank	1,355	1,219	1.6	0.12%	3.8%	49,000
Export-Import Bank	567	451	0.2	0.04%	1.5%	1,300

Source: Bank reports, PBC, Almanac of China's Finance and Banking

Figure 6.

Cost of funds, CDB vs commercial banks, %

	All interest-bearing liabilities	Debt securities	Deposits
China Development Bank	**3.87**	**4.11**	
Industrial and Commercial Bank of China	2.14		2.17
China Construction Bank	2.03		2.03
Bank of China	2.18		2.17
Agricultural Bank of China	2.01		1.98

Note: Debt securities account for 85% of CDB's interest-bearing liabilities
Deposits account for 89% of commercial bank interest-bearing liabilities
Source: Bank annual reports

Figure 7.

Average loan interest rates, CDB vs commercial banks, %

	2008	2009
China Development Bank	**7.02**	**5.74**
Industrial and Commercial Bank of China	7.07	5.21
China Construction Bank	7.16	5.37
Bank of China	7.01	5.22
PBC 1-year benchmark	7.04	5.31

Source: Bank reports, PBC