Chinese banks had the biggest quarterly increase in bad loans since 2005 as a slowdown in the world’s second-largest economy causes defaults to rise.

Nonperforming loans rose by 54 billion yuan ($8.7 billion) in the three months through March to 646.1 billion yuan, the highest level since September 2008, according to data released by the China Banking Regulatory Commission yesterday. Bad loans accounted for 1.04 percent of total lending, up from 1 percent three months earlier.

The 10th straight quarterly increase in defaults adds to concern banks’ profitability may slip as they build buffers to cover loan losses. Policy makers have also been cracking down on financing to weaker borrowers to rein in total debt that has climbed to more than double the nation’s gross domestic product.

“Asset quality is now the biggest overhang on the banking sector,” Rainy Yuan, a Shanghai-based analyst at Masterlink Securities Corp., said by phone. “The government’s reluctance to use stimulus and ease monetary policy has made it difficult for many borrowers to repay debt.”

Concern that profitability will decline further dragged the Hong Kong shares of China’s five biggest banks down by an average 7.3 percent this year to yesterday, compared with the benchmark Hang Seng Index’s 2.5 percent drop. The lenders traded at an average 4.8 times estimated 2014 profit, close to the lowest valuations on record.

**Narrower Margins**

Industrial & Commercial Bank of China Ltd., the nation’s largest bank by market value, dropped 0.8 percent to HK$4.78 as of 9:37 a.m. Hong Kong time, compared with the Hang Seng’s 0.6 percent decline. China Construction Bank Corp. (939), the second biggest, lost 0.5 percent.

Combined net income at China’s banks rose 16 percent to 427.6 billion yuan in the first quarter from a year earlier, the CBRC data show. Their net interest margin, a key measure of lending profitability, fell to 2.58 percent as of March from 2.68 percent in December.

Lending in China is slowing as the government discourages credit to overextended industries and local governments as it cracks down on activity outside the formal banking system. The nation’s broadest measure of new credit shrank 9 percent in the first quarter and money supply in March grew at the slowest pace on record, underscoring risks of a deeper slowdown.
China’s economy expanded 7.4 percent in the first quarter, the slowest in 18 months. Growth of 7.3 percent is forecast for this year, the weakest pace since 1990, based on the median estimate in a Bloomberg News survey of economists.

**Loss Reserves**

The economic slowdown has hurt borrowers’ ability to repay debt and driven defaults higher. The five biggest lenders had 377.1 billion yuan of nonperforming loans at the end of March, an increase of 8 percent from the beginning of the year, a separate CBRC statement yesterday showed.

Chinese banks had 1.8 trillion yuan of loan-loss reserves at the end of March, accounting for 274 percent of their nonperforming loans, according to the regulator. That fell from 282.7 percent as of December.

Shanghai Chaori Solar Energy Science & Technology Co. in March became the first Chinese company to default on onshore bonds when it failed to make a full coupon payment. China averted its first trust default in at least a decade in January as investors in a 3 billion-yuan product distributed by ICBC were bailed out days before it matured.

The government has spent more than $650 billion bailing out banks by carving out bad loans and injecting capital since the late 1990s, after years of government-directed lending caused default risk to balloon. In 2005, the nonperforming loan ratio at state-owned banks stood at 15 percent.

The government pumped $15 billion of capital into ICBC in April 2005. In October 2008, the government injected $19 billion into Agricultural Bank of China Ltd. (601288) and removed about 800 billion yuan of nonperforming loans from its balance sheet.

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