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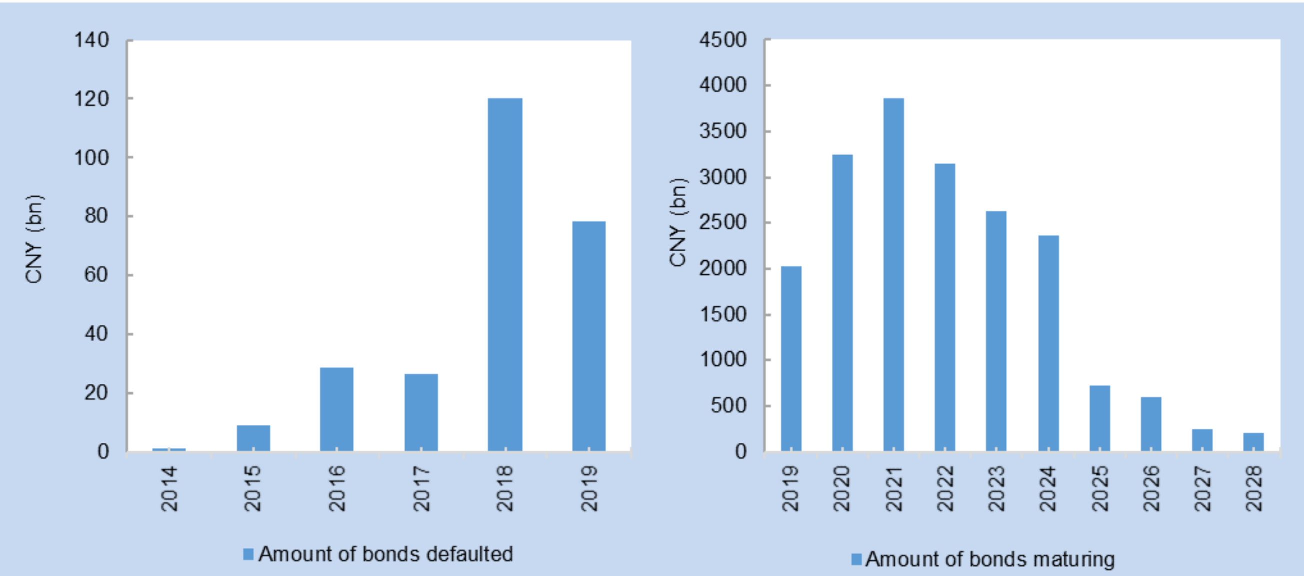
Credit risk remains on China's non-financial corporates despite easing credit conditions

by Anthony Prayugo

Amid the ongoing US-China trade tension and a global economic slowdown, the Chinese government faces difficult choices on whether to loosen its monetary policies (and therefore risking its debt to continue rising) or face a threat of a further economic slowdown. Until recently, the Chinese government has been striving to create a balance between debt deleveraging and economic stabilization as it feared for an economic downturn while also trying to prevent its debt from getting out of control. This balancing act, referred by the People's Bank of China (PBOC) as "stabilizing macro leverage", might have contributed to the improving credit outlook on China's non-financial corporates in 2019. As shown in Figure 1 below, the NUS-CRI 1-year Aggregate (median) Probability of Default (Agg PD) data for publicly listed China non-financial corporates decreased earlier this year as the Chinese government started to shift away from their previous stance of deleveraging. But Agg PD for China's non-financial corporates started to rise again amid a global economic slowdown and the escalating trade war between the US and China. The subsequent reserve ratio cut by PBOC in Sep 2019 to stimulate China's economy seems to indicate that the Chinese government has all but abandon its previous policy of deleveraging. While the easing of credit conditions can boost China's economic growth, it has also opened up the possibility of worsening its debt problem.

Figure 1: NUS-CRI Aggregate 1-year PD for China's non-financial corporates from 2015. Source: *NUS-CRI*

As shown in Figure 2a below, the amount of corporate bond defaulted was relatively low before 2015 as local governments usually came to the rescue of financially troubled companies. The deleveraging campaign that was brought forward in 2016 to tackle debt issues led to the increasing number of corporates that defaulted on their bonds. This culminated in 2018 when a total of CNY 120bn worth of corporate bonds defaulted. Despite policymakers' effort to boost liquidity and ease credit conditions in 2019, the amount of corporate bond defaults in China showed no sign of slowing, reaching CNY 78.4bn which is 51% higher from the same period last year. This is driven by several reasons. Firstly, many firms might have already been facing financial difficulties due to previous loose expansion policies. Although the new policies that were implemented enable banks to loan more money, banks will be reluctant to lend to distressed firms due to the recent stricter policy on bad debt recognition. In May 2019, the China Banking and Insurance Regulatory Commission encouraged banks to classify corporate loans overdue for more than 60 days as non-performing, down from 90 days previously in a bid to improve asset quality and reduce risk. Hence, distressed firms will likely be unable to refinance or obtain new loans from banks when banks are busy offloading bad debts from their balance sheets. Secondly, the economic slowdown and trade dispute with the US have adversely affected many of China's non-financial corporates' ability to repay their debts.



Figures 2a (LHS): Amount of bonds defaulted by China's domiciled corporates. Figure 2b (RHS): Outstanding amount of China's non-financial corporates' bonds. *Source: Bloomberg*

This year, the Chinese government has already taken several measures to ensure economic stabilization through monetary and fiscal policy. On the monetary front, PBOC has cut the required reserve ratio (RRR) by 50bps and would further reduce the ratio by 100bps for some qualified banks effective from 16 Sep 2019. It is the third cut this year as PBOC has also previously lowered the RRR by a total of 100bps in January. In addition to the CNY 800bn that was free-up for new lending earlier this year, the new RRR cut will also mean an additional CNY 900bn of liquidity being released into China's economy. Furthermore, to attract more overseas investment, the Chinese government has announced to remove limits on foreign institutions wanting to invest in its stocks and bond markets under the Qualified Foreign Institutional Investor (QFII) scheme, offering unfettered access to the world's second-largest capital market. Meanwhile on the fiscal front, besides the earlier tax cuts that have been introduced this year, the Chinese government has also cut the tax rate on rare-earth producing companies to boost production effective from Sep 2020.

Despite the easing of credit conditions, China's non-financial corporates might still need to exercise caution, especially in the short-run. Bank of International Settlements Q1 data showed that non-bank borrowers in China have USD 501bn of outstanding US dollar debt securities and loans. The weakening of yuan this year amid the US-China trade tension increases the burden of corporates that service their debts in US dollar as a rise in the US dollar value will increase their debt servicing cost. On top of that, China's non-financial corporates will face a record amount of approximately CNY 12tn worth of maturing bonds between 2019 and 2022 (see Figure 2b). Besides the record amount of maturing bonds, some companies in certain sectors such as real estate issue a substantial portion of their bonds in US dollar and thus more exposed to the weakening of the yuan to US dollar. While the easing of credit conditions provides ease of refinancing, an unexpected event (such as a worse than predicted recession) can have detrimental consequences on the corporates' credit profile.

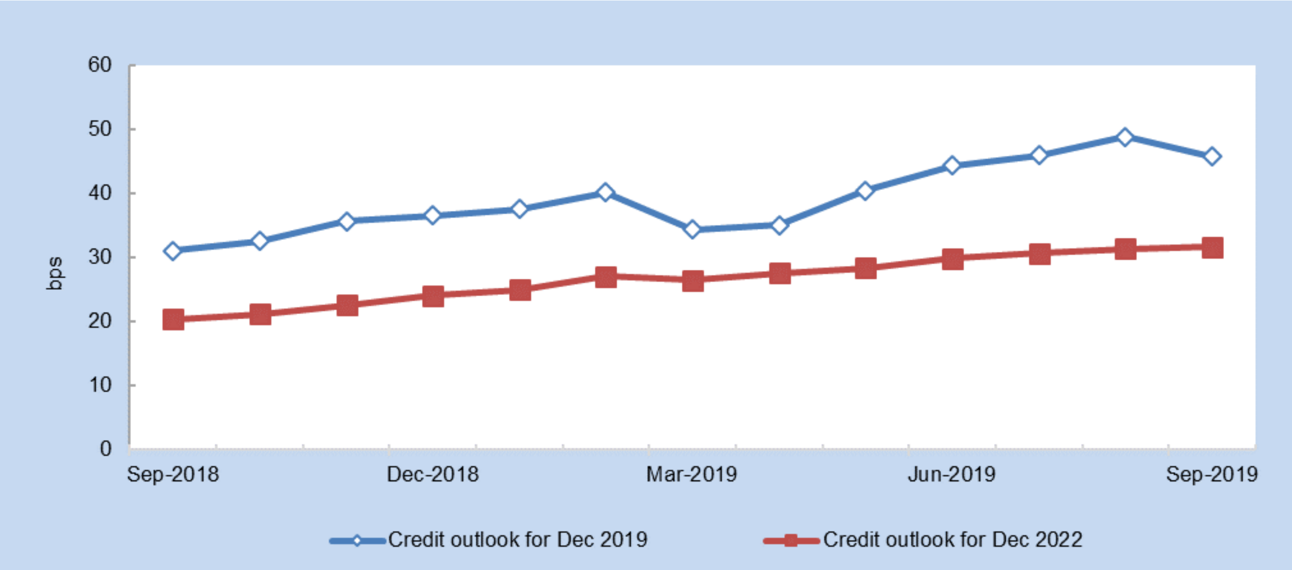


Figure 3: NUS-CRI Aggregate Forward 1-year PD time series for China's non-financial corporates based on information from different historical months looking to Dec 2019 and Dec 2022. Source: *NUS-CRI*

Figure 3 shows that in the last one year, the market has been expecting a better credit outlook for China's non-financial corporates in the long run than in the short future. For any month from Sep 2018, the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD) of China's non-financial corporates is higher for Dec 2019 (blue curve) than that for Dec 2022 (red curve). Take Sep 2019 for example, Figure 3 shows that the 1-year PD of a typical China non-financial corporate conditioning on its survival till Dec 2019 is 46 bps, while the longer-future forward 1-year PD conditioning on its survival till Dec 2022 is 32 bps. While the credit outlook for China's non-financial corporates in Dec 2022 is consistently better than the one in Dec 2019, it is worthwhile to note that both curves are generally in an upward trend, indicating that the market expectation of future credit outlook for China's non-financial corporates has generally worsened for the past few months amid a global economic slowdown.

To sum up, the Chinese government has switched its focus from deleveraging to its economic growth. A report from the National Institution for Finance and Development stated that China's total debt-to-GDP ratio jumped by 5.1% in Q1 2019 and another 0.7% to 249.5% as of the end of June. Although the recent government policies enable China's non-financial corporates to have more favourable financing options, China's non-financial corporates will need to be prudent to not over-leverage as this may lead to worsening credit profiles in the future.

Other NUS-CRI WCBs on China's non-financial corporates:

Credit review and outlook on China's non-financial corporates in the backdrop of deleveraging

Credit News
Chinese groups turn seller to shed USD 40bn in global assets **Sep 16.** Chinese groups have agreed to sell about USD 40bn in oversea assets so far this year, while they have bought just USD 35bn of oversea assets, making China a net seller. Formerly acquisitive companies have unwound portfolios and US divestments are soaring. In some disposal cases, the government-hold-companies played a role. China's foreign exchange regulators also have helped to hold back oversea acquisitions in protection of China's dollar reserves. Moreover, the trade conflict between US and China, and the shrinking dollar inflow from exports to US, have contributed to the tightening of control over Chinese overseas deal-making. (FT)

US junk bond inflows signal investor optimism

Sep 13. The US junk bond inflows in the past week hit historical high since the beginning of February. Data showed that investors are becoming more comfortable with riskier junk bonds from borrowers, signalling investor's confidence towards US economy. The Federal Reserve is expected to follow ECB rate cut, entrenching investors' view that bond yield will remain low and that central bank is stepping out to support the global market. US recession fears have ebbed after some solid economic data released. The postponement of higher tariffs and the talk between US and China in October have further bolstered investor optimism. (FT)

China default risks hit bid for debut Dollar bond issuers

Sep 13. Due to the record pace of Chinese defaults this year, bond buyers are putting significantly more scrutiny on borrowers now, amidst China's economic slowdown and the trade war. Chinese companies trying to sell dollar-denominated bonds for the first time have been finding it a whole lot tougher lately. There have been only 13 debut sellers so far this quarter, against 22 in April-to-June and yields on junk-rated Asian dollar bonds, 60% of which are made up by Chinese borrowers, have been climbing since June. First-time issuers were a big source of that growth in sales but now investors are avoiding those deals or asking for bigger pricing concessions. (Bloomberg)

Austria's 'century bond' rally highlights demand for long-term debt

Sep 12. Austria issued a rare "century bond" two years ago with market scepticism. The Vienna-backed security is now trading at 178 cents on the euro, hitting a high of 210 in August. The gain of the century bond this year is expected to outperform any US stock market on record. The extraordinary rally highlights an intense demand for longer term debt, especially from pension funds and insurers. The demand for safer, highly-rated debt is driven by the dimming economic outlook and the rising expectation of looser monetary policy, and liability-driven investors have further contributed to the demand of long-term debt. (FT)

Yearlong debt crisis hits plans for bigger India bond market

Sep 11. India's efforts to stimulate its corporate bond market are facing significant headwinds – a yearlong credit crisis. Sales of rupee-denominated bonds rated below AAA have halved year-to-date to USD9.7 billion as a wave of debt defaults and a funding crunch in the shadow banking sector make investors reluctant to buy riskier notes. The nation's credit crisis is impeding changes to the rupee bond market, which has operated consisting largely of a few big local banks and brokers doing deals based on long-standing relationships. Lower-rated issuers are responding by tapping alternative sources of funding, such as borrowing overseas, utilizing unused bank lines and selling bonds to individual investors; which however, increases their overall funding costs. (Bloomberg)

Coordinated strikes knock out half of Saudi oil capacity, more than 5 million barrels a day (CNN)

South Africa unsecured loan boom leaves 40% of borrowers in default (Bloomberg)

Trade hopes lifts stocks, bond yields (Reuters)

Regulatory Updates

European Central Bank cuts its deposit rate, launches new bond-buying program

Sep 12. ECB announced a massive new quantitative easing program on Thursday in an attempt to boost the deteriorating Eurozone economy – consisting of EUR20 billion per month of net asset purchases for as long as it deems necessary. The central bank also cut its main deposit rate by 10 bps to -0.5%, a record low but in line with market expectations. It expects rates to remain at their present or lower levels until inflation restabilized near its target of 2%. This will be the second round of QE from the ECB, the first coming four years ago in response to the chaotic fallout of the euro zone sovereign debt crisis. A slowing euro zone economy, persistent low inflation and the U.S.-China trade war had all pointed toward the central bank being forced to inject stimulus. Euro zone bond yields tumbled and the euro weakened as a result of the new measures. (CNBC)

China scraps purchasing cap for approved foreign investors

Sep 10. China is scrapping a quota system "QFII" for foreign institutional investment, removing the purchasing limit of USD 300bn for qualified fund managers to buy stocks and bonds. A yuan-denominated cap applied to "RQFII" programme was also scrapped on Tuesday. China seeks to cushion the impact of an economic slowdown and its trade war with the US. The move would gradually open up the country's financial sector and greatly enhance the convenience of participating in China's onshore market for foreign investors, adding liquidity to the financial market and renewing the flow of investment into China. However, data shows that the removal of quotas may not be followed by a flood of foreign investment. (FT)

ECB has USD 51bn fund questioning future of inflation hedging (Bloomberg)

Emerging market central banks most dovish since financial crisis (FT)

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