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

by Yao Xuan

As the authorities changed their policy tone from "deleveraging" to "stabilizing macro leverage"[1], it seems like debt is roaring back, delivering a prospect of easier credit conditions in China. However, defaults continuously take place with little signs of slowing down, provoking a question: What's next for China's non-financial corporates' credit risk? With the aid of historical probabilities of default (PD) and Forward PD time series generated by NUS-CRI, we provide a credit review of China's non-financial corporates in the backdrop of deleveraging and show an optimistic outlook on the credit environment for China's non-financial corporates.

In order to minimize the impact of the global financial crisis on the economy, Chinese government proposed a stimulus package in Sep 2008, which involved CNY 4tn (USD 586bn) to invest mainly in infrastructure. Supported by the surge in demand and implicit state guarantee, state-owned commercial banks were funding state-owned enterprises' (SOEs) investments. Private-owned enterprises (POEs), however, were forced to tap the unregulated shadow banking system[2] as state-owned commercial banks were less willing to lend to POEs. Until early 2016, both debt scale and leverage ratio of China's non-financial corporate sector have climbed to an unprecedented level, which exposed a considerable threat to the stability of the country's real economy (Figure 1). The exploding credit and the subsequent 2015 stock market crash, almost pushed the non-financial corporates' NUS-CRI 1-year Aggregate PD (Agg PD) back to the level of the CNY 4tn infrastructure package period, indicating great credit and systematic risk (Figure 2). To tackle the debt issue, Chinese authorities launched a campaign of deleveraging in 2016.

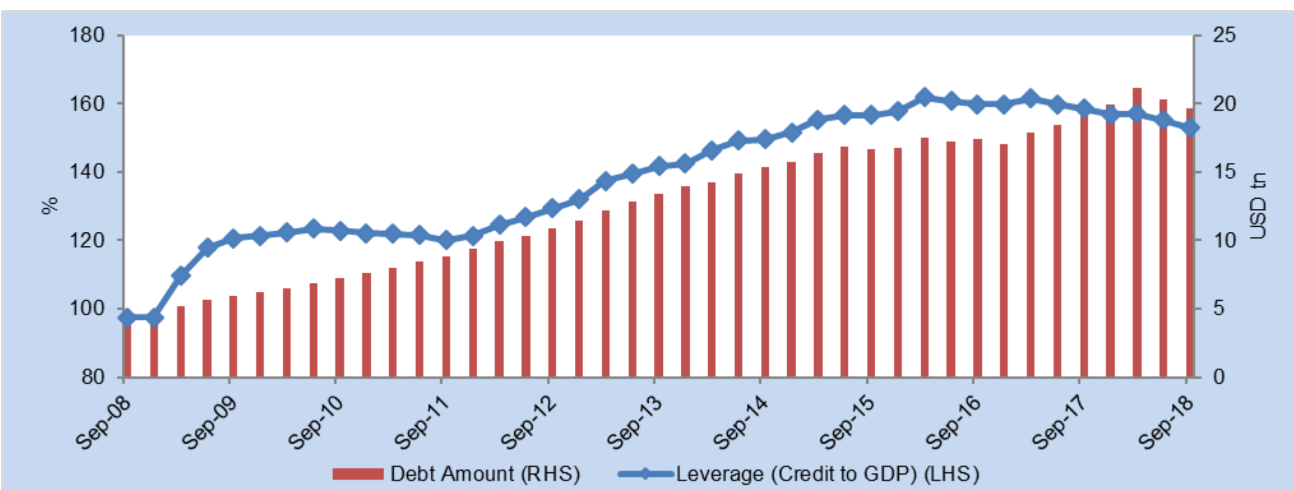

Figure 1: China's debt and leverage from non-financial corporates. *Source: BIS*

[1] A country's leverage, is mainly measured from four sectors, government, households, non-financial corporates and financial institutions. More specifically, the government's leverage could be further divided into central and local government's leverage. Among them, the first three sectors belong to the real economy while the financial sector provide support for the real economy. When we talk about China's deleveraging campaign, it usually refers to reducing the leverage from local government, non-financial corporates, and financial institutions. One sector's leverage could be transferred to another, which means they are not independent. In this WCB, we focus on the leverage of non-financial corporates.

[2] China's shadow banking system consists of three components in our WCB's definition, which are entrusted loans, trust loans, and undiscounted bankers' acceptances.

The specific measures to cut the corporate's leverage include, (I) debt disposals among those "zombie" SOEs[3] to address the "soft budget" problem[4]; (II) prevent commercial banks from lending money to certain industries with serious overcapacity; (III) clamp down the shadow banking sector. After the second half of 2017, corporate's leverage was beginning to be controlled and the NUS-CRI 1-year Agg PD decreased back to a lower level.

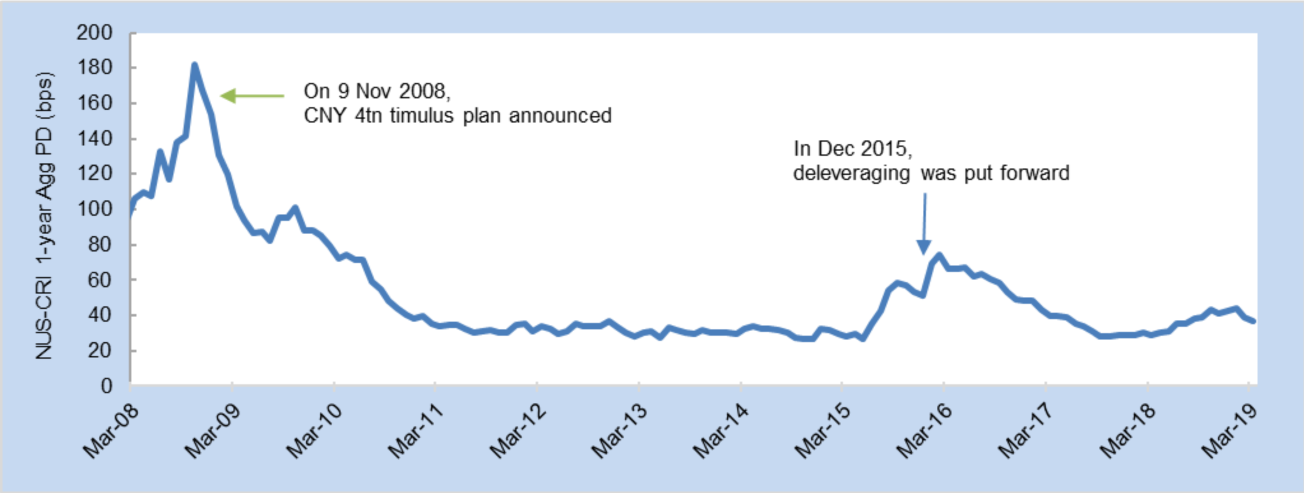

Figure 2: NUS-CRI 1-year Agg PD for China's non-financial corporates. *Source: NUS-CRI*

However, the deleveraging process is far from over and the side effects of these measures have started to appear. The curbs on SOEs' debt dampened economic activities; the clean-up of overcapacity in certain industries led to more unemployment; the monetary tightening and the reduced shadow banking activities cut POEs off their credit supply. These issues together with the US-China trade tensions in early 2018 have caused borrowers to default on a record CNY 119.6bn, almost quadruple the tally for the previous year. The default wave is extending into 2019 affecting both private and listed firms (Figure 3a). As expected, defaults mainly happened in the industries hit by overcapacity such as Basic Material and Industrial (Figure 3b).

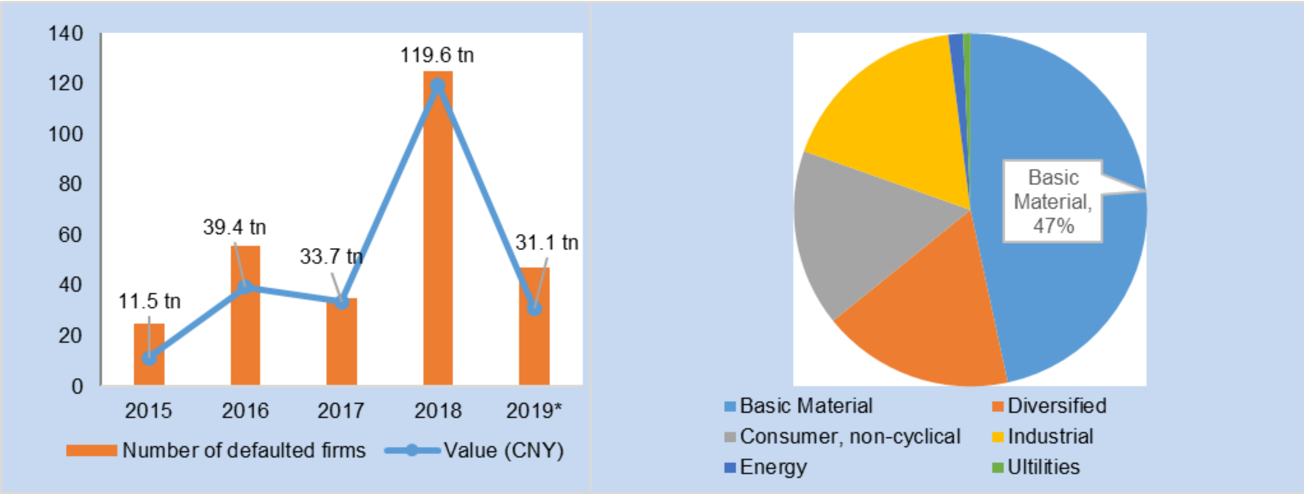

Figure 3a & 3b: China's defaulted firms and value (left), and industry distribution (right) since 2015 as of 15 April 2019. *Source: Wind*

[3] Zombie companies refer to indebted businesses that, although generating cash, after covering running costs, fixed costs, they only have enough funds to service the interest on their loans, but not the debt itself. China's zombie firms remained in operation mainly because of government subsidies or further loans from state-owned banks.

[4] Soft budget constraint refers to an investment situation where profits of state-owned enterprises (SOEs) are largely privatised to SOEs personnel and losses of SOEs are socialised on to the state budget.

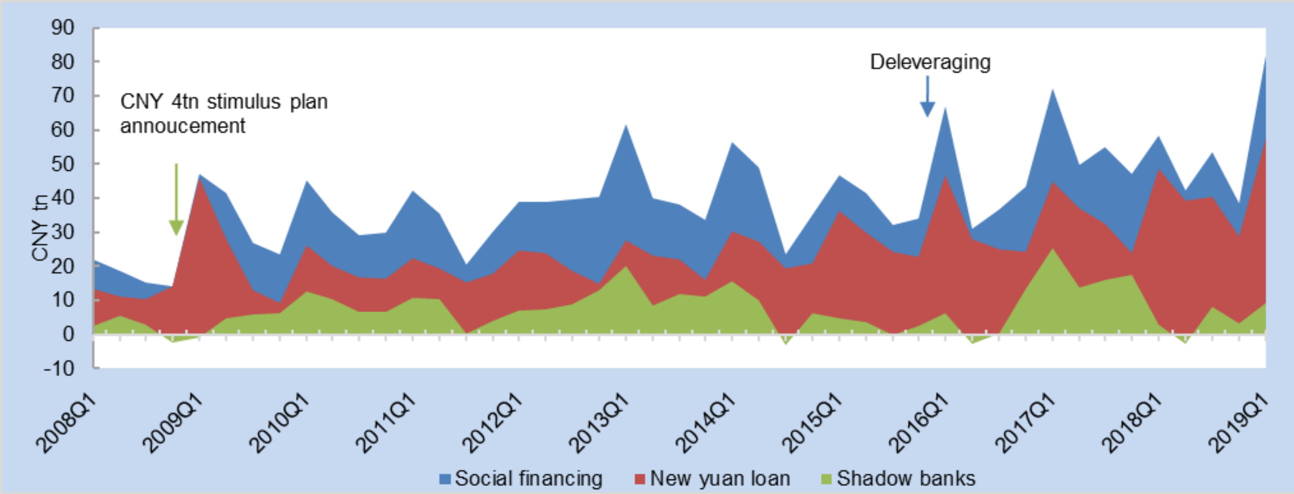

Figure 4: China's social financing since 2008. *Source: People's Bank of China*

While defaults continue to persist in 2019, Chinese government maintains the signal of easing credit conditions to ensure adequate liquidity in the financial system. On the monetary front, the central bank cut the bank reserve requirement ratio (RRR) by 1% effective in Oct 2018 and expanded the range of pledged assets for commercial banks to apply for targeted medium-term lending facility (TMLF), which is used to provide specific loans to small and private businesses. China's total social financing (TSF), a broad measure of credit and liquidity in the economy, hit a record high in Q1 2019, even with seasonal factor considered[5]. This increase is mainly due to a rise in new yuan loans, rather than shadow banking financing, which has been declining since Q1 2017 (Figure 4). On the fiscal front, a series of tax cuts have been implemented to stimulate growth since Apr 2019. The tax cuts, including the adjustment of VAT and import tax etc., will help reduce enterprises' cost and create a stable credit and fair business environment.

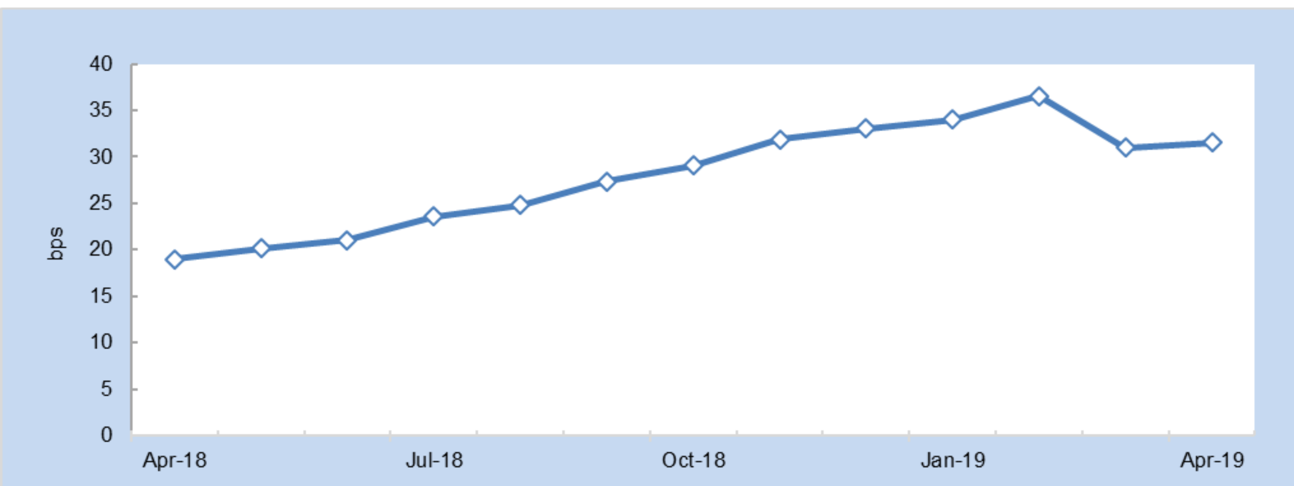

Figure 5: NUS-CRI Aggregate Forward 1-year PD time series for China's non-financial corporates based on information from different historical months looking to Dec 2019. *Source: NUS-CRI*

The NUS-CRI Aggregate Forward 1-year PD (Forward PD) time series also provides a positive outlook of the future of China's non-financial corperates' credit. The Forward PD computes the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. Taking Dec 2019 as the point of interest, figure 5 illustrates the change in credit risk outlook of China's non-financial coporates, based on information from

[5] TSF includes off-balance sheet forms of financing that exist outside the conventional bank lending system, such as initial public offerings, loans from trust companies and bond sales. The People's Bank of China has revised the way it calculates TSF by adding financial institutions' asset-backed securities and loan write-offs. It has also added local government special bonds issuance into the TSF calculation from September 2018. Details please refer to http://www.chinabankingnews.com/total-social-financing/

different historical months. Although deteriorating credit conditions in 2018 dampened the confidence of China's non-financial corporate credit outlook, the Forward PD has been decreasing in the past few months, which may indicate an improving credit outlook. This could be due to the authorities changing the policy tone from "deleveraging" to "stabilizing firms' leverage".

Credit News

Asian bond issuances in dollars, euros and yen hit record pace

Apr 12. The value and volume of Asian bond issuance in dollars have accelerated this year. Companies are rushing to make the most of Fed's dovish signals on interest rates and more willingness by Chinese regulators to approve the issuance of offshore debt. Chinese real estate developers accounted for a third of the total issuance of bonds in Asia while financial groups contributed about 30% and tech, media and telecoms companies accounted for 10%. The high issuance is projected to continue in Q2 2019 as markets conditions remain receptive. Some analysts however warned that it would be difficult to maintain the momentum as the strong supply eventually will overwhelm the market. (FT)

Corporate debt levels risk amplifying economic fragility, says IMF

Apr 10. IMF stated that the presence of high corporate debt levels across nearly three quarters of the global economy can amplify any economic downturn and put financial stability in peril. Although vulnerabilities in the world's households and financial sectors were much lower than at the time of the financial crisis, corporate debt would "amplify" any economic downturn as bankruptcies and default would increase any economic strains. To address financial stability concerns, the IMF recommended that countries should strike up balance between monetary stimulus and efforts to stop further debt increase. Currently, advanced economies' corporate debt vulnerabilities are primarily concentrated in nonbank lenders and, in the US, companies are increasingly borrowing to pay out greater sums to equity holders, leaving companies vulnerable to large economic and financial shocks. (FT)

Hyflux default could signal more trouble ahead for Singapore bond market: S&P

Apr 10. As world economies continue to slow down, heavily debt funded businesses in Singapore might face financial distress as S&P Global Ratings cites the recent defaulted water and power company Hyflux as an example. S&P expects this to be caused by a combination of slowing earnings and higher interest rates. S&P also highlighted that companies with the highest default risks would be companies that are smaller in size and operate in more volatile activities such as property development or commodities. The potential defaults are expected to burden the Singdollar bond market, especially over the next 12 to 18 months, with SGD 10bn of corporate bonds maturing by the end of 2020. (Business Times)

Bad debts may still be a headache for India's state banks

Apr 10. The market outlook for most of India's state lenders remain weak despite reforms in the banking sector according to an asset manager. This is due to the sheer volume of bad assets that the public sector banks own which will increase their credit cost. The high managerial costs and low profitability would mean that these banks are not generating capital. Indian public sector financial institutions control about 70% of all banking assets in India and have the highest exposure to bad loans. The bad debt problem have shown some signs of improvements from the recent bank earnings report and the resolutions that has happened after India's insolvency and bankruptcy act. (CNBC)

ECB's lending operations fail to ignite bank lending

Apr 9. ECB is going to release detailed information on TLTRO-III, a new round of low-cost loans designed to boost new loans to households and companies across the bloc. But there are concerns that TLTRO has failed to inject steady lending through its two iterations to date, because the fundamental problem is from the demand side, not the supply side. Despite rock-bottom interest rates in the program, the percentage of banks reporting an increase in demand for loans to businesses in the previous quarter dropping to zero, from 9% at the end of last year. With households and companies already indebted and facing uncertainties, they do not want to borrow more. However, most economists advocate the extension of the program, concerning the situation will be even worse without TLTRO. (FT)

Debt investors draft in lawyers to fight for better protections (FT)

China local governments flood market with USD 179bn in bonds (FT)

In hunt for yield, Japan's banks snap up leveraged US debt (Reuters)

Regulatory Updates

China to Maintain Prudent Monetary Policy, PBOC's Chen Says

Apr 14. Chinese central bank deputy governor Chen Yulu has announced that China will continue its prudent neutral monetary policy this year. The RMB exchange rate will be kept in line with fundamentals at an adaptive equilibrium level. Economic growth will be encouraged by focusing on pro-active fiscal policies instead, which include recent regulatory changes to foreign-capital investments like the opening up of formerly closed-off markets. Cutting taxes and fees, as well as a general clean-up of "zombie" state-owned businesses will be a focus as well. (Bloomberg)

US non-bank mortgage lenders come under scrutiny

Apr 10. As US non-bank mortgage companies' role in American finance ballooned, they are facing intensified oversight by the federal government. Ginnie Mae, a US government agency that guarantees payments on USD 2tn of mortgage-backed securities (MBS), is advancing proposals that would require non-bank mortgage lenders to compile 'living wills' which dictate how to keep their operations running if they get into trouble. While post-crisis regulation forced traditional banks to have larger amounts of capital and more resilient liquidity backstops, non-banking sector is much more loosely supervised, causing them to be poorly equipped to weather financial shocks. Currently non-banks are the main lenders to borrowers with weaker credit rating and the increased scrutiny of non-banks comes as some see declining profitability and overcapacity in the sector. (FT)

ECB policymaker sees no need for tiered rates to help banks (Business Times)

Turkey to take steps to strengthen banks' capital (Reuters)

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