Deleveraging And Deregulation: China's Two-Pronged Approach Toward Financial Stability

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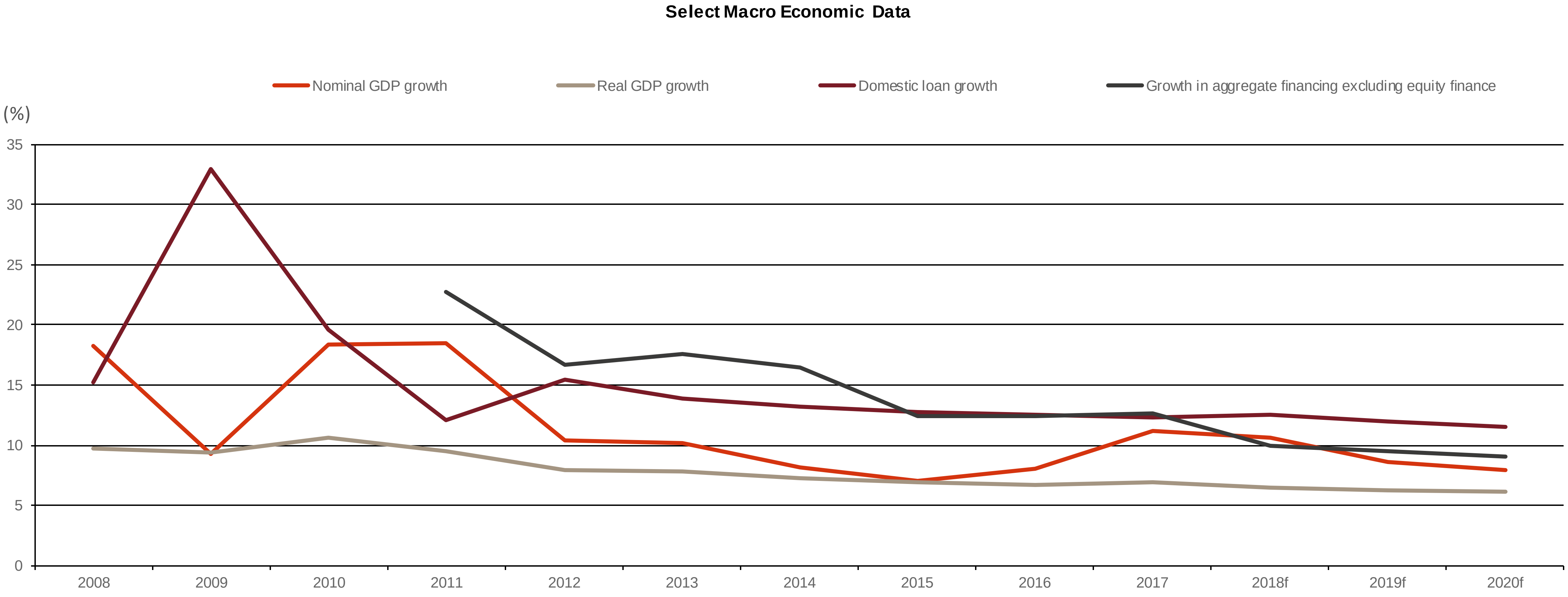
Overview

- China's economic and financial conditions.

- Drivers of China's holistic policy tightening, and counterintuitively, financial liberalization.

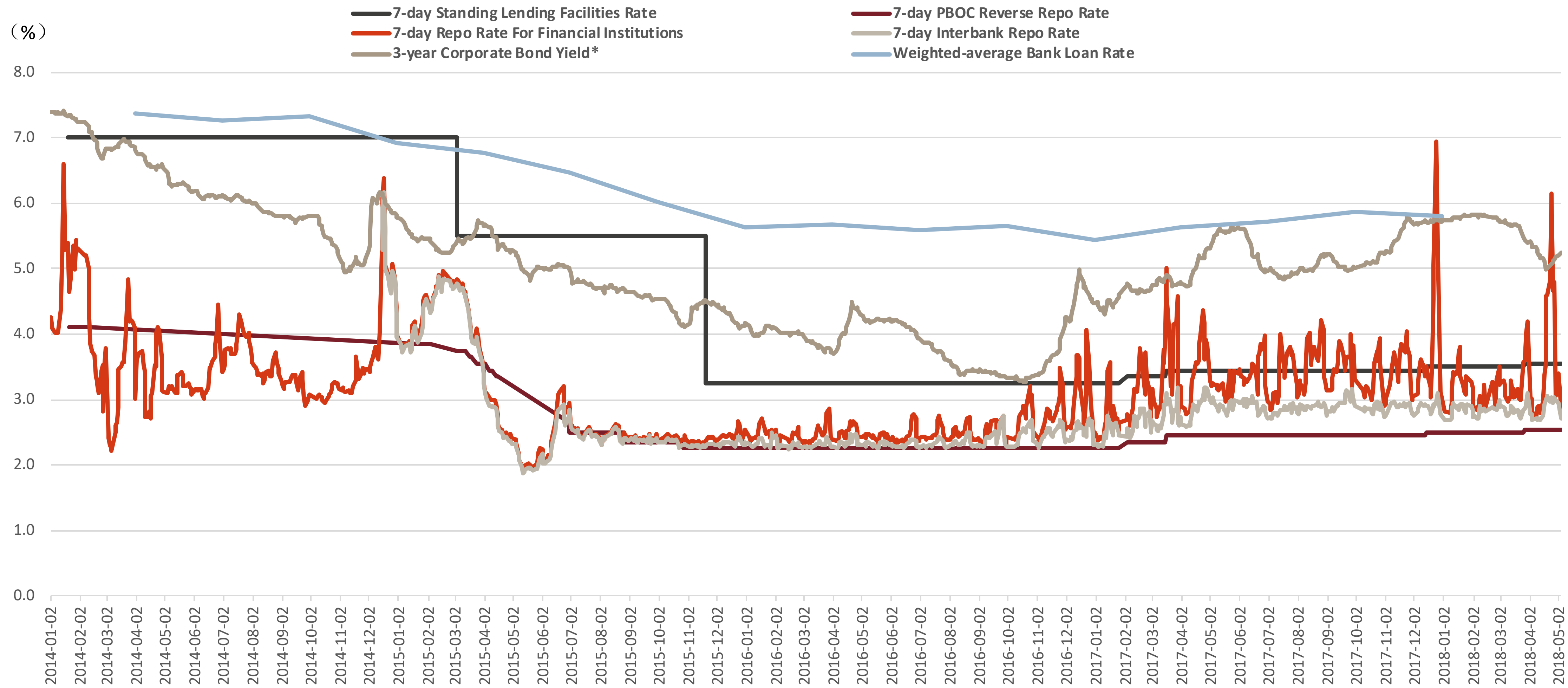
- China's delicate balance between financial deleveraging and stability.

China’s Economic Expansion Has Recently Rebounded, But Still Trails Credit Growth



Note: Year-over-year growth up to Dec. 2017. 2018f, 2019f and 2020f refer to S&P Global Ratings forecasts. Source: The People's Bank of China, S&P Global Ratings.

Interest Rates Largely Rising Since 2016, At Varying Speeds And Volatility



Source: Wind. S&P Global Ratings

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Holistic Policy Tightening Despite Recent Fine-tuning

- We have seen concerted regulatory tightening on multiple fronts.
- Recent policy fine-tuning is unlikely to alter the policy direction.

Policy Target	Date	Policy Initiative	Credit Implication
Shadow Banking	11/17/2017	Proposals on asset management products to 1) end implicit guarantees to investors; 2) prohibit multi-tiered product structuring; 3) reduce permitted leverage levels for many products.	Outstanding WMPs are likely to decline.
	12/1/2017	The PBOC tightened regulations on micro-loans including on their funding sources, pricing caps, and maximum financial leverage. This includes online micro-loans, often for consumer purposes.	We expect a stagnation in online micro-loans and peer-to-peer loans.
	12/22/2017	The CBRC banned commercial banks from diverting funds into real estate, local government financing vehicles, industries with overcapacity, and the stock market via trusts, and required banks to apply a look-through approach to related trust products if the underlying assets were not "true-sale".	We see rising refinancing risks for select segments that rely on trust loans, and heightened regulatory capital strain on banks.
	1/5/2018	The CBRC updated its rules to restrict the source of funds commercial banks can use to make entrusted loans; nor can hey be used for financial investments.	This could trigger a decline in entrusted loans outstanding and sell-off pressures in the bond markets.
	1/5/2018	The CIRC noted that insurers were banned from offering financing to local governments or LGFVs through equity investments. It also forbid insurers from 1) using private equity investment schemes as a channel to skirt regulations; 2) investing in debt disguised as equity.	Rising refinancing risks for select segments.
	1/12/2018	AMAC banned fund managers from 1) raising investor funds to lend in the form of multi-tiered structure products, trusts, entrusted loans or other special-purpose vehicles; 2) participating in a rolling-based "asset-pool" which creates duration mismatch.	This could trigger a decline in WMPs and add to refinancing risks for select segments.
Risk Management	11/8/2017	The State Council's newly established Financial Stability and Development Committee held its inaugural meeting.	This highlights financial stability as a top priority for the government.
	12/6/2017	The CBRC introduced a NSFR (net stable funding ratio) and two other new quantitative measures to improve the liquidity risk assessment framework.	This could force banks to reduce wholesale funding and to derisk on the asset side.
	12/14/2017	The PBOC raised its reverse repo and other key policy rates by a moest 5bps following the U.S. Federal Reserve's recent (larger) rate hike.	This gesture suggests the PBOC will keep interbank rates relatively stable.
	1/3/2018	The PBOC and the three other regulators issued a notice to restrict the size of leveraged bond investments relative to the net asset value of the financial institution in question, and to ban ill-incentivized accounting practices for repurchase transactions for regulatory avoidance or arbitraging.	This could trigger further unwinding of leveraged bond investment positions and add to sell-off pressures in bond markets.
	1/5/2018	The CBRC proposed to align its regulations on banks' large exposures with Basel standards, which among other things, would cap 1) a single-name interbank exposure to 25% of tier-1 capital (or 15% among G-SIBs); 2) a single-name corporate exposure to 15% of tier-1 capital (or 20% for connected group companies). Furthermore, any investment receivables for which a look-through approach cannot be applied shall be treated as an "anonymous" corporate exposure.	Apart from imposing better risk management on large exposures, the rule would restrict the use of investment receivables for regulatory arbitrage.
	1/13/2018	The CBRC issued a notice to further its crackdown on various irregularities in Chinese banking market including deficient corporate governance, regulatory arbitrage, and risk-taking through shadow banking.	This confirms a continued regulatory tightening stance this year.
Unauthorized local government debt	11/10/2017	The MOF clarified the scope of PPP projects and carved out projects which provide guarantees to private investors by local governments. Such as: 1) assured to repurchase back the principle invested; 2) promised fixed returns; 3) any sort of guarantees on projects' borrowings.	This may help fix loopholes for unauthorized local government borrowing, hence reducing credit demand for infrastructure investment.
	11/24/2017	SASAC restricted central SOEs from overinvesting in PPP projects by 1) capping net PPP investment (including bond, equity and guarantees) to 50% of last year's group-level net assets; 2) prohibiting highly indebted or loss-making group subsidiaries from participating in PPP projects alone; 3) banning central SOEs from providing guarantees or promising returns to other equity investors.	This could reduce credit demand from PPP projects.
	12/24/2017	The MOF warned that "the illusion that the central government will provide a final guarantee should be smashed" and the central government will not bail out LRGs and financial institutions when default risks arise.	Heightened refinancing risks for LGFVs.
Environmental protection	12/8/2017	The central government highlighted "tackling pollution" as one of China's top three policy priories in the next three year in Dec 2017. With a target to reduce carbon emission by 18% in the 13th Five-Year plan, China's battle against pollution has already led to operation suspensions at many polluting companies and the newly introduced environmental tax.	While forced shutdowns have reduced supply and supported the gross margins of surviving industrial companies, the crackdown could lead to operational disruptions to polluting manufactures and weigh on banks' asset quality.

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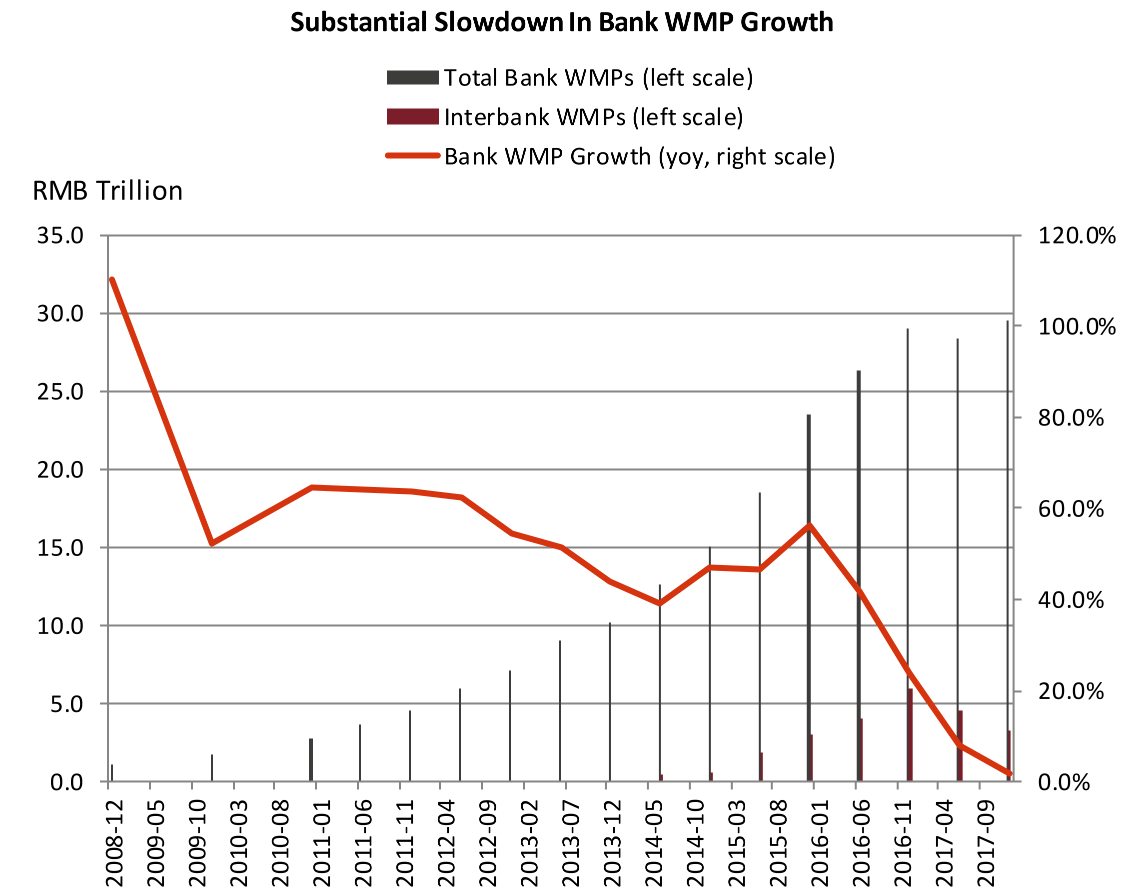
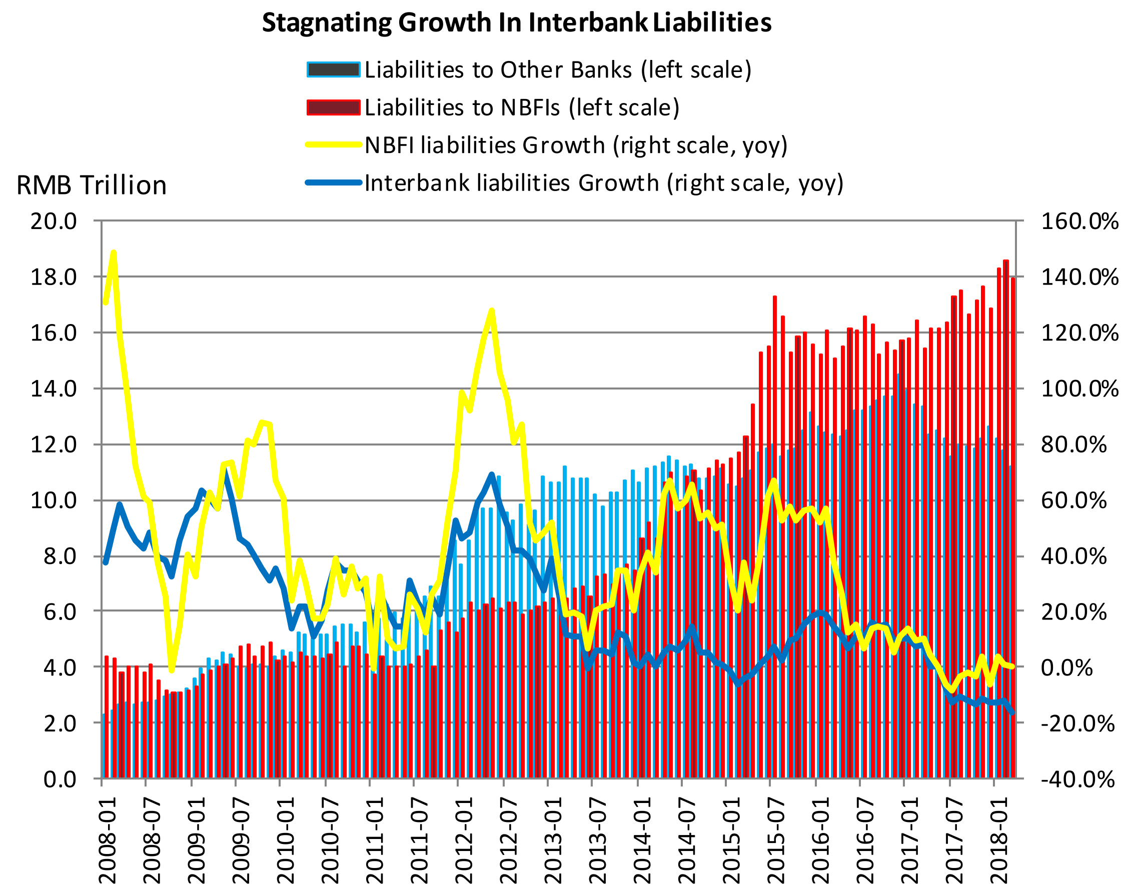
Financial Sector Deleveraging Is Underway



Source: Wind. S&P Global Ratings



Source: Wind. S&P Global Ratings

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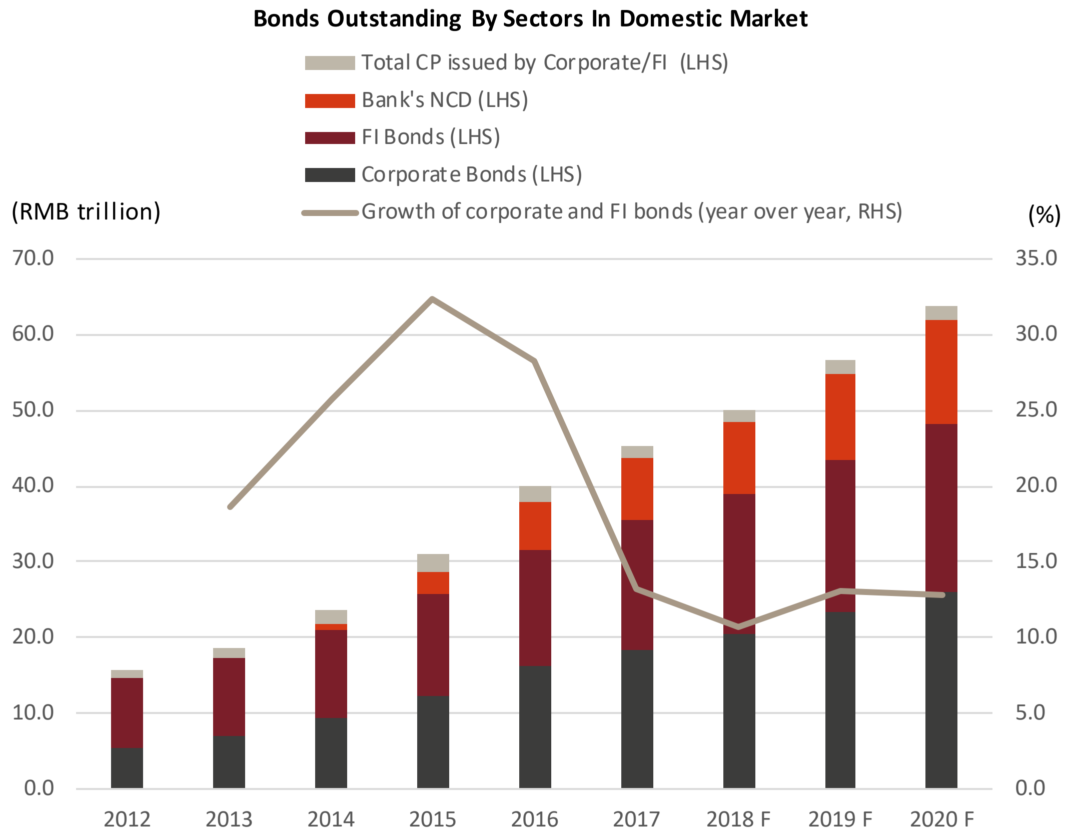
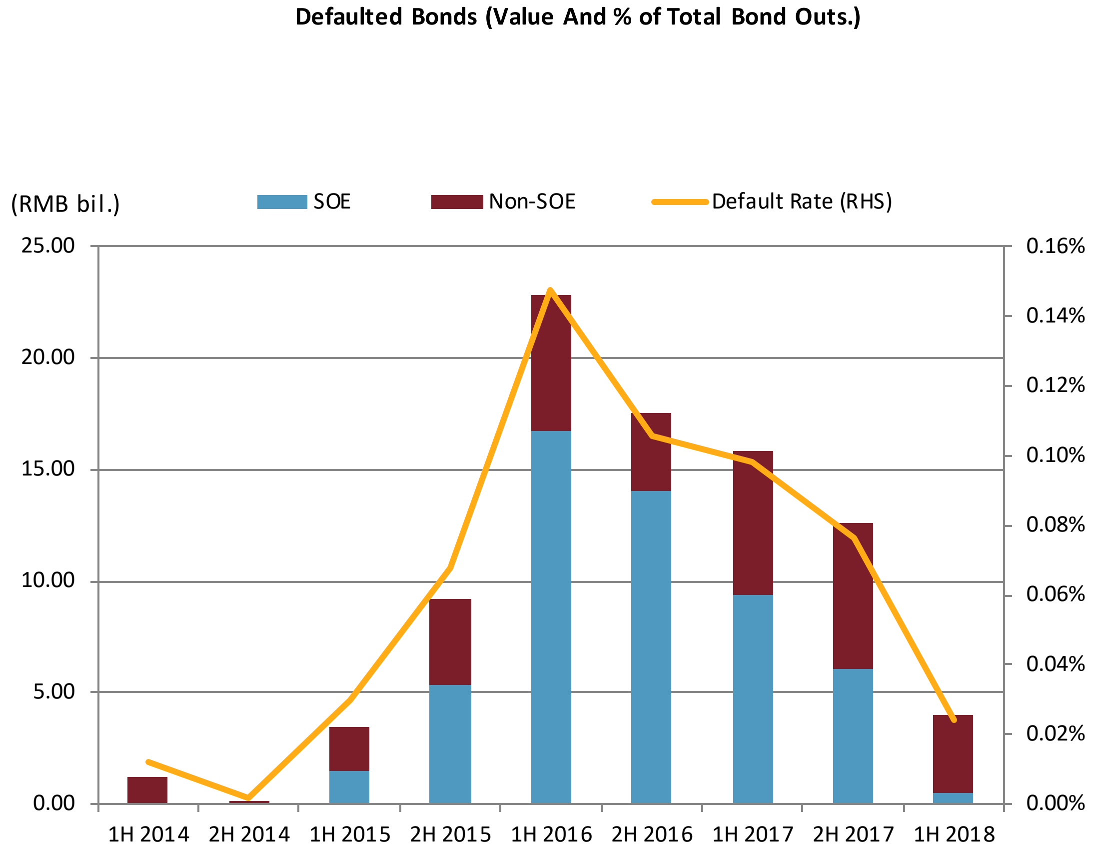
Substantial Deceleration In Bond Issuances, But Onshore Defaults Remained Very Low





FI – Financial Institutions, CP – Commercial Paper, NCD - Negotiable Certificate Of Deposit
Source: S&P Global Ratings, ChinaBond, Shanghai Clearing, China Securities Depository and Clearing Corporation Limited

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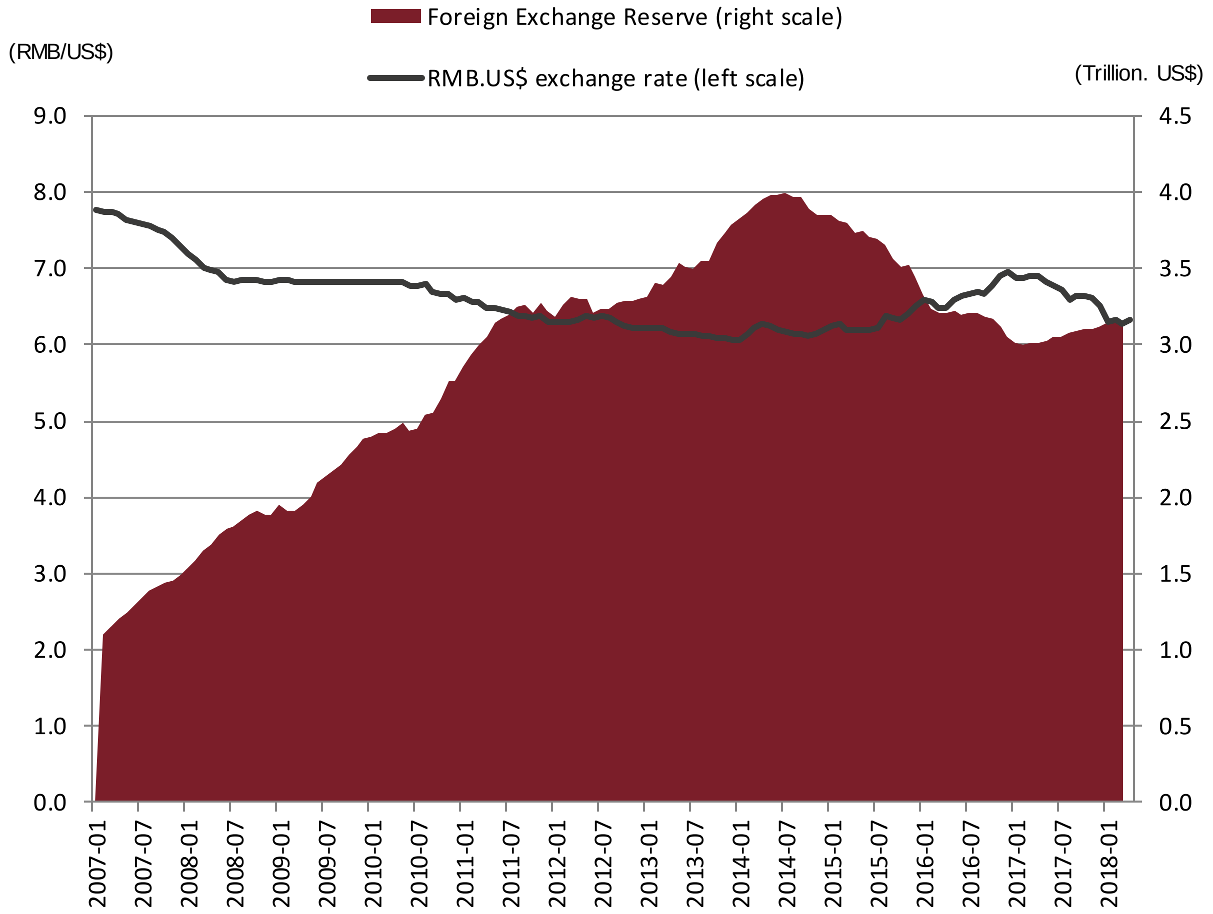
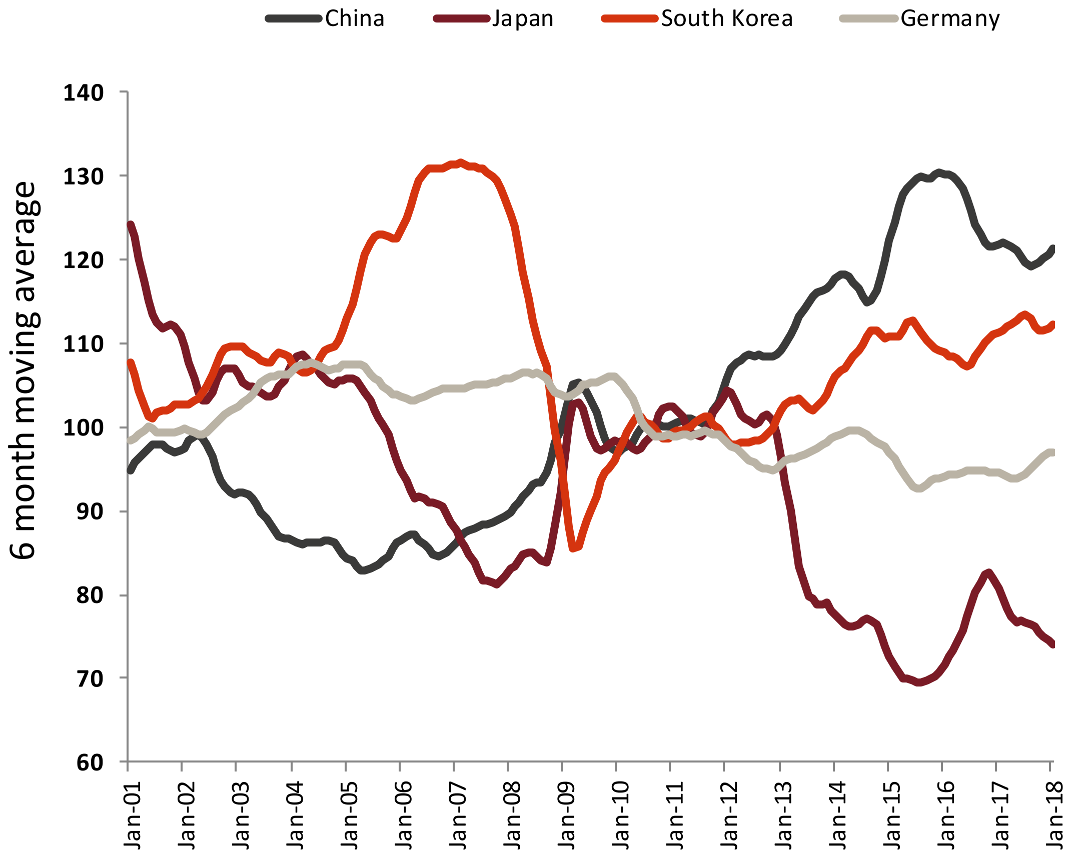
Capital Outflow Risks Have Eased; RMB Strengthening

RMB/US$ Exchange Rate And Foreign Exchange Reserves



Source: Wind. S&P Global Ratings

Real Effective Exchange Rate Index (2010 = 100)



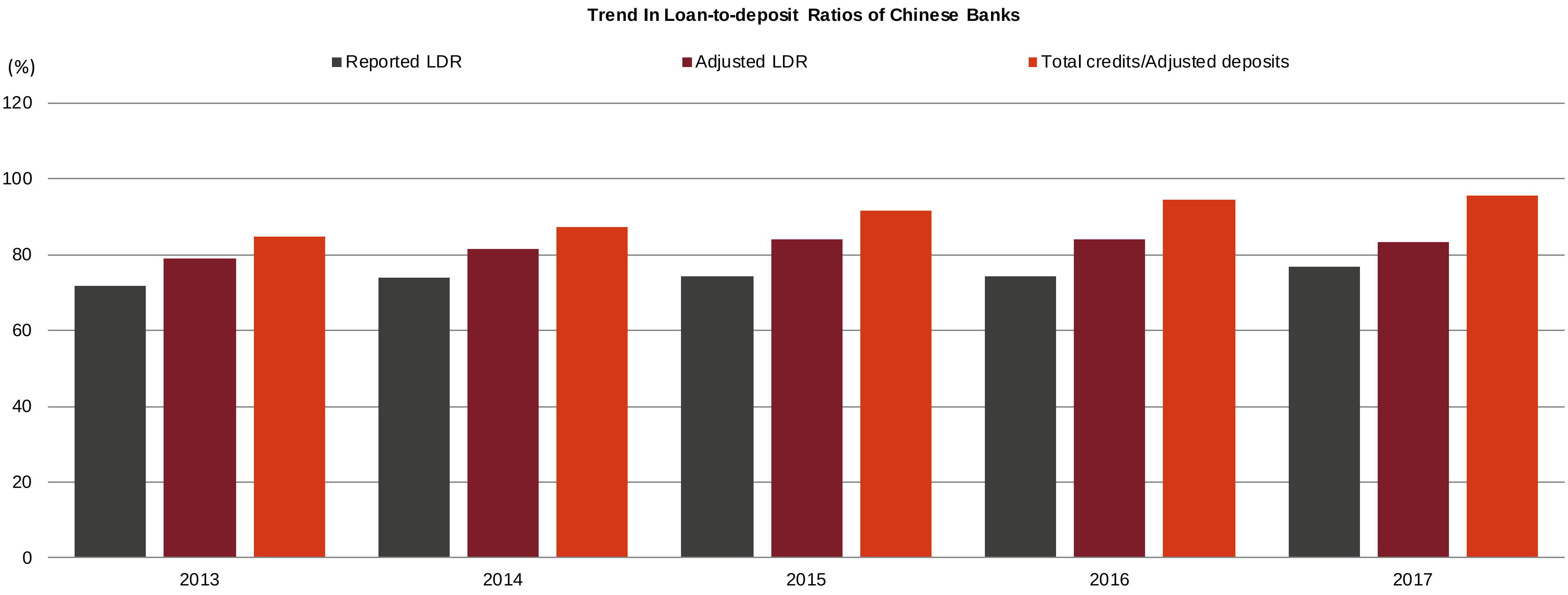
Source: S&P Global Ratings

Why China Is Pushing For Financial Liberalization Amid Policy Tightening

- Capital inflows associated with stronger investor confidence could widen "funding headroom" for China to maintain affordable interest rates.
  - Two-way movements in RMB exchange rates.
  - Bond Market Connects, Equity Market Connects, free trade zones.
  - Greater market access to foreign financial intermediaries.

- Defaults associated with reduced government interventions could discipline credit risk underwriting and pricing, reining in credit growth and enhancing capital allocation efficiency.

China Can Still Fund Itself With Domestic Savings, But Headroom Is Shrinking



Note: Reported LDR refers to the ratio of total customer loans to total customer deposits. Broadly Adjusted LDR refers to the ratio of Chinese banks' reported private sector credits plus shadow lending exposures to the reported customer deposits plus wealth management products.
Source: The People's Bank of China, S&P Global Ratings.

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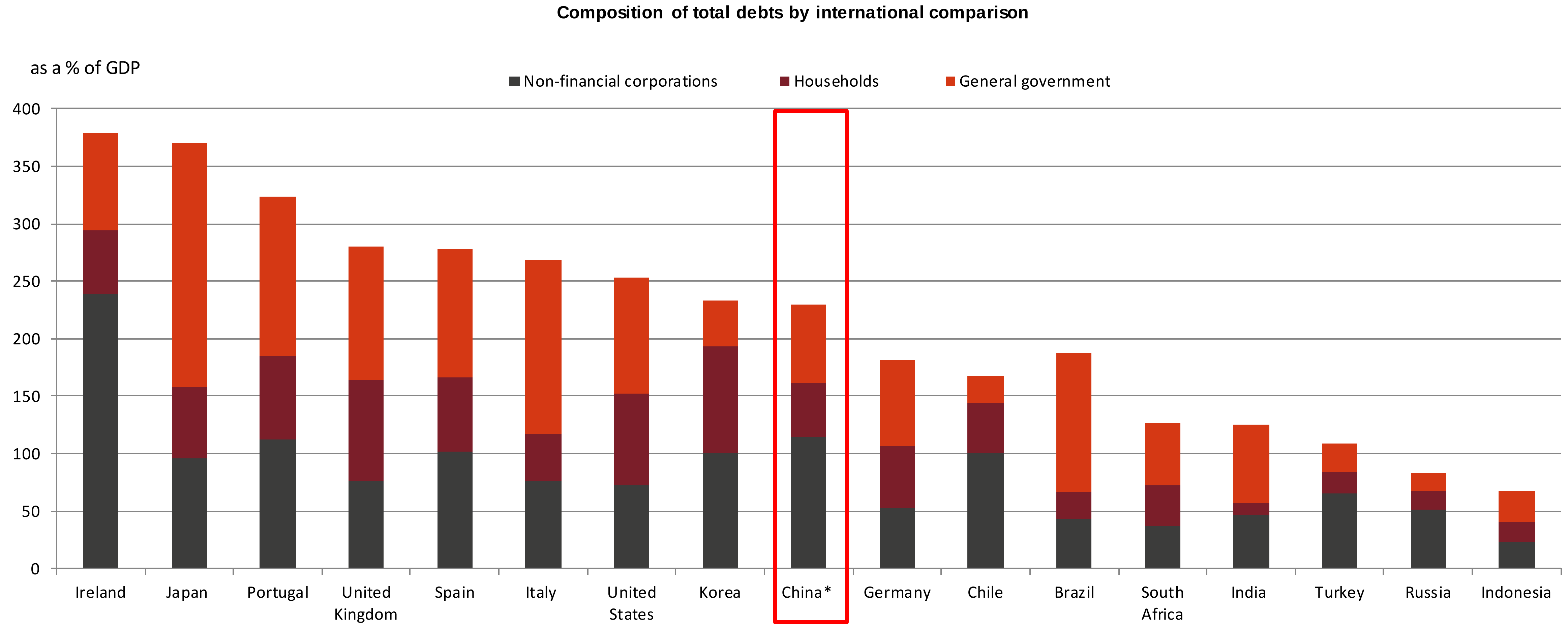
Spotlight On China's Debt Issue



Source: Bank for international settlements. Data as end of 2016
*China data is estimated by S&P Global Ratings based on IMF data after adjustments for quasi public sector debts and shadow lending outside Total Social Financing.

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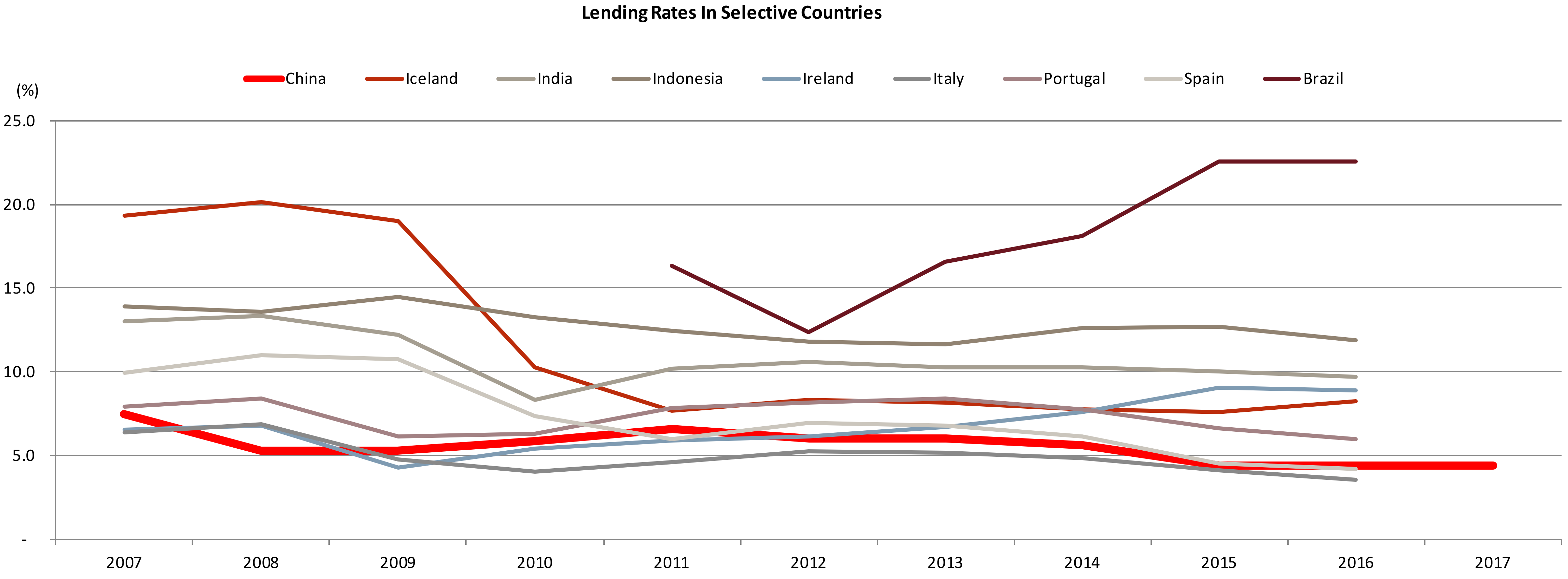
China’s Debt Issue: A Cost Angle



*data from IMF; data on Turkey not available; data on Brazil is free-market rates on corp debt.

Source: IMF, S&P Global Ratings.

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Thank you!

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