Chinese insurers face heightened credit risk amidst falling premiums and exposure to the domestic real estate market

by Wang Anyi

- **The NUS-CRI Agg PD demonstrates the heightened credit risk of Chinese insurers against the relatively stable credit quality of global insurers**
- **NUS-CRI BuDA toolkit demonstrates that Chinese insurers' exposure to changes in the domestic real estate prices poses a risk for their credit quality.**

While globally listed insurers remain relatively resilient to the initial impact of the pandemic as covered in our Weekly Credit Brief last year, Chinese insurers[1] have faced multiple challenges. The NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) illustrates that Chinese insurers' credit risk has been elevated since the beginning of this year and surged above the BBB- upper bound according to PDiR2.0[2]. In contrast to the relatively stable credit quality of global insurers, the increasing PD of Chinese insurers reflects a number of key challenges faced by the industry such as declining premiums and a potential increase in investment risk. In addition, the NUS-CRI Forward 1-year PD (Forward PD[3]) demonstrates that credit outlook for Chinese insurers has worsened. This suggests that Chinese insurers may face potential headwinds pertaining to their exposure to possible asset bubbles in the domestic real estate market.

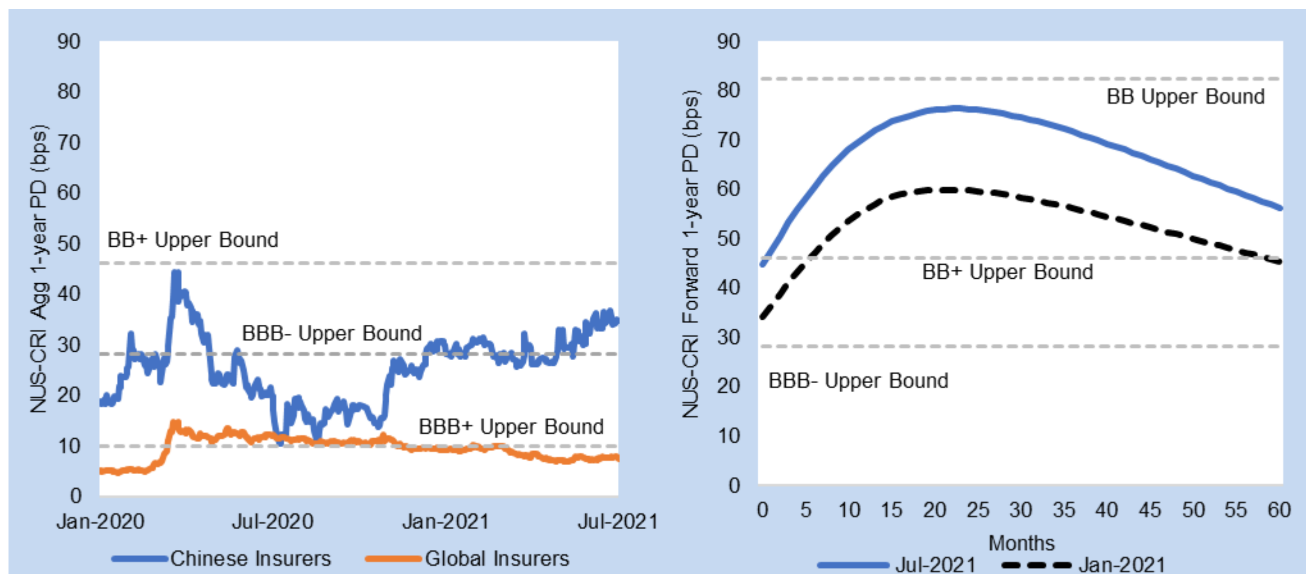


Figure 1a (LHS): NUS-CRI Agg 1-year PD for Chinese listed insurers and global listed insurers from Jan-2018 to Jul-2021 with reference to PDiR2.0 bound. Figure 1b (RHS): NUS-CRI Forward 1-year PD for Chinese insurers as of Jan-2021 and Jul-2021. *Source: NUS-CRI*

Despite a strengthening Chinese economy, the Chinese insurance industry has struggled to rebound. Based on a recent report by the China Banking and Insurance Regulatory Commission (CBIRC) in Jun-2021, premiums enjoyed by Chinese insurers have edged down YoY consecutively in March, April, and May of 2021 (see Figure 2a). Premium growth rate already slowed down at the start of the pandemic in Q1 2020 with a QoQ growth rate

[1] There are 13 listed Chinese insurers in total according to Bloomberg Industry Classification System 2020. In this article, we only focus on listed companies with core business in the insurance industry. These companies are China Pacific Insurance Group Co Ltd, PICC Property & Casualty Co Ltd, New China Life Insurance Co Ltd, ZhongAn Online P&C Insurance Co Ltd, People's Insurance Co Group of China Ltd/The, Ping An Insurance Group Co of China Ltd and China Life Insurance Co Ltd.

[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

[3] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults between the 6th month to the 18th month, conditional on the firm's survival in the first 6 months.

of 2.29%, 13.6 percentage points lower than in the same period of 2019. Furthermore, the median ROE of Chinese insurers in Q1 2021 is 13.06%, lower than the 15.44% in Q1 2020, given that China's insurance companies saw falling profit as COVID-19 disrupted businesses and hurt investment returns. The liquidity of Chinese insurers also saw a decline, with the median cash to total asset ratio standing at 1.74 in Q1 2021 compared to 2.32 in Q1 2020. Though the declining premium growth rate of the insurance industry is a cause of concern, the solvency ratio has remained relatively stable. The average comprehensive solvency ratios of the Chinese insurance industry stood greater than 240% in 2020.

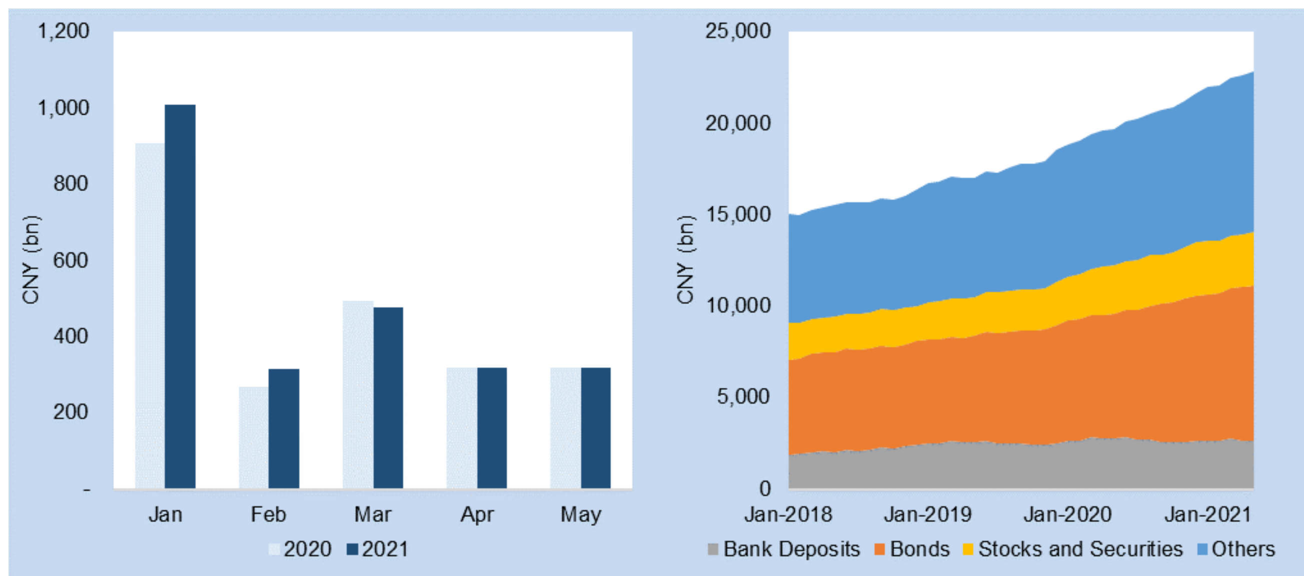


Figure 2a (LHS): Premium of Chinese insurers from Jan to May in 2020 and 2021. Figure2b (RHS): Outstanding investment assets breakdown of Chinese insurers from Jan-2018 to May-2021. *Source: CBIRC, Wind*

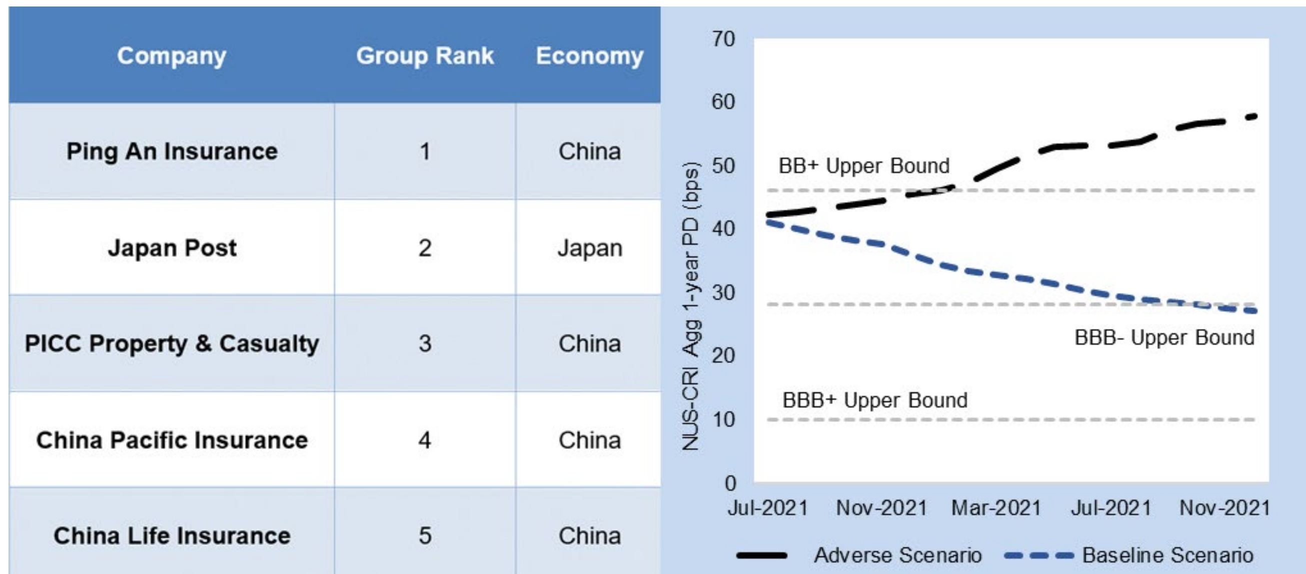
Looking into the allocation of insurers' investment assets, fixed income occupies the largest share (Figure 2b). The current low interest rate environment indicates that the performance of investments would be a concern for insurers. Over the past months, the Chinese 10-year treasury yield has been trending down and is currently at around 3.1%. As such, the investment yields of insurers may remain pressured and may push insurers into riskier or more illiquid assets. In Nov-2020, CBIRC issued a new rule with regard to loosening restrictions on equity investment by insurance companies. This could be favorable to insurers since they face fewer constraints and may improve returns. However, the investment in equity may leave Chinese insurers vulnerable to deterioration in risk-based capitalization due to increasingly volatile investment assets. This would increase the investment risk of insurers and add pressure to the regulatory solvency ratio[4].

The insurance industry plays a vital role in the stability of financial systems. The NUS-CRI Systemically Important Insurers (CriSII) in Figure 3a illustrate the group rank[5] by systemic importance of insurers worldwide. Among the top 5 systemically important insurers, there are 4 insurers from China. The links of insurance companies to the real estate sector have raised alarms as a potential source of systemic risk for the industry. In the years prior to the pandemic, many insurance companies have acquired stakes and/or invested in real estate companies, and have even become the largest shareholder of some real estate companies due to their low valuation. For example, Ping An Insurance Group, the largest insurer in China and Aisa-pacific, is exposed heavily to the real estate sector, including exposure of around USD 8bn to the indebted developer China Fortune Land Development Co before it defaulted in Feb-2021. As regulators want to cool the housing market, the debt-laden real estate sector is under increasing scrutiny.

To understand the influence of the real estate sector on the top 4 systemically important Chinese insurers, we utilize the NUS-CRI Bottom-Up Default Analysis toolkit (BuDA[6]) (Figure 3b) to stress test China's Housing Price Index (HPI) against the NUS-CRI Agg PD for 4 of the top 5 systemically important insurers domiciled in China. In the baseline scenario, we assume a 1.5% QoQ growth in HPI from Q3 2021 till the end of 2022. In the adverse scenario, the HPI is set to decrease by 5% QoQ over the same period. The baseline scenario sees a steady improvement in the Agg PD of the 4 insurers. While in the adverse scenario, the Agg PD rises, indicating the

[4] The regulatory solvency ratio is the actual capital as a percentage of the minimum capital requirement according to CBIRC. It is a key metric to measure an insurer's ability to meet its debt and other obligations.
[5] Group rank is the systemic importance rank of the companies within the same industry group (insurance industry) worldwide.
[6] The Bottom-up Default Analysis (BuDA v3.3.0) is a credit stress testing and scenario analysis toolkit jointly developed by the Credit Research Initiative (CRI) team of National University of Singapore (NUS) and the International Monetary Fund (IMF).

simulated deterioration of credit quality for Chinese insurers should house prices fall, potentially driven by government-driven regulatory policies to curb the growth of a housing bubble.



Company	Group Rank	Economy
Ping An Insurance	1	China
Japan Post	2	Japan
PICC Property & Casualty	3	China
China Pacific Insurance	4	China
China Life Insurance	5	China

Figure 3a (LHS): Top 5 NUS-CRI Systemically Important Insurer (CriSII) as of Jun-2021. Figure 3b (RHS): Agg PD for 4 systemically important Chinese insurers under adverse and baseline scenarios. *Source :NUS-CRI, BuDA v3.3.0*

Although home prices are likely to see a sustained increase in the short term, Chinese insurers with significant exposure to the real estate sector could see their credit profiles worsen in the long run as Chinese authorities intensify their efforts at controlling house prices. Furthermore, the Chinese insurance industry's exposure to non-motor sectors due to the lack of reinsurance coverage would make them vulnerable to climate-related disasters, as the economic losses from natural disasters amounted up to CNY 370bn last year, CNY 327bn in 2019, and CNY 264bn in 2018. Compared to their global peers, Chinese insurers have also lagged behind on environmental risk management, which may restrain their earnings and capital, and pose headwinds for their credit outlook. On the bright side, however, the digitalization trend in the Chinese insurance sector may expand the industry's digital capabilities in handling sales, underwriting, and risk assessment. This, in turn, should bode well for insurers' operational capabilities.

Credit News

ECB to crack down on dangerous risks in banks' leveraged lending

July 2. ECB's head of supervision warned that additional capital requirements might soon be introduced to address the risks in leveraged loan and equity derivative markets. He expressed worry that though the support provided by the government and central banks has protected the financial system, it has also made it complacent. He also warned of a sudden correction in prices driven by the withdrawal of government support and potential future inflation expectations. He stressed that the risks posed by a combination of higher leverage, financial complexity, and opacity necessitate a revamp of regulatory and supervisory dialogue at a global level to discuss the implementation of new solutions. (FT)

Dollar and government debt rally as investors shun risky bets

July 1. Ahead of Friday's US jobs data release, the dollar strengthened and government bonds firmed, with the US dollar index posting monthly gains of almost 3% and the yield on the benchmark 10-year US Treasury note settling at 1.46%. Economists expect Friday's report to show US employers added over 700,000 in June, up from 559,000 in May. However, fund managers are reluctant to make big bets ahead of the jobs report as April and May payrolls turned out significantly different from economists' forecasts. Most economists polled in the FT-IGM survey now expect at least two rate hikes by the end of 2023, but a weak report on Friday may push back expectations around the Fed's timeline to tighten monetary policy (FT)

Rising China bond yields prompt fears over coming surge in defaults

June 30. Increasing investor concerns over uncertain finances of China's most economically vulnerable provinces resulted in a sell-off in state-run groups' bonds, with analysts cautioning a spike in defaults in China's USD 17tn credit market. The median yield on bonds issued by state-owned enterprises (SOEs) in these provinces and municipalities rose above 5% from 3.5% last year. In contrast, the nationwide trend indicated that most SOE bond yields fell over the last six months. Divergence in yield highlights the divide between the country's more dynamic regional economies and the less developed ones in their recovery from Covid-19. With global investors increasing scrutiny on China's bond market, where confidence has been unnerved by multiple state-linked defaults, fears over increasing defaults are rising as Chinese authorities seem to be more willing to let unprofitable SOEs go bankrupt. The pandemic has strained regional governments' finances, leaving fewer funds available to bail state-run companies, challenging long-held assumptions that the government will step in to support them. (FT)

China's local governments roll over more debt to ease risks

July 5. Sales of refinancing bonds have more than doubled as local governments try to reduce repayment pressure from maturing debt. CNY1.9tn (USD 293bn) of refinancing bonds were sold in 1H 2021 as compared to CNY 700bn sold in the same period of 2020. Local governments have also simultaneously reduced bond sales related to infrastructure projects due to a lack of quality projects and a tough stance taken by Beijing on the debt-laden sector. Overall investment in the domestic infrastructure industry has been decreasing MoM, with May-2021 recording a 3.6% decline in investment growth. However, as recovery picks up steam, the government expects fiscal revenues to reach normal levels and stabilize (Bloomberg)

Commercial Debt backed by lone borrowers and properties rebounds

June 30. Commercial real-estate bonds backed by single borrowers and properties are facing increased demand. Billions of dollars of debt have been sold by banks, indicating a remarkable recovery after issuance of single-asset, single-borrower bonds paused last year when the Covid-19 pandemic emptied commercial real estate across the country. With low borrowing costs, single-asset, single-borrower bonds are predicted to face a further rise in demand. According to Bank of America, banks will price two more single-asset deals worth more than USD 1bn combined over the next few months. It is estimated that these deals will double this year, surpassing pre-pandemic levels. However, hotels and office spaces remain vulnerable despite reopening and increased return-to-work plans. (WSJ)

EU bond sales run by four banks previously suspended for antitrust (FT)

Banks turn to blockchains to reform costly bond market (FT)

Developer China Evergrande says debt level down to CNY 570bn (Reuters)

Regulatory Updates

ECB's Knot warns central bank could be underestimating inflation

July 3. Although the ECB predicts that the current inflation, caused by rebounding energy prices and supply shortage, is temporary, one of the ECB policymakers, Klaas Knot, suggested ending the emergency monetary stimulus around March 2022. Knot warned that the ECB could be underestimating the current inflation and overestimating people's capacity to bear it. Learning from the longer-than-expected negative interest rate in 2014, Knot suggested that house prices can provide a suitable proxy to measure inflation. (Bloomberg)

Global regulators try again to eliminate money-market hazards

June 30. The Financial Stability Board (FSB) released a report advising an overhaul of regulations for money-market funds, as the Covid-19 fuelled financial panic made clear their susceptibility to investor runs and difficulties when forced to dump assets under pressure. The report presents a range of policies, including charges for early and large-scale redemption moves, a "minimum balance at risk" rule or a capital buffer, as well as stress tests and more public disclosures of assets in the funds. It also suggested imposing fees when liquidity falls below a specified threshold. Some of these provisions incentivized investors to pull out money before the fees were imposed, so decoupling the threshold from penalties could give funds greater flexibility in managing their liquidity. The FSB is soliciting public feedback on the new report and a final version will be released before October (Bloomberg)

Regulators to tighten scrutiny of asset managers to stop 'greenwashing' (Reuters)

Bank of Japan cuts some bond purchase targets over next quarter (Bloomberg)

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Contributing Editors: Yao Xuan, Raghav Mathur