China's post-virus stimulus packages may put its financial system at risk

by Luo Weixiao

Over three months since the novel coronavirus outbreak, the number of active cases in China has been brought down to 2,000 in early Apr from its peak at 58,000 in mid-Feb and the lockdown of the cities has been gradually removed. To revive the economy hit by the containment, several stimulus measures are carried out by the Chinese authorities. However, though the stimulus moves are beneficial for the corporates to stay afloat in the short run, they may pressure the country's financial system in the backdrop of rising defaults in recent years.

To fight the economic fallout from the coronavirus pandemic which IMF mentioned to be 'way worse than the global financial crisis', the People's Bank of China (PBOC) has implemented several expansionary monetary policies to inject liquidity. The central bank last week announced the third Reserve Requirement Ratio (RRR) cut of this year, targeting smaller banks to support small and medium enterprises (SMEs). The three rounds of RRR cut would pump CNY 1.75tn (USD 0.25tn) of long-term funds in the banking industry to boost lending. The authorities also took measures to lower the borrowing cost for the companies even at the expense of banks' profitability. The benchmark one-year loan prime rate was cut further to 4.05% this Feb, the fourth reduction in the last one year. Moreover, a fast-track regulatory process in the interbank market was built for virus prevention and control bonds (virus bonds) and the coupon rates are generally lower than the YTM of the issuer's outstanding bonds with a similar maturity date. Some of the state-owned banks and state-owned institutional investors are mandated to buy the virus bonds to support the corporates.

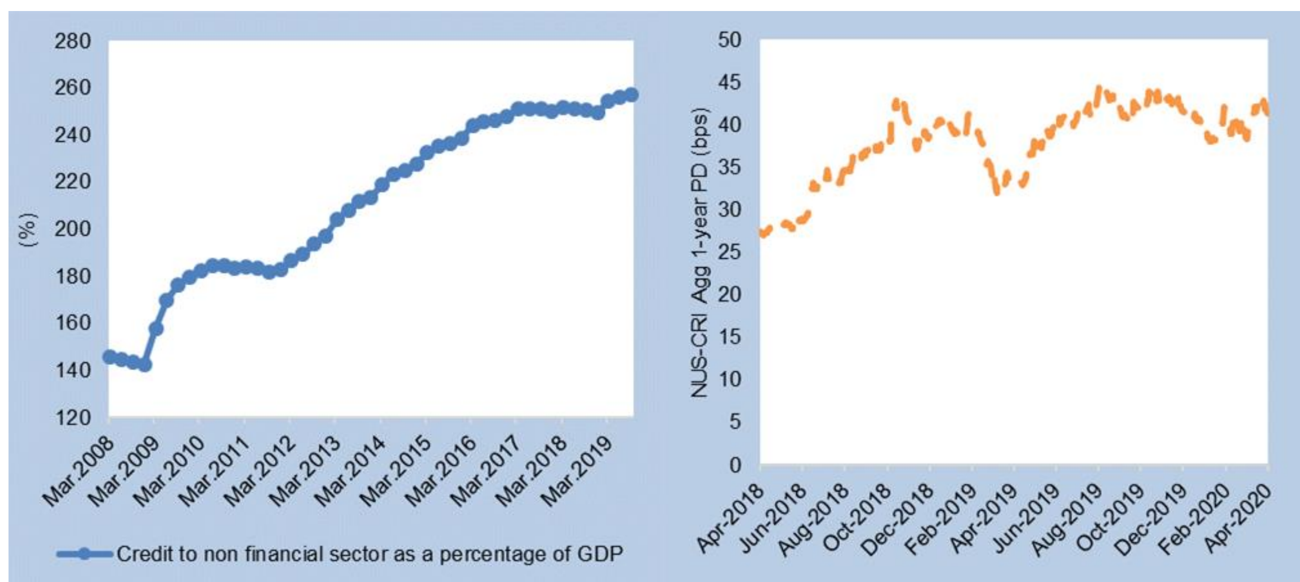

Figure 1a (LHS): Leverage (credit to GDP) of Chinese non-financial corporates. Figure 1b (RHS): NUS-CRI Agg PD for China-domiciled non-financial corporates. *Source: Bloomberg, NUS-CRI*

There are concerns that the large scale stimulus may impose risk on the financial system because it is more fragile than more than ten years ago. Chinese corporates have been building up debt through banks and the bond market since 2008. The leverage of Chinese non-financial corporates (credit attained from all sectors as a ratio of GDP) increased by around 100% to 257% in Q1 2019, from 158% in Q1 2009. This was driven by the CNY 4tn (USD 586bn) stimulus package comprising massive investments in infrastructure projects post the Great Recession and 2008 Sichuan earthquake. However, the central government only provided around 30% of the funding and the rest came from local government expenditures and various types of debts - including local government bonds, corporate bonds, medium-term notes and bank loans. Though the leverage curve was

flattened during 2017 and 2018 due to the government's deleveraging campaign, the number climbed again in 2019 – albeit at a slower pace compared to the growth rate before 2017 - since the government had to ease the credit environment amid the economic slowdown. Correspondingly, the credit profile for the China domiciled non-financial corporates have deteriorated in the recent two years as tracked by NUS-CRI Aggregate (median) Probability of Default (Agg PD) for the corporates (as shown in Figure 1b).

The high leverage will render the monetary policies less effective now compared to 2008, especially during a time of record defaults in the bond market. There were mainly government bonds in the market before 2008 but in recent years, corporates have much easier access to bond issuance and the issued amount of corporate bonds hit CNY 45.3tn (USD 6.4tn) in 2019. The weak economic growth and the looming side effects of the deleveraging campaign sent the number of defaulted corporate bonds to its highest level in 2018 and 2019 (as shown in Figure 2a). While the central bank has been injecting liquidity since late 2019, the default number in 2020 shows no sign of slowing down. In any case, market was anticipating more default in 2020 because of the coming maturity wall, a sluggish market outlook and less government bailout at the end of 2019 – before the COVID-19 outbreak. Now, the pandemic eruption has made the situation worse. As mentioned in the previous NUS-CRI Weekly Credit Brief, the deeply indebted sectors, such as real estate and airlines, are facing weakened profit and tightened cash flow because of the business interruption caused by COVID-19.

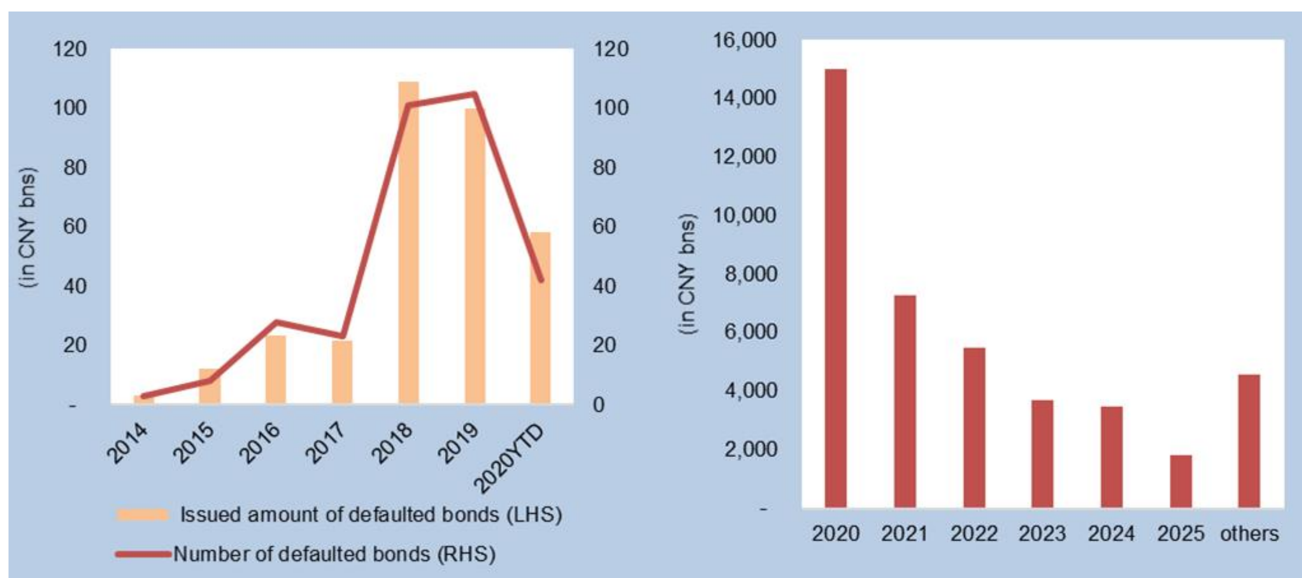

Figure 2a (LHS): Defaulted bonds issued by China-domiciled corporates. Figure 2b (RHS): Non-performing loan (NPL) ratio of Chinese commercial banks. *Source: Bloomberg, CEIC*

What comes together with rising bond defaults is higher non-performing loans (NPLs) in the banking system. Similar to the bond default curve (see Figure 2a), the NPL ratio has reached its second-highest level after the Great Recession at 1.86% (the highest level was 1.87% in 2018) as shown in Figure 2b. Though the NPL ratio is below the regulatory threshold of 5%, the asset quality of the banks may deteriorate further amid the current slowdown. The authorities have called on commercial banks, including state-owned banks and regional banks to play a key role in supporting struggling companies. Since most of the struggling companies are SMEs, who are naturally more delicate than state-owned enterprises and the leading private-owned enterprises, the credit extended to those companies is inherently riskier than the existing loans which mainly support corporates with a stronger credit profile. Thus, besides expecting that the NPL ratio for the banks to rise to 3.5%, Fitch and S&P have also warned that up to 11.5% of the total loans, amounting to USD 2.1tn, could turn sour.

What makes this recession different from the previous ones is that the pandemic is changing consumer behaviour across categories and the high unemployment rate caused by the outbreak will likely curb consumer spending for a long time. It will be important for corporates especially retailers and other companies in the consumer industry to adapt themselves to the changing tides to recover from the fallout. While cheap and easy funding can help corporates to roll over their maturing debt, they could also impose long-term risk in the financial system at the same time.

Credit News

Asian firms rush to meet USD 69bn in second-quarter debt refinancing

Apr 6. Amid the turbulent capital markets, Asian-Pacific companies need to raise USD 69.3bn to refinance their existing borrowings in this year's second quarter. This amounts to the second-highest level of USD corporate debt maturing in the region, only slightly behind the USD 71.4bn that matured during the same time last year. Particularly, some of China's largest state-owned corporates and Australian banks have large amounts of bonds due to expire in the next months. Asian companies are searching for alternative ways of financing to diversify their funding sources. While USD 220bn has been raised in the US corporate credit market in the past two weeks, at the same time only USD 2.57bn has been raised in Asia. (Reuters)

Oil majors raise USD 32bn of debt to weather crisis

Apr 5. Large oil companies worldwide have raised a total debt of USD 32bn to cushion against the financial losses of the coronavirus outbreak while preserving their shareholder payouts. There is a worrying surplus in the oil market as oil demands drop due to the coronavirus pandemic and oil supplies increase as a result of the Russia-Saudi Arabia price war. The international oil benchmark, Brent crude, fell to its lowest since 2002. As a result, many smaller oil companies are cutting dividends while larger oil firms have increased their bond issuance to secure liquidity and funding. This is the case for large oil firms, as they are more hesitant in cutting payouts because they prioritize the need to retain investors in the carbon-intensive industries. Although existing payouts from major oil firms are not threatened for now, the return of scrip dividends might happen in the future when oil firms undergo more financial stresses. This means investors have the option to receive shares instead of cash payments. (FT)

Investor appetite returns for junk bonds

Apr 3. Recently, investors begin to show a renewed appetite for junk bonds. Mutual funds and exchange-traded funds that invest in junk bonds had USD 7bn in inflows, the biggest-ever weekly sum, ending a 5-week run of outflows. The inflows come after a wave of global central bank and government stimulus, strong hunger for new deals and the rising price of oil, which helps the energy firms that make up a big chunk of the junk bond market. Furthermore, the inflows also come as the difference between the yield on US junk bonds above equivalent government debt narrowed to 9.1 percentage points from the high 10.1 percentage points last seen in March. (FT)

Corporate bond downgrades grow as coronavirus spreads

Apr 2. US corporates bonds are being downgraded at a breakneck pace over the last two weeks as the coronavirus continues to spread. While the total downgrades remained lower than that during the financial crisis, the pace of downgrades in the last two weeks was the fastest since 2002 with a net of USD 560bn of investment-grade corporate bonds in the ICE BofAML U.S. Corporate Index downgraded last month. Analysts warned that there is still room for more firms to fall down the rating ladder, despite the Fed's recent efforts to support the corporate debt market. The downgrades, however, have not stopped a deluge of new bonds being sold by investment-grade companies and even some speculative-grade companies also have joined in last week. (WSJ)

How the muni market became the epicenter of the liquidity market

Apr 2. The coronavirus triggered a liquidity crisis in municipal bonds, a market that has already condensed in the past decade. Desperate sellers across most markets sold assets at deep discounts last month as the spreading new coronavirus left investor fearful and hungry for cash. Municipal-bond funds hemorrhaged an unprecedented USD 28bn last month through March 25, and high-yield funds lost 8% of their holdings to redemptions in two weeks. Banks and brokers that trade munis have become less inclined to warehouse debt. The shift in sentiment left the market susceptible to extreme volatility when worried investors fled bond funds, triggering forced selling with few other buyers willing to pay top dollar. (WSJ)

GM reduces loan refinancing target, may pay up for new debt (Reuters)

T-Mobile borrows USD 19bn to fund Sprint takeover (FT)

Rating agencies brace for backlash after rash of downgrades (FT)

Regulatory Updates

Regulators free up USD 500bn capital for lenders to fight virus storm

Apr 6. The impact of the Covid-19 pandemic has caused the global economy on track for its sharpest slowdown since the Great Depression with millions of people worldwide losing their jobs. In an answer to that, central banks and regulators took several measures to stabilize the economy. They reliefed nearly USD 500bn capital for lenders, ordered banks to conserve capital by freezing dividends and to rein in bonuses. Furthermore, central banks supported lenders by granting cheap loans and lowering reserves or liquid assets requirements. Central bankers are confident that the banking system is better positioned than during the 2008 financial crisis and the capital buffers can now be released. (FT)

China frees up USD 56bn for virus-hit economy by slashing small banks' reserve requirements

Apr 3. The People's Bank of China (PBOC) said on Friday it was slashing the amount of cash that small banks must hold as reserves, releasing around CNY 400bn to increase the liquidity and cushion the economic blow from the coronavirus pandemic. While most of the country's factories are believed to be up and running again, services companies, especially the small, privately owned ones, are still struggling to get back on their feet. The export sector is also facing a fresh shock, as the swift spread of the virus around the world prompts many countries to impose draconian containment measures similar to those used in China. As a result, the rate cut on excess reserve can be seen as an indicator that PBOC is open for a further cut to the medium-term lending facility (MLF) to lower credit costs for companies. (Reuters)

BOJ set to buy more benchmark bonds to assert yield control (Bloomberg)

Bailey rejects monetary financing as tool in virus crisis (FT)

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