Weekly Credit Brief
Sep 12 - Sep 18 2023

Chinese insurers' credit outlook remains pressured under a stressed operating environment

by Raghav Mathur

- **NUS-CRI Agg PD of Chinese insurers suggests that the credit profile of the subsector has improved, but structural and transitory headwinds cloud the subsector's outlook**
- **NUS-CRI SII suggest that elevated PD for the top 5 systemically insurers could lead to an uptick in contagion risk, should their solvency ratios fall below regulatory thresholds**

China-domiciled publicly listed insurance companies (Chinese insurers) have largely remained under the radar, when compared to the wider financial sector, given the current property crisis and lagging economic growth facing the country. The credit health of Chinese insurers, though improving since mid-2022, remains elevated as suggested by the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) shown in Figure 1a. The Agg PD of the sub-sector currently is stable around the BB upper bound when proxied using PDiR2.0[1], suggestive of both macroeconomic and regulatory factors contributing to its elevated credit risk profile. The NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[2]) in Figure 1b, suggests that, in the short term, the credit risk associated with the subsector is likely to remain elevated with deterioration in credit outlook pertinent across the interquartile range of Forward PDs. This may suggest that the sub-sector continues to face pressured balance sheets that are likely to be impacted by a multitude of structural (such as low penetration rates) and transitory (such as weak investment income) challenges facing the economy.

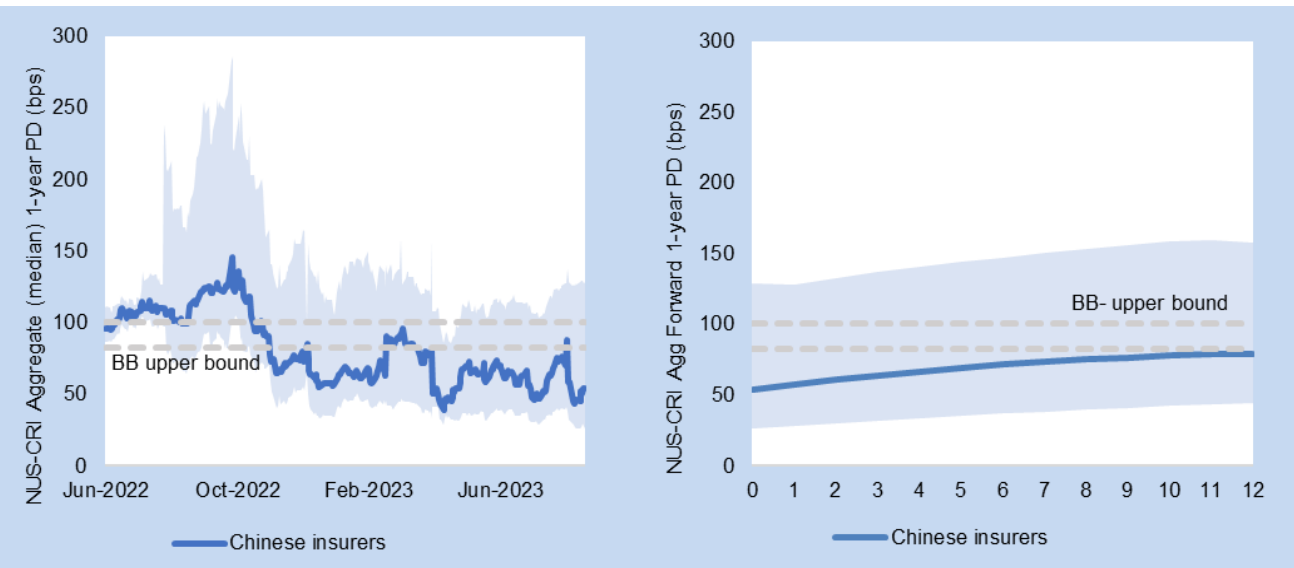


Figure 1a (LHS): NUS-CRI Agg (median and interquartile range) 1-year PD for Chinese insurers, with reference to PDiR2.0 bounds. Figure 1b (RHS): NUS-CRI Agg (median and interquartile range) Forward 1-year PD for Chinese insurers as of Sep-2023, with reference to PDiR2.0 bounds. *Source: NUS-CRI*

Chinese insurance firms have generally benefited from improved market conditions (See Figure 2a for an increase in the FTSE China A 200 Life insurance index) and inflating balance sheets as their asset size and insurance density improved over 2021, benefiting their credit profiles in 2022. The subsector's AUM grew by 11.51% YoY to CNY 24.89tn in 2021. Assets of reinsurance companies, in particular, grew by 22.22% over the same period, suggestive of widespread de-risking by life insurance and property insurance firms given the low economic growth burdening household incomes and an uptick in property market stress. More recently, in 2023,

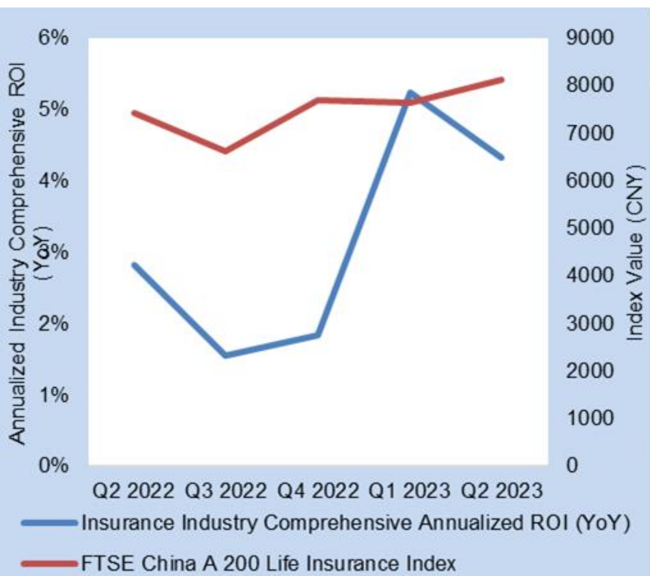
[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying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

[2] 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 during the period from 6 months onwards to 18 months, conditional on the firm's survival in the next 6 months.

the end of China's zero-Covid policy has improved the potential of insurance firms to increase face-to-face sales, providing a reprieve to the sectors' revenue-generating capabilities post the slump faced during the pandemic.

However, Chinese insurers still face significant challenges in the short term that pose pressures to the subsector's credit risk profile. Firstly, despite easing pressures, premium income remains constrained, growing at 4.6% YoY in 2022, compared to 6.1% and 12.2% YoY respectively in 2020 and 2019. The combined profit for Chinese insurers reduced by close to 57% in 2022, adding pressure to future short-term growth prospects that may hinder improvement in their credit profile. In addition, regulatory concerns regarding the potential fallout of risky investment practices by insurance firms may further dampen performance and asset quality for Insurance firms, especially those that have participated in aggressive investment practices to boost income earned to fund high-yielding policy products (See Figure 2a). The average investment return for 2022 was 3.6%, however, proposed caps by the regulators have ensured that companies that are offering higher rates of return to policy buyers may need to revise their rates substantially, hurting the competitiveness in the industry and particularly disadvantaging weaker insurance firms that are unable to take on market share without offering competitive rates, potentially explaining the increase in the interquartile range of Forward PD for the subsector by the end of this year. Though these policies help in limiting weaker performance for insurance firms moving forward, they do provide some benefits in mitigating the widespread contagion of heightened insurance sector credit risk, potentially dampening the risk from a financial stability standpoint.

Furthermore, posing further headwinds to the insurance subsector's credit risk profile is the regulatory crutch of China's Risk-Oriented Solvency System phase 2 (C-ROSS II). Enhanced regulatory scrutiny and increased capital buffering for insurers with assets classified as higher risk not only weakens insurance firms' liquidity but also reduces the types of products they can sell should their comprehensive and core solvency ratios fall below the threshold of 100% and 50% respectively. These red lines, introduced as benchmarks that could aid in mitigating widespread aggressive investing practices, could limit the capital available to the subsector, effectively rendering them unable to pay and fulfill longer-term obligations and policy claims. However, in the long term, when the macroeconomic environment improves and the credit cycle starts expanding, these regulatory policies could act as countercyclical capital buffers that limit overheating in an economy that is already beset by sectors' over-expansion during economic boom phases. As seen in Figure 2b, as per the Aug-2023 rankings of CRI Systemically Important Insurers (CRISII), the top 5 insurers all have solvency ratios above the minimum capital requirement. However, they also have elevated PDs, with 3 of the 5 companies well above the industry median, posing potential systemic risk challenges should their solvency ratios decrease substantially.



	CRISII Ranking (Aug-2023)	Comprehensive Solvency Ratio	PD as of Sep 15, 2023
Industry Median	N.A.	220.9%	53.78
Ping An Insurance Group Co of China Ltd	1	166.4%	349.34
New China Life Insurance Co Ltd	2	238.2%	59.38
Hubei Biocause Pharmaceutical Co Ltd	3	156.2%	293.02
COFCO Capital Holdings Co Ltd	4	254.0%	119.35
PICC Property & Casualty Co Ltd	5	202.2%	25.24

Figure 2a (LHS): Insurance industry's annualized return on investments YoY (LHS) and the FSE China A 200 Life Insurance Index (RHS). Figure 2b (RHS): Comprehensive solvency ratio and latest PD (as of Sep 15, 2023) for the top 5 CRI Systemically Important Insurers based on Aug-2023 rankings. *Source: CBIRC, Bloomberg, NUS-CRI*

A silver lining for the industry, that may limit the potential downside in its credit risk outlook, is its relatively low penetration rate. Penetration rates have remained relatively muted in the Chinese economy compared to other Asian countries, coming in at 2.8% for life insurance and 1% for P&C insurance at the end of last year. With higher demand for protection and rising longevity rates a potential signal of rising demand for insurance products moving forward, such structural tailwinds may provide insurance companies with a boost in their top line that could help them bolster their capital positions and profitability metrics in the long term. Suffice it to say that the industry still faces major challenges in the short term. In the low domestic interest rate environment, weak performance in the financial markets, and the resultant impact on their investment income, is going to add repayment pressure for insurers that sold high-yielding policies when interest rates were higher. This, in conjunction with the current low uptake of commercial insurance products, makes short-term realizations of potentially increased demand difficult. Over the next twelve months, as suggested by the Forward PD term structure in Figure 1b, Chinese insurers are likely to have a relatively worsened credit risk outlook that deepens their woes pertaining to solvency and liquidity in the absence of government support, especially for the weaker companies in the subsector.

Credit News

Hedge fund bets could spark turmoil in US Treasuries, BIS warns

Sep 18. The Bank for International Settlements (BIS) has raised an alarm about the increasing use of leveraged bets, specifically in the US Treasuries market. This practice, referred to as the basis trade, involves hedge funds capitalizing on minor price differences between Treasury bonds and their counterparts in the futures market. The BIS is worried that the buildup of leveraged short positions in US Treasury futures could create financial vulnerability, trigger margin-related issues, and potentially disrupt the core fixed-income markets. The BIS's warning comes after similar concerns were expressed by the Federal Reserve and the Financial Stability Board regarding the risks associated with hedge fund activities in the bond market. (FT)

Investors urge greater scrutiny of climate funding tools

Sep 18. Banks play a crucial role in financing clean energy projects amid global efforts to transition to a low-carbon future. The influx of funds into environmental and social bond funds reached $18 billion in the first half of 2023, nearing the total for all of 2022. While green bonds have been a primary tool for sustainable finance, sustainability-linked bonds (SLBs) are gaining popularity. SLBs tie a company's debt interest payments to their environmental promises, though critics argue that the penalties for missing targets are insufficient to drive meaningful change. Despite the growth in green bonds, there are challenges in defining what constitutes a green project and measuring their impact accurately. Additionally, higher interest rates in some regions may affect the financing of green projects, although subsidies and regulations could offset these effects. (FT)

China's top developers lost close to USD 3bn due to weakened yuan

Sep 18. Leading Chinese property developers have reported significant foreign exchange losses of nearly USD 3bn in the first half of the year, primarily due to the weakening yuan against the US dollar. These losses further compound the financial difficulties faced by these developers in managing their growing debts. Research conducted by Nikkei Asia reveals that, among the top 30 mainland Chinese developers, 24 have collectively recorded net foreign exchange losses totaling CNY 21.25bn (USD 2.75bn) during the first half of 2023. It's important to note that these losses are currently only on paper and will be realized or mitigated based on future exchange rate fluctuations. Nevertheless, they highlight the exchange rate risks associated with the foreign currency-denominated debts of property developers facing financial challenges. (Nikkei Asia)

Rising rates make big companies even richer

Sep 15. The Federal Reserve's interest rate hikes, intended to cool the economy, inadvertently boosted the profits and spending power of major, high-quality corporations. These firms had secured low-interest rates during the pandemic, so the rate increases had a minimal immediate impact on their borrowing costs. Instead, they earned more on their cash reserves as rates rose. Weaker companies that couldn't secure low rates or choose floating-rate loans faced challenges. Consumer patterns mirrored this dynamic, with those who secured low mortgage rates benefiting while others faced challenges. The largest stocks performed well. However, the longer the Fed maintains high rates, the more bonds even strong issuers will need to refinance at higher costs, posing potential challenges in an economic downturn. (WSJ)

US junk debt issuers use window to extend liabilities but at higher costs, Morgan Stanley report says

Sep 16. U.S. junk-rated companies are taking advantage of a favorable debt issuance environment this year to extend short-term liabilities, but this comes at a high cost, warns a Morgan Stanley report. Although the amount of junk-rated bonds and loans due in 2024 has decreased by approximately $70 billion in 2023, the overall debt load for year-end 2025 is down nearly 35% compared to 2022 levels. Junk bond issuance has surged recently due to strong demand and growing optimism, with 12 high-yield issuers raising $9.6 billion this week. However, refinancing is costlier, with issuers paying 100 to 300 basis points more in coupons on new refinanced debt. (Reuters)

Evergrande's life insurance arm taken over by new state-owned vehicle (Nikkei Asia)

Hong Kong homebuyers flock to rare bargain amid depressed market (Nikkei Asia)

Bond fund giant Pimco prepares for 'harder landing' for global economy (FT)

Regulatory Updates

ECB raises interest rates to all-time high

Sep 14. The ECB has raised interest rates to an all-time high to combat surging consumer prices, but the euro declined as the ECB signaled a potential end to its rate-hiking cycle. The ECB's move, the 10th consecutive rate increase, lifted the deposit rate by 25bps to 4%. This decision coincided with a reduction in the ECB's growth forecasts for the eurozone. While the euro slipped against the dollar, yields on two-year German Bunds fell. Economists suggest that major central banks are approaching the end of their rate hikes due to decreasing inflation and slowing economic growth. The ECB hinted that borrowing costs in the eurozone may have peaked and emphasized its intention to keep rates steady. Despite raising its inflation forecasts for this year and next, the ECB lowered its 2025 inflation projection. The outlook for the eurozone economy has also weakened, with growth forecasts revised downwards. (FT)

Bank of England expected to raise interest rates to 5.5%

Sep 18. The Bank of England is expected to raise interest rates by 0.25% to 5.5%, the highest since 2008, due to persistent inflation signals, including wage and service cost increases. While some Monetary Policy Committee (MPC) members had cast doubts on the hike, recent data has been too inflationary to support an immediate pause. The MPC will closely watch August's inflation data, especially in the services sector, as a key indicator of underlying inflationary pressure. Additionally, revisions showing the UK's better-than-expected economic performance in 2020 and 2021 are unlikely to change the MPC's stance on inflation but may impact their view of the economy's growth potential. (FT)

Central bank body BIS flags new unpredictability in interest rate markets (Reuters)

Economists expect Fed to defy investors with more interest rate rises (FT)

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Contributing Editors: Wang Chenye