China: How alarming is the default risk?

We have seen default cases rising in China's bond market. But is it really a bad thing?

Source: Shutterstock

Is this a fall off the cliff or a healthy clean up?

As always defaults are eye-catching and bad news for investors, issuers and the market.

For the economy, if poor credits can access funding to cover existing debts, and rollover "forever" then accumulating these debts, without defaults, isn't a great situation as it has the potential to create a default time bomb.

Therefore, the question is if the recent round of defaults is a large scale fall-off-the-cliff event that will rock the market or just a cleanup of bad credits.

China bonds default cases have increased

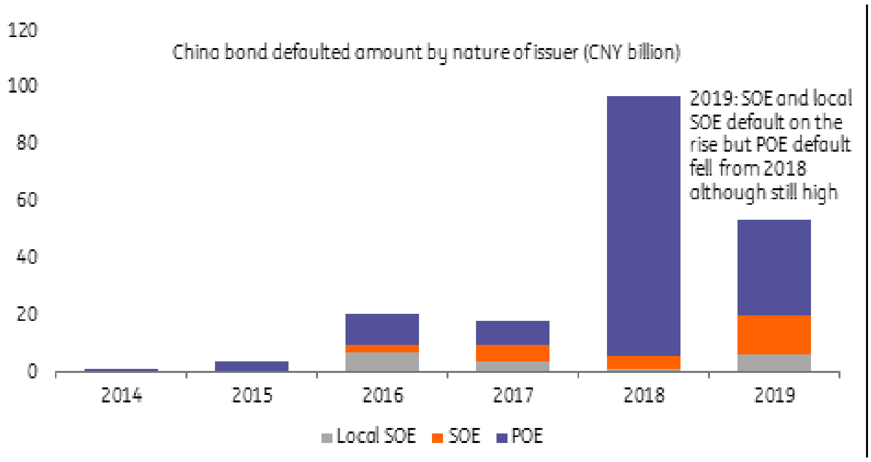
We think there are three reasons why the number of defaults in China has increased:

1. Lots of local government special bonds - around CNY2.5-3 trillion - have been issued in 2019 to support infrastructure projects. The market has started to question if this influx could generate a series of defaults, which would be on what are by nature corporate bonds and therefore not guaranteed by the local government.

2. Land sales revenue for some local governments has been small while relief measures have increased due to the trade war. The combined effect of these factors impacts local governments' ability to pay. Default from local SOEs jumped from nearly zero in 1Q18 to more than CNY6 billion in 3Q19.
3. Defaults on bonds issued by privately-owned enterprises have been high though these have fallen since 2018. Then, the government aimed to clean up POE bonds after the cleanup of SOE loans in 2016-2017. The issue with POE is more complicated as major shareholders usually pledge their shares as collateral for loans. Should the company be unable to repay the loan, the stock market then reflects this through a lower share price, in turn making repayment more difficult.

China bond default on the rise

Data as of 4th December 2019 from Bloomberg do not include private placements.



Source: ING, Bloomberg

Shadow banking is shrinking at the same time

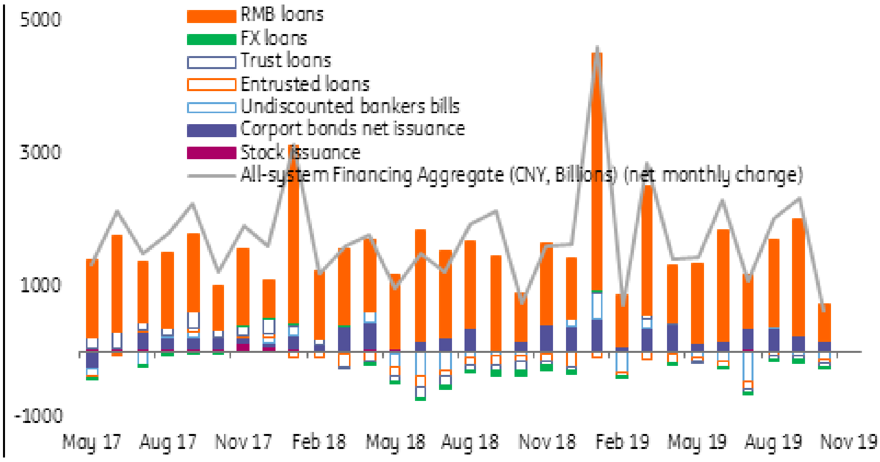
This view is confirmed by shrinking shadow banking activities.

Shadow banking activities have been shrinking since early 2018, thanks to the efforts of the central government to restrict these. In 2019, the shadow banking activities most affected have been peer-to-peer (P2P) lending platforms, which accepted loans drawn by mostly smaller firms that were facing difficulties. Trust companies then packaged the P2P loans and sold these to investors seeking yields.

In 2019, the central government has driven most P2P activities out of business. The Chinese central bank has increased incentives for banks to lend to smaller firms.

Shadow banking has been shirnking

Hollow bars are shadow banking activities



Source: ING, Bloomberg

More defaults to come in 2020

We expect more local state-owned enterprises to default in 2020 - land sales will be limited by restrictive housing measures and the credit ratings of local governments will continue to be diverse.

Local government special bond issuance has increased since late 2018. Usually, these bonds have maturity of five to 10 years. The concern isn't about these credits defaulting in 2020, but rather in 2023. By that time infrastructure projects should be completed and should begin to generate cash flows to repay the debts. In 2019, the rate of local state-owned company defaults has been faster than in 2018, also reflecting the government's intention to stop overlending at the local government level.

We also expect the default of private-owned enterprise bonds to continue at a high level of around CNY35 billion in 2020, similar to the level expected in 2019. Critical here is that shareholders pledge shares to get loans, which in turn has the potential to increase risk correlation between the share prices and the loan and bond markets.

China's sovereign bonds will remain intact as these are seldom affected by state-owned players’ default situations.

Author

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com