ShoreVest
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China Debt Dynamics

Sustained Shadow Banking Contraction Creating Private Credit Opportunities

Volume 5 | Issue 4
27 April 2021

Having brought the pandemic under control, Beijing is now trying to return the economy to a more normal footing by ending stimulus spending and normalizing monetary policy. That said, even as it winds back some pandemic era measures, it has doubled down on its corporate debt relief efforts. Loan forbearance policies that were introduced at the onset of the pandemic have been extended to the end of 2021. Programs designed to ramp up subsidized lending to small and micro firms have similarly been extended to year end. And the State Council has instructed the central bank to further reduce interest rates on loans, which have already declined over the past year.

Such policies were a vital safety net for many firms during the pandemic – albeit only for those able to access bank credit. For companies unable to borrow sufficiently from the banks, China's funding environment has deteriorated over the past year and is likely to worsen in 2021. Previously, firms unable to borrow from banks could raise funds from the shadow banking sector. However, shadow banking has been contracting since 2017, coming under further pressure in 2020 as banks moved to comply with asset management rules that are due take effect at the end of this year.

The crackdown on shadow banking is about reining in regulatory arbitrage and other risky practices that threaten the stability of the financial system. The authorities aren't deliberately trying to starve the private sector of credit. Quite the contrary. For years now the central bank has been exhorting banks to lend more to private firms. But banks' reluctance to rebalance their lending in favor of private the sector, combined with central authorities' efforts to more heavily regulate non-bank credit, means that tight lending conditions outside of the formal banking system looks likely to continue for the foreseeable future. That is creating unprecedented private credit opportunities.

China's Bifurcated Credit Market

With the onset of the pandemic, Beijing quickly mobilized the banks to minimize the economic fallout. Banks ramped up lending, with total outstanding loans increasing 13.2% in 2020, up from 12.5% in 2019. Data is lacking, but we assume that a significant portion of 2020's increase in lending went toward banks deferring loan repayments for troubled debtors. Meanwhile, banks moved to reduce the cost of borrowing. According to data published by the People's Bank of China, the average weighted interest rate on loans to companies came down to 4.61% at the end of 2020 from 5.12% a year earlier.

Beijing also implemented measures to ensure that vulnerable parts of the economy received greater access to bank credit than usual. The People's Bank of China (PBoC) massively increased its re-lending program whereby it provides banks with funding in order to make loans to small firms, and initiated subsidy programs to compensate banks for exercising forbearance on loans to small companies. Moreover, it has instructed large banks to increase their lending to small banks by 30% in 2021.

However, the support programs primarily help those firms that have already borrowed from banks, as well as a meaningful number of small and micro firms that were able to borrow from banks for the first time.

China has always had a bifurcated credit market, one divided between firms that are able to borrow from the formal banking system and those who must look elsewhere. State-owned firms are the traditional clientele of China's banks. The banking system was initially designed as a way to channel household deposits to state industrial firms as cheap credit. But since the turn of the century, the private sector has been an increasingly important part of the economy, with increasing demands for credit. While thirty years ago the economy was almost entirely state-owned, today the private sector accounts for about 80% of urban employment and 60% of value-added production.

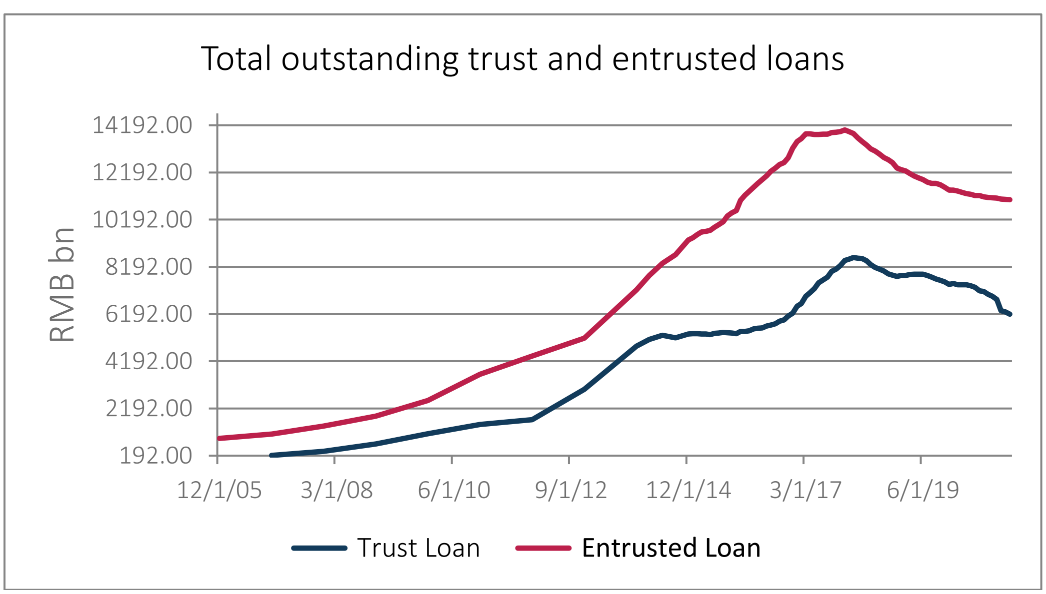
The banks have changed with the times. Although it's difficult to track just how much banks lend to the private sector, it's unquestionably far more than they once did a decade ago. Still, banks retain a preference for lending to state firms, and lending to the private sector isn't commensurate with the its role in the economy.

Shadow Banking Crackdown

Following the Global Financial Crisis (GFC), the private sector's funding problem was partially solved by the emergence of shadow banking, which was able to make up the funding shortfall, albeit at interest rates higher than those on offer at the banks. However, even though shadow banking was a key source of funding for many firms, it also funded speculative bubbles, and allowed property developers, local governments, and heavy industry to get around central government efforts to limit their borrowing. Of perhaps even greater concern for regulators was that much of shadow banking was funded by household savings, opening up ordinary mom and pop savers to greater risk than they typically understood.

In 2016, Beijing launched what it called a "deleveraging" campaign which was aimed at reining in shadow banking and instituting a safer, better regulated financial system. The China Banking and Insurance Regulatory Commission (CBIRC) says that since the start of the campaign, the amount of outstanding shadow banking credit has declined by 20 trillion yuan. That's been led by a contraction in trust and entrusted loans [Fig. 1], the two main pillars of shadow banking, which have shrunk year-on-year since the start of deleveraging. Meanwhile, other aspects of shadow banking – like peer-to-peer (P2P) lending – have been eliminated almost entirely. At their peak, there were about 5000 P2P platforms in China. There are now less than five.

Fig 1.



Shadow banking has been contracting for the past four years, but the availability of shadow banking credit took a further hit in 2020 with the decline of "non-standard credit" as a component of wealth management products (WMPs).

WMPs are short-term investment products packaged by banks and marketed to their customers as high-yielding, low risk alternatives to deposits. They took off in the years following the GFC and have since become a mainstay of the financial system. Funds raised from WMPs are typically invested in a mix of corporate bonds and interbank deposits, but to increase the return a portion routinely also goes toward funding corporate loans. This corporate lending component is referred to as non-standard credit (standard credit refers to corporate lending that can be traded on an exchange, like asset-backed securities).

At the end of 2018, Beijing rolled out new rules designed to ensure that banks take responsibility for the risk associated with assets packaged into WMPs. WMPs had traditionally been recorded off-balance-sheet, but the new rules require banks to move WMPs back onto their books, meaning banks will have to set aside provisions for the corporate loans packaged into WMPs.

Initially banks were given until the end of 2020 to comply with the new rules, but when the pandemic hit the deadline was postponed until the end of 2021. Banks started to accelerate their compliance with the rules in 2020, but it's anticipated that some small banks won't be compliant in time to meet the deadline.

According to China Central Depository and Clearing Co. – the interbank bond market clearing house – in 2020, the share of WMP funds invested in non-standard credit assets declined by a third to 10.9%, down from 15.65% in 2019. At the end of 2020 there were 25.86 trillion yuan worth of WMPs outstanding.

The Impact of Tight Non-Bank Credit

Efforts to rein in shadow banking have been focused on reducing risk for retail investors. P2P was mainly funded by household savings, which helps explain why P2P platforms have been all but eliminated. Similarly, banks have been forced to bring WMPs back on balance sheet so that they take responsibility for the risks being taken on by their retail customers. Meanwhile, even though trust loans have shrunk, trust companies still remain vibrant institutions as they focus their activities on the needs of institutional investors and high net worth individuals. In short, China's financial regulators see a role for non-bank finance as long as the risks are born by sophisticated investors that can bear the risk. However, the development of domestic institutional funding sources for private credit it still in its infancy and has been unable to fill the funding gap left by shadow banking.

Quantifying the impact of this tightening on the availability of non-bank credit is difficult given that shadow banking interest rates are seldom made public. However, at ShoreVest we've seen a sharp increase in the interest rates firms are willing to pay for private credit. Whereas private sector firms were willing to pay only mid-single digit returns on senior secured loans in 2018, that rose to between 10% and 12% in 2019 and the first half of 2020. It's currently between 15% and 18%.

There is little to suggest that credit conditions will improve. Financial regulators continue to crack down on non-bank sources of credit once they become large enough to raise concerns about financial stability. Their most recent efforts have focused on China's internet platforms, which as a group have made significant inroads into financial services over the last few years. Having previously taken a light-touch approach in the interest of fostering innovation, regulators have now changed course and are insisting fintech firms manage risk much in the same way as banks.

Conclusion

Beijing has said that its goal for 2021 is to keep debt levels basically stable relative to the size of the economy. It has also told banks that it expects the volume of new loans they issue this year will be in line with 2020. Meanwhile, regulators continue their assault on shadow banking with the result that non-bank channels of credit continue to tighten.

Those firms with access to bank credit are well positioned, particularly if the central bank manages to lower interest rates further. However, for those unable to borrow sufficiently from banks, the availability of credit will likely tighten in 2021, creating opportunities institutionally backed, long term stable capital managers like ShoreVest that are in a position to take private credit positions.

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