Economic Watch

China | To bail or not to bail? Understanding the logic behind Chinese-style deleveraging

Jinyue Dong / Betty Huang / Le Xia

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With the economic recovery becoming entrenched in the aftermath of the Covid-19 pandemic, China's authorities shifted their focus to containing the overall leverage and introducing market disciplines to the public sector. Particularly, a series of credit events, concerning China Huarong Asset Management Co.and the high-profile property developer Evergrande, coupled with the authorities' promise to tighten oversight of China's local government financing vehicles (LGFV), have sent severe shocks to both the offshore and onshore markets.

We previously reported that the authorities promulgated a series of new measures early this year to curb monopolistic behavior of e-commerce giants and their shadow banking activities.(Please see our previous report Corporate deleveraging campaign: from "proactive" to "passive"). This report focuses on the latest development of Chinese deleveraging. On top of reviewing the authorities' approaches to tackle a number of high-profile credit events, we try to shed light on the logic behind the authorities' decision to selectively extend their supports. We conclude that in the face of a fast-rising number of default cases, China's authorities extend their support to the firms with varying degrees according to their different types of ownership and industry.

China's deleveraging is proceeding in phases…

The Chinese bond issuers had long enjoyed the authorities' implicit guarantees which made default a rare phenomenon. Starting from 2014, the bond default cases gradually showed up in both Chinese domestic and offshore markets as the authorities wanted the market to play a decisive role in resource allocation as manifested at the 3rd plenum of the 18th national session of Chinese Communist Party (CCP).

During the period of 2014-2015, the economic downturn, coupled with the phase-out of previously implemented stimulus measures, led to a number of defaults cases. All but one defaulted firms are private owned during this first stage of China's deleveraging. The only exception is a local government-owned enterprise. In essence, the default cases in this stage are "passive" ones. Local governments still wanted to help those financial distressed firms but lacked the necessary resources to bail out all of them.

The economic slowdown became entrenched in the period of 2015-2016, which defined the second phase of China's deleveraging. In this stage, the authorities started to encourage the exit of zombie firms which consume credit resources but with little output. As such, the default not only appeared among private enterprise (POCs) but also spread to one state-owned-enterprise (SOE) controlled by the central government, Sinosteel. It is largely due to the fact that the authorities actively pursue an orderly deleveraging.

After a lull of tranquility in 2017, the authorities' ever-tightening regulations, as well as the unexpected outbreak of Sino-US trade war quickly ushered in the third stage of China's deleveraging. This stage is featured by a few cases of liquidation or restructure which had never seen since the start of new millennium. Baoshang bank, an Inner Mongolia bank with around RMB 400 bn in assets, was taken over by the government on May 2019. After government rescue of Baoshang bank, two more banks received official assistance to continue operating in June and August, including Bank of Jinzhou, a city commercial bank listed in Hong Kong and Hengfeng bank which is one of the 12 joint-stock banks with a national license.

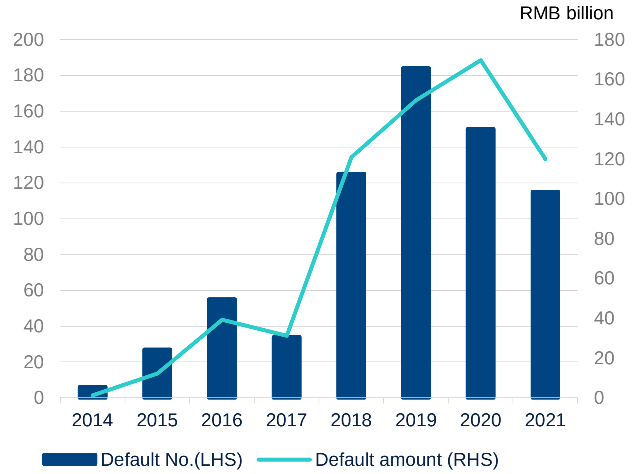
The latest stage of deleveraging started in the aftermath of the Covid-19 pandemic. The case of China Huarong Asset Management has attracted a lot of attention from market participants. Moreover, a number of high-profile property developers are also under a lot of stress now as the authorities seem unlikely to relent their tight regulations on the housing market. In particular, the Evergrande Group, one of Chinese largest property developer is on the verge of bankruptcy now, which has already led to violent turbulence in Chinese onshore and offshore capital market.

Table 1. **THE DEFAULT COMPANY LIST IN THE FOUR STAGES OF DELEVERAGING PROCESS**

First stages: March 2014 to October 2015	Second stages: October 2015 to December 2016	Third stage: 2018 to 2019	Current stage: 2020 2H to now
Default company list:	**Default company list:**	**Default company list:**	**Default company list:**
Chaori Solar（1st POE, onshore）	Sinosteel (1st Central SOE, onshore)	Baoshang Bank (1st Financial Institution, onshore)	Tsinghua Unigroup, Founder Group （1st and 2nd SOEs controlled by Public Institutions, onshore and offshore）
Shenhuan Cable (POE, onshore)	Sunnsy Gropu (POE, onshore)	Tsinghai Provincial Investment Group Co Ltd (Local government SOE, onshore and offshore)	Yongcheng Coal and Electricity Group Co. (Local government SOE,onshore)
Baoding Tianwei Baobian Electric Co. (1st local SOE, onshore)	Yunfeng group (Local SOE, onshore)	Huachen Energy (POE,onshore)	HNA Group Co.(Large-sized privated-owned Enterprise, onshore and offshore)

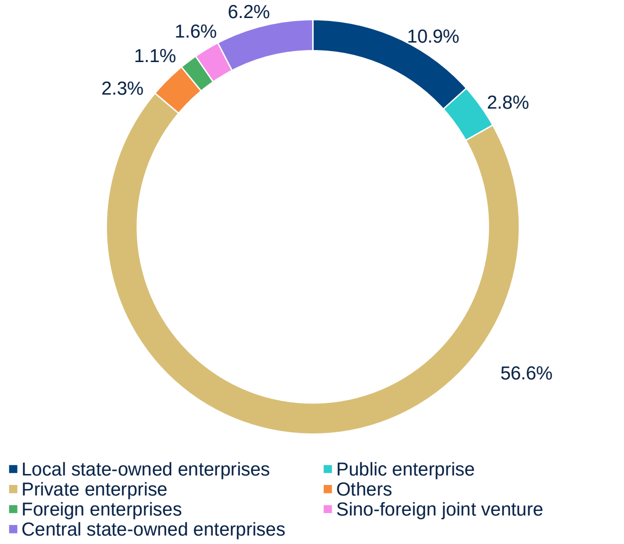
Source: BBVA Research

Figure 1. **BOND DEFAULT AMOUNT AND NUMBER ARE RISING IN CHINA'S DOMESTIC BOND MARKET**



Source: Wind and BBVA Research

Figure 2. **THE RISE OF DEFAULT CASES MAINLY CONCENTRATE ON POES,HOWEVER,SOES DEFAULTS ARE ON THE RISE**



Source: Wind and BBVA Research

Huarong's case reflects the authorities' concerns of systemic risk

Huarong Asset Management was established in 1999 as a distressed debt manager to clean up the banking sector's debts following the Asian financial crisis. Over the past 20 years, it has transformed to a financial conglomerate, expanding into almost all the financial fields including banking, trusts, asset management, leasing and securities broking. Huarong's woes started with the fall of its then chairman Lai Xiaomin in 2018. Mr. Lai was later arrested and sentenced to death early this year. It is reported that under Mr. Lai's leadership, Huarong Group was involved in enormous amount of risky lending and shadow banking activities.

After months of delaying its annual financial statement, the Huarong Group at last reported a record loss of RMB 102.9 bn (USD 15.9 bn) in 2020. Given its vast-size liability of RMB1530.6 bn (USD 238bn) as of end-June 2021, it implies that Huarong's capital buffer is far short of the regulatory minimum. The record loss was mainly due to the RMB 107.8bn in accrued credit impairments for both Huarong and its subsidiaries.

As one of largest financial conglomerates in the country, Huarong poses a systemic risk to China's giant financial sector. In the run-up of its delayed 2020 financial statement, the market participants reflected their ever-increasingly concerns over Huarong. For a while, its issued bonds in the offshore market were discounted greatly.

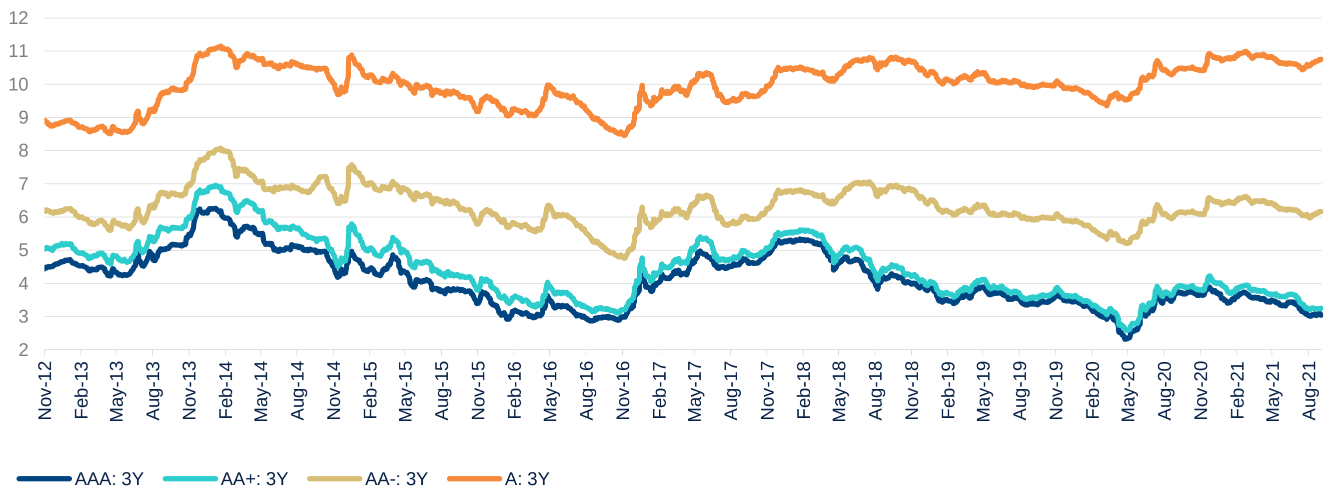
In the end, the Chinese government stepped in to bail out the Huarong. Under Beijing's guidance, a consortium of state-owned investors is organized in August 2021 for the recapitalization of Huarong. The members of this consortium include Citic Group, China Insurance Investment, China Life Asset Management, Cinda Management and Sino-Ocean Capital Holding. It is expected that these new strategic investors will help Huarong to honor its debt payment in the short term and then undergo a complete restructuring. However, for those debt holders of Huarong, it is still possible to accept certain haircut of their debt holding in the long run.

The solution of Huarong's case has reflected Beijing's general strategies in dealing with distressed financial institutions. As abovementioned, China's authorities set out to deal with the similar cases in 2019 including Baoshang Bank, Jinzhou Bank and Hengfeng Bank. Although the detailed methods varied case by case, the authorities generally adopted a cautious stance when liquidating or restructuring their failed banks.

For example, in Baoshang Bank's case, the People's Bank of China (PBoC) directly provided Baoshang Bank with RMB 23.5 billion standing loans to meet their liquidity needs. Meanwhile, the PBoC, through the existing deposit insurance scheme, provided full protection for personal deposits and interbank deposits below RMB 50 million. For institutional depositors above RMB 50 million, a 10% haircut was imposed. In the last step, the PBoC created a new bank, Mengshang Bank, to take over part of healthy assets and liabilities from Baoshang Bank and liquidated the rest part.

All in all, the Chinese authorities seem fully aware of the vulnerability of financial system and won't allow the individual failures of financial institutions to transform into a systematic debacle. Therefore, in dealing with failed financial institutions, the authorities usually take the first step to ensure their liquidity needs and then set out to liquidate or restructure it in an orderly way. Institutional stakeholders will be forced to receive a haircut of their debt holding after the equity part is wiped out. In so doing, the authorities are trying to introduce certain degree of market discipline.

Figure 3. **CREDIT DIVERGENCE BETWEEN DIFFERIENT RATING BONDS**



Source: Wind and BBVA Research

Evergrande is not "too big to fail"

Chinese property developers have long been famous for their high profitability and high leverage. The Evergrande Group is one of best representatives in this respect. Implementing extremely bold strategies of borrowing, Evergrande managed to grow up to one of largest property developers in China over the past ten years. According to its financial report, the total debt of the Evergrande group stood at 1.97 trillion RMB as of June 2021, which is even higher than that of Huarong, the largest failed Chinese financial intuition thus far.

Similar to Huarong, Evergrande issued a large amount of bonds in offshore markets (USD 15.5 bn as of September 2021) which are now seriously discounted in the market. To a certain degree, Evergrande is the victim of the regulators' ever-tightening efforts to clamp down property market bubbles. China's regulators imposed the so-called "Three Red Lines" limit on all the property developers in August 2020, in a bid to force the developers to reduce their debt as well as to accelerate their property development and housing sales.

The "Three Red Lines" are as below:

- a 70% ceiling on liabilities to assets, excluding advance proceeds from projects sold on contract,
- a 100% cap on net debt to equity,
- a cash to short-term borrowing ratio of at least one.

Due to its high-leverage business model, Evergrande became the largest developer which failed on all three Red Lines. Starting from early this year, Evergrande finds it increasingly difficult to meet their short-term liquidity needs, including both debt payment and business operation. Moreover, the diversification strategy of Evergrande doesn't help either. Its subsidiaries in other fields such as wealth management, electric vehicles and hoteling met liquidity problems as well. Many people believe that Evergrande is indeed using these subsidiaries as the vehicles to borrow more debts rather than develop their own businesses independently.

Although the market gave much stronger reactions to Evergrande than Huarong, we don't believe that the authorities will bail out Evergrande as they did to Huarong for a number of reasons.

First, Evergrande is a property developer, not a financial institution. As a financial institution, the fall of Huarong could immediately lead to uncontrollable contagion among the financial sector and then transform into a full-fledged breakdown of the entire financial system. This is alike a Lehman Moment. By contrast, a fall of a property developer like Evergrande, albeit with a bigger size than Huarong, has a much smaller chance of spilling over to the entire financial system. More importantly, it should be noted that China's financial sector is in essence state-owned. Investors' confidence in the financial sector, which is supposed to be reinforced by the recent bailout of Huarong, will limit the contagious risks of Evergrande to the financial sector.

In theory there is another contagious channel in that the fall of Evergrande drags down most of property developers first and then sinks the entire financial sector via their huge exposure to the housing sector. But it seems very unlikely too. It is true that the stock prices of many other developers plummeted in tandem with Evergrande. However, the developers differ quite a lot. To some degree, the implementation of "Three Red Lines" is equivalent to conducting a stress test on all these developers. Evergrande is a failed one but most of others have passed.

Second, Evergrande is private owed company. The authorities cannot have legitimate reasons to bail it out with the use of taxpayers' money. Moreover, Evergrande still has valuable assets on its balance sheet, mainly its land reserve. At the current stage, it is still uncertain whether Evergrande crisis is a liquidity one or a solvency one. Instead of directly bailing it out, the authorities will first push Evergrande to liquidity its assets and shed part of its debt. The authorities will surely help Evergrande to buy some time for it while there is a far cry from a direct bailout.

Last but not least, China's authorities continue to consider the clampdown on the housing market as a policy priority. Squeezing property developers is integral to this policy priority. At this moment, bailing out Evergrande is likely to make other property developers believe that this round of policy tightening is a toothless tiger, which could nullify all the previous policy and regulatory efforts to clamp down the housing market. That being said, the authorities might fine-tune their regulatory tightening on property developers to avert the sector-wide crisis and stabilize the economy, which, however, will only take place after the prospective liquidation of Evergrande.

In sum, Evergrande is unlikely to be bailed out directly. Instead, the authorities could form a debt-payment committee composed of government representatives and important debt holders. Under this debt-payment committee, Evergrande will liquidate its good assets to meet its debt obligation. The equity holders of Evergrande will take the final loss. Indeed, they are very likely to be wiped out. Meanwhile, the debt holders will be treated differently. That being said, the retail debt holders, mainly the homebuyers who paid the developers in advance, will be fully protected. Meanwhile, the institutional debt holders will share the loss which is not covered by the equity part. In this respect, we don't believe that the offshore bondholders of Evergrande will receive any favorable treatment than their onshore counterparts.

Pursuing an orderly deleveraging is more art than science

The cases of Huarong and Evergrande illustrate the authorities' distinct attitudes towards institutions of different ownership and in different sectors. For a troubled state-owned financial institution as large and systemicly important as Huarong, the authorities have no option but to bail it out. The state ownership also helps to justify the use of public funds in the bailout and therefore accelerate the process. In contrast, a private owned property developer like Evergrande is unable to receive the similar treatment from the government even though it outsizes Huarong. An orderly liquidation is the only way out for it.

Apparently, an orderly deleveraging is more art than science. The authorities will selectively bail out their favorable targets from a pool of distressed companies. We found some patterns after summarizing the default cases by company classification (Table 2). Local Government Financing Vehicles (LGFV) thus far hasn't experienced any default cases in both onshore and offshore markets. Given their strategic importance, local governments always manage to bail out LGFVs whenever they meet debt payment difficulties. Looking ahead, local government's fiscal capacity is expected to be limited by stringent regulations and tightening housing policies. Their financial support for LGFVs is set to weaken substantially. However, local governments are not going to capitulate easily. LGFVs are alike the last bastion in defense of the ever-strengthening default wave.

Table 2. **THE GOVERNMENT'S CAUTIOUS STANCE**

	Foreign debt		Domestic debt		
Classification of companies	Offshore loans	Offshore bonds	Onshore loans	Onshore bonds	Representative Company (Default Time)
Central Government SOEs	No	No	Yes	Yes	Sinosteel(2015)
Financial Institutions	No	No	Yes	Yes	Jinzhou Bank(2019) Baoshang Bank (2019)
SOEs controlled by Public Institutions	Yes	Yes	Yes	Yes	Tsinghua Unigroup (2020) Founder Group (2021)
Local Government SOEs	Yes	Yes	Yes	Yes	Qinghai Provincial Investment Group Co Ltd
Local Government Financing Vehicles	No	No	No	No	
Large-sized privated-owned Enterprises	Yes	Yes	Yes	Yes	HNA Group Co.,Ltd

Source: BBVA Research

Regarding local government SOEs, private enterprises and SOEs controlled by public institution, the implicit guarantees have already been broken. It is a welcome step to impose effective market discipline on firms and curb debt growth. It should not be surprise for us to see more default cases.

For central government SOEs and financial institutions, defaults only happened in the onshore market, reflecting the authorities' cautiousness in dealing with the similar cases. The authorities have already started a three-year reform plan of central government SOEs in 2020.In the plan, the central government SOEs were given more strategic importance in terms of helping the government to resist macroeconomic risks. Moreover, given the increasing geopolitical risks, China’s authorities are anticipating these big SOEs to spearhead into the deepening of One Belt One Road Initiatives. In this sense the offshore market is to play as an important channel for RMB internationalization. It is imperative for these SOEs to keep a good reputation and credit profile internationally.

For small domestic financial institutions, the authorities will push forward their restructuring if they have solvency problems. After successfully cleaning up a few banks over the past two years, the authorities are likely to do more in this area without triggering external pressures. For the large financial institutions, the authorities must be very cautious in restructuring them to guard against the potential systematic risks. Maintaining financial stability is still the top task of the central bank and financial regulators.

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BBVA Research: 95/F, International Commerce Centre, Austin Road West, Kowloon, Hong Kong
Tel. + 2582 3111 / Fax. +852-2587-9717
bbvaresearch@bbva.com www.bbvaresearch.com