CHINA’S DELEVERAGING STRATEGY AND EVIDENCE (II): RISING CREDIT SPREAD

What can be asserted without evidence can be dismissed without evidence.

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SUMMARY

- The recent tightening of asset management regulations by Beijing is an acute deleveraging effort that builds upon the previous measures on addressing the heart of China’s financial stress – regulatory arbitrage by the non-bank financial institutions (NBFIs)1.
- This will inevitably result in a short-term liquid squeeze, as the shadow banking market shrinks further, and more defaults among the asset management products leading to credit differentiation in the market. But the new measures should help improve China’s structural credit risk profile in the longer-term.
- Onshore credit spread will rise on the back of flight-to-quality flows. High-grade bond yields have room to fall due to a benign macroeconomic environment underscored by the PBoC’s policy shift to an easing bias.

I argued earlier2 that Beijing started in 2017 to tackle the debt problem by “surgical tightening” measures to force the shadow banks to deleverage, and that the policy objective of this first stage debt-reduction effort was to reduce systemic risk but not to cut the debt-to-GDP ratio to any specific level. The job of cutting the debt ratio is left to stage two later. Beijing is now deepening its first-stage effort by further tightening the regulations for the asset management business.

HITTING REGULATORY ARBITRAGE FURTHER

China’s four financial regulators, the People’s bank of China (PBoC), the China Banking and Insurance Regulatory Commission (CBIRC), the China Securities Regulatory Commission (CSRC) and the State Administration of Foreign Exchange (SAFE), jointly released tighter rules for regulating the asset management business in April. This move followed Beijing selective monetary and regulatory tightening last year to hit the NBFIs’ regulatory arbitrage activities. That first round tightening has resulted in sharp reduction in bank loans to the NBFIs which has spilled over to reducing total credit growth (Charts 1 and 2) and cutting significantly the share of shadow-bank credit flows into the system (Chart 3).

3 See appendix for the key points of the new rules.
CREDIT DIFFERENTIATION

As a result, the AUM of the NBFIs’ asset management products, which are funded by shadow banking, has fallen (Charts 4 and 5). The new, tighter, asset management rules aim at building upon this initial success on deleveraging. Small and medium sized banks and NBFIs are expected to suffer more than large financial institutions from the tighter rules as they are more involved in shadow banking.

One of the new rules bans financial institutions from using “hard redemptions” (guarantee on principal and/or returns on investment) in their asset management business. With almost 70% (or RMB91.7 trillion) of the wealth/asset management products having hard redemption guarantees, the ban will likely shrink the asset management product market further and create a short-term liquidity squeeze. But it should also help correct the moral hazard problem in the longer-term.

The intensification of the regulatory crackdown is also expected to cause more defaults in the wealth/asset management product market. So investors should be asking for higher risk premium on these products. Rising defaults will also increase the flight-to-quality flows, leading to widening of credit spread (Chart 6).

At this stage of the debt-reduction effort, which aims at reducing systemic risk without hurting GDP growth too much, the PBoC is expected to keep a neutral monetary policy and manage liquidity to prevent any prolonged credit squeeze (see Chart 6).

BOND YIELDS HAVE ROOM TO FALL

Meanwhile, slowing economic growth momentum is conducive to falling bond yields, contributing to further widening of credit spread. For example, fixed-asset investment has grown weaker than expected recently due to continued crackdown on local government infrastructure spending, property sales volume has continued to slow and retail sales growth has also weakened, just to name a few growth headwinds.

These forces reflect the growth-dragging impact of Beijing’s deleveraging efforts (see Charts 1 and 2) that has offset much of the growth strength from the new industries and the new economy. Thus, the PBoC’s move to cut the bank reserve requirement ratio in April was a pre-emptive move to cushion the impact of the credit slowdown on future growth.

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APPENDIX: KEY POINTS OF THE NEW ASSET MANAGEMENT REGULATIONS ANNOUNCED IN APRIL 2018

1) The rules clearly distinguish between standard and non-standard credit assets, and tighten the maximum investment by wealth/asset management products (WMPs/AMPs) in the non-standard assets to reduce balance-sheet mismatch risk and financial contagion.

2) Banks and NBFIs (including trust companies, securities companies, mutual funds and their subsidiaries, futures companies and their subsidiaries, insurance companies and asset managers) will be charged a risk levy equal to 10% of their management fees from their asset management business.

3) The new rules clarify the definition of “hard redemptions” (guarantee on principal and/or returns on investment) and forbid financial institutions from using hard redemptions in their asset management business.

4) Financial institutions have to enhance their information disclosure and corporate governance, and separate risk management of their asset management business from other businesses. Multilayer re-investments longer than a year, capital pool business and regulatory arbitrage are banned.

5) The leverage ratio (total-asset-to-net-asset ratio) of AMPs must not exceed the ceiling of 140% for open-ended mutual fund AMPs and 200% for close-ended fund AMPs and private equity AMPs.

6) The transition period for full compliance with the new rules will last till end-2020, allowing financial institutions sufficient time to adapt to the new rules without causing major short-term liquidity squeeze.

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