FitchRatings

Fitch On: China

Contents

About Fitch On: China

The Chinese bond market has grown to over USD14 trillion, becoming the second largest in the world after the US. China's offshore USD-denominated bonds have long been sought after by international investors, not only for diversification purposes but also for their attractive yields. More recently, onshore RMB-denominated bonds have seen growing participation from international investors due to both the inclusion of Chinese bonds in global indexes and more streamlined investment procedures via Bond Connect. Foreign investors' onshore bond holdings rose to CNY3.3 trillion by December 2020, up by more than CNY1 trillion from the same period a year ago.

As more international investors are entering China's offshore and onshore bond markets, there is a growing need for gaining an in-depth understanding of new market developments, and the risks and returns associated with different sectors in China. Our Fitch on China Journal aims to provide an update on these developments, while identifying risks to be aware of and highlighting the performance of the Chinese Sovereign, Corporates, Public Finance, Banks, Non-Bank Financial Institutions, and Structured Finance sectors. Fitch expects that the insights and opinions offered by this journal will benefit both new market participants and more experienced investors, bankers and issuers interested in China's fixed income market.

China Shows that Virus Containment Is Key

China's swift economic recovery after the coronavirus outbreak has been striking, but the subtext is a sobering message for other countries – namely that virus-containment seems to be a pre-requisite for a fully-fledged normalisation. GDP in China is now more than 3% above pre-virus levels and growing swiftly, helped by on-balance-sheet fiscal easing and a pick-up in credit growth.

Boosted initially by infrastructure, property and exports, the expansion recently has broadened to the consumer, with retail sales up by more than 4% yoy in October.

There is recent evidence of socially intensive services consumption (i.e. consumer activities that involve proximity to others) starting to return, following the collapse in new virus cases. Retail sales in the catering sector returned to yoy growth in October and domestic air travel has now recovered to above pre-virus levels. However, this shift still seems some way off in the US and Europe, where the recovery in consumer spending to date has been heavily geared towards durable goods, with services lagging.

China Forecast Summary

(%)	Ann. Av.2015-19	2019	2020F	2021F	2022F
GDP	6.7	6.1	2.3	8.0	5.5
Consumer Spending	8.2	5.9	-4.7	9.3	6.3
Fixed Investment	6.1	5.0	6.7	8.4	4.9
Net Trade (contribution pp)	0.0	0.6	0.2	0.1	-0.1
CPI Inflation (end-year)	2.0	4.5	0.8	1.6	2.0
Policy Interest Rate (end-year)	3.26	3.25	2.95	2.95	2.95
Exchange Rate, USDCNY (end-year)	6.63	6.99	6.70	6.90	6.90
(%)	**Av. 2014-2018**	**2019**	**2020F**	**2021F**	**2022F**
General government balance % of GDP	-2.4	-4.9	-11.1	-6.1	-5.2
General government debt % of GDP	48.3	46.9	56.1	56.8	57.7
Current Account Balance (CAB, % of GDP)	1.7	1	2	1.4	1

China's 2020 and 2021 Growth Forecasts Remain Robust

China is the only Fitch 20 country where we see positive GDP growth in 2020 as a whole. GDP growth picked up further in 3Q20 to 4.9% yoy and while this was a little weaker than the 6% we anticipated previously, the recovery has become more fully fledged. Recent monthly data have generally beaten expectations and we are confident that there will be a further pick-up in yoy growth in 4Q20. Nevertheless, as highlighted in our November update, we have lowered our 2020 forecast moderately to 2.3% from 2.7% in the September GEO.

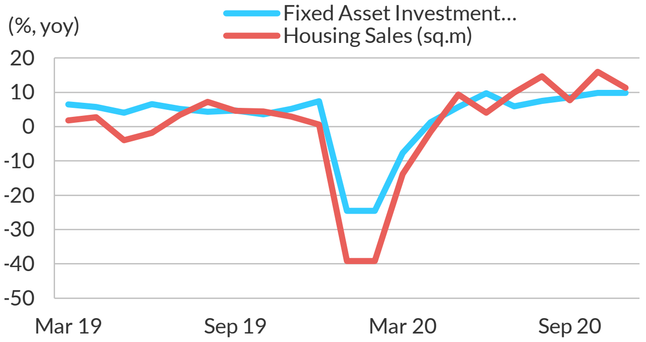
Fixed-asset investment rose to 9.8% in yoy terms in October, supported by ongoing strength in infrastructure investment, a further acceleration in housing sales, and a recent improvement in manufacturing investment. The latter may be related to the return to double-digit yoy export growth in October and November, supported by the resilience of global demand for durable goods including electronics.

There also has been a notable acceleration in consumer spending, with retail sales growth turning positive in yoy terms from August and reaching 5% in November. This partly reflects stronger conditions in the job market – urban unemployment rates have fallen back to pre-coronavirus levels – but most importantly, success in taming the virus. The virtual eradication of new cases has allowed socially intensive consumption to return, as evidenced by catering sales growth of 1.8% yoy in November after being down by nearly half in March.

We have revised up our 2021 GDP growth forecast to 8.0% from 7.7% in the previous GEO, on an increasingly broad recovery in domestic demand and the anticipated improvement in global prospects from 2H21 as vaccine deployment eases the health crisis. This would be well above our estimate of China's long-term growth potential of around 5.5%, but is quite achievable from such a low base in 2020.

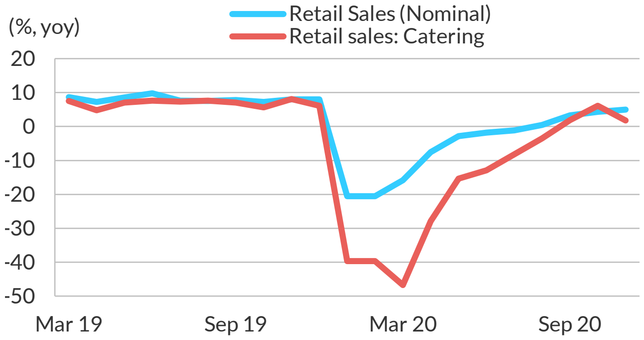
The need for ongoing macro policy support is clearly waning but we do not foresee increases in benchmark interest rates, particularly given the recent decline in core inflation and appreciation in the yuan. Nevertheless, credit growth looks to have now peaked.

China - Fixed Asset Investment & Housing Sales



Source: Fitch Ratings, CNBS, Haver Analytics

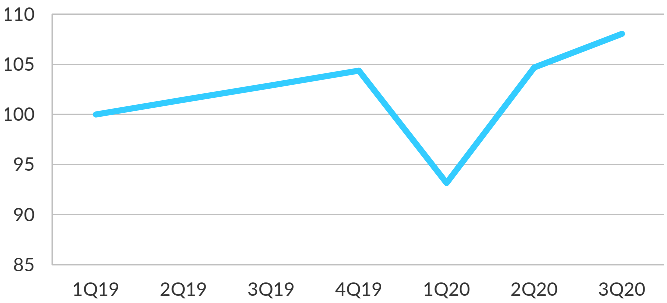
China - Retail Sales



Source: Fitch Ratings, CNBS, Haver Analytics

China - Seasonally Adjusted GDP

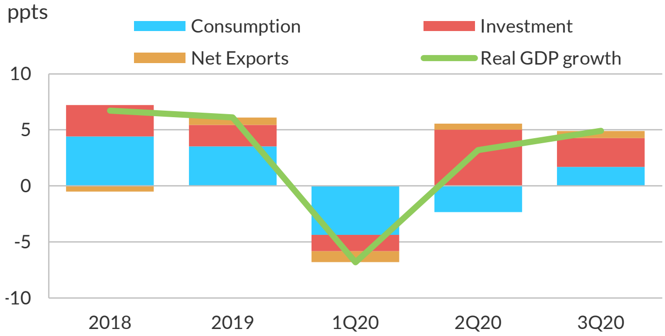
Index , 1Q19 = 100



Source: Fitch Ratings, NBS China, Haver Analytics

Real GDP Growth Contributions

ppts



Source: Fitch Ratings, CEIC

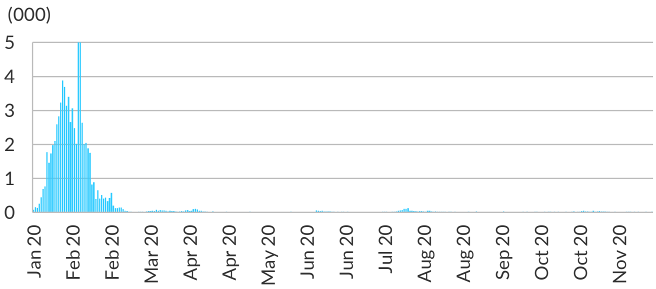
China Sovereign

China Sovereign

China Sovereign 2021 Outlook: An Increasingly Balanced Recovery

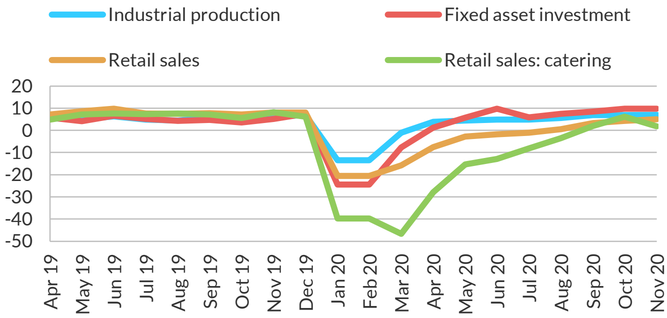
With the local spread of the virus contained since mid-March 2020, and many activity indicators at pre-pandemic levels, the economic recovery will become increasingly well-balanced next year. The resumption of most in-person social engagements will further stimulate entertainment spending and domestic travel, and lift consumption's contribution to overall growth next year. This in turn will support the labour market, which has already returned to pre-COVID 19 conditions. The industrial and tradeable sectors will continue their relative outperformance as the global economy recovers amid a nascent vaccine rollout.

New COVID-19 Infections
Mainland China



New infections of 15,152 on 12 Feb (above axis)
Source: Fitch Ratings, CEIC

China: Activity Indicators
(% yoy)



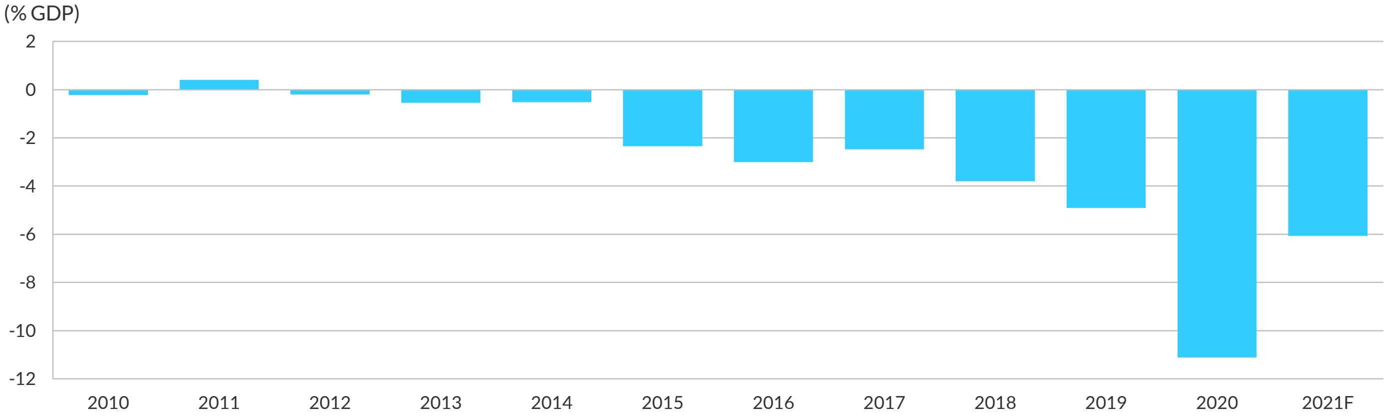
Source: Fitch Ratings estimates, CEIC

Economic Policy Easing to Be Gradually Withdrawn.

Fiscal policy settings will be gradually normalised, after an unprecedented degree of on-balance-sheet fiscal easing in 2020. Fitch's measure of the general government deficit is forecast to fall to 6.1% of GDP in 2021, from about 11% in 2020, though precise budget plans will not be unveiled until the National People's Congress (NPC) in March 2021. Our forecast points to a small (0.7pp) increase in the general government debt-to-GDP ratio in 2021 to 56.6%, after a roughly 9pp rise in 2020.

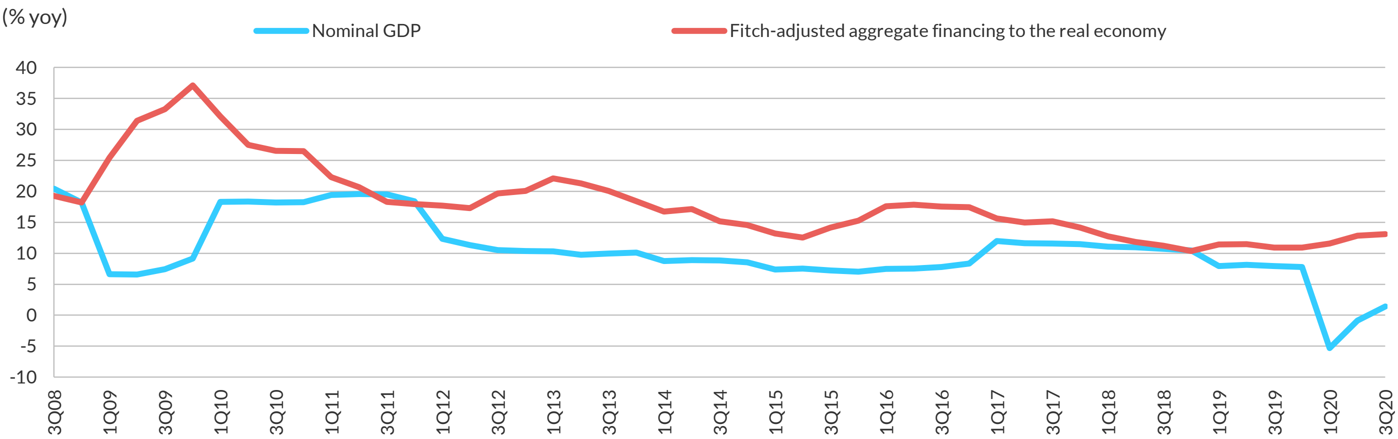
Credit growth will be scaled back in 2021, as the authorities become increasingly confident in the sustainability of the economic recovery, and policy priorities revert to prior objectives such as forestalling the build-up of financial sector risks. Policy rates will, nevertheless, remain unchanged. Fitch believes this will be broadly sufficient to stabilise the economy-wide leverage ratio in 2021, after an increase of about 20pp in 2020, largely driven by a negative shock to nominal GDP growth.

China: Fitch-Adjusted General Government Balance



Source: Fitch Ratings estimates, Government Work Reports, CEIC

China: Credit vs. Nominal GDP Growth



Source: Fitch Ratings, CEIC

2025 Growth Plans Compatible with Easing System Risks

Previews of China's 14th Five-Year Plan (FYP), ahead of its March 2021 release, have indicated that the government will set a goal of becoming a "high-income" country by 2025. The World Bank's current gross national income per capita threshold for high-income countries is USD12,536, though it is uncertain whether China will apply this definition. We estimate China's per capita income at about USD10,500 for 2020.

Fitch previously estimated China's sustainable real growth rate at 5.5% for 2019-2023. This would be more than sufficient to meet the World Bank's threshold by 2025, and is broadly in line with media reports speculating the final FYP may include an accompanying 5% annual growth target, down from targets of 6%-6.5% in recent years.

A less ambitious near-term growth objective bodes well for the authorities' stated goal of striking a balance between economic development and systemic-risk prevention. Efforts to meet a prior target of doubling real GDP between 2010 and 2020 contributed to rapid credit growth and the build-up of financial sector risks. This year proved to be a further set-back in this regard, as credit conditions were loosened to cushion the coronavirus shock. Fitch nevertheless expects leverage to stabilise in 2021, as stimulus is withdrawn amid China's ongoing economic recovery.

A Push for More Self Reliance Amid US-China Geopolitical Uncertainty

Fitch expects the administration of US President-elect Joe Biden will seek to avoid further escalations in US-China trade frictions, and pursue a more predictable and multilateral strategy when disputes do arise. Nevertheless, tensions between the US and China will endure over issues such as human rights, national security and freedom of navigation. Sustained geopolitical uncertainty will further incentivise multinational firms to pursue manufacturing diversification strategies, which may dampen China's export prospects.

Partly as a result, policymakers have reaccentuated the importance of domestic demand as a driver of growth in China's forthcoming 14th Five-Year Plan under a newly branded "dual circulation" strategy. This has been coupled with longstanding themes of high-quality development and innovation.

Although efforts to make growth more reliant on domestic demand are not new, the government's promotion of investment in high-tech areas, like semiconductors, under the dual circulation strategy also aims to enhance China's self-reliance in sectors where dependence on overseas technology remains high. Related policy goals also include strengthening the country's supply chains, infrastructure, digital-economy capabilities, and other emerging industries.

Fitch believes that productivity-enhancing modernisation across these sectors should be achievable, but in industries like semiconductors, large investments alone may be insufficient to allow Chinese companies to narrow the technological gap with overseas competitors.

Yuan Rising, but Faces Significant Hurdles

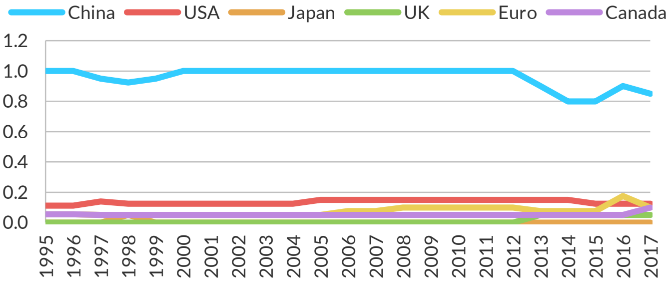
Fitch Ratings' analysis of the relative standing of the world's leading international currencies shows the US dollar's dominance across the global monetary landscape remains deeply entrenched, with the euro a distant second. The Chinese yuan has longer-term potential, but is unlikely to challenge the incumbents in the foreseeable future.

International use of the Chinese yuan has been rising in recent years across a number of categories, but from a very low base. Fitch believes that China possesses key attributes that could make the country a leading global currency issuer. These include its large economic size, dominant share in global trade, strong economic track record, and favourable medium-term growth outlook.

At the same time, China's efforts to internationalise the yuan also face significant hurdles, despite policymakers' recent progress in expanding foreign investors' access to the country's domestic capital markets. These include addressing the widespread prevalence of capital controls, limited liquidity in its government securities, as well as other governance and geopolitical challenges.

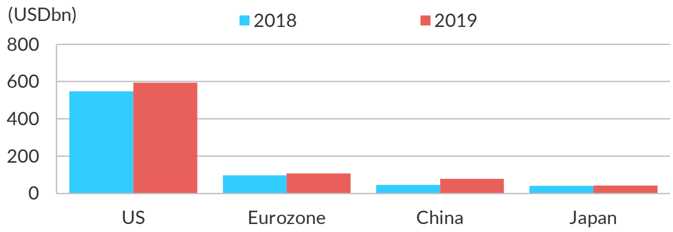
There is also a question of inertia, which will tend to favour incumbents in the absence of a major shock of global consequence. It is worth recalling that the transition from the pound to the US dollar as the leading international currency occurred over multiple decades and against the backdrop of two world wars, a period of history that resulted in a dramatic shift in the global power balance.

Capital Account Restrictions Index
(1 = most restrictions)



Source: Fitch Ratings, Fernandez, Klein, Rebucci, Schinder and Uribe (2016) " Capital Control Measures: A New Dataset", IMF Economic Review Vol. 64 (3): 548-574,2016

Market Liquidity - Government Bonds
Average daily trading volume



Note: China data includes central government, local government and policy bank bonds traded in the interbank market and Shanghai Stock Exchange
Source: Fitch Ratings, FRBNY, AFME, China Bond, Shanghai Stock Exchange, Japan Securities Dealers Association, ADB, Haver, CEIC

Fitch's Interactive Sovereign Rating Model (Click Here to View)

Fitch has launched an interactive Sovereign Rating Model (SRM) which contributes further to the enhanced transparency of our criteria by enabling users to input their own forecast assumptions across the range of quantitative variables that comprise the SRM, in order to generate a predicted rating, calibrated to the Long-Term Foreign Currency Issuer Default Rating scale.

FitchRatings | Sovereign Rating Model Powered by | FitchConnect

Model

QUICK GUIDE
Step 1. Press REFRESH in the Fitch Connect excel ribbon
Step 2. Press button to select Sovereign and Year
Step 3. Input your own data in the User Defined Scenario
Click this button to select Sovereign and Year

LEGEND FOR OVERWRITEABLE USER INPUT CELLS
Live FitchRatings data; unchanged since Rating Date.
Live FitchRatings data; updated since Rating Date.
Input by User [Tip: double click cell to revert to live data via FitchConnect data].

ANCILLARY FUNCTIONALITY
Use + buttons in top right corner unfold intermediate calculations
Click this button to Revert User Defined Scenario Back to Fitch Data
Click this button to Print Sheets To PDF

CHINA

FALSE
FALSE

Predicted Rating CHECK: TRUE

FINAL RATING (1. + 2.)

Powered by | FitchConnect **User Defined Scenario Implied Rating: A+**
as Number[2]: 12

FitchRatings **Long-Term Foreign Currency IDR[1]: A+**
Memo - Rating Date: 27-Jul-20 as Number[2]: 12

1. SOVEREIGN RATING MODEL (SRM)

User Defined Scenario — Predicted Rating[3]: A; Model Result: 11.38

Fitch Ratings — Predicted Rating[3]: A; Model Result: 11.48

Input Indicator[5]	Model Input Horizon[4] 2019	2020	2021	Coefficient	Final Input Data[5]	Output (Notches)	Model Input Horizon[4] 2019	2020	2021	Coefficient	Final Input Data[5]	Output (Notches)
Structural features						7.92						8.01
Governance Indicators (Percentrank)	n/a	41.2	n/a	0.075	41.2	3.11	n/a	42.8	n/a	0.075	42.8	3.23
GDP per Capita (USD)	n/a	10,422	n/a	0.040	52.1	2.06	n/a	10,246	n/a	0.040	51.3	2.03
Nominal GDP (USDmn)	n/a	15,000,320	n/a	0.607	2.9	1.76	n/a	14,746,714	n/a	0.607	2.9	1.77
Year of Most Recent Default / Restructuring[6]	n/a	No default	n/a	-2.481	No default	0	n/a	No default	n/a	-2.481	No default	0
Broad Money Supply (% of GDP)	n/a	211.5	n/a	0.185	5.4	0.99	n/a	211.8	n/a	0.185	5.4	0.99
Macroeconomic performance, policies and prospects						-0.37						-0.35
Real GDP Growth Volatility	n/a	2.6	n/a	-0.767	1.0	-0.73	n/a	2.5	n/a	-0.767	0.9	-0.70
Consumer Price Inflation (annual average %)[7]	2.9	2.7	1.2	-0.056	2.5	-0.14	2.9	3.2	1.8	-0.056	2.7	-0.15
Real GDP growth (%)	6.1	2.3	8.0	0.093	5.5	0.51	6.1	2.7	7.5	0.093	5.4	0.50
Public Finances						-1.73						-1.72
Gross General Govt Debt (% of GDP)	46.9	56.1	56.8	-0.021	53.3	-1.12	46.9	55.9	56.9	-0.021	53.2	-1.12
General Govt Interest (% of Revenue)	3.0	4.8	5.0	-0.046	4.3	-0.20	3.0	4.8	5.0	-0.046	4.3	-0.20
General Govt Fiscal Balance (% of GDP)	-4.9	-11.1	-6.1	0.055	-7.4	-0.40	-4.9	-11.1	-6.1	0.055	-7.4	-0.40
Fgn Ccy General Govt Debt (% of Total GGGD)	0.3	0.3	0.2	-0.006	0.3	-0.00	0.3	0.2	0.2	-0.006	0.3	-0.00
External Finances						1.06						1.04
Reserve Ccy (RC) Flexibility	n/a	1.6	n/a	0.551	1.6	0.86	n/a	1.5	n/a	0.551	1.5	0.84
SNFA (% of GDP)	22.4	22.0	19.8	0.011	21.4	0.24	22.4	21.9	20.2	0.011	21.5	0.24
Commodity Dependence	n/a	5.6	n/a	-0.003	5.6	-0.02	n/a	5.6	n/a	-0.003	5.6	-0.02
FX reserves (months of CXP)	n/a	15.1	n/a	0.027	n/a [RC > 0]	0	n/a	15.3	n/a	0.027	n/a [RC > 0]	0
External Interest Service (% of CXR)	2.0	2.1	2.2	-0.012	2.1	-0.02	2.0	2.3	2.3	-0.012	2.2	-0.03

China Corporates

China Corporates

China Corporates : Larger SOE Presence Likely in Next Wave of Bond Defaults

SOE Defaults to Rise Marginally in 2021

Fitch Ratings expects the number of defaults by Chinese state-owned enterprise (SOEs) to rise slightly in 2021. The People's Bank of China has shifted towards a more neutral monetary policy stance and we expect funding conditions to tighten in 2021 as economic growth is recovering from the coronavirus pandemic's impact.

Meanwhile, investor appetite for debt from SOE issuers is likely to diverge based on their credit profiles, after the default by Yongcheng Coal & Electricity Holding Group (Yongcheng), a Henan-based state coal miner, on 10 November 2020 that caught the market by surprise.

SOEs with weak financial profiles operating in commercialised sectors or sectors with overcapacity could become more vulnerable to liquidity tightening, as investors expect government support for such SOEs will be less likely after Yongcheng's default. Ninety-six companies have cancelled new issuance totalling CNY82.7 billion since 10 November, including four state-owned coal companies in Shanxi province

The total principal amount of SOEs' defaulted bonds hit a record high of nearly CNY40 billion in 10M20, mostly contributed by the Peking University Founder Group. Five SOEs defaulted in the first 10 months of 2020, close to levels in the previous two years.

Private Sector Remains Vulnerable

The number of privately owned enterprises (POEs) rated 'AA+' or lower on domestic rating scales (lower rated POOs) with maturing or puttable bonds in 2021 will fall to 324 from 466 in 2020.

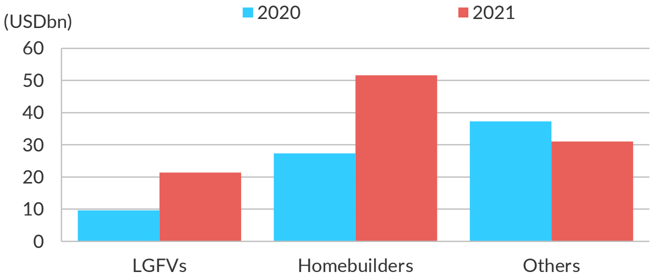
However, we do not expect a comparable drop in POE defaults in 2021. The amount of bonds to be repaid by lower-rated POEs in 2021 is similar to that in 2020, and about a fifth of weak POEs neither issued new bonds in past two years nor have sufficient cash to cover short-term debt.

Twenty POEs defaulted on their onshore bonds with a total principal amount of CNY49.2 billion in 10M20. Both stood at less than half of the 2019 levels, due to a slump in bond repayment pressure on lower-rated POEs and improved market liquidity to counter the impact of the pandemic.

However, the level of defaults may be understated by some issuers' tactics, including repaying bondholders outside clearing houses after the due date, persuading bondholders to give up put options, deferring the redemption of perpetual securities, and debt exchanges.

Offshore Corporate Bond Maturities

US dollar and dim sum bonds

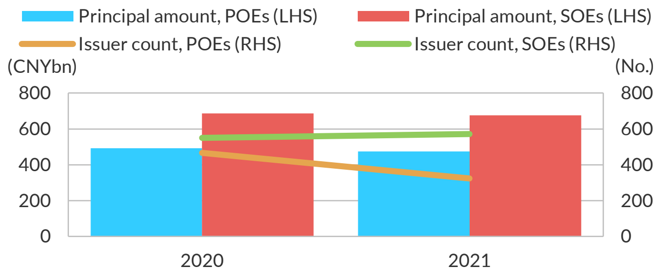


Including puttable bonds

Source: Bloomberg, Fitch Ratings

Onshore Corporate Bond Maturities

'AA+' or lower domestically rated issuers



Including puttable bonds; ratings are assigned by domestic rating agencies other than Fitch Bohua

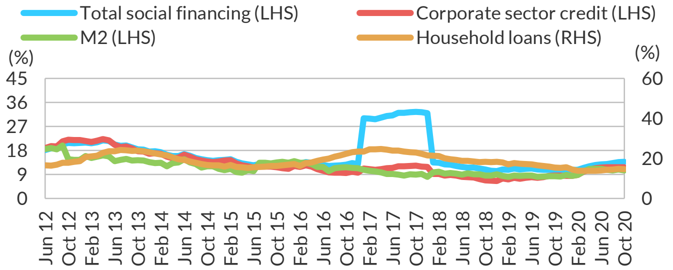
Source: Fitch Ratings, Wind Info

Offshore Defaults to Stay Flat

We expect Chinese corporates' offshore defaults in 2021 to be broadly in line with the level in 2020. While the amount of their maturing or puttable US-dollar and dim sum bonds will be 40.1% higher than in 2020, the rise will be mostly contributed by local-government financing vehicles or homebuilders, which usually have ample refinancing resources.

China's Credit Cycle

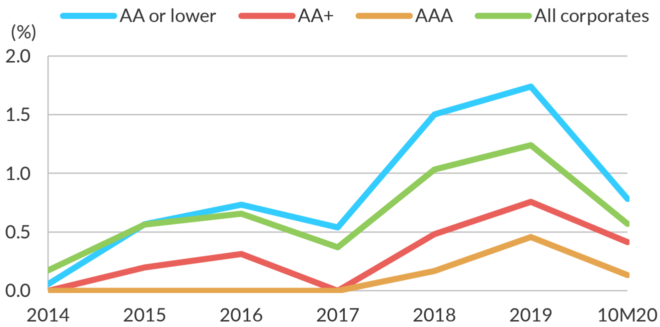
Yoy growth in outstanding amount



Corporate sector credit: total social financing less non-financial corporate equity funding, government bonds & household loans; NBS restated the government bond section since January 2017 to include central government bonds and local government ordinary bonds

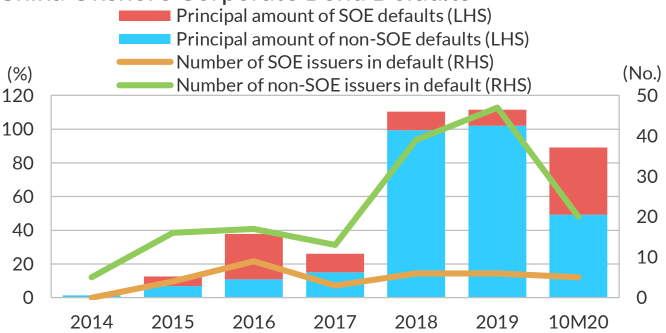
Source: Fitch Ratings, Wind Info

Corporate Bond Default Rate by Issuer Count



Source: Fitch Ratings, Wind Info

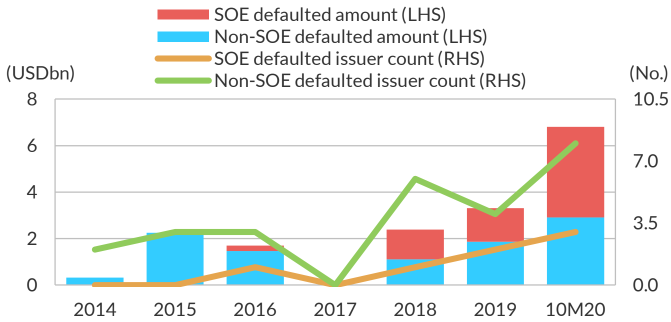
China Onshore Corporate Bond Defaults[a]



[a] Excluding bonds already in default in previous years

Source: Fitch Ratings, Wind Info

Offshore Defaults by Chinese Corporates

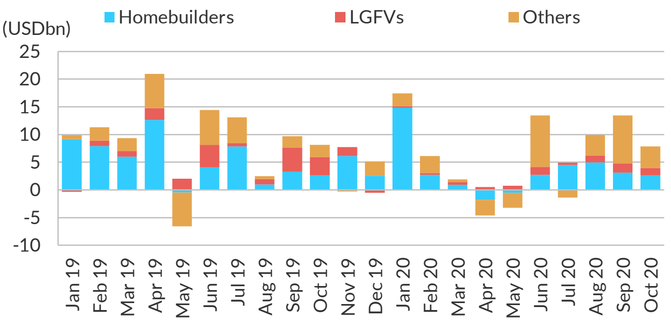


US dollar bonds and dim sum bonds

Source: Fitch Ratings, Bloomberg

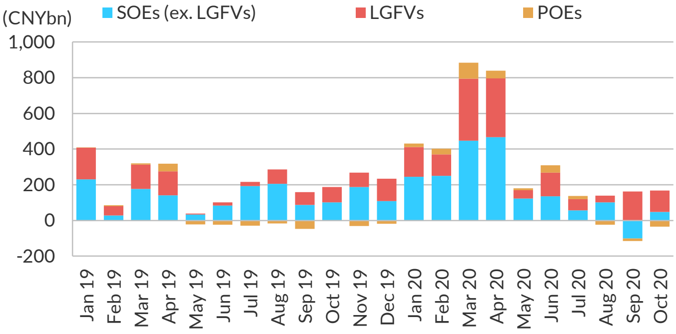
Chinese Corporates' Net Offshore Bond Issuance

US dollar & dim sum bonds



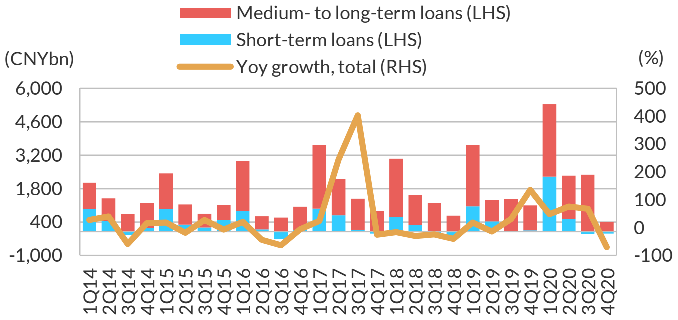
Source: Fitch Ratings, Bloomberg

Net Onshore Corporate Bond Issuance



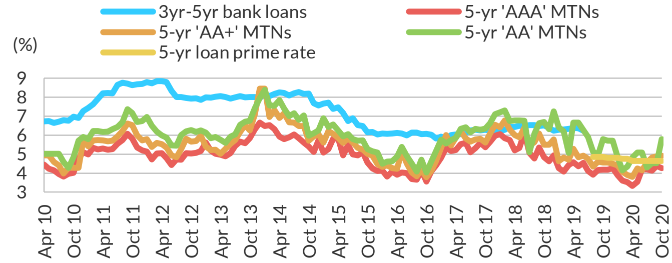
Source: Fitch Ratings, Wind Info

Net Increase in Outstanding Corporate Loans[a]



[a] Loans granted to non-financial corporates by banks and otherfinancial institutions
Source: Fitch Ratings, Wind Info

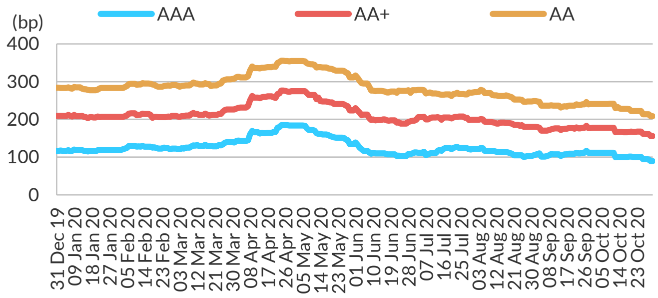
Average Funding Cost: Bank Loans vs. Bonds



Data on 5-year Loan Prime Rate (LPR) started from August 2019; relevant data required to calculate the average 3-5 years loan rate have yet to be released since end-1H19
Source: Fitch Ratings, Wind Info

Credit Spreads by Domestic Ratings

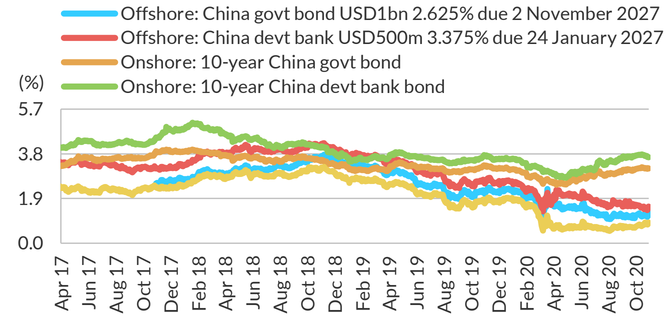
MTNs with around two-year maturity[a]



[a] At end-1Q20
Source: Fitch Ratings, Wind Info

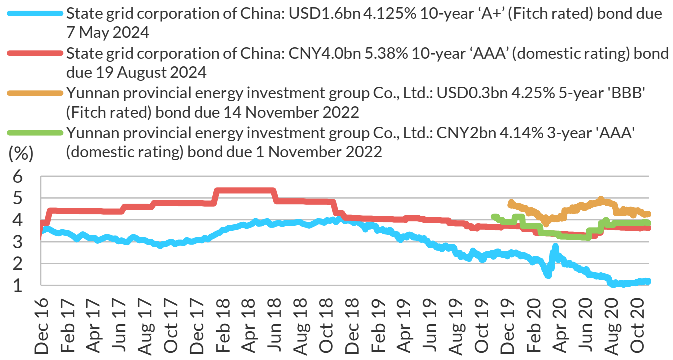
Benchmark Yields

Sovereign and policy bank



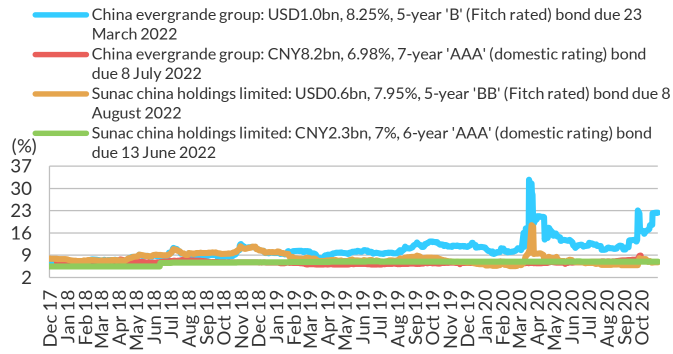
Source: Fitch Ratings, Bloomberg

Yield-to-Maturity Comparison



Source: Fitch Ratings, Fitch Solutions, Wind Info, Bloomber

Yield-to-Maturity Comparison



Source: Fitch Ratings, Fitch Solutions, Wind Info, Bloomberg

Case Study: Surge in Cancellation of Onshore Corporate Bond Issuance

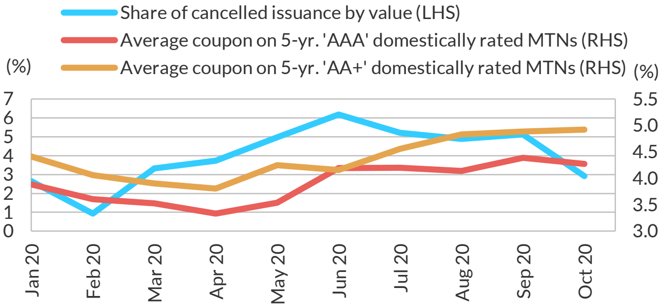
The amount of cancelled or postponed corporate bond issuance reached CNY429.6 billion in the onshore market in 10M20, or 70.1% higher than in 10M19, following record high issuance in 1H20. Meanwhile there were 454 corporates that cancelled or postponed their bond issuances, up sharply from 283 a year earlier.

The percentage of cancelled issuance among all planned primary deals by value started to pick up in March as more corporate issuers expected interest rates to decrease because the central bank injected more liquidity into the system to offset the shock from the COVID-19 pandemic.

However, bond issuance costs have rebounded since May. For example, the average coupon at issuance on five-year 'AAA' and 'AA+' domestically rated medium-term notes (MTNs) rose to 4.3% and 4.9%, respectively, by October from 3.3% and 3.8% in April.

Many corporates halted or delayed their planned issuance in the expectation that the coupon rebound would not persist. This led to a further rise in the share of cancelled primary deals to 5% or above from May to September.

Coupon on New Issuance Drives Share of Cancelled Issuance

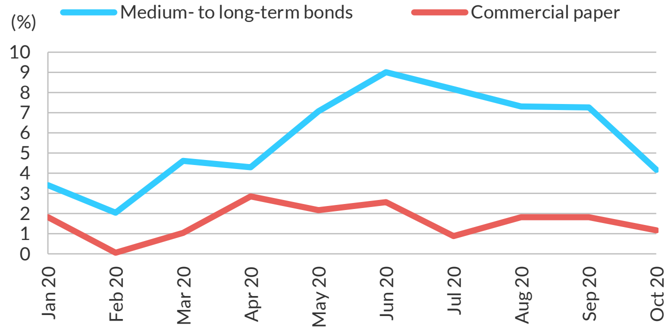


Source: Fitch Ratings, Wind Info

Over 80% of cancelled primary deals by value are medium- to long-term bond instruments, including MTNs, enterprise bonds, exchange corporate bonds and privately placed notes (PPNs).

Those instruments also consistently represented a larger share of cancelled deals among planned issuance than commercial papers (CPs) due to their long tenors, which makes issuers more sensitive to interest-rate volatility.

Share of Cancelled Issuance among Total Planned

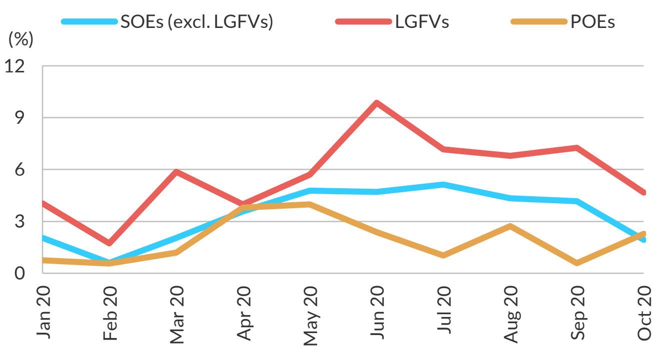


Source: Fitch Ratings, Wind Info

In addition, around 95% of the amount of cancelled issuance in 10M20 were by SOEs and local government financing vehicles (LGFVs), which cancelled or deferred a higher percentage of planned primary deals than POEs in most months.

Fitch expects cancellation of bond issuance to pick up in the rest of the year as weaker SOEs in highly commercialised and oversupplied sectors may find it more difficult to tap the bond market after Yongcheng's default on 10 November 2020. Since then, 96 companies have cancelled new issuance amounting to CNY82.7 billion as of 25 November.

Share of Cancelled Issuance among Total Planned Issuance



Source: Fitch Ratings, Wind Info

China Properties: New Lending Caps Impose Moderate Curbs on Housing Sector

New Caps on Banks' Property Exposure

The People's Bank of China (PBoC) and the China Banking and Insurance Regulatory Commission jointly announced new regulatory caps on banks' exposure to the property sector and mortgage loans at end-2020.

Larger state banks will need to limit outstanding property lending and mortgages to 40% and 32.5% of their total loans, while much smaller rural banks will be subject to caps of 12.5% and 7.5%, respectively.

Most banks' property-related lending is now below the caps, the PBoC said. There will be a transition period of two years for banks that have breached the caps by less than two percentage points (pp), or four years if they exceed the caps by two pp or more.

The new regulation came amid an increase in the share of property lending in overall bank loans and recent signs of overheating in the property markets of some higher-tier cities. Property-related loans accounted for 28.8% of overall outstanding loans, including a record high of almost 20% from mortgages, at end-3Q20.

Mild Headwind on Home Sales

Banks constrained by the caps will need to cut their property exposure if they do not enhance lending to non-property sectors. Meanwhile, the regulators also called on banks to avoid exceeding the limits and keep a stable share of property lending in their loan mixes.

Fitch believes outstanding mortgage growth could slip slightly below that of overall lending in 2021, which may drop to the pre-pandemic level of 12.5% in 2021 from 13% at end-3Q20 as monetary policies have turned neutral. The net increase in mortgages in 2021 may slow to CNY3.7 trillion from the 2019 level of CNY4.3 trillion.

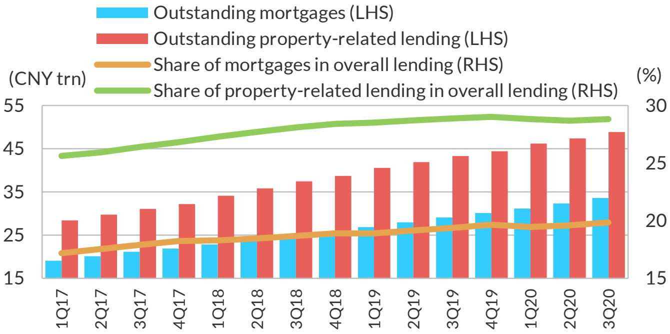
However, incremental mortgages usually fund a minor share of nationwide new-home sales, so we expect sales in 2021 to stay flat or retreat slightly relative to 2020.

Moderate Constraints on Homebuilders

Fitch does not expect banks to significantly cut their incremental exposure to homebuilders in 2021 as a result of the lending caps as most are not in breach of the limits and those that are have the transition period to take remedial action. Growth in outstanding property-related lending other than mortgages slowed to 7% yoy at end-3Q20, well below the 13% for overall lending.

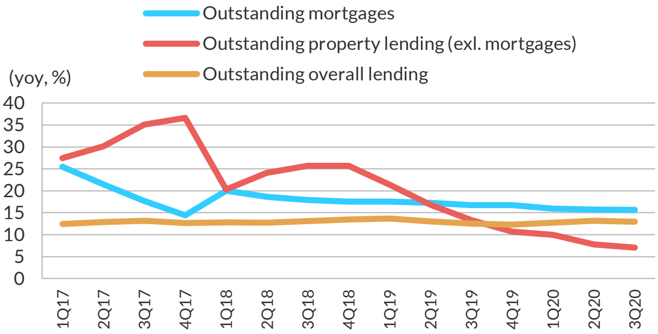
The majority of Fitch-rated Chinese homebuilders can well manage the impact of the new lending constraints due to significant flexibility over their cash outflows and sufficient deleveraging headroom, but a small number of low-churn or highly leveraged homebuilders may face higher liquidity or refinancing risks.

Share of Property Loans Have Increased



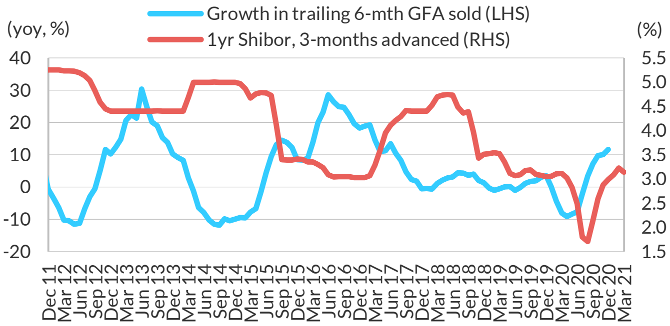
Source: Fitch Ratings, Wind Info

Growth in Property Loans vs. Overall Lending



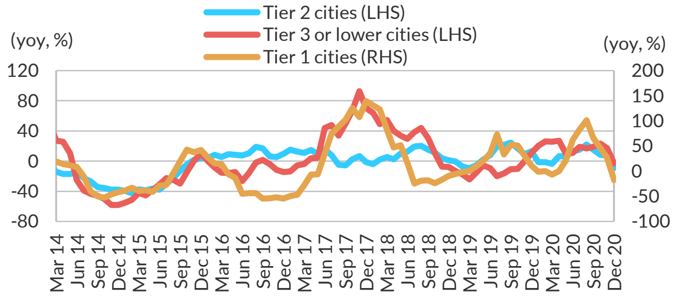
Source: Fitch Ratings, Wind Info

Residential Gross Floor Area Sold & Shibor



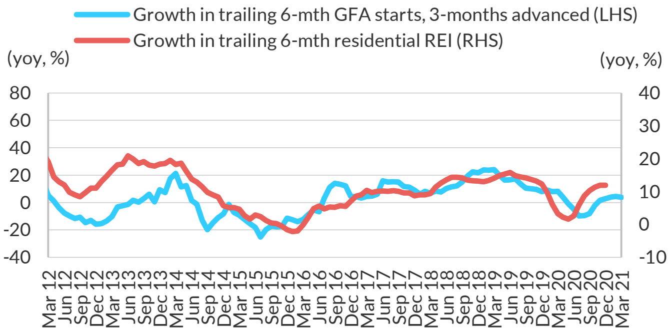
Source: Fitch Ratings, CEIC, National Bureau of Statistics, Shibor.org

Growth in Residential Land Transactions by Area



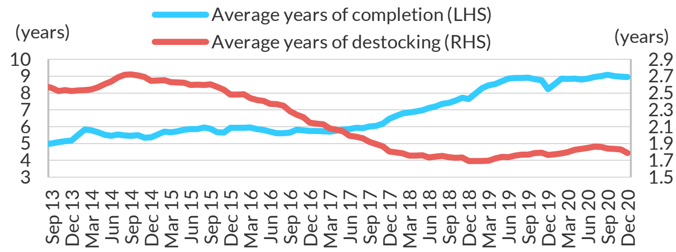
Trailing 6-months
Including four Tier-1 cities, 39 Tier-2 cities, and 57 Tier 3 or lower cities
Source: Fitch Ratings, Wind Info

Real Estate Investment & Residential Gross Floor Area



Source: Fitch Ratings, CEIC, National Bureau of Statistics

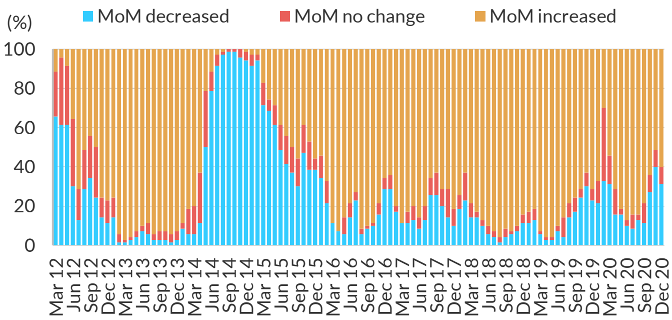
Years of Completion[a] and Destocking[b]



[a] Average years of completion: GFA under construction divided by GFA completed on a trailing 12-month basis;
[b] Average years of destocking: total GFA started minus total GFA sold since 1999 and divided by annualized GFA sold based on 36-month moving average
Source: Fitch Ratings, CEIC, National Bureau of Statistics

Price Changes in 70 Major Cities

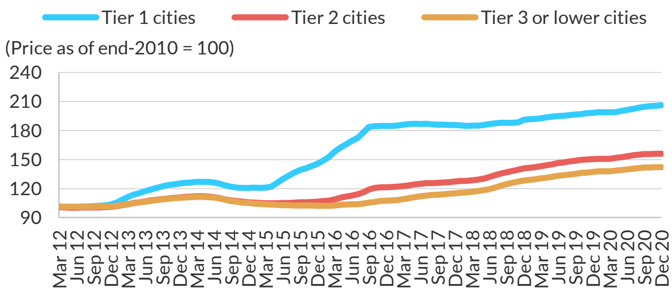
New residential properties



Source: Fitch Ratings, CEIC, Wind Info

Property Price Index[a]

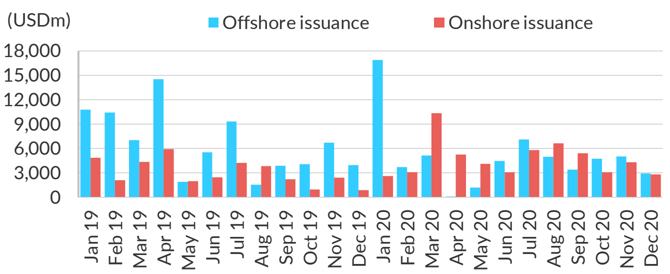
New residential properties



[a] 70-city average
Source: Fitch Ratings, CEIC, Wind Info

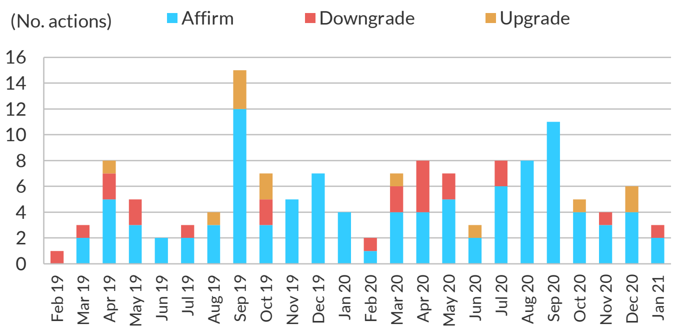
Bond Issuance by Chinese Property Developers

Offshore[a] & onshore[b]



[a] Including US dollar bonds and Dim Sum bonds
[b] Public issuance
Source: Fitch Ratings, Bloomberg, Wind Info

Fitch's Rating Actions on Chinese Property Developers



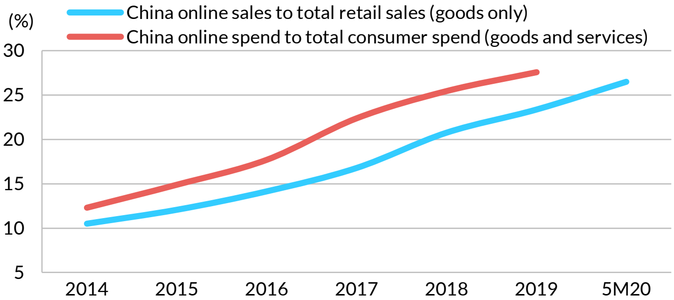
Source: Fitch Ratings

China’s E-tailing Sector

Part 1: China’s Structural Shift Towards Online Retail - Coronavirus Pandemic and Containment Measures Drive Online Shopping Growth

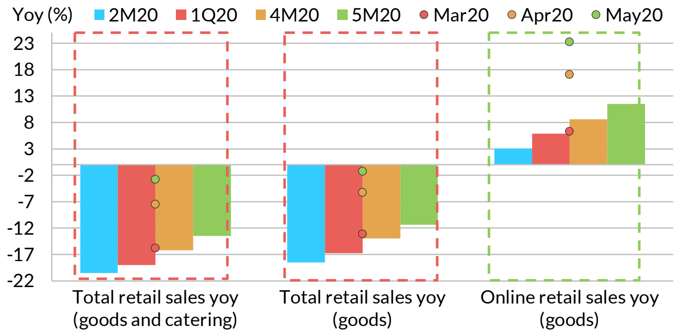
The coronavirus pandemic has given flagging online retail (e-tailing) sales growth in China a boost as consumers adhere to social distancing measures and limit shopping in physical stores. Fitch Ratings believes the pandemic will drive a structural shift in Chinese consumer behaviour. Fitch expects the ratio of e-tailing sales to total retail sales (goods only) to continue to rise in the rest of 2020, after hitting a high of 26% in 5M20. In comparison, e-tailing accounted for 11% of total retail sales (goods and services) in the US and 7% in the EU plus the UK (EU-28) in 2019.

Rising Share of Online Sales and Spend to Total



Note: Total consumer spend is a component of China's GDP, individual consumption only, excluding government consumption
Source: Fitch Ratings, National Bureau of Statistics

Online Goods Retail Grows Faster So Far in 2020

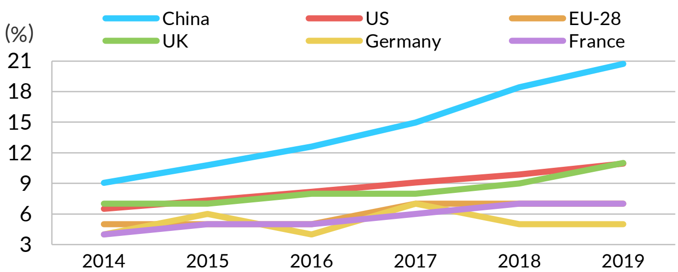


Note: January and February combined (2M20) due to Chinese New Year holidays
Source: Fitch Ratings, National Bureau of Statistics

China’s total online retail market, including goods and services, has been the world’s largest in US dollar terms since 2015, exceeding that of the US and the combination of 34 European countries. Although the ratio of e-tailing sales to total retail sales is higher in China than in the US and Europe, China’s e-tailing penetration rate by digital buyer to total population is lower than in the developed nations. This is due to lower urbanisation and internet penetration rates, although Fitch expects both to rise as the Chinese government pushes urbanisation and infrastructure development.

China’s demographic and economic structure is also favourable for continued development of online retailing. The internet-reliant and prime consuming population aged 20-59 accounts for nearly 60% of China’s total population in 2020, higher than in most developed nations. These consumers’ buying power will rise as the economy grows.

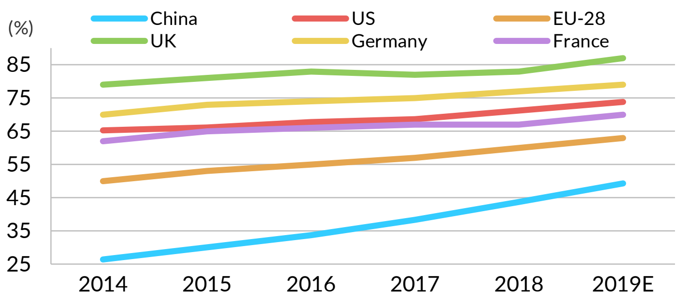
China's E-tailing/Total Retail Sales Ratio is Higher



Note: China and US as B2C e-commerce sales to total retail sales; EU-28 and European countries as enterprises' turnover from web sales/total turnover, based on Eurostat's value of e-commerce sales
Source: Fitch Ratings, National Bureau of Statistics, Eurostat, Census Bureau

China Has Lower E-tailing Penetration

E-shoppers as proportion of total population



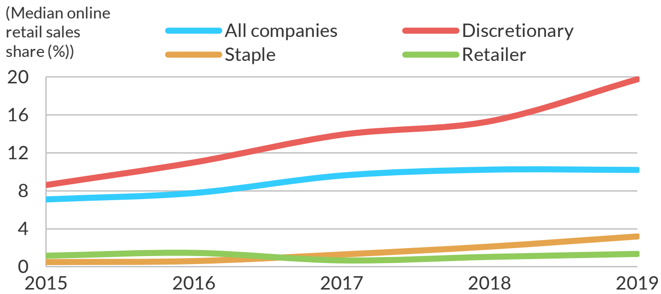
Source: Fitch Ratings, China Internet Network Information Centre, Eurostat, E-commerce Foundation

Part 2: E-tailing Awareness Boosts Corporate Growth

China's e-tailing sector has outgrown the overall retail sector by a wide margin so far this year and will continue to expand. As a result, e-tailing has become an integral force to be reckoned with in Chinese consumer goods and retail companies' business strategies.

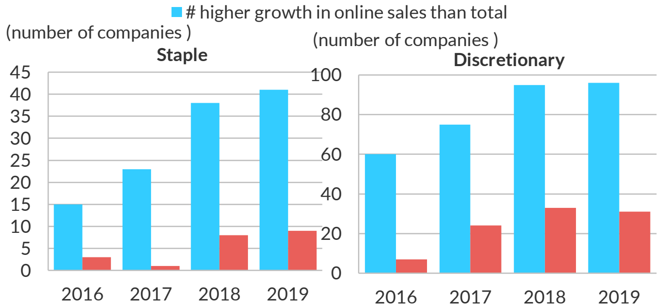
A study by Fitch Ratings of over 200 consumer goods companies and retailers with disclosure of online retail sales data reveals that their median online retail sales/total sales ratio increased to 10.2% in 2019 from 7.1% in 2015, in line with the trend of rising e-tailing penetration in China. We break the companies into 20 categories under three groups – consumer staple, consumer discretionary and retailers. Almost all categories saw higher median growth in online retail sales than total sales in 2016-2019. Companies with higher total sales growth also tend to have higher e-tailing exposure.

Median Online Retail Sales/Total Sales Ratio



Note: For companies with disclosure on online sales data, excluding distributors; number of samples may change each year
Source: Fitch Ratings, companies

Companies with Higher Growth in Online Sales Than Total Sales Outnumber Those with Lower



Source: Fitch Ratings,

The consumer staple group sees lower online retail sales share than the discretionary group, as consumer staple companies rely more on the traditional distribution model and many of their products are low-value and heavy items, requiring high express-delivery fees relative to product value. Instead, some consumer discretionary goods companies sell mainly through online channels.
The retailer group sees the lowest online retail sales share as they focus more on offering offline shopping experiences. Some companies are embracing the new retail model (online-to-offline with on-demand delivery) or social-networking retail, but this will take time to expand these companies' online retail sales shares.

Categories with higher online retail sales shares also tended to be more defensive during the coronavirus outbreak. These include: raw and processed food in the consumer staple group; beauty and cosmetics as well as packaged food and snacks in the consumer discretionary group; and hypermarkets and supermarkets in the retailer group.

Part 3: China's E-tailing Operators Vary in Business Models, Strategies and Competitive Edges

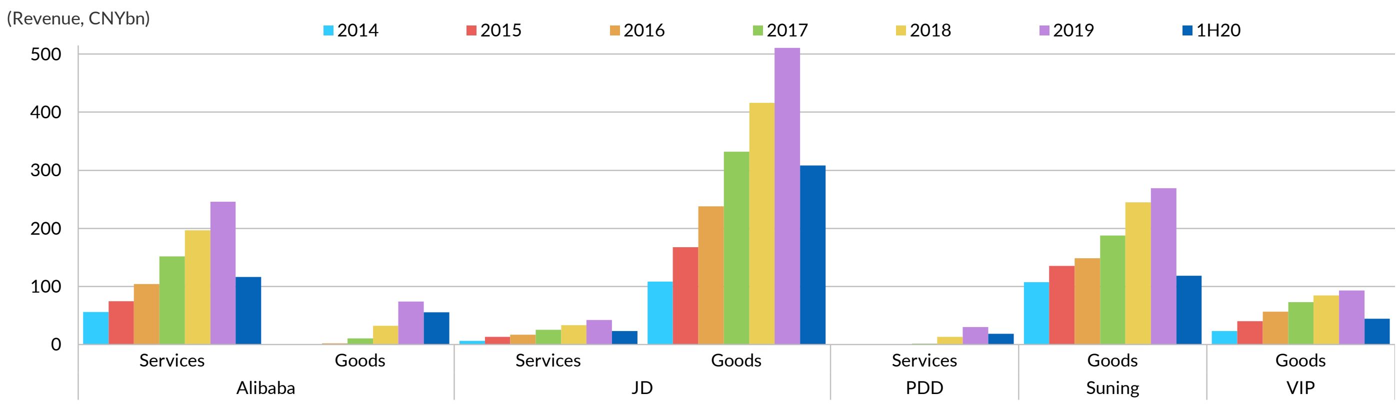
China's e-tailing sector is highly concentrated with leading operators such as Alibaba Group Holdings Limited (A+/Stable), JD.com, Inc. and Pinduoduo Inc. (PDD) dominating around 95% of national e-tailing gross merchandise value (GMV), followed by Suning com Co., Ltd. (Suning) and Vipshop Holdings Limited (VIP, BBB+/Stable) with low single-digit shares. These leaders can be segregated into two major camps: Alibaba versus Tencent Holdings Limited (A+/Stable), a strategic shareholder offering social sharing access to JD, PDD and VIP.

The five major players all have their own unique business models and strategies. Alibaba and PDD run mainly a platform-based model, featuring a wide variety of products, although Alibaba also sells goods directly. JD, Suning and VIP mainly sell goods directly, allowing them to have better control on product quality, and they also offer platform services to third-party merchants. The five companies also adopt different logistics strategies. JD and Suning feature the more reliable self-owned logistics systems for self-operated business but allow third-party merchants to employ other delivery vendors. Alibaba, PDD and VIP rely mostly on third-party logistics service vendors without self-built delivery force.

Business Model Comparison

	Direct goods sales revenue	Platform services revenue	Logistics
Alibaba	Minor	Major	Merchants' option; tech-solution
JD	Major	Minor	Largely self-operated; merchants' option
PDD	None	Major	Merchants' option; tech-solution
Suning	Major	Tiny	Largely self-operated; merchants' option
VIP	Major	Tiny	Outsourced to SF

Variances in Revenue Components due to Business Model



Note: Alibaba's services do not include logistics service; logistics and other services excluded from JD's services; Suning's goods include both online and offline sales
Source: Fitch Ratings, companies

Variances in business models and strategies mean huge differences in financial metrics. PDD's gross margin is much higher than JD's, Sunning's and VIP's due to its platform-based model (mainly services), but its margin after cost of revenue and marketing expenses is much poorer than peers due to aggressive subsidising. JD and Suning maintain inventory to support goods sales, and have higher capex for logistics and warehouse assets, therefore have weaker free cash flow (FCF) margins than platform-based peers.

International Public Finance

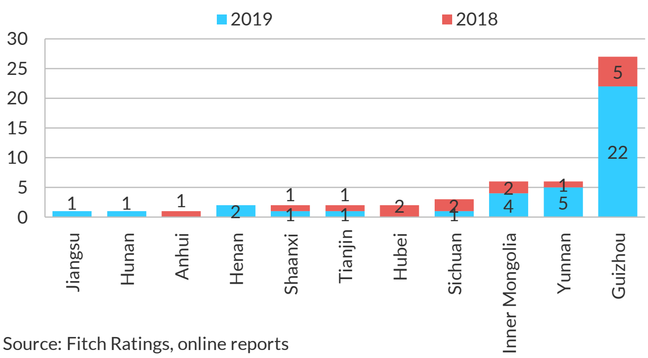
International Public Finance

Creditworthiness within Chinese LGFVs will become more polarised, in line with the government's efforts to provide official support more selectively, making non-core entities more vulnerable to rising default risk.

Credit situation of Chinese LGFVs worsens. There have been frequent reports of credit incidents including late payments at Chinese LGFVs, which have an adverse impact on market sentiments and may hurt their creditworthiness. The number of LGFVs involved in credit incidents more than doubled in 2019 from a year earlier, with most of them from less-developed provinces and lower-tier local governments. Fitch believes the situation is unlikely to improve due to rising uncertainties in China's economy, which will weigh on local governments' budgetary performance.

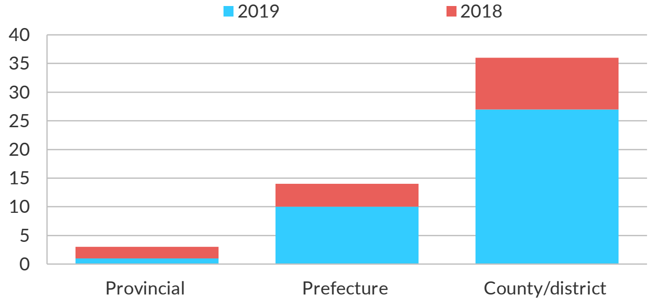
Nearly 40 Chinese LGFVs were involved in credit incidents in 2019, a substantial increase from more than 10 in 2018, according to public reports. More than 80% of the LGFVs involved were from western provinces, whose economies are less developed than those of the coastal provinces. The LGFVs of lower-tier governments, such as district and county levels, registered more credit incidents than those under higher-tier, including provincial, governments. This could be due to the poor credit profiles of these LGFVs as well as the weaker fiscal positions of their government sponsors, which constrain the capability to provide support.

Rising Numbers of LGFV Credit Incidents in Chinese



Source: Fitch Ratings, online reports

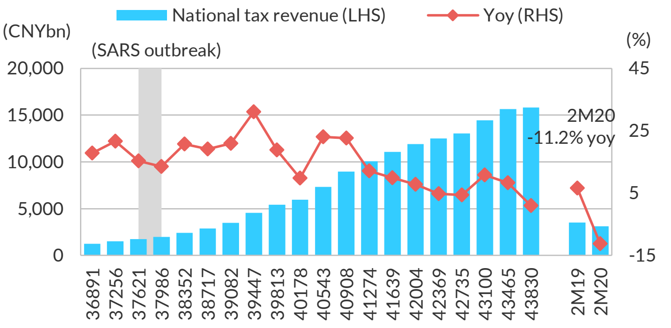
Lower-Tier LGFVs Report Most Number of Credit Incidents



Source: Fitch Ratings, online

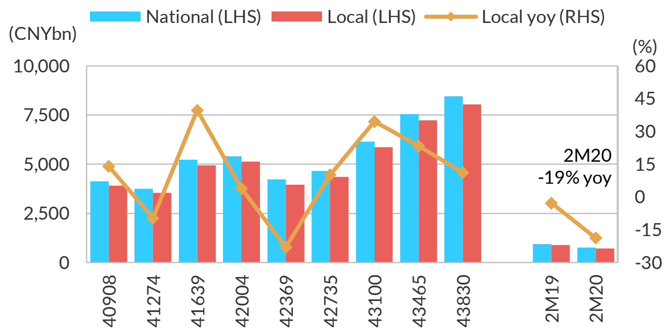
The increase in the number of credit incidents can be partially attributed to the slowdown in local economies. The GREs' major counterparts in their projects are their regional governments who pay for services provided by or assets bought from LGFVs, making the resilience of a local economy increasingly important in the GREs' creditworthiness.

Plunging Tax Revenue



Source: Fitch Ratings, Ministry of Finance

Capital Revenue Falls



Source: Fitch Ratings, Ministry of Finance, WIND

Narrowing Funding Channels: Chinese Local governments have implemented regulations to control the use of shadow financing, crimping the GREs' funding sources. Trust loans and financial leasing were also major alternative sources of funds for some GREs. These are now being squeezed, which will further constrain their funding sources.

We believe GREs with strong market positions will not be affected substantially by the crackdown as they are regarded as more creditworthy with lower risks of bad loans, helping them borrow from banks or through direct issuance. On the contrary, smaller or weaker GREs are more vulnerable as funding channels narrow. They may face greater challenges obtaining additional funds from banks or direct debt issuance, posing higher liquidity risks in the next few years.

The Chinese government's directives on reform and debt will add to the polarisation among LGFVs, on top of rising pressure from the economic slowdown and the headwinds from the drop in local governments' fiscal revenue.

Reform of state-owned enterprises directed by the government since 2017 has resulted in restructuring and consolidation among Chinese LGFVs. Fitch believes LGFV creditworthiness has improved through restructuring and consolidation, especially for stronger companies, and the pace is likely to pick up in the next few years.

LGFV consolidation can take place through the establishment of a new state-owned asset operation platform and the injection of several existing platforms into the new one. Alternatively, a local government can choose an existing LGFV, the largest in most cases, as the main platform and inject stakes of entities into it to complete the consolidation.

The consolidated LGFV in both cases will see a substantial expansion in assets with better ability to withstand financial and operational risks. The consolidated LGFV will also enjoy greater strategic importance due to its wider business scope and stronger functional role. This will also leave those that are not involved in consolidation, mainly peripheral LGFVs, at a greater disadvantage. The likelihood of the local government designating important tasks to them will be lower, resulting in looser government linkages while reducing the incentive for the government to provide extraordinary support under extreme circumstances.

The Chinese government has also emphasised the importance of containing the risks of local government debt, especially the ballooning of off-balance sheet debt at LGFVs. Authorities have taken various measures to rein in the risks including revealing the existence of off-balance sheet debt, issuing strict regulations to prevent further risky borrowing and converting implicit debt to explicit debt through a debt-swap programme. Fitch believes this goal will not waver even during the pandemic despite rising pressure to increase investments and stabilise economic growth.

Fitch expects local governments to adopt varied means to defuse hidden debt, rather than simply increasing the government's direct debt, including promoting LGFV reform and improving their operating profitability, injecting operational assets to augment the LGFVs' cash flow as well as facilitating refinancing and debt extensions through negotiations with financial institutions. The risk that the debt of Chinese LGFVs crystallise into their local governments' debt, often referred to as contagion risk, has dropped in recent years, mainly attributable to China's continuing efforts to separate LGFV debt from that of their governments.

These various policy moves will benefit some core functional LGFVs, but non-core entities will encounter greater challenges in terms of operations and financing, leading to worsening credit profiles and elevating credit risks. Fitch reiterates that the risk of an LGFV default is rising as their systemic importance declines under the central government's risk isolation measures. These are likely to be the lower-tier, or non-provincial, LGFVs, particularly those that mix commercial with policy activities, in less economically developed regions. This excludes the vast majority of Fitch-rated LGFVs, which are connected with high-ranking local governments and undertake key policy roles.

China's New Infrastructure Push Offers LGFVs Opportunities and Challenges

Senior leaders in the Chinese government have spoken about "new infrastructure" as an investment priority since March 2020, to foster innovation and development of emerging industries that will drive the economic recovery following the coronavirus pandemic.

According to the National Development and Reform Commission (NDRC), new infrastructure is categorised into three types:

1. Information-based infrastructure refers mainly to that required by the new generation of information technology, such as 5G telecommunications networks, 'Internet of Things' and industrial networks.

2. Converged infrastructure, which is the application of artificial intelligence (AI) and big data technology to the traditional transportation and energy segments.

3. Innovative infrastructure that supports science and technology research, innovation and production.

In Fitch's view, new infrastructure is characterised by:

1. Lower entry barriers to the private sector. In fact, most tech-related industries are invented, reshaped and upgraded by private entities.

2. Diversified funding sources. State-owned banks and funds, as well as private capital can participate in the form of venture capital and debt investors besides traditional loans. Furthermore, the government can come up with favourable policies for the sector, such as tax refunds or other subsidies.

3. For the two reasons above, new infrastructure investment is not likely to add significantly to the government debt burden or push up fiscal deficits. Instead, Fitch views it as a shift in investment focus, from massive backbone infrastructure to facilitate basic economic development, to upgrading the quality of the infrastructure and setting the stage for a more advanced economy.

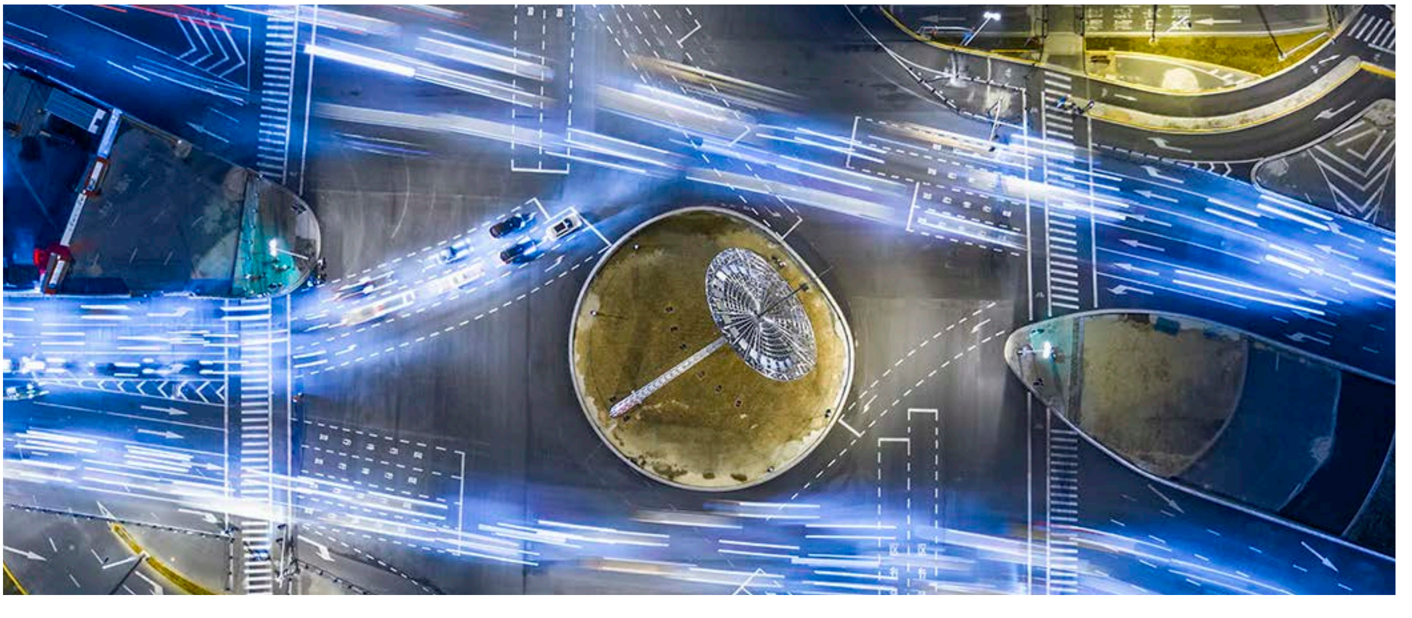
LGFVs' Role in New Infrastructure: According to the NDRC's definition of new infrastructure, the segment covers a wide range of industries that also includes digital transformation, intelligent upgrades of traditional infrastructure as well as infrastructure that supports the research and development of science and technology. Fitch Ratings believes LGFVs will be key players as some of these businesses are related to – or are extensions of – LGFVs' current businesses, and they can contribute by tapping their years of experience in urban construction and operation, as well as their advantages in financing and project implementation.

For information-based infrastructure, LGFVs can contribute by direct investment in relevant sectors and operating investment funds guided by local governments. The LGFVs, as key urban infrastructure construction arms and public-service providers for their respective regions, could promote converged infrastructure by upgrading and transforming traditional infrastructure under their operation and management. In addition, the high-tech zones and industrial parks are established by the LGFVs to support scientific and technology development, and foster strategic and emerging industries that can support innovative infrastructure development.

However, there are also some obstacles for LGFVs in handling new infrastructure projects. These may stem from the differences between new and traditional infrastructure projects, including business models and operating processes, as well as the high-level of technology content in some of the new infrastructure projects.

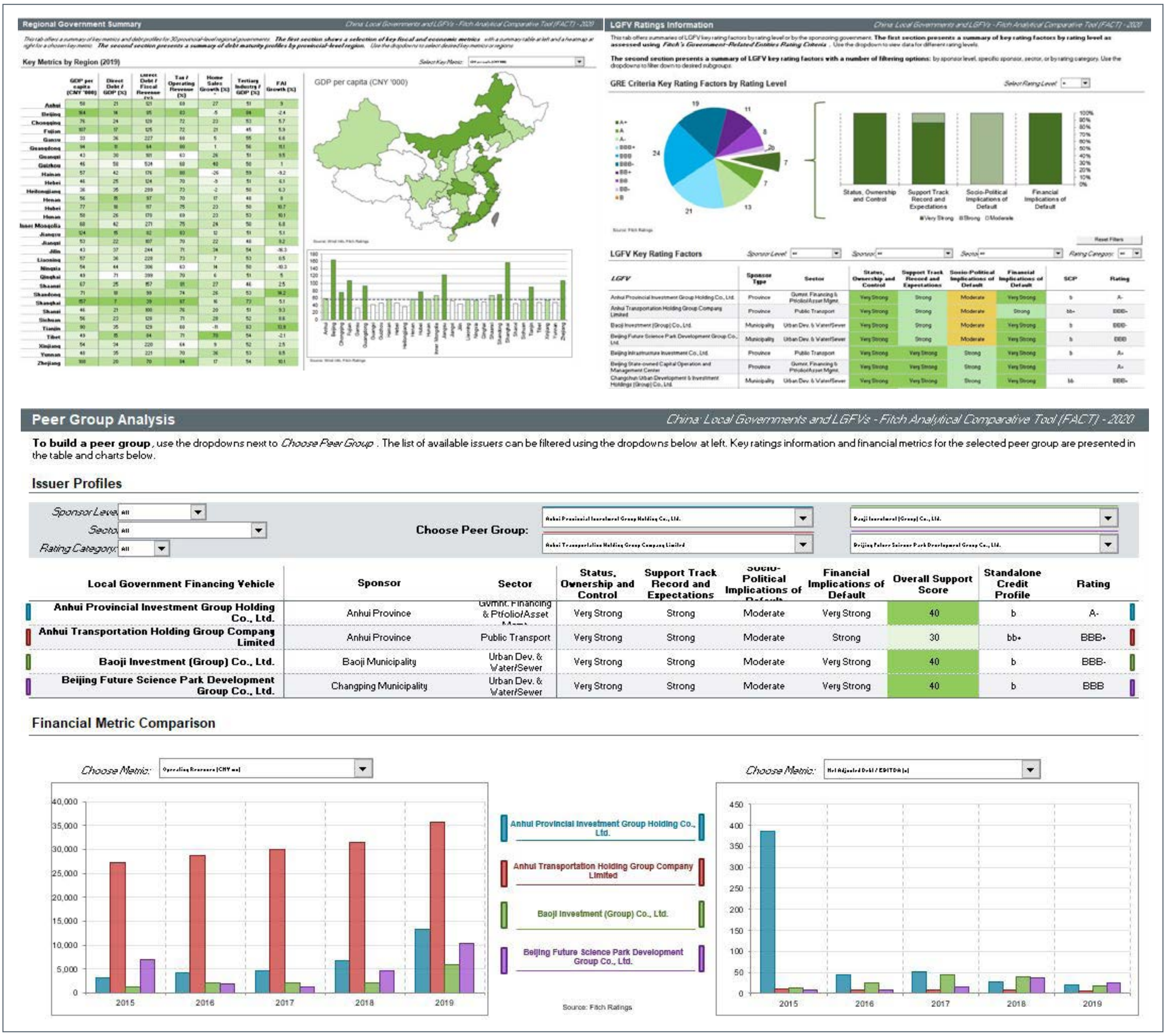
Credit Implications for LGFVs: Fitch expects the LGFVs that are involved in new-infrastructure development to strengthen their functional roles and boost linkages with their respective local governments. These LGFVs are likely to be more integrated into their local regions' overall development and move gradually towards being providers of comprehensive public services, resulting in a greater likelihood of the local governments extending support, if needed.

In contrast, those LGFVs which are not involved in the new infrastructure efforts and were already considered of marginal importance for their governments may see the expectation of support shrink further. This process could strengthen the polarisation of creditworthiness among LGFVs, as Fitch has been reporting in the past few years.

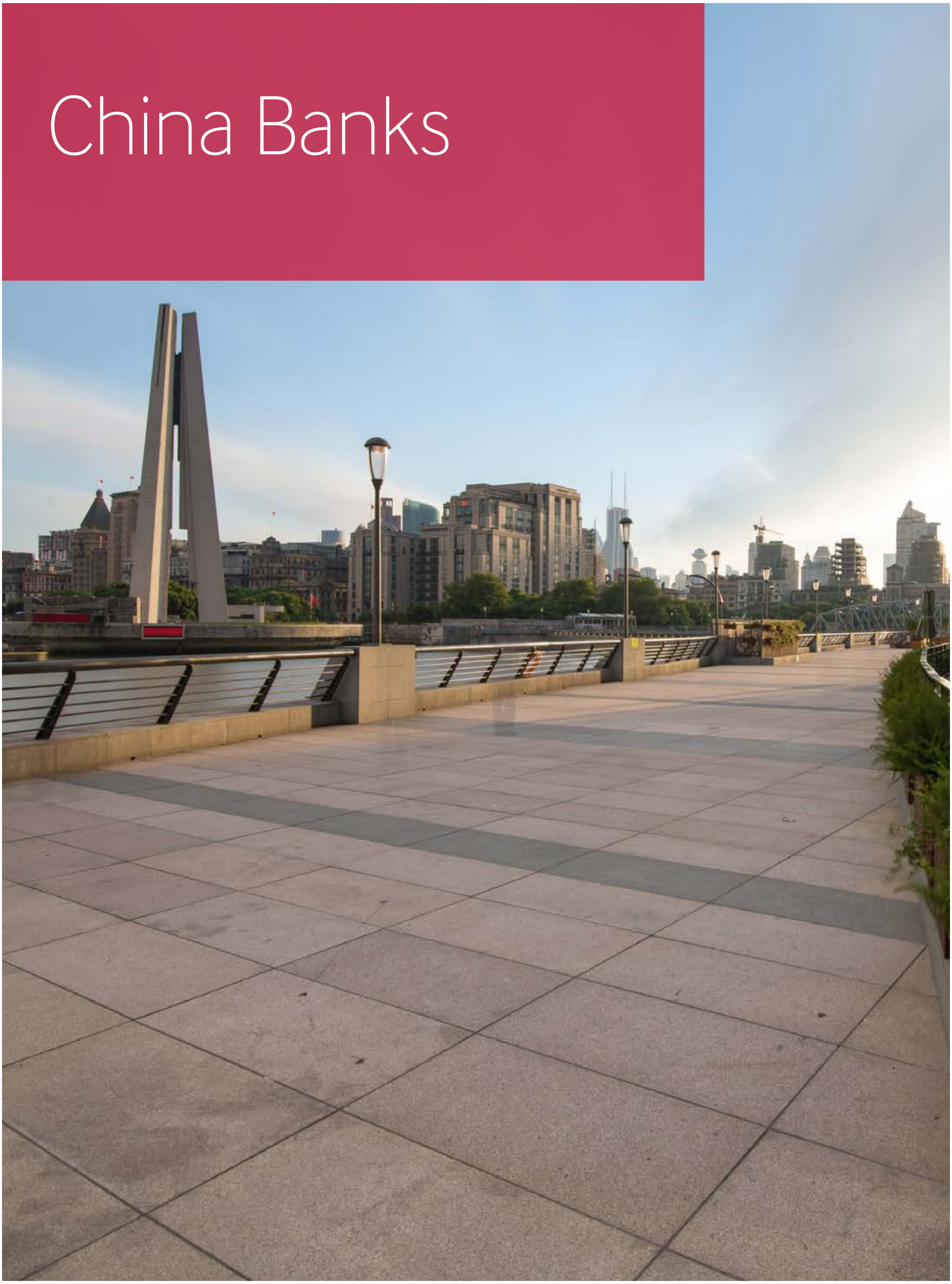


IPF China Fitch Analytical Comparative Tool (FACT):

Fitch launched its first analytical comparative tool for Chinese public sector entities - the [IPF China Fitch Analytical Comparative Tool (FACT)]() in June 2020. The Excel-based tool provides an easy-to-use, interactive platform with clear graphics to provide market participants with a clearer understanding of the credit profiles of Chinese public-sector entities. The tool allows for in-depth comparisons of economic data, financial fundamentals, and key rating drivers of Chinese local and regional government financing vehicles.



China Banks



China Banks

Faster Resolution of Credit Overhang Rests on Improved Credit Efficiency

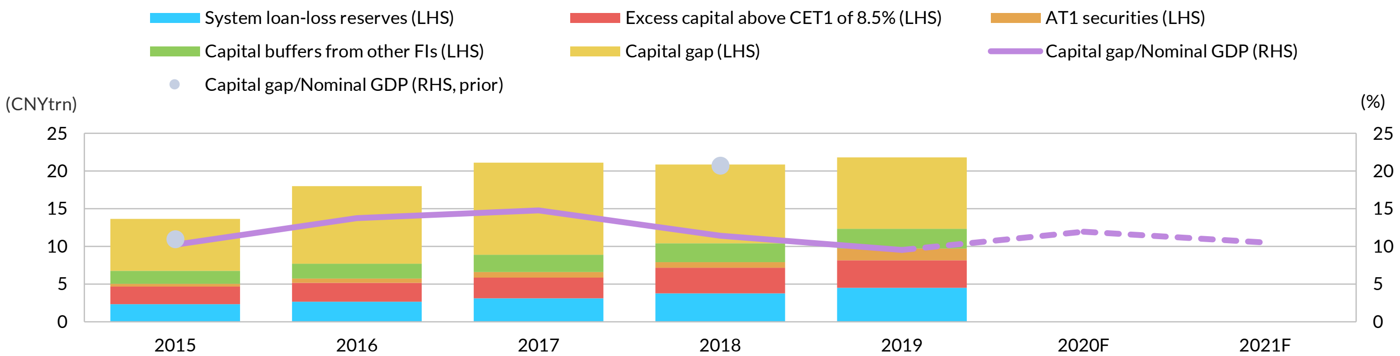
Capital Shortfall Stablising as a Percentage of GDP

Inefficient Credit High, Capital Gap Stable

Fitch Ratings believes China's inefficient credit ratio at end-2019 could be no lower than at end-2015, based on our scenario analysis examining credit efficiency rates. The 'silver lining' is that our analysis suggests the system's potential capital gap[1] is stabilising due to various policy initiatives. Further improvement in credit efficiency trends should reduce this gap over time.

We estimate inefficient credit could have been as high as 15%-22% of total credit at end-2019, implying a system-wide capital gap of CNY9.5 trillion-19.5 trillion or around 10%-20% of GDP, based on this scenario. This does not represent our base case, but it leads us to believe that reported asset-quality metrics understate risks.

Scenario Analysis – Capital Gap



Note: Scenario assumes a 35% impairment rate (70% loss rate) on inefficient credit relating to non-mortgage loans, non-loan credit, and a 15% impairment rate (35% loss rate) on inefficient mortgage loans. For prior estimated capital gap, please refer to Fitch's report in 2016
Source: Fitch Ratings, PBOC and CBIRC

1. Measured by the amount of capital needed to resolve potential inefficient credit (a proxy for the system's potential level of impaired loans, which is higher than official reported levels), in addition to the system's loan-loss reserves, excess capital above CET1 of 8.5%, AT1 securities, and capital buffers from other financial institutions

The range relative to GDP is similar to the gap we outlined at end-2015 (see Appendix), but inefficient credit has risen moderately as credit growth often exceeded nominal GDP growth. Our scenario also assumes a relatively high level of legacy credit is not productive, similar to our previous scenario, as the main purpose is to gauge how the potential capital gap has evolved in recent years.

We had expected the potential capital gap to worsen significantly from end-2015 without an affirmative policy response in reducing 'shadow banking' activities (down 20% by end-2019 from the 2017 peak) and the system maintaining sufficient profitability to accelerate non-performing loan (NPL) resolution.

More additional Tier 1 (AT1) issuance has boosted buffers, while decelerating credit growth and the switch in focus towards retail credit also helped to slow the formation of inefficient credit.

One-off Rise in Leverage for 2020

We estimate China's credit efficiency ratio will fall temporarily to 0.2 in 2020 (2018-2019: 0.5-0.7, 2009-2015: 0.2-0.5) amid a rise in leverage and our forecast of a sharp economic slowdown due to coronavirus (real GDP growth of 1.2%). Credit growth is likely to accelerate in support of borrowers and China's economic recovery, which could increase pressures on profitability and capital.

We estimate China's system leverage, as measured by outstanding Fitch-adjusted total social financing (FATSF[2]) to GDP, to reach around 265% in 2020 from 254% in 2019. However, this is still lower than we had expected to be the case before policy-makers tightened regulation over shadow-banking activities in 2017.

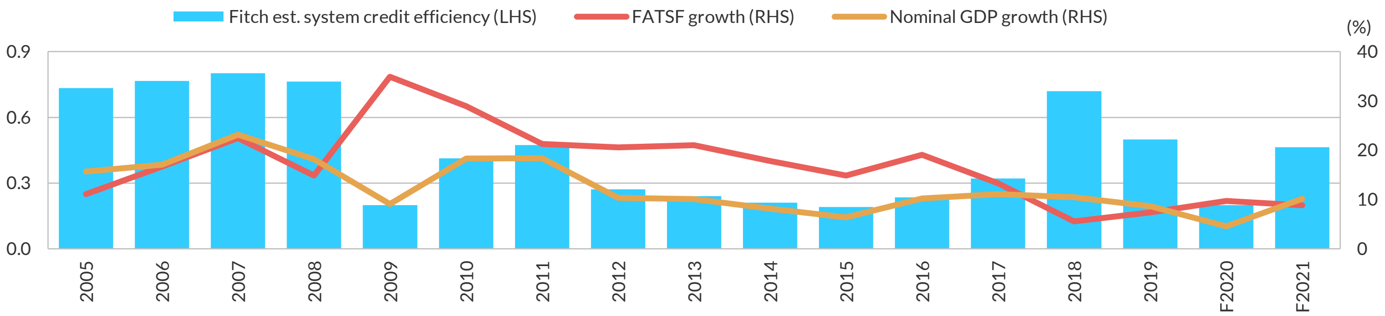
Rating Implications

Our outlook on the domestic banks' Issuer Default Ratings (IDRs) will remain stable in the event of no negative action on China's sovereign rating (A+/Stable), as they are all driven by sovereign support. The scenario in this report which outlines a stabilisation in the potential capital gap, as well as gradual improvements in credit efficiencies, are consistent with Fitch's revision of China's operating environment outlook to stable from negative in 2019. It has also been a factor in the upgrades of some state bank Viability Ratings (VR) in recent years.

However, if policy responses to the pandemic were to lead to any sustained acceleration in system leverage – not our base case – this could be negative for our assessment of China's operating environment (bb+/stable). In turn, this may be negative for banks' VRs. The VRs, currently ranging from the 'b' to 'bb' categories, reflect our view that reported NPLs may not fully capture banks' asset-quality risk (reported NPL and 'special mention' loan ratio at 1.9% and 3.0% at end-1Q20), although this is less of an issue for the large state banks than for mid-sized banks.

Assessing System-Wide Inefficient Credit

Credit Efficiency[a] and Credit Expansion



[a] Fitch's estimated credit efficiency is measured by comparing the incremental credit relative to nominal GDP generated during the year. This ratio hit a record low in 2015, but improved materially during 2018 and 2019, thanks to the regulatory crackdown on shadow- banking activities. During 2005-2008, CNY1.0 of credit contributed just under CNY0.8 of GDP, based on our analysis. We compare this against each unit of credit relative to GDP contribution during 2009-2015 and 2009-2019 to calculate an "inefficient credit rate". The CNY68 trillion rise in GDP from 2009-2019 could imply a CNY88 trillion increase in credit, but instead credit increased by CNY212 trillion. Excluding the increase in local government debt, we estimate 53% of the additional credit during this period, defined as "inefficient credit rate", could be at greater risk of impairment

Source: Fitch Ratings, PBOC, Bank for International Settlements, HKMA, Wind, CEIC, China Trustee Association

2. FATSF includes adjustments to The People's Bank of China's total social financing stock, predominantly excluding equity financing and central and local government liabilities while including foreign banks' offshore claims and claims from non-bank financial institutions

We conducted a similar scenario analysis on credit efficiency rates in 2016 to estimate the volume of potential inefficient credit which could be at higher risk of impairment. This is because China has seen very high rates of credit growth relative to incremental gains in GDP since 2009. The inefficient credit estimates in this report are no less that in our previous report, China: Multi-Year Resolution of Problem Credit, published July 2016, where we estimated the range to be around 15%-21% at end-2015[3] as there is still a large amount of legacy debt and system credit continues to expand faster than nominal GDP. Detailed calculations and assumptions are in the Appendix.

Our updated scenario analysis concludes that system-wide inefficient credit may have been around 15%-22% by end-2019, which implies a capital gap equivalent to 10%-20% of GDP at end-2019 compared with around 10%-19% at end-2015. We had expected the potential gap to worsen significantly to around 21%-33% of GDP by end-2018 without improvements to credit efficiency and risk-reduction initiatives at the banks as well as increased buffers over the past few years. Our figure also assumed no improvement in internal or external capital raising prospects, in contrast to policymakers' recent actions.

Capital Gap Stabilising

Our capital gap analysis assumes the system's loan-loss reserves (LLR), excess capital defined as common equity Tier 1 (CET1) CAR above 8.5%, and outstanding AT1 securities are available to absorb losses (although the latter's loss-absorbing nature is untested and sovereign support could become a factor under stress), in addition to estimated buffers for other financial institutions (around CNY2.6 trillion at end-2019 and CNY1.7 trillion at end-2015).

In reality, the authorities may waive minimum bank capital requirements temporarily under an extreme stress scenario, as observed in some jurisdictions amid the coronavirus pandemic this year, so the actual capital required could be significantly less. We use 8.5% CET1 as a cut-off point, which is the minimum requirement for domestic systemically important banks – in order to be conservative.

It is difficult to pinpoint what hypothetical assumptions would be most appropriate for China, due to data limitations and lack of a full credit cycle in the country. Our assumptions used in this analysis draw on historical experience in other markets where we had observed asset-quality stress, but we acknowledge that China, being a domestically funded banking system, may experience different credit paths under stress.

In addition, the mix of credit in China has shifted since 2017, and some credit which is not accretive to GDP may not face a materially higher risk of impairment (eg leveraged investments). Efforts to address moral hazard and implicit guarantees, for example through segregation of banks' wealth management product (WMP) businesses into separate entities and reduction in cross-holding of interbank WMPs, also have the potential to reduce system contagion and reduce overall impairment and loss rates. These are not explicitly captured in our scenario analysis, as we lack more granular data points to support a change in assumptions – as opposed to those used for mortgages.

Our potential capital gap analysis is highly sensitive to assumptions around the impairment rate and loss rate around what we consider as inefficient credit. For example, every 5pp change in the impairment-rate assumption in our scenario analysis can have an impact on our capital gap scenario analysis by up to 3pp-4pp of GDP, while every 5pp change in the loss-rate assumption can have a 1pp-2pp impact of GDP.

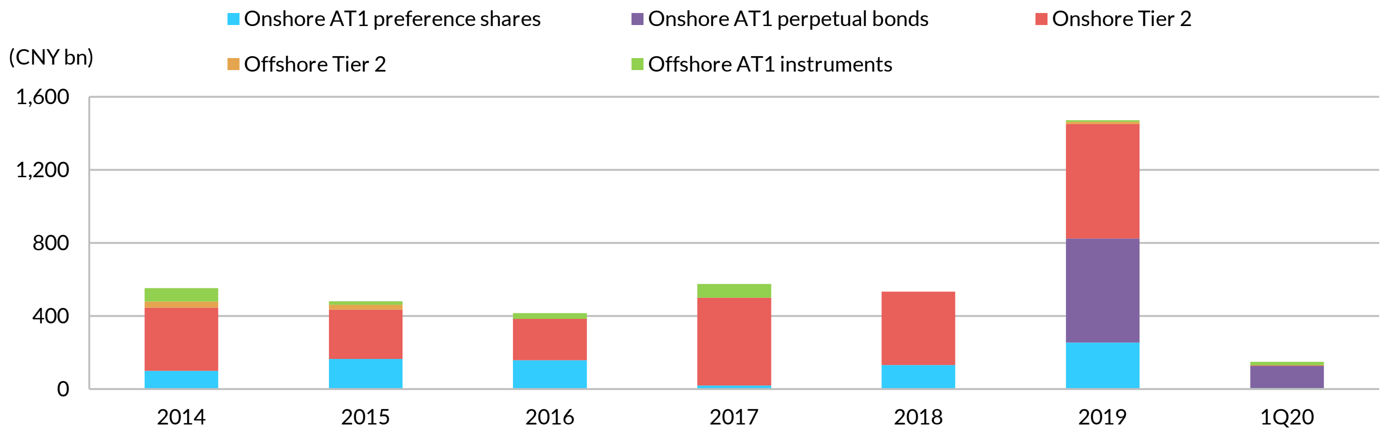
That said, the main purpose of this scenario analysis is to gauge how the potential capital gap may have evolved in recent years. The credit evolution suggests the potential capital gap is stabilising despite our assumptions for high impairment and loss rates.

This is important as it underpins our view that credit risks are not worsening among our rated bank portfolio in China. Sustained risk-reduction, especially in shadow-banking activities and reduction to exposure in over-leveraged sectors, should lead to lower expectations around impairment and loss rates over time.

3. Figures differ slightly due to the restatement of historical data and fine-tuning of our assumptions to factor in different impairment and loss rates for mortgage loans.

Our scenario analysis also points to the capital gap varying notably among banks. Many smaller or unrated banks have not published financial statements, but we believe them to have higher inefficient credit ratios and proportionately larger capital gaps relative to the large state banks. This appears to have been the case in failures we have observed in recent years. Smaller banks also have weaker access to funding from capital markets.

China Banks Capital Instruments Issuance



Source: Fitch Ratings, Wind

Improvements Set Back by Pandemic

We believe the credit efficiency ratio may fall temporarily to around 0.2 in 2020 due to significantly weaker GDP growth caused by the coronavirus pandemic. This represents a temporary set-back against the improvement in 2018-2019, where the ratio improved to 0.5-0.7, because tighter regulations kicked in during 2017. Many banks have also been starved of capital, given margin pressures to lower borrowing costs to support the economy and increased provisioning to keep pace with more stringent NPL recognition.

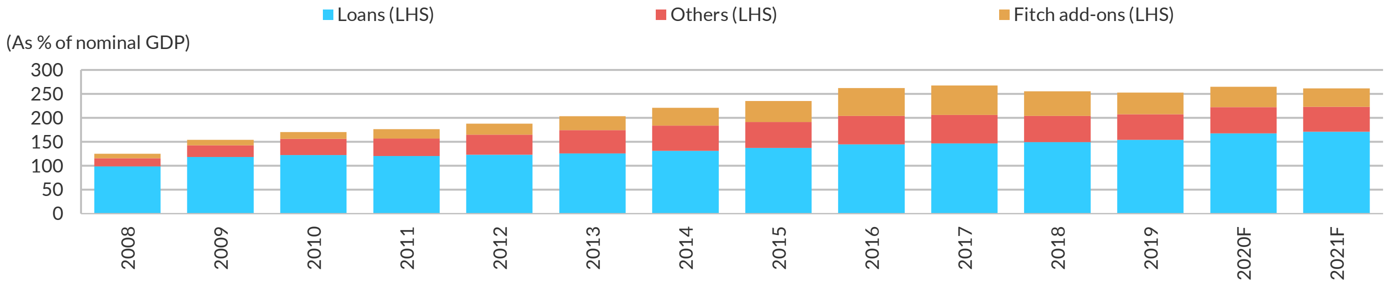
China's policy response to the coronavirus outbreak has adopted a different approach than during prior stimulus periods, with fiscal policy playing a much larger role than large-scale credit lent by banks. Fitch believes the authorities have demonstrated a greater willingness to use explicit sovereign resources, and to tolerate rising government leverage ratios.

That said, the authorities have still indicated faster monetary and credit growth, although we expect a mild acceleration in loan growth of only around 14% in 2020 (2019: 12%). We believe bank capital could constrain more aggressive credit acceleration even though policymakers are exploring ways to increase the system's access to capital sources. Regardless, we estimate FATSF to hit 265% by year-end but to stabilise in 2021, based on our expectation that GDP growth will slow markedly this year but recover in 2021.

There is no explicit GDP target set for 2020, which is a first for China. This may suggest less emphasis on GDP growth, which reduces the pressure for an excessive increase in leverage as seen in previous stimulus periods. The credit growth in the past few years has been focused more on household credit (both residential mortgages and unsecured consumer lending), as there was less lending to over-capacity sectors and over-leveraged SOEs. Greater emphasis over the quality and stability of bank earnings – as supposed to the level of reported profitability – should also enable more sustainable growth for the sector.

In addition, the level of non-bank credit within the system has also moderated since 2017, which helped to improve system transparency, thanks to the regulatory crackdown on shadow banking. We expect this trend will broadly continue despite the coronavirus-related stimulus. A rebound of credit efficiency and stabilising of system leverage under an economic recovery in 2021 should be helpful in reducing system-wide inefficient credit and ultimately narrowing the capital gap.

GDP and Credit Expansion



Note: Others refers to non-bank TSF, including entrusted loans, trust loans, undiscounted acceptances and etc.
Source: Fitch Ratings, PBO, Bank for International Settlements, HKMA, Wind, CEIC, China Trustee Association

Resolving Inefficient Credit

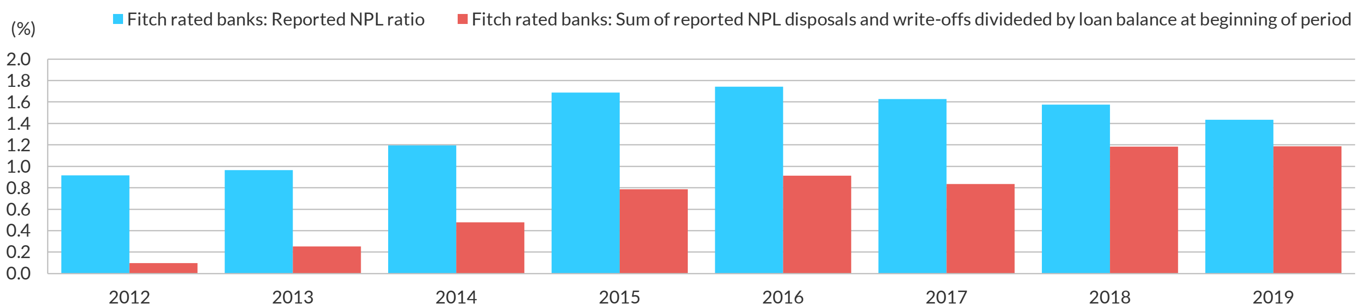
More productive credit that is accretive to GDP and less speculative in nature will reduce inefficient credit rates. Higher frequency and volume of NPL disposals/write-offs while maintaining bank profitability will help resolve inefficient credit. That said, resolving inefficient credit remains a multi-year task.

The sector has experienced an acceleration of bad debt write-offs and/or disposals in the past several years, supported by the banks maintaining core profitability. Fitch-rated Chinese commercial banks wrote off and/or disposed of at least CNY2.5 trillion worth of bad loans during 2017-2019, or around 0.8%-1.2% of loans on an annual basis over the same period. This is aligned with regulatory directives since 2017 to tighten asset-impairment recognition and rectify financial disorder by promptly recognising and resolving bad debt.

Banks have also made a greater effort to clean up and reduce risks on their balance sheets, especially exposure to overcapacity sectors. More disclosure around bank impairment and NPL recovery rates could lead us to reassess our assumptions in the future, while the raising of bank capital levels to increase loss-absorption buffers would also affect our capital gap estimates.

The combination of trade disputes and the pandemic this year has added to economic challenges, resulting in near-term pressures over bank profitability (Government Directives Pressure Profit Outlook for China Banks, published June 2020). Current banking trends are still supportive of a stabilisation in China's debt problem, which rests on the presumption that regulatory commitment and tightening over financial sector reform and system leverage will continue.

Resolution of NPLs



Source: Fitch Ratings, PBOC, Banks' annual reports

Scenario Assumptions

Key assumptions:

1. Inefficient credit rate of around 53%, based on post-2008 data
2. Impairment rates based on two variations:
   - Scenario 1: 35% impairment rate on inefficient credit relating to non-mortgage loans, non-loan credit, and a 15% impairment rate on inefficient mortgage loans
   - Scenario 2: 50% impairment rate on inefficient credit relating to non-mortgage loans, non-loan credit, and a 30% impairment rate on inefficient mortgage loans
3. Loss rates of 35%-70% on impaired credit (35% for impaired mortgages and 70% for other exposures).
4. We assume no losses on local government (LG) liabilities, instead viewing them as an obligation of the sovereign.

Fitch believes a "bottom-up" analysis is no more effective in estimating the size of inefficient credit in China than a "top-down" approach, given under-reporting and data limitations around off-balance sheet credit.

However, we have assumed different impairment and loss rates for mortgages in this scenario analysis, to reflect the shift in loan mix over the past four years. This, together with restatement in historical figures, results in the end-2015 findings being slightly different from our prior report published in 2016 (China: Multi-Year Resolution of Problem Credit).

Summary of Calculations, Assumptions and Outcomes

	End-2015	End-2019
Incremental gain in GDP from CNY1 unit of credit (2005-2008) (%) (A)	77.1	77.1
Incremental gain in GDP from CNY1 unit of credit (2009 to reference year) (%)	27.6	31.7
Additional GDP (2009 to reference year) (CNY trillion) (B)	36.0	67.8
FATSF at end-2008 (CNY trillion)	39.5	39.5
FATSF (CNY trillion)	164.5	251.6
Increase in FATSF (CNY trillion) (C)	125.0	212.1
Additional LG debt (2009 to reference year) (CNY trillion) (D)	17.8	24.3
Additional FATSF (less additional LG liabilities) (CNY trillion) (E)	107.3	187.8
Potential inefficient credit (2009 to reference year) (CNY trillion) (F = C – (B/A))	60.6	99.8
Potential inefficient credit (%) (G = F/E)	56.5	53.2
Blended credit impairment rates[b] (%) (H) Non-mortgage loans, non-loan credit Mortgage loans	 35/50 15/30	 35/50 15/30
Blended loss rate[c] (%) (I) Non-mortgage loans, non-loan credit Mortgage loans	70 35	70 35
Fitch-estimated nominal GDP (CNY trillion)	67.7	99.5
Loss-absorption buffer (CET1 >8.5%, loan-loss reserves, AT1) d (CNY trillion) (J)	6.7	12.3
Estimated loss (CNY trillion) (K = E x G x H x I)	13.6-19.7	21.8-31.8
Estimated capital gap (CNY trillion) (K – J)	6.9-13.0	9.5-19.5
Estimated capital gap/Nominal GDP	10%-19%	10%-20%
Foreign-exchange rate: USD/CNY = 6.99 (end-2019)		

Notes:
a: Inefficient credit is calculated by comparing the productivity rate of one unit of FATSF in terms of GDP contribution between 2005-2008 against 2009-2015 and 2009-2019
b: Impairment rates are Fitch assumptions, based on historical experience of asset-quality stress in China and other countries
c: Loss rate is a Fitch assumption, based on trends in recovery rates disclosed by Fitch-rated banks. We assume lower impairment and loss rates for mortgage loans in China because loan-to-value ratios are generally low, at 40%-60%
d: Banks' loan-loss reserves, surplus CET 1 above 8.5%, outstanding AT1 securities plus estimated buffers for other financial institutions
Source: Fitch Ratings, People's Bank of China, China Banking and Insurance Regulatory Commission

China Securities Companies

China Securities Companies

Operating Environment and High Risk Appetite Weigh on Standalone Credit Profiles

Capital Market Developing

Fitch Ratings views China's capital market as less developed relative to other large economies. China's heavy reliance on indirect finance, evolving regulatory and legal framework, and visible interventions from government, underscore the capital market's weakness in terms of depth and breadth.

Fitch expects the Chinese government to continue capital-market reform aimed at liberalising the capital-markets, achieving greater financial stability, and attracting inbound foreign capital.

High Risk Appetite

Risk appetite and the still-developing market weighs on Chinese issuers' credit profiles. In particular, securities firms' exposure to proprietary trading and involvement in 'shadow-financing' activities – partly encouraged by brokerage commission fee pressures – reflect their appetite for risk in an evolving market.

However, relatively low leverage – sector assets/equity (net of cash held on behalf of clients) ranged between 2.7x-3.1x during 2016-1H20 – partly mitigates the risk of potentially large asset impairments.

Business Models Diverging

We expect competition and regulation to continue to encourage greater differentiation in business models as securities companies vie for opportunities outside the conventional brokerage business. The market has become increasingly consolidated, with the 10 largest securities companies' share of industry profit at about 55% in 2019 compared with sub-50% in 2016.

Profitability Potentially Volatile

Leading Chinese securities companies have stronger profitability relative to regional peers, a reflection of their higher business risks. Profitability is increasingly sensitive to market volatility, with the two main sources of revenue – proprietary trading and brokerage (particularly retail) – subject to market confidence.

Confidence-Sensitive Funding Profiles

Chinese securities companies are exposed to greater credit market volatility due to reliance on wholesale funding. In addition, the reliance on short-term funding increases the sensitivity of funding profiles during any significant deterioration in market liquidity.

Support-Driven IDRs

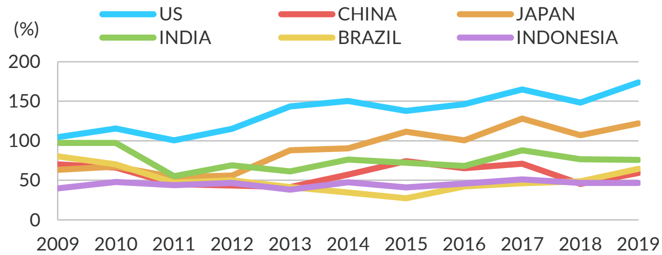
Fitch's published Issuer Default Ratings (IDRs) for Chinese securities firms reflect government support, given the shareholding structures with the ultimate controlling shareholder being the Chinese sovereign. This reflects an assessment of their strategic role in policy development, and high reputational risk to the government in the case of default.

Reform Strengthening Capital Market Development

The extent of relative market underdevelopment is highlighted when measured in terms of domestic market capitalisation/GDP, with the country's high economic growth being driven mainly by a reliance on indirect borrowing, i.e. bank and shadow-bank lending. This has led to a financial system where overall leverage is high and transparency is opaque. Reforms have been aimed at a more comprehensive capital-market framework to encourage fund-raising directly from the capital markets and to strengthen foreign investor confidence, as the authorities look to contain the associated risks stemming from high systemic leverage.

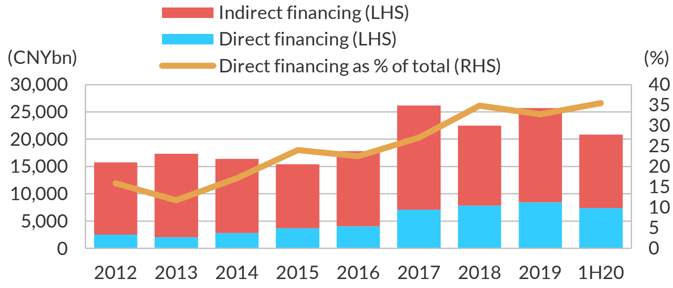
The Chinese regulators have introduced a series of measures (see Appendix) to improve transparency and institute a more comprehensive legal framework that promotes market-based principles. These initiatives, if implemented well, will help deepen capital-market reform for sustained growth.

China's Capital Market Development still Lags behind Developed Economies
Domestic Market Capitalisation/GDP



Source: Fitch Ratings, Fitch Solutions, The World Bank, World Federation of Exchanges

Growing Share of Direct Financing amid China's Financial Deepening

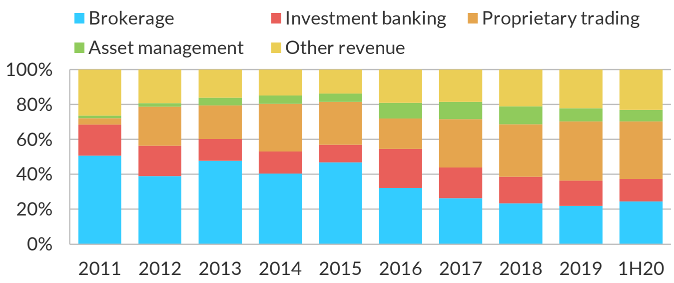


Note: Direct financing and indirect financing are based on flow numbers
Source: Fitch Ratings, Fitch Solutions, PBOC

Business Model Evolution and Consolidation

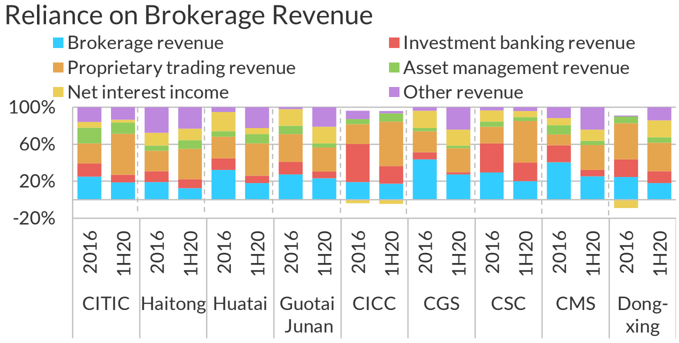
Similar to the global brokerage industry, the Chinese sector has undergone significant changes due to wider use of electronic trading, putting brokerage fee income under pressure with the introduction of close-to-zero-commission trading. In order to make up for the lost brokerage fee income, leading securities firms in China have diversified their activities with higher revenue contributions from investment banking, proprietary trading, and asset-management operations.

Chinese Securities Sector Transitioning from Brokerage-Centric to More Diversified Business Model



Note: Interest income is included under 'Other Revenue'
Source: Fitch Ratings, Fitch Solutions, Securities Association of China

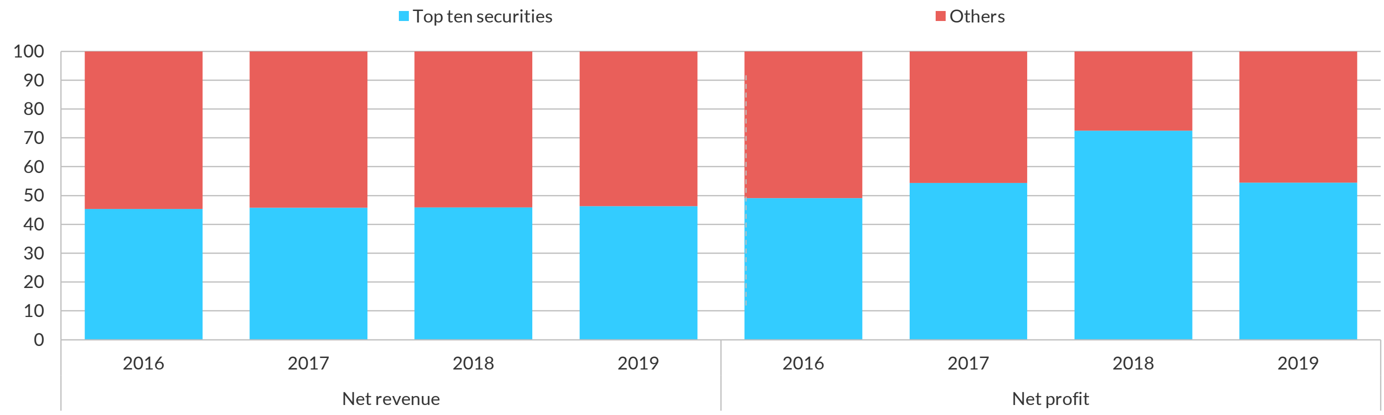
Chinese Securities Firms Have Gradually Lowered Their Reliance on Brokerage Revenue



Source: Fitch Ratings, Fitch Solutions, Company

Business model evolution has also put the leading securities firms in a better position to compete, in light of their product-innovation capabilities and advantages from economies of scale. Industry consolidation has been visible through the leading firms' growing importance, with the top 10 companies taking up more than half of the industry profit – supporting the overall resilience of the larger players. Franchise differentiation is increasingly evident in times of stress, when the top-10 firms accounted for over 70% of industry profit in 2018.

Competition has Made Franchise Differentiation Even More Evident



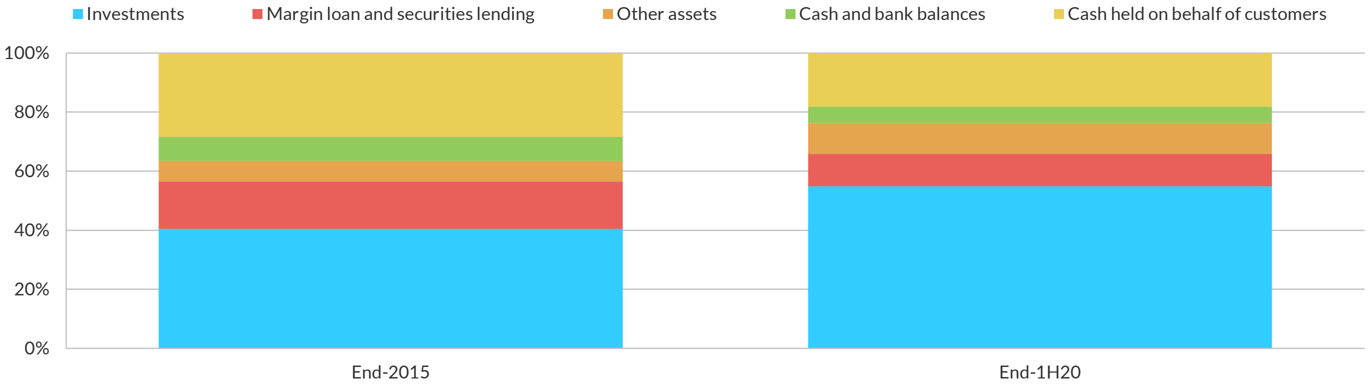
Source: Fitch Ratings, Fitch Solutions, Wind

Lower Leverage Partially Mitigates Higher Business Risks

Transitioning into a more diversified business model has also brought associated business risks. Fitch sees greater appetite for risk-taking, particularly market risk arising from their proprietary trading activities, with their investment portfolios now accounting for over half of the asset size and proprietary trading now the largest revenue driver (33% of sector revenues at 1H20).

Rising asset-quality pressure in the shadow-financing system also has the potential to expose securities firms to greater contingent liability, as they may still be held accountable should their non-standard asset-management products – which are used to conduct irregular financing activities – default in light of an untested legal framework, even when they are not legally obliged to compensate for investor losses. Fitch calculates that the total size of the asset-management business (regular asset-management activities and irregular shadow-financing activities) by our selected securities firms amounts to about 6x their total equity base.

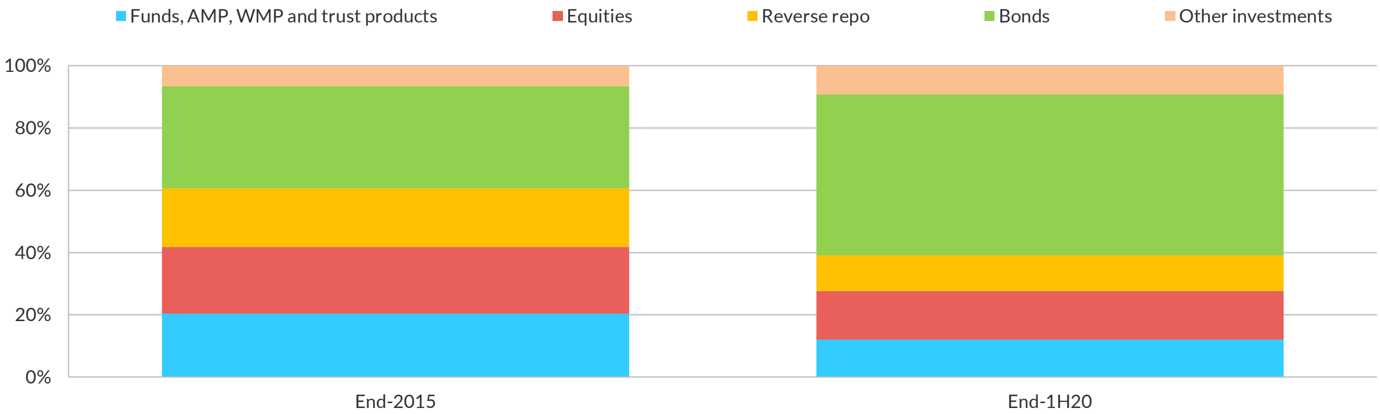
Chinese Securities Firms Have Increased Investment Exposure for Higher Profit as Brokerage Commission Drops
Asset Breakdown for Fitch Selected Universe



Source: Fitch Ratings, Fitch Solutions, Company Financials

In order to assess the sensitivity to market-valuation risk, we have conducted a scenario analysis to evaluate the impact of changes to asset prices arising from the investment portfolio amid capital market volatility, and the associated impact on the regulatory capital leverage ratio (defined as core net capital/total on- and off-balance-sheet assets) for our selected universe on an aggregate basis.

Investment Breakdown for Fitch Selected Universe



Source: Fitch Ratings, Fitch Solutions, Company Financials

We categorised the investment portfolio into two, based on the risk nature of the assets, and applied different haircuts to assess the potential capital impact. Our analysis suggests the selected securities companies would face around CNY466 billion in asset impairments on an aggregate basis under the extreme scenario with a 40% fair-value decline in the riskier type of assets – funds, asset-management products (AMP), wealth-management products (WMP), trust products, derivatives and equity investments which either provide limited transparency or are subject to higher valuation risks – and 10% fair-value decline for the remaining investment assets which typically see lower volatility

Sensitivity Test for Capital Impact

Capital leverage ratio (%)		**Decline in fair values for risker-type of investment assets (%)**				
		10.0	17.5	25.0	32.5	40.0
Decline in fair values for other investments	2.0	17.6	15.6	13.5	11.4	9.1
	4.0	16.3	14.3	12.2	9.9	7.5
	6.0	15.0	**12.9**	**10.7**	**8.4**	6.0
	8.0	13.7	11.5	9.2	6.8	4.3
	10.0	12.3	10.1	7.7	5.2	2.6

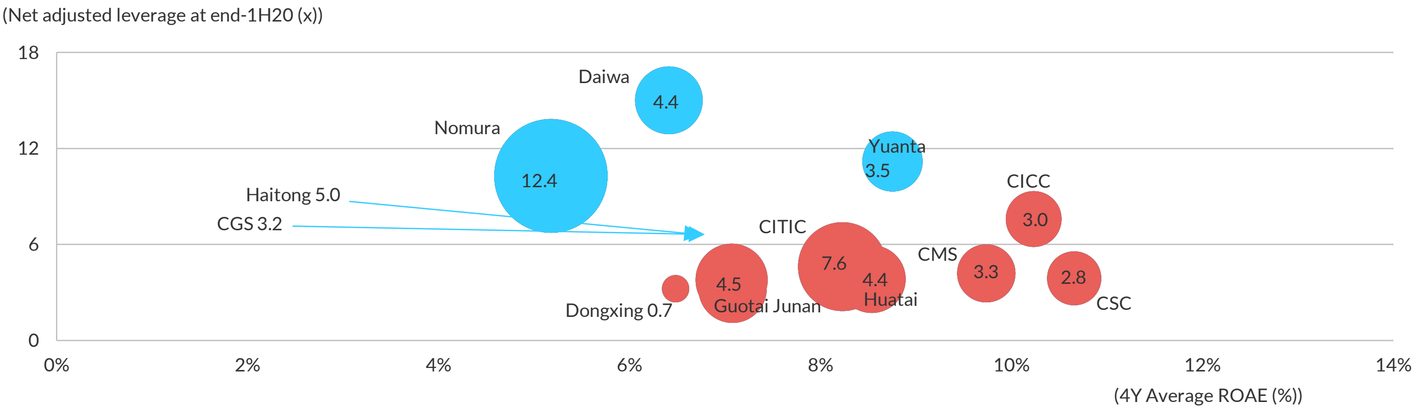
Source: Fitch Ratings, Fitch Solutions

Our analysis shows that our selected securities firms, on an aggregated basis, could face a capital shortfall under the most extreme scenario, but are able to maintain their capital leverage ratio at above the regulatory requirement of 8% (equivalent to about 12.5x asset-to-equity leverage) in most cases – given the relatively low leverage across the group. Despite their low leverage, we assess their capitalisation and leverage score[1] at the sub-investment-grade level, taking into consideration the sensitivity to capital-market volatility and the assessment of the wider operating environment in China.

Low-Cost Structure Supports Profitability

Chinese securities firms generally enjoyed higher profitability among the largest securities firms in Asia-Pacific (measured by return over average equity). This is attributed to Chinese securities firms' larger trading gains and brokerage commissions, as well as their more efficient cost structures. However, as a result, earnings are sensitive to market movements and confidence-linked brokerage activity. We believe the leading firms will still be able to sustain their relative earnings strength in the next few years, with the help of further franchise differentiation and rising market demand.

Chinese Securities with Generally Lower Leverage but Higher Average ROAE



Bubble sizes denote net revenue of 1H20 (annualized) in USDbn
Yuanta is considered on a consolidated Financial Holding basis. For Nomura and Daiwa, financials are as of end-Mar 2020 (the latest available)
Source: Fitch Ratings, Fitch Solutions, Company Financials

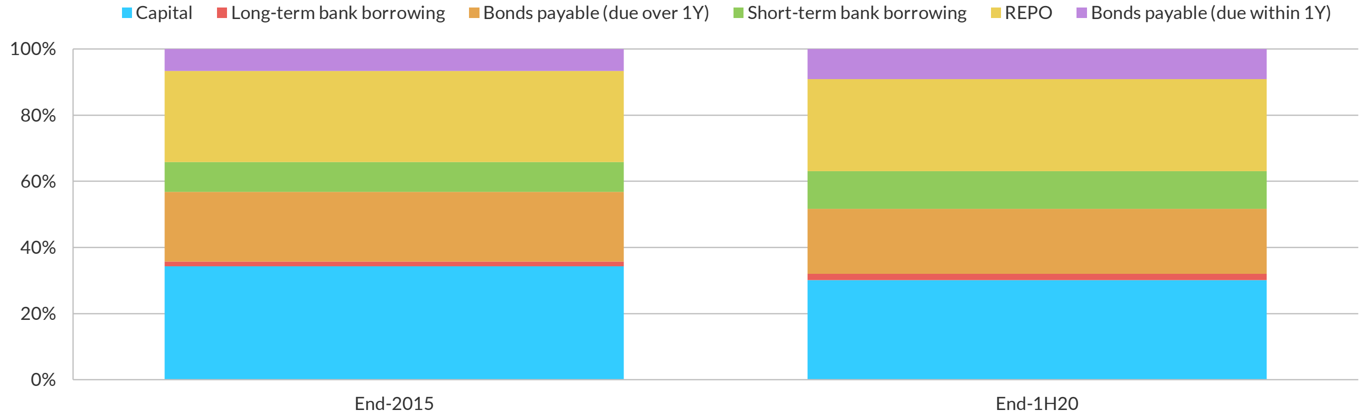
1 Fitch uses net adjustable leverage, measured by Tangiable Asset - Reverse Repo - SEC. Borrowed/ Tangiable Equity, to assess the capitalization and leverage score for high balance sheet-usage securities firms

Short-Term Wholesale Funding Reliance Grows

The Chinese securities firms have diversified their funding profiles over the past few years with the issuance of overseas bonds and hybrid securities, and capital raising exercises, as they expand their business portfolios. This is likely to be a positive development in the long run, allowing them to optimise their funding profiles, but reliance on wholesale funding does lead to elevated refinancing risks. Short-term funding grew to 48% of total funding in 1H20 from 41% in 2015.

With that said, and even with their size of financial investments appearing to be sufficient to cover their short-term funding, the transparency and credit quality of their investment assets as well as the liquidity and volatility of the capital market could undermine issuer liquidity as they address short-term debt repayment needs.

Funding Mix for Fitch Selected Universe



Source: Fitch Ratings, Fitch Solutions, Company Financials

Credit Profiles Underpinned by Support

The Chinese securities firms under our rated universe are all support-driven. We consider them strategic subsidiaries of their shareholders, reflecting important roles for their shareholders, their shareholders' large ownership, and substantial reputational damage to their shareholders upon defaults.

Government support has only been factored in for the large securities firms where the ultimate controlling shareholder is the central government. We do not believe any Chinese securities firms would receive support from the authorities based on systemic importance, in light of the size and level of interconnectedness with other parts of the financial system. Furthermore, in most cases we would not factor in extraordinary support for mid- to-small-sized firms and a small number of large securities firms owned either by local governments or private companies.

We typically apply wider notching for the securities firms from their anchor ratings, as opposed to other state-owned enterprises in sectors that are essential to the functioning of the nation, considering the level of importance to the Chinese government.

Chinese securities firms' standalone credit profiles are typically assessed to be below the 'bbb' range, reflecting a weaker operating environment and their higher risk appetite – larger exposure to investments with high market risk and volatility, and underdeveloped risk-management frameworks. Hence their IDRs are mostly support-driven, given our "Higher of" rating approach.

Government Intervention Drives ESG Risks

ESG factors that are most likely to drive risk considerations across the sector relate to governance and potential intervention risk by the authorities. In particular, when the equity markets have undergone material corrections in the recent past, the authorities have used the securities firms to buy up stocks as a means of stemming the market correction.

Fitch-Selected Universe Includes Leading Chinese Securities Firms Under our Coverage:

CITIC Securities Co., Ltd. (CITIC)

Haitong Securities Co., Ltd. (Haitong)

Huatai Securities Co., Ltd. (Huatai)

Guotai Junan Securities Co., Ltd. (Guotai Junan)

China International Capital Corporation Limited. (CICC, BBB+/ Stable)

China Galaxy Securities Co., Ltd. (CGS)

CSC Financial Co., Ltd. (CSC, BBB+/ Stable)

China Merchant Securities Co., Ltd. (CMS)

Dongxing Securities Co., Ltd. (Dongxing, BBB+/ Stable)

Appendix: Regulatory Development Since 2015

Timeline	Details of the announced measures
Jul 15	CSRC banned share sales by controlling shareholders and investors with more than a 5% stakeholding for six months.
Jan 16	Shanghai Stock Exchange, Shenzhen Stock Exchange and the China Financial Futures Exchange jointly introduced a circuit-breaker system on 1 January 2016, where a 5% movement would trigger a 15-minute trading halt and a 7% movement would lead to a trading halt for the remaining day. CSRC decided to suspend market circuit breakers after just four trading days as the mechanism created unexpected liquidity problems and increased market volatility.
Sep 17	SSE and CSDC released a consultation paper on stock-pledged repos, as high levels of stock-pledged loans posed risks to equity markets. The new stock-pledged repo measures officially took effect in March 2018, stipulating that the overall pledged shares of a single stock shall not exceed 50% of its total outstanding shares, and a securities firm or an asset-management product shall not accept collateral shares exceeding 30% or 15%, respectively, of its total outstanding shares.
Apr 18	Chinese regulators released rules to regulate the nation's asset-management sector – positve for the asset-management market development in improving overall financial system transparency and helping to contain riskier types of leverage, particularly associated with shadow banking.
Oct 18	CSRC released regulatory measures on CDR and GDR listed on SSE and LSE, respectively, to facilitate Shanghai-London Stock Connect.
Nov 18	CSRC released guidance on stock trading suspension and resumption to establish key working principles, shorten the trading suspension period, and enhance the disclosure requirements. CSRC strengthened its supervision of share trading suspension and resumption, and addressed a long-standing concern that investors can be stranded for months when selling their positions.
Jan 19	CSRC released guidance on STAR Market and related registration-based system.
Aug 19	CSRC released guidance related to STAR Market listed companies' material asset restructuring.
Dec 19	CSRC released revision of the Securities Law, which has added a new chapter for investor protection, laying out the compensation mechanism and civil suit procedures for investor losses and strengthened responsibilities for financial intermediaries.
Mar 20	The revision of the Securities Law began to take into effect.
Jul 20	PBOC announced the grace period for Asset Management New Rules will be extended to end-2021 from end-2020.

Source: Fitch Ratings, PBOC, CSRC, Shanghai Stock Exchange, Shenzhen Stock Exchange, and the China Financial Futures Exchange

Key Financial Metrics of 10 Largest Chinese Securities Companies (in Revenue Terms)

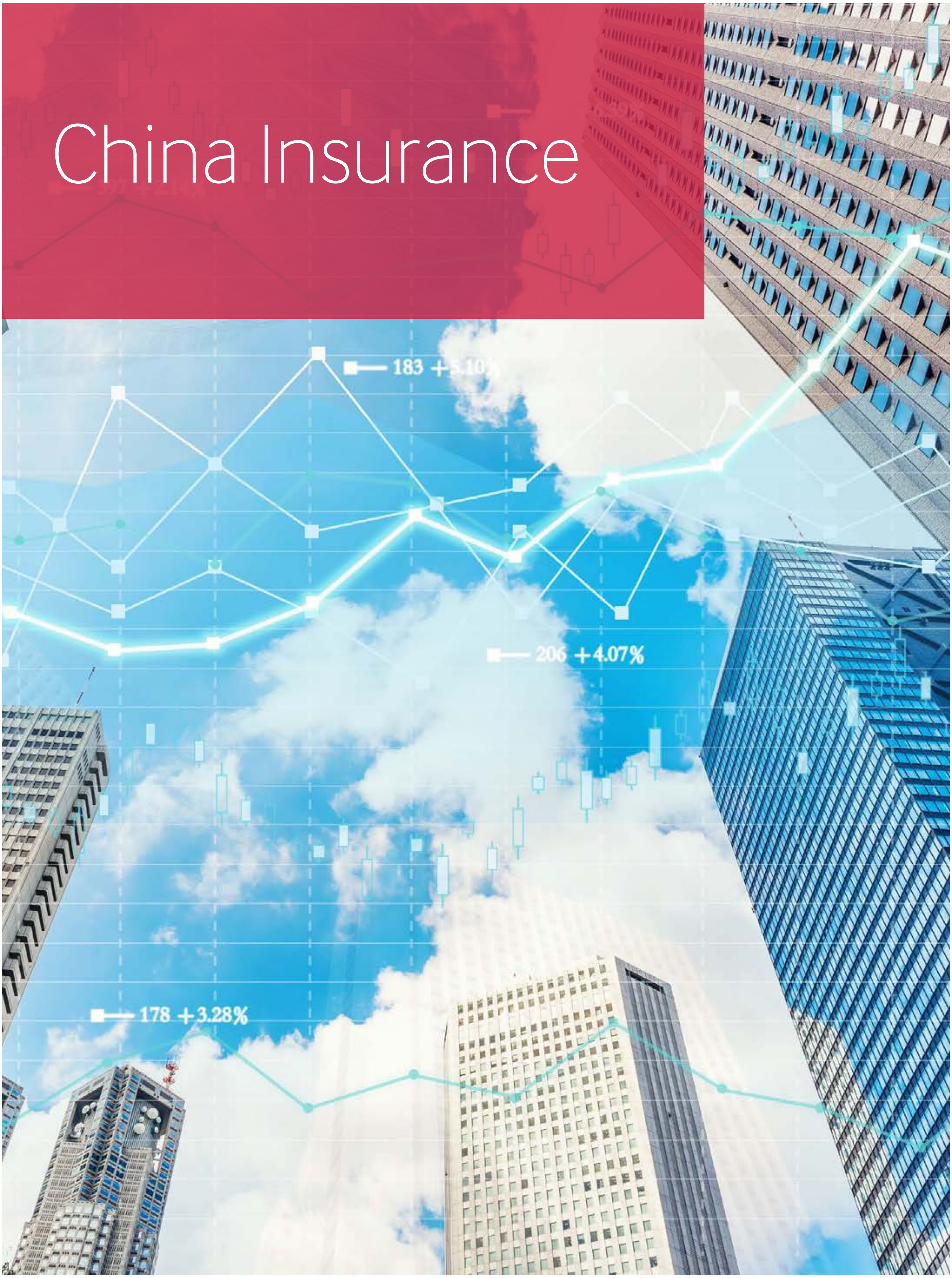
	CITIC		Haitong		Guotai Junan		Huatai		Guangfa	
IDR/ Outlook	N.A.		N.A.		N.A.		N.A.		N.A.	
	2019	1H20	2019	1H20	2019	1H20	2019	1H20	2019	1H20
Total assets (USDm)	113,313.6	137,949.2	91,139.8	96,425.8	80,050.7	88,145.6	80,460.9	84,062.8	56,446.4	59,655.9
Total assets (CNYm)	791,722.4	975,039.0	636,793.6	681,547.2	559,314.3	623,022.2	562,180.6	594,164.2	394,391.1	421,654.2
Total equity (CNYm)	165,449.8	179,999.2	141,118.7	146,229.8	146,093.8	141,307.5	125,654.7	128,293.3	94,136.6	96,858.5
Net income (CNYm)	12,648.4	9,220.3	10,540.7	5,901.5	9,051.4	5,732.3	9,057.2	6,443.2	8,110.3	6,118.9
ROAA (%)	1.8	2.1	1.7	1.8	1.8	1.9	1.9	2.2	2.1	3.0
ROAE (%)	7.8	10.7	7.8	8.2	6.5	8.0	7.9	10.1	8.9	12.8
Regulatory Capital leverage ratio (%)	13.7	15.9	24.5	23.1	20.0	28.4	18.5	27.6	19.7	20.1
Gross leverage (x)	4.8	5.4	4.5	4.7	3.8	4.4	4.5	4.6	4.2	4.4
Gross leverage (net of cash held on behalf of clients)	4.1	4.4	3.9	4.0	3.1	3.5	3.8	3.8	3.4	3.4

	Orient		CMS		CGS		Shenwan Hongyuan		CICC	
IDR/ Outlook	N.A.		N.A.		N.A.		N.A.		BBB+/ Stable	
	2019	1H20	2019	1H20	2019	1H20	2019	1H20	2019	1H20
Total assets (USDm)	37,637.2	38,307.0	54,640.3	59,844.6	45,179.0	54,519.0	50,594.9	57,293.5	49,373.3	61,993.3
Total assets (CNYm)	262,971.4	270,757.9	381,771.9	422,987.3	315,665.9	385,346.1	353,506.2	404,956.4	344,971.2	438,174.9
Total equity (CNYm)	54,011.6	54,488.2	70,127.8	74,508.5	71,921.7	73,579.9	77,378.6	78,751.1	48,531.5	50,577.0
Net income (CNYm)	2,478.7	1,524.9	7,313.3	4,340.0	5,250.1	3,595.6	5,662.7	3,970.0	4,247.8	3,078.8
ROAA (%)	1.0	1.1	2.1	2.2	1.9	2.1	1.7	2.1	1.4	1.6
ROAE (%)	4.7	5.6	10.8	12.0	7.6	9.9	7.8	10.2	9.3	12.5
Regulatory Capital leverage ratio (%)	13.0	12.7	13.4	18.3	25.4	21.8	19.9	18.7	10.5	13.3
Gross leverage (x)	4.9	5.0	5.4	5.7	4.4	5.2	4.6	5.1	7.1	8.7
Gross leverage (net of cash held on behalf of clients)	4.1	4.1	4.6	4.7	3.4	4.0	n.a.	n.a.	6.1	7.5

Note: CICC's 2019 capital leverage ratio and its 1H20 data are IFRS-based

Source: Fitch Ratings, Fitch Solutions, Company Financials

China Insurance



China Insurance

China's Life Insurance

Coronavirus a 2020 Headwind

The coronavirus outbreak has led to a slowdown in China's GPD growth, lower interest rates and higher volatility in capital markets, heightening the issues over life insurers' new business sales, investment income and capital buffers. The residual pandemic claims on insurers are limited, because basic medical expenses for infected individuals will be covered by public medical insurance funds. The Insurance Association of China revealed accumulated claim payments related to COVID-19 amounted to CNY516 million as of 1 July 2020.

Premium growth of the life sector declined to 6.0% yoy by original premiums in the first half of 2020 (1H20) from 15.2% for 1H19, due mainly to disruption to offline agency sales by COVID-19. A lower-interest environment results in lower reinvestment yields and the knock-on effects on overall profitability and capital in 1H20.

What to Watch

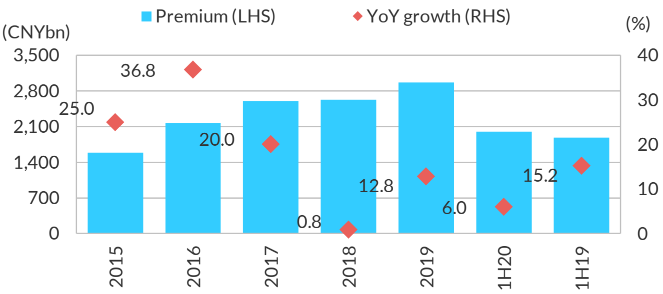
Sector Outlook Revised to Negative: Fitch revised our sector outlook for China's life insurance to negative from stable on 18 March 2020. The revision reflects uncertainties and risk associated with the pandemic, which affect the credit quality of insurers.

Weaker Top-Line Growth Likely: We expect lower premium growth than the 12.8% in 2019, due to hindered opening sales in January-February resulting from social distancing practices and economic contraction. This weakness will be partially offset by stronger sales of health insurance, particularly online sales during the lockdowns. Health insurance generated 23% of total premiums in 1H20, up from 20% in 1H19.

Low Interest Rates a Key Challenge: Profitability remains under pressure. Persistently low interest rates will impair insurers' earnings due to lower recurring yields from fixed-income type assets. Although 2020 profitability is likely to be worse than in 2019, we anticipate larger insurers' fundamental financial profiles will normalise after the pandemic runs its course, given their continued focus on maintaining a quality business mix with protection-type, regular pay, and long-term products, which typically carry wider margins.

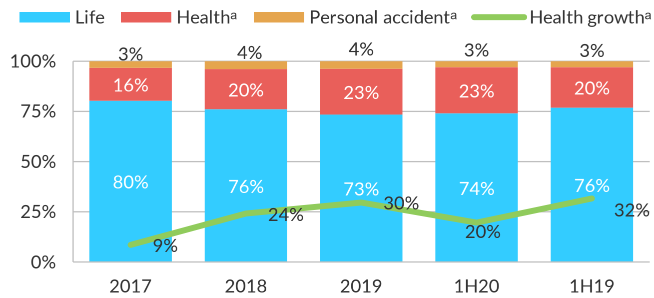
Solvency Position: Low interest rates would induce insurers to invest in more risky assets, such as stocks, funds, long-term equities and equity-type non-standard assets, which generate a higher dividend return. Insurers would be susceptible to a higher capital requirement if they raise risky-assets exposure. Notwithstanding the average comprehensive solvency ratio of the life sector above 200% as of end-2Q20, life insurers are more vulnerable to deterioration in their risk-based capitalisation due to heightened capital market volatilities.

Original Premium Growth Trend



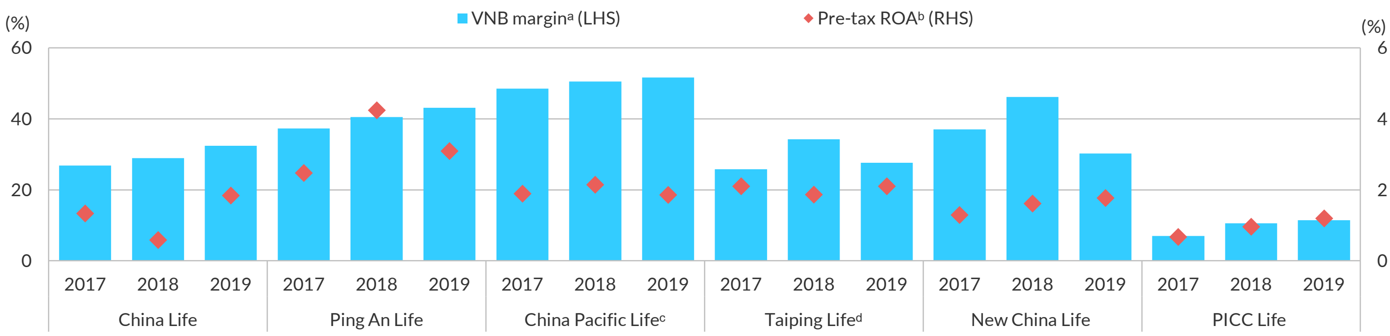
Source: Fitch Ratings, China Banking and Insurance Regulatory Commission (CBIRC)

Product Mix by Original Premium



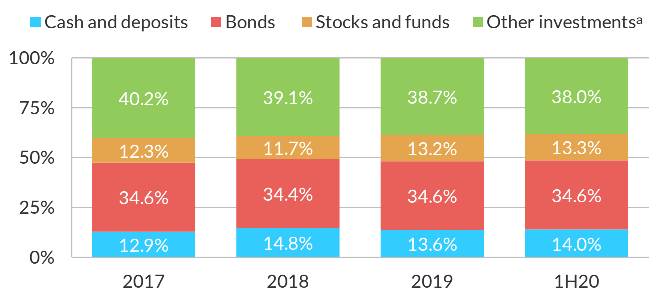
[a] Includes non-life sector's health and personal accident premiums
Source: Fitch Ratings, CBIRC

Profitability of Listed Life Insurers



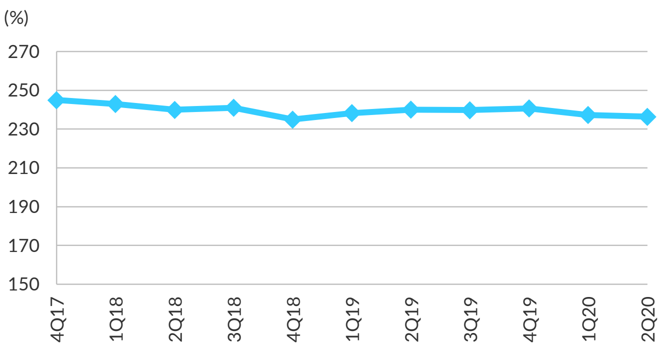
[a] VNB margin = Value of new business/first-year premiums (FYP) FYP on original premium, while Ping An Life's and Taiping Life's FYP on gross written premium
[b] Pre-tax ROA = Pre-tax operating earnings/average total assets net of reinsurance assets
[c] China Pacific Life's FYP Includes premiums from agency channel and renewal premiums from group insurance as no detailed split
[d] Taiping Life's FYP includes renewal premium from group insurance
Source: Fitch Ratings, Company data

Chinese Insurance Sector's Investment Mix



[a] Other Investments include long-term equity investment, project-based debt schemes, trust plans, asset management products and investment properties
Source: Fitch Ratings, CBIRC

Life Industry Average Comprehensive Solvency Ratio



Source: Fitch Ratings, CBIRC

China's Non-Life Insurance

Slowdown in Growth Dynamics Due to the Coronavirus Pandemic

Premium growth of China's non-life insurance market declined to 8% yoy by direct premiums in the first six months of 2020 (6M20) from 11% for 6M19. Stagnant new-vehicle sales suppressed the demand for motor insurance, while non-motor businesses such as health or liability continued to outpace motor insurance because of relatively lower penetration.

The major insurers reported a decline in investment return in 1H20 due to capital-market volatility and a lower yield from fixed-income instruments, although claims related to COVID-19 remained manageable for non-life insurers. The 'combined ratio' of the major listed non-lifers improved, reflecting better underwriting results due to a combination of lower claims and expenses despite slower premium growth. The Insurance Association of China said accumulated claim payments related to COVID-19 amounted to CNY148 million as of 18 May 2020.

What to Watch

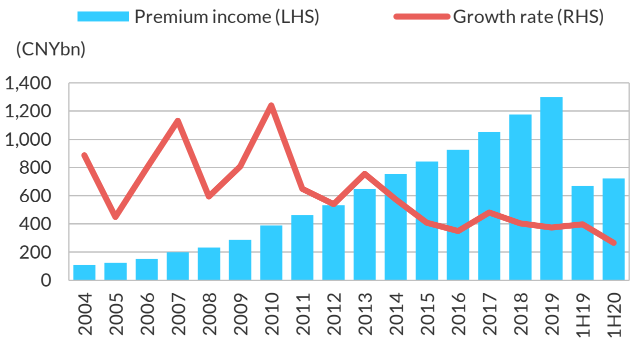
Negative Sector Outlook: Fitch Ratings revised our sector outlook for Chinese non-life to negative from stable on 23 March 2020. The revision reflects the uncertainty and risk associated with capital and operating performance – given the potential impact from the pandemic.

Underwriting Profitability: The claims position from the motor line is likely to improve mildly, due to fewer traffic accidents following restrictions on travel to contain the spread of coronavirus, offsetting potentially higher losses from guarantee and credit insurance. Depending on their risk appetite, motor insurers could incur higher acquisition costs to compete for motor business to achieve their planned target, if the demand for motor policies remains sluggish in 2H20.

Non-Motor to Increase: Fitch anticipates insurers will accelerate expansion in non-motor insurance as government has eased restrictions on travel and allowed factories and stores to reopen. It remains uncertain whether the launch of numerous regulatory initiatives to stimulate new vehicles sales could dramatically boost the demand for motor insurance policies. Non-motor business increased to about 43% of total market direct premiums for 6M20 (2019: 37%).

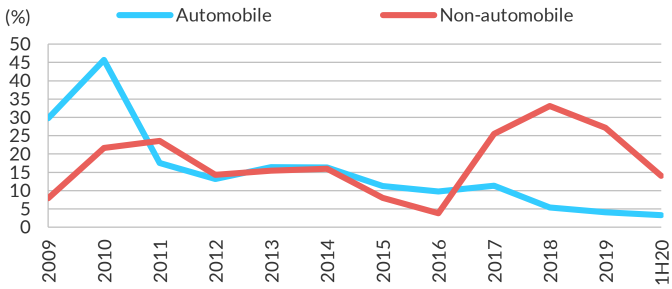
Capital Adequacy: Slower business growth is likely to reduce insurers' burden for additional capital infusion. Persistently low interest rates, however, give insurers a greater incentive to invest in long-term equities with stable dividend yield or equity-type non-standard assets. Insurers might be subject to higher capital requirement if they increase their allocation to these riskier assets. Nonetheless, the major non-lifers still maintained a healthy solvency position as of end-2Q20.

Non-Life Sector's Premium Income and Growth



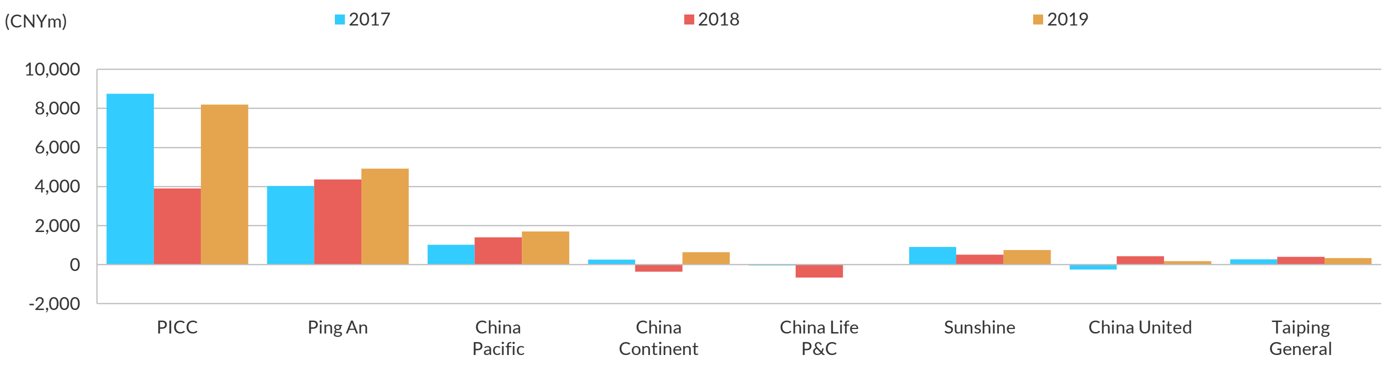
Source: Fitch Ratings, CBIRC

Average Growth Rate of Top 3 Non-Life Insurers[a]: Automobile vs. Non Automobile



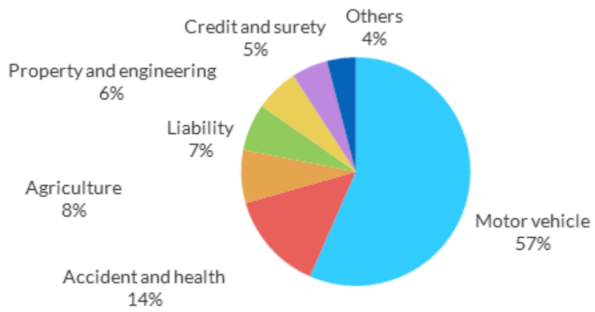
[a] Top 3 non-life insurers include: PICC, Ping An and China Pacific
Source: Fitch Ratings, the companies

Underwriting Results of Motor Class
(Based on PRC GAAP)



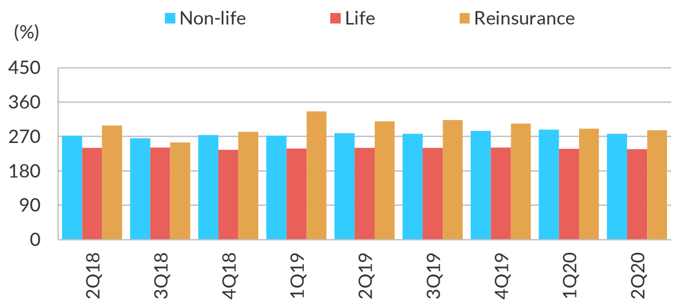
Source: Fitch Ratings, the companies

Business Composition in 1H20
(By direct written premiums)



Source: Fitch Ratings and CBIRC

Chinese Insurers' Capital Ratio Under C-ROSS Framework



Source: Fitch Ratings, CBIRC

China Structured Finance

China Structured Finance

What is Fitch's latest sector view on China Structured Finance Sector? What is Fitch's Rating Outlook for Chinese ABS and RMBS?

China's GDP continue to rebound with 4.9% yoy growth in 3Q20, compared with the 3.2% yoy growth in 2Q20 after the steep fall of 6.8% in 1Q20. Fitch forecasts China's real GDP will expand by 2.3% in 2020 and 8% in 2021. Chinese structured finance transactions have improved in performance after early delinquencies peaked in February 2020 amid the pandemic. Recovery and prepayment also returned to more normal levels. However, asset performance continues to face pressure with uneven recoveries and subdued economic activity in certain sectors like travel and leisure. Fitch has adjusted base-case assumptions for new and existing transactions, where appropriate, in light of the economic environment.

We are maintaining our rating Outlook at Stable for both Chinese auto ABS and RMBS transactions. Our conclusion is supported by the robust performance of the underlying assets to date and the build-up in credit enhancement in most transactions over time. Fitch believes the Chinese SF transactions we rate continue to be able to withstand our rating stresses at their current ratings.

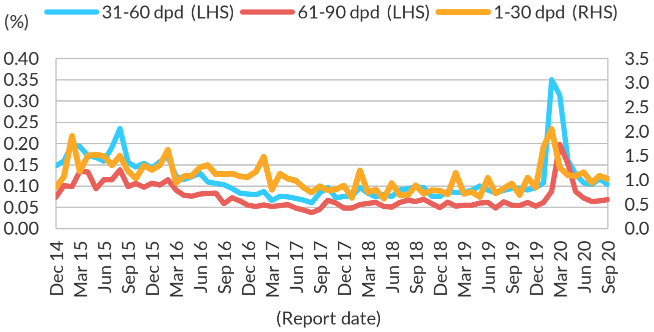
How does each asset class (Auto ABS, RMBS, Consumer-Loan ABS) perform in 3Q2020? How Did the Pandemic Affect Chinese ABS and RMBS Transaction Performance?

Auto ABS Defaults Edged Lower: The annualised gross loss (AGL) index for all auto loan originators edged lower to 0.47% in September, from 0.50% in June 2020 and the peak of 1.59% in April. Performance continues to be supported by falling unemployment and rising income, although the ratio is also influenced by the increased outstanding collateral balance of the asset class. The AGL would be 0.55% if the effects of the issuance were removed.

The proportion of loans that are 31-60 and 61-90 days past due (dpd) remained low in 3Q20, and stood at 0.10% and 0.07%, respectively, at end-September 2020, slightly higher than their pre-crisis levels. The 1-30 dpd rate decreased to 1.02% in September from 1.16% in June, suggesting a steady recovery trend to pre-pandemic levels.

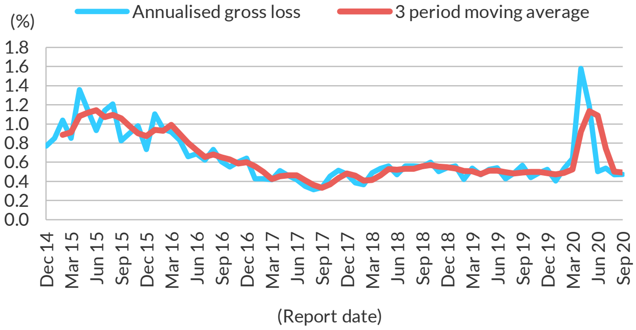
Fitch observed that many auto finance companies promoted higher loan-to-value ratio, including financing add-on services such as vehicle insurance, and longer loan tenor products to increase consumer affordability over the past few years, as seen with an increasing trend of WA LTV in recent transactions. Aggregated average WA LTV for new transactions in 3Q20 recorded 64.5%, increased from 2019 average of 63.1%. The trend may be more obvious for in an originator's entire book information, as most of credit expansion hasn't filtered into securitized pools.

Monthly Delinquency



Source: Fitch Ratings, trustee reports

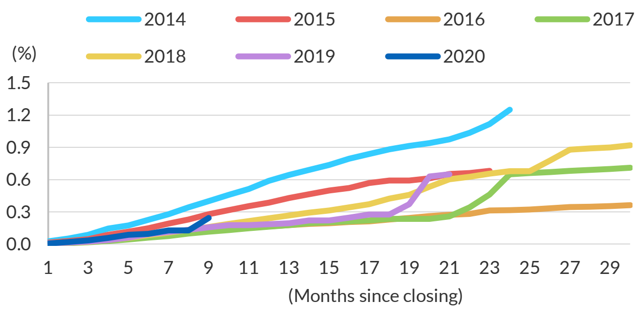
Annualised Gross Loss Index



Source: Fitch Ratings, trustee reports

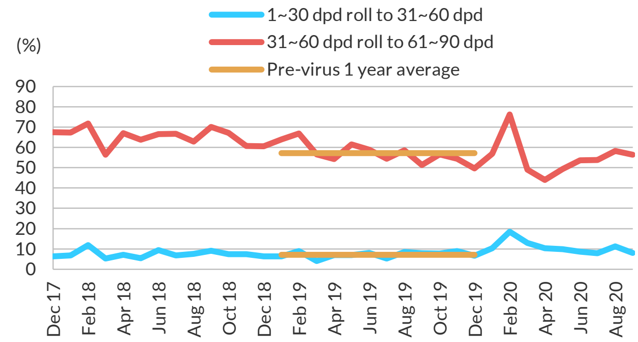
Cumulative Default Rate (Non-Bank)

By transaction vintage



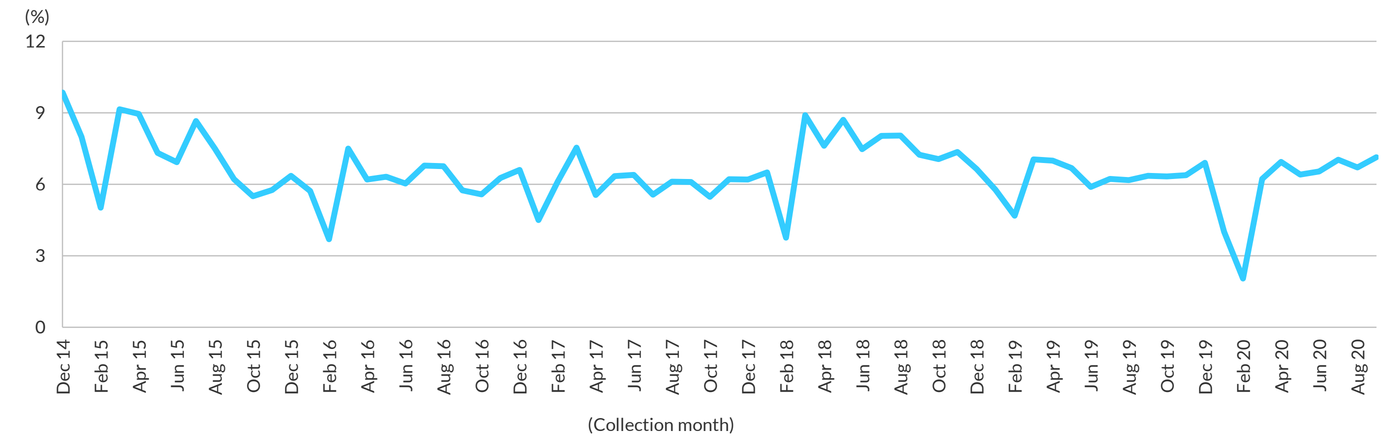
Source: Fitch Ratings, trustee reports

Roll Rate



Source: Fitch Ratings, trustee reports

Annualised Conditional Prepayment Rate (Non-Bank)

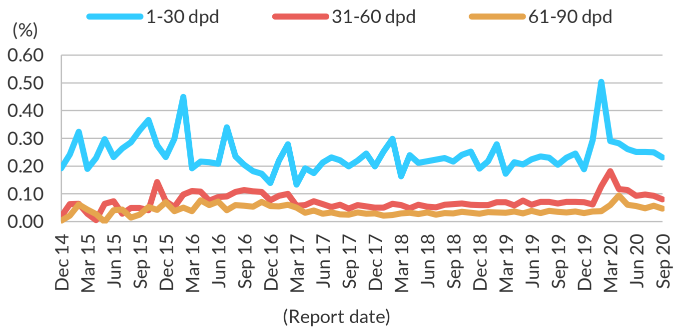


Source: Fitch Ratings, trustee reports

Chinese RMBS Delinquencies Improve: The AGL index for RMBS fell to 0.36% in September after reaching 0.50% in August and 0.54% in May. The unusual twin peaks in August and May for RMBS are due mainly to about half of the transactions recognising defaults 180 days after loans fall delinquent and another half recognising defaults 90 days after delinquency.

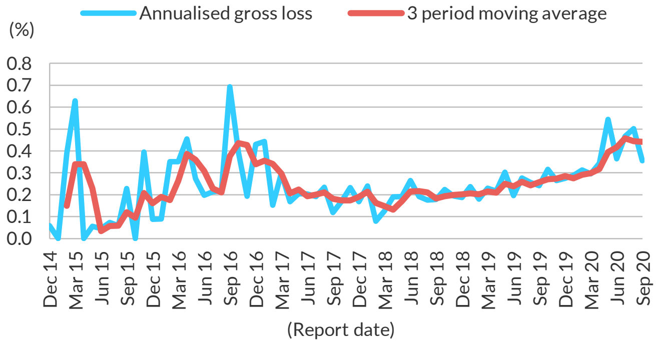
Loans 1-30, 31-60 and 61-90 dpd declined from the June levels of 0.25%, 0.09% and 0.06%, respectively, to 0.23%, 0.08% and 0.05% in September, still above the pre-crisis levels of 0.19%, 0.07% and 0.03%, indicating serviceability was still under pressure for some borrowers. Prepayments increased to 12%-14% in 3Q20 from 11%-12% in 2Q20, above the normal trend of 8%-10%, supported by improving employment and income, and active property transaction volume.

Monthly Delinquency



Source: Fitch Ratings, trustee reports

Annualised Gross Loss Index



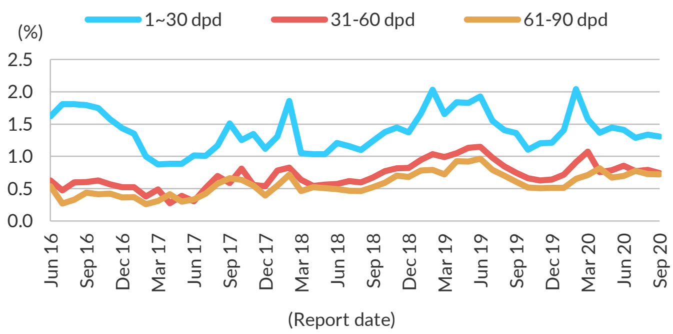
Source: Fitch Ratings, trustee reports

Chinese Consumer Loan Defaults Slow: The AGL index for consumer loans rose to 8.37% in August, before falling to 7.56% in September, a level still much higher than before the pandemic, but may also be due in part to low issuance volume. There had been no credit card transactions and only seven consumer loan transactions issued in 9M20, against eight and 22, respectively, last year. Bank credit card transactions have fared better – the AGL peaked at 7.31% in August and declined to 6.46% in September – than non-bank consumer loan transactions.

Consumer loans are more likely than housing mortgages and auto loans to comprise lower-income borrowers, whose serviceability also recovers slower than higher-income borrowers. Consumer loans' 31-60 and 61-90 dpd improved to 0.74% and 0.72%, respectively, as of September, from the peak of 1.07% and 0.82% in March and April.

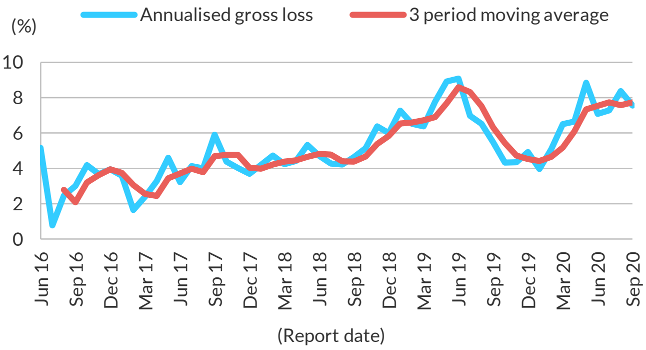
The sector continues to be dominated by China Merchants Bank Co., Ltd.'s (BBB+/Stable) revolving credit card deals and Home Credit's issuance, which made up 84% and 9% of the total outstanding balance as of September 2020, respectively.

Monthly Delinquency



Source: Fitch Ratings, trustee reports

Annualised Gross Loss Index



Source: Fitch Ratings, trustee reports

How will ABS transactions be affected by the new guideline regulating online microloan (OM) companies?

CBIRC released an interim guideline on 2 November for supervision of online microloan (OM) companies. The guideline targets a less regulated subsegment of the Chinese consumer lending industry that uses new technology (i.e. fintech) to offer microloans via online channels. The regulations are aimed, in part, at levelling the playing field between OM companies and other financial institutions regulated by the CBIRC.

The guideline will increase barriers to entry in the sector by requiring additional central government regulatory approval for OM companies to operate outside of the province in which they are registered, and registered capital of at least CNY5 billion to qualify, significantly higher than the levels currently required, which vary by region but are usually below CNY1 billion. Larger players are better positioned to meet this requirement, which could lead to industry consolidation over time. This would be credit positive for related ABS transactions if the process results in more financially sound originators or servicers, as it would reduce risks over servicing continuity.

The regulations propose to cap OM companies' exposure to single borrowers at the lower of CNY300,000 or one-third of three-year average income for individuals. The usage of loans should be stipulated in the contracts and the loans cannot be used for investments or home purchase. The proposed requirement for OM companies to fund 30% of any loans jointly sourced with banks better aligns their interests with those of banks; banks have so far provided the majority of the capital to back OMs. Higher capital commitment from OM companies should enhance credit-risk management.

We believe the proposed requirement for bank or shareholder loans to not exceed 1x of net assets, and for funding backed by bonds or ABS to not exceed 4x of net assets, will limit the leverage and size of OM companies and reduce ABS issuance. It should also curb potential contagion risk to banks and the ABS market from OM activities, as more moderate and sustainable growth would be positive for the OM sector's long-term development and asset quality.

OMs amounted to around CNY 8 trillion (USD1.2 trillion) at end-2019, at around 14% of domestic yuan household loans. Some of the microloans originated or sourced by OM companies are packaged into trust products or ABS, and investors in these products could face asset-quality risk

The first five Chinese asset-backed commercial paper (ABCP) transactions were launched in June 2020, making a new short-term instrument available to investors. What are the key factors that make Chinese ABCP programmes differ from international practices?

Chinese ABCP programmes differ from western peers in three important aspects. Firstly, in the global markets, ABCP is typically set up as an evergreen programme, where short-term commercial paper with terms of less than one year is continuously issued to fund longer-term assets or assets with revolving features, such as credit cards, often with fluctuating notional amounts. The ABCP programme, therefore, needs to be refinanced on a regular basis to continue to fund the asset portfolio. All Chinese ABCP transactions issued to date envisage limited market refinancing. Some comprise static portfolios of loans or leases (meaning maturing assets are not replenished with new assets and the transaction amortises as assets mature), and the ABCP will be refinanced once to match the term of the assets. Some allow limited replenishment of very short-term trade receivables, but do not envisage the constant rollover and reissue of ABCP to make such the programmes evergreen.

Secondly, of the initial four public ABCP programmes in China were all sponsored by corporates, mostly factoring or leasing companies, with their own accounts receivable or those bought from third parties. Liquidity and credit support in these programmes are provided by either the sponsors or the obligors' parents or affiliate companies, whereas in international markets, the sponsors and liquidity and credit support providers are usually banks, which provide the ABCP funding structure to multiple customers through the same vehicle. Under the current regulatory regime, banks in China are not permitted to provide guarantees for third-party financing, so we do not expect to see bank-led ABCP programmes in China any time soon.

Thirdly, the underlying portfolios in international ABCP transactions normally consist of diversified assets, while in three out of the four public Chinese ABCP programmes, each had essentially only one obligor, as the assets are trade receivables that are payable by the single obligors to suppliers. As a result, the ABCP investors' risk is concentrated in one obligor. Chinese regulators have encouraged more diverse short-term assets to be included as underlying assets for ABCP programmes, and three of the five subsequent ABCP programmes, which came to market in August, comprised granular consumer loan portfolios.

To summarize, Chinese programmes so far are single-seller, fully supported programmes issued by non-banks, unlike programmes in developed markets where sponsors and liquidity providers are mostly banks.

How would China's Private-Lending Rate Cap affect the ABS market and Fitch's rated ABS transactions?

China's Supreme Court's decision to cap private-lending rates at 4x the loan prime rate, if applied to regulated financial institutions, could have ramifications for asset-backed securities (ABS) issuance, as we would expect a drop in the origination of underlying consumer loans. However, we do not believe our existing portfolio of rated Chinese ABS transactions will face rating pressure, as these are not likely to be affected by the cap.

The cap would reduce the maximum rate on private lending to around 15.4%, based on the current loan prime rate, from the previous effective cap of 24.0%. This is lower than caps in many neighbouring markets, such as Taiwan (20.0%), Japan (20.0%) and Hong Kong (48.0%).

The ruling does not directly apply to institutions such as banks or consumer and auto finance companies that are regulated by the China Banking and Insurance Regulatory Commission (CBIRC). Nevertheless, CBIRC-regulated entities may face pressure not to exceed the maximum rates permitted for private lenders. This was an informal standard that applied when the 24.0% ceiling for private lending rates was in place.

Depending on how regulators interpret and clarify the ruling, fields such as consumer finance, micro-lending and used-car auto leases, where pricing is more market driven, could be particularly affected. New-car auto loans and leases would be less affected, as most of these benefit from interest subsidies provided by car manufacturers.

Among ABS transactions, those that involve consumer finance are likely to be the most exposed if the court's ruling is applied broadly. Our analysis of a non-exhaustive set of public ABS transactions suggests that the proportion of underlying assets with interest rates exceeding 15.0% is around 15%-95% for consumer-finance transactions, 10%-20% for credit cards, 1%-7% for auto leases and up to 1% for auto-loan transactions. The ruling does not apply to contracts already in effect, so will not affect Fitch's existing portfolio of rated ABS transactions.

Contacts

Global Investor Development Team:

Aymeric Poizot
Global Head of Investor Development
+33 1 44 29 92 76
aymeric.poizot@fitchratings.com

Helen Wong
Investor Development – Asia Pacific Head
+852 2263 9934
helen.wong@fitchratings.com

Jade Li
Investor Development – China
+8610 5957 0963
jade.li@fitchratings.com

Business & Relationship Management:

Sing Chan Ng
Co-Head of Asia-Pacific Business Development
+65 6796 7210
singchan.ng@fitchratings.com

Henry Hung
Head of Greater China Business Development
+852 2263 9628
henry.hung@fitchratings.com

fitchratings.com