Questions That Matter

China | Do Recent SOE Defaults Indicate Systemic Risks?

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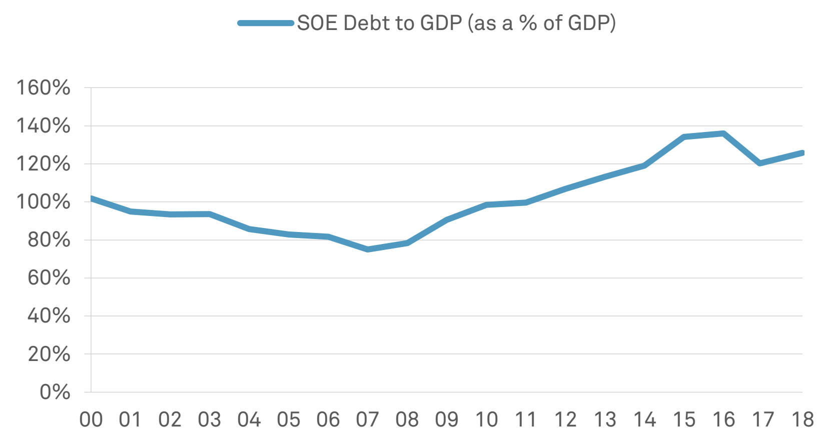
Unexpected defaults by Chinese state-owned enterprises in recent months sparked questions around the Chinese government's willingness to bailout the distressed borrowers. However, we believe this will unlikely lead to systemic risk.

How this will shape 2021

More SOE defaults ahead. We expect to see more defaults of state-owned enterprises (SOEs) as the Chinese authorities refocus on the deleveraging of SOEs now that the worst of the COVID-19 pandemic has passed. We anticipate the overall indebtedness of SOEs as a percentage to GDP will rise, reflecting policy stimulus that called for some SOEs to expand investments.

Chart 26

IMF's Estimate Of SOE Debt As Percentage Of GDP



Source: International Monetary Fund's People's Republic of China 2019 Article IV Consultation, August 2019

The strain on public resources will lead to more market-based debt restructuring in China

More market-based resolution. The strain on public resources will lead to more market-based debt restructuring in China. Debt restructuring is often the preferred option for stakeholders because it preserves the company as a going concern without hurting local employment.

Systemic risk unlikely. Despite our expectation of higher default rates, the still-low overall default rate is unlikely lead to any systemic risk. Most Chinese SOE debt is held domestically.

Read More

China Recovery Could Bring More Defaults, Nov. 17, 2020

Rising Funding Costs May Tip China's Weaker SOEs Into Default, Sept. 15, 2020

China's Local Governments Experiment With Diversified Debt Spending, Nov 23, 2020

No Hiding Off-Budget Risks For China's Local Government, Dec. 2, 2020

What we think and why

Stressed SOEs. Even before COVID-19, SOEs were struggling to reduce leverage. Funding costs are diverging, with investors demanding higher coupons for weaker SOEs. Tighter monetary conditions could also speed the journey to default.

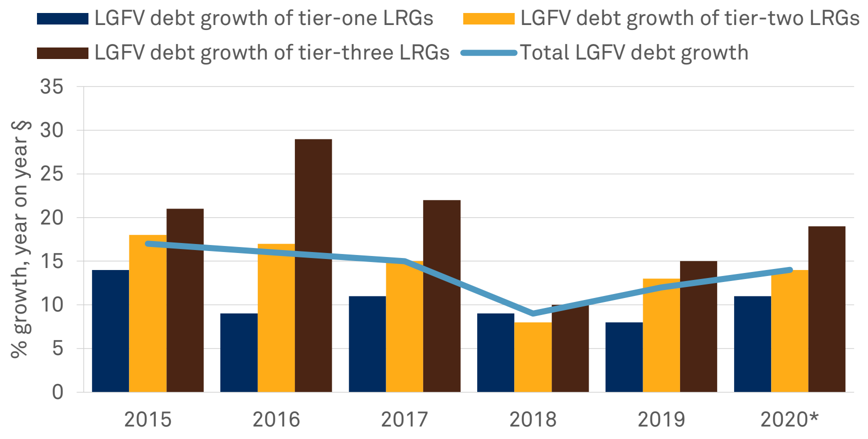
Selective support. Our ratings on SOEs are based on: (i) an entity's stand-alone credit profile; (ii) government rating; and (iii) likelihood of extraordinary government support. The pandemic and increasingly stringent regulations from central authorities could affect (ii) and (iii) by restraining local governments' power to coordinate financial resources, and willingness to support SOEs and local government financing vehicles (LGFV). LGFV, a subset of SOEs, are often companies that were created specifically to facilitate off-budget investments in infrastructure and land development on behalf of the local regional governments.

More transparency and better default resolution. Following Yongcheng Coal and Electricity and Huachen Automotive Group's defaults, the central government is expected to address concerns about information disclosure or poor governance.

Chart 27

After An Interlude, Debt Growth Of LGFVs Is Starting To Climb Again

Debt growth of identified LGFVs, by tier*



Sources: Wind, S&P Global Ratings. *Tiers are defined by China's fiscal hierarchy, where tier one largely refers to provincial governments or peers in the same hierarchy, tier two largely to city governments, and tier three to county governments. §As of Sept. 31, 2020. LGFV--Local government financing vehicle.

What could go wrong

Uncertainty about government support. While government willingness to support will remain stronger for more public policy focused SOEs, credit differentiation is likely among SOEs as well. Governments may commercialize parts of their operations and rely on them less for policy investments, implying a reduced propensity by a government to extend support.

Continuing lack of transparency. The uncertain information transparency and stakeholder governance of SOEs is a concern to investors. There have been instances of borrowers having cash in hand but failing to pay, or attempting to shuffle assets between companies to limit creditors' ability to seize and recover.

Slow development of default resolution regimes. While China has for several years been moving toward a clearer legal process of default resolution, the process has yet to be fully tested and can be somewhat ambiguous when applied to SOEs. Not uncommonly, default cases can be complicated by intragroup activity.

This report is an extract from the S&P Global Ratings report, "Global Credit Outlook 2021: Back On Track?"

This report does not constitute a rating action

S&P Global Ratings believes there remains a high degree of uncertainty about the evolution of the coronavirus pandemic. Reports that at least one experimental vaccine is highly effective and might gain initial approval by the end of the year are promising, but this is merely the first step toward a return to social and economic normality; equally critical is the widespread availability of effective immunization, which could come by the middle of next year. We use this assumption in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

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