5 China: is financial deleveraging a concern for investors?

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What are the recent financial deleveraging measures and timeline?

Ever since Mr. Guo Shuqing became the new CBRC Chairman in February 2017, investors have continued to see financial deleveraging measures coming from the CBRC (China Banking Regulatory Commission), and there are clear timelines for banks to report on specific areas. The markets have perceived this as immediate liquidity tightening from the financial deleveraging. However, the markets are wrong as this is the first stage of a review mainly in 2017, but not implementation. The recent onshore Chinese market correction reflects that thinking.

China financial deleveraging measures and timeline, since March 2017

Date	Regulator	Policy
17-avr	CBRC	CBRC issued 7 documents to clear up **irregular practices** in the financial markets.
12-mai-17	CBRC	The commercial banks are required to report the **underlying assets of their entrusted investments** on a weekly basis.
19-May-17	CSRC	CSRC (China Securities Regulatory Commission) urged securities and fund management companies not to engage in any **channel businesses** which transferred the supervisor obligations.
12-juin-17	CBRC	All banks are required to submit **self-exam** report by Jun 12th under Document 46 (Examination on Three Arbitrages) & Document 45 (Examination on incompliance issues)
15-juil-17	CBRC	All banks are required to submit **self-exam report** by July 15th under Document 53 (Examination on Three Improper activities);
20-juil-17	CBRC	All banks are required to submit **1H17 work progress** by July 20th under Document 6 (To improve Risk management for banking)
30-nov-17	CBRC	All banks are required to have **fixed issues found in self-examination** and regulatory examination and submit report under Document 45 & 46 by Nov 30th.

Source: CBRC, Amundi Research

What are the worries over financial deleveraging in China?

1. Financial deleveraging leads to **tighter liquidity in the overall economic system**, which hurts GDP;
2. Financial deleveraging leads to much **tighter liquidity in the capital markets,** especially stock and bond markets;
3. Financial deleveraging is likely to lead to **systemic risks, more than expected defaults**, hence to the extreme **China hard-landing**;
4. **Financial deleveraging is likely to lead to over-tightening.**

What are the misunderstandings here?

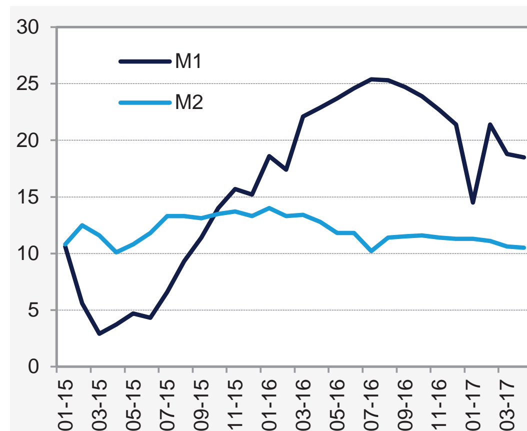
1. Misunderstanding about the difference between **expected liquidity tightening** and **actual liquidity tightening (markets act on expectations);**

The essential

Financial deleveraging in China has been a concern for investors, but we believe it is overdone both in terms of expected potential liquidity tightening and market corrections. It only results in credit tightening in the financial sector, not in the real economy, and not in monetary tightening. Hence, we believe market worries over financial deleveraging will subside from H2 17 (probably from July/August), and headwinds may return again around Q1 2018 when full implementation is rolled out.

We believe the current financial deleveraging measures will impact three areas in particular: (1) equity and bond market leverage (the size may come down by RMB 2 to 3 trillion from currently RMB 10 trillion); (2) lower quality real estate and infrastructure investments; (3) bond issuance by low-quality issuers. The reallocation may be: (1) shifting non-standardised credit assets to regular high-quality loans; (2) shifting bond investments back to banks, and shifting equity investments in small-cap companies to large-cap companies; (3) shifting irregular loan practices in small and mid-sized banks to regular high-quality loans. And the reallocation overall will be positive long term for the health of the Chinese financial markets and the real economy.

1 China M1 & M2, yoy % growth



Source: Bloomberg, Amundi Research

2. Misunderstanding about the difference between **monetary tightening** and **credit tightening**;
3. Misunderstanding about the difference between **credit tightening for the financial sector** and **credit tightening for the real economy;**
4. Regulatory examination does not mean regulators want to over-tighten the liquidity in the system.

What is the reality?

1. Financial deleveraging only leads to **credit** (not overall liquidity, not monetary) **tightening** in the **financial sector** (not in the real economy, as reflected clearly in CBRC lending to the real economy which is guaranteed to be at least at or above the current level);
2. Expectation of tighter liquidity (credit, monetary and the real economy) resulting from financial deleveraging led to Chinese stock/bond market corrections. **The expectations are overdone hence the market corrections;**
3. **Monetary expansion** remains at very high levels, with M1 (18.5%) and M2 (10.5%) both experiencing double-digit growth, and substantial TSF (total social financing, RMB 6.9trn in Q1 17 vs. RMB 6.7trn in Q1 16);
4. **Monetary expansion** facilitates **credit tightening in the financial sector,** will largely reduce systemic risks in the financial sector, hence no hard-landing risks near term.

What will be impacted most when implementation takes place?

The current ongoing regulatory examination focuses on the three areas including: (1) non-standardised credit assets (size of RMB 28 trillion) through asset management channels; (2) funds invested in bond and equity markets (size of RMB 10 trillion); (3) funding in small and mid-sized banks (size of RMB 3-5 trillion) through irregular practices.

The total size is therefore over RMB 40 trillion, around 20% of China's total credit in the system. This does not imply this 20% of credit will evaporate or contract significantly. Rather, it means that this considerable sum of RMB 40 trillion will be allocated to other areas with more transparency.

The reallocation may be: (1) shifting non-standardised credit assets to regular high-quality loans; (2) shifting bond investments back to banks, and shifting equity investments in small-cap companies to large-cap companies; (3) shifting irregular loan practices in small and mid-sized banks to regular high-quality loans.

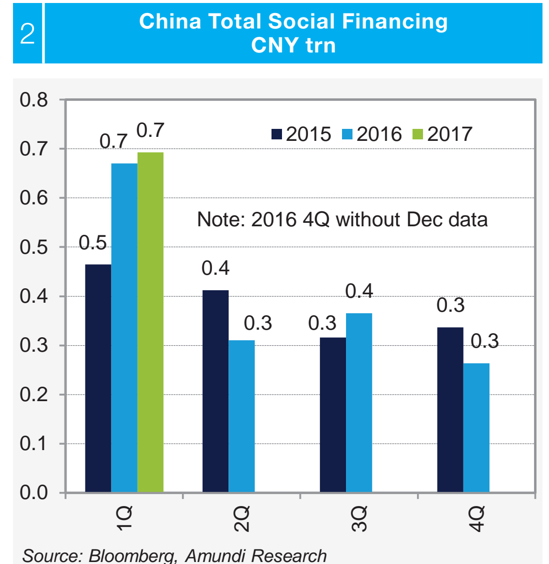
Hence, we believe the current financial deleveraging measures will impact three areas in particular: (1) equity and bond market leverage (the size may come down by RMB 2 to 3 trillion from currently RMB 10 trillion); (2) lower quality real estate and infrastructure investments; (3) bond issuance by low-quality issuers.

Conclusion

1. Near term, the Chinese stock market and bond market both face expectations of liquidity constraint hence correction pressure;
2. We believe expectations of tighter liquidity will subside after H1 (probably July/August), when both stock and bond markets see more upside with extended earnings' improvement;
3. Expectations of tighter liquidity may become a headwind again for the markets, probably in Q1 2018 when full implementation takes place;
4. Clearly large banks and quality names are beneficiaries during this financial deleveraging in China.

Equity and bond market leverage will have to come down!

2 China Total Social Financing
CNY trn



Source: Bloomberg, Amundi Research

Shifting from irregular loan practices to regular loans

Shifting from low-quality to high-quality loans

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