



## Credit ratings in China: pushing a narrative built in wonderland

BY VAISHALI BASU SHARMA ON 16 JUNE 2022

On May 12, one of China's largest property developers, Sunac China Holdings, admitted that it had defaulted on a \$750 million bond. Sunac Holdings is the latest in a string of Chinese companies to announce that it cannot meet its obligations. The Chinese bond market is rife with excessive debt, especially among real estate firms, as well as rampant consumer speculation.

The problem of unsustainable debts came to the fore when Evergrande, China's second largest property developer by sales, admitted having unpaid bills in excess of \$300 billion and has struggled to pay back its creditors and business partners since then. Other major Chinese firms that have defaulted are Sinic Holdings, China Properties Group and Fantasia. China Huarong Asset Management has lost \$15.9 billion last year and its debt-to-equity ratio at one point reached a staggering 1,333%. Kaisa, a property company, also defaulted on \$400 million of bonds.

This spate of defaults is in fact indicative of a deeper malaise in the Chinese economy, r



the least of which is the inflated ratings accorded to money-losing companies by Chinese Credit Rating Agencies (CRAs).

## The evolution of credit rating in China

The concept of credit rating was first introduced to China in the 1980s, but it was only in the mid-2000s, with the expansion of the bond market, that the credit rating industry there gained momentum. At the end of 2020, the Chinese bond market was the world's second largest, behind that of the US, with a total value at nearly \$19 trillion (£14 trillion), representing 15% of the global bond market.

The issuers on the Chinese bond market have gradually expanded from early state-owned enterprises to private and foreign enterprises, as well as overseas institutions. The bond market has successively launched various kinds of innovative products such as asset-backed securities, along with convertible, exchangeable, and green bonds. At the same time, the globalisation of the RMB and the opening up of financial markets have brought new opportunities. A complete Chinese credit rating system gradually formed along with the diversification of issues and products. By the end of 2020, nearly 900 overseas institutions entered the Chinese bond market.

However, despite continuous opening up, the total amount held by foreign investors is just about 3.3%. And while there has been a dramatic increase in the number of domestically-issued bonds by Chinese companies, the number of defaults has increased. Corporate debt levels in China pose a threat to the broader economy. In both 2019 and 2020, Chinese firms defaulted on more than \$20 billion in debt. Fallacious local credit ratings are one of the largest hurdles to transparency in China's bond market. [Five of the nine domestic CRAs are partly state-owned, indicative of a clear conflict of interest](#) given the large percentage of state-connected bond issuers.

## Symptoms of a deeper malaise

According to the Bank for International Settlements (BIS), China's total debt ballooned from \$6.5 trillion at the end of 2008 to \$36.8 trillion at the end of 2019, equivalent to 258.7% of GDP. By the second quarter of 2020, the World Bank reported that China's debt-to-GDP ratio had risen to an even higher 283%. Under-capitalised banks, an ageing population and the Covid-19 pandemic have exacerbated the revenue shortfalls. Years of unbridled lending threatens persistent current account deficits which Beijing strategically seeks to override by seeking foreign capital and global investments. With state-owned 'big six' banks channelling low-cost funds, more than half of the companies that have defaulted in the bond market are state-owned enterprises (SOEs). In 2020, SOEs defaulted on more than \$11 billion debt, accounting for 51% of total defaults.



The striking concentration of AA-and-above rating in the Chinese bond market has been growing over the years. In 2008, ratings above AA were merely 56% of the total, but by 2020 that proportion has reached almost 87%. In 2018, 96% of non-financial bonds carried a rating of AA or above. Despite the rising number of defaults, risk assessments on Chinese borrowers, made by credit rating agencies headquartered in China, still lie in the AAA and AA category. Alternatively, ratings of the same corporations by international [CRAs rank at least 6-7 points lower on average.](#)

Considering that the number of CRAs inside China is far more than in the US, a fierce competition among agencies drives up the ratings. In the American market, less than 10 per cent of bonds are rated AA and above. Because until recently rating was a mandatory requirement, most rating agencies are issuer-oriented – paying more emphasis on expanding their market share instead of building an upstanding reputation, thus constantly leading to rising ratings. With issuers paying for the credit service, domestic CRAs significantly underestimate the risk of default. Furthermore, even under the issuer-payment mode, [“the charge of about 200,000 yuan \(US\\$30,800\) per service is pretty low.”](#)

Quantitative research by Liu Shida and Wang Hao, of Tsinghua University, indicates that domestic ratings have poor early warning capabilities ahead of defaults, and there is often a phenomenon of sharp downward adjustments immediately before one. [Chinese regulators have incorporated minimum credit ratings, typically AAA or AA, into rules governing firms](#) and discourage CRAs from issuing downgrades because they fear that this could lead to decline in investor confidence, sell-offs, higher borrowing costs, and further downgrades, resulting in defaults. According to a BIS working paper, a single point downgrade by a domestic CRA, such as a change from AAA to AA+, increased bond yields by about 60 basis points.

## Normalisation of defaults

Years of debt accumulation plus the impact of the pandemic have led to a deterioration of business operations. China's National Institution for Finance and Development (NFID), a government-linked think tank, put the [nation's overall debt at 270.1% of GDP at the end of 2020, up from 246.5% at the end of 2019.](#) Outstanding foreign debt, including US dollar debt, reached US\$2.4 trillion in 2020. The bulk of China's local government debt is held by state-owned or state-controlled financial institutions, whose hidden debts were estimated to be between 30 trillion yuan (US \$4.2 trillion) and 40 trillion yuan by S&P Global Ratings in 2018. The number of defaults is now significantly higher, especially unexpected defaults of large SOEs with inflated ratings, which has impacted the market negatively.

## Restricted access for international CRAs

No fully foreign-funded CRA, such as S&P, Moody's and Fitch, is accredited to rate Chir



firms in the domestic markets, but they are free to rate the bonds of Chinese firms in international markets outside of China. Although foreign ratings agencies have been allowed entry into China's bond market, there is a possibility that global ratings agencies may also feel pressure to provide higher ratings in order to gain market share as Chinese companies seek the highest rating possible. In his testimony to the US-China Economic and Security Review Commission, 'Hearing on China's Quest for Capital', on January 23, 2020, David Loevinger, Managing Director of asset management firm TCW, said that it remains ["an open question" whether foreign ratings agencies will be able to issue objective ratings and "call it like they see it" in China's financial markets.](#)

## Conclusion

Systematic ratings inflation by Chinese ratings agencies not only compromises the integrity of credit rating in mainland China, but it also conceals debt risk and ultimately harms overseas investors exposed to China's fixed income markets. Chinese regulators have aimed to improve the domestic credit rating regime and claim that they are aiming for market-based credit rating in the domestic bond market. In February 2021, the China Securities Regulatory Commission (CSRC) finalised amendments to the administrative rules of credit rating business in the securities market and for issuance and trading of corporate bonds. It removed the requirement of mandatory credit rating for issuing public corporate bonds, and only issuer rating will be required.

While making credit rating "*not mandatory*" is a significant step towards change, it is not a panacea to transform the credit rating regime in China, to become market-based overnight. The disproportionate representation of SOEs in the bond market inflates the ratings distribution because investors assume state-sector borrowers enjoy government support and therefore present a lower credit risk. Beijing must implement looser restrictions on CRAs' abilities to discuss debt issuers' weaknesses. Credit rating agencies need to rebalance the latest developments in order to remain relevant. Meanwhile, the bond market remains regulation-driven and not market-driven.

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Financial markets	Financial services	Kaisa	Macro-economics	Narratives	Real estate
Sinic Hldgs	State-owned enterprises	Sunac China Hldgs			



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