



2017 Credit Risk Outlook for China's Financial Guarantee Industry

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Abstract

Financial guarantee institutions are companies that provide credit enhancement services for capital market products. At present, the number of guarantee institutions engaged in financial products guarantee business in the domestic market is relatively small. The industry is still in its initial stage of development, but the industrial concentration is high, and most of the guarantee institutions are state-owned. In recent years, with the rapid development of China's bond market, especially the issuance of quasi-municipal bonds, the demand for financial guarantee institutions has risen rapidly owing to the influence of investors' preferences. However, the compensatory risk of guarantee institutions is mounting up due to high industrial and regional concentration and increasing pressure of payment upon bond maturity peak. In terms of investment made by guarantee institutions, impacted by external economic downturn, the ROI for own funds is yet to be improved.

At present, China has not yet formulated corresponding laws, regulations or industry standards for the financial guarantee industry. Therefore, the relevant laws, regulations and regulatory requirements are to be urgently introduced. With the breaking of rigid payment in China's bond market, the compensatory risk of the financial products guarantee institutions is intensified. Therefore, relative legal means still need to be strengthened.

- The financial guarantee industry has a high degree of concentration. Although the capital strength of some guarantee institutions has been strengthened in 2016, the overall strength of the industry is still weak. Since most of the guarantee institutions are state-owned, the shareholders are more willing to provide support, which increased the compensatory capacity to a certain extent and improved the credit profile.
- Having benefited from positive market environment since 2016, the volume of bond guarantee business has grown rapidly and the profitability has further increased. However, the ROI for own funds still needs to be improved.
- With a substantial increase in the scale of financial guarantee industry, guarantee institution's leverage level continues to rise, increasing the guarantee multiplier, thus the business risk is worthy of attention.
- As guaranteed bonds are dominated by quasi-municipal bonds, the industrial and regional concentration is relatively high, and the credit concentration risk of the guaranteed bonds cannot be ignored.
- Risk events in the domestic bond market has increased significantly in 2016, and the overall industry provision coverage level is not high. With the bond maturity peak impending, the compensatory capacity of guarantee institutions needs to be further improved.

Industry Outlook

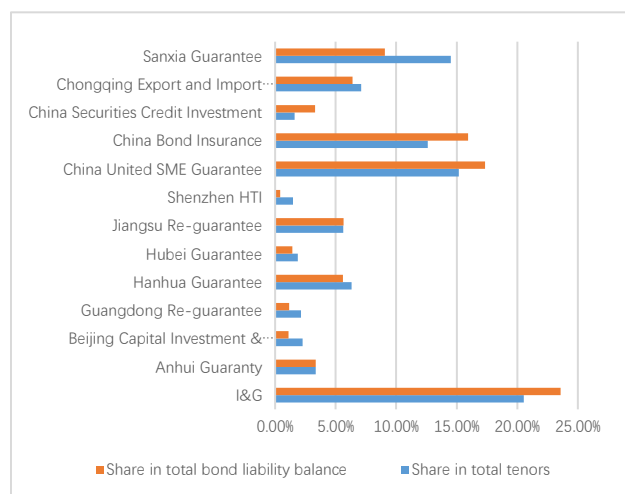
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1. Review on the Industry in 2016

The industrial concentration of financial guarantee is relatively high. Although the capital strength of some guarantee institutions has been strengthened in 2016, the overall strength of the industry is still weak.

With the development of China's bond market, domestic guarantee institutions engaged in bond guarantee business have witnessed rapid development in recent years. As of Mid-December 2016, there were about 27 guarantee institutions engaged in bond guarantee business in the market, accounting for only 0.34% of the total number of guarantee institutions. As of December 2016, according to Wind statistics, a total of 38.68 trillion yuan of bonds were issued, with guaranteed bonds accounting for 2.34%; over the same period, in terms of the market share of bond guarantee liability balance, 7 guarantee institutions, including China National Investment and Guaranty Corporation, China United SME Guarantee Corporation, China Bond Insurance Corporation, Sanxia Guarantee Group, Hanhua Guarantee Group, Jiangsu Re-Guarantee Group, and Chongqing Export & Import Credit Guarantee Corporation, account for 83.54% of the total, showing high industrial concentration. (See Figure 1)

Figure 1 : Tenor and Liability Balance of Guaranteed Bond by Guarantee Institutions as of the End of June 2016 (%)

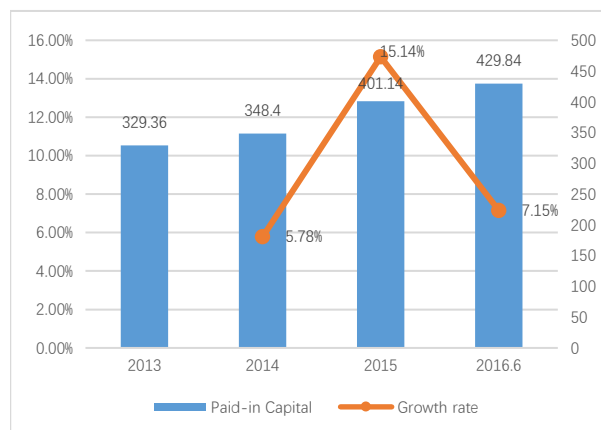


Source : Public data; compiled by United Ratings

Principal is the core competitiveness of guarantee institutions. With the rise in business scale, the requirement regarding capital is highlighted. At present, the capital of guarantee institutions is derived from shareholders' capital increase and profit retention. In recent years, guarantee institutions actively carry out financial products guarantee businesses, including bond and capital guarantee funds, etc., which increases the need for capital, and the paid-in capital is on the rise. As shown in Figure 2, as of the end of June 2016, the paid-in capital of major bond guarantee institutions reached 42.984 billion yuan of funds, increased by 7.15% compared with that at the beginning of the year. As the bond guarantee business brought forward higher requirements for capital strength, and to expand the scale of business and meet the regulatory requirements, major guarantee institutions increased their capital

strength through shareholder financing, bond issuance and listing in the first half of 2016.

Figure 2 : Paid-in Capital of Guarantee Institutions from 2013 to June 2016 (RMB100 Million , %)



Source : Public data; compiled by United Ratings

Guarantee institutions that increased capital are mainly policy-oriented and state-owned in nature, underlying that the shareholders are more willing to provide support and the effect of credit enhancement is better. With the increased strength of state-owned guarantee institutions, more resources can be used to resolve the compensation. In 2016, State-owned guarantee institutions are injected capital significantly, as shown in Table 1.

Table 1 : Paid-in Capital of Major Guarantee Institutions in 2016 (RMB100 Million)

Corporation	The end of 2015	The end of June 2016	The Nature of Shareholders
Guangdong Financing Re-Guarantee Corporation	50.10	60.10	State-owned
Jiangsu Re-Guarantee Group	46.49	53.49	State-owned
Chongqing Export & Import Credit Guarantee Corporation	26.40	28.10	State-owned
Northeast China SME Credit Re-Guaranty Co., Ltd.	20.00	30.00	State-owned

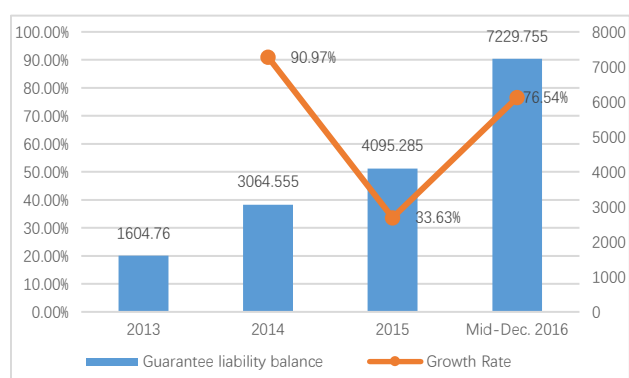
Source: Corporate Financial Statements; compiled by United Ratings

Having benefited from favorable market environment since 2016, business scale and profitability of the bond guarantee industry has been growing faster.

In recent years, impacted by the increased downward pressure on the Chinese economy and the deterioration of the operating environment of SMEs, guarantee institutions has shifted business focus to bond guarantee, expecting to bear lower risk. According to public statistics, from 2013 to 2016, the scale of bond guarantee business kept growing, with the liability balance reaching RMB

160.476 billion, RMB 306.456 billion, RMB 409.259 billion and RMB 722.976 billion respectively, and incremental liability balance reaching RMB 71.850 billion, RMB 145.98 billion, RMB 103.073 billion and RMB 313.447 billion respectively. In the second half of 2015, due to the impact of the stock market plunge, the bond market issuance conditions turned for better, and the demand for guarantee institutions decreased, resulting in a substantial decline in the income of the guarantee institutions. However, from the second half of 2015 to December 2016, bond market defaults were frequent and investors have shown preferences for bonds guaranteed by guarantee institutions. As a result, bond guarantee liability balance increased significantly, up by 76.54% over that in the end of 2015.

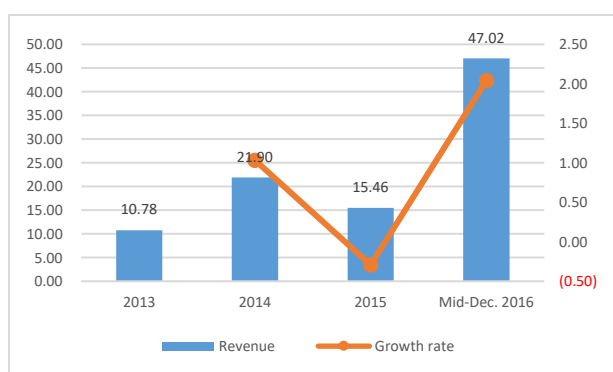
Figure 3 : Bond Guarantee Liability Balance, 2013-Dec. 2016 (RMB100 Million , %)



Source : Wind; compiled by United Ratings

With the rapid growth of the bond guarantee liability balance, the operating income level of bond guarantee institutions also continued to rise. Since 2016, the bond guarantee business income level has been increasing significantly, with the industry-wide income of 4.702 billion yuan, up by 204.14% compared with that of the 2015.

Figure 4 : Operating Income of Bond Guarantee Business, 2013-Dec. 2016 (RMB100 Million , %)



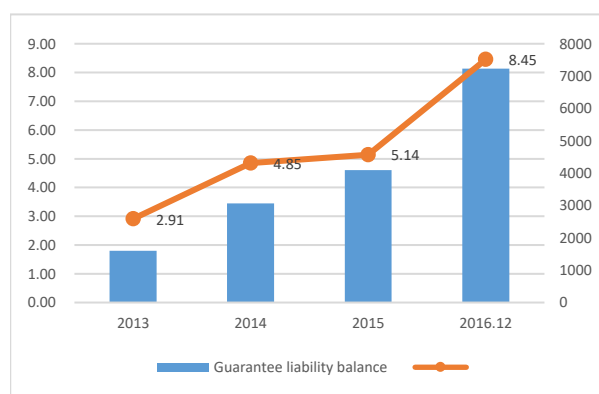
Source : Wind; compiled by United Ratings

Note: The operating income is calculated as the incremental guaranteed bond multiplying by the guarantee charge rate of 1.5%.

The operating risk cannot be ignored with the continued rise of leverage level and increase of guarantee multiplier.

According to the 14 key institutions that are principally engaged in bond guarantee business, the guarantee multiplier has continued to rise since 2013, and the increase slowed down in 2015. Since 2016, with the number of guaranteed bonds continue to increase, the guarantee multiplier showed a substantial growth trend. As of the end of June 2016, the guarantee institution multiplier is 8.45 times, an increase of 3.31 times over that of 2015. On the whole, the majority of financial guarantee institutions' guarantee multiplier are still within 10 times, which is the ceiling of the regulatory requirements. However, some guarantee institutions' guarantee multiplier has far exceeded the regulatory requirements of 10 times, as the size of their bond guarantee business is bigger and grow faster. As of the end of June 2016, for example, I&G's guarantee multiplier is up to 30.43 times, and China United SME Guarantee's guarantee multiplier is 10.74 times.

Figure 5: Guarantee Multiplier of Guarantee Institutions from 2013 to Dec. 2016 (RMB100 Million; Multiplier)



Source: Wind; Audit report of Guarantee Institutions or other public data; compiled by United Ratings

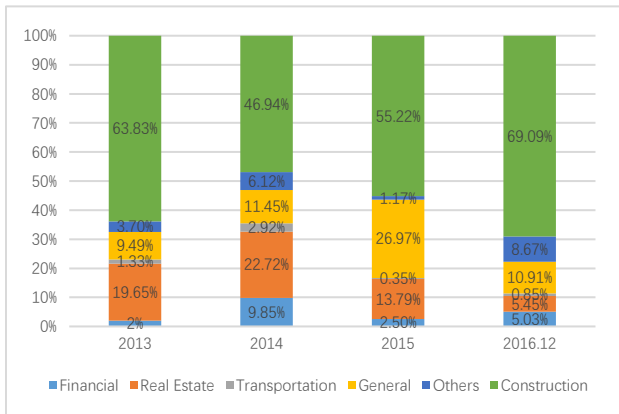
Note: Guarantee Multiplier=Guarantee Liability Balance/Net Assets

Credit concentration risk is worthy of attention due to high industrial and regional concentration of the guaranteed entities with most guaranteed bond being quasi-municipal bond.

In terms of bond type, the largest share is quasi-municipal bond, accounting for over 90% of the total; and in terms of industrial distribution, construction industry has the largest share, accounting for up to 69.09%, showing a rising trend. Most enterprises issuing quasi-municipal bond are construction enterprises, and since real estate industry is easy to be impacted by the policy, its operating stability is subject to uncertainty.

Since 2015, the guarantee institutions have taken the initiative to reduce the guarantee service for real estate enterprises. Thus, the real estate industry guarantee liability balance decreased gradually. The decline has been more significant since 2016, and down to 5.45% in December 2016 from 13.79% in 2015.

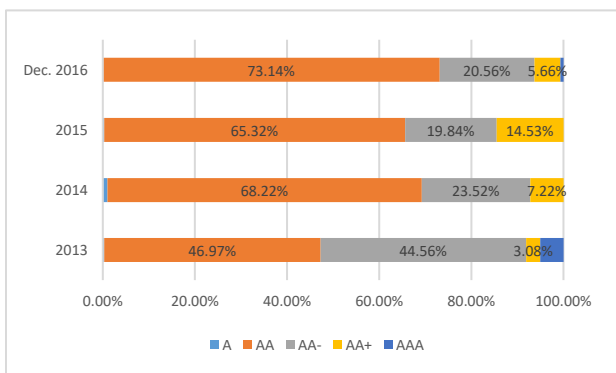
Figure 6 : Industrial Distribution of Guarantee Institutions, 2013 – Dec. 2016 (%)



Source : Wind; compiled by United Ratings

The credit ratings of guaranteed entities are mainly concentrated on AA and AA- levels. The guaranteed entities at AA level has increased from 46.97% of the total rated entities to 73.14% in December 2016, while the AA- down from 44.56% in 2013 to 20.56% in December 2016. This reflects that guarantee institutions put forward higher requirements to the issuers of the guaranteed bonds. Furthermore, the bonds guaranteed by guarantee institutions are mostly issued by quasi-municipal enterprises, whose rating levels are more often upgraded than downgraded. Compared with the industrial bonds that had more defaults, the credit profiles of quasi-municipal bonds are relatively better, since the bond market are more likely to trust those quasi-municipal enterprises. (See Figure 7)

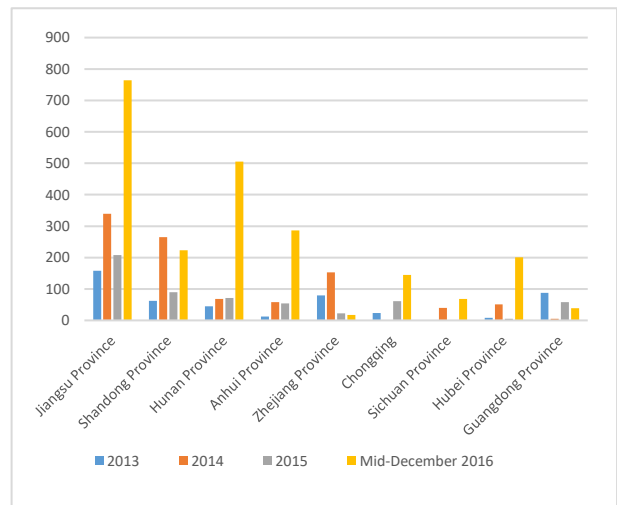
Figure 7: Issuers of Bonds Guaranteed by Guarantee Institutions (%)



Source : Wind; compiled by United Ratings

In addition, over the past three years, except for Shandong Province, Zhejiang Province and Guangdong Province, the guarantee liability balances of all provinces are on the rise, and the upward trend is more significant in 2016. As of December 2016, Jiangsu Province exhibited the highest guarantee liability balance, which was RMB76.42 billion, accounting for 33.98% of the total, followed by Hunan, Anhui, and Hubei Provinces, showing high regional concentration. (See Figure 8)

Figure 8: Bond Guarantee Liability Balance of Provinces from 2013 to December 2016 (RMB 100 Million)

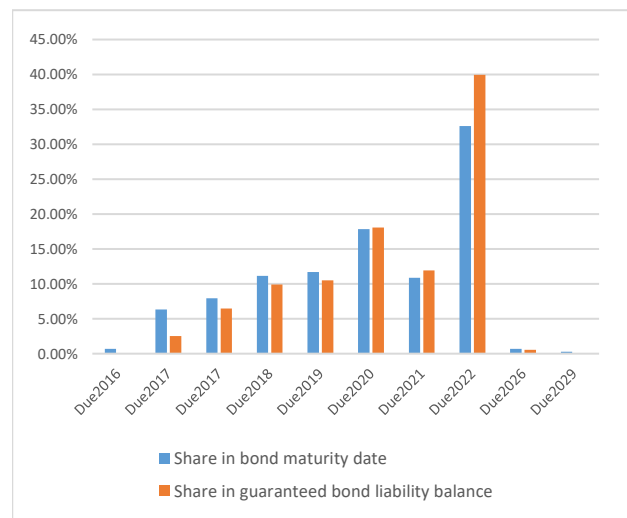


Source : Wind; compiled by United Ratings

Concentrated payment risk is worthy of attention since 2019 will be the bond maturity peak.

Since the beginning of 2016, the bond guarantee business volume has increased significantly. Given that the bond maturity is generally 5 years and 7 years, most bonds in the market will be due and repaid from 2019, and will reach their maturity peak in 2021 and 2023 respectively. Among them, the guarantee liability balance matured in 2021 and 2023 will be RMB130.722 billion and RMB288.62 billion respectively, accounting for 18.08% and 39.92% of the total guarantee liability balances respectively. (See Figure 9)

Figure 9 : Maturity of Bonds Guaranteed by Guarantee Institutions (RMB 100 Million, %)



Source : Wind; compiled by United Ratings

Since the beginning of the compensatory peak in 2019, in terms of maturity date and guarantee liability balance repayment pressure, Shandong Province will experience the highest repayment pressure

in 2019, while Jiangsu Province will face the highest repayment pressure from 2020 to 2030, and its average yearly maturity liability balance proportion is around 20%, as shown in Table 2.

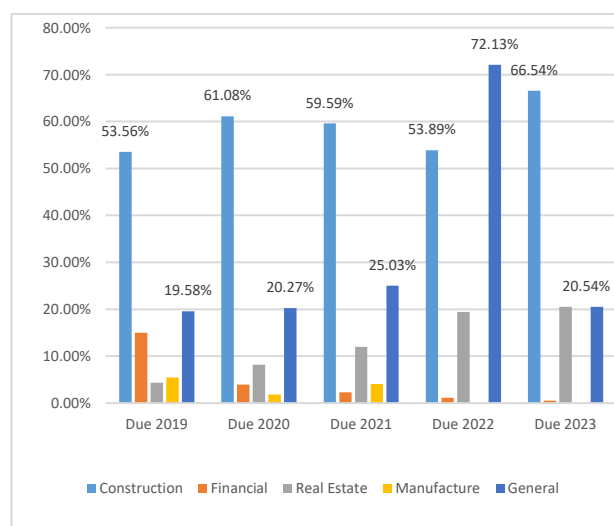
Table 2 : Top 5 Provinces that have the Largest Share of Bond Guarantee Liability Balance Due in 2019~2023 (%)

Due in 2019	Due in 2020	Due in 2021	Due in 2022	Due in 2023
Shandong 19.16	Jiangsu 17.90	Jiangsu 24.33	Jiangsu 23.34	Jiangsu 26.17
Jiangsu 14.26	Heilongjiang 10.81	Shandong 21.34	Tianjin 13.79	Hunan 17.50
Beijing 10.07	Guangdong 9.95	Zhejiang 8.95	Shandong 8.59	Hunan 9.58
Zhejiang 8.39	Zhejiang 9.75	Hunan 5.45	Hunan 7.90	Hubei 6.80
Sichuan 7.69	Henan 7.45	Anhui 5.28	Hubei 6.27	Shandong 6.47

Source : Wind; compiled by United Ratings

In terms of industry distribution, since the bond repayment peak in 2019, the guarantee liability balance of the construction industry will be the highest, accounting for over 50% of the total, and will reach its maturity peak of 66.54% in 2023, thus its repayment situation should be given more attention. Furthermore, 2020 will see most real estate guaranteed bonds to be due, accounting for up to 72.13% of the total. (See Figure 10)

Figure 10 : Industry Distribution of Guaranteed Bonds Due in 2019~2023



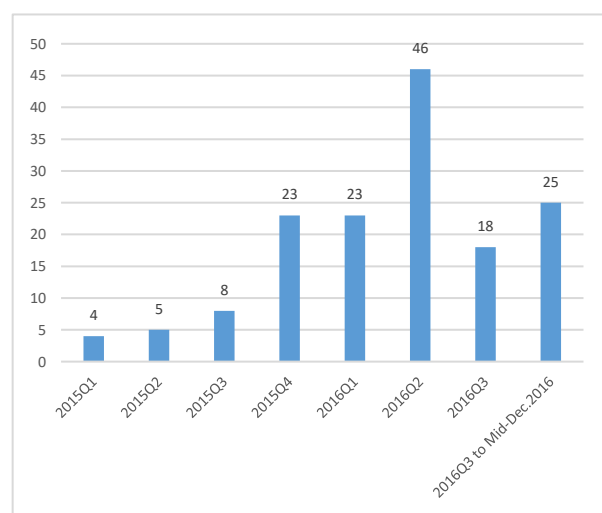
Source : Wind; compiled by United Ratings

Due to the surge of risk events in the domestic bond market since 2016, the compensatory risk for the guarantee institutions engaged in bond guarantee business has increased significantly, and the overall provision level of the industry is not high.

In recent years, the number of credit events has also seen a significant upward trend. As shown in Figure 11, since the fourth quarter of 2015, the number of credit risk events has increased

significantly. As of December 2016, the number of credit risk events affecting guarantee institutions has reached up to 112 cases, increasing by 72 cases compared with that in 2015. In terms of quarterly distribution, credit risk events also show a certain regularity, with the second quarter witnessing the most credit risk events. Since the peak of the risk events in the fourth quarter of 2015, the compensatory frequency of guarantee institutions has been mounting up due to the fracture of enterprises' capital chain, which was the result of loan-withdrawal by banks. Furthermore, the credit profile and risk awareness of small and medium-sized enterprises is relatively poor. With further deterioration of the external environment, the compensatory frequency for the guarantee institutions is increasing. China Bond Insurance Co., Ltd. saw the most compensation for the guaranteed bonds, followed by Jiangsu Re-Guarantee Group (see Table 3).

Figure 11 : Bond Credit Risk Events from 2015 to December 2016



Source : Wind; compiled by United Ratings

Note: Risk events include deficiency in disbursement of funds, default risk warning, subject to credit rating watch list (further downgrade is possible), and the compensatory payment by guarantor.

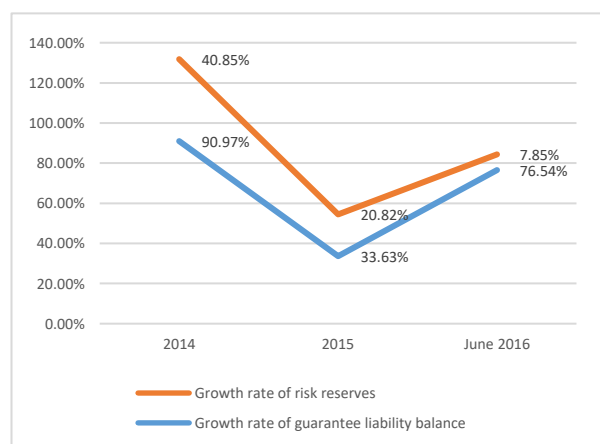
Table 3: Compensation for Bonds by Guarantee Institutions from 2015 to December 2016

Acronym of Bond	Type of Bond	Guarantor	Date of Default	Event of Default	Action upon Event of Default
12 Suqian SMECN1	SMECN	Jiangsu Re-Guarantee	Nov. 27, 2015	Unable to pay the principal and interest on schedule	compensatory payment made by guarantor on schedule
13 Qingdao SMECN II 001	SMECN	China Bond Insurance	Jan. 18, 2016	Unable to pay the principal and interest on schedule	compensatory payment made by guarantor on schedule
13 Ningde SMECN II 001	SMECN	China Bond Insurance	Jan. 27, 2016	Unable to pay the principal and interest on schedule	compensatory payment made by guarantor on schedule
13 Dazhou SMECCN 001	SMECN	China Bond Insurance	Apr. 8, 2016	Unable to pay the principal and interest on schedule	compensatory payment made by guarantor on schedule
13 Sichuan SMECN1	SMECN	China Bond Insurance	Apr. 15, 2016	Unable to pay the principal and interest on schedule	compensatory payment made by guarantor on schedule
14 Yangzhou SME Debt	Set Enterprise Bond	Jiangsu Re-Guarantee	Jun. 15, 2016	Unable to pay the principal and interest on schedule	compensatory payment made by guarantor on schedule
13 Ningde SMEC II 002	SMECN	China Bond Insurance	Jun. 28, 2016	Unable to pay the principal and interest on schedule	compensatory payment made by guarantor on schedule

Source : Wind; compiled by United Ratings

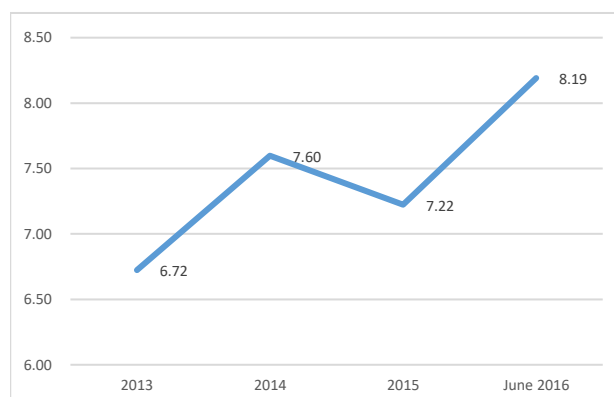
In terms of the compensatory rate, the compensatory rate of the guarantee institutions engaged in bond guarantee business in 2015 was 2.45%, down by 0.15 percentage point than that in 2014. In 2016, against the background of greater macroeconomic downward pressure, bond default risk was mounting up, and the compensatory risk of guarantee institutions would be increasing accordingly.

Given that compensation has been multiplying, the financial guarantee industry's risk reserve growth rate is lower than the

Figure 12 : Growth Rate of Guarantee Liability Balance and Risk Reserves from 2014 to June 2016 (RMB 100 Million, %)


Source : Wind; compiled by United Ratings

growth rate of the industry's guarantee liability balance. According to the public statistics on the 14 selected guarantee institutions mainly engaged in bond guarantee business, as of the end of June 2016, the bond liability balance of financial guarantee institutions was RMB 722.976 billion, an increase of 76.54% over that in the end of 2015; while the growth rate of risk reserves in the same period is 7.85%. It can be seen that the growth rate of the risk reserves of the guarantee institutions is obviously lower than that of the guarantee liability balance in the same period, which means that the guarantee institution's allocation of risk reserves was not enough, and their capacity to withstand risks should be urgently enhanced.

Figure 13 : Average Return on Equity of Guarantee Institutions from 2013 to June 2016 (%)


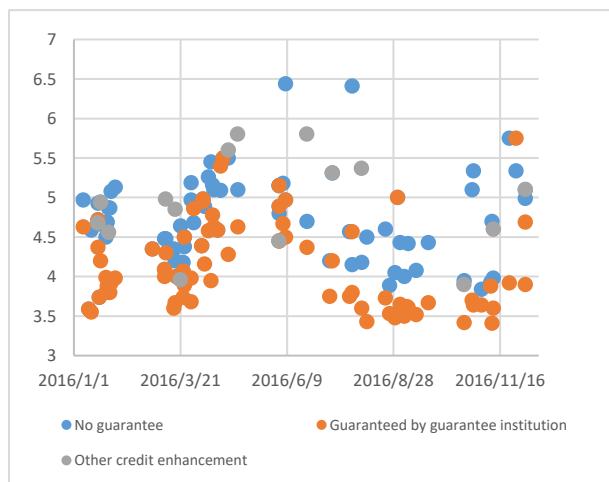
Source: Public Statistics on Guarantee Institutions; compiled by United Ratings

The profitability of guarantee institutions was greatly improved in 2016, yet the ROE presented a great fluctuation, indicating the return on investment for own funds is yet to be improved.

The overall profitability of the guarantee institutions is moderate. With the increase in the amount of bond guarantee business, although the overall ROE of the guarantee institutions has exhibited a fluctuating uprising tendency since 2013, it decreased in 2015. Since 2016, benefited from the increase of bond guarantee business, the level of ROE has risen sharply, reaching 8.19%. (See Figure 13)

For the issuers, credit enhancement by professional guarantee institutions can save the cost of financing as well as speed up the issuance efficiency. For the issuer whose credit rating is AA- or below, the credit enhancement by a guarantee institution may uplift the bond credit rating by at least two notches, which is of great help to reduce the difficulty of financing and financing costs for enterprises. As shown in Figure 14, from January to December 2016, the interest rate of the enterprise bond issued by a corporation rated with AA and has a credit enhancement by a guarantee institution is generally lower than the issuance interest rate of the bonds with credit enhancement measures provided by non-guarantee institutions. The difference between the interest rate of a bond with credit enhancement measures by non-guarantee institutions and that by guarantee institutions is about 40BP, indicating that the profitability of guarantee institutions still leaves room to desire.

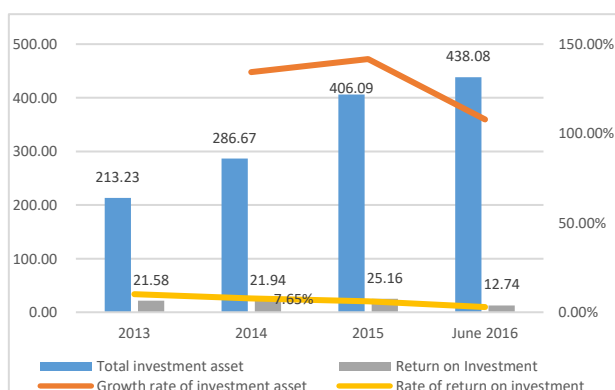
Figure 14 : Comparison of Interest Rates of Enterprise Bond Issued by Entities Rated as AA (%)



Source : Wind; compiled by United Ratings

In addition to ordinary guarantee credit enhancement business, in order to increase investment income, the guarantee institutions also carry out the operation of capital to improve asset returns without impacting liquidity. On the whole, the investment direction of guarantee institutions mainly includes entrusted loans, bonds, stocks, trust investment plans, and bank financial products with the characteristics of complete in range and flexibility in operation mode. As of the end of June 2016, the size of the investment assets of the major guarantee institutions reached 43.808 billion yuan, up by 107.88% from the beginning of the year. However, with the increase of the investment assets, the ROI was declining. The ROI in the same period was 5.82%, which is mainly affected by the overall adverse market environment, and the overall rate of return of its portfolio products also showed a downward trend. (See Figure 15)

Figure 15 : Investment Income from 2013 to June 2016 (RMB 100 Million, %)



Source : Wind; compiled by United Ratings

Note: The investment assets include available-for-sale financial assets, financial assets at fair value through profit or loss, long-term equity investment, purchase of resale financial assets and held-to-maturity investments; Rate of return on investment = (investment income + interest income) / total investment assets.

The compensatory capacity of the financial guarantee institutions is enhanced since their shareholders can provide more support. The credit profile of the guarantee institutions is relatively good, yet having not undergone the entire economic cyclic test, its credit quality remains to be further observed.

The guarantee institutions that increased capital are mostly state-owned and policy-oriented in nature, which means that the shareholders are more willing to provide support, and the effect of credit enhancement would be better. With the increasing strength of state-owned guarantee institutions, the rating upgrade for them is more obvious (As shown in Table 4).

Table 4 : Guarantee Institutions with Upgrade of Credit Rating from 2015 to December 2016

Corporation Name	Rating before Adjustment	Rating after Adjustment	Date of Adjustment
Shenzhen Small & Medium Enterprise Credit Financing Guarantee Group Co., Ltd.	AA	AA+	2015.7
Hubei Guarantee Group Co., Ltd.	AA	AA+	2015.10
Guangdong Financing Re-Guarantee Co., Ltd.	AA+	AAA	2015.9
China National Investment and Guaranty Corporation	AA+	AAA	2016.2
Anhui Credit Guaranty Group Co., Ltd.	AA+	AAA	2016.5
Jiangsu Re-Guarantee Group	AA+	AAA	2016.6

Source : Wind; compiled by United Ratings

For now, financial guarantee industry exhibits a relatively good credit profile and strong compensatory capacity. However, since the financial guarantee industry has not undergone the entire economic cyclic test, the credit quality of the industry and each guarantee institution remains to be further observed.

2. Industry Outlook

The bond guarantee business has a broad space for development, and the capital increase by state-owned guarantee institutions will continue. The industry will tend to concentrate further.

In 2016, due to the withdrawal of loan by banks and the rupture of enterprise's capital chain, the operating condition of enterprises in the market deteriorated, and the number of defaults increased. The significant changes in day-to-day operation of the enterprises highlighted the important role of guarantee institution in providing financial support for SMEs. Thus, government's support for guarantee institutions, especially for the state-owned guarantee institutions will continue to strengthen, and capital increase will continue. The interest rate of bonds guaranteed by the guarantee institutions in the market is generally lower than that guaranteed by non-guarantee institutions. Due to high market recognition, it is expected that the business volume of guarantee institutions will grow further.

The overall profitability of the guarantee institutions is relatively weak, and the overall compensatory capacity is still low. With the external credit risk mounting up, the repayment pressure

increased, calling for higher requirements for the compensatory capacity of guarantee institutions.

The overall profitability of the guarantee institutions is still low. With continuing of credit differentiation of quasi-municipal debt, and the fluctuation in the real estate market, the compensatory risk of guarantee institutions is also on the rise. 2019 will see the boom of guaranteed bond repayment, and 2023 will see the peak of repayment. Guarantee risk has been mounting up with the increase of maturity bonds and the impact of external credit environment. Since the compensation by guarantee institutions depend highly on the capital increase of their shareholders, the state-owned shareholders with strong overall strength and high comprehensive strength have played a positive role in withstanding the compensatory risk. It is expected that guarantee institutions engaged in bond guarantee business in market will still be dominated by state-owned ones. The compensatory capacity of the guarantee institutions has become the focus of attention with the increase of risk events.

The corresponding legal procedures for the bond guarantee business are still unsound, which is not conducive to the recovery after the compensation.

In accordance with the "Provisional Management Measures on Financing Guarantee Institutions" promulgated by China Banking Regulatory Commission and other six ministries, the financing guarantee liability balance of a financing guarantee institution shall not exceed 10 times of its net assets. As the business priority varies from institution to institution, the actual commitment to the guarantee liability balance varies greatly accordingly. If the guarantee business of financial products by guarantee institutions is measured with the uniform standard, the guarantee multiplier of

major guarantee corporations engaged in bond guarantee business will surpass the 10 times required by the regulatory institutions, or even reach 20 to 30 times, as the volume of bond in capital market mounting up. Since the guarantee multiplier calculated by the uniform formula could not reflect the real loss bearing capacities of different guarantee institutions, the risk weighing indicator on capital occupation by different products needs to be further unified, and the relevant evaluation system still is yet to be improved.

Western society has established a relatively sound credit system. In the event of bad records, individuals and institutions will bear the consequences and responsibilities, and those whose loan defaults will be punished severely by law. In contrast, "Provisional Management Measures on Financing Guarantee Institutions" jointly issued by China's seven ministries and commissions is not only with far weaker legal effect than relevant laws in developed countries, but also fuzzy in key provisions such as the ownership structure, financial compensation, risk sharing support system and operational rules, etc. The compensation behavior of guarantee institutions after default is still largely up to guarantee institutions' willingness to compensate.

Overall, under the influence of bond market expansion and preference of investors, direct financing guarantee for financial products will become one of the main businesses for guarantee institutions with strong capital strength. It is expected that the volume of bond guarantee business will further increase in 2017. As the phenomenon of breaking rigid payment after bond default gradually appeared, guarantee institutions will be confronted with great potential compensatory risk. In 2017, guarantee institutions will take risk control and reinforcing compensatory capacity as their priorities, which is conducive to the long-term business development. Taking the above factors into account, United Ratings assigns "stable" outlook for China's financial guarantee industry in 2017.