Office of the Comptroller of the Currency

ON POINT

ECONOMIC AND POLICY INSIGHT FROM THE OCC

Asian Corporate Bond Spreads May Not Reflect Underlying Risks

Corporate debt levels in emerging Asia have been growing rapidly. According to Bank of International Settlements data for 2020, 42.5 percent of all credit extended to the nonfinancial corporate (NFC) sector is to Asian economies; at roughly $34 trillion, that is equal to a third of global GDP. [1] China's corporate sector alone owes $24 trillion dollars—over $6 trillion more than U.S. corporations. Corporate credit as a share of China's GDP is 160 percent as of the end of 2020, exceeding the corporate credit share in most emerging and many advanced economies. The same is true for several other Asian economies, including Hong Kong, where corporate debt as a share of GDP is nearly 250 percent, even higher than in China.

Despite the accumulation of debt, average yields on Asian corporate bonds have generally fallen since the financial crisis of 2008, and before the COVID-19 pandemic there was little differentiation between credit risk spreads on U.S. dollar bonds by high-yield and investment grade issuers. At the onset of the pandemic, however, bond spreads rose sharply, especially on high-yield bonds. And although spreads have since retreated, spreads on U.S. dollar bonds issued by BB-rated Asian corporations remain well above spreads on those issued by their investment grade BBB-rated peers. This suggests that risks associated with high-yield bonds were higher than implied by pre-pandemic spreads, which tightened in an environment of accommodative global monetary policy. Going forward, credit risk on Asian corporate bonds may remain elevated; default risk on Chinese bonds was on the rise even before the pandemic, while shortening maturities point to refinancing risk. At the same time, a gradual withdrawal of monetary stimulus may help reduce downward pressure on yields and credit risk spreads.

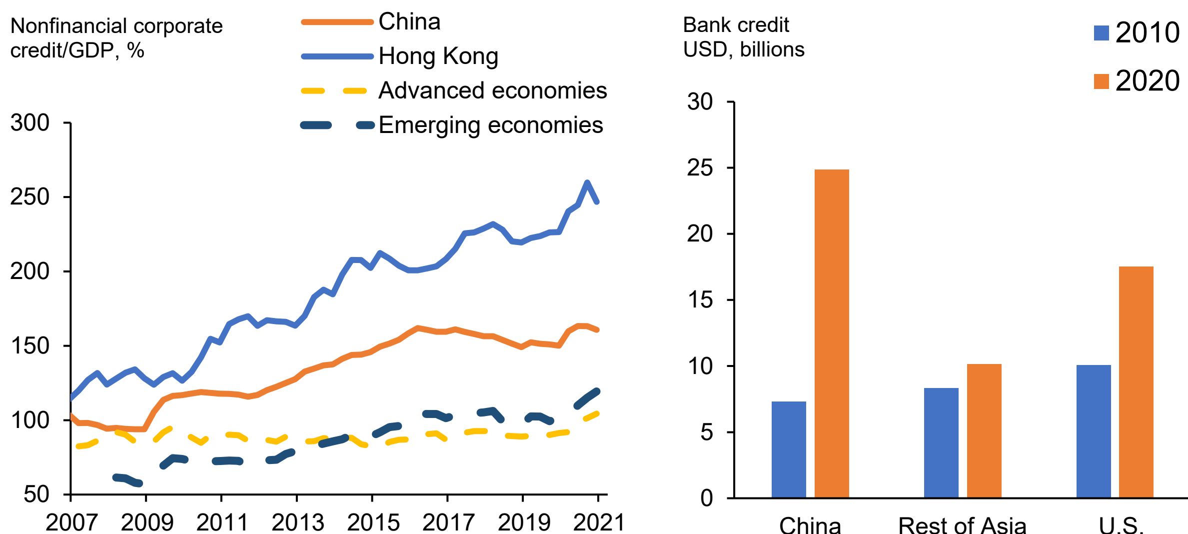
Rising Debt Could Translate to Increased Credit Risk

Higher debt levels have raised financial stability concerns, given that excessive credit growth has been a harbinger of financial crises in the past. In recent years, credit was readily available for corporations in many emerging market countries, as low interest rates in advanced economies prompted global investors to search for yield elsewhere. In some emerging market countries, domestic policies to promote economic growth further fueled credit expansion.

[1] Bank of International Settlements. Reporting countries for emerging Asia include: China, South Korea, Hong Kong, Singapore, Indonesia, Malaysia, and Thailand.

For example, Chinese NFCs, which accounted for less than half of debt owed by NFCs in emerging Asia in 2010, now account for 86 percent. Corporate debt is rising in other Asian economies as well, particularly in Hong Kong, which serves as a financial conduit for some Chinese corporations. In the fourth quarter of 2010, Hong Kong's NFC debt-to-GDP ratio was 154 percent, rising to 258 percent 10 years later—an even faster growth pace than China, as shown in figure 1.

Figure 1: Nonfinancial Corporate Credit Outpaces GDP Growth in Key Asian Economies, Partly Fueled by Bank Credit



Source: Bank of International Settlements (BIS), Haver Analytics
Note: As defined by BIS, emerging economies include China and Hong Kong as well as Argentina, Brazil, Chile, Colombia, the Czech Republic, Hungary, India, Indonesia, Israel, South Korea, Malaysia, Mexico, Poland, Russia, Saudi Arabia, Singapore, South Africa, Thailand, and Turkey. Advanced economies comprise Australia, Canada, Denmark, the euro area, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom, and the United States.

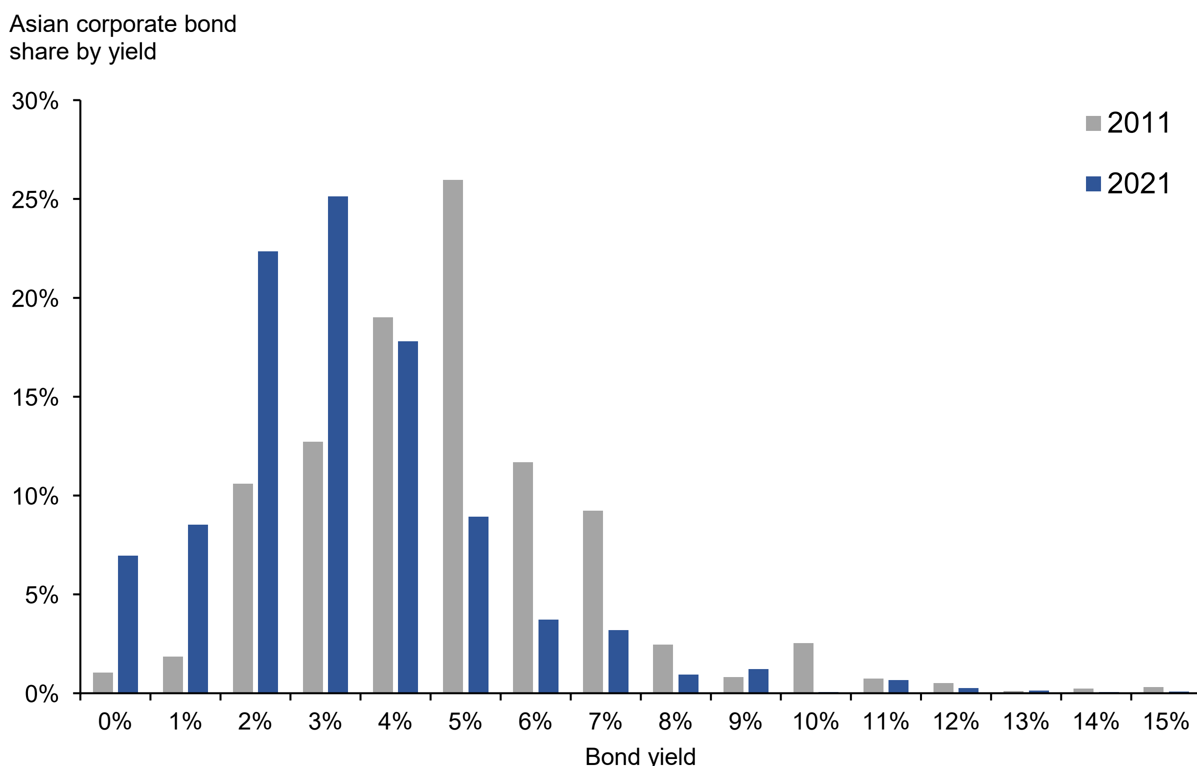
Much of Asia's corporate debt is owed to Asian banks. However, nonbank private sector investors, and international banks, are also exposed to Asian corporate credit risk, and several financial data providers include Asian corporate bonds in their U.S. dollar or local currency bond indexes (although inclusion of Chinese bonds is still evolving). U.S. banks have more than $1.2 trillion in exposure to Asian economies as of the first quarter of 2021, with 19 percent of that exposure to the corporate sector. In addition, if systemic corporate problems arose, U.S. banks would be exposed via loans and investment in Asian financial institutions.

Credit Risk Premiums: A Good Deal Until They're Not

Over the past 10 years, yields on corporate U.S. dollar debt from Asian issuers fell. Figure 2 shows that in 2011 almost 75 percent of U.S. dollar bonds outstanding yielded 4 percent or higher; in 2021 this was only 37 percent, while close to 20 percent yielded less than 2 percent.

The yield decline partially reflects the lower interest rate regime globally, but it is also driven by compression of credit risk spreads.[2]

Figure 2: Median Yield on Asian Corporate Debt Has Declined Since 2011



Source: Moody's Credit Edge

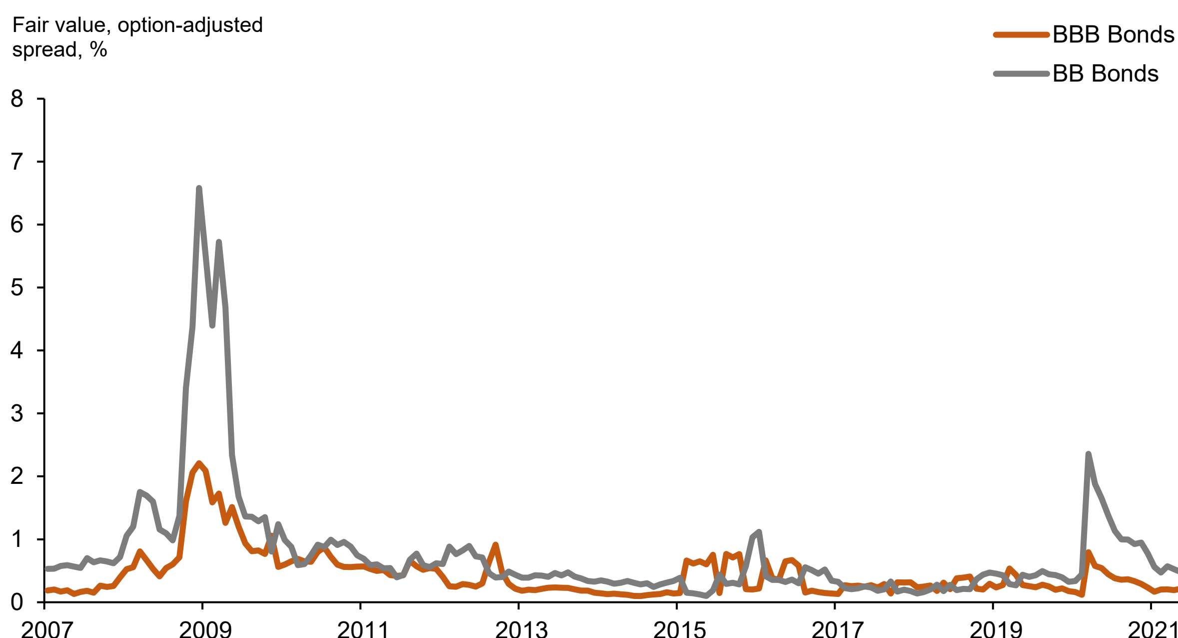
Credit risk spreads differ across borrowers and countries because of differences in expected loss, liquidity risk, maturity, and vulnerability to unexpected changes in economic conditions such as the COVID-19 pandemic. In addition, credit risk spreads include a credit risk premium that reflects the additional yield required to induce investors to buy the bond and assume the default risk on their balance sheets. The risk premium cannot be measured exactly, because ex ante we can only approximate metrics such as expected loss. However, we can track the evolution of estimated credit risk premiums by calculating the difference between observed spreads and an estimate of "fair value" spreads based on credit fundamentals of the corporation.

Figure 3 shows credit risk premiums for BBB and BB bonds calculated on the basis of Moody's fair value option-adjusted spread. Compression of credit risk premiums hovered around 30 basis points, particularly from 2013 to 2015 and from 2017 to 2019. In addition, the figure shows convergence of premiums on investment grade bonds and high-yield bonds issued by corporations in Asian emerging markets. However, during systemic events such as the financial crisis of 2008-2009 and the COVID-19 pandemic, credit risk premiums on high-yield bonds

[2] Credit spread is the difference between the bond yield on a bond and the risk-free rate for an equivalent maturity structure.

widened much more than the premiums for investment grade bonds, imposing losses on holders of high-yield bonds.[3]

Figure 3: Risk Premiums for High-Yield and Investment Grade Bonds Diverge During Times of Market Stress, but Are Otherwise Compressed



Source: Moody's Credit Edge
Note: the lines represent the means (after removing the 1% lowest and highest observations) of option-adjusted spreads minus fair value spreads for bonds rated BBB and BB.

Rating Downgrades Represent Weaker Earnings

Higher-risk premiums for BB bonds reflect expectations for weaker corporate capacity to service debts as revenue declines. The revenue declines were exacerbated by the pandemic in 2020. In the decade leading up to the pandemic, low interest rates and steady economic growth buoyed firms' sales and profitability, which permitted debt servicing ratios to remain relatively stable as debts accumulated. However, Fitch Ratings now expects aggregate revenue for its Asia-Pacific (APAC) portfolio to be 7 percent lower in 2021 compared with its pre-pandemic forecast for 2021.[4] Post-pandemic forecasts for APAC leverage ratios increased almost twofold for high-yield issuers and by half for investment grade issuers. With an uncertain economic outlook and the possibility of eventual monetary policy tightening, firms would face refinancing risks and higher borrowing costs.

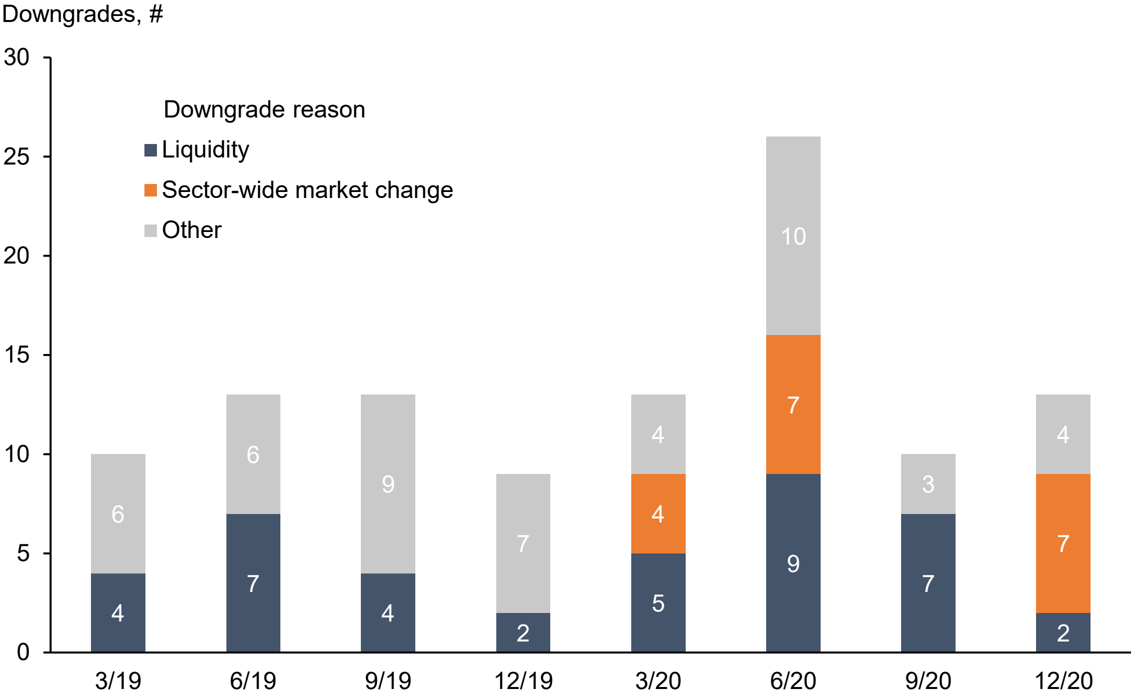
The number of Asian corporate rating downgrades increased in 2020. While some downgrades were due to idiosyncratic risks of individual companies, a large portion were a direct result of stress related to the pandemic and the associated lockdowns. Fitch downgraded 61 Asian corporate issuers in 2020 (up from 45 in 2019) citing worsening liquidity, sector-wide market

[3] The same pattern is visible for observed option-adjusted spreads (i.e., without subtracting fair value spreads).

[4] Fitch Ratings, "Pandemic Progress Check: APAC Corporates," November 11, 2020.

changes, and weaknesses of individual companies. Even as the impact of the pandemic wanes, there are several factors that point to a persistent increase in credit risk compared with pre-pandemic levels. For example, default rates in bonds issued by Chinese corporations had already started to increase in 2018 and 2019, which may point to a gradual normalization of default rates from levels that were previously below international averages.[5] Chinese corporations will also face higher refinancing risk as maturities of newly issued onshore bonds have fallen.[6]

Figure 4: APAC Corporate Downgrades Driven by Pressure From Pandemic-Related Lockdowns



Source: Fitch Ratings Report, "APAC Corporate Rating Action Heat Map: Fourth Quarter 2020"

The Point?

The widening of credit risk spreads on Asian corporate bonds beginning in early 2020 shows that the convergence of high-yield and investment grade spreads before the pandemic was not justified in light of differences in the underlying risk of issuers.

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[5] S&P global ratings, "China Bond Defaults 2021: More Tolerance For Bigger Hits," June 2021

[6] Bloomberg News, "China Braces for $1.3 Trillion Maturity Wall as Defaults Surge," May 23, 2021