



China’s financial markets have recently experienced heightened volatility on the back of regulatory changes in several key sectors, such as real estate, the internet and education. In this investment note, Fiona Cheung, Head of Global Emerging Markets Fixed Income Research, details the genesis of these changes and highlights key issues that investors should be aware of moving forward. With access to both onshore and offshore insights, Fiona and her team also believe the government’s implementation should be viewed as a positive for China’s long-term socio-economic development.

China credits on-the-ground: Observations on China’s shifting regulatory environment

Overall, we view the increased scrutiny on sectors such as real estate, the internet, and education as part of the Chinese government’s initiative to address the concerns of its citizens. With notable market movements over the past week, credit spreads moderately widened in some impacted sectorsⁱ. We believe the macro impact of these regulatory moves should be insignificant for China’s second-half 2021 GDP and beneficial for China’s long-term socio-economic development.

First, a look at recent regulatory developments. Recent announcements went beyond the expectations of many market observers but were not a complete surprise. We believe that investors should pay close attention moving forward, as the regulatory environment may experience further changes.

Backdrop for regulatory policy changes

Having said that, we also believe investors need to understand the policy reasons behind these notable changes. Indeed, since 2017 the government has shifted its top economic priority from promoting quantitative growth to encouraging more tangible

qualitative outcomes. That is, economic development should result in greater benefits for the every-day lives of citizens as opposed to merely chasing impressive headline GDP figures. Building off this framework a key goal of the recent regulatory changes is to mitigate a now shrinking national population through decreasing costs related to education, promoting family formation. The government has previously expressed concerns over potentially harmful social consequences in the following areas:

- **After-school tutoring:** Data from the 2020 population census highlighted the risk of a rapidly ageing population and the prohibitive costs of raising a family. Education expenses, particularly after-school tutoring, is a significant factor for many families to consider when having children. The legal basis of the recently released Double Reduction education policyⁱⁱ started in 2018 and involved different stakeholders in the drafting process. The legal framework was finalised three months ago and released in late July.
- **Food-delivery riders:** Since September 2020, articles on the safety risks associated with food-delivery riders circulating on the internet led to a society-wide discussionⁱⁱⁱ. Almost a year later, on 26th July, the State Administration for Market Regulation (SAMR)^{iv} and six other departments jointly issued detailed guidelines on protecting food-delivery riders’ rights and interests.

- **Internet:** Since China's regulators halted an IPO last year, China's regulators have placed internet names under increased surveillance. In the past two weeks, the regulations on China's internet sector have significantly escalated^v. The areas under scrutiny relate to banking, anti-trust regulation (the nation's law went into effect in 2008), data security, and social equality. We anticipate that greater oversight of the Chinese internet sector will continue; however, if the companies involved comply and work with the government, regulatory overhangs should be manageable. Also, risks relating to the variable interest entity (VIE)^{vi} structure should be more on a case-by-case basis than broadly structural.
- **Real estate speculation:** Starting in 2016, "Houses are for living, not for speculation" has been reiterated at numerous high-ranking government meetings. Since then, policies intended to curb real-estate speculation have been introduced (except due to the COVID-19 pandemic last year). The "Three Red Lines" rules, as well as other tightening measures would curb speculation (by taking excessive leverage) on both the physical market and property developers' side^{vii}.

Policies promote long-term socio-economic development

In our view, the short-term impact of the new regulations shouldn't materially affect China's second-half economic growth trend this year. Over the longer term, it could have a positive effect on the social and economic development of the country and key sectors:

- **Education:** While the regulation update on the after-school tutoring sector is extensive, this is believed to be a relatively small segment of the economy: approximately 0.7% of China's 2019 GDP^{viii}. We think the government will take a gradual approach during the transition period. The sector employs many highly educated tutors, many of whom are recent university graduates. Additionally, front-loaded payments are typical for after-school education, which could lead to extensive financial losses.

Over the long-term, we believe the regulatory changes in the sector could help alleviate the high costs of education and raising kids for the middle class, free-up more consumption spending power, and foster a more diverse education environment, as non-school curriculum tutoring businesses will still be allowed.

- **Internet:** New regulations on the internet sector should have limited macro impact, as they mainly deal with improving employee benefits, cybersecurity, and curbing monopolistic power. Enhancing protection for employees and customers may lower the overall social risks associated with the sector. A reduction in the monopolistic tactics of internet platforms should also foster market competition and spur economic innovation.

From a credit perspective, China's internet names will be structurally challenged in terms of medium-to-long-term growth and profitability, as they now face additional headwinds to leverage their market dominance and grow across industries. Given the ongoing headline risks, we expect to see higher volatility in bond performance in the China internet sector.

- **Real estate:** The curbing of speculation in the real estate sector should be manageable for the financial system, providing greater long-term development prospects. The average mortgage-related loan-to-value ratio (LTV) in the Chinese banking system is around 50%, and the excess leverage from shadow banking and P2P lending has reduced in the past few years. In addition, the People's Bank of China conducted rounds of real estate-related stress testing for the banks in the second half of 2020 to ensure the system can weather a potential correction.

[In a recent outlook](#), we observed that developers with ample land reserves and access to diversified funding channels in both onshore and offshore markets should be in an advantageous position.

Conclusion: Recurrent volatility in financial markets is always unnerving for investors. However, in this case, we believe that investors should understand the genesis and reasoning behind the changes. More importantly, we believe these policies should bolster China's socio-economic environment and help investors looking for attractive risk-adjusted returns over a longer time frame.

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ⁱ As of 30 July 2021, Manulife Investment Management. Chinese internet credits have been relatively well-behaved: benchmark China IG internet bonds widened around 15-20 basis points over the week, with high-beta China IG widened around 50-60 basis points.

ⁱⁱ 24 July 2021, a set of guidelines to ease the burden of excessive homework and off-campus tutoring for students undergoing compulsory education was jointly issued by the General Office of the Communist Party of China Central Committee and the General Office of the State Council.

ⁱⁱⁱ A study published in the Chinese labor security magazine, *Laodong Baozhang Shijie*, shows that 84 percent of delivery staff work more than 10 hours daily. Delivery workers in Beijing, for example, spend on average up to 11.4 hours every day on the job. This piles up risks of them suffering from overwork.

^{iv} On July 26, 2021, the State Administration for Market Regulation (SAMR) and six other departments jointly issued detailed guidelines on protecting food delivery riders' rights and interests, such as mandatory injury protection insurance, flexible employment, and ensuring local minimum income.

^v Other internet-related regulations include: 1) The Data Security Law, set to become effective on September 2021, will have more regulatory oversight on companies that possess a significant amount of personal privacy data, and their businesses are related to Critical Information Infrastructure. 2) The Cyberspace Administration of China (CAC) announced a cybersecurity inspection on certain ride-hailing platforms in early July soon after the IPOs of a few concerned companies in the US. In fact, the "Measures for Cybersecurity Review" – aim to ensure the security of critical information infrastructure and safeguard national security, has already been in effect since June 2020.

^{vi} Holding companies entitling foreign owners to the economic benefits flowing from Chinese companies but limiting their control of the business.

^{vii} The People's Bank of China and the Ministry of Housing announced in 2020 that they'd drafted new financing rules for real estate companies. Developers wanting to refinance are being assessed against three thresholds: a 70% ceiling on liabilities to assets, excluding advance proceeds from projects sold on contract, a 100% cap on net debt to equity, a cash to short-term borrowing ratio of at least one.

^{viii} Bloomberg, 27 July 2021.