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Low-calorie loans: How bankers' acceptances are undermining the impact of credit growth

China's credit growth bounced backed in May. However, that improvement was far less stimulatory than a typical uptick in credit. That's because discounted bankers' acceptance drafts (BADs) – a key form of very short-term bridge financing – accounted for a disproportionately large share of new credit in the month.

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Key takeaways

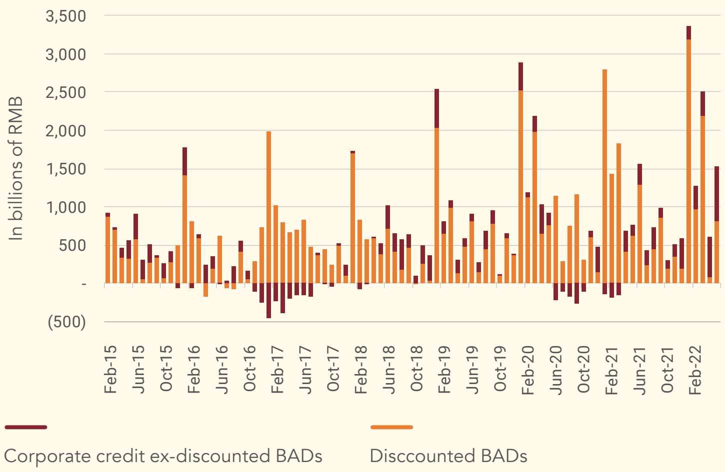
- Indeed, in April and May, discounted BADs increased by RMB 1.2 trillion. That's 30% more than new short-, medium-, and long-term loans combined, which rose by only RMB 902 billion in those two months.
- That matters because medium- and long-term loans, in particular, are the types of credit typically able to help stimulate economic activity.
- Meanwhile, BADs are little more than a liquidity management tool for firms. They can help companies stay solvent but don't contribute to economic growth.
- Indeed, banks have traditionally accelerated BAD discounting when they're under pressure to lend but don't want to. This allows them to inflate their headline lending numbers while preserving capital and meeting official demands that they extend more credit to small firms.
- Banks can entice firms to discount their BADs by dropping the discount rate. The weighted average discount rate peaked at 3.52% in the first quarter of 2021. It subsequently fell to 2.18% in Q4 2021, before rebounding to 2.40% in Q1 2022. Q2 data is yet to be published, but we expect rates fell again over the last three months.
- Beijing needs banks to retrench their discounting activity and ramp up medium- and long-term lending. But for that to happen, new state-led investment opportunities need to emerge. Until viable investment opportunities manifest in sufficient volume, banks will continue to try and balance competing goals by using these low-calorie loans.
- This dynamic will only continue to undermine Beijing's already-lackluster attempts at demand-side stimulus of the economy.

China's credit growth bounced back in May, albeit from a fairly abysmal growth rate in April. Net new bank loans were RMB 1.89 trillion, higher than the forecasted RMB 1.3 trillion, and credit growth was 10.5% y/y, up from 10.2% in April.

And importantly, despite the small uptick, off a low base, there's even less here than meets the eye. Indeed, discounted bankers' acceptances – a key form of very short-term bridge financing – accounted for 46.7% of new corporate credit in May. Meanwhile, medium- and long-term loans were only 36.4%.

This phenomenon isn't limited to May. In April and May, discounted bankers' acceptances increased by RMB 1.2278 trillion, 30% more than new short-, medium-, and long-term loans combined, which rose by only RMB 901.68 billion [Fig. 1].

Fig. 1 – Newly discounted BADs relative to increase in other types of corporate credit



Source: PBoC, Trivium

That matters because it's medium- and long-term loans that help finance genuine economic activity. Discounted bankers' acceptances drafts – which the PBoC calls "bill financing" and which we'll refer to as discounted bankers' acceptance drafts (BADs) – are little more than a liquidity management tool for firms. They can help firms stay solvent, but don't contribute to economic growth. In fact, banks have traditionally accelerated BAD discounting when they're under pressure to lend but don't want to. It's their way of inflating lending data with short-term, low-risk credit – which does very little for the economy.

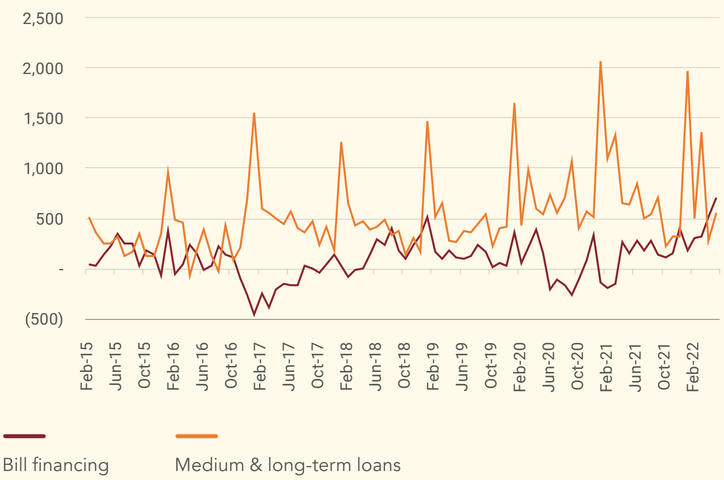
For China's growth to accelerate, banks need to discount fewer BADs and ramp up medium- and long-term lending. That could happen in June as new infrastructure projects come online. However, it's far from certain to happen. Indeed, it has been widely reported that firms currently just aren't willing to borrow, which is understandable given weak consumption and the threat of further COVID-19 lockdowns. For the same reasons, banks are reluctant to lend.

All that said, data on discounted BADs can be pretty volatile, so it's possible that new discounting could decline or even contract in the months ahead. Still, for that to happen, the message from Beijing must not just be "more credit," which the banks have heard loud and clear and have responded to by using BADs to fulfill the letter but not the spirit of what's been asked of them. Instead, state-led investment projects need to start coming online in increasing volume. Beijing has been pushing local authorities to do just that, so the June credit data could well meaningfully Improve. However, in our view, the overall volume of new projects will take time to ramp up, so we could still see another month or two where the loan data is padded with low-calorie lending.

Understanding bankers' acceptances

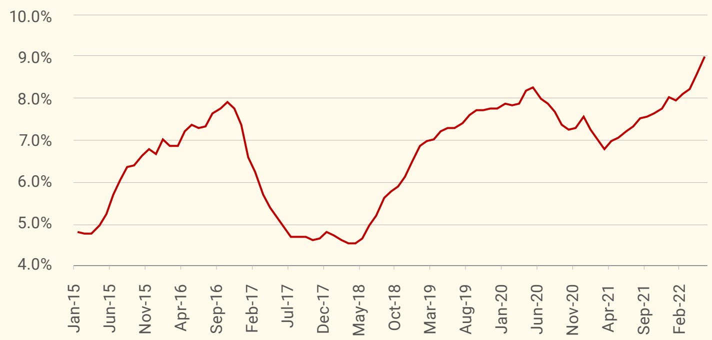
What concerns us is that May saw the single biggest ever m/m increase in discounted bankers' acceptances since the central bank (PBoC) started publishing detailed data in 2015 [Fig. 2]. Banks have unquestionably been leaning more heavily on discounted BADs over the last couple of months. Consequently, discounted BADs' share of total outstanding corporate loans has been inching upward, hitting 9.0% at the end of May, a record high [Fig. 3].

Fig. 2 – Month-on-month change in corporate credit



Source: PBoC, Trivium

Fig. 3 – Discounted bankers' acceptances as a percentage of total outstanding corporate credit



Source: PBoC, Trivium

Moreover, bankers' acceptances are one of the least understood parts of China's financial system. Most of the time that doesn't matter, as they usually account for a relatively small part of overall credit. However, at certain times they become central to commercial banks' short-term lending strategies – and now is one of those times.

To understand the implications of this shift, it's essential to know how BADs are used in practice. When a company sells a product to another firm, it can either demand cash upfront from the buyer or offer terms – that is, it can agree to accept payment at some later date. For many companies, offering payment terms is a vital part of their business, allowing them to boost sales and remain competitive. But by accepting payment in the future, companies face credit and liquidity risks.

Credit risk is the risk that the buyer will no longer be in business when the bill comes due or is otherwise unable – or unwilling – to pay its debt. Liquidity risk arises when a seller, while waiting for the bill to be paid, finds that it has insufficient cash to sustain its operations. Consequently, the seller might have to lay off employees, sell assets, or even shut down entirely – even though, on paper, its profits might look quite robust.

BADs insert a bank between buyer and seller as counterparty to both. The BAD is essentially a promise by a bank that when payment comes due, it will pay the supplier the amount owed. The bank will then seek payment from the buyer.

BADs deal with credit risk by shifting responsibility for payment onto a bank. In China, where all banks are assumed to be implicitly backed by some level of government, a bank's promise to honor its BADs is broadly perceived as relatively risk-free. Hence, BADs effectively remove the credit risk associated with selling goods on terms.

BADs also help companies deal with liquidity risk because they are transferable and tradable. If a company that has been paid with BADs finds itself short of cash, it can use the BADs to pay its suppliers. Those suppliers can then use the BADs they have received as payment to pay their suppliers, and so on and so on. As such, a BAD can be passed along the supply chain multiple times – and whoever holds the BAD when it matures can redeem its full face value in cash by presenting it to the bank that issued it.

Discounting and corporate credit

More importantly, BADs can also be discounted. Discounting occurs when a BAD is presented at a bank – or some other financial institution – and exchanged for cash before its due date. When this happens, the bank pays less than the full face value of the BAD – which is to say that it acquires the BAD at a discount. When the BAD matures, the bank that acquired it at a discount can redeem the full face value upon presenting it to the issuing bank.

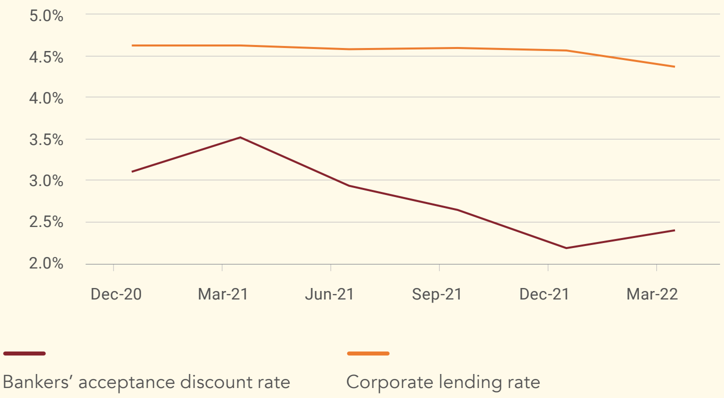
Bankers' acceptance discounting is technically a type of trade finance, but it works in a way that's not dissimilar to a low-interest payday loan. It's a way for firms to get cash for sales they've already made, but for which payment from the customer is pending. In 2017, the last period for which we have data, nearly 84% of the funds extended by banks from discounting went to small- and medium-sized firms (SMEs) – a group largely made up of private companies that are most likely to run into cashflow issues in times of economic and financial stress.

As a rule, companies don't like discounting their bankers' acceptances. Many Chinese firms operate on wafer-thin margins, and discounting erodes their profits. What's more, in a slowing economy, there's little scope to pass the cost of discounting on to customers through higher prices. Still, sometimes companies can't avoid it, and so the willingness of companies to massively increase discounting over a short period partly reflects their need for cash – but it also reflects changes in the discount rate.

By adjusting the rates they are willing to offer on discounted BADs, banks have been able to ramp up discounting activity over the past year. Unfortunately, the PBoC only publishes quarterly data on the discount rate banks charge their customers. The latest data indicate that the weighted-average discount rate for BADs peaked at 3.52% in the first quarter of 2021. It subsequently fell to 2.18% in Q4 2021, before rebounding to 2.40% in Q1 2022.

Notably, even as discount rates dropped by a third throughout last year, lending rates on corporate rates remained basically unchanged. Indeed, the quarterly weighted-average interest rate banks charged on corporate loans barely moved over the period, hovering around 4.60% until Q1 2022, when it fell to 4.36% following reductions in the loan prime rate (LPR) in December 2021 and January 2022 [Fig. 4].

Fig. 4 – Quarterly weighted average interest rates



Source: PBoC, Trivium

The reason that banks have been so willing to drop the discount rate, especially in comparison to very stable corporate lending rates, is that while discounted BADs are classified by the PBoC as being corporate loans, they are, in effect, interbank loans. When a bank discounts a BAD, the cash goes to a company, but the bank's real counterparty – that is, the party that will pay out the BAD at maturity – is the bank that issued the BAD. Consequently, discounted BADs are treated by the authorities as being relatively safe assets. The amount of risk-adjusted capital banks have to hold against BADs is only 20% or less, depending on the maturity of the BAD – which is far lower than the 100% capital requirement for ordinary corporate loans.

Under normal circumstances, banks don't like discounting BADs because the discount rate on BADs is typically lower than the interest rate on conventional loans – reflecting lower risk. As such, discounting reduces a bank's profits in good times, so under normal circumstances, banks often try to deter companies from presenting BADs for discounting by wrapping the process in red tape.

However, discounting BADs currently allows banks to balance competing demands. At present, banks are under pressure from policymakers to ramp up lending to small firms that have been hit hard by COVID-related lockdowns. But in a slowing economy, lending to small firms – widely acknowledged as being the riskiest group of borrowers in the economy – is likely to be a drag on banks' asset quality. By discounting BADs – most of which are presented by small firms – Chinese commercial banks can check the box of distributing more resources to SMEs while conserving capital and preserving asset quality.

Conclusion

Discounting BADs is a way for banks to meet multiple political objectives. It's technically a way to provide small firms with credit. It's also a way to ramp up lending – as policymakers have requested – in an environment with weak demand for medium- and long-term loans. Finally, it's also a way to preserve capital and maintain asset quality in an environment where lending is increasingly risky.

However, this type of lending undercuts Beijing's already-timid attempts to boost the economy through demand-side support measures. As such, officials will need to look beyond traditional credit stimulus – and lean more on fiscal policy and administrative measures to get local governments to ramp up state-led infrastructure investment, which they are indeed starting to do.

Ultimately, then, getting banks to wind back their BAD discounting will require a significant increase in the emergence of attractive, state-led lending opportunities. So while we expect the balance between discounted BADs and medium- and long-term loans to improve in favor of the latter in June, it will only be the first step. It will be several months before the lending balance returns to normal – which will further hamper the expected recovery of China's economy in H2 2022.