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Credit FAQ:

The Contraction Of China's Private Credit Market

April 15, 2025

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Key Takeaways

- China's private credit market has significant structural differences from those in the U.S. and Europe. It lacks alternative investment funds and direct lending, is heavily regulated, and banks remain key players.
- We estimate the China market has shrunk to RMB21 trillion as of Dec. 31, 2024, nearly half its size since 2017. The decline comes on the back of new regulations, increased competition from local bond markets, and compressed margins.
- A combination of softening demand and disruption in supply from lenders will likely lead the overall size of the private market to further contract.

To the world outside its borders, China's private credit market often comes across as an enigma.

Since its inception and formalization following the global financial crisis, private funding in the world's second largest economy has largely operated within its own domestic borders, under a structure and governance that differs substantively from how the U.S. and Europe have defined private credit.

Foreign participants are few and far between, the market is heavily regulated compared with those of the U.S. and Europe, and borrowers and lenders alike face curbs on both the magnitude of debt and where they can place investment funds. This means the route to and from private credit isn't always straightforward.

Over the past seven years, the Chinese private credit market has significantly declined amid robust competition from local bond markets and compressed margins, which make the risk-reward ratio far less appealing.

In this Credit FAQ, subject matter experts from S&P Global Ratings and S&P Global (China) Ratings answer key questions about the evolution of China's private credit space, what sets it apart, and the outlook for 2025 and beyond.

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What Is Private Credit In China, And How Does It Differ From The West?

In China, private credit is typically defined as non-standard debt. Similar to the U.S. and Europe, the market provides an alternative means of funding to borrowers who are otherwise unable to gain credit from traditional funding outlets. And like in the West, non-standard debt funding typically has higher rates than public bond markets.

However, unlike in the West, China's non-standard debt market is highly regulated. Chinese non-standard debt lenders are subject to the same requirements of all financial institutions in the country, which means they need a license to operate, must meet qualifying conditions, and are required to regularly disclose key information such as capital investment figures, income distribution, and net product value.

China's regulator, the National Financial Regulatory Administration, also stipulates which entities can participate in its private credit market and sets limits on how much any one entity is allowed to lend or borrow.

But perhaps one of the most prominent differences is that intermediaries in the Chinese market are almost always investor vehicles (i.e., funds launched by the investors themselves), and apart from a few exceptions, there is a distinct lack of alternative investment fund vehicles and direct lending.

Banks and government entities also remain key players in the non-standard debt market in China, contrasting with how the West defines private credit traditionally within the nonbanking financial institutional space.

How Do You Estimate The Size Of China's Non-Standard Debt Market, And Who Are The Major Lenders And Borrowers?

Due to the paucity of private markets data in China, S&P Global (China) Ratings approximates the size of the non-standard debt market by measuring the total investment flows into the main product types.

We've based our estimates of investment flow on data from local domestic market sources, including the People's Bank of China (PBOC) and industry associations. These suggest the size of China's non-standard debt market as of 2024 at RMB21 trillion (U$2.89 trillion) as of year-end 2024. In contrast, we estimate the size of the standardized debt market within a corporate finance framework, at RMB33 trillion for 2024.

We derive our estimates from the value of cumulative product investments among the three largest owners of investment sources into non-standard debt products (namely trust funds, insurance funds, and banks' wealth management products), which represent the key investors of non-standard debt in China.

Among these, trust funds hold the lion's share (at 53.7%) of China's overall non-standard debt asset investments. Funds raised by insurance companies and commercial banks are not permitted by regulators to invest more than 35% and 10%, respectively, of their total investment portfolio in non-standard debt assets.

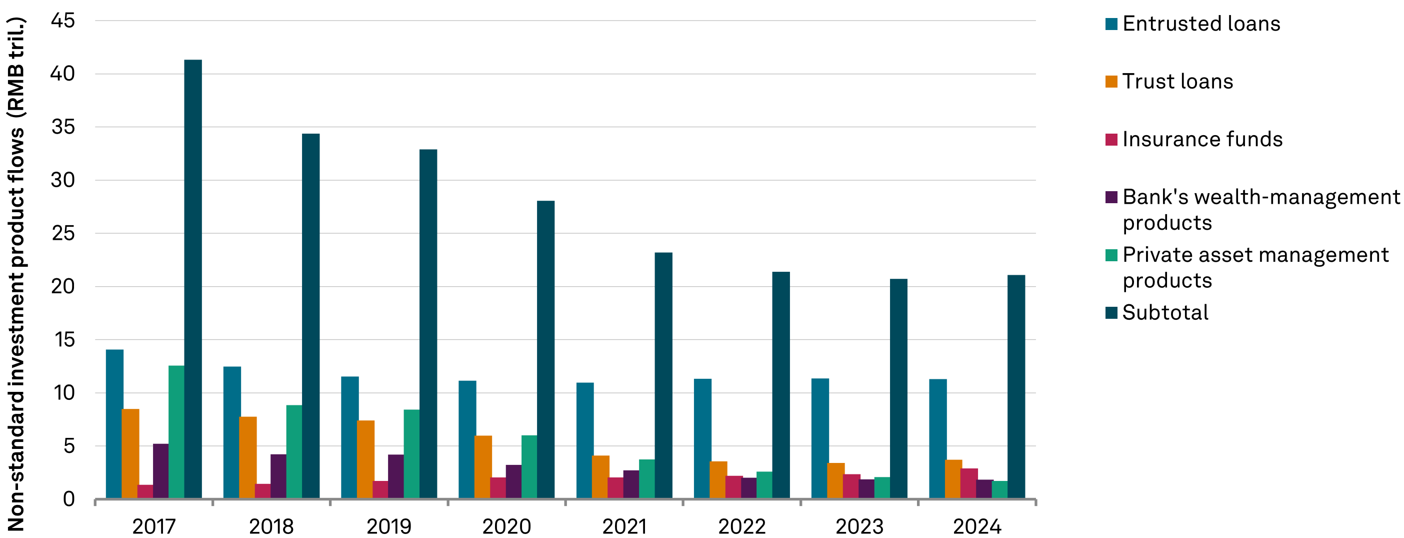
As such, insurance and bank funds are typically raised through commercial banks' wealth management products, trust funds raised by trust companies, and long-duration funds raised by insurance companies.

Major borrowers are largely local government financing vehicles (LGFVs), real estate developers, and small and midsize enterprises (SMEs). The profiles of these private credit borrowers have materially changed, however. Real estate developers have historically been primary players, but that's no longer the case because of a significant slump in the Chinese real estate sector in recent years, alongside prominent defaults by private developers.

Demand for funding is now predominantly driven by LGFVs, certain manufacturing enterprises, and central/local state-owned enterprises. This also mirrors the funding structure in the public bond market in China.

China's major non-standard debt flows ebb with increased regulation

From 2018, new regulations have driven investment flows into non-standard debt products lower



Sources: People's Bank of China (PBOC), S&P Global (China) Ratings, S&P Global Ratings.

What Types Of Debt Products Exist Within The Chinese Capital Market?

According to China's Standard Debt Assets Classification Rules, standard and non-standard debt assets are differentiated based on the adequacy of information disclosure:

- Whether the issuer is obliged to repay investors with cash or financial instruments;
- The availability of liquidity mechanisms, equity and trading options; and
- Whether trading is on the interbank market or stock exchange market.

Such classifications are verified by the central bank. These rules were jointly published by the PBOC, National Administration of Financial Regulation, and other ministries in 2020.

Non-standard debt products include money trusts initiated by trust funds, insurance investment plans originated by their asset management functions, banks' wealth management products, small- and medium-size debt products associated with debt asset exchange and rights of benefits transfer, and debt and claim financing plans traded on the Beijing Financial Assets Exchange. Parts of the domestic corporate bond markets could also potentially be defined as private credit, but official statistics documenting their classifications are not evident.

How Does The Profile Of Borrowers In China's Non-Standard Debt Market Compare With Borrowers In The U.S. Private Credit Market?

Spanning both small and large borrowers, the spectrum of borrower profiles in China and their underlying credit qualities are not too dissimilar from those in the U.S. But the types and motivations of large corporate borrowers, which are a growing segment of private markets, vary between the two regions.

In both markets, SME private companies have long been the staple borrower. In the U.S. over the past decade, private credit has scaled up in size and sophistication, with an increasing number of large corporates (greater than $50 million in EBITDA) having raised capital through private credit. These large corporate private companies traditionally would have accessed broadly syndicated loans (BSLs) and the direct lending markets or even high-yield bond markets for funding.

Yet the trend for large U.S. corporate borrowers turning to private credit accelerated during the transition to higher-for-longer interest rates in 2022-2023. Since then, they have retained interest in funding via private markets as a strategic alternative to public markets. This is true for both performing and distressed borrowers. However, these participants are still primarily speculative-grade companies.

The borrowers in the non-standard debt market in China are smaller firms with riskier profiles and fewer assets. They face difficulty accessing the public bond markets but can also include some large companies with high credit quality.

These large companies seek funding in China's non-standard debt market because they have large funding needs, which cannot be sufficiently met by bank loans. This is because banks are subject to regulatory requirements that cap their exposure to individual clients, limit concentration levels in any one industry, require them to meet capital adequacy standards, and limit their public bond financing.

Furthermore, some of these borrowers, such as real estate companies, which recently faced a downturn, may also be restricted from raising any incremental debt in the open market. The banks, however, can provide additional funding to the non-standard debt market via their investments in trust funds.

The private debt market in the U.S. is often associated with corporate lending (and is now seen branching into asset-based, infrastructure, and other types of funding). In contrast, borrowers of non-standard debt in China already include a diverse and largely non-corporate group. These borrowers are generally LGFVs, real estate developers, and central/local state-owned enterprises, and they have differing credit risks.

Another key difference is in the size of the funding groups. As private credit has scaled up in the U.S. in the past decade and increased its capacity to fund large corporates, the funding structure remains bilateral or limited to a small group of participants. In China, this is not the case--the routes to funding are fixed due to regulation and often borrowers are affiliated with the government or state in one way or another.

How Has The Regulation Of The Non-Standard Debt Market In China Evolved?

The non-standard debt market in China has changed materially over the last seven years.

Prior to 2018, the market saw rapid and unrestrained growth, leading to a total market size of over RMB100 trillion (US$15 trillion) as of year-end 2017.

At that time, "regulatory arbitrage" (or market players attempting to capitalize on regulatory loopholes) was a frequent feature as the same categories of debt products were subject to different sets of regulatory rules and standards. Some products were constructed with multiple layers, generating tremendous underlying risks. Implicit payment guarantees were prevalent, resulting in an unregulated nonbanking system that was birthed out of the conventional banking system.

These dynamics created substantive challenges for regulators to retain macroeconomic and prudential oversight over China's private credit market. Market misbehavior also substantially raised financing costs and increased the likelihood of cross-sector and market spillover effects. Almost all credit defaults in recent years have surfaced from the non-standard debt sector, significantly escalating their associated credit risks.

The introduction of regulation in 2018 marked a key inflection point for the non-standard debt market's development when PBOC and ministries published "The Guiding Opinions on Regulating Financial Institutions' Asset Management Business" (also known as 2018 No. 106 document, or "The Opinion" for short).

Aimed at strengthening product compliance and preventing the uncontrolled burgeoning of financial risks, these rules set unified requirements for investments in non-standard debt products in terms of investment quota, liquidity, and maturity matching, and restricted off-balance-sheet lending instruments on the product side. Because of the implementation of this regulation and the decline in the real estate sector, the overall size of the non-standard debt market decreased rapidly, shrinking to nearly half the size seen in 2017.

From A Risk Management Perspective, What Are The Differences Between Standard And Non-Standard Debt Products?

Risks in non-standard debt products are primarily mitigated by collateral repossession. Excluding borrowers with strong credit quality, non-standard debt products get credit enhancement through guarantees and collateral. Non-LGFV enterprises, such as real estate developers, mainly receive credit enhancement by setting land parcels and properties aside as collateral. As such, their recoveries are primarily realized through collateral disposal, whereas recovery for standard debt products is mainly via litigation.

The recent real estate downcycle and successive outbreaks of default among developers have exacerbated the challenges in the recovery process, as asset disposal could now span three to seven years.

What Is S&P Global (China) Ratings' Near-Term Outlook For China's Non-Standard Debt Market?

S&P Global (China) Ratings believes a combination of softening demand and disruption in supply from lenders will likely lead to a further contraction in the overall size of the non-standard debt market in China.

Demand for non-standard debt products has shrunk amid ample supply within the Chinese capital market, and a downward trend in central bank rates. LGFVs and central state-owned enterprises are widely expected to increasingly seek financing from the bond markets, fueled by regulatory requirements that lower funding costs for bonds and constrain incremental debt. In addition, private developers that previously buoyed strong demand for non-standard debt issuance will see that curtailed on the back of an uptick in defaults.

On the supply side, lenders are seeing a mixed situation. There is solid demand from insurance funds, which typically have long duration, low costs, and need to be matched with assets with a similar maturity that yield higher returns. The proportion of non-standard debt investments held by insurance funds is relatively small and far below the regulatory cap, indicating that there is still room for further growth in this segment.

Meanwhile, S&P Global (China) expects trust funds to see the scale of their investments curtailed further as regulators require that the proportion of non-standard debt products in overall collective trust investments do not exceed 30%.

How Are Market Participants Navigating The Current Headwinds?

In China's non-standard debt market, additional value is placed upon borrowers' willingness to repay debts on top of their fundamental credit risks. China's public bond market and non-standard debt market differ greatly when it comes to the impact of defaults on borrowers' reputation and refinancing capabilities. Thus, the number of defaults in China's public bond market remains small.

If an entity borrows money in both markets, it is more likely to selectively default first on its non-standard debt agreements while still honoring its public bond obligations, to protect its reputation. This means borrowers are typically less willing to make repayments on non-standard products, lifting the probability of selective defaults on such products.

Given the amount of regulation and oversight placed on the non-standard debt market in China, industry and government work closely in partnership. Moreover, because of the current credit risk environment, there has been an extended period of quantitative easing in China. Borrowers are typically able to refinance or extend their loan maturity period with relative ease, so long as they do not acquire any new incremental debt. This has helped to provide a lifeline to many of these firms and stave off defaults.

Additionally, trust funds in China fundamentally serve as conduits for commercial banks--because they are essentially funded by commercial banks. From a risk management perspective, these funds have wider systemic exposures to consider, particularly given their high concentration in the real estate sector.

The market thus expects trust funds' investments into non-standard debt products to decline significantly.

We also expect the scale of investment from commercial banks' wealth management arms to contract. As stipulated in regulation, the maturity term of the products is required to match the investment period of the investment funds. From the perspective of the underlying asset, most funds have a maturity of at least one to two years, while most wealth management products have a term of a single year--limiting the scope of investments.

With a transition toward net-value-based management for wealth management products and decreased risk appetite, we believe investors' willingness to invest in higher-risk non-standard debt products will invariably decline.

Related Research

- Demystifying China's Domestic Debt Market, Feb. 19, 2019

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