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Research on Debt Risk Prevention Strategies for Chinese Financial Institutions

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Abstract: In recent years, many enterprises have been unable to repay debts on schedule due to liquidity constraints, leading to prominent debt risks in financial institutions. To mitigate such risks, this study takes CDL Securities as a case example. Empirical analysis is conducted on the interest rate spreads and returns of CDL's investments in all A-share listed companies in China from 2015 to 2019 (based on 2011–2018 stock indices). Based on the findings, specific strategies are proposed, including: improving the debt risk management system, optimizing debt financing structures and capital allocation, and strengthening internal governance and external controls.

Keywords: economic downturn; financial institutions; debt risk; prevention strategies; risk management

1. Introduction

In recent years, China's economic growth has slowed down, and a large number of companies have been affected by liquidity and unable to repay their debts on time, resulting in prominent debt risks for many financial institutions[1]. How to scientifically and correctly analyze and solve the debt risk problems faced by financial institutions and provide response strategies has also become a problem worthy of research. This study focuses on the prevention and response of debt risks of financial institutions, conducts analysis, and proposes specific response and prevention strategies. The main challenges faced by debtors of financial institutions include: (1) the decline in demand caused by market shrinkage and the market fluctuations caused by channel contraction. Enterprises not only have to pay wages to employees, but also have to prepare funds to purchase goods and allocate market resources, or organize corresponding innovation projects to be implemented. The financial pressure is relatively large, and many enterprises have the problem of broken capital chain; (2) Employees are less motivated and the turnover rate is high. Enterprises do not have sufficient labor resources. Most enterprises need labor input. For example, the labor price of processing-based factories has skyrocketed[2]; (3) Customer resources are declining, and

channels need to be reorganized and customer resources updated. In the later stage of the epidemic, most enterprises need to reconnect with domestic and foreign customer resources, conduct effective communication, re-formulate channel development strategies and market positioning, and update product and project strategies before resuming work and production; (4) Enterprises face financial pressure, such as relatively large comprehensive cost pressures such as rent, wages, and taxes. Many enterprises need to rely on loans to barely support themselves. Comprehensive costs have become the biggest obstacle to enterprise development. The above challenges have caused the liquidity of enterprises to deteriorate, and some enterprises are unable to repay their debts on time.

2. Literature Review on Financial Institution Debt Risk Prevention

2.1 Definition of Debt Risk

Debt risk of financial institutions refers to the risk that the debtors of financial institutions cannot repay the principal and interest in time. The formation of debt risk of financial institutions is affected by the management and operation mode of financial institutions on the one hand, and by factors other than management and operation mode on the other hand. Management and operation factors mainly include the loan-to-deposit ratio, loan review system, loan procedures, bad debt provision ratio, risk identification and classification, and risk transfer decision-making of financial institutions. These factors are controllable factors. The particularity of the commodity-currency operated by financial institutions determines that the debt risk of financial institutions is inseparable from the development of the economy and society. Therefore, factors other than management and operation mainly refer to environmental factors that affect the debt risk of financial institutions, mainly including the operating conditions of various industries, market supply and demand, consumer concepts and changes in habits, etc. These factors are uncontrollable factors [3].

2.2 Characteristics of debt risk of financial institutions

1. Objectivity. The management and operation of financial institutions must comply with the relevant system provisions of national laws and regulations, including many relevant laws and regulations on business operations, such as some clauses on financial and debt defaults in the Contract Law. All financial institutions must meet the relevant provisions of the Contract Law. Once a breach of contract or a breach of contract by the other party occurs, corresponding penalties and corresponding debts will be incurred. All debts, including investment income, litigation settlement, merger settlement, debt-to-equity swaps, etc., need to be resolved in a fair and objective manner. The most important manifestation of financial institution debt risk is objectivity. Each debt is classified into different debt categories and remains independent. It can be collected independently or collected together. The agreed period for debt risk of financial institutions is generally no more than 5-10 years. Depending on the content of special debt risks, it can be extended to 12 years at most[4].

2. Latent. Financial institution debt risk has the characteristics of latent. The latent characteristics refer to a series of clauses and restrictions encountered in the process of

contract signing and negotiation that are difficult to negotiate or have "ambiguous" solutions. These requirements cannot be effectively stipulated or resolved in the current period, and it is impossible to clearly measure the interests or risks of one party in the long-term uncertain risks. Such risks are considered to be latent. In addition, there will be a force majeure clause in the contract. The purpose of establishing a force majeure clause is to limit the liability of one party to be exempted if there is a dispute between the two parties or if there are no dispute conditions during the performance of the contract [5].

3. Damage. The debt risk of financial institutions also has the characteristic of damage. Damage means that all matters that cause losses to the enterprise are considered to be damaging, such as economic losses, customer losses, reputation losses, intellectual property losses, and corporate market resource losses [6].

4. Cyclical. The cyclical characteristics of the debt risk of financial institutions are also quite obvious. This is mainly because during the operation process, the enterprise has its own accounting period and production cycle. For example, futures companies use the delivery period of futures contracts as the cycle, and insurance companies use the duration of insurance contracts as the cycle. Therefore, the corresponding risks also show cyclical characteristics.

5. Coexistence. The debt risk of financial institutions and the income of financial institutions are interdependent. If there is income, there will inevitably be debt risk. The higher the returns of a financial institution, the greater its corresponding debt risk. Conversely, the lower its returns, the smaller its corresponding debt risk. The primary goal of financial institutions is to pursue profits, and therefore, debt risk is inevitable in the process of achieving these goals.

2.3 Research on Debt Risk Prevention in Financial Institutions

Generally speaking, a small portion of a financial institution's loans will contain non-performing assets, and the bond market will also experience defaults where repayments are not guaranteed. Once a local enterprise's capital chain breaks, the companies that guarantee each other may be dragged down, leading to a series of defaults. Serial debt defaults can lead to pessimistic market expectations, causing financial institutions to tighten lending, reducing liquidity, and ultimately lowering their asset returns. Therefore, debt risk prevention in financial institutions is particularly important. Western countries have a relatively mature theoretical foundation for debt risk management in financial institutions, covering its causes, conditions, hazards, and countermeasures. However, due to different political and economic environments, approaches to debt risk management vary from country to country. Before the US subprime mortgage crisis of 1929, traditional debt risk management focused on balance sheet management. Financial institutions could mitigate and control debt risk through more rational capital operations. The study proposed to use the method of real business bills to manage debt risk, but the real bill theory also has limitations. During economic recessions, even real bills may not be repaid, which will lead to debt risks for financial institutions[7]. As financial products are constantly updated, it becomes more difficult to realize assets during economic downturns, and the debt risks of financial institutions will increase accordingly. The collapse of the Bretton Woods system in 1971 brought about the marketization of interest rates, and market interest rates rose sharply. It was

difficult to achieve the purpose of debt risk management by relying solely on balance sheet management. In 1977, the early asset-liability integrated management theory advocated the separate management of business risk and transaction risk. The study combined moral hazard and adverse selection for the first time and created a credit allocation investment model. The model found that the reason for the large differences in risk levels between banks and regions was the uneven ability of bank lenders to identify and judge risks[8]. The focus of debt risk management should be on adjusting the asset-liability portfolio and determining the interest rate differential[9]. Debt risk needs to be managed by utilizing the relationship between financial instruments and financial markets. By issuing securities, banks can package and sell their non-performing assets to obtain cash flow, or they can divide and sell the packaged assets according to different rating results[10]. However, with the development of economic globalization, financial products are becoming increasingly abundant, and the debt risk management faced by financial institutions is becoming more and more complex. The management of single debt risk is difficult to meet the needs, and comprehensive risk management has emerged. Traditional risk management often separates debt risk management from business, resulting in a lack of initiative in risk identification and evaluation. Reducing business volume to avoid risk actually hinders business development. Comprehensive risk management should establish a "multi-dimensional" comprehensive risk management system, set accurate coefficients for each dimension, and quantify the relationship between debt risk, interest rate risk, operational risk, and liquidity risk[11]. Judging from the UK asset protection plan and the Swiss government rescue plan, the government plays a vital role in debt risk management. The solution to the debt risk of financial institutions cannot rely solely on government subsidies, which will have a negative impact on debt risk management. First, it will increase the government fiscal deficit, and second, moral hazard will bring hidden costs[12]. Financial institutions should strengthen the analysis and risk identification of related-party transactions to prevent debt risks. This is because, on the one hand, group companies use mutual guarantees to apply for credit, and credit risks are transmitted internally through the guarantee chain, but systemic risks are not effectively dispersed. On the other hand, related-party transactions have a large operating space, and the financial distortions they bring increase the debt risk of financial institutions[13]. Debt risk warning should combine the creditor committee with the guarantor risk monitoring mechanism, focus on monitoring and analyzing the operating data of core guarantee enterprises, timely identify and warn of potential risks, and take measures to cut off the risk transmission path [14].

3. Types of Debt Risks in Financial Institutions: A Case Study of CDL Securities

3.1 Company Profile

CDL Securities, also known as CDL Co., Ltd., is a national comprehensive securities institution registered in Shenzhen in March 2001 with the approval of the China Securities Regulatory Commission, with a registered capital of RMB 1.6 billion. The company was established following a capital increase and restructuring of the former Xi'an Securities Co.,

Ltd.

3.2 Types of Corporate Debt Risk

1. Default Risk. As mentioned above regarding objective characteristics, debt risk is partially caused by breaches of agreements or contracts. This type of risk is most likely to exist in the development of financial institutions, and CDL Financial Institutions also faces this risk. If the control of default risk is careless or the system is imperfect, it can easily lead to long-term risks for the financial institution and unbalanced corporate development.

2. Operational Risk. In the daily development and business operations of CDL Financial Institutions, most financial operations rely on human judgment. Professional teams or traders determine the amount and direction of upcoming stock or bond purchases based on the risk and value recovery benefits. However, operations are not foolproof and even carry significant operational risks. Human error or misunderstandings often lead to operational failures, resulting in declining investment returns or even debt.

3. Capital risk. Capital risk primarily refers to the balance between the amount of capital held and the percentage of capital invested in or purchased equity, bonds, or stocks. Maintaining a balanced development strategy for financial institutions involves significant risk. Only by scientifically assessing the balance between capital and loss risk can funds be effectively allocated for investment and debt risk reduced.

4. Force majeure risk. As discussed above in the analysis of its characteristics, the purpose of a force majeure clause is to limit liability to one party if a force majeure event occurs during the performance of the contract, even if there is a dispute between the parties or the absence of such a dispute. Therefore, this authority exposes the capital provider to significant risks of debt default and financial loss.

3.3 Analysis of the Causes of Corporate Debt Risk

1. Susceptibility to economic cycles. Financial institutions often produce products with low technological content, inadequate management systems, and limited risk tolerance, making them highly vulnerable to market fluctuations. During periods of economic growth, financial institutions can earn higher profits, making capital recovery easier and businesses generally able to repay principal and interest, thus avoiding non-performing loans (NPLs). However, during periods of economic downturn, financial institutions face increasing competitive pressure, rising costs, declining profits, and difficulties in capital recovery, which in turn leads to NPLs. These businesses also face significant challenges in upgrading and transforming.

2. Irrational debt scale and structure. Some financial institutions rely solely on debt to expand and grow, potentially exposing them to significant debt repayment pressure and even creating negative leverage, which in turn reduces their profitability. If the maturity structure of financial institutions' liabilities is not properly configured, this can impact their capital utilization and even prevent them from repaying their debts on time, ultimately leading to debt risk.

3. Inadequate internal control systems. Financial institutions have their own internal control systems, which serve as a safeguard for their normal operations. An inadequate internal control system prevents financial institutions from effectively executing their

management decisions, leading to inefficient use of internal resources, inefficient employee performance, and ultimately, the formation of debt risks within the financial institutions.

4. Lack of a professional debt risk management team. Without a professional debt risk management team and organization, financial institutions are likely unable to effectively utilize internal and external data for decision-making, making it difficult to develop targeted debt risk prevention and response measures, ultimately leading to debt risks within the financial institutions.

5. Susceptibility to the subjective influence of the controlling shareholders. Many financial institutions are subject to family-style management, resulting in a lack of management systems, philosophies, and corporate culture. Decisions on business operations and overseas investment are made by the owners, making them prone to blind expansion and misappropriation of funds. This increases the likelihood of a broken capital chain and, consequently, a greater probability of loan defaults.

6. Susceptibility to moral hazard. Many financial institutions are subject to family-style management, resulting in incomplete management mechanisms and systems and a low level of information disclosure. Therefore, it is difficult for banks to further verify the financial data and information of customers when conducting financial institution loan business. The problem of information asymmetry is very serious, and the possibility of adverse selection and loan risks is higher. In recent years, major banks have encountered the problem of false loans from financial institutions. In this context, banks have become increasingly strict in their review of loans to such customers, resulting in other financial institutions being unable to develop further due to insufficient funds, forming a vicious cycle[15].

4. Empirical Analysis: CDL Securities Case Study

4.1 Methodology and Findings

Based on the preceding analysis, this study conducts a correlation analysis of CDL Securities' investment spreads and returns on all A-share listed enterprises (2014–2021) during 2018–2022. The StackedPlot model in MATLAB was employed for empirical analysis. The dataset comprises multiple independent spread records across different years (2014–2021) and CDL's profitability metrics, as shown in Table 4-1.

Table 4-1. Spreads and Returns (2015–2019)

Year	Spread (%)	Profit (¥B)
2015	0.20	125
2016	0.30	145
2017	0.40	156
2018	0.30	160
2019	0.70	189

The StackedPlot model results (Fig. 4-1) reveal: Column 1 (Spreads): Spreads increased continuously from 2018 to 2020, while CDL's profits rose concurrently. Column 2 (Returns): Despite a 0.1% spread decline in 2021, profits grew due to additional business revenue (SR income). In 2022, spreads and profits rebounded positively. Overall trend: Spreads and returns exhibit positive correlation, though SR income offsets sporadic spread contractions.

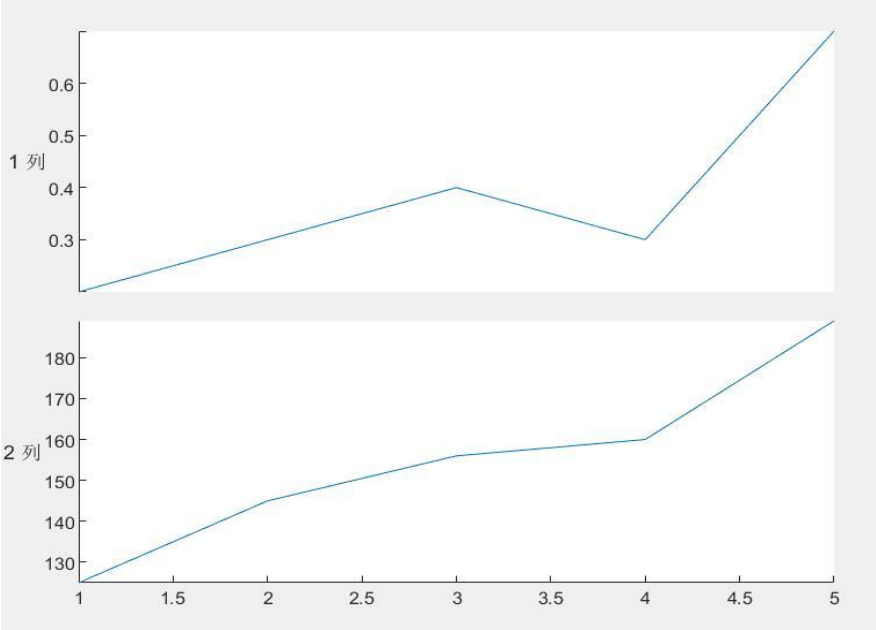

Figure 4-1. Stacked plot of interest rate spreads and returns for all A-share listed companies from 2014 to 2021 from 2018 to 2022

Surf 3D Model Analysis (Fig. 4-2):Confirms a positive correlation between spreads and profitability. Key driver: SR income (non-core business revenue) compensates for spread volatility, reflecting the industry trend of diversifying beyond interest-dependent operations.

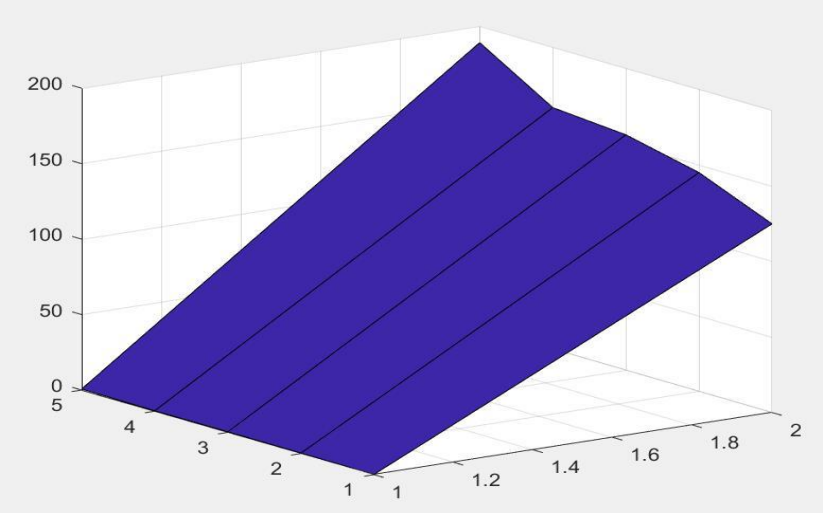

Figure 4-2. Correlation Model of Interest Rate Spread and Return Surf of A-Share Listed CDL Enterprise Investments from 2014 to 2021 from 2018 to 2022

The above analysis shows that, within the investment returns of CDL financial institutions, larger investments lead to faster profit growth, but this requires a lower risk profile. Assuming a higher risk factor and a smaller interest rate spread, returns decrease accordingly, and the greater the risk, the higher the risk. CDL companies' future debt offers considerable returns, and risk control measures can achieve a certain degree of risk prevention, making long-term profitability more feasible. However, the model diagram shows that if debt risk is elevated due to various factors, the implementation of the company's debt prevention strategy will increase debt risk and result in additional losses.

4.2 Credit Effect Testing

4.2.1 Reliability Test

Reliability was assessed using Cronbach's α coefficient. A coefficient > 0.7 indicates acceptable reliability; > 0.9 denotes excellent consistency (Eisinga et al., 2012)[16]. All variables exceeded 0.7 (Table 4-2), confirming data reliability.

Table 4-2. Reliability Test Results

Variable	No. of Items	α Coefficient
Perceived Ease of Use	6	0.865
Perceived Usefulness	6	0.857
Perceived Risk	5	0.934
Initial Online Trust	6	0.879
Sustained Online Trust	4	0.799

Consumer Innovativeness	7	0.884
Usage Intention	2	0.731
Usage Behavior	2	0.731

4.2.2 Confirmatory Factor Analysis (CFA)

CFA evaluated construct validity (content, structural, and convergent validity). Content validity was ensured via expert-reviewed scales[17].

Structural Validity:

Fit indices met standards (Table 4-3): $\chi^2/df < 3$, RMSEA < 0.1, CFI/IFI/TLI > 0.9.

Table 4-3. Model Fit Indices

χ^2/df	RMSEA	CFI	IFI	TLI
1.879	0.047	0.929	0.929	0.923

Convergent Validity: All constructs satisfied thresholds (Table 4-4): Factor loadings > 0.63(Hair et al., 2005)[19]. AVE > 0.5, Composite Reliability (CR) > 0.7.

Table 4-4. Convergent Validity Test Results

Construct	Item	Factor Loading	AVE	CR
GY	Q1	0.716	0.5194	0.8662
	Q2	0.721		
	Q3	0.727		
	Q4	0.671		
	Q5	0.718		
	Q6	0.768		
GU	Y1	0.685	0.5017	0.8578
	Y2	0.675		
	Y3	0.728		
	Y4	0.686		
	Y5	0731		
	Y6	0.742		
GF	F1	0.869	0.7392	0.9341
	F2	0.886		

	F3	0.84		
	F4	0.846		
	F5	0.857		
IT	C1	0.723	0.5453	0.8779
	C2	0.724		
	C3	0.732		
	C4	0.718		
	C5	0.76		
	C6	0.772		
ST	X1	0.693	0.4951	0.7958
	X2	0.714		
	X3	0.685		
	X4	0.722		
IN	I1	0.73	0.5191	0.8831
	I2	0.714		
	I3	0.719		
	I4	0.71		
	I5	0.741		
	I6	0.738		
	I7	0.69		
UI	S1	0.781	0.6053	0.7541
	S2	0.775		
UT	L1	0.764	0.5679	0.7243
	L2	0.743		

From the test results, it can be seen that the test standard values fluctuate around 0.71, and the rationality of the test is relatively consistent with the effectiveness of the debt risk prevention and response strategies of financial institutions. The risk content and verification basis found in the survey show that the basic coverage and elements of the debt risks of financial institutions are reflected in the financial risk content surveyed. Combined with these survey results, basic response and innovation strategies can be proposed.

5. Debt Risk Prevention and Response Strategies for Financial Institutions

(1) Improve the Debt Risk Management System and Strengthen the Risk Feedback Mechanism

First, debt risk in financial institutions is an objective reality and cannot be completely eliminated. Financial institution managers must leverage their professional expertise and years of practical experience to make effective operational and management decisions to mitigate the likelihood of debt risk and reduce losses. However, the industries in which financial institutions operate are constantly evolving, and the debt risks they face are also constantly changing. The operational and management strategies of financial institution managers will also impact the overall debt risk profile of their institutions. Therefore, establishing and improving a debt risk early warning mechanism for financial institutions is crucial. This will not only help financial institution managers deepen their understanding of debt risk but also, to a certain extent, enable them to take timely measures to mitigate debt risk in the event of an emergency. Specifically, financial institutions can establish a debt risk early warning mechanism based on financial indicators, monitoring and analyzing key financial indicators. By observing vertical changes in these indicators and conducting horizontal comparative analysis with peers, they can identify operational and management issues and help them proactively address them. Furthermore, financial institutions can also use stackplot models to analyze and monitor their debt risk profile and take proactive preventative measures.

(2) Optimizing Debt Financing Structure and Improving Capital Allocation

Debt financing structure directly impacts the financing risks of financial institutions. Adjusting and optimizing this structure is crucial to their development. Amidst a downward economic trend, financial institutions face increasing industry uncertainty and need to shift their approach. They should adopt a prudent approach to debt financing to mitigate the debt risks posed by changes in the external environment. In optimizing their debt structure, financial institutions should rationally allocate the proportion of long-term and short-term debt to prevent short-term liquidity issues caused by changes in the external environment. At the same time, financial institutions must carefully balance risk and return, adjusting their debt financing ratio based on capital-to-return ratios to leverage debt and promote their development. At the capital allocation level, financial institutions need to fully consider the risks of their businesses and the portfolio effects of their assets, assessing the risk-return balance of their asset portfolios. They should promptly address asset portfolios exhibiting significant adverse trends to free up space for other, more profitable businesses. In addition, financial institutions can also broaden their financing channels and diversify their debt risks by selecting diversified financing sources, while reducing their liability costs [16].

(3) Strengthening Internal Governance and External Control

Amidst the economic downturn, financial institutions need to further establish and improve their internal governance systems and rationally plan their internal controls. Modern financial institutions' internal governance is no longer simply a matter of corporate management. In the information age, internal governance also places higher demands on precision and accuracy in all aspects of financial institutions' data monitoring and management. Therefore, internal governance must be organically integrated with information platforms. First, further strengthening financial institutions' internal controls requires a shift from previous management models. Internal controls cannot be confined to a single department; instead, they must be elevated to the level of a comprehensive management framework. Second, further strengthening financial institutions' data oversight and

management requires the establishment of specialized information platforms. These platforms can effectively assist financial institution management in making informed decisions and effectively reduce the error rate associated with manual processes. Furthermore, the use of information platforms can more intuitively identify specific issues within financial institutions, facilitating more targeted problem resolution. Finally, the establishment and operation of information platforms will accelerate the transformation of financial institutions' internal functional departments. Data processing and departmental management within information platforms will require greater centralization and scalability, placing higher demands on financial institution management.

(4) Establish a bond and contract security prevention mechanism

First, strengthen the risk prevention and response capabilities of financial institutions in the early stages of bond and contract agreements, continuously improve the audit requirements and standards of the bond repurchase and equity purchase process review mechanism, and provide targeted risk adjustment directions for the content of the agreement by the risk control department. Strengthen personnel operation training in bond repurchases and improve the awareness and risk prevention capabilities of operators, especially managers. The bond and contract security mechanism mainly includes: (1) Improve the management of financial institutions and the debt risk prevention mechanism of financial institutions, and enhance risk prevention efforts from the overall perspective of the company; (2) Improve personnel awareness and enhance the capabilities of operators based on the content of bond and contract security protection, and improve risk prevention ideas and response strategies; (3) Use the content of the financial bond and contract security protection agreement to restrict some risky operations and expenditure behaviors, and impose conditional restrictions on some rights such as options and debts to reduce risks.

Second, expand the scope of mortgage collateral. First, improve the guarantee approval process, reduce intermediate costs, and improve the system for using property rights such as land, houses, and equipment as mortgage collateral. Second, encourage the use of intellectual property rights such as invention rights, patent rights, and trademark rights as mortgage collateral. The third is to support the inclusion of accounts receivable, warehouse receipts, etc. in the production and operation of enterprises into the category of collateral.

(5) Focus on Financial Product Innovation and Provide High-Quality Financial Services

Financial institutions should first strengthen their assessment of local economic development, conduct on-site research on businesses, formulate policies tailored to their specific circumstances, prioritize product quality, and promote personalized services. Financial institutions should provide more personalized services to businesses. By categorizing clients, they should develop differentiated products to provide them with the most appropriate financial services and products. They should prioritize product promotion and increase investment to educate more customers about the advantages of their products. Businesses should embrace a diverse range of options to achieve efficient financing operations and streamline management mechanisms. They should continuously strengthen cooperative and symbiotic development relationships, enhance consumer rights with businesses, and improve the vitality of financial products. Financial institutions should achieve comprehensive development through an open, cooperative, and equal model.

Leveraging the advantages of financial platforms, they should develop collaboratively with more businesses, thrive through collaboration, and ensure that customers can feel their sincerity. Financial institutions should leverage their strengths and unique characteristics to seek partnerships with businesses, increase their market share, broaden their reputation, and foster continuous communication with them. While developing, they should also contribute to the development of the local industrial economy. In the context of the current economic downturn, financial institutions should strengthen financial product innovation, find a development path that suits them, and make their own contributions to the development of local social economy through new development ideas. Financial institutions should explore more development paths and space, strive to create products that meet the needs of the public, and expand the market share and influence of their products[19].

(6) Make full use of Internet finance to reduce debt financing costs.

In the context of economic downturn, financial institutions are easily affected by the external environment and fall into debt risks. Therefore, it is very necessary for financial institutions to choose effective and appropriate financial tools to avoid debt risks. Financial institutions can set up investment and financing departments to effectively analyze and find appropriate investment and financing opportunities and methods. In the context of the rapid development of Internet finance in the new era, Internet financial derivatives have also become a new investment and financing method. Financial institutions can reduce the inefficient use of financial institutions' funds through innovative financing methods, thereby further promoting the efficient flow of financial institutions' funds. Financial institutions can also use the Internet's third-party platform and the mutual guarantee alliance to further reduce guarantee fees and avoid guarantee risks, thereby further reducing debt financing costs. Financial institutions can also expand the use of financial derivatives by leveraging government-supported HP financial tools or Internet financial innovations. They can also further broaden their financing channels and methods by leveraging the emerging Internet bond market, thereby controlling their debt risks at a low level.

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