Zhou Xiaochuan: Explore market position to promote corporate bond development

Speech by Mr Zhou Xiaochuan, Governor of the People's Bank of China, at The International Seminar on Bond Market Development - opportunities and challenges, 12 December 2003.

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Good afternoon, ladies and gentlemen,

It is a great pleasure to join you for a discussion on issues related to bond market development in this important and timely international seminar. In my view, development of the corporate bond market is critical to the overall financial market development in China. As you all know, with the recent conclusion of the 3rd Plenum of the 16th CPC National Congress, certain decisions have been taken by the central government on issues concerning further improving the socialist market economic system. Many financial reform initiatives adopted in the *Decisions* such as "improving macro financial management mechanism", "steadily advancing market-based interest rate reform", "improving RMB exchange rate regime" and "maintaining financial stability and preventing systemic financial risks" are all directly related to development of financial market. Despite certain progress made in developing China's financial market, much more remains to be done. In particular, the development of a corporate bond market, a salient deficiency for the moment, has yet to be nurtured. It is an important issue on the reform agenda which holds great significance for financial development in China. Extensive studies have been carried out on the development of corporate bond market. Due to time limit, I would like to focus my discussion on the market position of corporate bond.

International experience

In mature markets, corporate bond issuers are usually confined to corporations of different size, ranging from large corporations with good credit standing which issue high-grade bonds to the small and medium-sized corporations which issue non-investment grade or even junk bonds. The investors are mainly institutions such as the insurance companies, mutual fund, commercial banks, pension fund, trust companies etc, and the individual or retail investors are rarely seen in the bond market. According to relevant statistics, individual or retail investors only account for 10-15 percent of the total market share of corporate bonds above investment grade in the United States, and the proportion of individual or retail investors in non-investment grade corporate bonds is negligible. The reason why there are individual or retail investors sticking with the non-investment grade corporate bonds at all is mainly because their investment has gone sour and become unsalable after the issuer's credit rating was downgraded due to changes of various factors. Among those 10-15 percent individual or retail investors in the corporate bond market, most of them are rich people who either have their own private investment advisers or have their financial assets managed by certain institutions. Therefore, they can be regarded as institutional investors to some extent.

This kind of investment structure in the corporate bond market is actually associated with market requirements in financial strength and information disclosure of the investors. Based on this consideration, corporate bond investors must have strong risk analysis capability so as to make sensible investment decision and manage relevant risks properly. In the same vein, corporate bond needs to be priced by market forces, for this kind of pricing mechanism could compensate the default risks of the bond issuers.

In the transition and emerging market economies, underdevelopment of institutional investors has greatly hampered the development of corporate bond market. Absence of institutional investors implies an excessively high proportion of individual or retail investors in the market. Corporate bond was initially called "enterprises bond" in China, and the market infrastructure in respect of intermediary services like credit rating, accounting and external auditing at that time was weak, which has undermined the credibility of information disclosure and credit rating of the bond issuers. Moreover, corporate bond issue at that time also involved extensive government intervention, ranging from quota allocation to implicit guarantee by the local governments. Such combined deficiencies have made China's corporate bond market fall sharply short of our expectation.

Preventing distortion

In the early days of corporate bond issue in China, a relatively high proportion of bond issuers were found in default of debt redemption. To prevent substantial losses of the individual investors due to lack of risk analysis capabilities and to preserve social stability, the government took the decision to either allow the enterprises to issue new debt and use the proceeds to pay for the old one, or authorize other enterprises to issue replacement debt, or even allow the underwriters to issue debt to fulfill their redemption obligations. Such a practice has caused market distortion, which may lead to uncertainties for future corporate bond market development or prolonged sluggishness of the market activities. Recently, emphasis on direct financing and a desire to overhaul the structure of the domestic financial market has once again made the call for development of corporate bond market clearly audible.

Since we have seen turns and twists in the development of corporate bond market, we need to be more cautiously mindful of the new development trend in the market. In particular, we have observed a general tendency demanding secured solvency of the bond issuers. However, due to various uncertainties in market operation, it is not easy to secure solvencies for the issuing enterprises whose reform is still underway. In terms of credit rating, the world famous rating agencies are not even willing to assign comfortably high ratings for China's sovereign debt, so it will not be difficult for us to imagine the credit ratings they could possibly give to corporate bonds issued by domestic enterprises. In the mean time, although our domestic credit rating companies more than frequently give AAA ratings for domestic issuers, which to some extent has made us feel insensible to anything like AAA, we do not exactly know what the domestic ratings of AAA truly stand for, not to mention some of the domestic rating companies have not even had their reputation established in the market. Under such circumstances, despite the fact that an emphasis on corporate solvency can help strengthen protection for the investors, it will result in concentration of issuers in large projects or large state enterprises with good credit standing.

Another tendency in the corporate bond market is observed in the general requirement of guarantee, provided in practice by the commercial banks, for the debt issue. On the one hand, this kind of guarantee arrangement can undoubtedly improve the credit ratings of the bond and hence the confidence of the investors, but on the other hand it implies implicit state guarantee for the commercial banks, particularly the large state-owned commercial banks, which could lead to a change in market perceptions about the nature of the corporate bond. In such a case, the corporate bond is not issued based on creditworthiness of the issuing enterprises, but rather on the credit standing of the commercial banks which provide guarantee for the debt issue. This arrangement will also have some impact on the bond pricing mechanism. Of course, the corporate bond pricing mechanism has its own inherent problems. For example, the bond spreads are strictly confined to floating within an extremely narrow band compatible with the benchmark lending rates of the same maturities, thus ruling out many potential bond issuers, especially the small and medium-sized enterprises, for their issuing price has to cover the default risks.

The above two tendencies are closely related to the market position of the majority investors. If the majority of investors are individuals or households, strong protection is reasonably needed and only those enterprises with strong repayment capability and sufficient guarantee will be singled out to issue corporate bonds. In this case, the development speed of the corporate bond market might be sacrificed, for it is a bit hard to find debt issuers meeting all these stringent criteria. The problems even get worse if the credit ratings are conducted in line with international practice to reflect the true financial situation of the bond issuers. Apart from that, many of the large and medium-sized enterprises in China are currently facing daunting challenges in the reform of their corporate governance, internal control and accounting practice, and therefore hard to be assigned high credit ratings.

With regard to debt guarantee, we have heard some concerns of the commercial banks. They have complained first about the unreasonable guarantee price and the resulted inadequate coverage of default risks, and then worried that such an explicit guarantee could become a prominent weakness of the commercial banks in terms of risk control in the future. Although partial guarantee or credit enhancement is sometimes adopted in many mature markets to promote corporate bond market development, targeted guarantee for bond redemption is rarely seen, and this practice is even strictly forbidden in certain economies. Some Asian countries have experienced fast economic growth since the 1960s and 1970s, and their financial market and corporate bond market have also witnessed rapid development, though in different ways. Take Korea as an example. There was a high proportion of secured corporate bond in the market before the outbreak of the Asian financial crisis at the end of

1997. Such corporate bonds were issued in the early days with guarantee provided mainly by the commercial banks. Later on, the non-bank financial institutions including the merchant banks and the finance companies also started to provide guarantee for corporate bond issue. Fueled by fierce competition and with the benefit of no regulatory requirement in terms of capital adequacy, these non-bank financial institutions saw rapid development of corporate bond guarantee business. Up to 1997, 90 percent of the corporate debt issue in Korea was backed by guarantee. However, such secured corporate bonds revealed moral hazards and market risks during the Asian financial crisis, thus aggravating the financial turbulence. Recognition of the risks led to abrupt adjustment. By 1998, the share of guaranteed corporate bonds in total corporate bond issue fell sharply to 30 percent and subsequently declined to 5 percent and approached zero in recent years. Whether to provide guarantee is a commercial-based decision rather than a government requirement. However, in practice, due to factors concerning market rules, target investors and relevant experiences, the growth of guaranteed corporate bond has been unduly high, resulting in intensified market distortion. Special attention should be paid to Korea's experience in this regard. Excessive reliance on guarantee does not represent the future trend of corporate bond market development.

Exploring market position

In China, should the institutional investors be the major player in corporate bond market? If so, their development should be actively promoted. In recent years, investment fund and specialized fund management companies have developed in the securities market. In particular, open-end fund and some specialized fund have grown rapidly. However, they are still in the early stage of development and unable to meet market demand. Further efforts need to be made to promote their development. Other institutional investors, such as insurance companies and social security fund, also have great growth potential.

In China, individual investors have relatively few investment choices. They look forward to the development of new investment products. Nevertheless, development of corporate bond will not meet such demand if most of them are not targeted for individual investors. On the other hand, if the major buyer of corporate bond is not institutional investor, then we will have to face the above-mentioned question, that is, whether we should further develop institutional investors. We may "stumble twice over the same stone" if we fail to properly identify the major investor in the corporate bond market. My opinion is that development of institutional investors will be a priority in China's corporate bond market development.

Financial market consists of many sub-markets. Most financial products are traded in one market. Some other products, particularly bonds and financial derivatives, are not confined to one market. For example, bonds are traded in both securities market and inter-bank market; financial derivatives involve not only equity and debt but also loans and foreign exchange, and some financial derivatives are traded in more than one market. The development of institutional investors may rely on some markets. How to promote the development of institutional investors is an important issue on the agenda of corporate bond development.

Institutional investors have accounted for an increasingly larger share in the transactions in the stock exchanges. As noted earlier, due to the weak basis, the proportion of institutional investors is still too small. Securities can be issued in the primary market in several ways. Their target investors should be more clearly defined. Once we introduce a financial product in the market, we have to consider whether the investor structure is appropriate. This involves the choice between approval system and registration system, information disclosure and accounting standards. Therefore, the first question we may have to address is whether a financial product meets the need of major investors.

Many people have noted that there are active bond transactions in the inter-bank market. In China, these bonds are mainly government bonds and financial bonds. Some of the financial bonds are issued by the policy financial institutions. Such bonds may not exist in other countries. Some financial debt instruments modified by financial engineering will also be traded in the inter-bank market. Participants in the inter-bank market include various types of financial institutions – banks, insurance companies, securities companies, investment funds, trust companies and finance companies. Moreover, over 1000 large enterprises have been conducting transactions in the broadly defined market as institutional investors.

Given the cross-market nature of corporate bond, we need to clearly identify the major investors in the market and seek more opportunities to promote its development.

While drawing on international experience, we must also make careful analysis in light of China's specific conditions. At the same time, we must respect the objective pattern of market development. Some people think that we should develop corporate bond market with Chinese characteristics, which, unlike in other countries, will mainly serve individual and retail investors. In my view, all opinions and studies should be encouraged. We should be active in exploring various possibilities while cautious in reaching conclusions. Only after adequate investigation and research can we come to a conclusive opinion, or a decision for further study.

Market infrastructure

Finally, I would like to emphasize that the development of bond market, particularly corporate bond market, relies largely on the financial market infrastructure. As we all know, the development of infrastructure cannot be done overnight. It requires careful planning. Financial market infrastructure involves the delivery, settlement, custody and registration of all products. We have made good progress in ensuring the safety and timeliness of transactions through electronic systems. However, given the relatively limited variety of products, simple transaction mode and the segregation of domestic market from international market, we need to make further improvement. The other aspect of infrastructure is market integrity. It involves the improvement of laws and regulations, including accounting standards, and the development of intermediaries, in particular lawyers, accountants, rating agencies and asset evaluation agencies. In recent years, we have made significant progress in improving accounting standards. Nevertheless, for transition economies and emerging markets, this is an area that needs further efforts. In the advanced economies and mature markets, new changes have taken place as the companies expand their activities. Accounting standards need to be improved to reflect these changes. Accounting standards should be designed to reflect the true financial position of the enterprises. This is not an easy task.

We all hope that law offices, accounting firms and rating agencies can provide high quality services to the corporate bond market. However, for the transition economies and emerging markets, such services and institutions are in the initial stage of development. Years ago, such institutions did not exist in China. In recent years, efforts have been made to establish, develop and promote these institutions. In their early stage of development, lack of qualified personnel and other problems and weakness may impair public confidence and market integrity. Market requires that these intermediary institutions jointly provide true information and data to investors. We should make overall consideration in light of both domestic development and global integration. Attention should be paid to promote the development of domestic institutions and to avoid damage to market integrity. I believe that infrastructure is very important for corporate bond market.

Corporate bonds and stocks have different investor structure, disclosure requirement and other regulatory requirements. Some people think that high disclosure requirement similar to that for stocks should also be applied to corporate bonds. Its feasibility and advantages and disadvantages are still under discussion. Financial market consists of many sub-markets and products. All markets and products will be developed sooner or later.

There are many issues that need careful study with respect to the development of corporate bond. I hope my speech today could serve as a catalyst to invite more valuable discussions and comments. Thank you.