Wu Xiaoling: Develop corporate bond market to improve financial asset structure

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Establishing financial market system in line with the intrinsic needs of socialistic market economy is an important task in China's economic and financial system reform. In recent years, China's financial laws and regulations have been greatly improved, financial assets have been gradually expanded, diversity of financial institutions has been largely increased, and the financial market has been developing in a steady, rapid and healthy way.

However, many problems still exist in China's financial market development, such as the irrational financial asset structure, the relatively high potential risks in the financial sector, the frequent occurrence of irregularities and frauds in financial institutions, etc. Capital market, which constitutes an important part of the financial market, also saw its role in resource allocation greatly hampered by problems such as unbalanced development between the stock and bond market. Therefore, how to steadily develop bond market, improve financial asset structure and advance the overall development of financial market poses a big challenge for policy makers like us.

I. Current financial asset structure hindered economic restructuring and increased the social cost of economic operation

1. Distinctions of China's current financial asset structure

In recent years, China's financial market development has accomplished some progress. However, growth of direct financing is relatively slow and the corporate sector still relies its financing largely on bank loans. At present, there are two main distinctions of China's financial asset structure.

First, the proportion of indirect financing stands excessively high in the economy compared to direct financing. With respect to overall financing structure in China's financial market, new loans in financial institutions totaled RMB3 trillion yuan in 2003, accounting for 85 percent of the total financing, while new issuance of stock, treasury bond, corporate bond for the same period of time amounted to RMB534 billion yuan, accounting only for 15 percent. The proportion of indirect financing is overwhelmingly higher than that of direct financing in the economy.

Second, government bonds take a too high proportion in direct financing, indicating a dominant control of financial resources by the government. With respect to the direct financing structure in China's financial market, a total of RMB1251.5 billion yuan worth of securities was issued in 2003. Among the new issues, RMB628 billion yuan were treasury bonds (accounting for 50.2 percent), RMB452 billion yuan were financial bonds issued by policy banks (accounting for 36.1 percent), RMB135.7 billon yuan were stocks (accounting for 10.8 percent), and RMB35.8 billion yuan were corporate bonds (accounting for 2.9 percent). Therefore, funds raised by enterprises from the stock market and bond market only accounted for a combined13.7 percent of the total direct financing, while the government took a share of 86.3 percent, indicating that the government has a high monopoly on funds allocation.

2. The underdevelopment of direct financing increased the social cost of economic operation

The underdevelopment of direct financing was evident in the limited access to credit and low capability of the enterprises to directly raise funds in the market, which has resulted in a low proportion of direct financing in the economy. On the one hand, a great amount of idle funds in the society lack direct investment channels, and investors could not make free investment decisions according to their own risk preferences. On the other hand, enterprises could not locate the favorable strategies to lower the cost of financing and adjust the scale and structure of production according to the demand and supply of products and funds in the market.

In a financial market system dominated by commercial banks with indirect financing playing a dominant role, if enterprises are unable to react to the signals of market change, the cost of economic restructuring may have to be mainly born by banks and the government. As a result, bad loans in the banking sector will likely increase and the government's financial burden could be aggravated. Subjecting risks emerged in the process of economic development that should be absorbed by the market entities to the banking system and the government could lead to an increase of social cost of economic operation.

3. Bond market constitutes an important platform for the development of direct financing

Steadily promoting the development of direct financing will provide incentives to market participants and enhance the efficiency of resource allocation. Direct financing market in market economies is dominated by fixed-income instruments, which account for 2/3 of the total market share, while equity instruments only account for 1/3. The fixed-income instruments usually consist of corporate bonds, public bonds and institutional bonds, with corporate bonds as its core component. However, in China the diversity of fixed-income instruments are yet to be improved as public bonds mainly limited to central government bonds and the public simply has no idea about institutional bonds. Even in corporate bonds, the public is unable to properly distinguish between bonds issued for project investment and bonds issued to support business operation of an enterprise. With fresh memory of the redemption risks of corporate bonds in 1980s and 1990s, the State Development and Reform Commission nowadays mainly limits its approval of bond issuance to project investment bonds not the ordinary corporate bonds issued to support enterprises' business operation, which has forced the enterprises to finance primarily through the stock market. In 2004 (till end-November), funds raised by enterprises in stock market amounted to RMB127.3 billion yuan, and that in bond market totaled RMB24.5 billion yuan (only accounting for 20 percent of the former). As the deep-rooted problems in stock market remains unresolved and fiscal policy tends to shift from a proactive stance to a sound posture, it has become a priority to steadily press ahead with the development of corporate bond market. A sound growth of the corporate bond market bears great significance in that it can help to disperse the concentrated financing risks, alleviate the financing pressures of the banking sector, improve financial asset structure, foster favorable credit environment and nurture commercial credit development.

II. Clarify risk responsibilities, cultivate institutional investors, and advance the development of corporate bond market

1. Risk responsibilities should be clarified to steadily develop corporate bond market

Both bonds and stocks are direct financing instruments for enterprises, which should follow rules and principles of market economy. While investors taking bond investment in an enterprise should have the right to get interests and principal of their investment repaid on time, they should undertake the enterprise's default risks as well. However, this principle is not reflected in our current legal framework. For instance, the *Provisional Administrative Rules for Corporate Bonds* published in 1987 to a great extent regarded corporate bonds as state-controlled resources. It failed to identify the risks that investors should bear, but stressed instead that the bond holders many not be responsible for the enterprise's performance. The *Administrative Rules for Corporate Bonds* issued in 1993 maintained relevant provisions and also failed to clarify the responsibilities of investors in taking enterprise's credit risks. Current rules even mandates guarantee, mostly provided by state-owned banks, for corporate bond issuance, which has not only removed the demarkation line between corporate bonds in terms of their credit ratings but also transferred market risks to financial institutions, especially the commercial banks. Therefore, current administrative rules for corporate bonds must be revised to identify relevant risk responsibilities of the corporate bond investors and remove the mandatory guarantees so as to further develop corporate bond market.

2. Institutional investors should be cultivated to steadily develop corporate bond market

Investing in corporate bond requires a great deal of work in information collecting and processing, and a high capability of investors in identifying and taking the risks. Also, the volatility of bond price is relatively small and only large-value transactions could effectively reduce costs. These features show that institutional investors who have relatively a strong capability in identifying and undertaking market risks are ideal investors for corporate bonds. Therefore, efforts should be made to cultivate institutional investors including insurance companies, commercial banks, pension fund and investment fund companies to increase market liquidity and reduce market risks so as to further develop corporate bond market. Individual investors may indirectly invest in corporate bonds through collective investment instruments such as investment-insurance and fund products, etc.

3. Historical lessons need to be learned in the process of steadily developing corporate bond market

While developing corporate bond market, reviewing historical experience and lessons on market supervision and construction is a necessity for finding solutions for new problems. The slow development of corporate bond market in China could be mainly attributed to the following reasons:

First, heavy government intervention. From end-1980s to the beginning of 1990s, corporate bond issuance has been under strick quota control like the credit funds. Under such a system, corporate bond became a tool of governments at various levels to support local economic development and supplement the inadequacy of credit funds, leading to a sharp increase of default risks under the low-efficient expansionary economic growth pattern; local governments even forced local financial institutions to redeem the bonds at maturity on the behalf of the enterprises unable to fulfill their debt obligations, resulting in a great deal of unsettled problems.

Second, a mismatch between the individual investors and the underlying risks of corporate bond. For long, investors of corporate bonds in China are mainly individual investors, corporate bond issuance is also mainly targeted at small and medium-sized institutions and individual investors. These investors lack the capability in identifying and underwriting the risks, thus tend to ask the government or financial institutions to compensate any losses if the bond issuer finally defaults on redemption, which quite often leads to a rise of fiscal burdens and non-performing financial assets.

Third, lack of a sound system for corporate bond rating and information disclosure. In China's corporate bond market, due to the administrative approval system for bond issuance and the investors' limited awareness of risks, credit rating of corporate bonds is effectively artificial, which is neither good for the building of a market-based credit system, nor for the cultivation of qualified credit rating institutions. Also, China's corporate bond market lacks improved and effective information disclosure system.

Unmindful of the historical lessons, stricter control has been imposed later on the issuance of corporate bonds. Concerned about the threats of corporate bond default to social stability, zero risk has been targeted in the current supervision of bond issuance. To ensure repayment of principal and interests on debt maturity, the supervisory authorities conducted rigorous control both on the quality of the bond issuer and the quantity of the issuance. As a result, only a few qualified large state enterprises with good access to the capital market can issue bonds, while a large amount of the enterprises could not have their financing needs satisfied in the market.

III. Foster intermediaries and improve financial services to promote healthy development of the corporate bond market

1. Improve credit rating system for corporate bonds and cultivate credit rating institutions

According to advanced international experience, a credit rating system with public credibility is the foundation for corporate bond market development, because credit ratings could provide important information for the investors to make investment decisions. Market demand should serve as the catalyst for market supply, only in a market environment where enterprises are allowed to issue corporate bonds independently and investors undertake risks at their own discretion, will the real demand arise for credit rating of bonds, will the credit ratings function as the true signals for the risk profiles of corporate bonds, and will the credit rating institutions value their market reputation and improve service in competition.

2. Improve market supervision to facilitate corporate bond trading

The trading of financial products mainly falls into two categories: based on price match or on price negotiation. In general, price match is suitable for trading of financial products of small value or with simple trading factors while price negotiation is more applicable to the trading of financial products of large value or with complex trading factors. For the time being, in China's financial markets, bond transactions are either based on price match in the stock exchanges or based on price negotiation in the inter-bank bond market. Corporate bond featuring complex trading factors and demanding highly professional investment skills is an ideal financial product for institutional investors to be traded on large-value basis. In the advanced international markets, 95 percent of issuance and trading of bonds (including corporate bonds) is conducted through over-the-counter market. Allowing corporate bond issuers and investors to decide independently on the markets to issue and trade their products according to their individual needs is the best choice for the steady development of corporate bond market. In the meantime, supervisory authorities should improve market regulation, relax restrictions on corporate bond market and build up effective market incentives and disciplines, so as to ensure free flow of fund and strengthen market competition and transparency. In order to put into full play the role of intermediaries and other market participants, and guarantee transparency in the market, stringent requirements on information disclosure should be established in addition to a sound credit rating system for the bond issuers, in which the contents, standards, procedures, frequency of disclosure as well as the penalties for irregularities must be explicitly stipulated.

3. Improve bond custody and settlement services to facilitate bond transactions

Bond investors undertake the risks while the financial institutions and intermediaries only provide relevant services in bond investment. Therefore, the invested bonds and the margin deposits of the customers must be kept in custody of the third party. Current custody arrangement cannot protect the customers' invested assets from being misused, and hence must be thoroughly reformed.

Market participants differ in their demands for settlement services. The co-existence of China Securities Registry and Settlement Co. LTD and China Government Securities Depository Trust and Clearing Co. LTD with a highly efficient trans-custody relationship established between them should be able to promote market development, competition and services. The current arrangement based on custody through trading seats in these two companies leaves room for manipulation of customers' invested bonds and margin deposits, thus should be transformed to a system based on custody by the bond investors, so as to improve the custody efficiency and facilitate customers' choices of market for bond issuance and trading.

IV. Strengthen coordination among supervisory authorities and conduct functional supervision to advance corporate bond market development

1. Improve current supervisory system for the bond market and realize functional supervision

The bond market in China is currently under the supervision of different regulatory authorities, with the issuance of government debt supervised by the Ministry of Finance, the issuance of corporate bond by the State Development and Reform Commission, the issuance of financial bonds by the People's Bank of China, the bonds traded in stock exchanges by the China Securities Regulatory Commission and that listed in the inter-bank market by the People's Bank of China. Due to the problems associated with labor division and coordination among supervisory authorities, there tends to have an overlap in supervision which will hamper the healthy development of the bond market.

To avoid either an overlap or a void in supervision, the bond market needs to be brought under functional supervision in which the responsibilities for making the rules and supervising market entry and daily transactions must be assumed by different authorities. Adopting functional supervision requires a change of the supervision philosophy so that the different supervisory authorities could focus on: first, formulating rules on the issuance and trading of bonds; and second, improving information disclosure and credit rating system, establishing disclosure standards, monitoring disclosure progress, and punishing unfaithful, untimely or inadequate disclosure. Besides, restrictions set on the quality of bond issuers and the quantity of issuance and interest rate must be abolished so as to let the enterprises decide for themselves as to whether and how much they could issue corporate bonds in the market.

2. Set up a supervisory coordination mechanism to improve supervision efficiency

In order to improve supervision efficiency and propel the development of corporate bond market and the financial market as a whole, coordination and communication between the supervisory authorities should be enhanced under an institutional framework:

First, unify supervisory philosophy. The starting point of formulating relevant rules and implementing the supervisory function is to respect the independence of the bond investors and issuers, ensure adequate information disclosure and the openness, impartiality and fairness of trading, and make investors self responsible for the risks.

Second, unify supervisory rules. In the issue market, rules should be formulated respectively to accord the characteristics of public bonds, corporate bonds, institutional bonds and foreign bonds, while in the trading market, rules should be unified based on the trading formalities to facilitate the integration and efficiency of the bond market. Strict punishment on irregularities must be included in all supervisory rules to deter any wrongdoing. Self-discipline is of utmost importance in terms of market supervision, and the responsibilities of the supervisors should be to examine the compliance of market participants and enforce punishment on any violations of the rules.

Third, improve information sharing. This is the only way to improve supervision efficiency under the current framework of segregated supervisory functions.

Advancing the development of corporate bond market is of realistic significance for improving the structure of financial assets and speeding up the growth of direct financing in China. In the process, we should clearly define the risk responsibilities of various parties, foster financial intermediaries and institutional investors, and in the mean time, change the supervisory philosophy to realize functional supervision, strengthen coordination and cooperation among the supervisory authorities. On the one hand, the reform of commercial banks is deepening and disciplines on credit extension are strengthened, on the other hand, huge amount of funds in the economy are looking for proper chance of investment. Under such circumstances, we should speed up the growth of direct financing to improve allocation of financial resources. Both the large and small and medium-sized enterprises should be allowed to issue bonds in the corporate bond market, provided the information is truly disclosed, bond prices are adequate to cover risks and the investors have a capability to identify risks. With the deepening of relevant reforms and the implementation of consistent policy measures, the corporate bond market and the overall financial market in China will surely enter a new era of sustainable and fast development.