China's corporate bond market development: lessons learned

Zhou Xiaochuan[1]
People's Bank of China

We are very glad to see our central bank colleagues present at this seminar on developing corporate bond markets in Asia. It is our great pleasure to co-host this event with the BIS, and we are particularly pleased to have Malcolm D Knight, the BIS General Manager, joining us to share his insights on the seminar topics. In meetings to be held today and tomorrow, colleagues from around the region and the world will share their experiences with us.

I am also pleased to take advantage of our position as a co-host to talk about corporate bond market development in China thus far and, in particular, the urgent need to accelerate progress.

I. Macroeconomic environment

The Chinese economy has enjoyed GDP growth of approximately 9% per annum in recent years - with the strong momentum likely to continue in 2006 - while CPI inflation has been kept in check.

The abundant liquidity in the economy contributes to low interest rates and subdued inflation. Moreover, the savings rate is noticeably high. As a result, the M2/GDP ratio is high compared to other economies, and may well approach 200% in 2005. Commercial banks have continued to play a dominant role in channelling savings into investment. In contrast, financing through the equity market remains small, while the bond market accounts for less than 10% of such intermediation.

China's bond market appears to be very large, but in proportion to GDP, bond market financing is still insignificant. Of bonds outstanding, some 40% are government bonds, while the rest are corporate bonds issued by both financial and non-financial institutions. Furthermore, the value of financial institutions' bonds outstanding is seven or eight times that of non-financial corporate bonds.

Currently, the bond market in China is divided into an over-the-counter (OTC) market and an exchange market. The OTC market is basically an interbank market where there is little regulation, and institutions are free to participate and strike deals at the prevailing market prices. Since its establishment in 1997, the OTC market has expanded to include both financial and non-financial institutions, and currently the issues of more than 4,000 non-financial corporations are traded there. Meanwhile, we are also trying to develop our short-term corporate bonds and commercial paper in the OTC market. We are very eager to learn from the experience of other countries as to how to allow the bond market to play an important role in economic development.

II. Problems in corporate bond development

China's underdeveloped corporate bond market has distorted the financing structure in the economy, which poses a threat to financial stability, as well as to social and economic development. Setbacks and mistakes had their roots in the specific circumstances of the past. In particular, in the early days of China's economic transition, central planning still played a more important role than market forces. In 2003, however, the third Plenum of the 16th Communist Party of China Central Committee called for a

[1] Governor of the People's Bank of China. This text is based on the remarks made at the BIS/PBC seminar on "Developing corporate bond markets in Asia" held in Kunming, China on 17-18 November 2005. It also draws on a number of previous speeches.

greater role for direct financing through establishing a multi-tier capital market system, and through encouraging the growth of institutional investors. Only by thoroughly understanding the problems and mistakes of the past can we find more effective solutions. The following is a list of serious mistakes committed initially during the late 1980s and mid-1990s. Even today, some of these mistakes may still be impeding the development of the corporate bond market in China.

1) The administrative allocation of quotas for issue size and number of issuers was mandated by the central government to provincial and lower-level governments.

2) Administrative allocation of quotas was often used as a relief measure for financially distressed enterprises.

3) The absence of a credit rating system made it impossible for investors to obtain a clear idea of risks.

4) There was a lack of information disclosure to investors, due to i) inadequate accounting and external audit standards and ii) lack of regulatory emphasis on proper disclosure by issuers as well as prudent analysis by investors.

5) Administrative pricing of corporate bonds and price controls failed to reflect risks, thereby preventing effective risk management by issuers and investors.

6) Authorities required bank guarantees for corporate bond issuance and still do so today. Since issuance quotas were administratively allocated and prices controlled, and neither information disclosure nor credit ratings were available, bank guarantees seemed to be the natural solution. However, once guaranteed by a bank, the product was no longer a standard corporate debt but, rather, akin to a high-yield deposit at a commercial bank.

7) Bond issues were targeted at retail rather than institutional investors, who were capable of risk assessment.

8) Effective market discipline was not established. Market forces can discipline both the issuance and trading of corporate bonds as investors exercise their judgment in the choice of products - thereby giving them the final say on issue conditions, prices and consequences of default. Lack of effective market discipline can lead to a recourse to administrative means, which can give rise to a series of problems. In addition, in order for the OTC market to play a dominant role, a proper trading mode should be established to ensure proper assessment of counterparty risks and pricing flexibility.

9) Investor education was not sufficient. To a large extent, many investors used to treat corporate bonds as just another savings deposit product. Whenever a default of corporate bonds occurred, they would turn to government agencies and demand redemption by underwriters. Moreover, the protection given by local governments to bond investors undermined the incentive for them to evaluate the risks involved.

10) The current Bankruptcy Law did not provide investors with effective liquidation as a form of recourse in the event of default. In China, the residual assets - and even the issuer - could often simply disappear without going through legal procedures. Although we have been working hard on a new bankruptcy law, the current one does not provide adequate protection for creditors.

11) The underwriter's role was not properly defined. Underwriting and redemption typically came under the umbrella of central planning and administrative intervention. Furthermore, the underwriter was considered liable when the issuer failed, an arrangement that blurred distinctions between the underwriter, sales agent and redemption agent.

12) Administrative intervention was even stronger in cases of corporate issuer default. The default of a corporate issuer was not dealt with according to market principles; rather, for reasons of social stability, the underwriter would be requested to issue bonds on its own to meet the obligations of the corporate issuer - with the consequence that the liability of the default issuer was transferred to the underwriter. The problems of some securities companies undergoing liquidation or restructuring were partly attributable to the burden they had to shoulder for the defaulted corporate issuers.

III. Possible solutions

Thanks to our own lessons from the past as well as those drawn in other economies, we can find effective solutions to our problems. First, we have to move from a strategy based on central planning to one based on market forces. If the practices of quota allocation, administrative approval and government intervention were to continue, the prospects for the bond market would be dismal. Furthermore, the old-fashioned mindset that harks back to central planning must be put aside when we analyse what has gone wrong. It is unfortunate that some analysts attribute the derailing of bond market development to non-fundamental factors. Therefore, it is helpful to hold in-depth discussions to understand these questions on an occasion like today.

Second, we need to get the logic right. It is important that corporate bond issues should target the right investors and trade on the right trading platform. We have to start with Qualified Institutional Borrowers and OTC markets, so that institutions with strong analytical and risk management capabilities can play a bigger role. This will also facilitate streamlining of administrative approval and control because these qualified institutional investors rely mostly on information disclosure and market discipline, rather than on the judgment of the regulatory authorities. This in turn will also make guarantees by commercial banks unnecessary. Furthermore, institutional investors are better able to detect default risks, and are more resilient when such risks do materialise. The government does not need to worry too much about them.

Third, we should spare no effort in strengthening institutional arrangements and improving the financial eco-environment, to build on the progress already made. Our accounting standards are being brought into line with best international practice; requirements on disclosure and oversight have been enhanced; and the Bankruptcy Law is being amended with a view to better protecting creditors. In addition, we are trying hard to foster the domestic rating agencies necessary for bond market development, although these rating services may grow only slowly over time. The basic policy is to allow international rating agencies to set up joint ventures to provide high-quality services. Such a move is likely to be quite controversial due to the traditionally strong protectionist mentality of the past; however, we now have to accelerate progress towards international accounting standards and rating services.

Fourth, efforts are needed to improve government efficiency, and break bureaucratic segmentation in market organisation, service, infrastructure and supervision. Institutional and organisational impediments to market building and bureaucratic friction have hindered the development of China's corporate bond market - and we are still facing a legacy from the past in this regard. Different authorities are responsible for approving bond issuance, monitoring issuing conditions, and regulating the OTC and exchange markets. In addition, differences in market infrastructure make cross-market transactions difficult. These are problems we will have to deal with in the process of developing the bond market.

IV. Questions to be answered

There are a number of other problems we still face in developing corporate bond markets, ones for which there may be no easy solutions.

First, China shares with a number of Asian economies some similar macroeconomic conditions, such as high savings rates and abundant liquidity. Both of these macroeconomic conditions tend to militate against the development of a corporate bond market. Indeed, corporations with good credit standing do not have strong motivation to issue bonds as they can easily obtain loans from commercial banks at low interest rates. To develop the corporate bond market, adequate market liquidity may be desirable. However, if bond buyers are mainly institutional investors and financial institutions with too much liquidity on hand, they may not be very interested in trading in the secondary market.

Second, should we allow foreign participants to enter the domestic bond market? In China, the bond market remains relatively closed. Since the renminbi is not a convertible currency, we have not allowed foreign institutions access to the market. Recently, though, we did allow both the Asian Development Bank and the International Finance Corporation to issue local currency bonds in the domestic market, and have plans to open up the market further. We recognise that there are still impediments in both practice and mentality to promoting open markets. But eventually, we will open the domestic bond market to foreign investors, foreign issuers and foreign financial service providers such as credit rating agencies.

Third, in China there is constant debate on whether the bond market should serve mainly the financing needs of large corporations or small- and medium-sized enterprises (SMEs). One point of view is that easy access for large corporations to the capital markets would increase competition in financial intermediation and thereby encourage commercial banks to lend to SMEs - as has happened elsewhere in the world. To improve asset quality and reduce non-performing loans, commercial banks currently tend to lend to large and well-run enterprises. There is nothing wrong with this approach. However, once large and well-run enterprises develop a preference for financing through bond markets, commercial banks will get the message and divert more of their resources to study SME financing business, and may even establish their own SME departments.

Another approach is to focus on the development of a corporate bond market for SMEs, as they are critical to employment and social and economic stability. However, such bonds are likely to be high-yield and high-risk. Without sufficient preparation, a properly-qualified investor base and/or an adequate pricing mechanism, an SME debt market is likely to be problematic. Indeed, is it feasible to launch non-investment-grade bond products at such an early stage of market development? This is really an issue of how to sequence corporate bond market development. Should we develop a low-grade market after a high-grade corporate bond market is fully developed or foster the growth of both at the same time? We need to do more research on these issues. Many countries do not yet have a mature SME bond market. Even in the US, the collapse of the high-yield "junk" bonds in the late 1980s and early 1990s, as symbolised by the downfall of Michael Milken, might have both positive and negative impacts. I think this episode in the bond market history deserves careful study. We will also watch closely the experiences of other countries, especially those of our neighbours. On the other hand, we have to consider whether their experiences are applicable to China.

So, we have many questions in our minds. We sincerely hope that in the meetings to be held today and tomorrow, we can have fruitful discussions on these issues and share experiences candidly. Certainly, my PBC colleagues will benefit enormously from this seminar.