Zhou Xiaochuan: Learn lessons from the past for the benefit of future endeavour

Speech by Mr Zhou Xiaochuan, Governor of the People's Bank of China, at the China Bond Market Development Summit, Beijing, 20 October 2005.

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Ladies and Gentlemen,

It is a pleasure to attend the China Bond Market Development Summit. Let me focus on China's corporate debt and briefly summarize lessons from past experiences.

Corporate bond includes, among others, enterprise debt. The development of enterprise bond market has always had the attention of many. In the past, we made quite some mistakes in this field. Thus our corporate bond market has been very sluggish. Compared with some other financial instruments, and in the backdrop of a high savings rate and high proportion of M2 in GDP, China's corporate bond market has been developing very slowly, and its role in economic growth has been rather limited. Such lack of development has also distorted financing structure and produced considerable implicit risks, whose consequences may be grave for social and economic development. Of course, past setbacks and mistakes had their roots in the specific circumstances of that time, i.e. in the early days of the transition when the economy was more planned than market-driven and market economy had yet to establish itself as a way of thinking and a general environment. Therefore, a review of the past is not to find fault with anybody, but to draw lessons. The Decisions on Several Issues of Improving the Socialist Market Economic System adopted by the 3rd Plenum of the 16th CPC Central Committee has provided for enhancing direct financing, establishing a multi-layered capital market system, expanding debt market and encouraging the growth of institutional investors. Only by thoroughly understanding and clearly analyzing the problems and mistakes in the past, can we find an effective solution and implement the Decisions in a concrete manner.

I. Problems in enterprise bond development

A number of serious mistakes were made in the early days of enterprise bond development, i.e. from the end of 80s until the first half of 90s. As a result, the development was wrought with setbacks and never fully recovered. A thorough discussion on this issue is necessary. Here, I made a list of a dozen mistakes.

1. Issue quota and number of issuers were planned and allocated. Enterprise bond was not issued on a market basis. For example, quota was allocated by the government to the next level of government, from the state to the province, and then to the localities.
2. Administrative allocation of issue quota usually followed a principle of helping the poor. Enterprises in difficulties or poorly managed were more likely to get quota.
3. The absence of a bond rating system made it impossible for investors to get a clear idea of risks.
4. Information was not disclosed to the investors. On the one hand, accounting standards in China were not up to the international standards. Neither accounting practice by the enterprises nor external audit was proper and provided little information. One the other hand, information disclosure was not emphasized. Thorough analysis of the disclosed information was part of the decision making process.
5. Price was set administratively and price ceiling was controlled. Such pricing did not factor in risks and made effective risk management by issuers and buyers impossible.
6. Administrative rules required bank guarantee for enterprise bond issue. This is closely related to the problems mentioned just now. Since bond issue quota was administratively allocated and price controlled, and neither information disclosure nor credit rating was

available, bank guarantee seemed to be the natural solution. However, once guaranteed by a bank, the product was no longer a standard enterprise debt.

7. Bond was issued to individual investors, whereas the international practice is to institutional investors with analyzing capability, i.e. qualified institutional investors. Individual investors usually do not have sufficient market analysis ability or risk bearing capability.

8. Effective constraint by market was not established. Market mechanism can constrain the issue and transaction of corporate bond because investors form a judgment on and choose from products. That is, it is up to the market to determine what enterprise debts fare well and what don't, prices of products and consequences of default. If the market does not exercise effective constraint, we will have to use administrative and supervisory means for constraint, ensuing a series of problems. Alongside market constraint, a transaction mode should be established for OTC to play a dominant role, to enable measuring of counter party risks and flexibilities in price judgment.

9. Investor education was not sufficient. To a large extent, many investors at that time treated enterprise bond as a variation of savings product. Whenever default occurred, they would bring the problem to government agencies and request redemption from underwriters.

10. A proper bankruptcy law was absent. In case of default, the existing Bankruptcy Law cannot use bankruptcy as the last resort of deterrence to restrain the enterprise in question. As a result, creditors' rights and interests as provided for by the Bankruptcy Law usually cannot be protected. In case of bankruptcy, at least the residual assets of the failed enterprise can be claimed. But in China, the reality is many enterprises' residual assets disappeared without a trace and some enterprise issuers disappeared without going through any legal procedures.

11. Underwriter's role was not properly defined. In the past, underwriting and redeeming was planned and thus became the target of administrative intervention. An underwriter, which was expected to provide redemption, was liable when the enterprise failed to do so. In fact, the roles of the underwriter, sales agent, redemption agent and that of the redemption body are different and have different legal implications. These definitions were not clearly provided for, giving rise to many difficult problems later on.

12. When a default case was handled, the approach was more about administrative intervention. More often than not, default of an issuing enterprise was not dealt with according to market principle. Rather, through administrative intervention, the underwriter was requested to make a follow on offering. Thus, default obligations of the issuing enterprise were transferred to the underwriter and bogged the latter down. Recently, some securities companies have incurred problems and undergone liquidation or restructuring. The causes of these cases can be traced back to historical burden of defaulted enterprises.

II. An analysis of the past mistakes

The above mistakes are inter-related. We should look at them in a comprehensive manner, and identify major themes of analysis. To me, there are three major themes:

The first is people's mindset. When the economy was in transition, command economy mentality was at play in our economic sphere. We tended to follow the planned economy approach to deal with any problems. Thus, when first emerged, some problems did not get proper attention. Some elements of our previous approach, such as administrative allocation of quota, price control, mis-definition of roles, lack of information, and handling of default, were products of command economy mindset. People did not know enough about how a market economy would operate or the environment it would need. More study and efforts should have been made then. Today, when looking at issues, we should try our best not to simplify them and avoid a repetition of command economy approach.

The second is about logic. Ultimately, a series of mistakes related to enterprise bond was caused by lack of institutional design in market operation. Normally, the intended buyer of corporate bond is QIBs (qualified institutional buyers), who are strong in market analysis and risk taking. Corporate bond issue usually follows a simple procedure and can be done quickly. Individual investors, weak in market analysis and risk taking, tend to rely on government. Therefore, governments may require bank guarantee for bond issue. Also, lack of pricing ability may cause administrative pricing. In case of default, individual investors lacking proper means of self-protection tend to hold the government accountable; the government in turn may make the underwriter take over the responsibility through administrative intervention. A follow-on issue thus takes place, giving rise to many distortions and even more serious consequences. If we had QIBs as corporate bond investors, these inter-related problems would have been avoided. From a logic point of view, identifying a proper investor base is the key.

When launching a new financial product, we should take individual investors into account and aim at diversifying their investment choices. However, not all products are suitable to these investors. We need to develop or introduce financial products for them. In the future, more sophisticated financial derivatives are likely to be introduced. But, these products are not at all suitable choices of individual investors.

In developed countries, corporate debts are mainly issued to QIBs and mostly transacted through OTC. Counter party risks are emphasized and the two parties decide the price. A small amount of high-grade bonds with low default risks are transacted at organized exchanges. Organized exchanges usually impose a volume limit on corporate bond transaction. Large volume is all done through OTC.

Take the U.S. market, a highly developed bond market, as an example. Institutional investors hold about 90% of outstanding bond and individual investors hold the balance. These very wealthy individuals, more like institutional investors in nature, usually hold high-grade corporate debt. A very small amount of low-grade bond is in the hand of individual investors because bonds are downgraded as a result of declining corporate performance.

From a logical point of view, QIBs and OTC are the defining features of corporate bond market. If we fail to follow this logic, things will get problematic.

The third is about environment. Corporate debts need an appropriate eco-environment, which includes institutional set-up, such as good laws and regulations (that provide clear legal definition), an improved accounting system (that provides all the necessary information to investors without misleading them), regulation of information disclosure, and improved bankruptcy law, etc.

If we have the right mindset, logic and environment, without a heavy dose of control, QIBs and OTC transaction will foster the development of corporate debt, because market will exercise fairly strong constraint. Supervisory workload will be lighter as well. When SMEs, innovative and start-up enterprises issue bond by a large scale, the supervisors will have to work harder because some of innovative SMEs go public after relying on bond financing in its early stage of development. Often the process suffers from lack of transparency, no disclosure and cover-ups. The story of junk bond in the U.S. can provide some reference in this regard.

III. Possible solutions

A clear understanding of the problems helps us to find solutions.

First of all, we must adopt a market-oriented way of thinking. If the past practice of allocation, administrative approval and intervention continues, the prospect of bond market will not look bright. At the same time, old-fashioned command economy mindset must be put aside when we analyze what went wrong. Some cited non-fundamental, minor or even secondary problems as the root cause. Therefore, it is helpful to thoroughly discuss and understand these questions in a meeting like today's.

Second, we need to get the logic right when solving problems. The best starting-point is to have QIBs and OTCs, so that institutions with strong analytical and risk management capability can play a big role. This will simplify administrative approval and control because it relies on information disclosure and market restraint, rather than the judgment of approving authority. Guarantee by commercial banks is not necessary either. Even in the case of worsening performance or default of issuing company, institutional investors have the capacity to make a judgment and manage the risks in due time. The government does not need to worry too much about them.

Third, strengthening environmental and institutional setting and improving eco-environment. We have to do this job continuously. Indeed, things have improved greatly, but we still need to work hard on it. In recent years, our accounting standards have been more and more consistent with international best practice; requirements on disclosure and disclosure oversight have been enhanced; the Bankruptcy Law is being amended and expected to better protect creditors' interests.

In short, a key starting point is to develop QIBs and OTC as the best way to foster market development.

In this regard, a related matter is SMEs financing. People have come to understand the importance of developing SMEs and paid a lot of attention to their financing difficulties. How to look at this issue? We should avoid simplifying it. Usually there are two ways to develop bond market and provide SMEs with financing.

One is to develop external constraint and bring commercial banks' attention to SMEs. International experiences have shown that, when large companies and high-quality enterprises increasingly use bond market financing, banks will naturally provide financing services to SMEs. That is to say, market differentiation is a result of competition. At the moment, commercial banks lend to large and well-run enterprises as a way to improve asset quality and reduce NPLs. There is nothing wrong with this approach. However, once large and well-run enterprises has a preference for bond market, commercial banks will get the signal, divert more of their resources to study SMEs financing and establish a SMEs department.

Another way is to issue SMEs bond. Such bond is usually high-yield and high-risk bond. Without sufficient preparation, without a proper investor base and pricing mechanism, issuing SMEs bond is likely to be problematic. This is related to the general awareness of corporate debt. Is it feasible to launch non-investment-grade products at the early stage of market development? This is the sequencing issue of corporate bond market development. Should we develop low-grade bond 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. Many countries in the world have yet to have a mature SMEs bond market. Even in the U.S., which seems to be a success story, the Michael Milken incident had both positive and negative impacts. I think this experience deserves a careful study if we are to develop a SMEs bond market.

In conclusion, bond market represents the direction of market development and we have to make our best effort to get the job done. One precondition is to have a thorough understanding of past experiences. I welcome comments on my remarks and look forward to a lively discussion.