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China's First Onshore Corporate Bond Default and Its Implications for the Country's Debt Capital Market

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The debt capital market — whether conventional commercial banking, corporate bond issuance or shadow banking — in the PRC[1] has been growing in the past years. It is estimated that outstanding bank loans and bond debt among non-financial companies in Mainland China[2] had reached about U.S.$12 trillion[3] at the end of 2013, the equivalent of more than 120 percent of GDP.[4, 5] It is also estimated that China's corporate debt could hit U.S.$13.8 trillion in 2014, surpassing that of the U.S. as the largest in the world.[6] Total corporate bonds outstanding increased more than tenfold to RMB8.7 trillion (U.S.$1.4 trillion)[7] at the end of January 2014 since the end of 2007.[8]

Due to intervention — whether direct, indirect or perceived — of the PRC government, the debt capital market of Mainland China is characterized by capital allocation inefficiency and a dysfunctional credit system. This is particularly the case in the shadow banking market. Shadow banking is a term for the collection of non-bank financial activities that provide services similar to conventional commercial banks, sometimes through conventional commercial banks. In general, shadow banking takes place through three types of institutions.[9] The first includes third-party wealth management products and trust companies, or financial institutions without licenses and regulatory oversight. The second comprises credit guarantee companies, microcredit firms, or those without licenses and that are partially regulated. The last type includes entities with licenses but that have inadequate regulation, such as money market funds, securitized products, and off-balance-sheet products. While shadow banking is characterized by a lack of regulatory oversight, there is no parallel lack of government intervention. A result of this is mispricing and credit misallocation in this market.

On March 7, 2014, the first onshore[10] bond default occurred in Mainland China. The default concerned an onshore corporate bond issued by a struggling Chinese solar-equipment manufacturing company. The default has raised an alarm that is by no means confined to the corporate bond market, and it has forced reflections upon the threat and issues that the debt capital market in the PRC is facing.

This Focus article explores and reflects upon the circumstances pertaining to this landmark default and its implications for Mainland China's debt capital market, particularly the shadow banking market.

China's First Onshore Corporate Bond Default

On March 7, 2014, Shanghai Chaori Solar Energy Science & Technology Co. ("Chaori Solar"), a Chinese solar-equipment manufacturing company, failed to meet interest payments (the "Chaori Solar Default") of RMB89.8 million (U.S.$14.5 million) on a RMB1 billion[11] (U.S.$161.9 million) five-year bond it issued in 2011 (the "Chaori Solar Bond").[12] This is China's first onshore bond default,[13] and the first default on a publicly traded debt in Mainland China since the PRC government regulations began in 1999.[14]

Perhaps to the surprise of Chaori Solar and many others, there has been no bailout by the PRC government, an event that has been seen as a landmark for market discipline in Mainland China.[15] As of March 18, 2014, the Chaori Solar Bond was suspended on the Shenzhen Stock Exchange.[16]

Implications for China's Debt Capital Market

China's 'Bear Stearns Moment'?

A default of RMB89.8 million (U.S.$14.5 million) is relatively small. However, in an investment environment that is confidence- and speculation-based, the Chaori Solar Default may disrupt the stability of the debt capital market in general and cause panic that could spiral uncontrollably, leading to a chain reaction that is potentially serious. Three companies have postponed domestic debt issues after Chaori Solar warned of its default.[17] The proposed deals were relatively small (ranging from RMB300 million (U.S.$48.6 million) to RMB1 billion (U.S.$161.9 million), but the delays underlined the risk that an unprecedented default will make it more difficult for other companies to access capital.[18]

Some observers described the Chaori Solar Default as China's "Bear Stearns moment."[19] We would recall that six years ago, on March 14, 2008, when it became clear that Bear Stearns Companies, Inc. ("Bear Stearns"), an 85-year-old bank, was facing imminent insolvency, the U.S. Federal Reserve authorized the Federal Reserve Bank of New York to extend a bridge loan to Bear Stearns through JPMorgan Chase Bank, N.A. ("JPMC Bank"), to enable Bear Stearns to meet its immediate liquidity needs and to allow for time during the weekend for Bear Stearns to explore options with other financial institutions that might save it from bankruptcy.[20] On March 17, 2008, however, Bear Stearns was sold to JPMC Bank for U.S.$2 per share, a price which was ultimately raised to U.S.$10.[21] Six months later, Lehman Brothers Holdings Inc. collapsed in the biggest bankruptcy in U.S. history.[22]

The Chaori Solar Default may prompt investors in the debt capital market to "think again" before lending money at artificially low rates to weak companies. The small- to medium-sized private companies which do not have solid fundamentals may be hit the hardest, as demands for their bonds may drop, and borrowing costs may become higher.

As discussed below, the immediate impact of the Chaori Solar Default might be limited, but a default by a financial institution or a local PRC government may easily result in a downward spiral. The threat is not merely theoretical.

The local PRC government audit released in December 2013 showed that local PRC governments have become increasingly reliant on shadow banking to fund their investments. By law, local PRC governments are restricted from borrowing.[23] With the tacit approval of the central PRC government, local PRC governments created special purpose, arm's length vehicles known as LGFVs (Local Government Financing Vehicles), also known as UDICs (Urban Development and Investment Companies), which are permitted to borrow. With pressure on banks to curtail loans, these financing vehicles had borrowed from China's shadow banking market.[24] There are growing concerns centered on borrowing by local PRC governments, which have long used debt to stimulate growth in their regions, often by pursuing projects that are not economically viable or sustainable.[25] The local PRC government audit showed that liabilities carried by local PRC governments had ballooned to RMB17.9 trillion (U.S.$2.9 trillion) as of the end of June 2013, representing an increase of 67 percent compared with RMB10.7 trillion (U.S.$1.7 trillion) as of the end of 2010.[26]

Changing Expectation in China's Debt Capital Market — A 'Pilot Project'?

Nonetheless, the Chaori Solar Default may bring about a healthy change to Mainland China's debt capital market. In the past, the PRC government and state-owned banks often stepped in to provide bailouts or debt extensions to local entities in imminent danger of defaulting on their debts, keeping borrowing costs low for companies with high debts.[27] The primary reason was that the PRC government feared a systemic crisis in the debt capital market caused by panic outflows and loss of confidence.

Chemical fiber company Shandong Hailong in 2012 narrowly avoided default on its RMB400 million (U.S.$64.8 million) short term bond after an injection of capital from the PRC government and banks.[28] CITIC Trust was forced to delay payment on a wealth management product linked to a steel loan in Hubei Province in 2013, but investors were eventually repaid when the PRC government apparently stepped in.[29] In 2013, the investors in a wealth management product sold through Hua Xia Bank were repaid — despite a default on loans — by the unwilling guarantor of the product.[30] Chaori Solar itself narrowly avoided a bond default in February 2013 after the PRC government persuaded banks to defer claims for overdue loans.[31]

Most recently, in January 2014, China Credit Trust Co. ("CCTC") was bailed out of a RMB3 billion (U.S.$485.7 million) trust (the "CCTC Trust"). CCTC was a trust company and part of the PRC's non-bank debt capital

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market — to be specific, the shadow banking market.[32] Most CCTC Trust clients signed an agreement on January 28, 2014, to transfer their rights in the CCTC Trust to unidentified buyers in exchange for an amount equal to the product's face value but forgoing most of 2013's interest payments.[33] The offer to investors was presented on January 27, 2014, by Industrial & Commercial Bank of China Ltd., which distributed the trust product in 2011.[34] Separately, CCTC announced that it had reached an agreement with an unidentified third party to sell the shares it had acquired in Shanxi Zhenfu Energy Group.[35] Despite the uncertainty of the details, this was widely regarded as a bailout by the PRC government.

The Chaori Solar Default may be a "pilot project"[36] by the PRC government, signaling a landmark change as the PRC government takes a new stance in treating at least some corporate debt crises according to market rules.[37] As an 85 percent majority owner of the Chaori Solar Bond's underwriter, the PRC government appeared to have managed and even desired the Chaori Solar Default,[38] noting that the local PRC government and the underwriter involved had sufficient funds for a bailout.[39] Chaori Solar was a relatively small company that had been in crisis for years,[40] and was in a discredited industry suffering from an overcapacity problem. There was unlikely to be any major immediate impact on the debt capital market. By contrast, CCTC was a major Chinese shadow bank.[41] It was unlikely that the PRC government would have allowed a default that would create a systemic risk for the debt capital market or the economy.

Changing the 'Game Rule'?

The debt capital market in Mainland China had long assumed that even high-yielding debt carried an implicit state guarantee.[42] This was an unhealthy phenomenon, when investors looked for the highest yields without considering the risks. Investor education was lacking, with buyers mistakenly believing that these products were risk free. The bailout culture created a moral hazard phenomenon where investors were receiving the rewards and third parties were bearing the risks. Credit risk should play an important role in pricing, making the market more efficient in the allocation of capital. However, the Chinese market is distorted when investment decisions are influenced by whether the companies are most likely to be bailed out, rather than the performances and fundamentals of the companies. The bulk of the financial products developed under the shadow banking market, such as the CCTC Trust, were not priced according to the risk of the underlying assets.[43]

Money borrowed for the sake of growth alone is a poor allocation of capital. A good example may be found in the coal industry: It was hoped that financing from the CCTC Trust could be used to open a new mine to help generate cash flow to pay off the loan. However, the Chinese coal sector is riddled with overcapacity and unprofitable firms,[44] and capital was not turned into new productivity. The scale of China's credit boom is a global problem. China accounts for half of all the U.S.$30 trillion increase in world debt over the past five years.[45]

The scarcity of discipline in the shadow banking market is posing a risk to the Chinese economy. There is a critical need to have a slow and steady climbing down from the peaks of this moral hazard.

The Chaori Solar Default may force a change of the "game rule" in two respects.

At the market level, the Chaori Solar Default may force self-discipline in the debt capital market on the part of both investors and issuers. The change to the bailout culture, marked by the Chaori Solar Default, and rising default risk may have started to erode Chinese investors' confidence. Such adjustments, however, are necessary for China in the long run in correcting the phenomenon of mispricing and credit misallocation. Re-pricing in the shadow banking market and the corporate bond market may cause disruption to the existing markets. However, it will also improve capital allocation efficiency, where capital would flow to companies with sound fundamentals and where raised capital would be used to generate profit-making activities and real productivity.

At the governmental level, the PRC authorities are considering to regulate — and not merely to bail out — the non-bank debt capital market. The CCTC Trust crisis might have prompted the People's Bank of China and the National Audit Office to announce in January 2014 that they would begin an audit of shadow banking; the announcement followed the release of the local PRC government debt audit[46] and the State Council Document No. 107 calling for the strengthening of shadow banking regulations.[47] The scarcity of shadow banking regulations had in the past allowed a greater scope for financial innovation and stimulated the growth of small and medium enterprises (SMEs), providing a diversity of sources of financing and stimulating economic growth. Indeed, one of the dilemmas the PRC government may face is the conflicting goals of economic growth and control of the shadow banking market. To rein in riskier shadow banking lending would inevitably hamper economic growth, as many SMEs rely on the shadow banking market to fund their business ventures.

Spillover to the Banks

Although the Chaori Solar Default and the near-default of the CCTC Trust occurred in the non-bank debt capital market of Mainland China, it is hard to see that the bank debt capital market can isolate itself from the impact of the Chaori Solar Default.

In recent years, in order to curtail excessive leverage, the PRC government has tightened conditions for conventional commercial bank lending, implemented deposit interest rates control measures and financial/banking regulation that set limits on conventional banking activities. Credit constraints in the bank debt capital market have led to an inefficient capital allocation in the banking system, wherein a lot of companies, especially the SMEs, have found it difficult to access capital. These have led to the development and expansion of non-bank debt capital market, especially the shadow banking market.

In order to circumvent high reserve requirements and quantitative controls, conventional commercial banks have also moved loans off their balance sheets to wealth management products, fueling artificial credit expansion in the shadow banking market. The central feature of China's shadow banking market is its relationship with its regulated counterparts. Banks may arrange and act as an agent in a loan from one non-financial company to another. Banks can sell assets to trust companies or create wealth management products to channel client funds to them. Banks use non-discounted bankers acceptances to transfer assets to the shadow banking market, against a partial or full payment guarantee from the issuer. Corporate bonds may be bought by trusts, which are then re-packaged into wealth management products for depositors.[48] The involvement of banks may also serve as an enhancement to the apparent credit quality of the relevant product.

The debt capital market, whether in the form of bank loans, corporate bond issuance or shadow banking, is all interconnected. According to the chairman of the China Banking Regulatory Commission, Mainland China's banking industry may face a series of changes in 2014, including the country's economic adjustment, the emergence of Internet finance (such as peer-to-peer lending or crowdfunding, which are, broadly speaking, forms of shadow banking) and uncertainties in the global economy.[49]

Coming Soon . . .

Let the Market Develop!

The PRC government may be making a strategic decision to allow the Chaori Solar Default,[50] to help accelerate the pace of market reform.[51] The Chaori Solar Bond is a corporate bond issued by a struggling company in a discredited sector, and not a product of the shadow banking market like the CCTC Trust.[52] Some see it as a test case in a more isolated platform for the non-bank debt capital market in general, especially for the shadow banking market,[53] upon which the huge growth of debt in the Chinese economy is largely centered.[54]

The PRC government pledged in November 2013 to give markets a more decisive role in the Chinese economy. The Chaori Solar Default may well be one of the moves by the PRC government in line with its pledge. The challenge is to remove artificial credit expansion from the debt capital market without causing a credit crunch or liquidity shortage. Given the lack of transparency in the Chinese economy compared to other major economies, and the strong economic fundamentals of the PRC government, it is unlikely that the PRC government would allow any "market" development in the Chinese economy to go uncontrolled.

In correcting credit misallocation in the non-bank debt capital market and matching risks and prices to market standards, the PRC government may be moving in a healthy direction for the debt capital market as a whole in the long run. Introducing appropriate regulations to the shadow banking market may also prevent situations where the PRC government had in the past intervened in order to prevent systemic risk. The challenge is to balance risk and financial innovation: This will test the pace of the capital market development of China. More selective and managed defaults may be expected.

Alarm Triggered

A default of a more isolated nature may not cause major, immediate impact. A default to which many investors could relate by analogy, however, might precipitate fear in the non-bank debt capital market. Interconnectedness of transactions may give rise to systemic risk.

The risk of more defaults in 2014 is very real. The number of Chinese companies whose debt is double their equity has surged since the global financial crisis: Publicly traded non-financial companies with debt-to-equity ratios exceeding 200 percent have jumped 57 percent from 163 in 2007 to 256 in 2014;[55] some 63 of these publicly traded non-financial companies have a debt-to-equity ratio exceeding 400 percent.[56] Mainland China's renewable energy industry (Chaori Solar is a renewable energy company) alone faces a record U.S.$7.7 billion in bonds maturing in 2014.[57] "The domestic economy is slowing, liquidity is tightening globally and more bonds are maturing [in 2014] with greater refinancing pressure."[58] There were around 28 near or technical defaults since 2012, all of which involve trust products,[59] the largest form of shadow banking.[60] More than 43 percent of the RMB10.9 trillion (U.S.$1.8 trillion) worth of outstanding trust products fall due for repayment in 2014.[61] The threats are real.

The Chaori Solar Default has raised an alarm in Mainland China's non-bank debt capital market, in particular the less or non-regulated shadow banking market. The connection between the non-bank debt capital market and the bank debt capital market means that the latter would also be affected.

The Chaori Solar Default and the threat of further defaults may force an adjustment in investors' behavior, particularly in areas where investment products had been priced or traded based on an expectation or perception of government involvement.

As investors and issuers self-regulate their investment activities by market rules, we may see an improvement in capital allocation efficiency in Mainland China's debt capital market.

NOTES

[1] "PRC" in this article refers to the People's Republic of China, excluding Hong Kong, Macau and Taiwan.

[2] "Mainland China" in this article refers to the geopolitical area under the jurisdiction of the PRC, excluding Hong Kong, Macau and Taiwan.

[3] "Trillion" in this article refers to a million million, *i.e.*, 1,000,000,000,000.

[4] GDP means gross domestic product, the market value of all officially recognized final goods and services produced within a country in a year, or another given period of time.

[5] According to Standard & Poor's, see "China Bond Default Risk Prompts Others to Delay Fund Raising," Reuters, March 6, 2014.

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[6] According to Standard & Poor's, see "Shanghai Chaori in Default on Bond Interest Payments" by Lingling Wei, Wall Street Journal, March 6, 2014.

[7] In this article, the RMB to U.S.$ exchange rate is RMB1 = U.S.$0.1619. All figures are rounded to the nearest decimal place.

[8] "Shanghai Chaori in Default on Bond Interest Payments" by Lingling Wei, Wall Street Journal, March 6, 2014.

[9] According to the State Council Document No. 107 released in December 2013, which did not define shadow banking, see "Fears of China's Shadow Banking Implosion Are Overblown" by Nina Xiang, Forbes, February 18, 2014.

[10] "Onshore" in this article refers to the jurisdiction of the PRC.

[11] "Billion" in this article refers to a thousand million, *i.e.,* 1,000,000,000.

[12] "Chinese default landmark looms" by Jing Song, Finance Asia, March 5, 2014.

[13] According to Moody's Investors Service, see "Shanghai Chaori in Default on Bond Interest Payments" by Lingling Wei, Wall Street Journal, March 6, 2014.

[14] "Chaori Solar default is a test case for China's markets" by Linda Yueh, BBC News, March 7, 2014.

[15] "Watershed moment for China markets with Chaori Solar bond default," Reuters, Bloomberg, March 7, 2014.

[16] See data from the Shenzhen Stock Exchange (http://www.szse.cn/main/marketdata/hqcx/zqhq_history/) and Bloomberg (http://www.bloomberg.com/quote/002506:CH/profile).

[17] "China Bond Default Risk Prompts Others to Delay Fund Raising," Reuters, March 6, 2014.

[18] According to Moody's Investors Service, see "Shanghai Chaori in Default on Bond Interest Payments" by Lingling Wei, Wall Street Journal, March 6, 2014.

[19] See, for example, "China Bear Stearns Moment Seen by BofA in Solar Default" by Justina Lee, Bloomberg, March 7, 2014.

[20] "Bear Stearns, JPMorgan Chase, and Maiden Lane LLC," Transaction Data, Federal Reserve (last updated on August 2, 2013).

[21] "A Look Back At Bear Stearns, Five Years After Its Shotgun Marriage to JPMorgan" by Steve Schaefer, Forbes, March 14, 2013.

[22] See, for example, "China Bear Stearns Moment Seen by BofA in Solar Default" by Justina Lee, Bloomberg, March 7, 2014.

[23] See, for example, Budget Law of the PRC.

[24] " 'Shadow banks' pose risk to China investors" by Satyajit Das, Market Watch, the Wall Street Journal, February 26, 2014.

[25] "China's Li says debt defaults 'hardly avoidable,' " Agence France-Presse, March 3, 2014.

[26] "China's Li says debt defaults 'hardly avoidable,' " Agence France-Presse, March 3, 2014.

[27] According to Moody's Investors Service, see "Shanghai Chaori in Default on Bond Interest Payments" by Lingling Wei, Wall Street Journal, March 6, 2014.

[28] "Chinese default landmark looms" by Jing Song, Finance Asia, March 5, 2014.

[29] See "Latest China bailout reveals risk of local govt's hidden debts" by Gabriel Wildau, Reuters, May 7, 2013; "In China, troubled shadow bank product tests no-default policy" by Heng Xie and Gabriel Wildau, Reuters, January 16, 2014.

[30] See "Guarantor repays principal on failed Huaxia product" by Daniel Ren, SCMP, January 23, 2013; "In China, troubled shadow bank product tests no-default policy" by Heng Xie and Gabriel Wildau, Reuters, January 16, 2014.

[31] "Watershed moment for China markets with Chaori Solar bond default," Reuters, Bloomberg, March 7, 2014.

[32] "Losing Faith in China's Trusts?" by Shuli Ren, Barrons, February 8, 2014.

[33] "China Credit Repays Principal to Bailed-Out Trust Holders" by Bloomberg News, Bloomberg, January 30, 2014.

[34] "China Credit Repays Principal to Bailed-Out Trust Holders" by Bloomberg News, Bloomberg, January 30, 2014.

[35] "China Trust Default Avoided . . . What Comes Next?" by Oliver Barron, Forbes, January 27, 2014.

[36] "China's first bond default is no Bear Stearns moment" by Jamil Anderlini, Financial Times, March 6, 2014.

[37] "China's Chaori Solar Energy Not Counting on a Bailout" by Wynne Wang, Wall Street Journal, March 6, 2014.

[38] "China's first bond default is no Bear Stearns moment" by Jamil Anderlini, Financial Times, March 6, 2014.

[39] See, for example, "China Bear Stearns Moment Seen by BofA in Solar Default" by Justina Lee, Bloomberg, March 7, 2014.

[40] "China's first bond default is no Bear Stearns moment" by Jamil Anderlini, Financial Times, March 6, 2014.

[41] "Trust bailout highlights massive growth of China's 'shadow banking' " by Oliver Campbell, World Socialist Web Site, February 6, 2014.

[42] "Watershed moment for China markets with Chaori Solar bond default," Reuters, Bloomberg, March 7, 2014.

[43] "Trust bailout highlights massive growth of China's 'shadow banking' " by Oliver Campbell, World Socialist Web Site, February 6, 2014.

[44] "China's Shadow Banking System: A Threat to Aussie Share Prices" by Dan Denning, Money Morning, January 28, 2014.

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[47] "China Trust Default Avoided . . . What Comes Next?" by Oliver Barron, Forbes, January 27, 2014.

[48] " 'Shadow banks' pose risk to China investors" by Satyajit Das, Market Watch, the Wall Street Journal, February 26, 2014.

[49] According to Shang Fulin, chairman of the China Banking Regulatory Commission, in an article published by him in China Banking magazine earlier in March 2014, "Shadow banking system risk overestimated" by Chen Yang, Global Times, March 6, 2014.

[50] "Chaori Solar in landmark Chinese bond default" by Kim Gittleson, BBC News, March 7, 2014.

[51] "This is huge: China may allow its first-ever corporate bond default" by Gwynn Guilford, Quartz, March 5, 2014.

[52] "Chaori Solar default is a test case for China's markets" by Linda Yueh, BBC News, March 7, 2014.

[53] See, for example, "Chaori Solar default is a test case for China's markets" by Linda Yueh, BBC News, March 7, 2014.

[54] "Trust bailout highlights massive growth of China's 'shadow banking' " by Oliver Campbell, World Socialist Web Site, February 6, 2014.

[55] "Chaori Can't Make Full Payment in China's First Onshore Default" by Bloomberg News, Bloomberg, March 7, 2014.

[56] "Chaori Can't Make Full Payment in China's First Onshore Default" by Bloomberg News, Bloomberg, March 7, 2014.

[57] "Zombies Spreading Shows Chaori Default Just Start: China Credit" by Bloomberg News, Bloomberg, March 7, 2014.

[58] According to Zhang Yingjie, Beijing-based deputy general manager in China Chengxin International Credit Rating Co., Moody's Investors Service's joint venture in Mainland China, see "Zombies Spreading Shows Chaori Default Just Start: China Credit" by Bloomberg News, Bloomberg, March 7, 2014.

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