China's Opens Corporate Bond Issuance Market to Foreign Banks

Eiichi Sekine
Senior Analyst,
Nomura Institute of Capital Markets Research

I. Issuance of financial bonds

On 20 May 2010, the Bank of Tokyo-Mitsubishi UFJ (China), the Chinese subsidiary of the Bank of Tokyo-Mitsubishi UFJ, issued two financial bonds on China's interbank market for a total of RMB1 billion (about ¥13.5 billion)[1], marking the first issuance inside China of a yuan-denominated bond by a foreign bank's Chinese subsidiary (Figure 1).

These bonds, issued for a two-year term with a floating rate based on the five trading day average for 3-month Shibor[2] (the coupon was 2.43% at issuance), were rated AAA within China. Investors in the issue were primarily institutional investors who participate in the interbank bond market, and the funds procured must be used within China. Accordingly, the yuan procured was not transferred from the bank's Chinese subsidiary to its main branch in Japan.

The lead underwriter of the bond issue was the Bank of China, with 12 other companies participating in the underwriting, including three securities firms: the foreign capitalized BOC International (part of the Bank of China group) and two purely Chinese firms, Ping An Securities (the Ping An group) and Haitong Securities.

China has been gradually opening its issuance market to foreign firms. Examples of issues by nonresident entities include three Panda bond issues (yuan-denominated bonds issued by nonresident entities) from the International Finance Corporation (IFC) and Asia Development Bank (ADB) since 2005, and, from resident entities, a securitization of auto loans issued by GMAC-SAIC Automotive Finance in 2008. The prohibition on the issuance of yuan-denominated bonds by the Chinese subsidiaries of financial institutions in Hong Kong was lifted in 2007, and the Chinese subsidiaries of foreign banks issued yuan-denominated bonds in Hong Kong in 2009.

The prohibition on the domestic issuance of yuan-denominated bonds by the Chinese subsidiaries of foreign banks was formally lifted with The Opinions Regarding the Current Use of Financing to Spur Economic Development (Thirty

1 Conversion to yen based on RMB1=¥13.45, the mid-rate on 20 May 2010.
2 Shibor stands for Shanghai Interbank Offered Rate.

Figure 1: Bank of Tokyo-Mitsubishi UFJ (China) issues financial bonds

Item	Details
Issuance date	20 May 2010
Issuance amount	Rmb 1 billion
Issuance term	2 years
Issuance yield	2.43% when issued Five trading day average for 3m Shibor
Credit rating	AAA
Use of proceeds	Limited to use in China

Role	Company
Lead manager	Bank of China
Underwriting institution	Industrial & Commercial Bank of China, Agricultural Bank of China China Merchants Bank, China Minsheng Banking Shanghai Pudong Development Bank, Jiangsu Bank, Bank of Nanjing China Development Bank, Government Savings Bank BOC International, Ping An Securities, Haitong Securities
Rating agency	Shanghai Brilliance Credit Rating & Investors Service Co., Ltd. (SBCR)
Accounting firm	Deloitte Touche Tohmatsu CPA
Law firm	Zhong Lun Law Firm
Custodian	China Government Securities Depository Trust & Clearing Co. LTD (CGSDTC)

Note: The issuer was the Chinese subsidiary of the Bank of Tokyo-Mitsubishi UFJ's Chinese subsidiary.
Source: Nomura Institute of Capital Markets Research, based on offering materials from the Bank of China

Opinions on Financing) issued by the State Council on 8 December 2008[3], and further confirmed with the set of opinions issued by the Shanghai City government on the concept of a Shanghai international financial center[4] on 8 May 2009.

II. Status of China's corporate bond market

1. Continued growth in China's corporate bond market since 2008

Both the primary and secondary markets for corporate bonds in China are separated into exchange-traded markets and OTC markets (the interbank bond market and over-the-counter market), as shown in Figure 2. The supervising entity and rules differ depending on the issue.

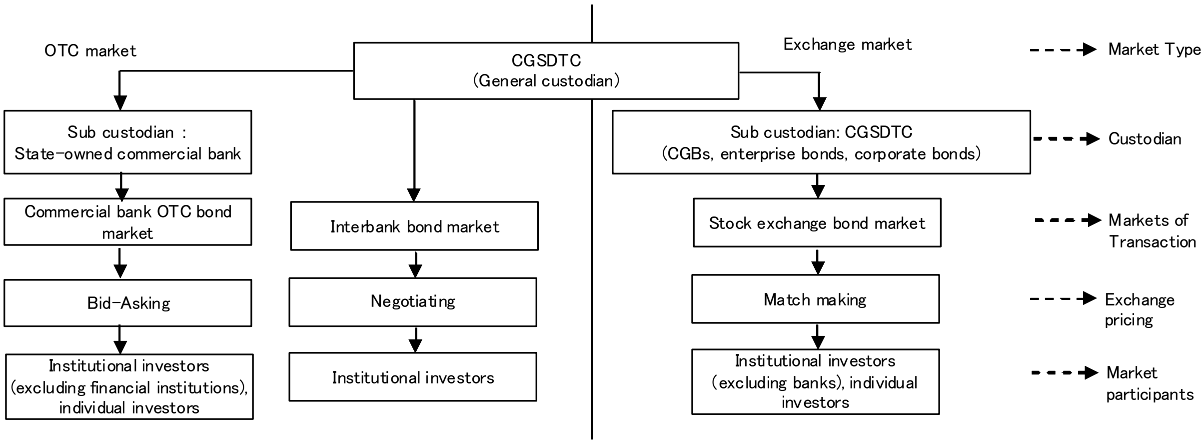
Issuance in China's corporate bond market in 2009 totaled RMB1.6599 trillion (¥22.5 trillion)[5], including, in the interbank bond market, RMB461.2bn of commercial

3 See Eiichi Sekine, *Chuugoku no Kin'yu Sanjuujou Iken wo Tsujita Shihonshijo Kaikaku* (China's thirty-point financial blueprint calls for further capital market reform), China Capital Markets Research, Spring 2009 (in Japanese).

4 See Eiichi Sekine, *Chuouseifu no Shouninn wo Ukete Ugoki dashita Shan'hai Kokusai Kin'yu Sen'taa* (Shanghai International Financial Center plan approved by the central government), China Capital Markets Research, Summer 2009 (in Japanese).

5 Conversions to yen in this section based on RMB1=¥13.55, the mid-rate on 31 December 2009.

Figure 2: Composition of China's bond market



Source: Nomura Institute of Capital Markets Research, based on data from ChinaBond

Figure 3: Issuance amounts in corporate bond market

(RMB billions)

	2005	2006	2007	2008	2009
Short-term finance bonds (CP)	142.4	292.0	334.9	433.2	461.2
Medium term notes (MTN)	0.0	0.0	0.0	173.7	690.0
Enterprise bonds	69.4	101.5	175.2	236.7	425.2
Corporate bonds	0.0	0.0	11.2	28.8	73.5
Convertible bonds	0.0	14.3	23.2	77.3	7.7
Asset backed securities (Interbank bond market)	7.2	11.6	25.8	30.2	0.0
Asset backed securities (Stock exchange market)	0.6	4.8	0.0	0.0	0.0
Collective bonds	0.0	0.0	0.0	0.0	1.3
Panda bonds	2.1	0.9	0.0	0.0	1.0
Total	221.7	425.0	570.4	979.8	1,659.9

Source: Nomura Institute of Capital Markets Research, based on data from Wind Information

paper (CP), RMB690bn of medium-term notes (MTN), RMB1.3bn of collective bonds (issued jointly by smaller firms), and RMB1bn of Panda bonds, and on the exchange bond market, RMB425.2 billion of enterprise bonds, RMB73.5 billion of corporate bonds, and RMB7.7 billion of convertible bonds. This set a new record high, surpassing the RMB979.8 billion of issuance in 2008 (Figure 3). This also marked two consecutive years (2008 and 2009) of bond issuance being higher than equity finance (domestic and overseas combined), which totaled RMB685.8 billion (about ¥9.3 trillion) in 2009.

The growth in the corporate bond market since 2008 can be attributed in part to the easing of regulations governing issuance in the interbank bond market[6]. The first round of deregulation, spurred by the introduction of MTNs in April 2008, was a

6 See Eiichi Sekine, *Chuugoku no Shasai Hakko Seido Kaikaku* (Reform of China's rules governing corporate bond issuance), China Capital Markets Research, Spring 2009 issue (in Japanese).

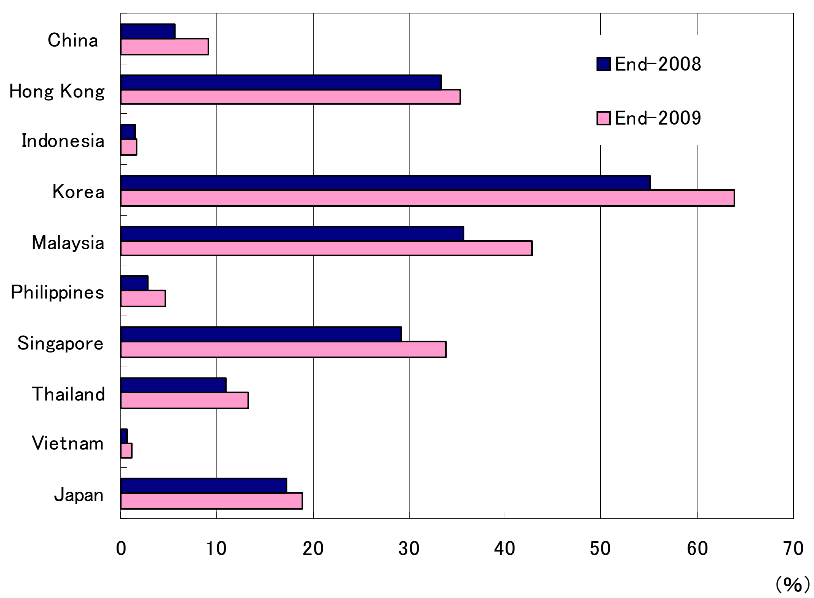
change in rules requiring that issuance of MTN and CP be subject to examination by the People's Bank of China to simply a requirement to register that issuance with a self-regulatory organization (SRO) that was established in September 2007. The second round was a change from each issuer having to apply and gain approval to merely a confirmatory registration process within preset issuance parameters. Thirdly, statutory minimum net asset requirements were removed, which opened the way for a diversification of issuers.

2. Extent of development of the corporate bond market: China vs. elsewhere in Asia

The volume of issuance in China's corporate bond market has in fact been growing, particularly since 2008, but how does it compare with issuance volume in other Asian markets relative to economic size?

The March 2010 edition of the Asia Bond Monitor, a quarterly publication of the ADB, ran a comparison of the local currency-denominated bond issuance outstanding (both government and corporate bonds) in each of the major Asian countries relative to GDP. At end-2009, outstanding issuance of corporate bonds was only 9.2% of GDP for China, below that for Korea, Malaysia, Singapore, and Thailand (Figure 4). For China's corporate bond market to grow to a level commensurate with the size of its economy, China must pursue reforms aimed at creating a deeper, more liquid market.

Figure 4: Local currency-denominated corporate bond issuance outstanding relative to GDP in the major countries of Asia



Source: Nomura Institute of Capital Markets Research, based on the March 2010 issue of the ADB's Asia Bond Monitor

III. Diversification of issuers and the new participation of foreign issuers

1. Prohibition on issuance of financial bonds by nonbanks is lifted

One of the most important reforms needed for China's corporate bond market is a further diversification of issuers in the primary market. Although there has yet to be any issuance as a result, on 18 August 2009 the People's Bank of China and the China Banking Regulatory Commission (CBRC) lifted the prohibition on the issuance of financial bonds on the interbank bond market by the financial lease companies and automobile financing companies (in both cases Chinese subsidiaries of foreign firms) whose establishment was authorized by the CBRC.

To be eligible to issue bonds, a company must meet the minimum capital requirements of RMB500 million for finance lease companies and RMB800 million for automobile financing companies, and must also have reported a profit for the past three years.

The CBRC has authorized 13 financial lease companies (Figure 5) and 10 automobile financing companies (Figure 6). The financial lease companies include a US subsidiary (Bank of America) and the automobile financing companies include two Japanese subsidiaries (Toyota Motor and Nissan Motor). Bank loans are the only option for financial lease companies or automobile financing companies to procure outside funding, whether they are capitalized domestically or by a foreign firm.

Figure 5: The major financial lease companies authorized by the CBRC (by total assets)

	Financial leasing company	Total assets (RMB billions)	Capital (RMB billions)	Shareholder composition	Shareholder composition (detailed)
1	CDB Leasing Co., Ltd.	30.3	8.0	Chinese side (100%)	China Development Bank HNA Group Avic Xi'an Aircraft Industry (Group) Company Ltd.
2	China Huarong Financial Leasing Co., Ltd.	21.6	2.0	Chinese side (99.9%)	China Huarong Asset Management Corporation (99%)
3	Industrial and Commercial Bank of China Leasing	11.6	5.0	Chinese side (100%)	Industrial & Commercial Bank of China (100%)
4	Jiangsu Financial Leasing Co., Ltd.	n.a	n.a	Chinese side (100%)	Jiangsu Communications Holding Co., Ltd. Bank of Nanjing
5	Hebei Financial Leasing Co., Ltd.	n.a	0.5	Chinese side (100%)	n.a
6	Shanxi Financial Leasing Co., Ltd.	n.a	0.5	Chinese side (100%)	Shanxi International Electricity Group Co., Ltd. Shanxi Jintong Investment & Management Co., Ltd.
7	China Merchant Bank Financial Leasing Co., Ltd.	n.a	2.0	Chinese side (100%)	n.a
8	Minsheng Financial Leasing Co., Ltd.	n.a	3.2	Chinese side (100%)	China Minsheng Banking (81.25%) Tianjin Port Free Trade Zone Investment Co., Ltd. (18.75%)
9	China National Foreign Trade Financial & Leasing Co., Ltd.	n.a	0.5	Chinese side (100%)	China Minmetals Corp. (50%) China Orient Asset Management Corp. (50%)
10	CCB Financial Leasing Corp. Ltd.	n.a	4.5	Chinese side (75.1%) Foreign side (24.9%)	China Construction Bank (75.1%) Bank of America (24.9%)
11	Bank of Communions Finance Leasing Co., Ltd.	n.a	2.0	Chinese side (100%)	Bank of Communications (100%)
12	Xinjiang Great Wall Financial & Leasing Co., Ltd.	n.a	0.5	Chinese side (100%)	China Great Wall Asset Management Corporation (100%)
13	Sichuan Financial Leasing Co., Ltd.	n.a	n.a	Chinese side (100%)	n.a

Source: Nomura Institute of Capital Markets Research, based on local news reports and each company's website

Figure 6: The major automobile financing companies authorized by the CBRC (by total assets)

	Company	(Foreign side)	(Chinese side)	Date established
1	GMAC-SAIC Automotive Finance Co. Ltd.	GMAC (40%)	Shanghai Automotive Group Finance Co. Ltd. (40%) Shanghai General Motors Co. Ltd. (20%)	August 2004
2	Volkswagen Finance (China) Co. Ltd.	Volkswagen	Wholly owned subsidiary	September 2004
3	Toyota Motor Finance (China) Co., Ltd.	Toyota Motor	Wholly owned subsidiary	January 2005
4	Ford Automotive Finance (China) Ltd.	Ford	Wholly owned subsidiary	July 2005
5	DaimlerChrysler Financial Services	Daimler Chrysler	Wholly owned subsidiary	November 2005
6	Volvo Financial Services	Volvo	Wholly owned subsidiary	July 2006
7	Dongfeng Peugeot-Citroen Auto Finance Co.	Citroen (25%)	BOC Insurance (50%) Dongfeng Peugeot Citroen Automobile Co. Ltd. (25%)	July 2006
8	Dongfeng Nissan Auto Finance Co., Ltd.	Nissan Motor (65%)	Dongfeng Motor Group Co., Ltd. (35%)	October 2007
9	Fiat Auto Financial Services Ltd.	Fiat	Wholly owned subsidiary	December 2007
10	Chery Huiyin Automobile Finance Co.	—	Chery Automobile Co., Ltd. (80%) Huishang Bank (20%)	June 2008

Source: Nomura Institute of Capital Markets Research, based on data from the Almanac of China's Finance and Banking and various other sources

Foreign firms are limited to capital brought in from the home country and yuan-denominated bank loans obtained locally. Increases in capital require approval by the CBRC and hence cannot be done flexibly, while local borrowing is affected by volume restrictions put in place by the monetary authorities during periods of monetary tightening. Allowing these nonbanks to issue bonds provides them a greater range of funding options, promotes business investment by way of equipment leases, and leads to growth in the production and sale of automobiles by making it easier to get an automobile loan, all of which should contribute to sustained growth in China's economy through the expansion of domestic demand.

2. There are also moves underway to allow foreign nonfinancial firms to issue bonds

According to preliminary figures published by the United Nations Conference on Trade and Development (UNCTAD)[7], foreign direct investment worldwide declined 38.7% to $1.0403 trillion in 2009, but the amount of FDI received by China was nearly flat on the year, only declining 2.6% to $90 billion. Foreign capital has a strong preference for FDI into China, the nexus of global growth. The Chinese government has continued to support policies that put a priority on foreign capital, while reconsidering ways to promote the influx of foreign capital. Consequently, the State Council announced on 6 April 2010 its Several Opinions of the State Council on Further Enhancing Utilization of Foreign Capital, wherein it proposed a new policy of selecting foreign capital linked to industrial policy, attracting foreign capital to central

7 Announced on 19 January 2010.

and western regions of China, and devolving the authority over inbound foreign capital to regional governments.

These Opinions contained a number of interesting aspects in regards to capital markets. Namely, they proposed a general approach to the use of capital markets through (1) promoting foreign capitalized strategic investments and M&A, (2) supporting the overseas listings of Chinese firms, (3) establishing with foreign capital (on a trial basis) a small business guarantee company, (4) supporting foreign capital investment in venture firms and private equity funds, and (5) supporting domestic stock offerings/listing and bond issuance by foreign firms. Regarding the last of these, which is especially germane to this paper, it explicitly proposes providing support to foreign-invested firms (Chinese subsidiaries of foreign firms) to publicly offer and list shares within China and issue enterprise bonds and MTNs, as well as gradually widening the scope for nonresident entities to issue yuan-denominated bonds in China. The National Development and Reform Commission and the Ministry of Commerce are the governmental agencies primarily in charge of administering these Opinions, which position the better use of capital markets as a way to improve the investment environment.

Excluding Greater China and tax havens, Japan was effectively the largest source of FDI into China in 2009 with total investment of ¥4.1 billion (Figure 7), higher than the ¥3.7 billion Japan invested directly in 2008. With a rising share of this FDI aimed at sales in China's domestic market and a consequent rise in the demand of yuan-denominated funds, Japanese firms are becoming increasingly interested in using China's capital markets.

Although there is a distinction between resident and nonresident entities, if the prohibition against foreign nonfinancial firms issuing yuan-denominated corporate

Figure 7: Source of FDI into China by country/region (2009)

Rank	Country/region	Issuance amount	
		$ millions	Share (%)
1	Hong Kong	46,075	51.2%
2	British Virgin Islands	11,299	12.6%
3	Japan	4,105	4.6%
4	Singapore	3,605	4.0%
5	Korea	2,700	3.0%
6	Cayman Islands	2,582	2.9%
7	US	2,555	2.8%
8	Samoa	2,020	2.2%
9	Taiwan	1,881	2.1%
10	Germany	1,217	1.4%
(reference)	EU	5,068	5.6%
	Worldwide total	90,033	

Notes: 1. Ordered from the highest amount of actual investment.
2. Inbound FDI from Hong Kong and tax havens includes circuitous investments originating elsewhere.
3. EU data is for 15 countries.

Source: Nomura Institute of Capital Markets Research, based on materials from the Ministry of Commerce bonds is lifted, we think it likely, based on the issuance terms thus far for MTNs, enterprise bonds, and Panda bonds, that (1) issuance maturities will be intermediate to long-term, i.e., over one year, (2) issuance proceeds will be limited to use within China, and (3) the brokerage firm will be a foreign capitalized firm with a subsidiary established in China.

There are already 20 foreign banks with Chinese subsidiaries, one of which have issued the financial bonds referred to in the introduction, and we expect to start seeing second issues from these banks. Moves toward the diversification of issuers in China's corporate bond market, and that market's opening to foreign firms, remain interesting areas to keep an eye on. Over the longer term, China will probably need to integrate its corporate bond market, now divided between stock exchange and OTC markets, in order to create greater market depth and liquidity.