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# The Legal Treatment of China's Corporate Debt Problems: Case Studies of Trust Products and Corporate Bonds

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## I. Failure to repay trust products

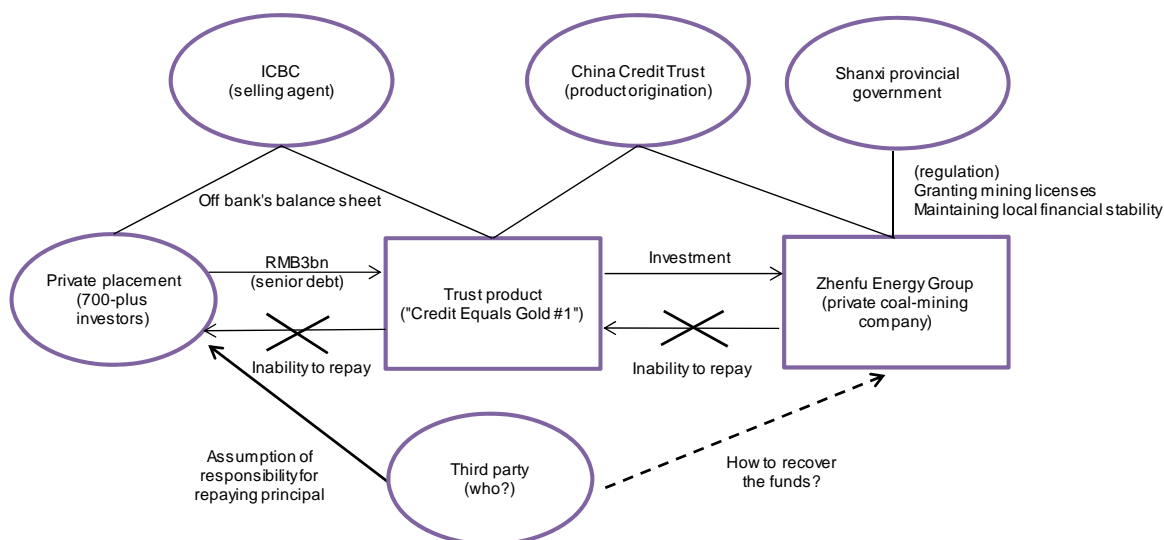
### 1. Failure to repay trust product invested in private coal-mining company in Shanxi Province

#### 1) Origination of trust products and sale via banks

Earlier this year corporate debt problems in China attracted the attention of market participants around the world. The cases in question were reminiscent of the collapse of Guangdong International Trust and Investment Corporation (GITIC), the financial arm of the province of Guangdong, in October 1998.

The first case was a failure to repay a trust product. In February 2011, China Credit Trust, one of China's largest trust companies, originated a collective trust product ("Credit Equals Gold #1") that was privately placed with qualified institutional investors (Figure 1). The proceeds of the issue were lent to Zhenfu Energy Group, a private coal-mining company in Shanxi Province. The amount raised was RMB3.03 billion and the maturity was three years.

**Figure 1: China: case of China Credit Trust's trust product**



Source: Nomura Institute of Capital Markets Research, from China Credit Trust data and *China Securities Journal*, 28 January 2014

The RMB30 million subordinated portion was kept by the group's owner, while the remaining RMB3.0 billion senior portion (with an expected rate of return of 9.5–11%)<sup>1</sup> was sold to investors via Industrial and Commercial Bank of China (ICBC). This kind of cooperation between trust companies and banks where banks market trust products is called in Chinese *yinxin hezuo*.

## 2) Repayment problem and outcome

The group used the money to develop its mining business. However, as a result of falling coal prices, problems with local residents, and its failure to obtain a mining license, the group found itself unable to repay its debts by the redemption deadline of 31 January 2014. This became public knowledge on 20 December 2013. As a result, according to a report in the *Shanghai Securities News* on 24 January 2014, the selling agent, Industrial and Commercial Bank of China (Shanghai Branch), announced on 23 January 2014 (1) that it would honor its responsibilities towards investors and (2) that it would publish a bailout plan by 28 January.

Subsequently, on 27 January, according to a 28 January 2014 report by *China Securities Journal*, China Credit Trust offered just over 700 investors the option of either (1) accepting repayment of only the principal by a third party and foregoing any payment of interest or (2) extending the maturity of the trust product (with no guarantee of (re)payment of either principal or interest) in what amounted to an agreement to repay the RMB3.0 billion of principal. We see this as an attempt to resolve the issue before the Chinese New Year holiday, which, as it happens, was due to begin on the mainland on 31 January. However, no one knows who assumed responsibility for repaying the principal or where the money came from.

## 2. Legal status of trust products

### 1) Regulations governing the trust business and trust companies

The trust business and trust companies are subject to the law.

First of all, as part of the process of restructuring trust companies and learning lessons from the collapse of GITIC (see above), the Standing Committee of the National People's Congress (China's parliament) passed and promulgated the *Trust Law* on 28 April 2001 with effect from 1 October 2001.<sup>2</sup>

The *Trust Law* consists of a total of 74 articles: Chapter I, General Provisions (Articles 1–5); Chapter II, Creation of a Trust (Articles 6–13); Chapter III, Trust Property (Articles 14–18); Chapter IV, Parties Concerned in a Trust (Section 1, Settler, Articles 19–23; Section 2, Trustee, Articles 24–42; Section 3, Beneficiary, Articles 43–49); Chapter V, Modification and Termination of Trust (Articles 50–58); Chapter

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<sup>1</sup> The interest rate set by the People's Bank of China on ordinary savings accounts is 0.35%, while that on one-year savings deposits is 3.00%. (Both rates have applied since 6 July 2012.)

<sup>2</sup> [http://www.pbc.gov.cn/publish/tiaofasi/272/1384/13844/13844\\_.html](http://www.pbc.gov.cn/publish/tiaofasi/272/1384/13844/13844_.html)

VI, Charitable Trust (Articles 59–73), and Chapter VII, Supplementary Provisions (Article 74).

Second, as part of the process of regulating trust companies, the industry’s regulator, the China Banking Regulatory Commission (CBRC), promulgated the *Rules Governing Trust Companies* on 23 January 2007 with effect from 1 March 2007.<sup>3</sup>

These rules consist of a total of 66 articles: Chapter I, General Provisions (Articles 1–5); Chapter II, Incorporation, Change and Termination (Articles 6–15); Chapter III, Business Scope (Articles 16–23); Chapter IV, Business Operations (Articles 24–42); Chapter V, Supervision and Regulation (Articles 43–57); Chapter VI, Penalties (Articles 58–63); and Chapter VII, Supplementary Provisions (Articles 64–66).

## 2) Defining “trust” and “trust property”

Next we consider the definitions of “trust” and “trust property.”

First, “trust.” Article 2 of the *Trust Law* defines “trust” as follows: “For the purposes of this Law, trust refers to the fact that the settler, based on his faith in the trustee, entrusts his property rights to the trustee and allows the trustee to, according to the will of the settler and in the name of the trustee, administer or dispose of such property in the interest of a beneficiary or for any intended purposes.”

Second, regarding the scope of a trust company’s business, Article 16 of the *Rules Governing Trust Companies* lists various types of trust business, including the following: (1) the entrusted management of cash, (2) the entrusted management of movable property, (3) the entrusted management of real estate, and (4) the entrusted management of securities. In addition, regarding the aforementioned administration or disposal of trust property, Article 19 of the *Rules Governing Trust Companies* stipulates (1) that a trust company may manage, use or dispose of the entrusted property by means of investment, sale, interbank placement, purchase-and-sellback, leasing and lending, etc. according to entrustment contracts, but (2) that, if the CBRC otherwise makes a policy on it, such policy shall prevail.

## 3) Different sources of trust business

Next we consider trust companies’ different sources of business.

First, trust companies have three different sources of business: (1) collective trusts, (2) single trusts, and (3) property management trusts. (1) Collective trusts manage the assets of a number of investors whereas (2) single trusts manage those of a single investor. In both cases, the trustee manages the entrusted assets (e.g., in the form of a loan trust or as a bond investment). The trust product mentioned earlier (“Credit

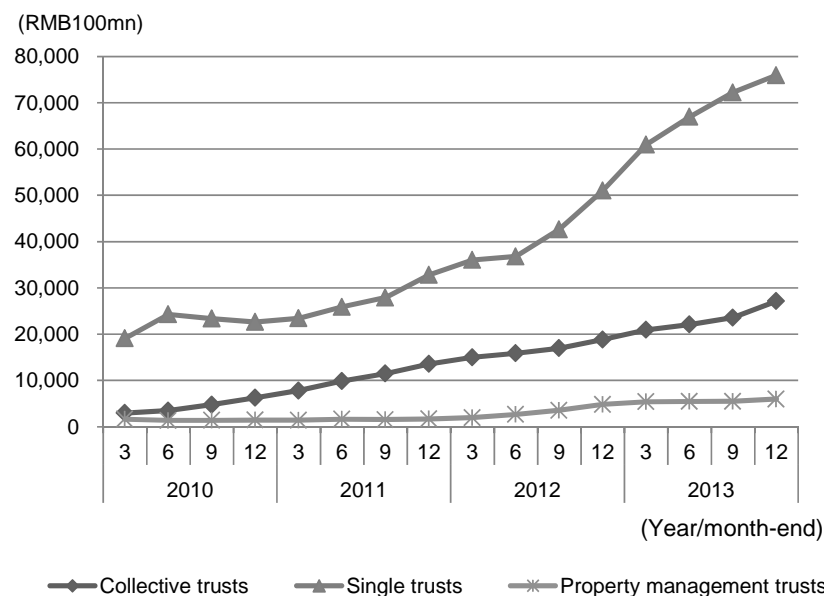
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<sup>3</sup> [http://www.cbrc.gov.cn/chinese/home/docDOC\\_ReadView/2007020146C75FE4EC42DAA9FFADADCB71D8A300.html](http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/2007020146C75FE4EC42DAA9FFADADCB71D8A300.html)

Equals Gold #1”) was a collective trust. Property management trusts manage entrusted assets according to the original function of a trust.

As of end-December 2013, the amount of trust assets under management in China was RMB10,907.1 billion. Of this amount, RMB2,715.5 billion was managed in the form of collective trusts, RMB7,503.0 billion in the form of single trusts, and RMB598.6 billion in the form of property management trusts (Figure 2). The lion’s share (namely, RMB4,858.1 billion or 47.13%) of the RMB10,308.5 billion in assets managed as either collective or single trusts as of end-December 2013 was managed in the form of loan trusts, while the next-largest share (RMB1,908.9 billion or 18.52%) was managed in the form of investments held until maturity.

**Figure 2: China: breakdown of trust assets under management (by value)**



Source: Nomura Institute of Capital Markets Research, from China Trustee Association data

### 3. Regulations governing collective trusts

#### 1) Rules on Trust Schemes of Collective Funds by Trust Companies

Investment schemes (products) based on collective trusts such as the aforementioned “Credit Equals Gold #1” are governed by special rules.

These are the *Rules on Trust Schemes of Collective Funds by Trust Companies* promulgated by the CBRC on 23 January 2007 with effect from 1 March 2007.<sup>4</sup> A revised version was subsequently promulgated on 4 February 2009 with immediate effect.<sup>5</sup> These rules consist of a total of 55 articles: Chapter I, General Provisions (Articles 1–4); Chapter II, Establishment of Trust Schemes (Articles 5–18); Chapter

<sup>4</sup> [http://www.cbrc.gov.cn/chinese/home/docDOC\\_ReadView/2007020140E41E8F4749E6F4FF15F12F68C86600.html](http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/2007020140E41E8F4749E6F4FF15F12F68C86600.html)

<sup>5</sup> [http://www.cbrc.gov.cn/chinese/home/docDOC\\_ReadView/200909155AD71D59AFD82FB5FFA27E225216B800.html](http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/200909155AD71D59AFD82FB5FFA27E225216B800.html)

III, Custody of Trust Scheme Property (Articles 19–22); Chapter IV, Operation and Risk Management of Trust Schemes (Articles 23–28); Chapter V, Alteration, Termination and Liquidation of Trust Schemes (Articles 29–33); Chapter VI, Information Disclosure and Supervision (Articles 34–40), Chapter VII, Beneficiaries’ Meeting (Articles 41–46); Chapter VIII, Penalties (Articles 47–51); and Chapter IX, Supplementary Provisions (Articles 52–55). The main points of the rules are as follows (Figure 3).

First of all, the rules define “trust schemes” as “entrusted fund management activities where a trust company acts as a trustee, in line with the clients’ will, to manage, use or dispose of the funds entrusted by two or more clients in a collective manner with a view to benefiting the beneficiaries.”

**Figure 3: China: main rules governing collective trusts**

Name of law	<i>Rules on Trust Schemes of Collective Funds by Trust Companies</i> (revised version promulgated with immediate effect on 4 February 2009)	
Definition of collective trust plan	Article 2	• Entrusted fund management activities where a trust company acts as a trustee, in line with the clients' will, to manage, use or dispose of the funds entrusted by two or more clients in a collective manner with a view to benefiting the beneficiaries.
Definition of settler	Article 5(1)	• The settler must be a qualified investor.
Definition of qualified investor	Article 6	• One of the following types of investor:
		① A natural person, corporation, or other organization investing at least RMB1 million in a single trust plan.
		② A natural person (individual or household) with financial assets of more than RMB1 million at the time of purchase. He/She must be able to provide proof of their financial assets.
		③ An individual with an annual income of more than RMB200,000 for the past three years or a couple with a joint annual income of more than RMB700,000 for the past three years. He/She/They must be able to provide proof of their income.
Requirements for establishment of trust plan	Article 5(3)	• No more than 50 natural persons per trust plan.
		• However, this numerical restriction does not apply if the amount entrusted per natural person investor or qualified institutional investor is at least RMB3 million.
Product design	Article 5(4)	• A trust period of at least one year.
	Article 5(5)	• The entrusted money must have a clear investment strategy and comply with government industrial policy and any related rules.
Rules governing product design	Article 8(1)	• The trust company may not guarantee the plan against losses or guarantee any minimum return.
	Article 27(1)	• The trust plan may not be used as a third-party guarantee.
	Article 27(2)	• Any loans to third parties may not exceed 30% of the value of the trust plan's assets on an actual return basis. However, any rules issued by the CBRC take precedence.
	Article 27(3)	• The trust money may not be invested, either directly or indirectly, by either shareholders or affiliates of the trust company. However, this does not apply if all a trust plan's money originates from the trust company's shareholders or affiliates.
Risks and losses to trust property	Article 14	• Where a trust company manages the entrusted property in line with the trust scheme documents, the risks arising from the management shall be covered by the entrusted property.
		• A trust company that infringes an entrustment contract or causes a loss to the trust property as a result of not taking due care must make good the loss using its own assets. If the trust company is unable to make good the entire loss, the investors must bear the residual loss.

Source: Nomura Institute of Capital Markets Research, from CBRC data

Second, only “qualified investors” may invest in collective trust schemes. As a rule, only investors with a minimum of RMB1 million to invest per scheme are considered.

Third, trust companies are forbidden from guaranteeing entrusted funds against losses or guaranteeing minimum returns.

## **2) Attitude of collective trusts to risks and losses to trust property**

The rules also define risks and losses to the trust property of collective trust schemes.

First of all, where a trust company manages the entrusted property in line with the trust scheme documents, the risks arising from the management shall be covered by the entrusted property.

Although the rules do not explicitly define “risk,” we assume that this would in practice mean extending the trust period. In such cases, a beneficiaries’ meeting has to be convened. Alternatives would be for the scheme concerned to be taken over by another scheme or, where the priority was to recover funds or distribute income at the end of the trust period, to proceed against the investment collateral.

Second, a trust company that infringes an entrustment contract or causes a loss to the trust property as a result of not taking due care must make good the loss using its own assets. If the trust company is unable to make good the entire loss, the investors must bear the residual loss.

This applies if the trust company infringes any regulations or fails to exercise due diligence. However, in such cases, investors bear joint responsibility for making good any losses.

## **3) The case of “Credit Equals Gold #1”**

It is not clear which of the above applied in the case of “Credit Equals Gold #1.” However, the fact that investors were given the choice of either having the scheme taken over by a third party or having the trust period extended suggests to us that it was probably the former rule that was applied.

As far as the identity of the third party is concerned, some take the view that it was (1) China Credit Trust, Industrial and Commercial Bank of China, or the Shanxi provincial government, while others take the view that it was (2) China Huarong Asset Management, a bad debt manager affiliated to ICBC. However, ICBC, the Shanxi provincial government, and Huarong all deny any involvement. Whatever the truth of the matter, the assets underlying the loan to Zhenfu Energy Group still exist, and investors will want to know how they are going to be managed and recovered.

## **II. Corporate bond defaults**

### **1. What are “corporate bonds” (*gongsizhai*) in China?**

In March of this year corporate debt problems in China attracted the attention of market participants around the world because of the first default on a corporate bond on the mainland. Before we look at this case in more detail, it may be appropriate to consider the types of fixed-income products available in China and the organizations responsible for regulating them. This is because the regulator and the market vary from product to product.

The first type of fixed-income product is “enterprise bonds,” which are regulated by the National Development and Reform Commission (NDRC). Although these bonds are listed on a stock exchange, they can also be listed on the interbank bond market.

The second type of fixed-income product is the commercial paper and medium-term notes registered with China’s National Association of Financial Market Institutional Investors (NAFMII), which is regulated by the People’s Bank of China (PBOC). Commercial paper and medium-term notes are issued on the interbank bond market.

The third type of fixed-income product is the corporate bonds regulated by the China Securities Regulatory Commission (CSRC). As these bonds are listed on a stock exchange, they have the status of publicly listed corporate bonds.

Because each type of fixed-income product is issued on a different market, they each attract different types of investors. The main investors on the interbank bond market are commercial banks and other financial institutions (institutional investors). Stock exchanges, on the other hand, attract both institutional investors, especially securities companies and fund management companies (investment trusts), and individual investors.

### **2. Default of Shanghai solar cell/panel manufacturer on corporate bond**

#### **1) Overview**

On 7 March 2012, the solar cell/panel manufacturer Shanghai Chaori Solar Energy Science & Technology Co., Ltd. (“Chaori Solar”) issued a corporate bond, which was listed on the Shenzhen Stock Exchange on 20 April of the same year. The bond is referred to as the “Chaori-11 bond.” The CSRC approved the issue on 20 October 2011.

The issue amount was RMB1 billion; the maturity was five years; and the coupon was 8.98%. Under the terms of the bond indenture, the issuer was due to pay interest on the bond on 7 March, starting in 2013, and had an option to vary the coupon or buy the bond back from investors from March 2015 (i.e., three years after the bond was issued). China Securities is the sponsor, lead manager, and “bond trustee” (i.e., bond manager).

## 2) Background to partial default on interest rate payment

The credit rating company was Pengyuan Credit Rating, which initially rated both the issuer and the bond AA. Pengyuan subsequently lowered its rating on both the issuer and the bond to CCC (non-investment grade) on 18 May 2013 after Chaori Solar made a loss for two consecutive years (2011 and 2012). Also, trading in the bond was suspended from 8 July 2013.

Chaori Solar faced a liquidity crisis at the end of 2012. The bond trustee, China Securities, called on Chaori Solar to increase its collateral. Once Chaori Solar did this, China Securities announced the fact on 18 January 2013.

However, on 5 March 2014, two days before Chaori Solar was due to make a payment of RMB89.8 million in interest, Chaori announced that it would only be able to pay RMB4 million in interest.

## 3. Legal status of Chinese corporate bonds

### 1) Regulations governing corporate bonds

The following are the main regulations governing Chinese corporate bonds.

First of all, China's *Securities Law*, the most recent amendments to which were promulgated on 27 October 2005 with effect from 1 January 2006,<sup>6</sup> governs the issue and listing of corporate bonds.<sup>7</sup> As happened in the case of the Chaori-11 bond, Article 60(5) stipulates that the stock exchange on which a corporate bond is traded must suspend trading in the bond if its issuer makes a loss for two years in succession.

Since April 1998, Chinese stock exchanges prefix the letters "ST" (special treatment) to the names of such listed companies. Furthermore, since May 2003, "\*ST" is prefixed to the names of such listed companies if the risk of a delisting is considered particularly high. This has been the case with the Chaori-11 bond since May 2013.

Second, on 14 August 2007, the CSRC promulgated *Provisional Measures for the Issuance of Corporate Bonds*<sup>8</sup> as detailed rules for the implementation of the *Securities Law* with immediate effect. These measures consist of a total of 32 articles: Chapter I, General Provisions (Articles 1–6); Chapter II, Terms of Issue (Articles 7–11); Chapter III, Issue Procedures (Articles 12–22); Chapter IV, Bondholders' Rights (Articles 23–27); Chapter V, Supervision and Regulation (Articles 28–31); and Chapter VI, Supplementary Provisions (Article 32).

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<sup>6</sup> [http://www.csrc.gov.cn/pub/newsite/flb/flfg/flxzs/201312/t20131205\\_239325.htm](http://www.csrc.gov.cn/pub/newsite/flb/flfg/flxzs/201312/t20131205_239325.htm)

<sup>7</sup> For further details of the *Securities Law's* rules governing the issuance of securities in China, see Nomura Institute of Capital Markets Research, "*Chuugoku Shouken Shijou Taizen*" (*Compendium of Chinese Securities Markets*), Nihon Keizai Shimbunsha, 2007.

<sup>8</sup> [http://www.csrc.gov.cn/pub/zjhpublic/zjh/200804/t20080418\\_14512.htm](http://www.csrc.gov.cn/pub/zjhpublic/zjh/200804/t20080418_14512.htm)



The following provisions are important with regard to Chaori Solar's default on the interest payment on its bond. First of all, Article 25 stipulates that the bond trustee must constantly monitor the credit status of the issuer and the guarantor, and, in the event that anything occurs that might materially affect the interest of the bondholders, convene a meeting of the creditors (i.e., bondholders). Second, Article 27 stipulates that one particular case where such a meeting must be convened is when an issuer is unable to service its debt according to schedule. Chaori Solar's default on payment of interest on its bond would seem to us a prime example of the need to convene such a meeting to determine what to do next.

## **2) Bond trustee's response to interest payment default**

In its public notice of 5 March 2014,<sup>9</sup> the bond trustee, China Securities, explained, first, that, in accordance with the bond's issue prospectus and deed of trust (i.e., indenture), it would give notice within five days of 7 March 2014, the date on which the issuer was due to pay interest, (namely, on 11 March 2014) of a creditors' meeting and would convene such a meeting in good time.

Second, it gave notice that the meeting would discuss matters within the bond trustee's competence: namely, any proposals for safeguarding the creditors' legal interests (e.g., by suing the issuer), taking any reasonable and practicable legal action, or proceeding against the collateral.

In addition, Article 25 stipulates that, if an issuer is unable to make repayments, the bond trustee is obliged to (1) either call on the issuer to increase its collateral or to request that the assets be protected by organs of the law in accordance with the law, and to (2) institute legal proceedings against the issuer, such as liquidation, compromise, restructuring, or bankruptcy, if requested to do so by the bondholders.

## **3) Creditors' meeting held on 26 March 2014**

In its public notice of 11 March 2014,<sup>10</sup> China Securities notified the bondholders that a creditors' meeting would be held in Shanghai on 26 March at 14:00. The notice also contained four proposals: (1) to authorize the bond trustee (i.e., China Securities) to bring a civil action against the issuer for default on its interest payment; (2) to authorize the bond trustee to proceed against the collateral of the Chaori-11 bond by way of payment of interest; (3) to authorize the bond trustee to institute legal proceedings (such as liquidation, compromise, restructuring, or bankruptcy<sup>11</sup>) against Chaori Solar; and (4) concerning how the creditors' meeting should be held and a vote taken. Proxy voting is permitted. As it emerged before the meeting due to be held on

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<sup>9</sup> <http://disclosure.szse.cn/m/finalpage/2014-03-05/63638382.PDF>

<sup>10</sup> <http://disclosure.szse.cn/m/finalpage/2014-03-11/63660439.PDF>

<sup>11</sup> For an overview of China's *Enterprise Bankruptcy Law's* rules governing the liquidation process in bankruptcy cases, see Sekine, Eiichi, "Chuugoku no Chihou Saimu o Dono You ni Toraerubeki na no ka" (What Should We Make of China's Local Government Debt?), *Capital Market Quarterly*, Autumn 2013 (in Japanese).

26 March that fewer than the number of bondholders needed for any resolution to be valid (namely, those holding more than 50% of the unredeemed bonds at par value) had registered, the bond trustee issued a notice on 21 March postponing the meeting.

While it is still unclear whether Chaori Solar's inability to pay part of the interest is simply confined to the interest or whether, in future, it could even extend to repayment of the principal, the above proposals suggest to us that the bond trustee may have allowed for the possibility that Chaori Solar could eventually be declared bankrupt. According to a 6 March 2014 report by Xinhua News Agency, Chaori Solar itself claims that it might be able to make an additional interest rate payment if negotiations to sell some of its equipment to Greece are successful. Be that as it may, the priority is to see what happens at the creditors' meeting.

#### **4) The views of market participants**

Judging by reports in the Chinese media, market participants have welcomed the default on an interest rate payment on a bond issued by a company in a sector with excessive production capacity such as solar cells/panels as reducing the risk of moral hazard by issuers and investors. They also appear to think that this is probably the policy objective of the financial authorities in China.

As it happens, at a press conference on securities and futures on 6 March 2014, Mr Ouyang Zehua, a delegate to the National People's Congress and Director of the CSRC's First Supervision Department for Listed Companies, said (1) that Chaori Solar's default was the first interest payment default on the market for publicly offered corporate bonds and (2) that the CSRC was watching the situation very carefully in case it developed into either an isolated or a systemic risk.<sup>12</sup> In addition, while the move by the bond trustee to take civil action against the issuer should be welcomed for increasing market discipline, it also suggests to us that the financial authorities were eager to avert any systemic risk.

### **III. Background to and outlook for China's corporate debt problems**

#### **1. Other examples of problems with trust products**

The case of China Credit Trust at the beginning of this report has actually not been the only example of a problem with trust products. A special report on trust products in the 27 January 2014 edition of *Century Weekly* describes 11 such cases that occurred in 2013. Six of these involved real estate companies, while two involved resource producers.

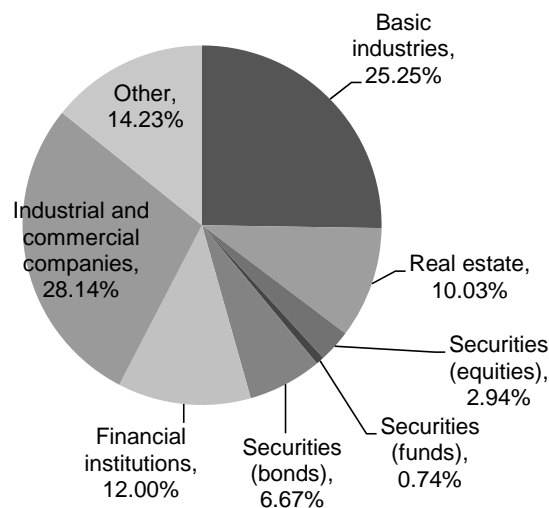
According to data from the China Trustee Association (CTA), the number of new trusts increased from 8,090 in 2010 to 13,428 in 2011, 16,729 in 2012, and 20,672 in

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<sup>12</sup> [http://www.financialnews.com.cn/yw/jryw/201403/t20140307\\_51076.html](http://www.financialnews.com.cn/yw/jryw/201403/t20140307_51076.html)

2013. Of the RMB10,308.5 billion of assets under management by trust companies as of the end of December 2013, the lion's share (namely, RMB2,900.5 billion or 28.14%) was invested in "industrial and commercial companies," while the next-largest share (RMB2,602.9 billion or 25.25%) was invested in "basic industries," with RMB951.3 billion (or 12.00%) invested in "financial institutions" and RMB811.9 billion (or 10.03%) in "real estate companies" (Figure 4). The private coal-mining companies involved in these cases probably belong to the category "industrial and commercial companies." Similarly, the category "basic industries" probably includes the local government infrastructure and utility companies financed by local government financing vehicles (LGFVs).

**Figure 4: China: breakdown of trust assets under management  
(by investment sector)**



Note: Data as of end-December 2013.

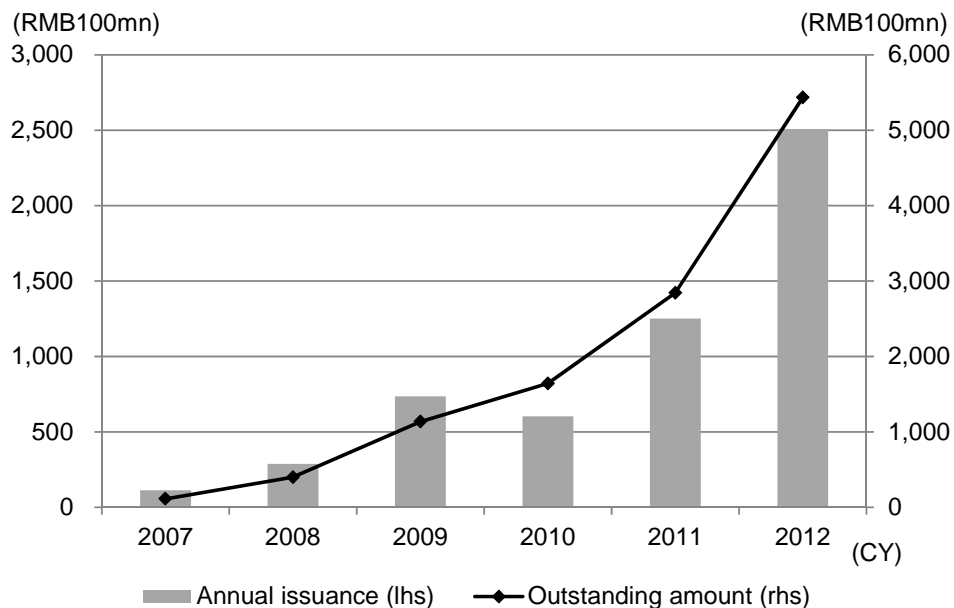
Source: Nomura Institute of Capital Markets Research, from CBRC data

The above cases and the amount of assets under management by trust companies suggest to us that the problems are currently confined to particular parts of the country or particular sectors of the economy. However, according to a 12 February 2014 report in the *Shanghai Securities News*, Shanxi Liansheng Energy, a private coal-mining company, failed to repay principal and interest on a trust product, originated by Jilin Province Trust and marketed by China Construction Bank, by the 7 February deadline and was in arrears. (The trust product had raised RMB289 billion and was expected to generate a return of 9.8% a year.) Investors, both Chinese and overseas, are following the situation closely to see whether the problems, which have thus far been confined to particular parts of the country and sectors of the economy, spread and how the financial authorities, trust companies, and the banks that market these products react—just in case the problems pose a risk to financial markets.

## 2. Size of corporate bond market and main industries

Since the corporate bond market was established in 2007, annual issuance, according to data from the CSRC,<sup>13</sup> increased 22.4-fold from RMB11.2 billion in 2007 to RMB250.7 billion in 2012 (Figure 5). Similarly, the outstanding amount of corporate bonds issued increased 48.5-fold from RMB11.2 billion at the end of 2007 to RMB543.3 billion at the end of 2012.

**Figure 5: Annual issuance and outstanding amount of corporate bonds**



Source: Nomura Institute of Capital Markets Research, from China Securities Regulatory Commission, *China Securities and Futures Statistical Yearbook 2013*, China Statistics Press, 2013

Also, according to a different source (data from Shanghai Wind Information), RMB50.8 billion (or 39.30%) of the RMB129.1 billion in corporate bonds issued in 2011 was issued by companies in the raw material sector while RMB44.7 billion (or 34.62%) was issued by industrial companies. In 2012, RMB74.6 billion (or 28.6%) of the RMB260.3 billion in corporate bonds that was issued was issued by industrial companies while RMB57.6 billion (or 22.11%) was issued by companies in the raw material sector.

As of 10 March 2013, 26 of the 1,578 companies listed on the Shenzhen Stock Exchange were prefixed with “\*ST,” with manufacturing accounting for 20 of these. Furthermore, as of the end of February 2014, 192 of these companies had issued bonds listed on the same exchange. One of these companies was Chaori Solar, which is classified as a manufacturer. Holders of the Chaori-11 bond had been alerted by the exchange’s delisting warning system of the risk that the bond might be delisted. In

<sup>13</sup> China Securities Regulatory Commission, *China Securities and Futures Statistical Yearbook 2013*, China Statistics Press, 2013.

addition, exchange trading in the bond had been suspended. Therefore the default of a bond prefixed with “\*ST” should not have come as a surprise to any of the bondholders, who should have been prepared for the news.

### **3. Possible risk scenarios**

Chinese companies have recently been able to raise funds via the shadow banking system, which includes products such as the aforementioned trust products, as well as in the more traditional form of bank loans or via the capital market. We can envisage two possible scenarios for the problems that emerged in 2014 in connection with trust products and corporate bonds.

First of all, trust products. The commercial banks that market these products are not responsible for their redemption. However, if they did accept some of the responsibility in order to preserve their reputation, overseas credit rating agencies would regard the amounts as contingent liabilities on the banks’ balance sheets and possibly lower their ratings. In particular, if banks listed on overseas exchanges were subject to a possible re-rating, this could have a knock-on effect on overseas financial markets (Scenario 1).

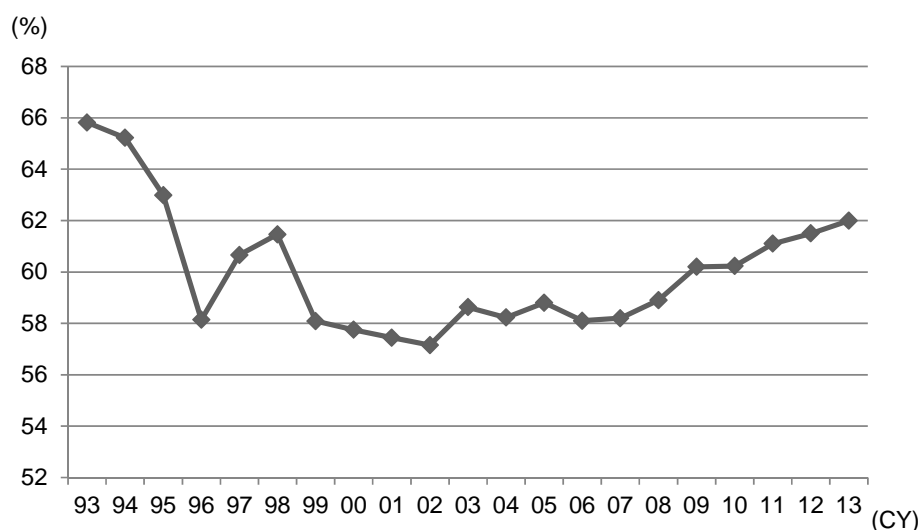
Second, if there were defaults on a large number of trust products, even if confined to particular parts of the country or sectors of the economy, this could have a knock-on effect, especially on domestic financial markets, if other companies in the same sector with corporate bonds were re-rated. This would inevitably affect the confidence of overseas investors, as well (Scenario 2).

In either case, if there was a knock-on effect on financial markets, the initial response of the government, including the financial authorities, and especially the dissemination of news to market participants and proposals for a convincing resolution, would be crucial.

## **IV. In conclusion**

Because of concern about corporate debt, the People’s Bank of China has published financial indicators for the country’s 5,000 largest companies. Following the global financial crisis of 2007, the debt-equity ratio (current liabilities + long-term liabilities/total assets × 100%) of these companies rose from its 2007 pre-crisis level of 58.3% to 58.9% in 2008 and to 60.2% in 2009 and 2010 (Figure 6). Since then, it has continued to rise (i.e., deteriorate): to 61.1% in 2011, 61.5% in 2012, and 62.0% at the end of August 2013.

**Figure 6: China: debt-equity ratio of 5,000 largest companies**



Note: 1. Annual data as of end-December. Data for 2013 as of end-August.  
2. Raw data from People's Bank of China.

Source: Nomura Institute of Capital Markets Research, from CEIC data

This deterioration illustrates the worsening of China's corporate debt problem. However, the economic reform program adopted by the Third Plenary Session of the 18th CPC Central Committee in November 2013 confirms a number of policies, including the creation of a long-term mechanism for preventing and alleviating industrial overcapacity as well as a system of mixed government/private-sector ownership to make it easier to restructure state-owned enterprises.<sup>14</sup> As it happens, on 4 July 2013 the State Council promulgated *Some Opinions on Promoting the Healthy Development of the Photovoltaic Industry* (the *Opinions* were actually issued on 15 July)<sup>15</sup> with a view to dealing with the industry's overcapacity by concentrating resources on assisting the development of key competitive companies while leaving uncompetitive companies to fend for themselves. In response, on 16 September, the Ministry of Industry and Information Technology, which oversees individual industries, published guidelines,<sup>16</sup> which, amongst other things, prohibit new capital investment intended merely to increase capacity and require companies planning to build new production facilities to invest in research and development at the same time. This was followed on 30 December 2013 (after the Third Plenary Session of the 18th CPC Central Committee) by the publication by the ministry of a list of 109 bluechip manufacturing companies that meet the criteria set out in the guidelines.<sup>17</sup> As Chaori Solar was one of the companies on the list (No. 60),<sup>18</sup> we need to wait for what is revealed at the creditors' meeting to find out whether its interest payment default was

<sup>14</sup> Sekine, Eiichi, "A Securities Market View of the Third Plenary Session of the 18th CPC Central Committee," *Nomura Journal of Capital Markets*, Spring 2014, Vol.5, No.4.

<sup>15</sup> [http://www.gov.cn/zwggk/2013-07/15/content\\_2447814.htm](http://www.gov.cn/zwggk/2013-07/15/content_2447814.htm)

<sup>16</sup> [http://www.gov.cn/zwggk/2013-09/17/content\\_2490100.htm](http://www.gov.cn/zwggk/2013-09/17/content_2490100.htm)

<sup>17</sup> <http://www.miit.gov.cn/n11293472/n11293832/n12845605/n13916898/15809356.html>

<sup>18</sup> <http://www.miit.gov.cn/n11293472/n11293832/n12845605/n13916898/n15809356.files/n15808982.pdf>

the result of temporary factors or of structural factors that could affect its ability to repay the principal.

Another important consideration is that China's corporate debt problem can only be resolved if corporate reforms and the financial reforms that should enable them are pursued in parallel. In our view, a consensus on such a holistic approach is being formed within the Chinese leadership. Another prerequisite with regard to the financial system is reform of the shadow banking system, which has helped Chinese companies to raise funds. However, we will address this issue on another occasion. Yet another prerequisite, if the tacit assumption underlying the corporate debt problem (namely, that the government will always bail out companies in trouble) is to be dispelled, is reform of the system of government approval of investment. For the time being we will have to take a long-term view of the package of reforms underlying how the authorities deal with individual cases.