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China's growing corporate bond issuance

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Executive Summary

Corporate bond issuance in China has been growing for the past several years. In addition to bond issuance to fund economic stimulus, such growth has been driven partly by the advent of new products.

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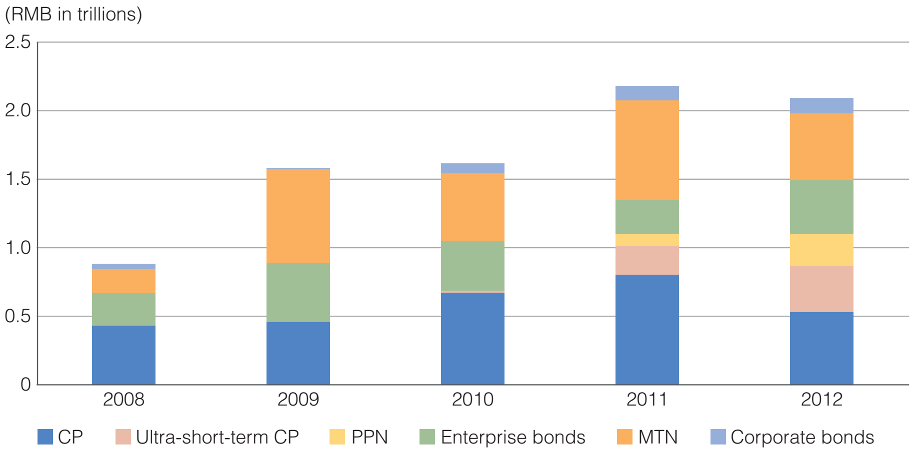
NOTE
1) Local government financing platforms are independent corporations that are established by local governments and borrow funds to finance government investment projects.
2) Including ultra-short-term CP discussed below.

Funding for economic stimulus and advent of new products

Nonfinancial corporate bond issuance has been growing in China for the past several years. While China's total bond issuance, including government bonds, decreased 20.4% to roughly RMB7.7 trillion in 2011, nonfinancial corporate issuance (including issuance by local governments' financing platforms[1]) increased 29.6% to some RMB2.3 trillion[2]. Such issuance's share of the total bond market has risen to 30.3% in 2011 from 13.7% in 2008. Corporate issuance mainly consists of commercial paper (CP), medium-term notes (MTN), enterprise bonds, and corporate bonds. In 2011, these instruments collectively accounted for approximately 80% of corporate bond issuance. Corporate bond issuance has remained robust in 2012 also (Exhibit 1).

Regulatory oversight of the corporate bond market is divided between three bodies: the National Development and Reform Commission (NDRC), China Securities

Exhibit 1: Chinese corporate bond issuance



Note: The above includes only major classes of debt instruments. 2012 data are for the first eight months of the year. PPN means private placement note.
Source: NRI, based on data from 2011 China Financial Market Report, Shanghai Clearing House, ChinaBond, and China Securities Depository and Clearing Corp.

Regulatory Commission (CSRC), National Association of Financial Market Institutional Investors (NAFMII), which operates under the supervision of the People's Bank of China (PBoC). The NDRC regulates enterprise bond issuance; the CSRC, corporate bond issuance; and the NAFMII, CP and MTN issuance.

One driver of recent growth in corporate bond issuance is China's economic stimulus policies since 2009, including urban infrastructure development, construction of subsidized housing, and financing support for SMEs. Local governments' financing platforms have been issuing so-called urban investment bonds to fund these development projects. Urban investment bonds are a relatively broad class of instruments ranging from CP to MTNs and enterprise bonds.

While overall corporate bond issuance has grown in recent years, enterprise bond issuance decreased in 2011. This decline was triggered by the emergence of default concerns about Yunnan Province's financing platform in April 2011. Such concerns depressed enterprise bond issuance for the remainder of 2011. Some issuers apparently chose to issue MTNs or CP issuance as a substitute for enterprise bonds. The CP market was similarly hit by default concerns around April 2012.

In response to such concerns, yields have diverged to reflect differences in corporate issuers' creditworthiness. Unlike the old days when only ultra-prime issuers could access the bond market, the universe of issuers is steadily diversifying in terms of credit quality. With some issuers able to issue MTNs at yields below interest rates on bank loans, direct finance is more advantageous than intermediated finance for blue-chip companies.

Another driver of growth in corporate bond issuance is bond market reforms carried out in parallel with macroeconomic factors (Exhibit 2). One such reform is product diversification. First, CP (maturities of up to one year) was introduced in the interbank bond market in 2005. The CP market is distinguished by a relatively lenient regulatory environment. CP issuance requires only registration, not regulatory approval. The advent of CP in China coincided with NAFMII's establishment by the PBoC. NAFMII exercises oversight of the interbank bond and call market as an interbank market self-regulatory organization. MTNs (maturities of 3–5 years) were introduced in China in 2008.

In 2009, SME collective notes were likewise introduced in the interbank bond market. Jointly issued by two to ten nonfinancial SMEs, SME collective notes were intended

Exhibit 2: Major debt instruments issued by corporate issuers

	MTN & CP	Enterprise bonds	Corporate bonds	SME private placement bonds
Regulator	NAFMII	NDRC	CSRC	Securities exchanges
Mode of oversight	Registration	Regulatory approval	Regulatory approval	Registration
Eligible issuers	Incorporated nonfinancial companies	Unlisted companies	Listed companies	Unlisted SMEs and microenterprises (based on Ministry of Industry and Information Technology's classification scheme), temporarily excluding financial and real estate companies
Issuance method	Public offerings	Public offerings	Public offerings	Private placement offerings (limited to 200 investors)
Maximum issue size	Up to 40% of issuer's net assets	Up to 40% of issuer's net assets	Up to 40% of issuer's net assets	No limit
Maturity	MTN: 3-5 years CP: up to 1 year	Medium/long term	Long term	1 year or longer (Shenzhen Exchange) or up to 3 years (Shanghai Exchange)
Major market(s)	Interbank market	Interbank market, securities exchanges	Securities exchanges	Securities exchanges' trading platforms, securities brokerages

Source: NRI, based largely on August 2012 edition of *Saiken*

to enable SMEs unable to individually issue bonds to join together to obtain bond financing. In some regions, SMEs with advanced technologies or promising products can currently issue SME collective notes with local government backing[3]. In 2010, ultra-short-term CP[4] (maturities of up to 270 days) was introduced into the market.

In 2011, private placement notes (PPN) made their advent. PPNs are bonds issued by nonfinancial corporate issuers to qualified investors through private placement offerings. Private placement issuance of equities and bank debentures had previously been introduced. In 2011, PPN issuers included blue-chip companies in the energy and transportation sectors[5]. PPNs could potentially also be utilized by SMEs with low credit ratings.

In markets other than the interbank market, new products are being rolled out in response to rapid product diversification in the interbank market. In 2012, securities exchanges introduced SME private placement bonds[6]. As of August, 59 investment bank had underwritten SME private placement bond offerings. Additionally, the NDRC apparently intends to promote revenue bonds to finance projects such as construction of subsidized housing[7].

A second reform is reduction in the red tape involved in bond issuance. In 2008, the NDRC streamlined the corporate bond issuance process in response to the CP and MTN registration system[8]. Meanwhile, the CSRC has shortened the regulatory review period for bond issues that meet certain criteria[9].

3) Such notes are known as regional collective senior notes. Collective note issuance has been limited to date.

4) Ultra-short-term CP would likely be classified as a money market product.

5) Bond Market Development Report 2011 (NAFMII)

6) On May 23, the Securities Association of China issued pilot regulations for underwriting SME private placement bond offerings by securities firms. To qualify as an underwriter, securities firms must be ranked in Class B or above in the most recent year, have net capital of at least RMB1 billion, have a clean disciplinary record over the preceding 12 months, and have established a pilot underwriting plan and operating regulations for private placement bond underwriting. Additionally, when underwriting private placement bonds, securities firms must evaluate investors' risk tolerance and risk assessment capabilities.

7) According to a report by the China Securities Daily (September 21, 2012).

8) The process previously required issuers to first obtain approval of the size of their bond issue and then obtain approval to proceed with issuance. The NDRC streamlined this into a one-step approval process.

9) To qualify, issuers must have net assets of at least RMB10 billion, have a AAA rating, or issue relatively short-term (3–5-year) bonds. The first bond issue that utilized this so-called green notification system took place in March 2011.

Competition among regulatory authorities

The division of regulatory oversight of the corporate bond market among different regulators has been seen as problematic, but competition among regulators is helping to drive reform by giving market mechanisms freer rein to function in place of regulatory approval and administrative guidance, as discussed above.

While the long-awaited rise of direct finance and diversification of capital markets are encouraging trends, recent growth in corporate bond issuance is in fact largely attributable to local governments' financing platforms. Amid the current economic slowdown, fixed asset investment by local governments is a fast-acting means of economic stimulus from the standpoint of the Chinese government's pursuit of stable growth. With local governments no longer able to depend on land sales as a reliable revenue source, the Chinese government could expedite deregulation of bond issuance to facilitate credit creation to shore up the economy, but doing so would entail risk. China needs financing instruments with greater transparency in terms of information disclosure.

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