Behind China’s Bond Selloff, a Risky Twist on the Repo Trade

Trading practice called ‘dai chi’ sprouted up in China’s long credit boom—and has helped exacerbate the bond-market rout

Sealand Securities, like many other Chinese financial firms, has practiced “dai chi” trading, or buying securities back at a profit as the three-year bull market in bonds raised prices. But problems arose after the government launched a campaign to constrain credit, sending bond prices sharply down. Above, a branch of Sealand Securities in Hechi city, south China's Guangxi Zhuang autonomous region.

Sealand Securities, like many other Chinese financial firms, has practiced “dai chi” trading, or buying securities back at a profit as the three-year bull market in bonds raised prices. But problems arose after the government launched a campaign to constrain credit, sending bond prices sharply down. Above, a branch of Sealand Securities in Hechi city, south China's Guangxi Zhuang autonomous region. PHOTO: QIN JIANGYING/IMAGINECHINA/ASSOCIATED PRESS

By SHEN HONG

Jan. 17, 2017 6:54 a.m. ET

1 COMMENTS

SHANGHAI—The turmoil at a Chinese midsized brokerage firm that exacerbated China’s recent bond-market rout also highlighted a little-regulated practice that companies have used to borrow hundreds of billions of dollars and move risky assets temporarily off their books.

Called “dai chi” in Chinese—literally, holding something on someone’s behalf—the trading practice resembles a short-term loan backed by bonds, and it has boomed as China’s bond market rallied during the past three years, according to half a dozen traders and executives at Chinese financial companies who have engaged in or are familiar with the practice.

Typically, sellers pledge to buy the bonds back after terms ranging from a few days to a few months, paying interest on the value of the securities as well as an added fee, the people said. The trade lets the buyer lock in a higher price, while the seller hopes that by the time it buys the bonds back, market prices will have appreciated even further.

The risk is that “dai chi” agreements tend to be informal and often don’t leave a paper trail. Several of the executives familiar with the practice said they have conducted the transactions over instant messaging services like China’s QQ, labeling them with the code “DC.” These transactions also, by one estimate, may easily top $1 trillion in value. The practice is just one of the many unexpected risks that have sprouted up in China’s long credit boom.

Last year, for instance, traders at Chinese brokerage firm Sealand Securities sold around $2.4 billion worth of its bond holdings to 20-odd companies ranging from fellow securities firms to small banks, promising to buy it all back later, at a higher price, according to people familiar with the deals and announcements by Sealand.

Sealand, like many other Chinese financial firms, had done this kind of transaction before, the people said, buying the securities back at a profit as the three-year bull market in bonds raised prices. At the end of last year, however, the government's campaign to constrain credit sent bond prices sharply down. In December, Sealand signaled it may not repurchase its holdings, news that accelerated China's worst bond selloff since 2013. Regulators stepped in and helped negotiate a settlement, according to people familiar with the matter.

"When we were told that Sealand … may not buy back the bonds, there was real panic," said an executive at a Chinese brokerage firm that had bought the bonds.

Sealand said it couldn't comment on the matter beyond its public statements.

Chinese regulators have said that a priority this year is taming asset bubbles, and the huge pool of money that has fed them after years of easy credit and low rates. That money helped send Chinese bond prices to a 14-year high in mid-August and pumped up markets for everything from iron ore to garlic.

In September, China's central bank started to raise short-term rates and tighten liquidity to discourage such leveraged investing and let some of the air out of the bond market. That made trades like Sealand's suddenly much less profitable.

As much as 12 trillion yuan ($1.73 trillion) in bonds—or 19% of the country's $9 trillion bond market—could be subject to such repurchase agreements, according to an estimate by Shui Ruqing, president of bond clearing-house China Central Depository & Clearing Co., cited last month in China's influential Caixin Magazine. Traders say the deals are so opaque that even estimates are hard to make.

Banks sometimes use the “dai chi” agreements to move risky assets temporarily off their books during earnings periods or audits, the people said. Brokers like Sealand typically use them to borrow quickly and flexibly—leveraging their investments many times over, they said.

Until last year, Chinese financial regulators had largely ignored the practice, beyond saying they opposed it during a bond-market crackdown in 2013. But the informal nature of dai chi also meant the trades could be difficult to enforce when conditions worsened.

“Because it’s not really an official business, agreements aren’t legally binding,” said the executive who had bought bonds from Sealand.

Sealand’s problems became apparent on Dec. 15, when the southern China-based company announced that two of its traders had forged dai chi agreements worth 16.5 billion yuan ($2.4 billion), a move that market participants interpreted as meaning the broker didn’t intend to honor the deals.

The amount was more than five times what Sealand had declared in its Sept. 30 financials as its financial assets under official repurchase agreements, and more than seven times its disclosed bond-holdings.

Sealand didn’t disclose the timing or terms of its bond sales, saying only that 80% was government or state-backed debt while 20% was corporate. But since bond prices broadly had tanked during the prior few months, sending the benchmark 10-year down 28% between Aug. 15 and Dec. 20, market watchers assumed the broker was facing losses on the trades.

Sealand says the bond agreements were forged by two of its employees and the police are investigating.

The news helped pummel Chinese government bonds, sending yields to a 15-month high on Dec. 20.

That night, Beijing stepped in. Li Chao, a deputy chairman of the China Securities Regulatory Commission, came to a midnight meeting between Sealand and its counterparties, telling the assembled executives to split any losses and resolve the situation calmly and quickly, said people

familiar with the matter. A spokesman for CSRC declined to comment beyond what was announced at a news conference in December, when the regulator urged Sealand and its counterparties to settle the dispute as soon as possible.

By early January, Sealand had reached a settlement with most of the counterparties, involving agreements to buy back 60%-70% of the bonds, according to people briefed on the talks.

Market-watchers say there may be more episodes like Sealand to come.

“The practice of dai chi is like a black hole in the bond market: No one knows how big it is, and it won’t be cleaned up overnight,” said Zheng Lianghai, an analyst at Dongxing Securities in Shanghai.

—Yifan Xie contributed to this article.

Write to Shen Hong at hong.shen@wsj.com