(BN) China Bond Market Set for Takeoff as Guo Consolidates Power
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2012-06-12 11:00:45.444 GMT

(Adds government bond yield in 14th paragraph.)

Bloomberg News
June 12 (Bloomberg) -- China is the opposite of other major economies when it comes to companies' ability to raise money by issuing bonds.

China's 4.2 trillion yuan ($659 billion) corporate bond market is just 9 percent of its gross domestic product. In the U.S., the $7.9 trillion in fixed-income securities is equal to more than half the size of economic output.

The government wants to change that, to give corporate bonds a bigger role in boosting growth and to divert risk from the state-owned banking system that provides 75 percent of the nation's credit. A mature bond market also would provide funding for capital-hungry small businesses that have few options beyond the unregulated world of shadow banking, which officials are seeking to wrestle under control.

Guo Shuqing, the 56-year-old head of the China Securities Regulatory Commission, has taken steps to consolidate regulatory power over bonds since he became chairman seven months ago. He's set up an office to study new products, and in May the CSRC, the equivalent of the U.S. Securities and Exchange Commission, said it's considering introducing municipal bonds. In early June, Guo launched a plan to allow small and medium-sized companies to sell debt comparable to speculative-grade bonds in other market.

"International experience shows that overreliance on bank credit in a financial system can, under certain circumstances, lead to systemic risk," Guo told the official People's Daily newspaper in March, saying that the bond market, which provides 13 percent of China's debt, "seriously" lags behind the demands of the real economy and needs to develop.

Power Grab

Three government agencies now split control over the bond market, including the CSRC, the National Development and Reform Commission and the central bank. The CSRC is pushing ahead with unifying all of the regulators' separate bond-disclosure, credit-rating, investor-protection and entry standards, according to a May 31 statement on its website.

Guo's unilateral power grab may create conflict, said Fraser Howie, Singapore-based managing director of CLSA Asia- Pacific Markets who co-authored the book "Red Capitalism" on China's financial system.

"Clearly there are others who are going to want to have a say when it comes to the fixed-income world," Howie said.
"What he needs to do is pick fights he can win."

If anyone can, it may be Guo. As head of the State Administration of Foreign Exchange in 2001-2005, he pushed through reforms by forging relationships between departments and building support, according to Hong Weizhi, a former spokesman for SAFE who worked with the chief regulator.

Bringing Together

"Maybe only he can bring things together, only he can persuade relevant departments," Hong said. "You need not worry when you hand a job to him. He attaches great importance to coordination and always puts state interests before his own agency's."

In April, the three bond-market regulators held their first meeting to coordinate policy on corporate securities, according to the central bank's website.

"In the long run there should be a unified supervision of this market," said Wang Ge, an executive director in debt capital markets at Goldman Gaohua Securities Co., Goldman Sachs Group Inc.'s joint venture in China. "Investors are eager to invest in corporate bonds, but the market is not sophisticated enough to allow them to hedge credit risk."

Junk's Debut

Guo's moves would change that. The introduction of junk bonds could allow China to have its first default, which would then allow the market to price the risk of a company going bankrupt and instill confidence in the market. So far, local governments or banks have bailed out any company that risked defaulting on its publicly traded bonds.

The debut sale went ahead as a private placement on June 8, with a 50 million yuan offering by Suzhou Huadong Coating Glass Co., based in the eastern province of Jiangsu, according to a release on the Shanghai Stock Exchange. The bond was priced to yield 9.5 percent, 3.19 percentage points above the benchmark bank lending rate. Similar maturity government bonds yield 2.35 percent.

"For a mature bond market we should allow some firms to go bust," said John Sun, managing director at Citic Securities International in Hong Kong. "The high-yield issuers will be small companies, so the impact on the whole market will be small, but psychologically it can impact the market sentiment because it's never happened before."

Although foreign banks, through joint ventures, can trade in bonds and underwrite them on the CSRC-regulated bond market via the two stock exchanges in Shanghai and Shenzhen, they mostly remain shut out of underwriting on the interbank market, which is 20 times larger and closed to individual investors.

Only HSBC

Only HSBC Holdings Plc has won approval to underwrite non- financial debt on the interbank bond market, and has yet to lead manage any sales. The London-based bank is the top underwriter in Hong Kong of so-called Dim Sum bonds, denominated in China's currency and sold offshore, according to data compiled by Bloomberg. HSBC declined to comment on Guo's reforms or potential for expansion for foreigners.

"It's awfully hard to see a foreign bank getting in, in a big way, in the early stages because the large local institutions are going to have to dominate to ensure that it works," said Jim Antos, a Hong Kong-based analyst at Mizuho Securities Asia Ltd. "A Chinese corporate would feel they have a better chance of success with a big local institution. That's the law of the jungle."

Foreign Underwriting

Foreign banks do stand to profit from the expansion of the domestic bond market as more Chinese companies are also allowed to sell Dim Sum bonds in Hong Kong. In addition to HSBC, Standard Chartered Plc, also London-based, along with BNP Paribas SA of France and Deutsche Bank AG of Germany have been the top underwriters of 227 billion yuan worth of debt since Baosteel Group Corp. became the first mainland non-financial company to sell yuan bonds in Hong Kong in November. Another four offerings are in the pipeline after being approved by the NDRC in April.

“European banks in China welcome the efforts made so far by the regulators to establish a strong liquid domestic bond market,” Dirk Moens, secretary general of the European Union Chamber of Commerce in China, said in a statement that urged China to “clarify the approval process and grant faster access to those qualified banks.”

Guo, a visiting scholar at Oxford University in 1986-87 who makes speeches in fluent English, has been pushing open China’s capital markets to foreign investors, an effort that had languished under his predecessor.

Market Priming

In April, the CSRC announced an almost tripling of the amounts allowed for U.S-dollar and yuan-qualified foreign institutional investors seeking access to China’s otherwise- closed markets. That money can be used to buy bonds sold through the stock exchanges. As of the latest figures available in March, 14 percent of the foreign investment had funneled to debt.

“He has done a lot for the first several months since he took over this position,” said Zhiming Zhang, Hong Kong-based head of China research at HSBC. “He’s rolling out a lot initiatives, but it’s all strictly within the CSRC.”

For years China’s bond market has meant shuffling money between state organs, with state-owned companies selling their paper to state-owned banks at controlled interest rates and banks holding the bonds on their books. Regulators have cornered different segments of the market: the NDRC primarily approves bond issuances of state-owned companies connected to local governments and the central government; the People’s Bank of China, or central bank, approves unlisted companies’ bonds; the CSRC handles companies already listed on the exchanges.

Expanding Reach

Back in 2009, the central bank had begun its own plan for small businesses to issue notes in an attempt to allow a wider range of companies to sell debt. Today, only 17 percent of private companies currently issue bonds rated AA- and above, according to data from HSBC.

Guo’s junk-bond plan expands the reach. It allows small and medium-sized companies to access funds, and investors to receive yields as much as three times the bank-lending rate. Companies, including unlisted ones, could also sell debt without administrative approvals, allowing the market to decide credit risk rather than the state.

“Commercial banks are very conservative in bond investing, so it’s not likely they will hold a large portion of the SME bonds,” said Wilson Li, a Shenzhen-based analyst at Guotai Junan Securities Co., naming mutual funds and insurance companies as the potential investors. “That shifts risk away from the banks.”

Few Tools

More than 68 percent of bond investors are banks, according to Chinabond, the nation’s bond clearing house. Currently in China there are few tools to hedge credit risk. Trading in new credit-default products introduced in 2010, known as credit-risk mitigation warrants, has never taken off.

Shandong Helon Co., a small fiber maker in eastern China that listed on the stock exchange, avoided default on its 400- million-yuan bond in April, despite being technically insolvent since September and reporting a loss of more than 1 billion yuan last year. Its overdue loans account for 582 percent of its assets.

Guo started early as a reformer. Born in 1956 in sparsely populated Inner Mongolia just ahead of China’s Great Leap Forward, Guo was dispatched to a rural work team during the Cultural Revolution in the 1970s. He published his first article, “Investigations on Reforming the Chinese Economy,” in 1984 while a Master’s student in Marxist and Leninist theory.

He sent the article unsolicited to the State Council's committee on economic reform hoping they could learn from it, according to an introduction he wrote for a collection of essays published in 2008.

Politician's Manner

Having worked in a number of state institutions, including as vice governor of landlocked Guizhou province and as a deputy in the central bank, Guo has a politician's manner. In his first speech as securities regulator in November to a Caixin magazine conference in a hotel in Beijing's central business district, he advocated allocating more resources to rural areas. Since then he has continued advocating for expanding the bond market.

Li Yang, vice president of the Chinese Academy of Social Sciences, the top state-supported research body, echoed the need in a forum in May, as cited by the official Xinhua news agency. He warned that corporate debt has exceeded warning levels, and companies could default on bank loans if the economy slows.

The central bank, the People's Bank of China led by Zhou Xiaochuan, who had headed the China Construction Bank Corp.
before Guo, manages the interbank market. Zhou led the first meeting of the inter-ministerial coordination mechanism for corporate bonds in April.

Fast Track

The NDRC, the country's economic planning agency which used to be the center of China's Soviet-style planned economy, approves most bonds to fund infrastructure projects. Such borrowing was crucial for China's 2008 stimulus and led local governments to rack up 10.7 trillion yuan in debt, 27 percent of China's GDP, from banks and bond sales, according to a June 2011 audit.

The NDRC plans to allow at least 500 billion yuan in a record for corporate-debt issuance this year, double the 2011 amount, according to a summary of a private talk by an NDRC official viewed by Bloomberg News. It has adopted a fast-track process for sales of public-housing debt by local governments, an official familiar with the decision said.

China has overwhelmingly relied on state-owned bank credit for its economic growth since reforms to the planned economy began in 1978. The ratio of all the financing in the economy to gross domestic product reached an all-time high of 44 percent in the first quarter of 2011, according to HSBC.

Weaning Off

In the early 1990s, Korea managed to wean state-owned borrowers off bank lending, Kim Eng Tan, a credit analyst at Standard & Poor's LLC said.

"They had a problem with state-owned companies financing only from banks, but when the bond market started, all the big companies rushed to the bond market, leaving the banks with no customers, freeing them up to lend to small and medium-sized companies," he said. "If you free the largest conglomerates to go to the bond market you solve the SME problem."

In China's system, that would require coordination among regulators that have overseen separate aspects of the bond market for more than a decade.

"When Guo stepped in he said we need more flexibility, we need to encourage more products in this market," Citic Securities' Sun said. "He's a very capable guy. When he was in China Construction Bank he did a good job there, but of course at his current position a lot of politics will be involved."

Guo's writings have demonstrated that he's aware of the challenge. In his essay introduction, he noted the difficulties.

“Changing the settled mindset and behavior of those involved in economic activity and leaders,” Guo wrote, “is not a simple study class, where you can attend some training sessions and finish the task.”

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