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Bonded to the State: A Network Perspective on China's Corporate Debt Market

**Li-Wen Lin
Curtis J. Milhaupt***

Introduction

The emergence of a corporate bond market, sometimes analogized to a “spare tire,” plays an important role in the maturation of bank-dominated financial systems of developing economies.¹ Corporate bond finance diversifies risk away from the banking sector and expands financing channels, particularly for small and medium-sized firms, which generally lack access to the capital markets and are usually not the primary recipients of bank loans. The corporate bond market also provides an alternative mechanism for monitoring corporate management and fosters practices essential to a robust financial system, such as a sound risk assessment culture and a reliable information disclosure regime. But creating a functional corporate bond market is difficult, because it requires a host of institutions that are usually underdeveloped or entirely lacking in a developing economy. These include credit rating agencies, a liquid trading market

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¹ See Alan Greenspan, Do Efficient Markets Mitigate Financial Crises?, Address Before the Financial Markets Conference of the Federal Reserve Bank of Atlanta, 1999; Pumping Up the Spare Tyre, *The Economist* Nov. 15, 2005, <http://www.economist.com/node/5169440> (“Developing deep and liquid bond markets, in particular, could make emerging economies less vulnerable [to banking crises].”). See also Patrick Bolton & Javier Freixas, How Can Emerging Market Economies Benefit from a Corporate Bond Market?, in Eduardo Borensztein et al. eds, *Bond Markets in Latin America: On the Verge of a Big Bang?* 29 (2008) (analyzing the spare tire function of a corporate bond market in emerging market economies).

for debt, a robust regulatory regime, and reliable legal mechanisms for protecting bondholders in the event of an issuer's default.

At least as measured by size, China has been spectacularly successful in developing a corporate bond market. Essentially nonexistent fifteen years ago, today China's corporate bond market is the third largest in the world. Yet looks can be deceiving. A Standard & Poor's report in 2014 garnered global media attention with its announcement that China had the largest amount of corporate debt in the world.² While technically accurate, this conclusion was potentially misleading: the S&P analysts had included in their estimate a huge quantity of bonds issued by financing vehicles set up by local governments. As typically defined by the international financial community, these bonds constitute "corporate debt" because they were issued by non-financial entities (i.e., special purpose vehicles). Moreover, in China the generic term "corporate bond" encompasses several different types of debt instrument (under the jurisdiction of three different government regulators), including the type issued by these local government financing vehicles.³ Yet these are essentially municipal bonds in disguise, designed to circumvent, with the tacit approval of the central government, a law prohibiting local governments from issuing debt. Given these complexities, the confusion wrought by the S&P report is understandable. As *The Economist* remarked of this episode, "Just as staggering [as the amount of Chinese corporate debt]...is the challenge of figuring out who owes what to whom."⁴

Despite its importance, size and complexity, however, China's corporate bond market has received relatively little academic attention.⁵ We seek to redress this situation, in part to deepen

² See China's Corporate Debt: Big, But Not the Biggest, *The Economist*, June 17, 2014. The S&P report has been removed from the firm's website.

³ Properly adjusted, the total amount of Chinese corporate debt (bank loans and bonds) is still huge, at around \$11.4 trillion, but smaller than the U.S. and European totals, at least for now. *Id.*

⁴ *Id.*

⁵ See, e.g., Franklin Allen, Jun Qian & Meijun Qian, Law, Finance, and Economic Growth in China, 77 *J. Fin. Econ.* 57 (2005), a prominent article on the Chinese financial system analyzing bank credit and equity finance, with no

understanding of an important component of the Chinese financial system and the lessons it may hold for other developing economies. Equally important, given the distinctive aspects of China's corporate bond market alluded to in the S&P example above, our study also serves to open a unique window into Chinese "state capitalism" in operation.

In this paper, we use a network perspective⁶ to explore the formation and effects of the complex web of relationships comprising China's corporate bond market – relationships that overwhelmingly revolve around the state. We highlight the consequences of state-centricity for the market's development – including concentration of risk in state-linked financial intermediaries, expansion of credit to local state-owned enterprises, and growth of the shadow banking system – and for its operation, including an increasingly fragile "no-default" norm that has protected bondholders from issuer default. State-centricity may have played a large role in the extraordinary growth of China's corporate bond market in the absence of the formal institutional infrastructure normally deemed essential to such a market's development. Yet state-centricity also has unanticipated or unavoidable consequences that may undermine national government policy in promoting growth of the corporate bond market. Thus, in addition to serving as a comprehensive study of this facet of China's financial system, our paper provides an important counterexample to the popular view of Chinese state capitalism as featuring a high

mention of the corporate bond market, which was admittedly insignificant at the time of their writing. Recent exceptions include Pierre Pessarossi and Laurent Weill, *Choice of Corporate Debt in China: The Role of State Ownership*, 26 *China Econ. Rev.* 1 (2013); Greg Shailer & Kun Wang, *Government Ownership and the Cost of Debt for Chinese Listed Corporations*, 22 *Emerging Markets Rev.* 1 (2015).

⁶ We use the term "network perspective" instead of "network analysis," because the latter term has taken on the connotation of a specific methodological approach which we do not follow completely. However, as in network analysis, our approach seeks to uncover patterns of ties in which actors or organizations are embedded, determine the conditions under which those patterns arise, and examine their consequences. See Linton C. Freeman, *The Development of Social Network Analysis: A Study in the Sociology of Science* 2 (2004). The utility of examining financial systems through a network perspective has recently been highlighted by scholars. See Franklin Allen & Ana Babus, *Networks in Finance*, in Franklin Allen & Ana Babus eds., *The Network Challenge: Strategy, Profit and Risk in a Networked World* (2009).

degree of coordination among government ministries and highly successful implementation of national industrial policy.⁷

Part I provides an overview of the development, structure and regulation of the Chinese corporate bond market, whose complexities have been shaped by a surprising degree of regulatory competition among the three central government ministries overseeing the issuance and trading of corporate debt instruments. Part II analyzes the Chinese corporate debt market as a *network*, first by describing the actors and highlighting their relationships to the state; next, by examining the linkages that bind the actors, based on ownership, personnel ties, and organizational membership. Part III explores the consequence of this network of relationships for the market's development and operation. Part IV considers some of the policy implications of our study, drawing in part on the experiences of Japan and Korea, two other, formerly high-growth, state-led⁸ East Asian economies with distinctive corporate bond markets in their developmental heydays.

I. Market Overview

In this section, we briefly trace the trajectory of the Chinese corporate bond market's development, provide an overview of the fairly complex array of debt instruments comprising the market and their regulation, and conclude by highlighting an important underlying dynamic

⁷ See, e.g., Richard A. D'Aveni, *Strategic Capitalism: The New Economic Strategy for Winning the Capitalist Cold War 64* (2012). (“Along with its array of control structures, the Chinese Communist Party (CCP) has managed to coordinate government policies across its ministries to put the nation and its business enterprises squarely behind the goals and methods of the CCP.... China has a grip on both strategy and execution in ways that other countries seem unable to match.”)

⁸ We use the label “state-led” here in the knowledge that (a) the Japanese and Korean governments pursued somewhat different development strategies in their respective economies, which had considerable structural differences, and (b) industrial policy and other forms of attempted governmental management of the economies were by no means always successful or necessarily the principal driver of growth in these countries. We use the term simply to signify a state that has placed the highest priority on economic development, and an economy in which most of the key actors have strong ties to government ministries and/or political leaders pursuing national industrial policy goals.

that has shaped the Chinese corporate bond market to this point – one not commonly perceived to operate in a system of state capitalism – regulatory competition.

A. Developmental Trajectory

China's corporate bond market, like those of other developing countries, including Japan and Korea in earlier decades, played only a marginal role in corporate finance during its takeoff period.⁹ The reasons include ready access to loans from state-owned banks for the largest (typically state-owned) firms, heavy regulation of the bond market, both to control allocation of credit and to protect the state-owned banking sector, the relative attractiveness to firm managers of equity finance over bond finance, and as noted, under-development of institutions needed to support a robust corporate bond market, such as independent credit rating agencies and a liquid secondary market.

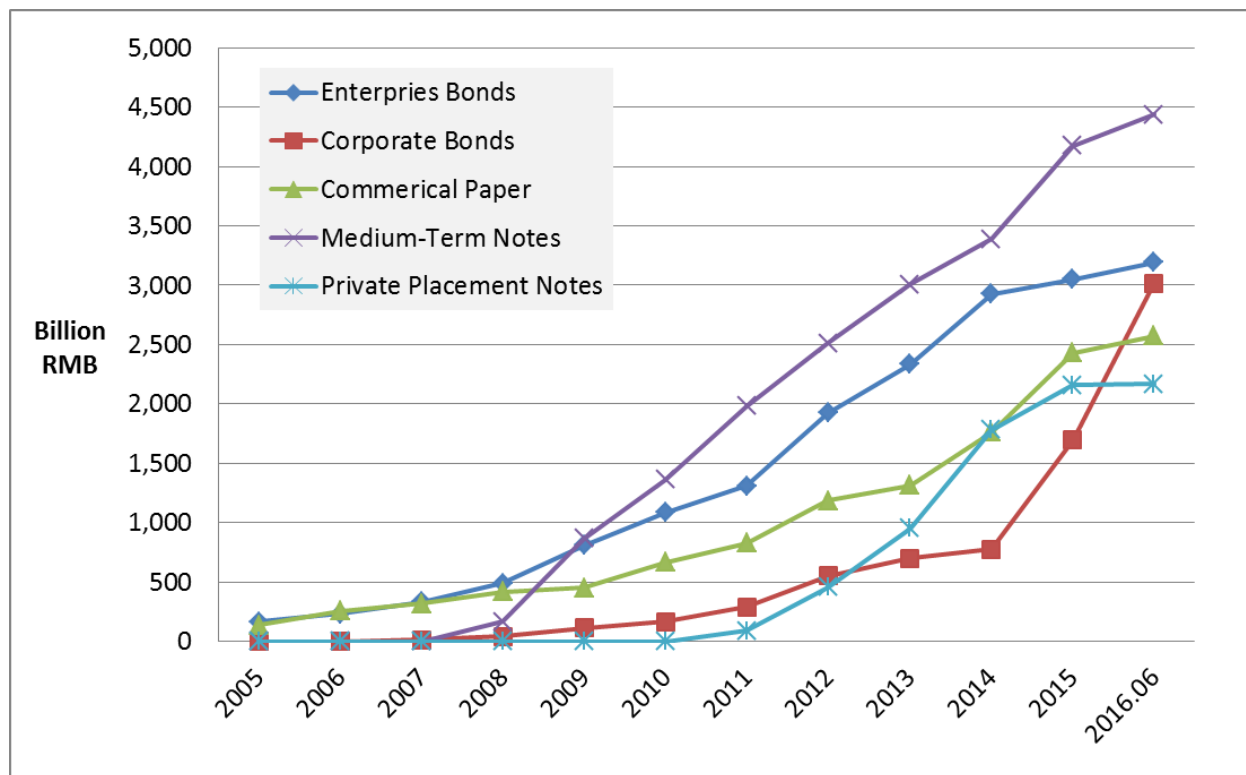
Notwithstanding these initial circumstances, as shown in Figure 1, China's corporate bond market has grown exponentially over the past decade, with 2007-08 marking the beginning of a sharp upward trend in the issuance of all types of corporate debt instruments, a result of several factors that will be explained in more detail below.¹⁰ In preview, these factors include, first, the Chinese government's eventual decision to prioritize development of the corporate bond market, both to diversify credit risk, which has been heavily concentrated in the banking sector, and to expand sources of funding for small- and medium-sized enterprises. Second and relatedly, the relaxation of regulatory constraints on the issuance of corporate bonds of all types, spurred in part by regulatory competition among the three government agencies overseeing different

⁹ See Asian Securities Industry and Financial Markets Association (ASIFMA), China Bond Market Roadmap 1 (2013) ("Traditionally, China has focused on equity markets and bank loans at the expense of bond markets...").

¹⁰ In addition to the factors enumerated in the text, the explosive growth of the corporate bond market after 2008 is also a result of China's 4 trillion RMB stimulus program in response to the global financial crisis.

segments of the market. Third, the explosive growth of bonds issued by financing vehicles affiliated with local governments to finance infrastructure investments.¹¹

Figure 1 Outstanding Balance by Type of Bond



Source: raw data collected from WIND (as of June 30, 2016), compiled by authors.

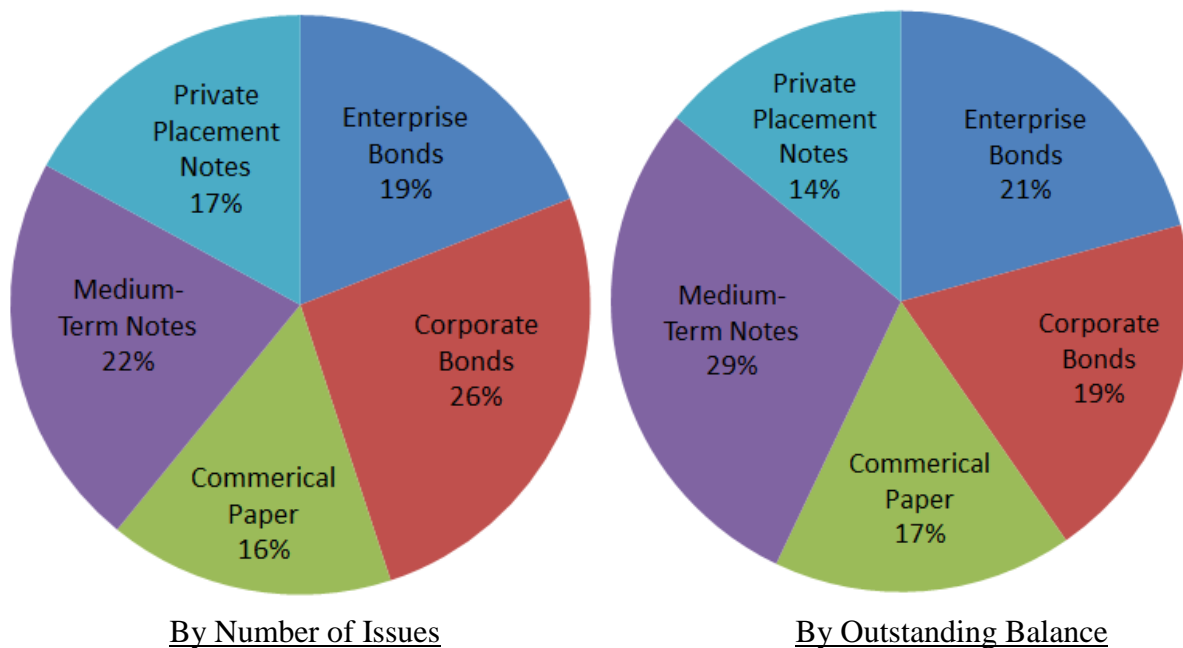
B. Market Segments and Regulation: As the *Financial Times* has noted, “China’s corporate bond market has long been divided into three separate fiefdoms.”¹² So-called “enterprise bonds,” traditionally issued by large, central state-owned enterprises (SOEs) to fulfill national development goals, are regulated by the National Development and Reform Commission, NDRC. The NDRC is China’s premier economic planning agency with responsibilities ranging from formulation of comprehensive industrial policies to overseeing key

¹¹ The explosive growth of China’s corporate bond market is part of a major uptrend in corporate bond issuance across the emerging markets since 2009. See IMF, *Global Financial Stability Report: Vulnerabilities, Legacies, and Policy Challenges: Risks to Emerging Markets*, at 94-95 (2015).

¹² Simon Rabinovitch, *China’s Corporate Bond Market Booms*, *Financial Times*, July 12, 2012, available at <http://www.ft.com/intl/cms/s/0/839017b4-cbf8-11e1-839a-00144feabdc0.html#axzz3nhPQXcEn>.

construction projects and fixed asset investments.¹³ “Corporate bonds,” as that term is commonly understood – long-term debt instruments issued by non-financial corporations – are regulated by the China Securities Regulatory Commission (CSRC). The CSRC is responsible for oversight of listed firms and the stock exchanges. Commercial paper, medium-term notes and private placement notes – unsecured, short-term corporate debt instruments issued in the money market – are traded in the interbank market and overseen by the People’s Bank of China (PBOC), China’s central bank. Figure 2 illustrates the relative size of each segment of the corporate bond market.

Figure 2 Size of Each Segment of China’s Corporate Bond Market



Source: raw data collected from WIND (as of June 30, 2016), compiled by authors.

1. *Enterprise Bonds*: Beginning in the early 1980s, enterprises were permitted to issue bonds with the permission of the PBOC. The first regulations (“Interim Regulations on Administration of Enterprise Bonds”) were promulgated by the State Council in March 1987.

¹³ See the NDRC’s website, <http://www.en.ndrc.cn/mfndrc>.

These debt instruments were called “enterprise bonds” because the corporate form was not available in China until the passage of the first Corporate Law in 1993. The Interim Regulations recognized the legal status of enterprise bonds, but limited eligible issuers to SOEs. The PBOC was charged with overseeing the issuance of enterprise bonds and, in cooperation with a number of government agencies such as the State Planning Office (predecessor of the NDRC), it set annual quotas for enterprise bond issues, which were implemented at the local level. But the Interim Regulations were weakly enforced, and the amount of enterprise bonds issued greatly exceeded the quotas. Many bonds fell into default, and disorder in the enterprise bond market began to negatively affect the sale of government bonds. In response, the government took a number of measures which reduced the attractiveness of enterprise bonds.

During this early period of economic reform, the Chinese government was actively seeking to develop the stock market, launching the Shanghai and Shenzhen stock exchanges in 1990. After the stock markets opened, bond issues declined in favor of equity issues. Enterprise managers perceived equity to be a cheaper form of capital than bonds, especially because at the time there was no expectation that listed firms would pay dividends. In fact, Chinese enterprises paid no dividends to their public or state shareholders for many years after the stock markets were established. Moreover, the largest, most listing-worthy firms in this era were state-owned, having been “corporatized” in the process of transitioning out of a centrally planned economy. The SOEs released only a small fraction of their shares to the public in the listing process; the vast majority were so-called “non-tradable shares” – more accurately, shares that could only be traded at the direction of the state, from one state-related entity to another. Public listing on a stock exchange therefore raised capital for the firm without diluting management’s (and the

state's) control rights or engendering meaningful capital market discipline. Given these circumstances, bonds were a less attractive source of capital.

In 1993, the State Council promulgated Regulations on Enterprise Bonds (“Regulations”). The Regulations provided that all enterprises with legal personality, not exclusively SOEs, were eligible to issue enterprise bonds through a public offering.¹⁴ The Regulations maintained the quota system for enterprise bond issues, and, in view of past disorder in the market, provided that any deviation from the quotas required explicit authorization by the State Council. Enterprise bond issues of central SOEs were to be approved by the PBOC in conjunction with the State Planning Office; local SOEs received approval from the local counterparts of the PBOC and State Planning Office. To be eligible, an enterprise was required to meet requirements relating to size, accounting standards, solvency and profitability, and the issue had to be guaranteed by a (state-owned) bank. Moreover, the Regulations required that funds raised in the bond issue be used in a manner approved by regulators and consistent with national industrial policy. The Regulations prohibited the use of bond proceeds for real estate, stock and futures investments. Although as a legal matter enterprise bonds could now be issued by any corporation, virtually the only firms that could meet the requirements were central SOEs. In 2011, the State Council promulgated new Regulations on Enterprise Bonds, but in substance, the new and old regulations are virtually identical.

While the Regulations contemplate that both the PBOC and the NDRC are responsible for regulating enterprise bonds, in practice only the NDRC exercises regulatory authority over this segment of the corporate debt market. NDRC regulatory authority is premised on the notion

¹⁴ A Corporate Law had been enacted by this point, granting legal personality to any firm that met the law's requirements. However, the Corporate Law was enacted very much with SOEs in mind and its provisions did not suit the needs of private enterprises very well. See Donald Clarke, *Blowback: How China's Efforts to Bring Private-Sector Standards into the Public Sector Backfired*, in Benjamin L. Liebman & Curtis J. Milhaupt eds., *Regulating the Visible Hand? The Institutional Implications of Chinese Corporate Capitalism* 29 (2016).

that enterprise bonds not only serve an individual firm's financing needs, but more importantly, support national industrial policies. As noted, the Regulations expressly implement this goal: capital raised in an enterprise bond issue must be used in a manner consistent with national industrial policies.¹⁵ Enterprise bonds have been used mostly to support government-approved projects on fixed-asset investment and technological innovation.

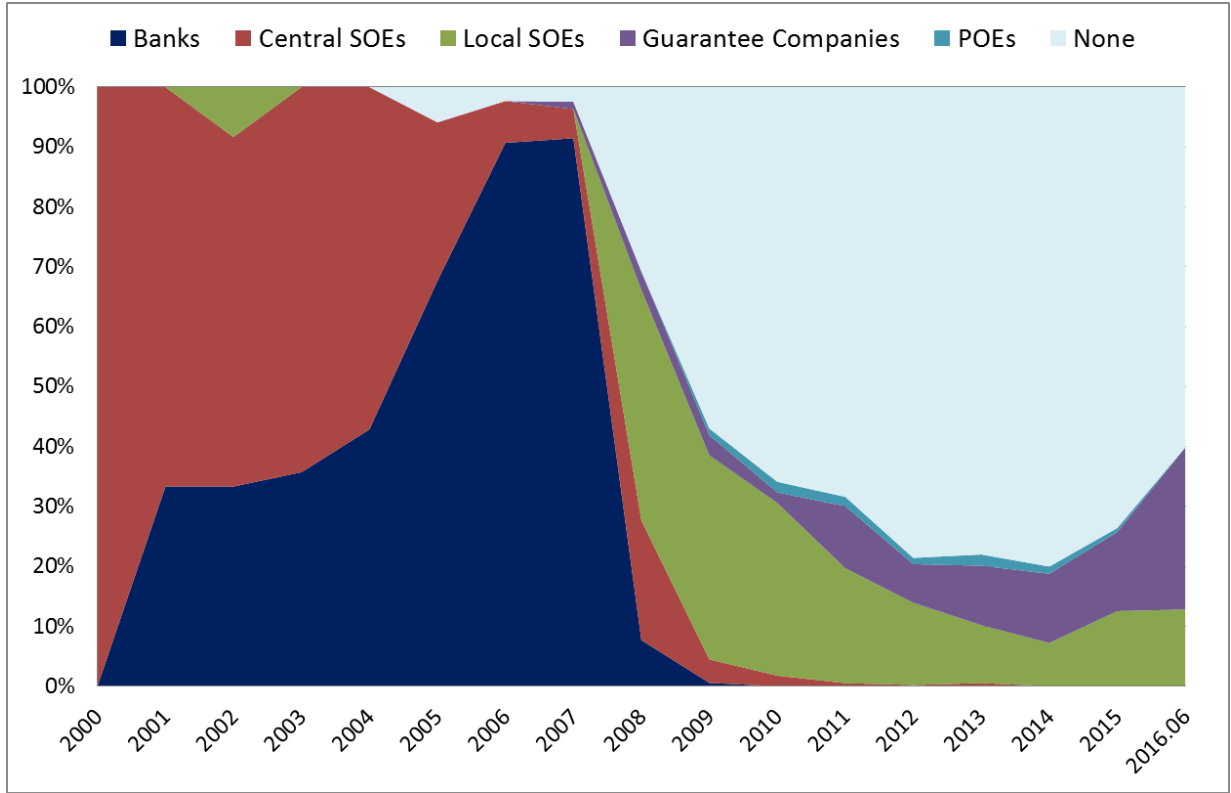
As Figure 3 indicates, virtually all enterprise bonds issued before 2008 were guaranteed, typically by a state-owned bank. However, in 2007, the China Banking Regulatory Commission (CBRC) announced a policy of prohibiting banks from serving as guarantors for enterprise bonds, and requiring that they withdraw from the market as soon as possible.¹⁶ The policy reflected concern over the substantial risks associated with conflating direct and indirect financing. The CBRC noted that guarantees transfer credit risk in the bond market to the banking system, potentially threatening the interests of bank shareholders and depositors. In 2008, the NDRC formally eliminated the guarantee requirement for enterprise bond issues.¹⁷ Accordingly, the data show the disappearance of banks as guarantors and the steep increase in bonds without guarantees beginning in 2008. Section II of the paper will explore the relationships between issuers and guarantors in more detail.

¹⁵ In April 2015, NDRC began to delegate some of its oversight to the China Government Securities Depository Trust & Clearing Co. Ltd. (CDC), a state-owned financial institution providing depository, registration and clearing services to the bond market. CDC reviews enterprise bond applications and produces reports to assist NDRC in deciding whether to approve issues. This new review process is believed to be a step toward a registration system.

¹⁶ CBRC's Opinions on Effective Regulation on Enterprise Bond Guarantee Risks [中国银监会关于有效防范企业债担保风险的意见] [*Zhongguo yinjianhui guanyu youxiao fangfan qiyezhai danbao fengxian de yijian*], CBRC [2007] No. 75.

¹⁷ NDRC's Notice on Promoting the Development of the Enterprise Bond Market and Simplification of Issuance Processes [国家发展改革委关于推进企业债券市场发展、简化发行核准程序有关事项的通知] [*Guojia fazhan gaigewei guanyu tuijin qiye zhaiquan shichang fazhan, jianhua faxing hezhun chengxu youguan shixiang de tongzhi*] NDRC Financial [2008] No.7, Jan 4. 2008.

Figure 3 Percentage of Enterprise Bonds Guaranteed, by Type of Guarantor

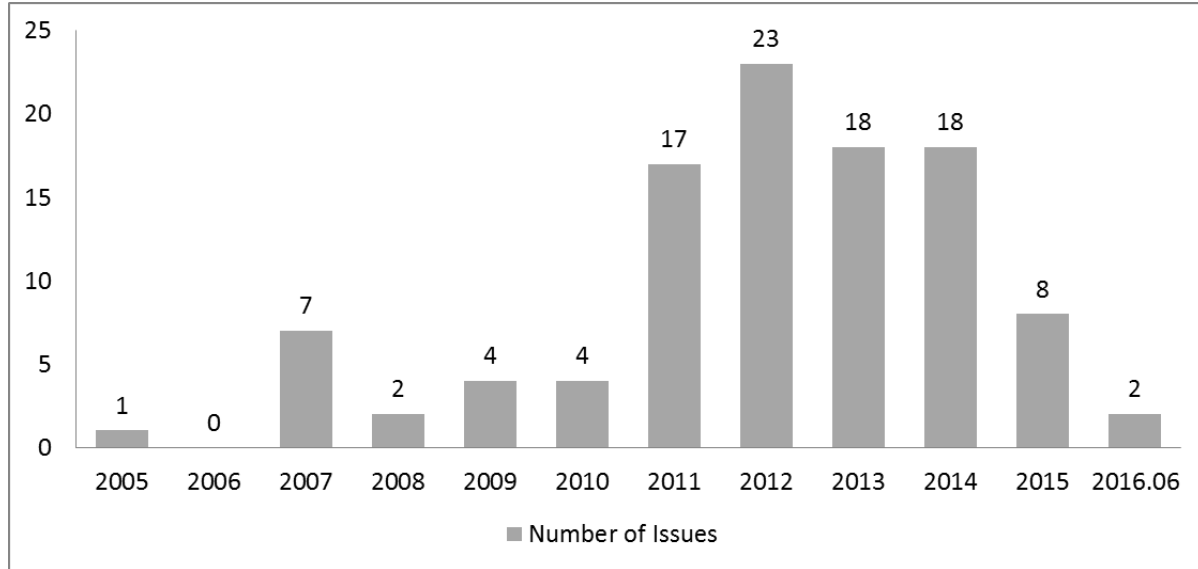


Source: raw data collected from WIND (as of June 30, 2016), compiled by authors.

Although enterprise bonds were traditionally issued exclusively by central SOEs, several exceptions developed in the latter half of the 2000s. First, in 2005, the State Council announced that privately owned enterprises (POEs) would be permitted to issue enterprise bonds.¹⁸ Figure 4 shows the number of enterprise bonds issued by POEs from 2005 through June 30, 2016.

¹⁸ State Council's Several Opinions on Promoting, Supporting and Guiding the Non-State-Owned Economic Development [国务院关于鼓励支持和引导个体私营等非公有制经济发展的若干意见] [*Guowuyuan guanyu guli zhichi he yindao geti siying deng fei gongyouzhi jingji fazhan de ruogan yijian*], State Council [2005] No. 5, Chapter 2, Item 11.

Figure 4 Number of Enterprise Bonds Issued by Private Enterprises



Source: raw data collected from WIND and www.chinabond.com (as of June 30, 2016), compiled by authors.

It is instructive to examine the POEs approved to issue enterprise bonds; they illustrate the NDRC's use of the debt instrument to promote national objectives. One such POE is Legend Holdings Limited, the controlling shareholder of its well-known subsidiary, the Lenovo Group. Legend issued enterprise bonds in 2011 and 2012, with most of the proceeds used to develop ethylene derivatives. The bond prospectus notes that "this product structure, market position, and the company's orientation toward the development of new materials and refined chemical engineering are consistent with the government's industrial restructuring plan during the period of the 12th 5-year plan."¹⁹ Another example is Tianrui Group, a cement producer, one of the 500 largest private enterprises in China. In 2014, the NDRC of Henan Province approved Tianrui's issue of up to 5 billion RMB (US\$750 million)²⁰ in enterprise bonds, a record for private enterprises. The NDRC approved the bond issue to alleviate oversupply in the cement industry

¹⁹ Available at <http://www.chinabond.com.cn/Info/15060526> (2012 prospectus in Chinese) and <http://www.chinabond.com.cn/Info/11908990> (2011 prospectus in Chinese).

²⁰ Throughout the paper, RMB is converted to US\$ at the rate of 0.15.

through mergers and acquisitions and technological upgrades.²¹ The NDRC's approval notice states that the bond proceeds should be directed toward a basket of measures such as acquisitions and plant closures to solve cement oversupply problems.

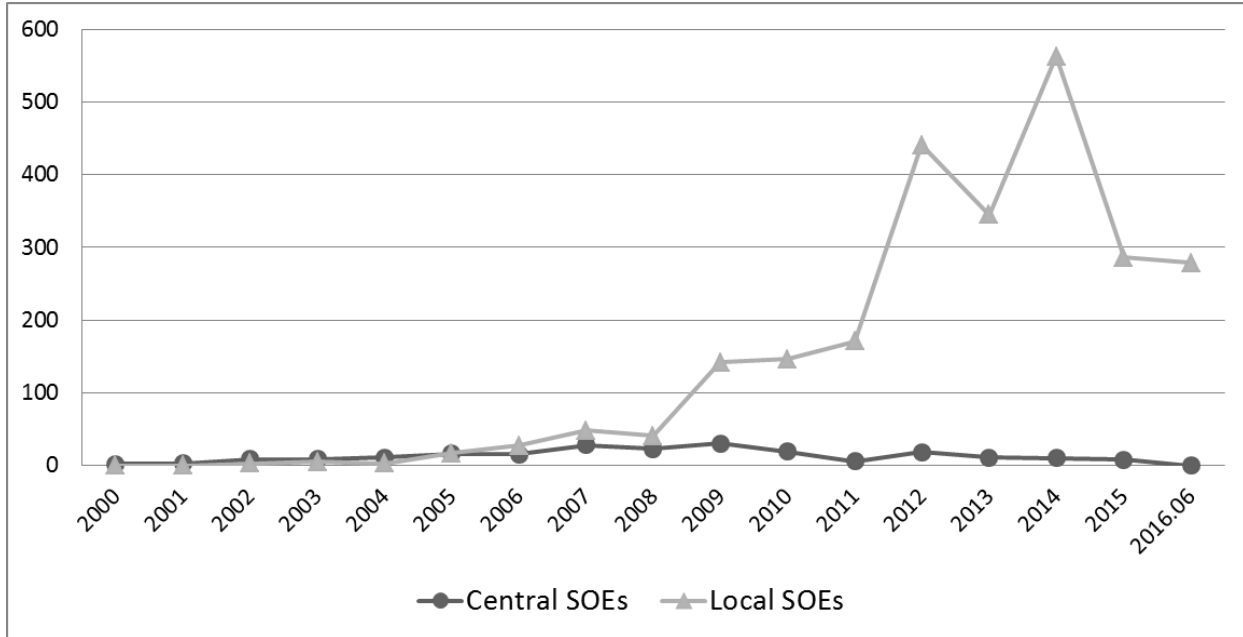
The second exception to the exclusive issuance of enterprise bonds by central SOEs is their issue by local SOEs and on behalf of local governments, which, as shown in Figures 5 and 6, began to spike in 2008 in the wake of the global financial crisis.²² The vast majority of the local enterprise bonds are so-called “urban construction and investment bonds” issued by special purpose vehicles formed by local governments, or “local government financing vehicles” (LGFVs). LGFVs circumvent a national prohibition against local government debt. Thus, as noted in the Introduction, local enterprise bonds might be thought of as municipal bonds in disguise, carrying an implicit guarantee by local governments.²³

²¹ Second Interbank Bond Issuance for Mergers, Tianrui Group's 5 Billion Staggering Volume [银行间债市第二单 并购债发行 天瑞集团 50 亿天量融资] [*Yinhangjian zhaishi dier dan bingou zhai faxing tianrui jituan 50 yi tianliang rongzi*] <http://finance.sina.com.cn/money/bond/20140620/024719467237.shtml> (reporting information from people inside NDRC). On the oversupply problem in the Chinese cement industry, see Michael Shuman, *Zombie Factories Stalk the Sputtering Chinese Economy*, *New York Times* (Aug. 28, 2015).

²² While the enterprise bond market grew rapidly over the past decade, the first quarter of 2015 saw a significant decline in the volume of issues. As of the end of April 2015, only 141 local enterprise bonds were issued with a volume of \$143.5 billion RMB, about half the amount issued in the comparable period of 2014 www.chinbond.com.cn. The decline is believed to be related to enhanced regulatory scrutiny by the NDRC in response to a series of recent default crises, discussed below. NDRC's Several Opinions on Comprehensively Strengthening Enterprise Bond Risks Prevention [关于全面加强企业债券风险防范的若干意见] [*Guanyu quanmian jiaqiang qiye zhaiquan fengxian fangfan de ruogan yijian*], September 26, 2014.

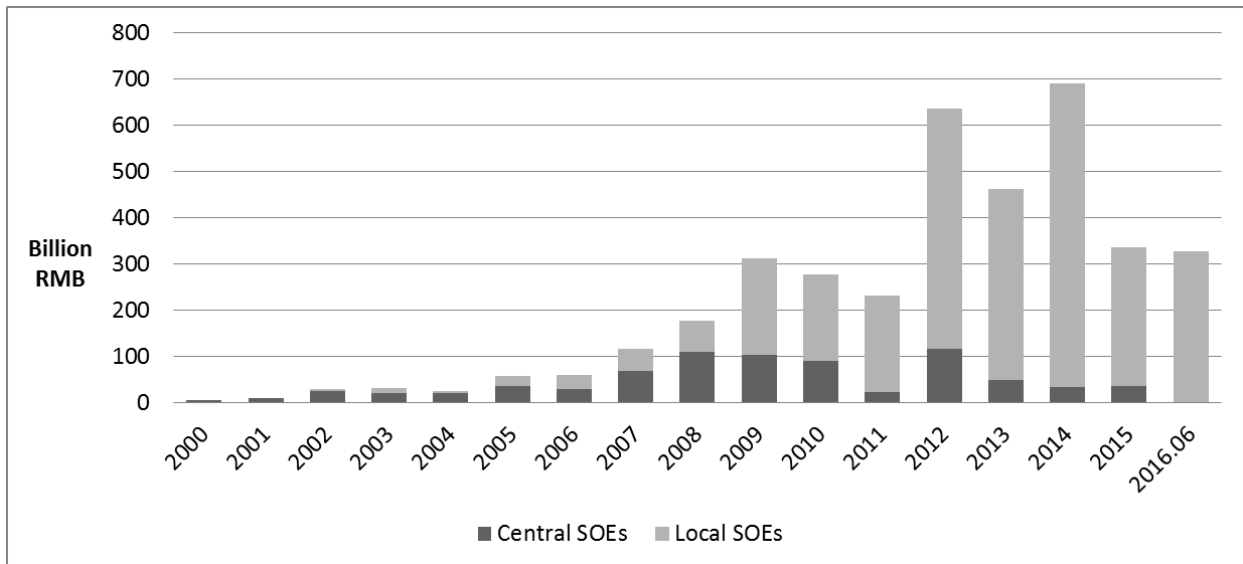
²³ It should be noted that this *implicit* guarantee is, by definition, not *legally* enforceable under the terms of the prospectuses under which LGFV debt is issued. See Donald Clarke & Fang Lu, *The Law of China's Local Government Debt Crisis: Local Government Financing Vehicles and Their Bonds*, unpublished working paper, 2016. But as discussed in Part III, political and social considerations may cause Chinese state actors to support bond issuers in the absence of a legal duty to do so.

Figure 5 Central SOEs v. Local SOEs by Number of Enterprise Bond Issues



Source: raw data collected from WIND (as of June 30, 2016), compiled by authors.

Figure 6 Central SOEs v. Local SOEs by Volume of Enterprise Bond Issues (Billion RMB)



Source: raw data collected from WIND (as of June 30, 2016), compiled by authors.

2. *Corporate Bonds*: Although Corporate Bonds²⁴ have been recognized in China's company law and securities law – and subject to regulation and approval by the CSRC -- since the 1990s,²⁵ virtually all of the bonds issued by Chinese corporations until the mid-2000s were enterprise bonds. Responding to this situation, China's 11th Five Year Plan (2006-2010) featured development of the corporate bond market as one of its major goals. The current regulatory framework for Corporate Bonds is provided by the CSRC's Administrative Measures on Corporate Bond Issuance and Trading ("Administrative Measures"), promulgated in January 2015.²⁶

The Administrative Measures (and the prior set of regulations they replaced) provide simply that Corporate Bonds may be issued by "companies" – listed or unlisted. However, in practice, until 2015 the CSRC permitted only listed companies to issue Corporate Bonds.²⁷ The CSRC must approve all Corporate Bond issues. Most of the bonds are traded on either the Shanghai Stock Exchange or the Shenzhen Stock Exchange. As Figure 2 indicates, Corporate Bonds represent a relatively small share of the overall market for corporate debt securities – accounting for 26% of the market by number of issues and 19% by outstanding balance as of

²⁴ To avoid confusion, Corporate Bonds will be capitalized when we are referring to the specific type of debt security authorized under the Company Law and regulated by the CSRC. The term will not be capitalized when we are referring to the generic class of debt securities issued by non-financial corporations, which includes all of the debt instruments discussed in this section.

²⁵ Article 160 of the 1993 Company Law; Article 154 of the 2005 Company Law.

²⁶ Key provisions of the Administrative Measures:

Article 2: Corporate Bonds refer to securities issued by companies pursuant to legal procedures with guaranteed payment of principal plus interest by a specified future date.

Article 3: Corporate Bonds may be issued through public or private offering.

Article 18: Corporate Bonds may be issued through public offering if certain conditions relating to credit and assets of the issuer are met.

Article 26: Private offerings of Corporate Bonds may be made only to qualified investors.

Article 69: Local government financing vehicles are not eligible to issue Corporate Bonds.

²⁷ In 2015, the CSRC permitted Zhoushan Port Group Corporation, an unlisted company wholly owned by the State-owned Assets and Supervision Commission (the local state shareholder and supervisor) of Zhoushan City, to issue Corporate Bonds. It issued 700 million RMB (US\$110 million) of Corporate Bonds, with a credit rating of AA+. (Because the credit rating is below AAA, the bonds could only be issued to qualified investors.) This represents not only the first Corporate Bond issue by an unlisted company, but also the first issued to qualified investors.

http://finance.ce.cn/rolling/201505/27/t20150527_5469937.shtml.

June 30, 2016. However, there has been a spike in the issuance of Corporate Bonds in the past year, after the CSRC began to permit their issuance by unlisted firms.²⁸

3. Commercial Paper, Medium-Term Notes, and Private Placement Notes: Commercial paper (CP) and medium-term note (MTN) issues first emerged in the late 1980s, but they were suspended in the ensuing decade due to market disorder. In an effort to jump start the corporate bond market, CP was reintroduced by the PBOC in 2005 and MTN were reintroduced in 2008.²⁹ Both forms of debt are traded in interbank markets. Figure 2 indicates that CP and MTN now comprise a majority of China's corporate bond market, both by number of issues and outstanding balance. There are several major attractions of CP and MTN over the other forms of corporate debt in China: they carry comparatively low interest rates and can be issued in small amounts; they are unsecured; and they impose no restrictions on the issuer's use of proceeds. Most importantly, CP and MTN issues are subject only to a registration regime, in contrast to the pre-approval process for enterprise bonds and Corporate Bonds.³⁰ Private placement notes, a form of short-term debt security similar to MTN, are privately placed with institutional investors.

4. Small and Medium-Sized Enterprise Bonds: China's financial system has historically provided privileged access to credit to large, particularly state-owned, enterprises. Small and medium-sized enterprises -- whether SOE or POE -- have faced more limited formal financing options. In recent years, the Chinese government has sought to address the situation. Each of the three regulators of the corporate bond market has created a debt instrument designed for use by SMEs. The NDRC introduced the "small and medium-sized enterprise collective bond" in

²⁸ Corporate Bonds accounted for just 8% of the total amount of bonds outstanding as recently as August 2015.

²⁹ In 2005, People's Bank of China promulgated Administrative Measures on Commercial Paper [短期融资券管理办法] [*Duanqi rongziquan guanli banfa*]; the Measures were replaced by Regulatory Measures on Non-Financial Enterprise Bond Financing Tools in the Interbank Market [银行间债务市场非金融企业债务融资工具管理办法] [*Yinhangjian zhaiwu shichang fei jinrong qiye zhaiwu rongzi gongju guanli banfa*], effective of April 15, 2008.

³⁰ CP and MTN issues are registered with the National Association of Financial Market Institutional Investors.

2007.³¹ This is a bond that essentially bundles the credit risks of a number of companies. A more successful competing alternative, “small and medium-sized enterprise collective medium-term notes,” was introduced in 2009 by the PBOC. And the CSRC now permits SMEs to issue bonds via private placement. It has delegated to the Shanghai and Shenzhen Stock Exchanges the authority to oversee issuance and trading of these bonds. In 2012, the stock exchanges jointly released Experimental Measures on Small and Medium-Sized Enterprise Private Placement Bonds. Under the Measures, bonds must be guaranteed and are traded on a special platform provided by the exchanges open only to qualified investors. As of the end of 2014, 631 bonds were listed on this platform, with a value of 91.2 billion RMB (US\$13.7 billion). A majority of the issuers are POEs, but small and medium-sized SOEs also participate in this market.

C. Regulatory Competition:

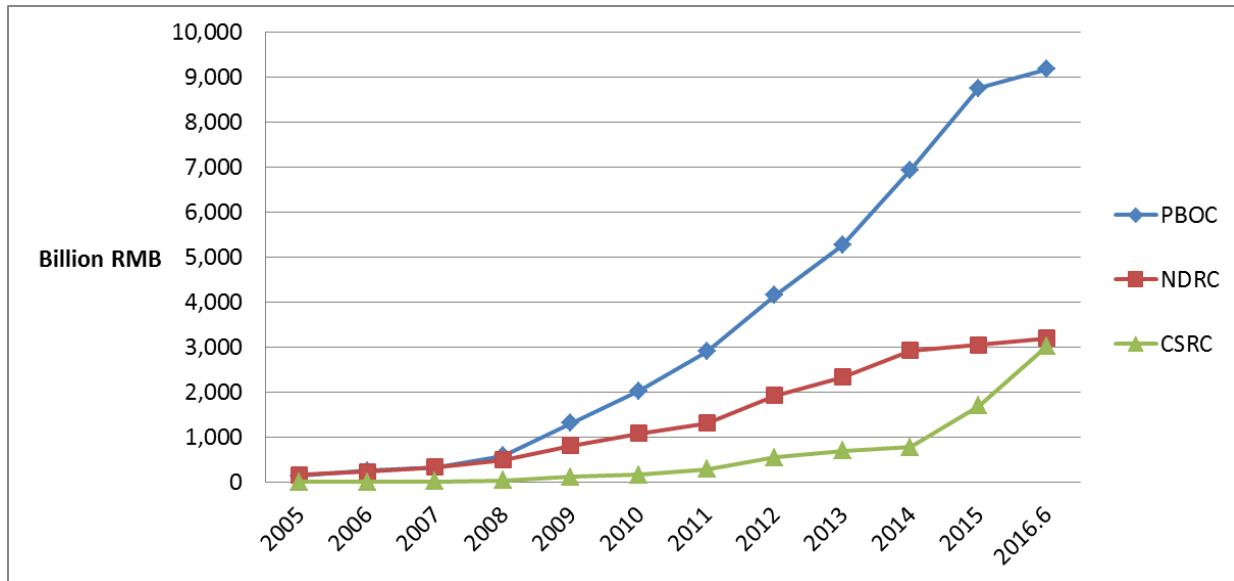
As we have seen, the multiplicity of debt instruments in the Chinese corporate bond market mirrors regulatory fragmentation, with three government ministries overseeing the issuance and trading of three different forms of corporate debt, and each ministry introducing its own regime for bond issuances by SMEs. The NDRC was for many years the sole de facto regulator of the corporate (i.e. enterprise) bond market.³² The NDRC’s de facto regulatory monopoly broke down when competitors, particularly the PBOC, began to authorize the issuance of alternative debt instruments on more favorable terms. Figure 7, showing outstanding corporate debt securities grouped according to regulatory jurisdiction, provides a means of visualizing this competition. As Figure 7 indicates, debt instruments under PBOC’s jurisdiction have

³¹ NDRC’s Notice Regarding Enterprise Bond Issuance Volumes and Approval Questions [关于企业债券发行规模及发行核准有关问题的通知] [*Guanyu qiye zhaiquan fa xing guimo ji faxing hezhun youguan wenti de tongzhi*], NDRC Financial [2007] No. 602.

³² Early regulations on the enterprise bond market granted sole regulatory authority to the PBOC. Regulatory reforms in 1993 resulted in a shift of authority to the NDRC, although the text of the regulations still treated PBOC as having regulatory authority along with the NDRC. For nearly the past two decades, the NDRC has been the sole regulator of enterprise bonds, which support national industrial policies. PBOC, lacking a direct role in industrial planning, shifted its focus to financial bonds and other debt instruments issued by financial institutions.

mushroomed from zero to RMB 9 trillion (US\$1.35 trillion) in the past decade, vastly surpassing the outstanding value of debt securities regulated by the NDRC and CSRC.

Figure 7 Outstanding Corporate Debt Securities, by Regulatory Jurisdiction



Source: raw data collected from WIND (as of June 30, 2016), compiled by authors.

The competition among the NDRC, PBOC and CSRS not only reflects the separation of power within China’s central bureaucracy, it also highlights significant differences in regulatory philosophy that drive the various regulatory methodologies and result in different degrees of market liberalization. NDRC-regulated enterprise bonds are a legacy of the planned economy, in which the state uses the market for its own purposes. To varying degrees, the PBOC-deregulated interbank market for short-term debt and the CSRC-regulated Corporate Bond market reflect the state’s continuous experimental efforts to build a market economy within the state-capitalist system.

At times, turf battles among the three regulators have surfaced publicly. One recent head of the CSRC publicly suggested consolidating regulatory authority over both enterprise bonds and Corporate Bonds in the CSRC. But the trial balloon was quickly shot down by the NDRC.

As Figure 7 shows, until very recently the NDRC regulated a larger share of the overall corporate bond market than the CSRC, placing the latter agency in a relatively weak position to argue that it should be the sole regulator. Moreover, the NDRC has justified its continued regulatory involvement in the market by contrasting the role of enterprise bonds in serving the needs of state-backed development projects with that of Corporate Bonds under the CSRC's purview, which serve the financing needs of individual firms. The NDRC's expertise and central role in formulating and implementing national industrial policy, perhaps bolstered by the legacy of the planned economy, have given it a leg up in its regulatory competition with the CSRC.

In contrast to the CSRC's unsuccessful direct public challenge to the NDRC, the PBOC has quietly sped past the regulatory space occupied by the other two ministries. As noted, prior to 2005, with limited exceptions, virtually the only corporate debt securities in the market were enterprise bonds regulated by the NDRC or its predecessor agency. The PBOC injected competition into the market when it authorized the issuance of CP in 2005 – a move explicitly aimed at resuscitating the moribund corporate bond market. Commercial paper quickly overtook enterprise bonds in number and volume. But the NDRC did not remain passive in the face of this competition,³³ and enterprise bond issues spiked up in the wake of the PBOC's initiative. The PBOC, in turn, responded by approving the issuance of MTN in 2009. Because MTN have terms and maturities quite similar to those of enterprise bonds and Corporate Bonds, they posed a direct challenge to the NDRC and CSRC. Innovations with respect to enterprise bonds (i.e., allowing POEs and LGFVs to issue enterprise bonds) and Corporate Bonds (i.e., allowing unlisted firms to issue Corporate Bonds), and the ensuing increase in the issuance of these debt

³³ The NDRC reputedly retaliated against firms that issued CP. It was understood within the bond market that issuers of CP would not be permitted by the NDRC to issue enterprise bonds.

instruments, were prompted in part by the challenge posed by the PBOC’s lighter regulatory approach.

While regulatory competition has probably benefited Chinese firms of all types seeking capital, the biggest winners in this competition are local SOEs and LGFVs – the principal issuers of enterprise bonds, CP and MTN since 2009 – and their backers, the local governments.

II. The Chinese Corporate Bond Network

Although the term “market” is ubiquitous in reference to the organizational structure in which the issuance and trading of corporate bonds takes place, as the Introduction noted, developing economies typically lack the institutional infrastructure needed to create a fully functional corporate bond market. China is no exception. For this reason, we believe that approaching the Chinese organizational structure for bond issuance and trading as a *network* provides a helpful analytical framework for understanding its features and consequences. Therefore, in this section of the paper, we examine the actors comprising the network and the relationships that bind them to the state.

A. Actors

1. Issuers: In China, corporate debt instruments are issued overwhelmingly by enterprises whose majority (and perhaps sole) shareholder is an organ of the central or local government. The largest issuers by amount of outstanding bonds are LGFVs, with 36.8% of the total. The next largest category of issuers, with 28.6% of the total, are central SOEs, whose controlling shareholder typically is the State-owned Assets Supervision and Administration Commission (SASAC).³⁴ SASAC, established under the State Council in 2003 and acting on

³⁴ A few of the central SOE bond issuers, such as the national railway or post office, are not under SASAC supervision.

behalf of the state, is the formal shareholder in non-financial, central SOEs. It also performs regulatory functions and, together with a senior Communist Party committee, appoints, rotates, and sets compensation for the top managers of the SOEs under its supervision. We described SASAC elsewhere as “the organizational manifestation of the party-state in its role as controlling shareholder.”³⁵ Next are local SOEs, under the control of provincial-level SASACs, with 21.7% of the total. Collective enterprises, also state-affiliated, comprise the smallest group of issuers, with 0.3% of the total. Issuances by POEs, at least as classified according to equity ownership,³⁶ account for only 12.7% of all outstanding corporate bonds.

2. *Underwriters*: One striking fact about corporate bond underwriting in China is the large number of lead underwriters in the market. Over 140 lead underwriters were involved in the issuance of the corporate debt instruments outstanding as of June 2016. No Chinese financial institution, however prominent, has captured more than a small fraction of the underwriting market. The big four Chinese state-owned banks together account for 22.4% of the market. Collectively, 117 securities firms account for 44.8% of the market. Several other major financial institutions, such as CITIC Securities and Agricultural Bank of China, each have 4-5% of the market. The large number of underwriters in the Chinese corporate bond market may partially be a function of the huge volume of bonds issued by local SOEs and LGFVs. But this does not appear to be the only explanation, as even the central SOEs have used 77 different lead underwriters. More importantly, it reflects an attempt by the government to diversify risk through syndication. This may be of particular concern to the government due to the second

³⁵ Li-Wen Lin & Curtis J. Milhaupt, We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China, 65 Stan. L. Rev. 697, 746 (2013).

³⁶ In separate work, one of us has cautioned that the SOE-POE dichotomy in China is very porous, because even privately owned firms often have extensive links to the Party-state. See Curtis J. Milhaupt & Wentong Zheng, Beyond Ownership: State Capitalism and the Chinese Firm, 103 Geo. L.J. 665 (2015). As discussed *infra*, this appears to be true of at least some of the POE issuers of corporate bonds in China.

striking feature of the underwriting market: the pervasiveness of state ownership. Of the financial institutions with at least 2% of the underwriting market, only one – Minsheng Bank, is not state-owned.³⁷

3. *Guarantors*: Most corporate debt securities are no longer required by law to be guaranteed. As discussed in Part I, virtually all enterprise bonds were guaranteed until 2007, when banks were prohibited from serving as guarantors. Of the bonds that are guaranteed, the guarantors are almost exclusively enterprises affiliated with the state: the most common guarantors are local and central SOEs, state-owned banks, and guarantee companies, which are state-owned or affiliated with state-owned banks.³⁸ In a small number of cases, a POE serves as a guarantor, principally in connection with a bond issuance by another POE, but in rare instances POEs have served as guarantors for bonds issued by local SOEs, LGFVs and collective enterprises. The reverse phenomenon also exists in some cases, where a POE receives a guarantee from a local SOE. These cases obviously suggest the existence of close linkages between the particular POE and local government officials. The resolution of some recent default crises discussed in Part III illustrates the effects of these linkages.

4. *Credit Rating Agencies*:

China has nine domestic credit rating agencies – a large number, even for a market of its size. Competition among the rating agencies is fierce, inviting credit ratings shopping. Five of the rating agencies are at least majority state-owned, although several have formed alliances with Moody's or S&P. Sixty percent of all rated corporate bonds in China were rated by a state-owned ratings agency. One of the most prominent rating agencies, Dagong Global Credit Rating

³⁷ Although classified by equity ownership as private, Minsheng Bank maintains close relations with the government. It was one of the “national team” of banks instructed to purchase equities during China’s severe stock market correction in August 2015. See Gabriel Wildau, China’s “National Team” Owns 6% of Stock Market, *Financial Times*, Nov. 26, 2015.

³⁸ Some guarantee companies were established by the government to help POEs issue bonds.

(18.4% of all ratings by volume), is privately owned, but commentators have expressed doubts about its actual independence from the Chinese government.³⁹ In fact, Dagong fits the profile of many prominent POEs in China: although it is “private” from the standpoint of equity ownership, its origins have roots in the Chinese government, and it is led by a politically well-connected controlling shareholder whose business model is closely aligned with the policy objectives of the Chinese government.⁴⁰ We assess the effects of the credit rating agencies’ links to the state in Part III.

5. *Bondholders*⁴¹: Major holders of Chinese corporate debt can be grouped into several categories. First, are trust corporations, funds and other nonfinancial institutions – members of China’s shadow banking system – which as of June 2016 held 32.2% of all outstanding corporate debt instruments. Chinese trusts are “a unique form of financial institutions, to which there is nothing comparable in the developed markets.”⁴² The trust is the only financial license in China that permits investments in the entire range of asset classes: the money market, the capital markets and unlisted assets such as loans. This allows the trust to serve as a conduit between firms that want to launch investment products or firms that want to invest in multiple asset

³⁹ A recent Brookings report goes so far as to state that Dagong Global is “controlled” by the central SASAC and “[t]herefore, there is fear that this rating agency is tilted toward the state-owned enterprises and might easily compromise under political pressure.” Douglas J. Elliot & Kai Yan, *The Chinese Financial System: An Introduction and Overview*, John L. Thornton Center at Brookings, July (2013).

⁴⁰ Dagong was established in the 1990s by several state-affiliated institutions and struggled financially before receiving an investment from Mr. Jiangzhong Guan, its current chairman and largest shareholder. Guan began his career in the Chinese Ministry of Aviation Industry and worked for a central SOE under SASAC supervision before becoming Dagong’s controlling shareholder. He has long championed the need for a Chinese rating system to challenge the supremacy of western rating agencies. Dagong recently entered into a joint venture with a Russian rating agency and a small US rating agency to form the Universal Credit Rating Group to counter the influence of the big three rating agencies. The UCRG is viewed as an attempt to increase Chinese influence on the global ratings system. *New Global Credit Rating Agency*, China Daily USA, September 19, 2013, available at http://usa.chinadaily.com.cn/epaper/2013-09/19/content_16980977.htm

⁴¹ The discussion in text is exclusive of Corporate Bonds regulated by the CSRC, which account for 19% of the entire corporate bond market. It is not possible to identify with certainty the holders of Corporate Bonds, because they are traded on public securities markets.

⁴² PingAn Trust & McKinsey & Company, *The Coming Transformation of China’s Trust Industry 15* (2013) [hereinafter *McKinsey Study*].

classes. The most prominent use of the trust license is by Chinese banks marketing wealth management products to high net worth individuals.⁴³ There are 68 licensed trust companies in China. According to one assessment, 27 of these are owned by a local government, 20 are owned by an SOE parent company, and 12 are part of a large corporate group, most of which are SOEs.⁴⁴ These state-affiliated trusts collectively account for 92% of assets under management in the trust industry.⁴⁵ A McKinsey study finds that “many trust companies are quite primitive in terms of quality of management” and investors perceive there to be an implicit guarantee of their principal, particularly since most trust companies are owned by SOEs and there is no way to verify the due diligence and risk disclosures made by the trusts.⁴⁶

Another major category of corporate bondholders in China is comprised of national commercial banks, virtually all of which are state-owned. As of June 2016, the banks collectively held 25.4% of outstanding corporate debt instruments. Individuals and unincorporated entities (which may include funds), accounted for 31% of the market. Not counting a small percentage of shares held by the Chinese government, foreign banks and offshore institutions, this leaves about 9% of outstanding corporate debt instruments held by “others.” The “other” category includes online money market funds, another actor in China’s rapidly expanding shadow banking system.

⁴³ Id.

⁴⁴ Credit Suisse, China: Trust Funds and Shadow Banking 21 (Feb. 17, 2015).

⁴⁵ Id.

⁴⁶ McKinsey Study, supra note 42, at 19.

B. Linkages

In previous work, we suggested that China’s central SOEs can profitably be understood as a “networked hierarchy.”⁴⁷ We used this term to describe the way in which the massive corporate groups under SASAC supervision (a very hierarchical form of organization) are deeply enmeshed in a dense network of party and government institutions through equity ownership, personnel rotations, and membership in organizations that transmit party and industrial policy. This network serves to connect the separate components of the state-owned sector into a complementary whole.⁴⁸ We argued that Chinese economic strategists’ encouragement of the formation of state-owned business groups in the 1980s and 90s reflected the familiar motivations of filling institutional voids in weak rule-of-law environments and internalizing the capital markets during an early phase of economic development.⁴⁹

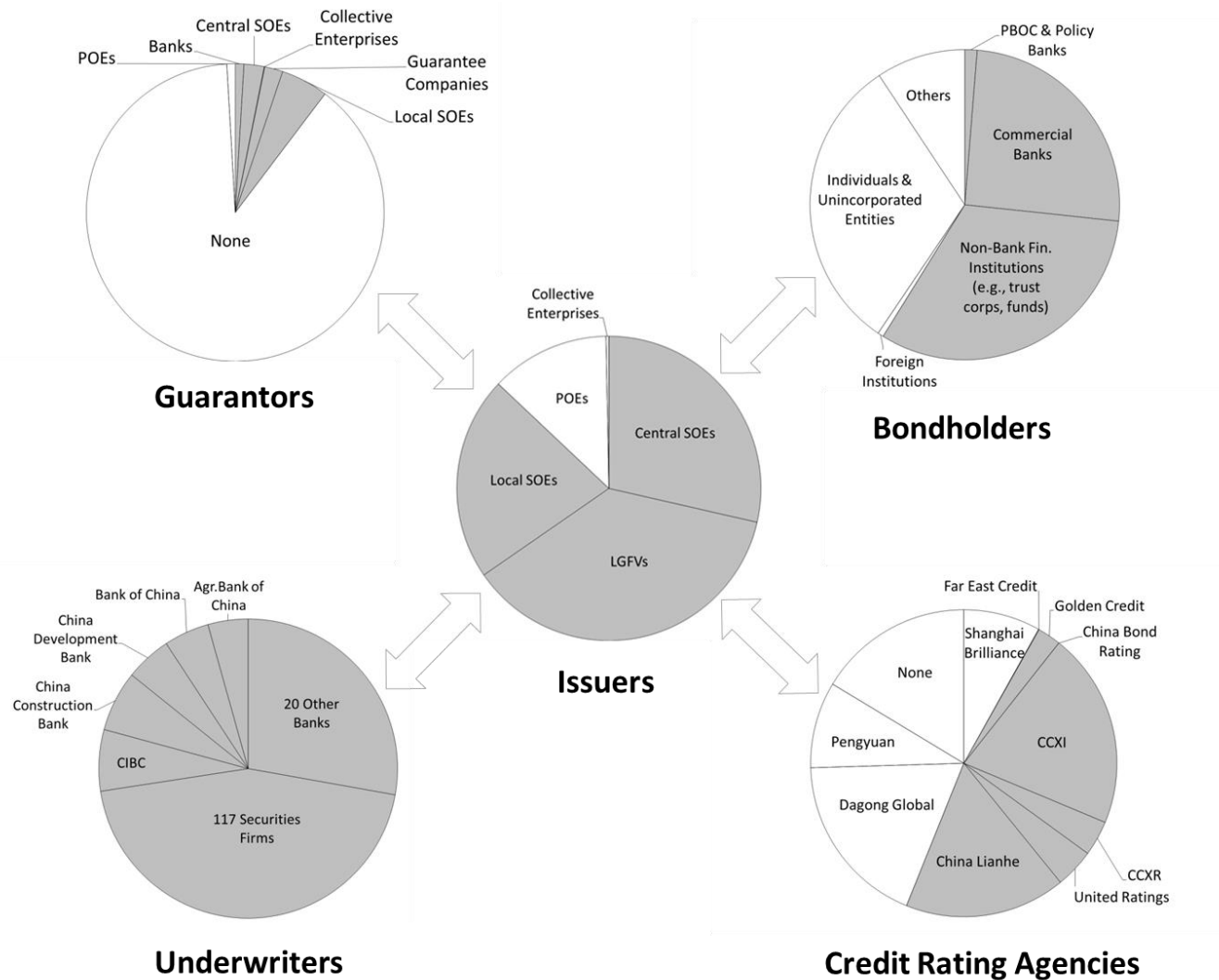
A similar networking phenomenon is at work in the formation of China’s corporate bond market. Lacking the institutional supports needed to create a true *market* for corporate bond issuance and trading, a state-centric network was assembled for bond issuance and investment that, as Part III will show, largely serves the interests of the state and state-linked actors. Figure 8 graphically illustrates the omnipresence of the state – at least as measured by ownership – in each facet of corporate bond issuance and investment in China. The dark-shaded slices of the pie chart indicate state-owned actors. As Figure 8 illustrates, in China, corporate bonds are issued, underwritten, rated, and purchased overwhelmingly by state-owned actors.

⁴⁷ Lin & Milhaupt, *supra* note 35, at 706.

⁴⁸ *Id.* at 706-711.

⁴⁹ *Id.* at 712. It also reflected an attempt to emulate the corporate groups in Japan and South Korea, which were at the apex of their global prominence in this period.

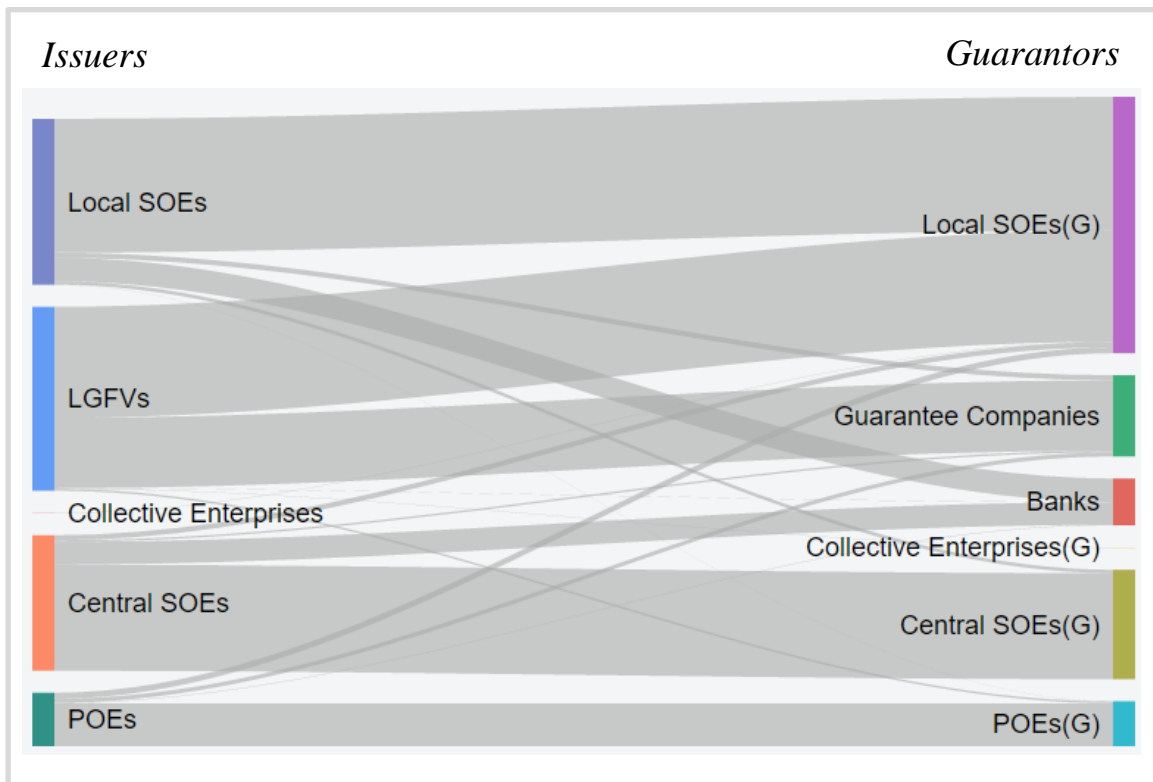
Figure 8 China's Corporate Bond Network



Source: raw data collected from WIND (as of June 30, 2016). Each pie chart represents the total outstanding balance of bonds issued/underwritten/rated/held. Gray shading indicates state ownership; white indicates private ownership.

One illustration of how ownership structures the relationships among actors in the network is provided by guarantees. As noted in the previous section, most Chinese corporate bonds are not guaranteed. However, for bonds that are guaranteed, there is a clear, if imperfect, pattern of risk sharing among actors based on ownership type. As Figure 9 shows, local SOEs mainly use other local SOEs as guarantors; LGTFs (set up by local governments) also mainly use local SOEs as guarantors; central SOEs rely predominantly on other central SOEs as guarantors; and private enterprises receive guarantees mainly from other private enterprises.

Figure 9 Issuer-Guarantor Relationship, By Outstanding Balance



Source: raw data collected from WIND (as of June 30, 2016). Bonds issued without guarantees are not shown. The width of each flow reflects the relative amount of outstanding bonds guaranteed by a particular type of guarantor.

As noted, in the SOE realm, personnel ties and membership in encompassing organizations under state supervision also serve to bind the network's separate components. This

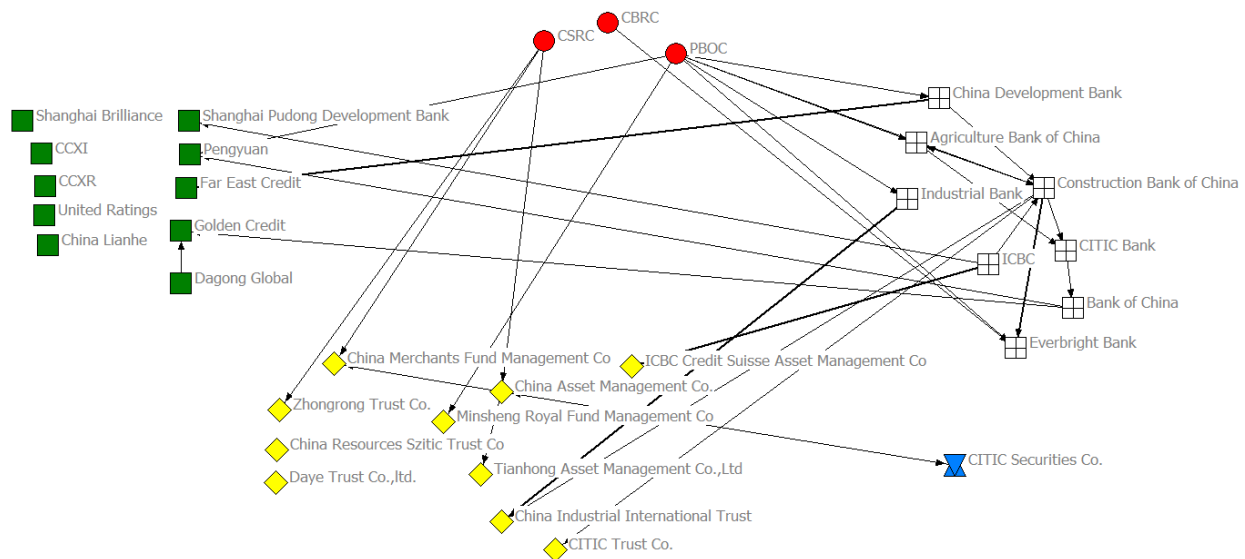
connective tissue is present in the corporate bond network as well, although it is less pervasive. While rotation of top managers within, and to a lesser extent, among central SOE corporate groups is commonplace, it is rare for managers to move between the corporate and financial sectors,⁵⁰ even though the state acts as an important owner in both sectors. Thus, few personnel ties bind corporate bond issuers (the largest of which are central and local SOEs) to the state-owned financial institutions which underwrite, guarantee, and invest in those bonds. This lack of cross pollination is not particularly surprising, however, given that the regulatory agencies, ultimate state shareholders, and skill sets differ between the corporate SOE realm and the state-owned financial sector. Within the financial sector, however, personnel connections are common, particularly ones flowing from the banks and the PBOC to other financial institutions in the corporate bond network, as shown in Figure 10.⁵¹ Of course, extensive personnel connections are also prevalent in the financial industry outside China. But the Chinese financial personnel network is largely a closed system: only four of the 52 CEOs/Chairman we investigated have professional experience outside the state sector.⁵²

⁵⁰ Li-Wen Lin, *State Ownership and Corporate Governance in China: An Executive Career Approach*, 3 Colum. Bus. L. Rev. 734 (2013).

⁵¹ Figure 10 shows personnel connections among the 52 CEOs/Chairman of the major players in the corporate bond market, which we have defined as the credit rating agencies (excluding CCXR, for which data were unavailable), the ten largest underwriters, the five largest trust companies and five largest asset management companies, and the largest banks. In Figure 10, when a chairman or CEO of an organization has previous work experience in another organization, there is a direct link between the two organizations. The network graph does not provide a full picture of their whole career patterns but only shows how these organizations under investigation are connected with one another through the top managers' career rotations.

⁵² Three of the four outsiders gained experience in foreign financial institutions that had invested in the state-owned financial institutions with which they are affiliated.

Figure 10 CEO/Chairman Career Network



Source: raw data collected from corporate websites and annual reports (as of Dec. 2015).

A third type of connective tissue in state-sector networks, whether corporate or financial, is membership in organizations that carry out quasi-governmental tasks. In the corporate bond network, this function is played by membership in the National Association of Financial Market Institutional Investors (NAFMII), a self-regulatory organization under the supervision of the PBOC.⁵³ Its members include individuals and institutions across the entire range of the financial industry. The management council of NAFMII has committees responsible for different market domains, the most relevant of which are a bond market committee and a credit rating committee, whose members include officials from PBOC, NDRC, the Ministry of Finance, and the Insurance Regulatory Commission. Self-regulatory organizations are of course commonplace in the financial industry around the world. In China, however, SROs are not substantively

⁵³ PBOC has delegated to NAFMII the authority to supervise the issuance of CP and MTN under a registration system.

distinguishable from other organs of the Party-state. Leadership of SROs is appointed through the Party's regular *nomenklatura* system, government regulators are also members, and most of the institutional members are affiliated with the state. Thus, SROs actually serve as a powerful coordinating mechanism for formulation and implementation of government policy.

III. The Consequences of State Centricity

Part II has painted a picture of the organizational structure for corporate bonds in China that is less like a "market" and more like what scholars have evocatively referred to as a "network with a spider."⁵⁴ These are "networks that form around (or are formed by) a central agent – a regime that exercises some control over the distribution of benefits and costs in the network."⁵⁵ China's corporate bond network has a very large, controlling spider at its core – the Party-state. In this section, we consider the impact of state-centricity on the corporate bond market's developmental trajectory and operation.

A. Market Development: As previously discussed, after a brief and problematic initial experiment with a lightly regulated corporate bond market in the 1980s, the Chinese government exerted tight control over the market for the next decade and a half, effectively limiting corporate debt issues (in the form of enterprise bonds) to central SOEs in service of national industrial policy. In this sense, the Chinese corporate bond market developed in a manner reminiscent of its Japanese and Korean counterparts, in which bond issues were effectively limited to the largest firms enjoying close relations with major banks and, by extension, the financial regulators. For example, in Japan corporate bond issues were strictly allocated among large firms by a group of large banks acting as the Committee on Bond Issues (*Kisaikai*) under the direct supervision of

⁵⁴ Ariel Porat & Robert E. Scott, Using Restitution to Support Business Networks, unpublished working paper, at 8 (2016).

⁵⁵ *Id.*

the Ministry of Finance.⁵⁶ Under the Committee’s guidelines, only firms that could post collateral were eligible to issue bonds. In combination with the regulation of interest rates, this practice resulted in capital being preferentially allocated to heavy industries in support of Japan’s export-oriented, income doubling plan.⁵⁷ In Korea, the government favored large business conglomerates (*chaebol*) in the allocation of capital; accordingly, the early corporate bond market was dominated by *chaebol* issuers. As in Japan, a high-growth, export-oriented economy provided a favorable environment for these Korean bond issuers. In all three East Asian countries, however, during their formative growth periods corporate debt played a distinctly secondary role to bank finance, both as a means of protecting the banking sector from competition and because growth of the corporate debt market raises the specter of risks that all three governments assiduously sought to avoid: losing control over the allocation of credit and the negative fallout of corporate bond defaults.

Despite these similarities, the development of the Chinese corporate bond market has several distinctive characteristics that set it apart from those of other developing countries. These distinctive characteristics bear the hallmarks of Chinese state capitalism. The first is the use of sophisticated structures developed in a market environment to advance political interests and policies.⁵⁸ A prime example is the LGFV, which puts the globally familiar capitalist tool of the special purpose vehicle to work in service of local Chinese infrastructure investment, circumventing a national-level prohibition against the issuance of local government debt. As one commentator notes, “[t]he central government acquiesced in or even supported local

⁵⁶ See, e.g., Yoshinori Shimizu, Convoy Regulation, Bank Management, and the Financial Crisis in Japan, Institute for International Economics Special Report No. 13, at 57, 58-59 (2000).

⁵⁷ *Id.*

⁵⁸ See Ian Bremmer, *The End of the Free Market? Who Wins the War between States and Corporations* (2010).

governments' efforts to tackle their financing problem,"⁵⁹ leading to a joint declaration by the PBOC and the CSRC supporting the issuance of enterprise bonds and MTN by local government financing platforms.⁶⁰ In this case, the corporate bond market functioned not as a means of financing the projects of individual firms or a national plan for economic growth, but as a device to ease the transition from a planned economy to a market economy, filling a funding gap created by decentralization of power and decline of revenues flowing from the center to the provinces.⁶¹

A second characteristic of the bond market closely associated with Chinese state capitalism is the blurring of the conventional distinction between state-owned and private enterprises, as determined by equity ownership. As one of us has noted in previous work, the state/private dichotomy breaks down in China because the institutional environment – extensive state intervention in the economy, weak formal institutions to check state power, and the pervasive influence of the Communist Party – encourages all firms to seek rents from the state by cultivating ties to party and government organs and by aligning their business models with the policy objectives of the Party-state.⁶² Examples in the corporate bond market include the NDRC's decision to allow POEs to issue enterprise bonds if the proceeds promote specific national industrial policies, POE guarantees of the bonds issued by local SOEs, and the perception of Dagong as a "state-controlled" credit rating agency despite its status as a "private" firm from the perspective of equity ownership.

Finally, the consequences of state centrism are clearly reflected in the characteristics of issuers in the Chinese corporate bond market. By number of bonds outstanding as of June 2016,

⁵⁹ Liao Fan, Quenching Thirst with Poison? Local Government Financing Vehicles – Past, Present and Future, in Benjamin L. Liebman & Curtis J. Milhaupt eds., *Regulating the Visible Hand? The Institutional Implications of Chinese State Capitalism* 69, 76 (2016).

⁶⁰ Id.

⁶¹ See id.

⁶² Milhaupt & Zheng, *supra* note 36.

LGFVs (5410 issues), and local SOEs (4189) are the largest issuers. There are somewhat more issues by POEs (2268) than by central SOEs (1726); however, the amount of outstanding bond issues and the average issue size of bond issues by central SOEs swamp those of POEs. For example, the average issue size of all types of corporate bonds issued by central SOEs is 2.6 billion RMB, as compared to 0.9 billion RMB for POEs. LGFV issues average 1.09 billion RMB and local SOE issues average 0.83 billion RMB. This is despite the fact that POEs are more profitable than the state-owned/linked issuers.⁶³ Proceeds of bond issues by state-owned/linked issuers have been used largely to finance construction, real estate, infrastructure and mining. Bond issues by POEs have financed a broader spectrum of industrial sectors. Collectively, the data suggest that China's corporate bond market principally serves the interests of state-owned/linked issuers, rather than the financing needs of China's private sector. The regulatory competition that has partially fueled explosive growth in bond issues, therefore, has principally benefitted state actors.

Arising out of this developmental trajectory, of potentially significant importance are the deep linkages that have emerged between China's corporate bond market and the shadow banking system, whose main players are also closely linked to the state.⁶⁴ As noted in the previous section, corporate bonds have become an important destination for investment by Chinese trust companies and funds, which market wealth management and related products to high net worth individuals seeking higher returns than are otherwise available in the domestic credit market. These funds have fuelled expansion of the corporate bond market, particularly by increasing demand for higher-quality bonds. At the same time, players in the shadow banking system leverage the corporate bond market to circumvent regulatory obstacles. For example,

⁶³ All data are from WIND and have been calculated by the authors. Average return on equity (ROE) of POE issuers in 2014 was 10.16, as compared to 5.86 for central SOEs, 2.22 for local SOEs, and 3.0 for LGFVs.

⁶⁴ Policy implications relating to the shadow banking system will be explored further in Part IV.

shadow banking actors use funds raised in the corporate bond market to finance SMEs that cannot themselves issue bonds, either due to eligibility requirements or because the costs of issuance are too high.⁶⁵ In similar fashion, LGFVs leverage the corporate bond market by issuing “special enterprise bonds” regulated by the NDRC and using the proceeds to extend credit to SMEs with low credit quality. The market considers these bonds to be effectively guaranteed by the local government that established the LGFV. Consequences of the interconnectedness between the corporate bond market and the shadow banking system will be explored in Part IV.

B. Market Operation:

State centrality has left an indelible mark not only on the market’s developmental path, but also on the way it currently functions. Credit ratings, pricing, and issuer defaults reflect the deep penetration of state policies and interests into the basic mechanisms of the market’s operation.

1. *Credit Ratings*: As discussed above, China’s credit rating industry is closely linked to the state, which is also the direct or indirect owner of the largest issuers in the corporate bond market. It is not surprising, then, that the reliability of China’s credit ratings has been questioned. Credit ratings in China are heavily skewed toward the high end of the ratings scale. According to our analysis, of the approximately 10,000 corporate bonds outstanding as of June 2016 that received a rating at the time of issuance, almost 90% received ratings of AAA to AA, and just 0.27% received a rating of BBB or lower.⁶⁶ There is a much wider distribution of corporate

⁶⁵ In a typical transaction, a low-credit-quality SME obtains a loan from a shadow bank. The funds for the loan come from wealth management products, trust products or fund products issued by the shadow bank to a high-credit-quality corporation that can access the corporate bond market at low cost.

⁶⁶ Data from WIND, analyzed by the authors. The Chinese rating scale has 13 steps: AAA, AA+, AA, AA-, A+, A, A-1, A-2, BBB+, BB, CCC, CC, C.

bond credit ratings in the U.S., the EU, and globally.⁶⁷ These ratings likely reflect the fact that the market, at least among rated issuances, has been largely confined to the largest and most politically connected firms, for which default risk has long been considered to be essentially nonexistent, as discussed in the next section. Consistent with this view, almost all corporate bonds issued by SOEs receive AAA rating, compared to less than 15% of bonds issued by POEs.⁶⁸ But this explanation is incomplete, as many of the default crises discussed below involved bonds rated A, and in some cases AA or AAA. As one report notes, “domestic Chinese credit ratings are widely considered to not be equivalent to ratings from international agencies.”⁶⁹ Available data support this contention: a small percentage of Chinese corporate bonds have been rated by both an international rating agency and a domestic rating agency. For these bonds, the international ratings display a much wider level of credit quality differentiation than the domestic ratings,⁷⁰ and some bonds rated AAA by Chinese rating agencies have received “junk” ratings from international rating agencies.⁷¹

2. *Pricing*: A straightforward motivation for issuing corporate bonds in China is the low cost of credit. Our analysis indicates that the yields on high-quality (AAA rated) corporate bonds of all types is lower than the prime rate on bank loans of comparable maturities. This finding is significant, particularly given the issuer characteristics noted above, in which state owned/linked firms have greater access to the bond market than private firms. Thus, in addition

⁶⁷ See Source: S&P, 2011 Annual U.S. Corporate Default Study and Rating Transitions, available at <http://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245331026864>; 2012 Annual U.S. Corporate Default Study and Rating Transitions, available at https://www.globalcreditportal.com/ratingsdirect/renderArticle.do?articleId=1098627&SctArtId=145785&from=C&nsI_code=LIME

⁶⁸ James Kynge, China’s Domestic Credit Rating Agencies See No Problem, Financial Times, June 30, 2016., <https://next.ft.com/content/dca6f042-3ec8-11e6-8716-a4a71e8140b0>.

⁶⁹ Manulife Asset Management, Chinese Bonds: Laying the Foundation for Long-Term Growth (June 2015) at 7.

⁷⁰ Id at 7-8. While the international ratings range from BB to AA- (nine rating grades), the domestic ratings range from AA to AAA (four grades).

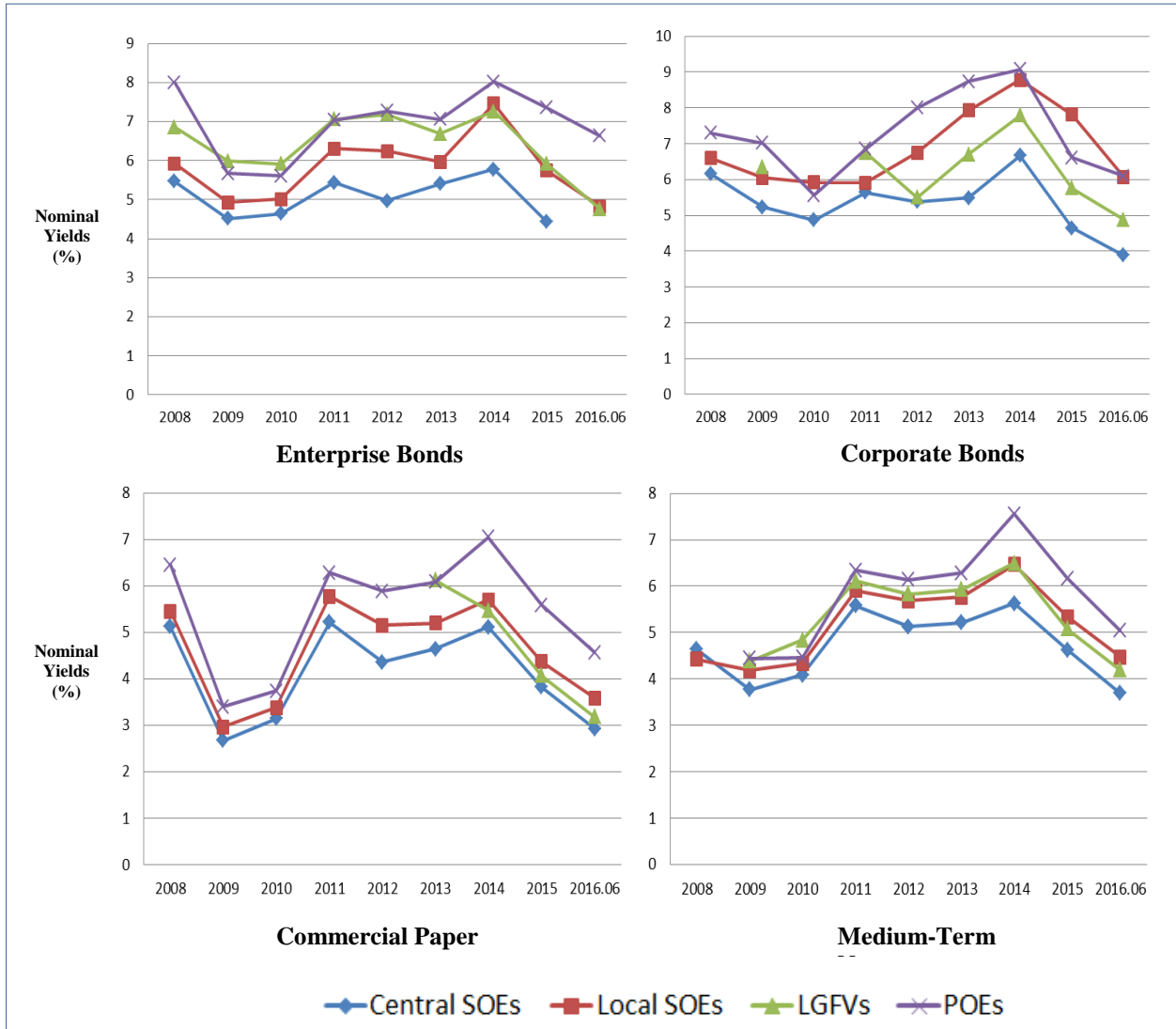
⁷¹ Kynge, supra note 68.

to preferential access to bank loans from the state-owned banking sector, SOEs (and POEs issuing debt to implement industrial policy) have preferential access to low cost, long-term capital provided by the bond market. Moreover, the hierarchy generated by state centrality is clearly reflected in the yield structure: as Figure 11 shows, the lowest yields are on bonds issued by central SOEs, followed by those of local SOEs, LGFVs, and finally POEs. As one analyst notes:

The term ‘bond market’ conjures up the cut and thrust of a developed economy, but in the Chinese context it means something very different. The market is distorted and fails to price risk appropriately. . . . The absence of default has made it impossible to price the bonds of state-owned firms and the deals are often done on the basis of other conditions as well. The result is a manufactured spread between government bonds, state-owned firms’ bonds and private firms’ corporate bonds.⁷²

⁷² Diana Choyeva (China fixed income analyst), quoted in David Keohane, FTAlphaville, March 11, 2014.

Figure 11 Nominal Yields, By Type of Issuer and Debt Instrument



Source: raw data collected from WIND (as of June 30, 2016), compiled by authors.

3. *Default:* In the absence of strong institutions to protect investors, it is common for bonds in emerging markets to be covered by an implicit guarantee. This was true in Japan, where market norms, though nothing in the law, required corporate bond trustees (uniformly major banks) to repurchase at par the bonds of defaulting issuers.⁷³ It has long been conventional wisdom that all corporate bonds in China are covered by an expectation of full repayment thanks

⁷³ Shimizu, supra note 56, at 59.

to an implicit guarantee from the government.⁷⁴ In recent years, the no-default norm has been challenged by a number of defaults and near defaults on Chinese corporate debt instruments.

Figure 12 lists defaults by ownership type of the issuer and type of bond.

Figure 12 Corporate Bond Defaults, by Type of Issuer and Type of Bond

Type of Bond	Type of Issuer		
	Central SOEs	Local SOEs	POES
Enterprise Bond	1	0	3
Corporate Bond	0	0	3
Commercial Paper	1	4	7
Medium-Term Note	6	1	2
Private Placement Note	2	9	0
Private Placement Bond	0	2	19
Total	10	16	34

Source: raw data collected from WIND (as of June 30, 2016), compiled by authors.

When an SOE defaulted on a bond payment in the spring of 2015, analysts were quick to interpret the episode as a “landmark for market discipline in the corporate bond market.”⁷⁵ Yet as we explore below, how and why the no-default norm has been operationalized – and the significance of default in the market – are more complex than conventional wisdom suggests. In this section, we examine several episodes of default or near default to understand how relationships among state-linked actors in the Chinese corporate bond market affect behavior during repayment crises. Close examination of these episodes provides a more nuanced perspective on when and why Chinese corporate bonds are implicitly backed by the state. This perspective, in turn, sheds light on how the no-default norm may begin to unravel as the Chinese economy slows.

⁷⁴ See, e.g. Gavekal Dragaonomics, Defaults are Coming: Where, When and How, April 22, 2014, at 4 (reporting that some Chinese investors have assumed that there is a “government guarantee of all fixed-income investments of all types”).

⁷⁵ News Analysis: The Bright Side of China’s Bond Defaults, Xinhua News, http://news.xinhuanet.com/english/2015-04/27/c_134189467.htm.

To structure the discussion, we disaggregate the motivations behind the no-default norm into three partially overlapping categories, which we label as follows: TCTF (Too Connected to Fail), in which an issuer is either an SOE enjoying the implicit guarantee of the central or (more typically, local) government, or a POE whose founder or controlling shareholder has strong political backing; TMTF (Too Many to Fail), in which a default would affect a group of individual Chinese bond holders large enough to raise the specter of social unrest, a deeply worrisome outcome for the Chinese Communist Party; and TBTF (Too Big to Fail), in which an issuer's default is avoided because it may trigger contagion in the financial system. Whereas TBTF responds to systemic risk, TCTF and TMTF respond to political and social risk.

It bears noting that, as Figure 12 shows, relatively few defaults have involved enterprise bonds or Corporate Bonds. Recall that enterprise bonds are issued exclusively by central SOEs, LGFVs and major POEs advancing national industrial policies, subject to pre-approval by the NDRC. Enterprise bond defaults could thus be embarrassing to the government, and may be avoided by arranging loans from state-owned banks to cover payments of interest and principal. Much the same holds for Corporate Bonds regulated by the CSRC, which are also subject to pre-approval and have been issued by large SOEs and POEs. Moreover, Corporate Bonds are traded on the stock exchanges and potentially held by significantly more private investors than bonds traded in the interbank market, heightening the risk of social unrest in the event of nonpayment. Virtually all of the repayment crises in the Chinese corporate bond market have involved CP, MTN, and privately placed bonds and notes. These instruments are subject to a lighter regulatory regime than enterprise bonds and Corporate Bonds. Moreover, because these instruments are placed with a small number of qualified investors, risk of social instability in the event of default is comparatively low.

TCTF: As the preceding analysis has indicated, many Chinese corporate bond issuers are affiliated with the state. Some SOE issuers are so integrally connected to the government that default can be avoided by invoking assistance from other entities connected to the same governmental controller. One example is CP issued by Shandong Helon Co. Ltd, a company controlled by Weifeng Investment, an SOE under the local SASAC of Weifeng City. When Helon was unable to repay its maturing CP in April of 2012, the funds were provided in the form of a loan from Evergrowing Bank, its lead underwriter. The loan was guaranteed by Weifeng City, in essence the ultimate controlling shareholder of Helon.

But SOEs are not alone in enjoying implicit backing from the state. Private enterprises that are important to the government also enjoy protection from default. LDK Solar is one example. LDK Solar is a manufacturer of photovoltaic products. Its controller was Xiaofung Peng, one of the wealthiest people in China and a member of both the 11th People's Congress and the 11th Political Consultative Conference of Jiangxi Province. LDK was hand-picked by the NDRC as one of six companies in the photovoltaic industry to receive government backing. The company grew rapidly with the financial support of the local government, eventually becoming the largest taxpayer and a major employer in Xinyu City. In 2012, LDK was ranked as the 266th largest company in China, and one the few from Jiangxi Province. But the company's performance declined rapidly after the financial crisis and due to an oversupply in the global photovoltaic market. As a result, LDK had trouble paying its debts, including a CP issue due in October 2012. But in the end, there was no default – LDK paid the CP at maturity. Although it has never been confirmed, the source of the funds is assumed to be Xinyu City, which had earlier approved, in apparent violation of a national law, the use of city government funds to pay off LDK's debts to a local SOE.

In the preceding case, the TCTF motivation was likely buttressed in part by localized TBTF concerns, given the importance of LDK to the local economy. But TCTF can be at work even where the bond issuer is neither an SOE nor a large POE. Private enterprises of little economic consequence to the government can be protected from default if the founder is sufficiently influential. For example, the earliest default crisis since the re-emergence of China's corporate bond market in the mid-2000s involved a small (100 million RMB; or \$15 million) CP issuance by Fuxi Investment Holding Co. Ltd, which invested in highway companies. Fuxi was controlled by Rongquan Zhang, a member of the 10th National People's Political Consultative Conference and numerous Shanghai business associations. Somewhat curiously, the small CP issuance was underwritten by the Industrial and Commercial Bank of China (ICBC), one of the big four state-owned banks.⁷⁶ When Zhang became embroiled in a corruption investigation in Shanghai, creditors sued Fuxi and succeeded in freezing its assets. Fuxi's ability to repay the CP was consequently put into doubt, and the credit rating on the paper was lowered to C, the first Chinese debt instrument ever to receive a rating that low. Bondholders (largely mutual funds) eventually participated in a negotiation hosted by the PBOC, during which an arrangement was made to deposit funds sufficient to repay the CP in a court-monitored account. The source of the funds is unknown, but it is assumed to be the Shanghai branch of ICBC.

TMTF: Another motivation for the no-default norm is the Chinese Communist Party's overriding concern for social stability. Where the effects of a default would be felt by a large number of bondholders, Party-state actors have substantial incentive to make them whole. An example is provided by Chaori Solar Energy Science and Technology Co., a manufacturer of solar energy products. Chaori was founded by Kailu Ni, originally a farmer, who enjoyed close

⁷⁶ A bank insider at the time expressed puzzlement at how a private firm could be powerful enough to warrant priority treatment. http://finance.ce.cn/200609/03/t20060903_8400825.shtml.

relations with the Shanghai local government. Chaori issued five-year unsecured Corporate Bonds in the amount of 1 billion RMB (\$150 million) in 2012. In March 2104, the company's board of directors announced that it would not be able to pay the interest coming due on the bonds. With the bond default, trading in the company's shares on the Shenzhen Stock Exchange was suspended. Chaori entered a bankruptcy reorganization process, which was approved by the local Shanghai court in December 2014. At the time it entered the reorganization process, Chaori's corporate bonds were held by 6300 bondholders, most of whom were individuals.⁷⁷ In order to ensure approval of the bondholders, two guarantors emerged to provide extra protection outside the reorganization process: China Great Wall Assets Management Corporation, wholly owned by the Chinese Ministry of Finance, and Shanghai Eternal Sunshine Investment Management Center, apparently a shell company set up by the Shanghai local government two weeks before the reorganization plan was to be approved by creditors.⁷⁸ The bondholders received full payment of principal, interest, and penalties for late payment. In the reorganization plan, eight private equity investors took control of the company. Subsequently it was revealed that behind layers of ownership, the private equity investors were all controlled by state-owned enterprises.⁷⁹ Chaori thus presents a case in which bonds issued by a private enterprise were indirectly guaranteed by the central and local governments, after which control of the firm was effectively transferred to entities affiliated with the central government. Given the large number of individual bondholders involved, maintaining social stability is widely assumed to be the motivation for this high level of government involvement in the Chaori debt resolution.

⁷⁷ <https://www.kpmg.com/CN/zh/IssuesAndInsights/ArticlesPublications/Newsletters/restructuring-newsletter/Documents/restructuring-newsletter-1412-02-Shanghai-Chaori-c.pdf>, Shanghai Shaori: China's First Domestic Bond Default [上海超日:中国第一例国内债券违约案] [*Shanghai chaori: zhongguo diyili guonei zhaiquan weiyuean*]

⁷⁸ <http://www.yicai.com/news/2014/10/4027523.html>. See also The Financial Times, <http://ft.com/intl/cms/s/0/10adc7be-4ebe-11e4-b205-00144feab7de.html>

⁷⁹ <http://www.yicai.com/news/2014/10/4027523.html>

The TMTF motivation also appears to apply to issuers that are not strategically important or particularly influential politically. A high-end restaurant chain called Beijing Xiangeqing Group, founded by a wealthy couple, had insufficient funds to make good on a redemption right on its 5-year unsecured Corporate Bonds issued in 2012. The firm's business had grown rapidly but then suffered under the government's anti-corruption campaign. An attempt to enter the technology field failed and ratings on the bonds were lowered from BB to CC. A trustee was appointed for the bondholders and eventually sufficient funds were marshaled by the issuer to pay the bondholders in full. But commentators suggested that the Xiangeqing bondholders never had to fear a haircut in this process because 60 percent were individual investors.⁸⁰

Limiting Cases: Other recent default crises in China suggest the limits of the no-default norm's application. The first is an inter-SOE creditor squabble, in which all players are politically connected and the number of bondholders is small. On April 21, 2015, Baoding Tianwei Group Co., announced that it could not pay interest due on a large medium-term note. Tianwei, which operates in the electricity equipment industry and had ambitions to develop new energy (particularly solar) technologies, began as a local SOE. In 2008, it became a wholly owned subsidiary of China South Industries Group Corporation (CSGC), a central SOE. In 2011, Tianwei issued two medium-term notes in the amount of 2.5 billion RMB (US\$375 million), which were rated AA+. But Tianwei had a history of known governance problems, including a series of investments lacking proper regulatory and internal approvals. At the end of 2014, Tianwei reported losses of 10 billion RMB, and it encountered loan repayment problems even before defaulting on the interest payment due under the note.

⁸⁰ <http://finance.people.com.cn/n/2015/0410/c1004-26822592.html> "ST Xiange Bond" Becomes the First Principal Default of Publicly Issued Bonds ["ST 湘鄂债" 成首单本金违约公募债券] ["ST xiange zhai" cheng shoudan benjin weiyue gongmu zhaiquan].

The Tianwei case is particularly interesting because the twelve note holders are all state-owned institutions, including large banks, as well as central SOEs under SASAC supervision. Tianwei's default triggered a flurry of legal activity among the note holders, who pressed for, among other things, an unconditional guarantee of the note by Tianwei's state-owned parent, CSGC. But CSGC refused to provide the funding necessary to rescue its subsidiary, and Tianwei has steadfastly rebuffed the demands of its creditors. For their part, the creditors did not relent: the finance company of the Baosteel Group (a central SOE under SASAC supervision) filed a lawsuit seeking immediate repayment of principal and interest on the two Tianwei MTNs it holds. In September 2015, Tianwei applied for reorganization through the bankruptcy process. It is striking that no smooth resolution could be found to this repayment crisis even though all of the players are SOEs under central government supervision. Why is the TCTF motivation not operative in this case? Tianwei's bankruptcy filing may indicate that the government is beginning to accept the formal bankruptcy process as a mechanism to resolve corporate debt problems, at least where the direct fallout on Chinese citizens is minimal.⁸¹ Indeed, bankruptcy institutions may be viewed by state strategists as playing a valuable intermediary role in reaching solutions to repayment problems that would otherwise require thorny compromises among different state actors. It may also be seen as serving a needed disciplining function, particularly within the SOE system.⁸²

An interesting contrast with this case is the resolution of involuntary bankruptcy petitions filed by trade creditors of China National Erzhong Group Co. (CNEG) and its controlled subsidiary China Erzhong in September, 2015, almost simultaneous to the Tianwei filing.

⁸¹ Subsequent to the Tianwei filing, two other subsidiaries of SOEs that defaulted on MTN also filed for reorganization.

⁸² SOE reform is a major initiative of the Xi Jinping regime. So-called "mixed ownership" reforms announced in 2013 seek to improve the performance and market orientation of the state sector by encouraging private investment in and professional management of SOEs.

CNEG is a wholly owned subsidiary of China National Machinery Industry Corporation (Sinomach). According to CNEG's announcement, the two local bankruptcy courts' acceptance of the involuntary filings would accelerate CNEG's payment obligations under 1 billion RMB (\$150 million) of MTN publicly traded in the interbank market and China Erzhong's obligations under a 310 million RMB (\$45 million) enterprise bond publicly traded in the exchange market. In contrast to the Tianwei case, the SOE parent of the issuers, Sinomach, offered to assume the two debt instruments in order to protect the creditors' interests. The bankruptcy courts accepted the assignment and the debt instruments resumed trading.

What explains the contrasting outcomes in Tianwei and CNEG/China Erzhong? Clearly, they cannot be explained by the different risk of contagion posed by the defaults of the issuers. Neither case presented anything approaching systemic risk to China's financial system. Rather, the explanation seems to lie in the attributes of the debt holders: whereas Tianwei's debt was held by a small number of institutional investors, the debt of CNEG and China Erzhong was publicly traded. Coming on the heels of the stock market debacle in the summer of 2015, which seriously dented the reputation of China's financial regulators, the CNEG/China Erzhong case offered the state the opportunity to purchase investor calm and a reputational boost at small cost.

The second limiting case is default on bonds issued in offshore markets. In these cases, although the issuer's business operations are located in China, the firm is incorporated offshore (typically the British Virgin Islands or Cayman Islands), its stock is listed on a foreign exchange, and the bonds are held exclusively by foreign investors. There are numerous examples of defaults under this scenario, including Suntech Power, listed on the New York Stock Exchange,⁸³

⁸³ Suntech, based in Jiangsu Province, defaulted on \$541 million of convertible bonds in March 2013 and filed for Chapter 15 bankruptcy in New York to seek protection from its U.S. creditors.

Ocean Grand Holdings, listed in Hong Kong,⁸⁴ and China Milk Products, listed in Singapore.⁸⁵

The most high-profile case is Kaisa Group Holdings, a real estate development company based in Shenzhen and listed on the Hong Kong Stock Exchange. After its chairman resigned and several of its projects were blocked as the result of a party corruption investigation in 2014, the company was unable to pay its debts as they came due, including interest on a 7-year, dollar-denominated high-yield note issued in Hong Kong. A deal to transfer the founder's controlling equity stake in the firm to a Hong Kong-listed company willing to negotiate repayment with bondholders fell through, and to date there is no resolution of Kaisa's debt crisis.

At one level, it is unsurprising that the no-default norm does not adhere to offshore bonds. These cases involve only non-Chinese bondholders, so the social stability motivation of TMTF is not present. Moreover, all of the operating assets of the issuers are located in China, while the legal issuers of the debt are offshore companies – just pieces of paper and mailing addresses in the Caribbean. So with the major exception of the Chinese employees of these troubled firms, there is a firewall to separate the negative externalities of the default from China itself. Yet these defaults may have a serious impact on foreign investor sentiment toward securities issued offshore by Chinese firms, a consequence likely to be of considerable concern to the Chinese government.⁸⁶ Thus, these cases support the impression that the no-default norm begins to unravel where direct domestic fallout is minimal and political support for the issuer has waned, either due to scandal (e.g. China Milk Products; Kaisa), or because the firm is in an industry suffering from overcapacity (e.g. Suntech).

⁸⁴ Ocean Grand was accused of accounting irregularities. Trading in its shares was suspended in 2006 and its chairman was convicted of defrauding the company.

⁸⁵ China Milk, caught up in a product contamination scandal, was unable to meet put-exercise notices on \$150 million of zero coupon convertible bonds issued in 2007.

⁸⁶ Charlie Zhu & Umech Desai, In Suntech's Home, High Hopes for a Bailout, <http://www.reuters.com/article/2013/03/21/china-suntech-bankruptcy-idUSL3N0CD1LU20130321#Y56PqJUXweWCGcKp>.97

A key takeaway from this analysis is that corporate bond issues in China are subject not only to credit risk, but also to an unusual form of political/policy risk. That is, all else being equal, default is more likely among issuers that have fallen out of favor with the Communist Party, or whose industrial sector or business model is no longer a priority in the government's economic strategy.

TBTF: None of the default episodes in the Chinese corporate bond market to date has presented a clear risk of contagion to the Chinese financial system. As we have seen, most of the cases have involved relatively small amounts of debt, and it is hard to imagine that the failure of any of the issuers would have seriously jeopardized the stability of major institutions in China's banking or shadow banking system. Since the largest bond issuers are central SOEs in "pillar" industries like power generation, oil, and mining, many of which enjoy monopoly power, it is almost inconceivable that default risk would arise or would not be mitigated by the state. As in the Japanese and Korean bond markets in their early developmental period, the Chinese government-supported no-default norm has thus far served to provide stability to a less-than-fully-formed market. But as the Japanese and Korean experiences also vividly demonstrate, the no-default norm can mask significant bad debt problems and create serious weaknesses in the underlying credit culture that eventually lead to a financial crisis.⁸⁷ To be sure, the potential for contagion in the event of widespread default in China's corporate bond market does exist, perhaps particularly with respect to LGFV debt.

⁸⁷ In Japan, the "convoy system" (in which regulation was designed to protect the weakest financial institutions) and concomitant no-default norm broke down in the late 1990s beginning with the failure of Yamaichi, one of Japan's largest securities firms, which triggered a cascade of bank failures leading to a decade-long financial crisis. In Korea, investors perceived the bonds of major *chaebol* companies to be risk free – until the bankruptcy of Daewoo in 1999. The government's settlement of the bankruptcy resulted in huge losses for the bondholders, after which the bond market seized up.

IV. Discussion and Policy Implications

Having explored the formation and consequences of China's state-centric corporate bond network, we now turn to policy implications. We motivate the discussion by first taking stock of China's efforts to date to build a corporate bond market that functions as a spare tire.

A. Assessment:

The major economies in East Asia – Japan, Korea and now China -- have addressed the institutional challenge of developing a corporate bond market to supplement their bank-oriented financial systems in roughly similar ways. In each case, the nascent corporate bond market was launched with the largest and most important firms in the economy – firms working in industrial sectors that benefit from investment-driven, export-oriented economic policies and which by definition enjoy government support and ready access to bank finance. Implicit government guarantees at the early stage of market development were pervasive in all three systems. These implicit guarantees serve several functions in an institutional vacuum: First, they provide a form of investor protection in the absence of a robust corporate information disclosure and credit rating regime. Second, they serve as a device to control systemic risk by erecting a backstop behind corporate bond issuers, which is necessary given that the issuers are, as just noted, also major borrowers from banks. Third, they lower the cost of bond finance (at least for favored firms), because issuer credit risk is essentially eliminated from the system.

The experience of all three countries also suggests the limitations inherent in this approach. Implicit guarantees distort the pricing mechanism, generate moral hazard, and stunt the growth of credit culture. The very institutional development needed to create a truly functional market is retarded in the shadow of the government's informal backstop. Benchmarks to set yields have an artificial quality, credit ratings lack reliability, the secondary market lacks

broad participation, and the bankruptcy regime is little used to resolve issuer distress. In this sense, the early corporate bond market development in the three countries did little to actually fulfill the “spare tire” role. In fact, at least in Japan and Korea, it may have helped, indirectly, to set the stage for or exacerbate the serious financial crises experienced in these countries.

Despite broad similarities in approach and developmental trajectories of the market in these three countries, China’s corporate bond market is distinguished by what we have called state-centricity. Whereas the governments of Japan and Korea worked hand in glove with private institutions that had close relationships with financial regulators and line ministries, the Chinese approach has been to pervade the entire corporate bond market with state-owned and state-linked actors. The principal role for private actors in this market is as passive suppliers of capital to SOEs and LGFVs,⁸⁸ mostly through the shadow banking system. Writing a decade ago, scholars Franklin Allen and co-authors ascribed China’s economic success, despite the weakness of its legal system and concomitant underdevelopment of its financial system, to the legacy of a Confucian relationship- and trust-based society that fostered alternative mechanisms to support the growth of the private sector.⁸⁹ Since their paper was published, China’s corporate bond market has grown from virtually nonexistent to the third largest in the world. Our network perspective has also focused on relationships as substitutes for formal institutions. But in the bond market, the crucial relationships were established by and revolve around the Party-state. This Party-state-centric networking phenomenon, in our view, is a distinguishing characteristic of Chinese state capitalism.⁹⁰

⁸⁸ The same is true, to a lesser extent, of China’s equity market.

⁸⁹ Allen et al, *supra* note 5, at 96-97.

⁹⁰ See Lin & Milhaupt, *supra* note 34 (describing the architecture of the Chinese SOE system as a “networked hierarchy”). See also Ronald J. Gilson & Curtis J. Milhaupt, *Economically Benevolent Dictators: Lessons for Developing Democracies*, 59 *Am J. Comp. L.* 227 (2013) (using a private equity metaphor to explain China’s “implicit contract for development”).

Two recurring themes seem to underlie all policy choices in the Chinese corporate bond market's developmental history: strengthening state capitalism and maintaining social stability. The state's tight control over the process of financial liberalization derives in part from its legitimacy concerns, but it also reflects confidence in the ability of economic regulators to manage the market – confidence that persisted until the stock market debacle in the summer of 2015. In the wake of that development, it seems fair to expect that concern for social stability will continue to drive policy choices in the bond market, as illustrated in the recent CNEG/China Erzhong case. Nonetheless, the Party-state is not a monolith, and rapid development, even within a tightly controlled market, breeds competing interests. The Tianwei case suggests the need for new dispute resolution mechanisms to mediate the opposing interests of different state actors. Moreover, the state cannot continue to rescue individual bond holders on an ad hoc basis indefinitely without risking serious moral hazard and other market distortions.⁹¹

The state capitalist approach has fostered tremendous growth in the issuance of corporate debt instruments, but it is not obvious that the consequences are favorable for China. The very entities that are underserved by the banking system and equity markets – POEs and SMEs – have benefitted the least from development of the corporate bond market. Instead, benefits have disproportionately flowed to the state sector: in fact, the principal role of the corporate bond market has been to *supplement* the loan market as a privileged financing channel for SOEs. It has played this role by providing even lower cost financing to SOEs than is available in the loan market and by creating a means of circumventing bank lending limits to favored SOE borrowers. Meanwhile, the rapidly developing shadow banking system (discussed below), illustrates the limitations of the corporate debt market as a financing channel for SMEs. In short, instead of

⁹¹ We discuss the potential development of the formal bankruptcy regime as a response to these concerns in the next section.

developing a competitive bond market with diverse products serving multiple classes of credit-worthy issuers, the Chinese government's approach has been to prioritize SOE interests over non-SOE interests in a tightly managed market that is simultaneously massive in scale and seriously underdeveloped institutionally.

B. Policy Issues:

1. *The Chinese Corporate Bond Market as a Spare Tire?* Does the Chinese corporate bond market function as a spare tire, supplementing China's banking system as an alternative financing channel, especially for firms not well served by banks, and as a means of diversifying risk away from the (mostly state-owned) banking sector? The analysis above strongly suggests a negative answer. In fact, state-centricity has compounded risk in the banking system and enhanced the privileged access to finance already enjoyed by state-owned firms.⁹² Moreover, recent reforms intended to alleviate China's corporate debt problem, centered on debt-equity swaps, will present still more risk to Chinese banks, as they hold large amounts of corporate bonds.

If not a spare tire, what is the function of the Chinese corporate bond market as it has developed to this point? There appear to be multiple functions, including providing additional, low-cost financing to SOEs, bypassing bank regulations that limit lending to individual firms, and channeling funds to local governments for investment projects. A likely byproduct of the growth of the corporate bond market, whether intended or not, is advancement of the interests of Party-state officials whose career prospects and/or opportunities for rent seeking are linked to the state sector. It may be too early to render a complete assessment of this market, however, bearing in mind its relatively short life to date and the hazards of measuring it against the

⁹² To be fair, the corporate bond market *is* providing some financing to SMEs, albeit largely indirectly through the actions of shadow banking actors (see point 4 below), and it should be noted that the corporate bond market is not the principal source of financing for SMEs in any economy.

standards of much older and more developed markets. In any event, whether the Chinese corporate bond market is capable of performing a spare tire function cannot be definitively judged in the absence of a banking crisis.

2. From Network to Market? The Potential Role for Regulatory Competition: Can a transition be made from a network comprised largely of state-owned and state-linked actors – one that principally has benefited those same actors – to a market that supplies accurately priced credit to firms on the basis of issuer fundamentals rather than ownership or industrial policy considerations; one that protects creditors through legal mechanisms rather than implicit state guarantees? Bond market reform of this sort confronts the fundamental dilemma at the heart of virtually all of the contemporary economic reform efforts in China, including the current “mixed ownership” strategy for improving the performance of SOEs⁹³: it requires the scaling back of state-owned entities as market participants and the transformation of the Party-state from network spider to neutral institution designer and enforcer.

Viewed over a time frame measured in decades, the Chinese corporate bond market has undergone an institutional transformation – a highly incomplete one to be sure – from a pure industrial policy tool in the hands of the NDRC to a partially deregulated financing platform, particularly at the issuance stage. This transformation may be gaining speed. As Figure 13 shows, the two largest drivers of private sector credit growth today are the development of the market for CP and other debt instruments under the jurisdiction of the PBOC, and the CSRC’s decision in 2015 to allow unlisted companies to issue Corporate Bonds. The principal disruptive force in this process of transformation has been regulatory competition, which as we have

⁹³ SOE reform is a major policy of the Xi Jinping administration. In brief, the policy seeks to encourage private capital investment in, and professional management of, SOEs while still maintaining state control and party guidance in the state sector. See Opinions of the State Council on the Development of Mixed Ownership Economy by State-owned Enterprises, September 23, 2015.

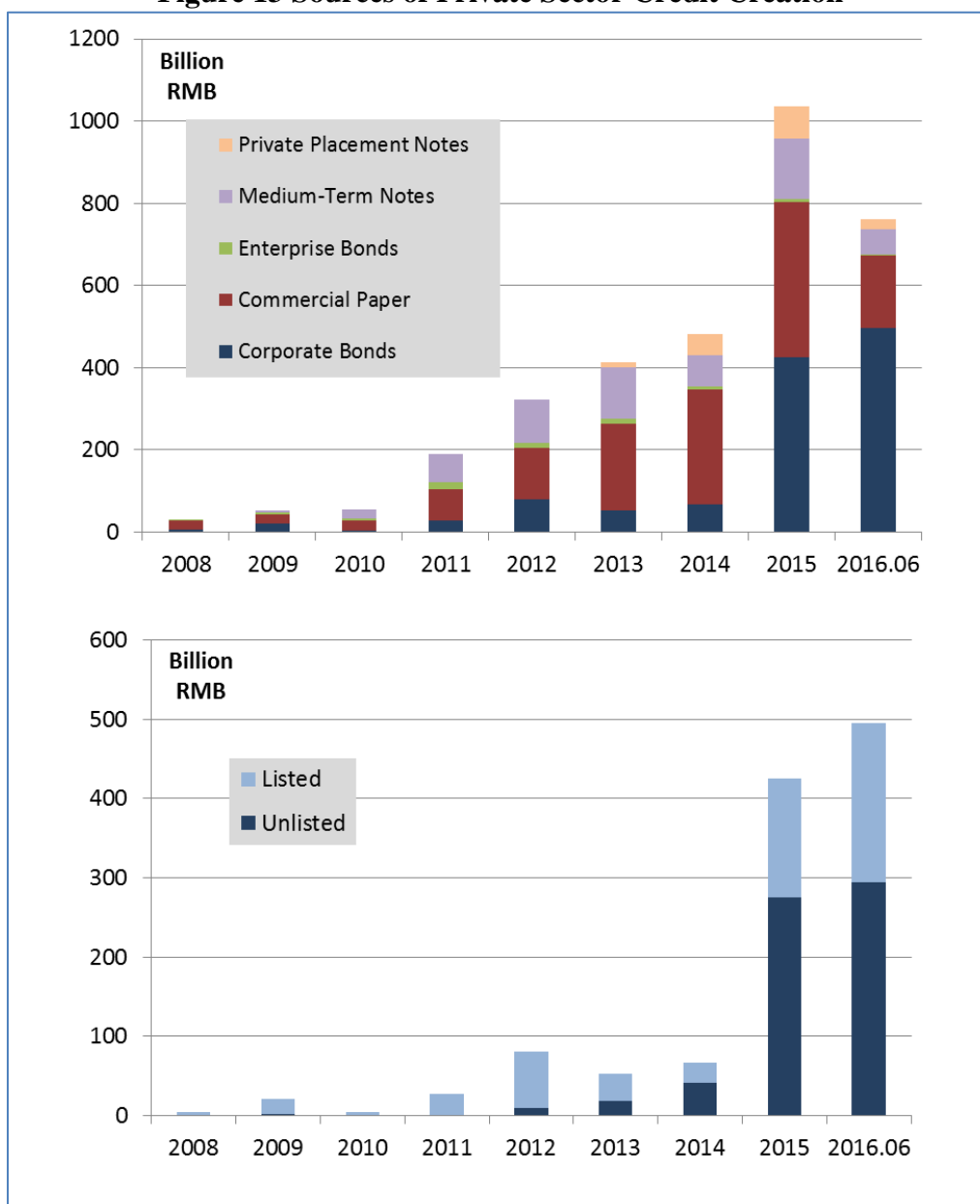
discussed was instigated by the PBOC and abetted by the CSRC. Of course, there are tensions between state centrality and regulatory competition; where higher state interests are at stake, at times the relationship among the bond market regulators has been more cooperative than competitive.⁹⁴ But regulatory competition will likely remain the most powerful force available to counteract the state-capitalist impulses that typically drive policy choices in the market. This is particularly the case because the PBOC is a front-line actor in China's global financial relations and policies.

Yet the consequences of regulatory competition as currently playing out in the Chinese corporate bond market are ambiguous. Against the benefits of the PBOC's efforts to liberalize the financial markets must be weighed the risks inherent in the expansion of short-term debt finance promoted by the PBOC's jurisdiction over CP and MTN. The weighted average maturity of Chinese corporate debt has been declining with the mushrooming of CP issuances. It now stands at just 1.5 years, as compared to four years in 2011.⁹⁵ As maturities decline, the danger of Chinese borrowers being unable to roll over the debt in the event of a shock to the economy, leading to a wide-spread seizing up of the credit markets – i.e., a Lehman episode with Chinese characteristics – cannot be dismissed.

⁹⁴ For example, in order to stave off a financial crisis posed by high local government debts, since 2015 local governments have been allowed to issue low-yield, long-term bonds in exchange for the high-yield, short-term LGFV enterprise bonds issued under the regulatory jurisdiction of the NDRC. But the market for these new bonds is illiquid, as investors did not find them attractive. As incentive to purchase the new bonds, the PBOC allowed banks to use the new bonds as collateral for low-interest loans from the PBOC. In effect, the PBOC monetized local government debt, and helped to retire problematic bonds issued under NDRC auspices, for the sake of financial stability.

⁹⁵ Xiao Qi, Defaults Send Chill Through China's Bond Market, Financial Times, April 15, 2016, <http://www.ft.com/cms/s/3/e6611fe6-030d-11e6-af1d-c47326021344.html#axzz4CDvSA6xd>.

Figure 13 Sources of Private Sector Credit Creation



Source: raw data collected from WIND (as of June 30, 2016), compiled by authors.

3. Managing the Decline of the Non-Default Norm? The Potential Role for Bankruptcy

Law: If a more fundamental transition in the corporate bond market is to take place, an important part of the process will be the carefully managed withdrawal of the state from the informal, often politically motivated, resolution of issuer distress. As we noted in the previous section, there are

preliminary signs that Chinese policy makers are attempting to initiate this process. It may seem surprising that they chose to start within the SOE system itself. But this starting point has several advantages: (1) the prospect of social fallout is greatly reduced where the debt holders are state-owned institutions; (2) orderly defaults will expose the SOE sector to badly needed market discipline, a major objective of the above-mentioned mixed-ownership reform strategy;⁹⁶ and (3) the process can be overseen by SASAC and party organs.

As the number and complexity of defaults expand, the orderly demise of the no-default norm would appear to require the emergence of a functional bankruptcy regime. China's corporate bond market designers have long been conscious of the potential role for bankruptcy law.⁹⁷ But a variety of closely related Party-state concerns have all but eliminated its functional role in the market. For one, Chinese courts are reluctant to accept bankruptcy petitions, even when properly filed, without a green light from local party officials.⁹⁸ In part, this is because the potential for employee layoffs in bankruptcy implicates the social stability concerns previously discussed. Additionally, severe ideological resistance to, and public criticism of, "loss of state assets" greatly complicates the valuation and sale of state assets in a reorganization process. Importantly, these concerns affect SOEs in all of their various roles in bankruptcy proceedings – as debtors, creditors and purchasers of assets. Thus, as long as state-linked actors continue to be the predominant players in all aspects of the corporate bond market, there would seem to be serious limitations on the role of the bankruptcy process as a pathway to the decline of the no-default norm. However, with the important exception of unemployment considerations, POEs

⁹⁶ See Opinions, *supra*, note 93, at Item 1(2) ("It is important to respect both the law of market economy and the law of enterprise development, treat enterprises as market players, [and] give full play to the role of market mechanisms...").

⁹⁷ A 2005 speech by PBOC Governor Zhou indicates that he viewed bankruptcy law as a key aspect of the corporate bond market infrastructure. He called upon the Chinese legislature to add creditor protections to the Bankruptcy Law.

⁹⁸ See Gabriel Wildau, *China Bankruptcies Surge as Government Targets Zombie Enterprises*, Financial Times, June 23, 2016, <https://next.ft.com/content/70aec7b2-3869-11e6-a780-b48ed7b6126f>.

are free of this baggage. If, as the recent data suggest, bond financing by POEs gains momentum, it is conceivable that the bankruptcy regime could begin to develop around private issuer defaults.

4. *The Implications of China's Shadow Banking System:* A potentially major complicating factor in managing a transition from network to market is China's shadow banking system, which, like the corporate bond market, has grown exponentially since the global financial crisis. Moody's Investors Service estimated that China's shadow banking assets reached 41 trillion RMB (\$6.3 trillion) by the end of 2014, representing 65% of China's GDP.⁹⁹ Growth of the shadow banking system may generate significant benefits for the Chinese economy, by creating financing options for POEs and SMEs unable to access bank credit, and by providing higher returns to Chinese savers than those offered by the tightly regulated banking sector. For this reason, a recent Columbia Business School white paper suggests that "shadow banking is paving the way to market liberalization as the [Chinese] economy transitions from strict state ownership and control to a broader focus."¹⁰⁰ In a similar vein, a Brookings report suggests that while shadow banking is often negatively associated with regulatory arbitrage, "in an over-regulated economy with too large a State role, there can be societal benefits from such regulatory arbitrage. It can diminish the deadweight costs of inappropriate or excessive regulation and it can help force the pace of more comprehensive reforms."¹⁰¹ At the same time, analysts have tended to downplay the risks posed by China's shadow banking system in view of its relative simplicity and small size as compared to that of the United States.

⁹⁹ Moody's Investor Service, Shadow Banking Slowdown Reduces Financial Risks, but Changing Composition of Credit Flows Poses New Challenges, https://www.moody.com/research/Moodys-Shadow-banking-slowdown-reduces-financial-risks-but-changing-composition--PR_323993.

¹⁰⁰ Jerome A. Chazen Institute of International Business, White Paper: The Future of Shadow Banking in China 3 (2015).

¹⁰¹ Brookings Institution, Shadow Banking in China: A Primer 5 (2015).

But the deep connection between China's shadow banking system and its corporate bond market, a connection that is typically not analyzed in detail, has implications both for the risks posed by the shadow banking system and its role in financial market liberalization. In fact, if shadow banking is broadly defined as non-bank intermediated finance, China's corporate bond market is an *integral part* of the shadow banking system.¹⁰² Although the corporate bond market is itself highly regulated, as we discussed above, it is extensively leveraged by banks, SOEs, and LGFVs, all important players in the shadow banking system.

The interconnection between the corporate bond market and the shadow banking system has several major implications. First, the rapidly expanding shadow banking sector increased the size and trading volumes of the corporate bond market. As we have discussed, wealth management products and other off-balance sheet assets of banks are often channeled into corporate bonds. Since 2008, LGFVs have issued large amounts of enterprise bonds. And SOEs, acting through their finance company affiliates,¹⁰³ have on-lent the proceeds from bond issuances to SMEs that otherwise lack access to credit. The resulting increase in the size of the bond market accomplished the government's policy objective of easing the liquidity shortage and boosting market confidence in China's economic growth. Second, shadow banking actors' leveraging of the corporate bond market in this way potentially increased default risk in the debt market. By permitting low-credit-quality SMEs to access corporate bond proceeds (through on-lending by LGFVs or SOEs) and through various shadow banking products offered by banks, the corporate bond market has been exposed to risks that otherwise would not have metastasized into

¹⁰² Steven Barnett & Shaun Roache, What's Lurking in the Shadows of China's Banks, IFM Blog, <https://blog-imfdirect.imf.org/2014/09/15/whats-lurking-in-the-shadows-of-chinas-banks>. While it may be controversial to include the corporate bond market in the definition and measurement of the shadow banking system, see Brookings Institution, *supra* note 95, at 8, our concern is functional rather than definitional.

¹⁰³ The national SOEs are organized and legally registered as corporate groups. One major benefit of registration as a corporate group is eligibility to establish a finance company, which is otherwise not permissible for non-financial firms. On an asset basis, the largest SOE finance companies are the equivalent of regional state-owned banks. See Lin & Milhaupt, *supra* note 34, at 719.

it. Moreover, by connecting the corporate debt market with wealth management products, the shadow banking system extended the liability chain to individual investors. Along these dimensions, synergies between the corporate bond market and the shadow banking system have the potential to greatly amplify risk in China's financial system. These risks are compounded by the inherent risks of shadow banking itself.

The interconnectedness of the corporate bond market and the shadow banking system may also place limitations on the latter's ability to pave the way for market liberalization. Ironically, while Chinese shadow banking is largely motivated by the desire to circumvent restrictive banking regulations,¹⁰⁴ informal norms generated in the highly regulated financial sectors, including the corporate bond market, have metastasized into the shadow banking system. A clear example is the no-default norm's application in the shadow banking system. Investors in shadow banking products expect to be made whole for the same reason that bond holders expect to be rescued: the issuer is owned by or linked to the state, and weaknesses in the surrounding institutional supports incapacitate other forms of redress. Thus, while shadow banking can potentially foster contractual innovations that reduce dead-weight loss from over-regulation, it is not clear that the benefits of these innovations in China currently outweigh the costs. In short, orderly demise of the no-default norm and further liberalization of the corporate bond market would appear to be *complicated* rather than fostered by its deep linkages to the shadow banking system.

Conclusion

In this paper, we have used a network perspective to examine the major features of China's corporate bond market. Our analysis has revealed how a key attribute of the market –

¹⁰⁴ This is the common consensus among analysts. See, e.g. Chazen Institute, *supra* note 100; Brookings Institution, *supra* note 101.

state centrality – has indelibly shaped its developmental trajectory and operation, and channels its future evolutionary path. While we have not attempted to draw a list of concrete policy prescriptions from our analysis, a network perspective on China’s corporate bond market helps frame an inquiry into the challenges of China’s transition toward a more market-oriented financial system.

The creation of a massive corporate bond market over the past decade, essentially from scratch and in the absence of most of the institutional infrastructure generally considered indispensable to that task, is a major accomplishment of Chinese state capitalism. Yet close examination reveals a number of paradoxes and limitations inherent in this developmental path. One paradox is that the corporate bond market to date has principally served the same state-owned issuers already privileged by the banking system. A second is that while regulatory competition may ultimately prove to be the most potent force capable of weakening state centrality in the corporate bond market, one of its principal effects in the market’s take-off period was to fuel the issuance of bonds directly tied to state industrial policies and the interests of important state actors. A major limitation inherent in a state-centered approach to financial market development is that China’s Party-state strategists have at times steered clear of meaningful steps toward liberalization out of concern for their ability to manage the process while maintaining social stability and legitimacy, a task greatly complicated by institutional underdevelopment – itself a consequence of state-centrality. The development of China’s corporate bond market over the past decade thus well illustrates both the accomplishments and limitations of state capitalism.

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