The Big Read **China Business & Finance**

China bond party attracts few takers

Beijing wants foreigners to invest in its debt market but fears over defaults have hit demand

APRIL 20, 2017 by: Gabriel Wildau in Shanghai

Too big to ignore but too opaque to entirely trust.

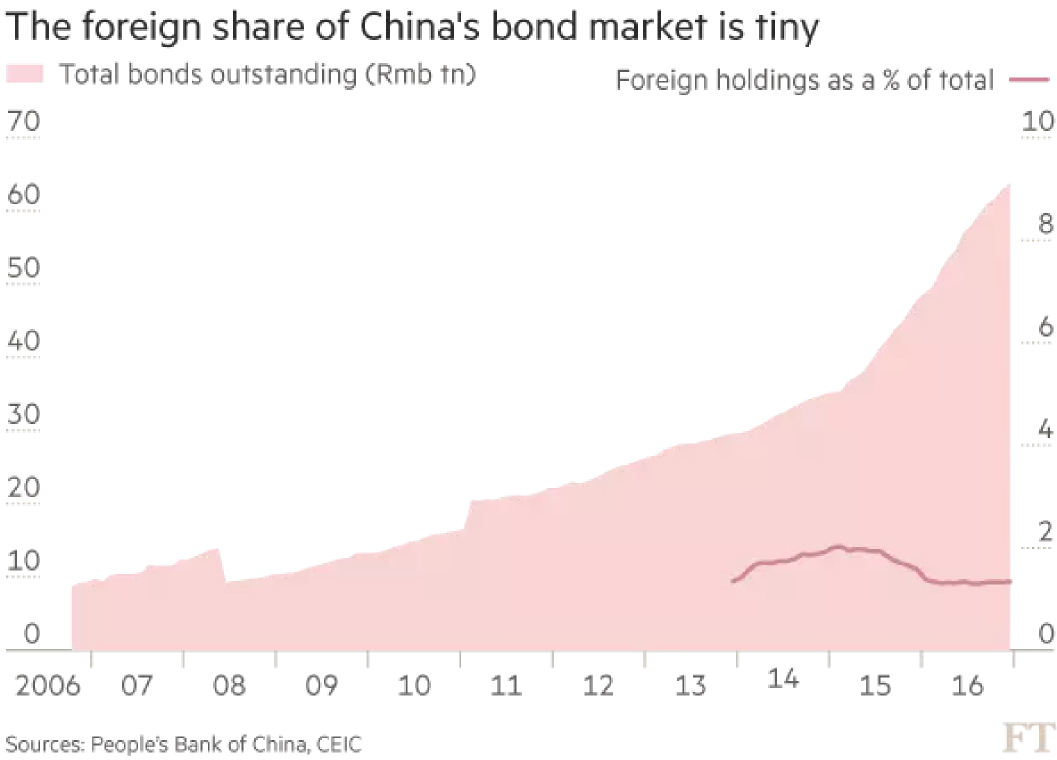
China is engaged in a charm offensive to lure foreign money into its bond market, which has grown in a short period of time from a minnow to the third largest in the world, after the US and Japan.

The opening of the bond market to foreigners is part of a transformation in the international financial system, which is slowly linking up with a Chinese economy that was once walled off behind tight capital controls. It is a crucial step in Beijing's plan to turn the renminbi into one of the anchor currencies of the global economy.

But the risk for China's economic planners is that no one shows up to their bond market party, amid fears over capital controls and default risk. International fund managers acknowledge that Chinese onshore debt is bound to become a big part of global fixed-income portfolios, but add qualifiers such as "eventually" and "medium- to long-term". Few, it seems, want to go in first.

"For an economy that is a tenth of the global economy with a similar share in global exports and investment, the singular lack of financial integration is striking and cannot last," says Qu Hongbin, chief Greater China economist at HSBC in Hong Kong.

Until recently, foreign participation in the Chinese market was tightly controlled by quotas and licensing requirements. That changed in February 2016, when the People's Bank of China threw wide open the doors to the interbank bond market, where most Chinese debentures trade. With one stroke, the central bank cleared the way for banks, insurers, securities firms, asset management companies, pension funds and non-profit endowments to enter the market without prior approval.



Last month the government widened access further, announcing a programme to let investors in Hong Kong buy Chinese onshore bonds through their own brokerages. Modelled on the Stock Connect programmes linking Hong Kong's exchange with those in Shanghai and Shenzhen, the Shanghai Bond Connect will allow foreigners to buy onshore Chinese bonds without the need for an onshore account.

Despite expanded access, however, interest from foreign investors has so far been tepid. Foreign holdings of Chinese domestic bonds rose a modest 13 per cent last year, according to central bank figures. At Rmb853bn ($124bn) by the end of 2016, foreign holdings equal only 1.3 per cent of total market value.

"China's interest rates are modestly higher than in the west, and the long-term prospects for the economy and the currency are still good," says David Dollar, former US Treasury economic and financial emissary to China and now a senior fellow at the Brookings Institution in Washington. "However, there are all kinds of risks, and interest rates strike me as low relative to the risks."

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Among the types of foreign investors, central banks and sovereign wealth funds have responded most positively. After the International Monetary Fund's decision in late 2015 to add the Chinese currency to its special drawing rights, the renminbi officially assumed the status of reserve currency in October last year. Because all IMF members hold SDRs among their reserves, this change meant renminbi assets automatically entered the reserve portfolios of the fund's 189 member countries.

Beyond these automatic purchases, many other sovereign investors take their cue from the IMF. “As the renminbi becomes a bigger part of the SDR basket, central bank reserve managers, large sovereign pension plans and the like will probably have to adjust their holdings to reflect the higher allocations within global sovereign portfolios,” says Manu George, senior investment director for Asian fixed income at Schroders Investment Management.

Stock news on a bridge near Shanghai's Oriental Pearl tower © AFP

Global central banks owned $84.5bn worth of renminbi assets as foreign exchange reserves at the end of last year, equal to 1.1 per cent of global reserves, IMF data show.

Taken together, the IMF and PBoC data suggest that central banks account for about two-thirds of total foreign holdings of Chinese bonds. Adding SWFs — whose renminbi holdings are mostly excluded from the IMF data — the government share of total Chinese bond holdings appears higher still. The flipside of these figures, however, is considerable caution on the part of private fund managers.

One factor is the risk of defaults. The first default in the Chinese bond market occurred only in 2015 by Shanghai Chaori Solar, after years in which bailouts were the norm. Though bonds remain safer than other credit in China, defaults have become more common.

Legal bankruptcies are also increasing in regularity, following years in which a bankruptcy law passed in 2006 was little used. Even so, large restructurings of important companies are typically orchestrated by government officials through extra-legal negotiations, which introduce political considerations into the process. “For large enterprises with debt in the hundreds of billions, they are traditionally handled through administrative means. Local governments or even the State

Council will take control and settle things out of court," says Wang Xinxin, a professor at Renmin University Law School in Beijing.

In the case of Huishan Dairy, whose shares dropped 85 per cent last month, provincial authorities in northeastern Liaoning province ordered creditors not to sue. The case showed how officials will intervene with debt problems even at a privately owned company, if its potential collapse threatens the local economy or the solvency of local banks. The ban on legal action meant that even creditors with collateral were at risk of being unable to enforce their claims.

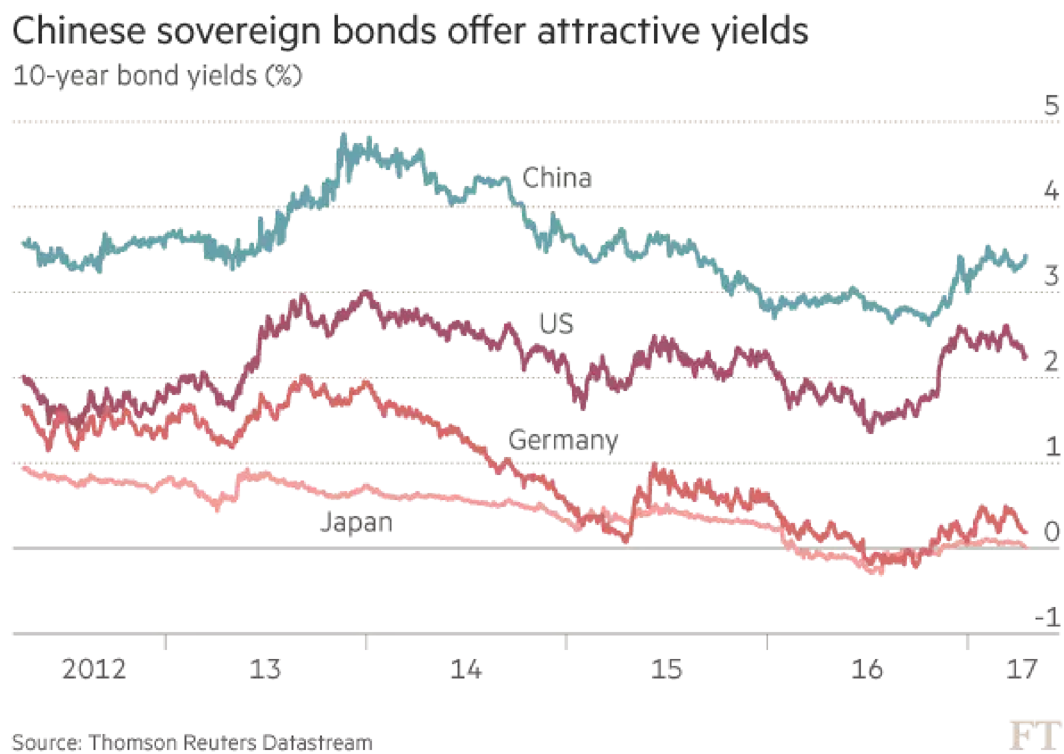
Another issue is credit ratings. The three large global rating agencies — Fitch, Moody's and Standard & Poor's — all have Chinese joint ventures. But rating methodologies differ substantially.

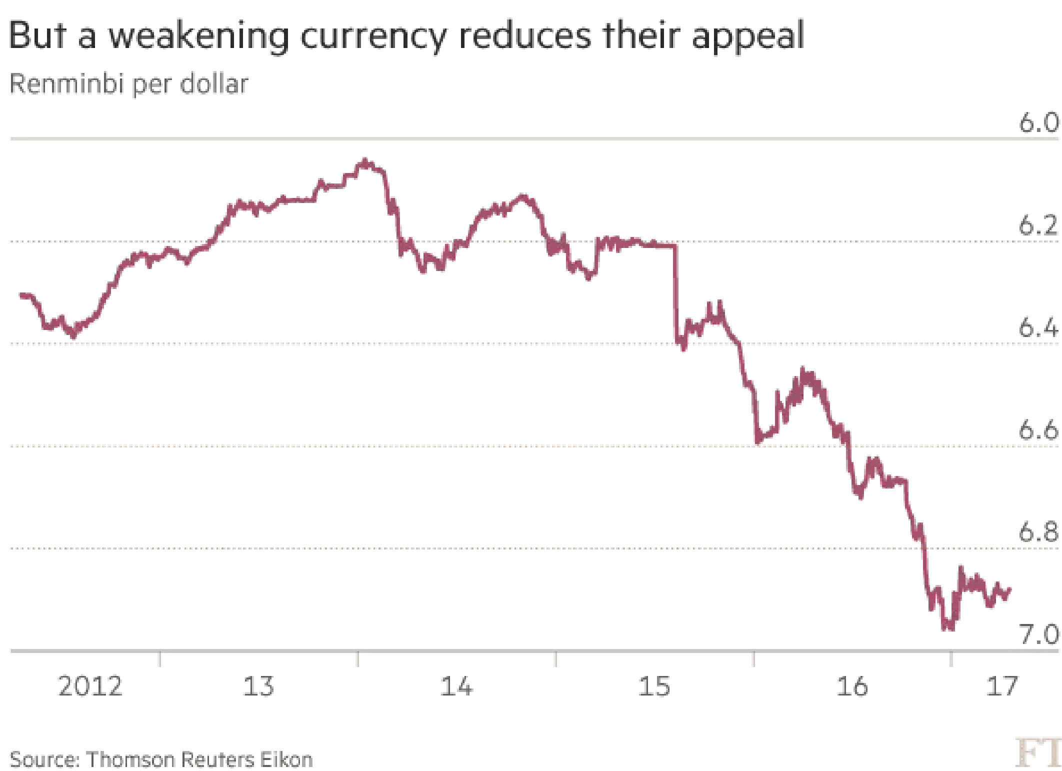
"There seems to be a disparity in analysing companies. If it's one notch — OK, fine. But you can't have the equivalent of an A rating onshore and then have Fitch and S&P rate it as a B," says Jamie Tadelis, co-head of sales at SC Lowy, a Hong Kong investment bank.

Chinese rating agencies counter that their ratings are often higher in part because most bond issuers are state-owned enterprises. Local agencies place more weight than their foreign counterparts on the likelihood of government support for a company, even if such support is not codified in law.

"We will pay attention to credit fundamentals, but at the same time, we also pay attention to the degree of credit support from various levels of government. Sometimes this support takes the form of an implicit guarantee," says Yan Yan, chairman of China Chengxin Credit Rating, a joint venture with Moody's.

Some investors are also worried that the corporate bond market is indistinguishable from the broader debt overhang facing the Chinese economy. Non-financial debt in China hit 277 per cent of gross domestic product at the end of 2016, up from about 150 per cent at the end of 2008, when Beijing unleashed a fiscal and monetary stimulus to cushion the impact of the global financial crisis. Corporate debt has been the biggest driver of the overall increase.





However, despite the risk of excessive debt for China's broader economy, the bond market is a relatively safe entry point for foreign debt investors. Banks — along with non-bank "shadow" lenders such as trusts, securities companies and fund management companies — are where China's riskiest debt lurks, analysts say.

In the bond market, junk bonds barely exist. An approval process filters out the worst would-be issuers. Most actual issuers are large state-owned companies and banks with strong credit profiles.

By contrast, the shadow-banking system is the main refuge for weak borrowers unable to access credit from cheaper sources.

Moreover, bonds are not the driver of China's credit boom. Despite rapid volume growth, bonds still account for only 11 per cent of total outstanding corporate and household debt, according to the central bank. By contrast, bank loans comprise 72 per cent, while shadow bank credit makes up 16 per cent.

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Even in government bonds, which carry minimal default risk, investors have other concerns, including whether their money could be trapped in China. Late last year, in a bid to curb capital outflows and cut pressure on the renminbi, Beijing cracked down on outbound acquisitions by Chinese companies, after a record-breaking year. Chinese individuals have had difficulty buying foreign exchange for personal use.

Regulators insist they are merely tightening enforcement and that the moves do not amount to new capital controls. But for investors, this distinction is semantic. In practice, currency conversion and cross-border remittance are more difficult than a year ago.

So far, foreign investors in Chinese stocks and bonds have not faced restrictions. And for the moment, downward pressure on the renminbi has eased and foreign exchange reserves have stabilised, reducing the likelihood of further restrictions. But every dollar of foreign investment that flows into China's bond market today increases the regulators' incentive to keep that money from exiting tomorrow if outflow pressure resumes, as many analysts expect it will.

Beyond PBoC's liquidity management, higher rates are also due to a crackdown on wealth management products © Bloomberg

“The government’s desire to build up its bond markets, in tandem with the goal of making the renminbi a prominent international currency, suggests that foreign investors can count on relatively unconstrained financial flows,” says Eswar Prasad, professor at Cornell University and former China head of the IMF. “However, investors may not be fully persuaded by the government’s reassurances.”

Despite their concerns, foreign investors may soon have little choice but to at least dip their toes. In January, Bloomberg became the first major index provider to include Chinese onshore bonds in a benchmark index. Days later, Citibank’s index unit announced it would add Chinese treasuries to its series of government bond indices. A month earlier, Citi became the first US bank to obtain a coveted trading licence for China’s interbank bond market.

Adding Chinese onshore bonds to key benchmark indices would force asset managers’ hands. Inclusion in emerging-market bond indices could create automatic inflows worth $25bn-$40bn. If they are added to global bond indices, an additional $200bn-$300bn could flow in, according to Luke Drago Spajic, Singapore-based head of emerging Asia portfolio management at Pimco.

“Once they’re in your index — especially emerging market indices — then if you don’t own them, you could end up with massive tracking error. You can’t own nothing,” says Mr Spajic.

Beyond passive money, active managers will be attracted by high yields. Chinese 10-year government bonds currently yield about 3.4 per cent, compared with 2.35 per cent for the US, 0.25 per cent for Germany and 0.1 per cent for Japan. That creates an incentive to add more Chinese bonds.

“The question isn’t just whether investors are going to raise their holdings to benchmark levels. They may have to start buying more than index levels in order to outperform. That’s where it gets interesting,” says Mr Spajic.

China’s currency is perhaps the single biggest factor worrying foreign fund managers. The renminbi suffered its worst fall on record in 2016. It has stabilised this year, but most economists believe that it will still fall further over the next 12 months.

“Even with yields very attractive in onshore China, wiping out a lot of that through hedging activity drives overall return prospects lower,” says Schroders’ Mr George.

Additional reporting by Tom Mitchell, Ma Nan and Xining Liu

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An investor in Anhui province watches share prices during the market rout of July 2015 © Getty Images

Regulation and reaction: Beijing learns lessons from crisis

China's reaction to the stock market rout in mid-2015 also fuelled worry that in times of market turbulence, the government will not hesitate to sacrifice investors on the altar of financial and social stability.

At the height of the stock market collapse, Chinese regulators banned stock sales by major investors, cracked down on short selling, and poured money into the market to prop up benchmark indices. They also decimated the equity futures market by imposing higher margin requirements for speculative trades.

Paula Chan, senior fixed income portfolio manager for Manulife Asset Management in Hong Kong, says that while concerns are understandable, regulators have learnt lessons from the 2015 debacle. "What happened in the stock market two years ago was really shocking, but we have to give some credit to Chinese regulators. I think the market has taught the regulators, 'If you do something like this, we will withdraw money from the system'," she said.

Moreover, different regulators have different track records when it comes to market interference. The China Securities Regulatory Commission, which took the lead in intervening during the stock market rout, is generally seen as more interventionist than the People's Bank of China, which has primary authority over the bond market. The central bank led the campaign to promote the renminbi as an international reserve currency by relaxing the government's grip on interest rates, exchange rates and cross-border capital flows.

While the CSRC's interventions hit domestic investors, the impact on foreign investors was negligible. By contrast, given the role of foreign central banks in China's bond market, the PBoC is well aware that heavy-handed meddling would come at a higher cost to China's global credibility