



# SOE Bond Defaults in China

MONETARY AND CAPITAL MARKETS DEPARTMENT

December 9, 2020

*Recent defaults by some state-owned enterprises (SOEs) in China have triggered pressures in corporate bond markets and contributed to broader funding market pressures. Investors were particularly worried about apparent cases of selective default, raising concerns about creditors' rights, governance, and investor disclosures. They also wondered about a possible weakening of the implicit guarantees extended to SOEs by governments. While defaults are expected to remain relatively limited, further volatility is possible as uncertainty about implicit guarantees interacts with pre-existing debt vulnerabilities and post-pandemic policy normalization. While any large-scale SOE reform would likely require the exit of non-viable SOEs, a strong set of policies are essential to support the transition away from implicit guarantees, including improvements in restructuring frameworks, financial sector buffers, and social safety nets.*

**Unexpected defaults by some SOEs have caused bond market pressures.** The default of a AAA-rated provincial government-owned coal firm in mid-November was the latest in a string of high-profile SOE defaults this year. The repayment failure has raised investor concerns that local governments' implicit guarantees may be weakening amid widespread debt-servicing weakness among SOEs and some local governments. The incident had an outsized, persistent impact on market sentiment in part because it was the second default in a month where assets had been shifted out of reach of creditors, raising concerns that SOEs were selectively reneging on creditor obligations. Credit spreads widened for the weaker AA-rated segment, considered to be below investment grade in the Chinese market, in particular at the front end of the yield curve.

**Liquidity strains also appeared to be a factor driving market stress.** Risk-free bond yields, swap rates, and term bank funding costs rose in November, particularly at shorter-term maturities. The spread between repo rates available to nonbank financial institutions and rates available to depository institutions increased, in what is normally seen as a measure of rising interbank market pressures. This was consistent with reports that some investment funds were facing redemption pressures and collateral standards were tightening in some parts of the repo market, increasing funding market strains. It also reflected a gradual tightening of overall funding market conditions prior to the SOE default, as authorities have allowed interest rates to increase notably in recent months amid concerns about rising financial risks. Repo and particularly bond market trading volumes have fallen since the beginning of October, indicating weakening liquidity conditions and deteriorating investor sentiment.<sup>1</sup>

**Authorities have taken steps to support investor confidence and market liquidity.** The Financial Stability and Development Committee (FSDC) issued a statement urging regulators and local governments to better protect creditors' interest in such situations and guard against systemic risks. The People's Bank of China (PBC) also stepped up liquidity injections into the interbank market, including a surprise addition

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<sup>1</sup> For more on the significance of trading and repo volumes in China's bond markets, please see Adrian, Hoyle and Natalucci, "Patterns of Trading in China's Bond Market", in *The Future of China's Bond Market*, ed. Alfred Schipke (Washington: IMF, 2019), pp. 257–279.

of long-term funds via the Medium-term Lending Facility outside of its normal mid-month operations.<sup>2</sup> While some short-term risk-free interest rates have since fallen, risky bond yields and bank term funding costs have declined only marginally, and primary corporate bond issuance has remained weak.

**Defaults by SOEs are expected to remain rare despite their generally weak debt-servicing capacity.**

As part of past efforts to reform the SOE sector, local governments have been under pressure to reduce support for zombie firms, particularly in certain heavy industry sectors. Concerns about SOE credit risks are exacerbated by local governments' own rising debt loads and weakened revenues amid the pandemic, which in some cases may constrain their capacity to support weak firms. Nevertheless, local governments are likely to continue to avoid outright defaults by SOEs when possible, in part to avoid reputational damage that might in turn weaken credit market access for other local borrowers. Market pricing suggests investors do not see a cascade of defaults among even weak SOEs, as only a handful of bonds have seen significant price drops.

**Continued volatility is however still possible as uncertainty about implicit guarantees interacts with widespread pre-existing debt vulnerabilities and post-COVID policy normalization.**

While most local governments may opt to continue supporting the debt of local SOEs, perception of weakening implicit guarantees could tighten financial conditions if they lead to a pullback in credit provision for weak firms. This could create adverse macrofinancial feedback loops in certain weaker regions, as moderating economic activity leads to deteriorating local government finances, which could further reduce the credibility of backstops for local SOEs. Risks could then spill over to banks in the form of worsening asset quality, as they are the primary creditors to local government financing vehicles and local SOEs.<sup>3</sup> The potential for financial stress may also be heightened by authorities' planned shift towards tighter monetary and credit policies as the recovery from the pandemic takes hold. Senior policymakers at the PBC have also recently reiterated their focus on controlling debt growth and removing implicit guarantees, suggesting limited appetite to facilitate bailouts for struggling firms.

**The recent SOE defaults highlight the need for a strong set of policies to support any large-scale SOE reform including the transition away from implicit guarantees.**

Better protection for creditors' rights and improved SOE disclosures and governance will support market confidence. Stronger restructuring frameworks for both firms and banks will be critical to minimizing the impact of defaults on financial stability and facilitating an efficient reallocation of resources from nonviable to viable firms. Banks should be encouraged to strengthen capital and liquidity buffers. A strong social safety net is likewise important to mitigate the economic drag from job losses that may result from closing inefficient and insolvent firms. More broadly, a stronger fiscal coordination framework could help ease negative feedback loops between deteriorating public finance and tightening financial conditions in some weaker provinces.<sup>4</sup> This would support economic adjustment in these provinces and lessen the possibility of disorderly market pressures.

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<sup>2</sup> Market analysts speculated that authorities also directed intermediaries to provide liquidity support to the exchange repo market, which saw notable volatility.

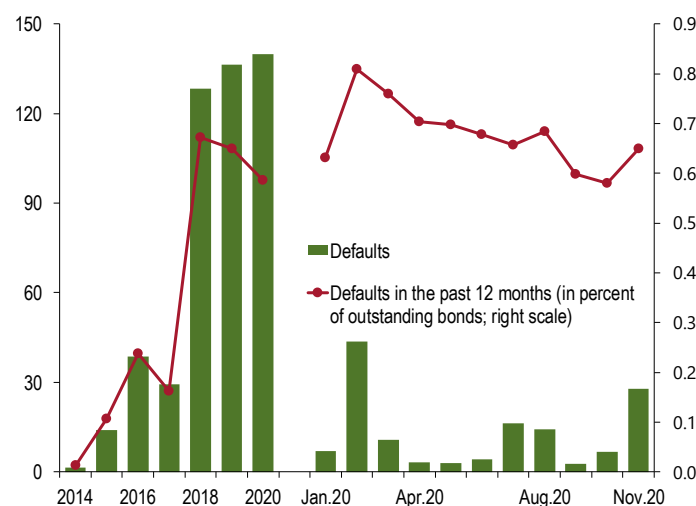
<sup>3</sup> See "Box 1.3: Interlinkages among Local Government, Corporate, and Bank Vulnerabilities in China" in Chapter 1 of the October 2020 GFSR (p. 32).

<sup>4</sup> The forthcoming 2020 China Article IV Staff Report provides additional discussion on recommended SOE reform and policy measures.

- Defaults have risen in recent years but remain relatively rare, reflecting the prevalence of implicit guarantees
- Missed payments have not picked up notably during the pandemic, in part reflecting strong policy support

**Chart 1. Corporate Bond Defaults**

(In billions of RMB)



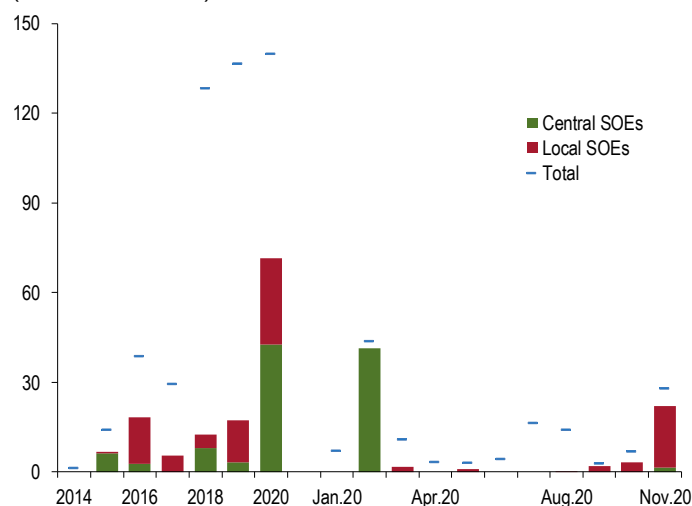
Sources: WIND; and IMF staff calculations.

Note: The figures for 2020 and November 2020 are as of November 23.

- SOEs have however accounted for a larger share of defaults in 2020
- Peking University Founder Group, a central SOE, and Yongcheng Coal & Electricity, a provincial SOE, were the largest default cases this year

**Chart 2. Corporate Bond Defaults by State-Owned Enterprises (SOEs)**

(In billions of RMB)



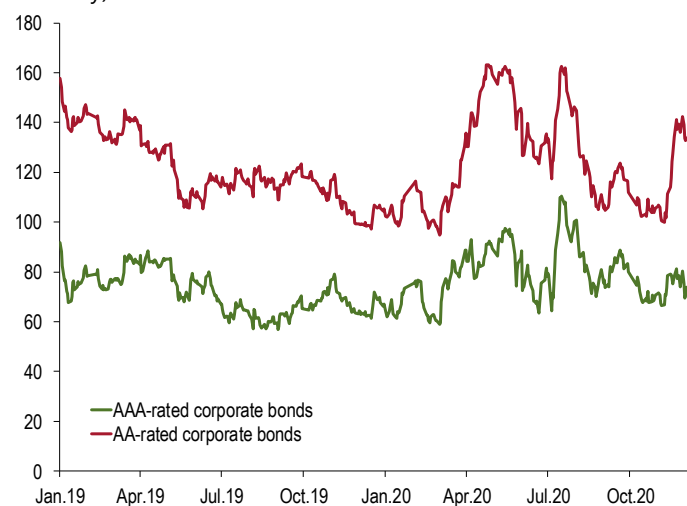
Sources: WIND; and IMF staff calculations.

Note: The figures for 2020 and November 2020 are as of November 23.

- Yongcheng's unexpected default in November led to credit spread widening in the lower-rated AA segment
- Spread widening earlier in the pandemic occurred during a period when corporate bond yields declined but government bond yields fell more

**Chart 3. Risk Premiums of Corporate Bonds**

(In basis points; relative to central government bonds; 3-year maturity)

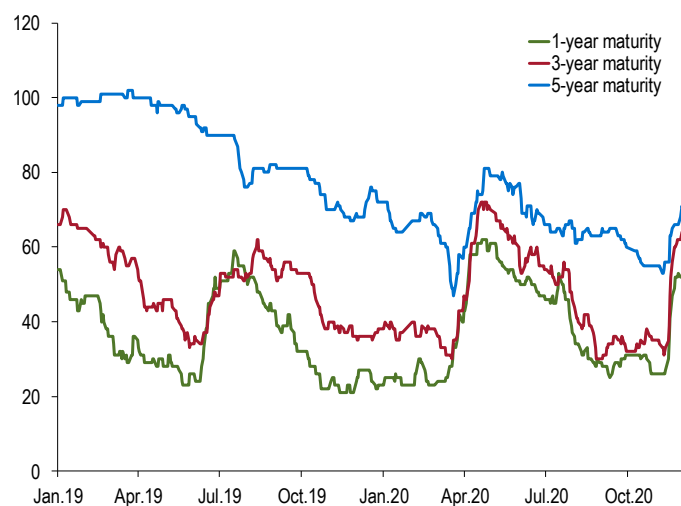


Sources: Bloomberg Financial L.P.; and IMF staff calculations.

- Investors became more worried about exposures to lower-rated bonds, especially at shorter maturities
- In aggregate, spread widening remains comparable with the bond market stress that occurred after the Baoshang Bank takeover in May 2019

**Chart 4. Spreads of Corporate Bond Yields**

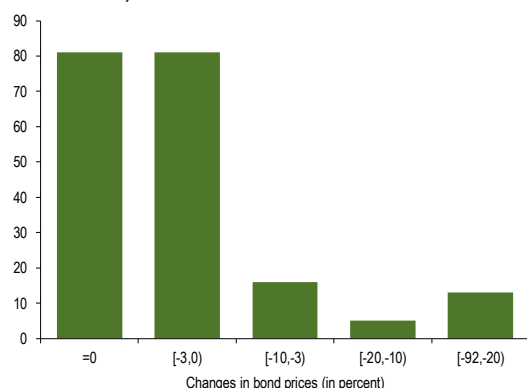
(In basis points; between AAA-rated and AA-rated issuers)



Sources: Bloomberg Financial L.P.; and IMF staff calculations.

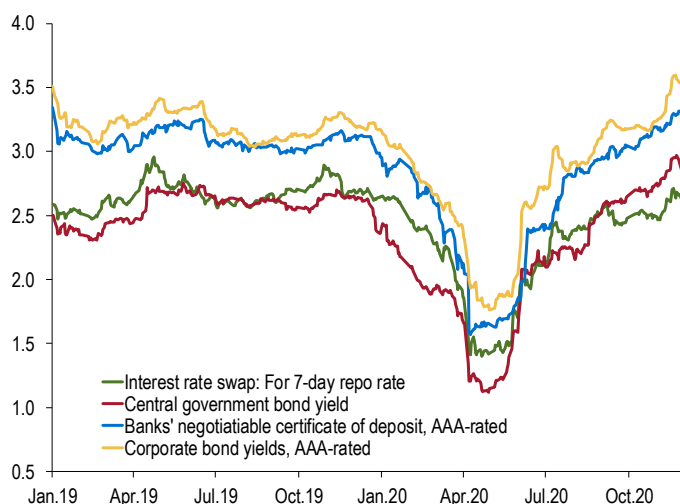
- Markets are not pricing in a cascade of defaults so far, as most bonds identified as facing repayment pressures have seen relatively limited price declines
- In only a handful of cases do price declines suggest risk of imminent default (e.g., price declines above 20 percent)
- Short-term interest rates have been rising since May amid a shift towards monetary policy normalization and rising net supply of government bonds
- The recent default episode further drove up funding costs for governments, financial institutions, and firms

**Chart 5. Changes in Bond Prices of Companies Facing Repayment Pressures, November 2020**  
(Number of bonds)



Sources: Bloomberg Financial L.P.; and IMF staff calculations.  
Note: The sample covers 188 bonds issued by 83 companies facing debt repayment pressures, as identified by Bloomberg. The criteria include (i) that companies made disclosure on repayment uncertainty, (ii) that companies faced tight liquidity as noted by rating agencies, and (iii) that companies were revised by rating agencies for downgrade to speculative grade.

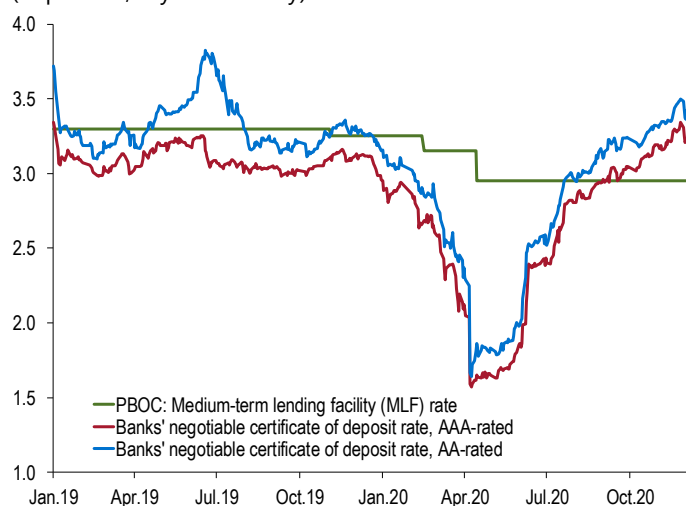
**Chart 6. Funding Costs**  
(In percent; 1-year maturity)



Sources: Bloomberg Financial L.P.; and IMF staff calculations.

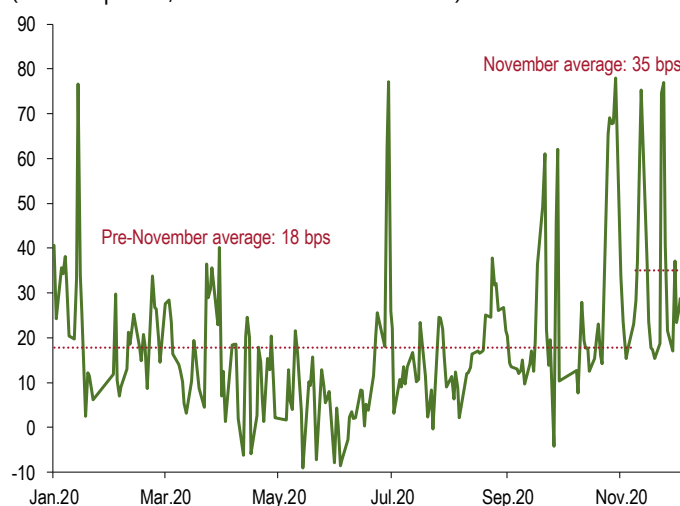
- Tighter liquidity conditions have pushed term funding costs above the PBC's benchmark policy rate even for highly-rated banks
- With higher funding costs, net issuance of NCDs has turned negative in the last two weeks
- There have been signs of stress in repo markets, with the overall interbank repo rate exceeding the rate of repo transactions among banks
- This points to tightening repo market conditions for nonbank borrowers in particular

**Chart 7. Bank Negotiable Certificate of Deposit Rates**  
(In percent; 1-year maturity)



Sources: Bloomberg Financial L.P.; and IMF staff calculations.

**Chart 8. Spread of Interbank Repo Rates**  
(In basis points; between R007 and DR007)

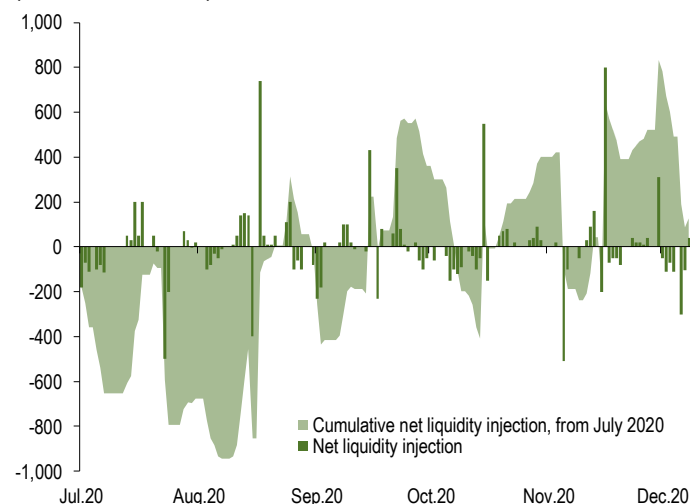


Sources: Bloomberg Financial L.P.; and IMF staff calculations.  
Note: DR007 is the 7-day repo rate based on transactions only between depository institutions, while R007 is the 7-day repo rate based on all transactions.

- In response to recent financial stress, the PBC stepped up liquidity injections to stabilize market conditions
- The PBC provided net liquidity of nearly 1 trillion RMB during November 10-30 before withdrawing liquidity in early December

**Chart 9. PBC's Net Liquidity Injection**

(In billions of RMB)



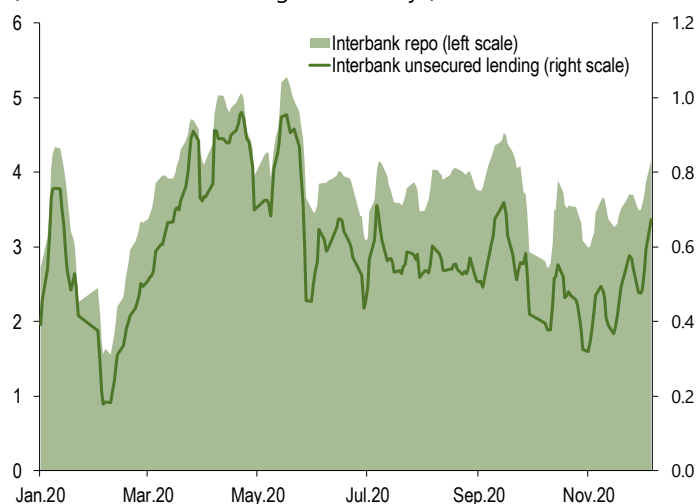
Sources: Bloomberg Financial L.P.; and IMF staff calculations.

Note: Liquidity injection occurs through daily open market operations (i.e., 7-day reverse repos) and monthly lending via the medium-term lending facility (with 1-year term).

- While remaining contained so far, financial stress may be more readily amplified because liquidity appears not be evenly distributed across the financial system
- Interbank lending activity (both secured and unsecured) has been relatively low since October

**Chart 10. Interbank Repo and Lending Volume**

(In trillions of RMB; average over 5 days)



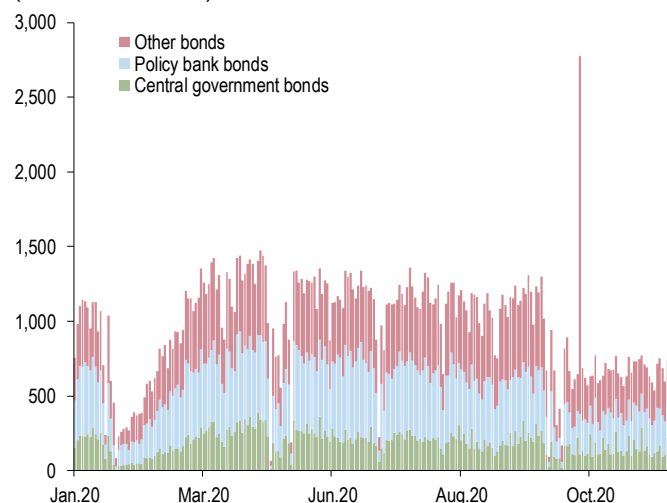
Sources: Bloomberg Financial L.P.; and IMF staff calculations.

- Similarly, trading volume in bond markets has dropped to a lower level since October, pointing to low market liquidity and weak investor sentiment
- Anecdotally, some fixed-income funds have faced redemptions, with asset liquidation adding to market pressures

- Many corporates have delayed bond issuance in November amid more challenging market conditions
- The amount of delayed issuance in November reached 93 billion RMB

**Chart 11. Bond Trading Volumes**

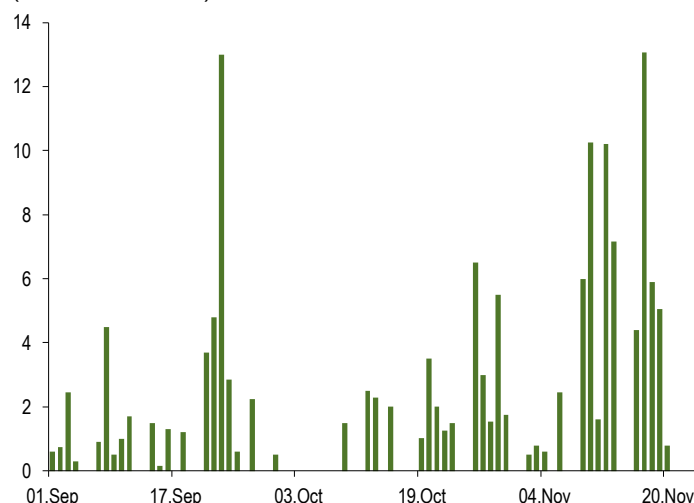
(In billions of RMB)



Sources: Bloomberg Financial L.P.; and IMF staff calculations.

**Chart 12. Canceled Corporate Bond Issuance**

(In billions of RMB)

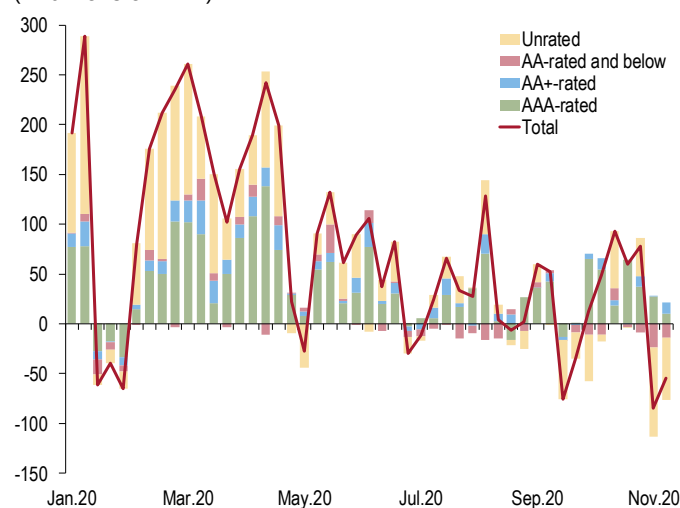


Sources: WIND; and IMF staff calculations.

- Net corporate bond issuance has slowed since May as firms tapped bond markets earlier this year
- Lower-rated and unrated issuers find it more challenging to refinance their bonds in recent weeks

**Chart 13. Weekly Net Corporate Bond Issuance**

(In billions of RMB)

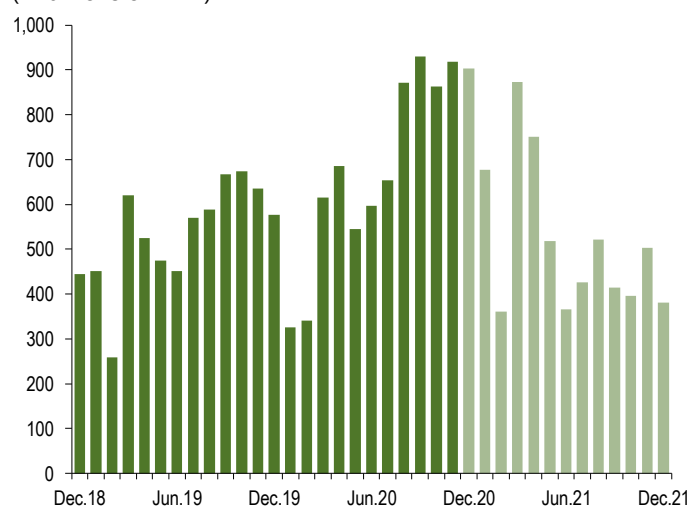


Sources: WIND; and IMF staff calculations.

- Going forward, corporates still have to manage bond refinancing needs, particularly in March and April 2021

**Chart 14. Monthly Corporate Bond Maturities**

(In billions of RMB)



Sources: WIND; and IMF staff calculations.

**Table 1. Onshore Corporate Bond Defaults in China, October–November 2020**

Issuer Ownership	Date of Default	Amount of Defaulted Bonds (Millions of RMB)	Total Outstanding Bond (Millions of RMB)
Shanghai Bann Water (private enterprise)	October 19	500	400
Shenyang Shengjing Energy Development (provincial SOE)	October 23	500	0
Brilliance Auto, a subsidiary of Huachen Automotive (provincial SOE)	October 23	1,000	16,200
	October 29	1,000	...
Yongcheng Coal & Electricity, a subsidiary of Henan Energy & Chemical Industry (provincial SOE)	November 10	1,000	21,410
	November 12	19,710	...
Chenglong Construction (private enterprise)	November 13	200	820
Tsinghua Unigroup (central SOE)	November 16	1,300	16,446
Fujian Fusheng (private enterprise)	November 19	1,000	10,010
Ningxia Yuangao Industry (private enterprise)	November 23	100	1,030

Sources: WIND; and IMF staff calculations.

Note: Only first-time defaults in 2020 are presented.