November 2019

CHINA CREDIT: A GUIDE TO INVESTING IN THE ONSHORE MARKET

Opportunities for foreign investors to participate in China's onshore markets are exploding as major benchmark providers add the country to their global indices. Many investors are taking a close look at the country's capital markets for the first time. From outside China, the view can be perplexing—both familiar and strange. While the markets superficially resemble their global counterparts, the institutions and conventions that underpin them have their own unique character. This paper provides a practical guide for understanding and navigating China's onshore corporate-bond market and its evolving regulatory and legal landscape.

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As China's stock and bond markets have become more integrated into the global financial markets, their distinctive character and features have begun to evolve. Understanding how they are changing—and in what ways they are likely to retain a local flavor—is essential for any investor making an allocation to China.

This is as necessary for China's domestic credit market as it is for its other capital markets. Corporate bonds comprise 54% of the country's US$12.5 trillion bond market, the rest consisting of government bonds and public-sector bonds issued by government-affiliated companies.[1]

The credit market's structure, which reflects successive phases in the market's development and liberalization, is unique. Its most striking characteristics are diversity and complexity (*Display 1, page 2*): It includes four kinds of securities (enterprise bonds, corporate bonds, medium-term notes and commercial paper), two trading platforms (exchange and over-the-counter) and no fewer than three regulators. "Firms can issue instruments with similar characteristics and maturities in different segments, each governed by a different regulatory agency, subject to different issuance and rules, and traded on different platforms."[2]

Enterprise bonds are issued mainly by state-owned enterprises (SOEs), among which local government financial vehicles (LGFVs) are by far the biggest issuers, accounting for about 80% of the market. The sector is regulated by the National Development and Reform Commission (NDRC), and the securities can be traded on both the interbank market and the Shenzhen and Shanghai exchanges.

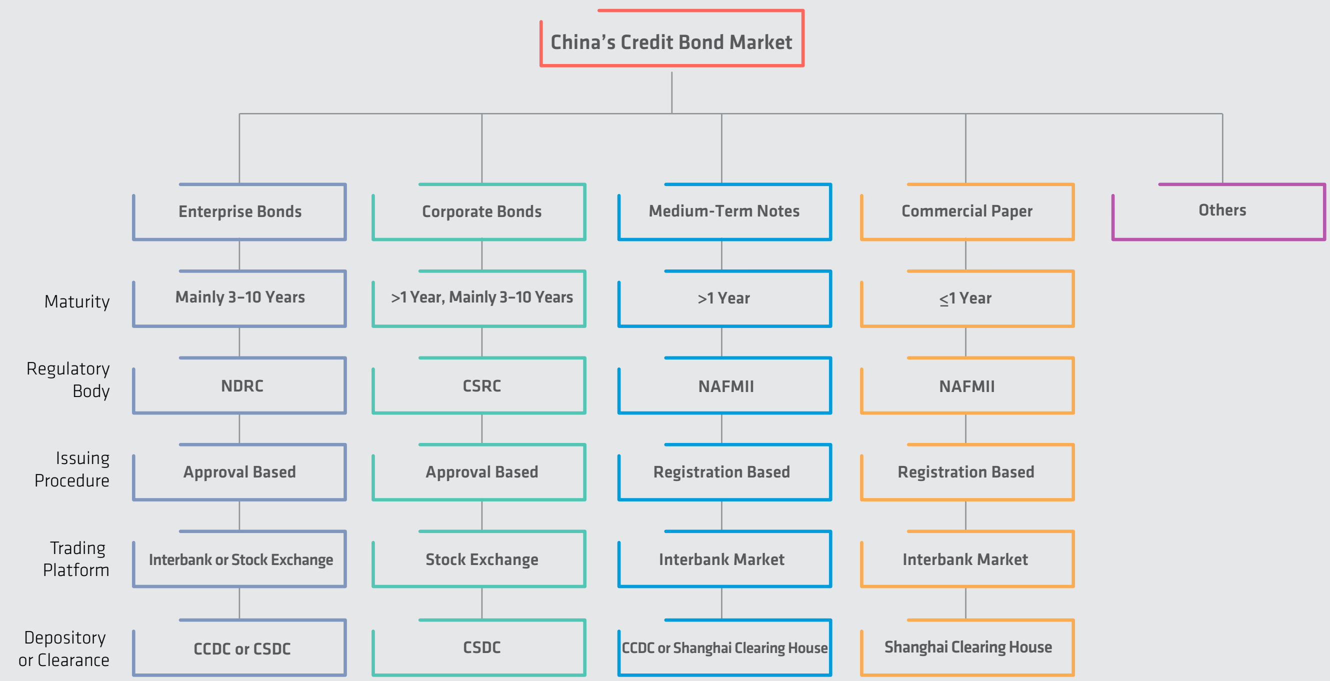
Corporate bonds, which are exchange traded and overseen by the China Securities Regulatory Commission (CSRC), were launched as a sector in 2007 as part of the government's plan to open up and develop the capital markets.

The following year, China launched the **medium-term notes** sector, which is traded on the interbank market and regulated by the National Association of Financial Market Institutional

1 Asia Securities Industry and Financial Markets Association (ASIFMA)
2 Alfred Schipke, Markus Rodlauer and Longmei Zhang, eds., *The Future of China's Bond Market* (Washington, DC: International Monetary Fund, 2019).

DISPLAY 1: CHINA'S CREDIT MARKET IS DIVERSE AND COMPLEX

Corporate Bond Market Characteristics by Sector



As of October 31, 2019

CCDC: China Central Depository and Clearing Corporation Limited; CSDC: China Securities Depository and Clearing Corporation Limited; CSRC: China Securities Regulatory Commission; NAFMII: National Association of Financial Market Institutional Investors; NDRC: National Development and Reform Commission

Source: International Monetary Fund

Investors (NAFMII), a self-regulated agency under the People's Bank of China (PBOC). The interbank market in China, unlike its counterparts elsewhere, is not limited to financial entities, and corporates and large institutional investors are able to participate.

Regulation, law and government policy—particularly in the areas of economic and financial-market reform—have been, and continue to be, important drivers of the market's growth. So too is the increasing involvement in the market of global investors, credit rating agencies, law firms and other intermediaries.

Below, we look at how these agents of change are affecting credit ratings, covenants, bankruptcy law and defaults—four areas that are critical to the market's future success.

THE COMPLEXITY OF THE REGULATORY ENVIRONMENT CONTRIBUTES TO POSITIVELY SKEWED RATINGS

CREDIT RATINGS: THE DRAGON AT THE GATE

In any bond market, credit ratings are an important factor in an investor's decision to buy a security. For investors in China's onshore credit market, however, ratings present a challenge and are probably the one area in which the market differs most sharply from its offshore counterparts. In some ways, they stand as a forbidding and rather problematic dragon at the gate.

China's ratings industry consists of seven agencies, of which four—China Chengxin Credit Rating Group, Lianhe Ratings Global, Dagong Global Credit Rating and Golden Credit Rating International (Orient)—are dominant (*Display 2*). While the ownership details of a number of these agencies remain somewhat opaque, owners in some cases include government-related entities. (Orient, for example, is fully government owned.)

A potentially important trend is the increasing involvement of Western agencies. In 2006, international ratings agency Moody's Investors Service took a 49% stake in Chengxin. The following year, Fitch formed a similar relationship with Lianhe, and Standard & Poor's (S&P) has had a technical partnership with local agency Brilliance since 2008.[3]

Clearly, government ownership of credit rating agencies in a bond market where many issuers are also state owned creates a potential conflict of interest. In addition, there are instances of questionable practices that reflect intense competition between some of the agencies, as well as lax standards of corporate governance. In 2018, for example, Dagong Global Credit Rating, which is entirely privately owned, was banned for a year for providing (at an exorbitant rate) consultancy services to companies it also rated.

The most striking feature of China's domestic ratings, however, is how unevenly distributed they are, compared with ratings in other markets such as the US, the UK and Europe. According to Wind Information, 59% of Chinese bonds are rated AAA and AAA+, the highest possible ratings, compared with less than 2% in the US. Altogether, 99.6% of Chinese bonds are rated AA or above.[4] *Display 3, page 4,* shows this skew.

DISPLAY 2: SEVEN DOMESTIC RATING AGENCIES COVER CHINA

China's Domestic Rating Agencies: Market/Regulator Accreditation

Agency	Interbank Market (PBOC)	Exchange-Based Market (CSRC)	Markets for Enterprise Bonds (NDRC)
Chengxin	✓	✓	✓
Lianhe	✓	✓	✓
Dagong	✓	✓	✓
Orient (Golden Credit Rating International)	✓	✓	✓
Pengyuan	✗	✓	✓
Brilliance	✓	✓	✓
Far East	✗	✓	✓

As of October 31, 2019
Source: Bank for International Settlements

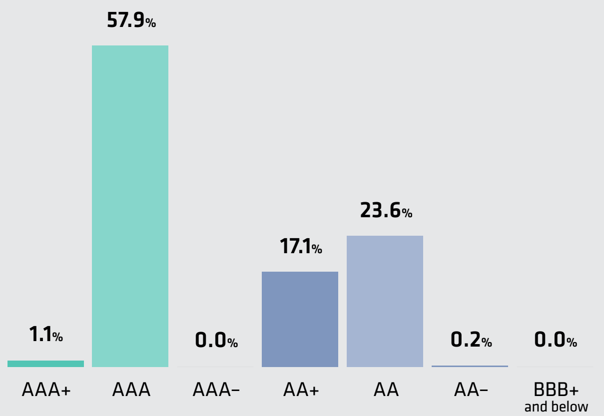
The skew is attributable to various factors, including the multilayered, overlapping and fragmentary nature of the regulatory environment. In addition to the PBOC and the regulators CSRC and NDRC, the China Banking and Insurance Regulatory Commission (CBIRC) has the authority to approve rating agencies. It also directs banks and insurers to invest only in bonds rated AA and higher, providing little incentive for domestic rating agencies to assign lower ratings.

Another factor often cited is that many domestic bond issuers are state owned or deemed to have government support. As analysis by

3 Miles Livingston, Winnie P.H. Poon and Lei Zhou, "Are Chinese credit ratings relevant? A study of the Chinese bond market and credit rating industry," *Journal of Banking & Finance* vol. 87(C) (February 2018): 216–232.
4 ASIFMA

DISPLAY 3: CHINA HAS A SEVERE DOMESTIC RATINGS IMBALANCE

Bond Ratings at Issuance



As of November 13, 2019
Source: Wind Information

the Bank for International Settlements (BIS) illustrates, Chinese rating agencies tend to place greater weight on asset size as an indicator of creditworthiness compared with their global counterparts, and less emphasis on the potentially negative effects of leverage. [5] For overseas investors used to the ratings rationales of the global agencies, this might create a sense of culture shock.

The difference in the way that global and domestic agencies view Chinese credits is most easily seen in the discrepancies between Chinese issuers' domestic and offshore ratings. These are largely caused by global agencies not being allowed to rate Chinese companies' offshore bond issues higher than China's sovereign credit rating of A+. Research by the PBOC suggests that, on average, ratings assigned by domestic agencies are six to seven notches higher than those assigned by agencies based outside China.[6]

As an example of how these discrepancies can play out on a day-to-day basis, Moody's assigned a B2 rating to Huachen Energy when it first came to the market as an offshore issuer. Local agency Lianhe assigned the same entity a rating of AA+. The local rating was 13 notches higher than Moody's.

In November 2018, Huachen defaulted on a domestic bank loan and appeared to struggle to meet an interest payment on US$500 million of senior unsecured notes. In response, Moody's lowered Huachen's rating by two notches, to Caa1, denoting substantial risks. At first, the local agency also downgraded the credit by two notches, but that only brought it to AA–. Eventually, the agency downgraded Huachen by a total of ten notches, to BB, which is in the speculative category—but still higher than Moody's assessment.

Such dramatic downgrades by domestic agencies have been an unnerving feature of recent defaults in China and reflect poorly on the agencies' ability to provide disciplined and continuous monitoring of issuers' credit quality. Confusion and lack of transparency are obstacles to the domestic bond market's ability to achieve its full potential.

However, change is afoot. Global rating agencies began acquiring stakes in, or otherwise partnering with, domestic agencies in 2006. More recently, Moody's and Fitch have announced plans to launch their own Chinese rating operations. And in January 2019, S&P won regulatory approval to rate domestic bonds; in July, it became the first foreign agency to assign a rating domestically, awarding a AAA to ICBC Leasing—in line with the rating assigned by domestic agency Lianhe.

Skeptics might wonder why, given the average differences between global and domestic ratings, S&P assigned a rating identical to that issued by a local agency. For one thing, S&P is not constrained by the sovereign rating when rating domestic bonds. And, ratings from a domestic agency partly owned by a global rating house such as Fitch, which has owned 49% of Lianhe since 2007, may also help to increase investor confidence.

For global investors, the growing presence of Fitch and its peers in China is an encouraging sign that the domestic ratings market is moving toward higher standards of transparency, accuracy and consistency.

5 Drago Bergholt, Vegard Høghaug Larsen, Martin Seneca et al.,"Business cycles in an oil economy" (working paper, Bank for International Settlements, 2017).
6 Kate Jaquet, "Understanding China's Bond Ratings," The Diplomat (June 27, 2019).

DISPLAY 4: REGULATORS REQUIRE DISCLOSURE OF MATERIAL EVENTS

MATERIAL CHANGES TO THE ISSUER'S BUSINESS STRATEGIES AND OPERATING ENVIRONMENT	CRIMINAL PROCEEDINGS OR SIGNIFICANT INVESTIGATIONS AGAINST ANY DIRECTOR, OFFICER OR SUPERVISORY BOARD MEMBER
DEFAULT IN THE PAYMENT OF DEBT	MATERIAL LEGAL OR ARBITRAL PROCEEDINGS OR REGULATORY PENALTIES
INCURRENCE OF SIGNIFICANT DEBT	SIGNIFICANT LOSSES EXCEEDING 10% OF ISSUER'S NET ASSETS
ENCUMBRANCE OR FREEZING ORDERS OVER ISSUER'S MATERIAL ASSETS	INSTITUTION OF A BANKRUPTCY OR LIQUIDATION PROCEEDING
WAIVER OF CREDITOR'S RIGHTS FOR SIGNIFICANT AMOUNT OF DEBT OWED BY THIRD PARTIES	MERGER, SEPARATION OR REDUCTION IN REGISTERED CAPITAL

As of October 31, 2019
Source: Fangda Partners

In the medium to long term, the trend may result in a significant redistribution of ratings.

For the time being, however, caveat emptor applies for investors using ratings as a guide to buying domestic bonds. In case of doubt, or where significant discrepancies exist between ratings assigned by domestic and global agencies, the proprietary credit research of financial intermediaries such as asset managers or investment banks is likely to prove useful.

COVENANTS: A LONG WAY TO GO

The low level of credit differentiation in the Chinese domestic bond market affects not just ratings but covenants, too. With so many domestic issuers rated AA or above, the notion of a high-yield bond market in China—and the investor protections that normally accompany such a designation—lags established practice in other markets.

Even so, the situation has progressed somewhat since 2014, when Shanghai Chaori Solar Energy failed to make an interest payment in full on an exchange-traded bond and became the first company in China to publicly default on an issue. The event was a milestone for the market. It showed that the government—as part of its move to liberalize the economy and financial markets—was willing to allow some companies to fail. An implicit government guarantee for public debt issues could no longer be taken for granted.

In September 2016, regulator NAFMII launched sample investor protection guidelines for nonfinancial issuers in the interbank market. These included cross-default clauses, financial ratio covenants and change-of-control put options.[7] The provisions differed from offshore counterparts in that any breach did not necessarily lead to default. Instead, a bondholders' meeting would be called.

REORGANIZATION IS NOW A LEGAL ALTERNATIVE TO LIQUIDATION

7 Christine Chen, David Liao and Annie Shen, "High-Yield Debt in China," *High-Yield Debt* (website), May 15, 2019, https://gettingthedealthrough.com/area/87/article/29377/high-yield-debt-high-yield-debt-china

DISPLAY 5: A COMPARISON OF ONSHORE AND OFFSHORE COVENANTS

Huachen Energy: US and Domestic Bond Prospectuses

Limitations on:	Offshore Prospectus	Onshore Prospectus
Indebtedness and Preferred Stock	**STRONG**	WEAK
Restricted Payments	**STRONG**	WEAK
Dividend and Other Payment Restrictions Affecting Restricted Subsidiaries	**STRONG**	NONE
Sales and Issuances of Capital Stock in Restricted Subsidiaries	**STRONG**	NONE
Issuances of Guarantees by Restricted Subsidiaries	**STRONG**	WEAK
Transactions with Shareholders and Affiliates	**STRONG**	NONE
Liens	**STRONG**	WEAK
Sale and Leaseback Transactions	**STRONG**	NONE
Asset Sales	**STRONG**	WEAK
Company's Business Activities	**STRONG**	WEAK

Limitations on:	Offshore Prospectus	Onshore Prospectus
Use of Proceeds	**STRONG**	NONE
Designation of Restricted and Unrestricted Subsidiaries	**STRONG**	NONE
Government Approvals and Licenses; Compliance with Law	**STRONG**	WEAK
Anti-Layering	**STRONG**	NONE
Suspension of Certain Covenants	**STRONG**	WEAK
Preservation Measures on Properties and Assets	**STRONG**	WEAK
Cross-Default Clauses	**STRONG**	WEAK
Changes of Prospectus Terms	**STRONG**	WEAK
Change of Control Events	**STRONG**	WEAK
Debt Restructuring	**STRONG**	WEAK
Consolidation, Merger and Sale of Assets	**STRONG**	WEAK

As of October 31, 2019
Source: AllianceBernstein (AB)

BANKRUPTCY PROTECTION FOR BOND INVESTORS IS EVOLVING IN THE RIGHT DIRECTION

A bondholders' meeting is a common investor protection measure in the Chinese bond market. Issuers are generally required to hold such meetings as part of the terms and conditions of their debt securities.

Trigger events for the meetings, and the meeting procedures, are governed by rules issued by the NAFMII and the CSRC. It's debatable, though, how effective these meetings are in protecting investors' interests. There have been several instances in which bond issuers have refused to implement resolutions agreed to at the meetings, leaving investors no option other than to sue.[8]

Issuers are subject to disclosure requirements—both periodic (in quarterly and annual financial statements) and when material events occur—while their bonds remain outstanding. *Display 4, page 5,* lists some of the material events requiring disclosure, as determined by the NAFMII and the CSRC.

Display 5, page 6, compares how onshore and offshore covenant requirements limit certain risks. As a case study, we've used the US and domestic bond issue prospectuses of the Chinese issuer Huachen Energy. The onshore prospectus is in all respects weaker than its offshore counterpart. A third of the time, it sets no limitations at all (*see Appendix 1, page 12*).

The offshore prospectus is stronger because it stipulates more covenants. Also, in many cases, breaches of those covenants may trigger a default event. In the onshore prospectus, on the other hand, a breach might require an issuer to notify the bondholders' trustee, but the notification itself will not necessarily trigger even a bondholder meeting, still less a default.

For example, while the offshore prospectus places several limitations on the issuance of new debt and preferred stock, the onshore version places no special or specific limitations on new loans or indebtedness. The only obligation placed on the issuer is to notify the trustee when new loans or external guarantees in a given year exceed 20% of the issuer's net assets at the end of the previous year.

Similarly, sale and leaseback transactions are limited under the offshore prospectus, but there is no such limitation in the onshore prospectus—even on the risk that assets might be sold at an unfair price. The only recourse investors have in this respect is under Chinese bankruptcy law, in which asset sales at "an obviously unreasonable price" might be revoked, if they took place less than a year before bankruptcy proceedings began.

Clearly, where covenants are concerned, the Chinese domestic bond market has a long way to go to catch up with the standards that prevail in more mature markets. Yet change is likely as investors' knowledge of Chinese credit risks improves and—in a painful but necessary condition of an efficiently priced market—more companies are allowed to default.

As this process unfolds, what approach should investors take to the market? We don't think they should stand on the sidelines. Rather, they should be cautious buyers. We believe that investors can be agents for the change that they want to see, by continually engaging with regulators in a constructive dialogue aimed at nudging the market toward better and, ultimately, best-practice covenants.

BANKRUPTCY: CHINA GETS ITS ACT TOGETHER

For only a dozen years has China had a broad-based bankruptcy law covering all legal entities other than individuals. Previously, the bankruptcy code applied only to SOEs.

The Enterprise Bankruptcy Law of 2006 (effective June 2007) replaces 1986 legislation and is notable for drawing on the bankruptcy laws of developed markets, particularly the US. It consists of 136 articles in 12 chapters and applies to entities domiciled in China, although it extends to certain cross-border assets.

The new law clarifies and enhances previous legislation regarding liquidation. Most notably, it adds reorganization as a legal alternative to liquidation, along similar lines to Chapter 11 in the US bankruptcy code. Another significant development is the reclassification of the order of claims, particularly regarding employees. Whereas the old bankruptcy law gave workers first claim to the debtor's assets, the 2006 law ranks employee claims after senior creditors and ahead of unsecured creditors only.

8 ibid

In several respects, the law resembles those of the US and the UK, applying key concepts such as voluntary and involuntary bankruptcy, an independent administrator, involvement of creditors in the administration of the bankruptcy, restructuring and settlement, extraterritoriality, and voidable transactions. The order of priority for claims is the same as that in the US.

But there are differences in areas such as the insolvency test, criteria for commencement, who controls the bankruptcy proceedings, and the importance of the creditors' committee. For example, one major difference between the Chinese law and US Chapter 11 concerns who may propose a reorganization plan. The Chinese law gives the debtor in possession or the administrator the exclusive right to propose a plan for six months after the reorganization application has been accepted by the court (the period may be extended for another three months).

It further provides that, once exclusivity has expired, the court shall terminate the reorganization case and declare the enterprise bankrupt. In contrast, the US code gives creditors and other parties in interest the right to propose competing reorganization plans once the exclusivity period expires.

The role of the creditors' committee is also noticeably different in China, where it is not required by law. (It may be established at a creditor meeting and should include creditor and employee representatives and consist of no more than nine people.) In the US, the trustee is required to appoint a

DISPLAY 6: CHINA'S BANKRUPTCY LAW CONTAINS SOME GRAY AREAS

Enterprise Bankruptcy Law (2006): Key Innovations and Uncertainties

INNOVATION	UNCERTAINTY
The law applies to private enterprises, including financial institutions (e.g., commercial banks, insurance companies and securities companies)	Complex nature of financial institutions creates risk that Chinese regulatory or supervisory agencies might intervene in administration of bankruptcy proceedings
A voluntary bankruptcy proceeding can be initiated only if the debtor is both cash-flow and balance-sheet insolvent	Lack of transparency and uniformity of accounting standards and the practice of maintaining two sets of books and records for nonpublic companies in China could be problematic
The law purports to extend to assets of a debtor located outside China. It allows the court to recognize and enforce foreign court orders and judgments pursuant to existing treaties, international conventions or comity	There is no treaty for enforcing judgments between China and the US or UK. It is unclear whether a Chinese court would be willing to enforce a US or UK court order against assets located in China or vice versa

As of October 31, 2019
Source: Kirkland & Ellis

creditors' committee—usually made up of the seven largest unsecured creditors—as soon as practicable after commencement of Chapter 11.

The Enterprise Bankruptcy Law of 2006 also has some gray areas (*Display 6, page 8*). There remains ambiguity around what constitutes "adequate protection" for secured creditors under Chinese law. In the US code, it is clearly defined as cash payment for loss in value or replacement lien.

The 2006 law also recognizes and enforces foreign court orders and judgments, to the extent that such orders or judgments may be enforced or recognized by a Chinese court pursuant to existing treaties, international conventions or the principle of comity. So far, no such cases have come to light in the public market, and it will be interesting to see whether a Chinese court will be willing to enforce a foreign court order against assets located in China. (For a detailed comparison of the law with its US and UK counterparts, see Appendix 2, *page 14*.)

Overall, the 2006 law is sophisticated, market driven and sound. It has embraced internationally recognized insolvency concepts and procedures and has provided better protection to creditors. That no changes have taken place to the law since it was enacted (and none are envisaged) is testament to its quality.

Nonetheless, investors need to monitor how the bankruptcy law is implemented and executed. So far, the outcomes in cases of default have varied widely across different judges, provinces and courts, to the extent that no pattern has yet emerged that would provide meaningful guidance for investors.

On balance, we believe that bankruptcy protection for bond investors is evolving in the right direction in China. Improvements over the last few years have done much to encourage greater confidence in the market. As case law continues to develop, we see an opportunity for investors, law firms and market associations to work together to monitor outcomes and engage with government officials and the legal system on the need for consistency in applying the law.

DEFAULTS: A MARKET'S GROWING PAINS

China's corporate bond market has only a short history of defaults, beginning in 2014 with Chaori Solar's failure to make a full interest payment.

According to Wind Information, there were 27 defaults the following year. Defaults continued to climb in subsequent years, reaching 174 defaults in 2018 and on track to surpass that in 2019 (*Display 7, page 10*).

What has caused this escalation in defaults, and what does it mean for investors? The cause lies in a combination of government policy and economic circumstances, as the government has attempted to deleverage the economy at a time of downward pressure on economic growth.

Corporate issuers, rather than SOEs, have suffered the most. According to statistics compiled by rating agency Fitch, private companies accounted for nearly 87% of the number of bond defaults during 2018, and 90% of the principal amounts. One reason for this was the government's imposition in 2017 of tighter regulations on wealth-management plans, which reduced still further the flow of funds to corporate bonds, especially those with lower credit ratings that were already close to defaulting.

The corporate sector tends to be at a disadvantage from a funding perspective, even though private corporates are relatively efficient in terms of return on equity and return on assets, have better profitability and lower leverage than SOEs, and have made a significant contribution to China's economic growth. For historical reasons, they are underserved by the traditional banking sector and have no real option other than to resort to high-cost and short-term shadow-bank funding. This has dampened their debt servicing capability over time, especially when, as now, macroeconomic growth has begun to slow, and policy intervention has adversely affected liquidity among the shadow banks.

The prevalence of defaults in the private sector during the last two years has reinforced flight-to-quality behavior in both the traditional banking sector and the debt capital markets. Consequently, liquidity has become less available to the private sector, creating a vicious cycle.

MORE DEFAULT EXPERIENCE LEADS TO MORE ACCURATE PRICING

A spate of regional bank failures, including Baoshang Bank in May 2019 and Bank of Jinzhou two months later, threatened to exacerbate the problem by reducing interbank-market liquidity for smaller banks, which traditionally have had a higher risk appetite for lending to the private sector. The PBOC helped to steady the market and keep interbank lending rates low by supplying ample funds to the banking system.

From a longer-term perspective, however, the trend in defaults can be a welcome sign of the market's growing maturity. It shows that the government is no longer prepared to bail out defaulting entities automatically—a morally hazardous policy that encourages borrowers to take on too much debt.

A striking example of how the market has begun to evolve in this respect occurred in August 2017 with the debt restructuring of an SOE, Dongbei Special Steel (*see* "A Landmark Debt Restructuring," *page 11*). It wrong-footed the market's expectation that the defaulting bonds would be fully repaid and instead forced a more realistic revaluation of the company's debt.

The case was a landmark for China's bond markets. In the past, defaulted bonds were usually fully repaid, a practice that had hindered the development of an efficient risk-pricing mechanism. For the first time, bondholders had to agree to a deep discount on par value for a cash repayment or a debt/equity swap. This broke the traditional market expectation regarding the recovery of defaulted bonds and pointed the way to their revaluation, possibly at a more significant discount to their par value to reflect the increased risk of loss.

Greater experience of defaults and their resolution should guide the market to become more discriminating in its assessment of credit and ultimately lead to both greater differentiation between credits and more accurate pricing.

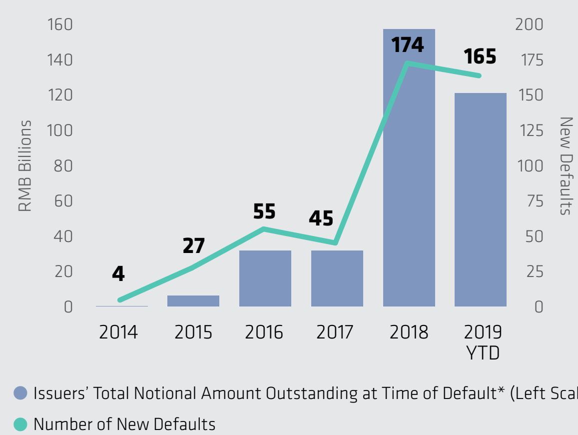
It's vital, in our view, that the Chinese government continues to break the implicit guarantee on SOEs and LGFVs, so that a proper credit culture can develop. One way to help ensure this is for investors and their intermediaries, through active and sustained conversation with government officials and regulators, to continue to encourage China in its process of market liberalization.

EVOLUTION EQUALS OPPORTUNITY

The long-term liberalization of China's capital markets, including the onshore credit market, represents an exciting opportunity for global investors. The process involves structural reform, which takes time and can be uneven in its progress. As we have seen, positive changes are taking place in four key areas for credit investors—ratings, covenants, bankruptcy and defaults—but much also remains to be done. While these changes run their course, we believe it's important that investors not passively wait in the wings for the "right time" to engage.

DISPLAY 7: CHINA'S CREDIT MARKET HAS A SHORT DEFAULT HISTORY

Onshore Bond Defaults



Through November 13, 2019
*Excludes defaults from privately placed corporate bonds (i.e., those regulated by the CSRC) issued prior to 2015; assumes that if a company defaults on one bond, it is in default on all its bonds
Source: Wind Information

INVESTORS SHOULD TAKE AN ACTIVE INTEREST WHILE CHINA'S CREDIT MARKET IS STILL EARLY IN ITS EVOLUTION

Instead, we believe that the best approach is to take an active interest while the market is still at an early stage of its evolution. This requires effort on two fronts. The first is research, to monitor progress with reforms and assess their investment implications. The second is dialogue with government officials, regulators and other influential bodies in China, to help ensure that reforms continue to steer the market toward international best practice.

Research is particularly relevant in making sense of China's credit-rating regime and tracking the evolution of bankruptcy case law. For example, dialogue may lead to improvements in bond covenants and—to the extent that it might encourage the government's increasingly market-oriented approach to defaults—help lead over time to more accurate risk pricing.

Of course, investors don't have to shoulder the burden of research and dialogue alone. They can access the research resources and contacts within China of those asset managers, investment banks, credit rating agencies, law firms and market associations that have the appropriate country expertise.

By taking advantage of these existing resources and by becoming actively involved today, investors can do much to drive the changes that they wish to see tomorrow. Indeed, with China's credit markets, evolution itself is the opportunity.

A LANDMARK DEBT RESTRUCTURING

On August 11, 2017, the Dalian Intermediate People's Court approved the proposed bankruptcy restructuring plan of Dongbei Special Steel, an SOE, which had defaulted on debt payments. This is the first case of a Chinese company adopting a debt/equity swap in resolving defaults on its publicly issued bonds.

THE MAJOR POINTS OF DONGBEI RESTRUCTURING:

RMB45.6 billion

Total Amount of Restructured Debt

RMB5.5 billion

Infusion by Two Strategic Investors in Exchange for 53% Shareholding

RMB0.5 million

Maximum Amount Each Creditor Was Entitled to as a Full Repayment of Debt

For any debt over RMB0.5 million, nonfinancial creditors and bondholders could choose either to receive a lump-sum cash partial repayment or to swap the debt in full for equity. Financial creditors had no choice but to swap.

This case indicated the government's increasingly differentiated support for SOEs. The government would provide direct financial support to defaulted SOEs only if they were engaged in activities closely aligned with national policy, or if the government was concerned that a default could have wider systemic implications. In general, the debt problems of other SOEs would be resolved through negotiations with creditors, with bankruptcy as a last resort.

As of September 30, 2019
Source: Fangda Partners

APPENDIX 1: COMPARISON OF ONSHORE AND OFFSHORE COVENANTS

	Offshore	Onshore	Comments
Limitation on Indebtedness and Preferred Stock	1. No incurrence of indebtedness and preferred stock unless (1) no default has occurred and (2) fixed charge coverage ratio would be no less than 2.5 to 1.0. 2. No incurrence of disqualified stock. 3. Carve-outs include permitted indebtedness, permitted subsidiary indebtedness for non-guarantor subsidiaries, etc. 4. The company, in its sole discretion, shall classify and reclassify items of indebtedness in one or more types of indebtedness described above.	Disclosure and a separate written notice from the company to the Ttrustee are required if the company has accumulated new loans or external guarantees in the year that exceed 20% of the net assets at the end of the previous year.	Offshore covenants prevent the company from increasing debt without proper causes or checks or balances. However, under onshore covenants, only disclosure is required if debt increases by a certain level without any remedies.
Limitation on Restricted Payments	1. No restricted payments permitted if (1) a default has occurred; (2) the company could not incur at least US$1 of indebtedness under "Limitation on Indebtedness and Preferred Stock"; or (3) such restricted payments exceed 50% of consolidated net income of the company (or minus 100% of loss) accrued on a cumulative basis. 2. Carve-outs include permitted restricted payments. 3. The amount of any restricted payments will be fair market value.	Disclosure and a separate written notice from the company to the trustee are required if the company incurs a loss of more than 10% of the net assets at the end of the previous year.	Offshore covenants provide stronger protection to bondholders, preventing the company from incurring unnecessary cash leakage out of the restricted group. However, under onshore covenants, only disclosure is required without any remedies.
Liens	1. The company will not, and will not permit any restricted subsidiary to, assume or permit to exist any lien on any of its assets or properties of any kind, unless the notes are secured equally and ratably with the obligation secured by such lien. 2. Notwithstanding the foregoing, there are permitted liens.	Disclosure and a separate written notice from the company to the trustee are required if the company has accumulated new loans or external guarantees in the year that exceed 20% of the net assets at the end of the previous year.	Offshore covenants ensure that no new, senior claims are added to the company's assets, which may hinder the ability to repay notes. Under onshore covenants, only disclosure is required without remedies.
Change of Control Triggering Event[9]	Repurchase of notes upon a change of control triggering event.	A relevant clause covers when management personnel are unable to perform their duties normally, resulting in material repayment uncertainty over the company's debt, in which case only a written notice from the company to the trustee is required.	Offshore covenants grant noteholders a put option upon change of control triggering event. Where the company fails to make or consummate an offer to purchase under this covenant, an event of default is automatically triggered on the notes. Under onshore covenants, although the change of control event, as defined in offshore covenants, shall be deemed to have material impact on the company's ability to pay, only a written notice from the company to the trustee is required.
Cross-Default Clauses	An event of default with respect to any Indebtedness of the company or restricted subsidiaries having an outstanding principal amount of US$15 million will trigger cross-default to the notes.	Disclosure and a separate written notice from the company to the trustee are required if the company fails to make any debt payment when due.	Offshore covenants protect bondholders' interest by automatically triggering cross-default on the default of any indebtedness above a minimum size. The most relevant onshore covenants require only the company's disclosure and a separate written notice to the trustee.

9 "Change of Control Triggering Event" means the occurrence of a Change of Control and a Rating Decline. The Company may trigger the Event of Default only upon the occurrence of both a Change of Control and a Rating Decline, as well as the failure to make an Offer to Purchase.

	Offshore	Onshore	Comments
Asset Sales	1. No asset sales unless: (1) no default; (2) consideration received is at least equal to fair market value; (3) at least 75% of consideration received consists of cash or replacement assets. 2. Net cash proceeds may only be applied to (1) repay senior indebtedness, (2) repay the notes or any pari passu debt, or (3) acquire replacement assets.	Disclosure and a separate written notice from the company to the trustee are required if the company incurs a loss of more than 10% of the net assets at the end of the previous year.	Offshore covenants aim to ensure that the Company retains its assets. The net cash proceeds shall be used for permitted specific purposes, and there should be no excess proceeds remaining. There are no specific covenants onshore which limit asset sales.
Consolidation, Merger and Sale of Assets	1. No merger or disposal of all or substantially all the company's and its restricted subsidiaries' properties and assets, unless such conditions are met as no default, surviving person, officers' certificate, no rating decline, etc. 2. Carve-outs include internal consolidation, namely mergers or consolidation of any subsidiary guarantor with and into the company or any other subsidiary guarantor.	Disclosure and a separate written notice from the company to the trustee are required if the company reduces capital, merges, dissolves or applies for bankruptcy.	Offshore covenants, in principle, restrict mergers of the company and restricted subsidiaries to ensure sustainable debt serviceability of the notes, which is absent in onshore covenants.
Transactions with Shareholders and Affiliates	1. No transactions with (1) any holder (or any affiliate of such holder) of 10% of more of any class of capital stock of the company or (2) any affiliate of the company. 2. Two conditions for permitted affiliate transactions.	None	Offshore covenants prevent the company from transferring assets or damaging the creditor's interests by engaging in businesses with unfair terms. Onshore covenants have no such clause.
Limitation on Sales and Issuances of Capital Stock in Restricted Subsidiaries	1. No issuance or sale of capital stock of the company or any restricted subsidiary. 2. Four carve-outs for this proviso, including that net cash proceeds of such issuance or sales should be applied in accordance with the Limitation on Asset Sales covenant.	None	Offshore covenants prevent dilution in shareholding structure without applying the net cash proceeds of any issuance or sale to proper uses. There are no comparable covenants in onshore bonds.
Issuances of Guarantees by Restricted Subsidiaries	1. Restricted subsidiaries, which are not subsidiary guarantors, will not be permitted to guarantee any indebtedness of the company or any restricted subsidiary. 2. Two exception to the foregoing proviso, under which issuance of such guarantees will be permitted.	Disclosure and a separate written notice from the company to the trustee are required if the company has accumulated new loans or external guarantees in the year that exceed 20% of the net assets at the end of the previous year.	Offshore covenants ensure that the notes will receive pari passu guarantee from nonsubsidiary guarantors if they guarantee any Indebtedness, directly or indirectly.
Limitation on Dividend and Other Payment Restrictions Affecting Restricted Subsidiaries	No encumbrance or restriction on the ability of any restricted subsidiary to pay dividend on any capital stock owned by the company.	None	Offshore covenants ensure the issuer's debt serviceability by removing hindrances to the restricted subsidiaries' upstream dividends. However, under onshore covenants, there is no such a concept as restricted subsidiaries.
Use of Proceeds	The company will not, and will not permit any restricted subsidiary, to use proceeds other than in the approximate amounts and for the purposes specified.	None	No specific limitations under onshore covenants on use of proceeds. The company shall be diligent and comply with relevant laws and regulations.
Suspension of Certain Covenants	If the notes have a rating of investment grade from at least two rating agencies and no default has occurred, some provisions will be suspended.	None	Onshore covenants stipulate that a change of ratings constitutes a significant event, of which the company shall notify the trustee.

APPENDIX 2: COMPARISON OF KEY ASPECTS OF US CHAPTER 11, UK ADMINISTRATION AND CHINESE BANKRUPTCY LAW

Item	US Chapter 11	UK Administration	Chinese Bankruptcy
Applicable Law	US Bankruptcy Code	Insolvency Act 1986	China's Enterprise Bankruptcy Law of 2006
Applicable Supervisory Court	US Bankruptcy Court	High Court of England & Wales	The People's Court in the debtor's domicile
Purpose	Reorganization—requirement of insolvency (cash flow test only for involuntary petitions instituted by creditors).	Rescue, or achieving a better result for creditors than if the company were immediately wound up, or realizing property to make a distribution to secured or preferential creditors (in that order)—requirement for insolvency (cash flow or balance sheet).	Reorganization, conciliation or liquidation, with a requirement for insolvency (cash flow and balance sheet for voluntary proceedings and cash flow only for involuntary proceedings).
Commencement	Court petition by debtor or three creditors holding noncontingent, undisputed claims aggregating at least $12,300 more than the value of any collateral.	Court petition by debtor, debtor's directors or creditors, or out-of-court appointment by debtor or its directors, or the holder of a qualifying floating charge.	Court application by debtor or creditor.
Moratorium	Yes, extensive—upon filing of petition. Applies unless leave of court is given. In some cases, can be extended to actions against third parties if necessary to protect debtor.	Yes, extensive—from date application to court is made or when notice of intention of appointment of administrator is filed with the court or (where no notice is necessary) from the time the relevant forms are filed with the court. Applies unless leave of court is given.	Yes, limited—once the application for bankruptcy is accepted by the court, any litigation or arbitration involving the debtor is suspended but can be resumed once the administrator is designated. Also, a 15-day window period between time of filing petition and grant of bankruptcy, during which creditor may foreclose against its collateral.
Control of Procedure	Debtor remains in possession unless a trustee is appointed by the court for cause, including fraud, dishonesty, incompetence or gross misconduct. Examiner may also be appointed to investigate debtor's affairs.	Registered insolvency practitioner (administrator), who is usually an accountant, is an "officer of the court" and has duties to the court and the creditors. Management of debtor transfers to the administrator. Director's powers are suspended. Administrator may delegate powers back to directors and management as appropriate. The administrator is appointed by the petitioning party.	Debtor in possession and/or court-designated administrator may manage the affairs of the debtor. The creditors' committee can be actively involved in the management of the debtor's affairs.
Secured Creditors	Entitled to adequate protection (e.g., cash payment for loss in value, replacement lien).	Have first-priority protection and the right to enforce their security and appoint an administrator before other creditors.	General provision permitting adequate protection. What constitutes "adequate protection" is unknown.
Claim Priorities	Secured, bankruptcy expenses, priority claims (e.g., taxes), unsecured claims.	Secured, expenses, preference claims, unsecured claims.	Secured, bankruptcy expenses, priority claims, unsecured claims.
Creditors' Committee	Yes. As soon as practicable after commencement of Chapter 11, the US trustee appoints a creditors' committee, usually made up of the seven largest unsecured creditors willing to serve.	Optional, to be decided by the creditors' meeting. At the first meeting of creditors (maximum 10 weeks after appointment) the administrator may appoint a creditors committee—membership optional.	May be established at the creditors' meeting. Will include creditor and employee representatives. A maximum of nine persons.

Item	US Chapter 11	UK Administration	Chinese Bankruptcy
Proposal to Creditors	Only the debtor may propose a reorganization plan for the first 120 days after petition, which exclusivity may be extended up to 18 months after the petition date. After this period, the creditors' committee or an individual creditor may propose a plan. Debtor also has 180 days to obtain acceptances of the plan from impaired creditors and shareholders, which period may be extended to 20 months after the petition date. A court-approved disclosure statement must precede the solicitation of votes on the plan. Applies to all claims and equity interests.	Within eight weeks of commencement of administrator's appointment (or longer period as court may specify), the administrator must send his proposals for achieving the purposes of the administration to the creditors and within 10 weeks of commencement of appointment present these proposals to the creditors' meeting. Meeting may accept, reject or accept with modifications the proposals.	Only debtor or bankruptcy administrator may propose a reorganization plan with a six-month exclusivity period, which may be extended for three months. Four classes of creditors are entitled to vote on the plan: secured creditors, workers' compensation claimants, tax claimants and other general unsecured creditors.
Method of Exit from Process	The objective in a reorganization case is the confirmation of the plan. A plan is the master document that provides for the recoveries by all interest holders and creditors, and the transactions through which the debtor will carry out its plan. A plan confirmed by the court is binding on the debtor, all interest holders and creditors (even dissenting ones); except in rare cases, certain debts cannot be discharged by a debtor.	The administrator may propose a company voluntary arrangement (CVA), which will act as a contractual variation of creditors' claims against the company, or a scheme of arrangement, which is a court-sanctioned arrangement between a company and its creditors (or any class of them) or its debtors. A distribution may also be made within the administration.	A plan provides for the recoveries by all interest holders and creditors, and the transactions through which the debtor will carry out its plan. A plan confirmed by the court is binding on the debtor, the creditors and the interest holders. The administrator is authorized to supervise the implementation of the plan, and reports to the court.
Voting Requirements for Approval of Plan	A majority in number and two-thirds in value for each affected class present at the creditors' meeting for plan voting. All classes must approve for a plan to be effective, but cramdown applies subject to specified factors similar to those under Chapter 11.	For a CVA, 75% in value of those creditors present and voting at meeting. For a scheme, a majority in number and two-thirds in value for each affected class. Cramdowns apply.	A majority in number and two-thirds in value for each affected class present at the creditors' meeting for plan voting. All classes must approve for a plan to be effective, but cramdown applies subject to specified factors similar to those under Chapter 11.
Expenses	Paid from bankruptcy estate, subject to strict court supervision. Expenses have priority.	Costs of the administration are paid after fixed charges but before all other claims. Priority of payments within this category is set down in law. The remuneration of the actual administrator is toward the bottom end of this list.	Paid from bankruptcy estate. Administrator's expenses subject to creditors' committee review and court approval. Bankruptcy expenses are paid at first and second priority.
Recognition of Foreign Proceedings	Centralizes the process of recognition of foreign proceedings (both main and nonmain proceedings) in the bankruptcy courts. Upon recognition of the foreign proceeding, several provisions of the Bankruptcy Code automatically apply with respect to the debtor and all of its property within the territorial jurisdiction of the United States, including the "adequate protection" of a secured creditor's interest in property of the debtor, the automatic stay, and the right of the foreign representative to use or sell the debtor's property and adequate protection of the interests of secured creditors. Additional assistance may also be granted, subject to standards.	Regimes apply to recognize foreign proceedings, depending on the location and type of proceeding. The EC Regulation on Insolvency Proceedings applies to European proceedings, section 426 of the Insolvency Act applies to Commonwealth proceedings, and the Cross-Border Insolvency Regulations 2006 (implementing the UNCITRAL Model Law, as Chapter 15 of the Bankruptcy Code does in the US), recognizes proceedings and grants relief depending on whether the proceedings are foreign main or nonmain. Court discretion generally applies.	Under limited circumstances, permitting recognition of foreign orders and judgments, based upon principle of comity or international convention. Details on implementation of such provision need to be developed.

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