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The Capital Market and Credit Rating in China

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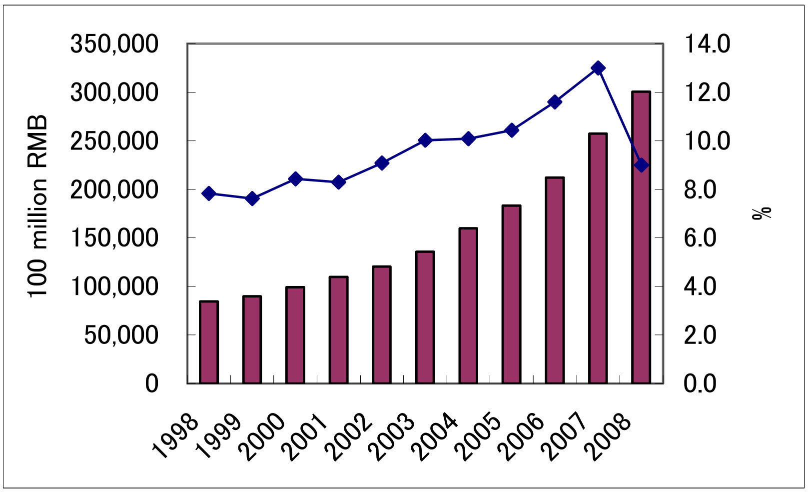
A. The Capital Market in China

A-1 Introduction

China has continued the double-digit growth between 2003 and 2007 (see Figure1). In 2008, to the first half of year, China has continued good economic performance by the

Figure 1 Level of Nominal GDP and Growth Rate of Real GDP (1998–2008)[a]



[a] 2008 is preliminary.
Source: 1998–2006, National Bureau Statistics (2008)
2007–2008, National Bureau Statistics (2009)

help of Olympic effect, but since fall of this year, "Financial Tsunami" also hard-attracted Chinese economy. Chinese economy experienced severe slowdown. To response of this economic crisis, Chinese government decided to the huge fiscal expenditure, which amounts to 4,000 billion RMB (Ren Min Bi, 人民幣), to launch the several policies stimulating domestic demand. At the same time, Chinese government also plans the industrial restructuring policy, that stimulate to the growth in the spinning, iron, automobile etc. nine selected industries.

As policies related to capital market, the focus is on the improvement of market for the efficient allocation of financial resources. In the stock market, government intends to enhance the special board for small and medium enterprises and start the special board for venture enterprises, as such, establish much type of stock markets. On the other hand, government also promotes to realize the efficient resource allocation by M&A.

On the other hand, for bond market, government enhances the total volume of bond issue and develop the markets of various types of bonds—corporate bonds, CP, short term bill etc. Especially government intends to develop steady "collective bonds for small and medium enterprises" and makes model case of issuance of short term CP by small and medium enterprises.

Thanks to these policies, in the first half of 2009 Chinese economy achieved 7.1 percents growth compared with the same period of the last year. The Chinese economy is expected as the engine toward the recover of world economy.

A-2 Corporate Finance of Chinese Enterprises

At the outset, we survey Chinese capital market from the viewpoint of the corporate finance. Table1 depicts the structure of corporate finance of Chinese enterprises by internal and external funds. Table1 is constructed from the figures of non-financial corporation sector in "Flow of Funds Accounts for Financial Transaction" Table.

Table 1 The Structure of Financial Funds in Non-financial Corporations (1992-2006)

a. Value (100 million RMB)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Internal Funds[a]	3533.7	3447.3	5727.1	4889.0	7730.7	6523.7	5096.9	6665.8	9967.4	8077.0	10197.1	16673.0	18863.3	14722.0	28092.0
External Funds[b]	6876.2	9119.7	12410.1	12968.4	19698.5	15161.1	13543.4	13084.4	15236.7	13802.0	20646.8	31204.0	27944.0	29439.0	37729.0
Total	10409.9	12567.0	18137.3	17857.4	27429.2	21684.8	18640.3	19750.2	25204.1	21879.1	30843.8	47877.0	46807.3	44161.0	65821.0

b. Proportions (%)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Internal Funds[a]	33.9	27.4	31.6	27.4	28.2	30.1	27.3	33.8	39.5	36.9	33.1	34.8	40.3	33.3	42.7
External Funds[b]	66.1	72.6	68.4	72.6	71.8	69.9	72.7	66.2	60.5	63.1	66.9	65.2	59.7	66.7	57.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

[a] Uses of Funds in "Flow of Funds Accounts" Table
[b] Sources of Funds in "Flow of Funds Accounts" Table
Sources: *Almanac of China's Finance and Banking* (various years)

"Internal Funds" in Table1 corresponds to "Uses of Funds" of "Flow of Funds Accounts" and "External Funds" corresponds to "Sources of Funds". The proportion of internal funds, although it shows the trend to rise in recent years, is only about 43 percents in 2006.

As Imai and Watanabe (2006) mentioned according to the data by 2000, the Chinese characteristic of corporate finance is the low proportion of internal funds (retained profits and depreciation) compared with American enterprises, Japanese enterprises etc. As the main reason of this phenomenon, they suggested the reason because Chinese (state-owned) enterprises had submitted the residual profit, that capitalist enterprises can retain in own budget, to government. Although recently this reason is weaker and weaker, but our Table1 suggests the tendency to depend on external funds in excess still remains in Chinese corporations.

Then we see what about the structure of external funds. Table2 is also constructed from "Flow of Funds Accounts for Financial Transaction" Table. Table2 describes four

Table 2 The Structure of External Financial Funds in Non-financial Corporations (1993-2006)

a. Value (100 million RMB)

Items	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Loans	7063.1	8802.9	9696.3	15041.3	11297.7	10148.5	9140.4	9317.8	9413.6	14486.0	23735.0	17707.6	19166.0	26403.0
Corporate Bonds	85.1	45.0	−24.7	74.6	35.4	41.6	101.7	100.0	147.0	325.0	358.0	327.0	2010.0	2266.0
Shares	198.0	49.6	22.7	306.2	1473.0	835.2	926.4	2099.7	1251.9	961.7	1438.0	1686.7	1075.0	2814.0
Foreign Assets & Debts[a]	2338.5	4355.0	4761.5	5071.7	4269.5	3890.5	4277.0	4775.6	3439.6	4324.3	4297.0	6087.6	8562.0	7273.0
Total	9684.6	13252.5	14455.8	20493.7	17075.6	14915.8	14445.5	16293.1	14252.2	20097.0	29828.0	25808.9	30813.0	38756.0

b. Proportions (%)

Items	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Loans	72.9	66.4	67.1	73.4	66.2	68.0	63.3	57.2	66.1	72.1	79.6	68.6	62.2	68.1
Corporate Bonds	0.9	0.3	−0.2	0.4	0.2	0.3	0.7	0.6	1.0	1.6	1.2	1.3	6.5	5.8
Shares	2.0	0.4	0.2	1.5	8.6	5.6	6.4	12.9	8.8	4.8	4.8	6.5	3.5	7.3
Foreign Assets & Debts[a]	24.1	32.9	32.9	24.7	25.0	26.1	29.6	29.3	24.1	21.5	14.4	23.6	27.8	18.8
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

[a] "International Capital Flow" before 1996. The total in "Foreign Direct Investment" and "Other Forerign Assets & Debts" after 1997.
Sources: *Almanac of China's Finance and Banking* (various years)

items which compose "Source of Funds" of non-financial corporation—Loans, Corporate Bonds, Shares and Foreign Assets & Debts (the total of these four items in Table2 is not same as external funds in Table1, i.e. total of "Sources of Funds", because the other items are included in "Source of Funds").

From Table2, we can understand Chinese enterprises largely depend on indirect finance (bank loans). In 2006, the proportion of loans is 68.1 percents. Although annual fluctuation is relatively large, foreign assets & debts also composes not small parts (18.8% in 2006). On the other hand, one of direct finance, share finance is also largely fluctuating each year, but tends to increase steadily. In absolute value, shares have increased from 198 (100 million RMB) in 1993 to 14 times or more, 2,814 in 2006. In proportion, shares have increased from only 2.0 percents in 1993 to 7.3 percents in 2006. Lastly another direct finance, bond finance is the smallest among others now. But it seems that this item has rapidly increased after 2005. The proportion of bond finance is 5.8 percents in 2006. We would like to mention the development of Chinese bond market in detail later.

A-3 Stock Market in China

A-3-1 The kinds of stock traded

In 1990 two stock exchanges are established in Shanghai and Shenzhen, the stock market is boned in China. In 1993 *Company Law* was issued (was enforced in July 1994). This law provided two type enterprises, "Limited liability corporations" and "Share-holding corporations limited " as company that two or more shareholders invest to. The number of listed companies was only 10 in 1990, but increased to over 1,550 (CSY 2008) now.

In China, the share of listed companies consist of two types—"tradable share" and "non-tradable share". "Non-tradable share" has occupied over 60 percents of all shares by recent day. Furthermore "non-tradable share" consists of two types—"state share" which central and local governments hold and "state-owned share" which state-owned enterprises hold. "State share" has occupied near four-third of all "non-tradable share". The large parts of Chinese listed companies were established by restructuring of former state-owned enterprises. "Non-tradable share", especially "state share" existed because government holds the rights to state-owned assets as owner.

One of the main reasons that Chinese government promotes the reform of capital market is that improves corporate governance of Chinese enterprises through the work of capital market. Formally *Corporate Law* and *Securities Law* provide corporate governance. For listed companies the "Code of Corporate Governance for Listed Companies" (2002) also specially provides related condition. According to these standards, managing board and auditing board are obligated to establish under shareholders' meeting. It is formally the same as governance system of western-style enterprises.

The improvement of the corporate governance of Chinese enterprises, however, has not advanced easily. The government came to recognize the problem is in the existence of "non-tradable share" gradually. Hence government tied to translate "non-tradable share" into "tradable share" (sell "non-tradable share" in the stock market) in 1999 and 2001. But both trials failed due to the declining of stock price.

After that, in September 2005, the government restarted "non-trading share" selling plan. The government recognized the past twice failures were due to repulsion by the existing tradable share's holders. So in this time government considered their interests. Concretely, the existing tradable share holders are compensated by the voluntary conveyance of the stocks and money etc. Moreover the agreement of three-second existing tradable-share holders in shareholders' meeting is needed for conducting the reform in each company. This plan succeeded. By the end of July 2007, about 90 percents listed companies completed non-tradable share reform.

On the other hand, tradable shares consist of A-share, B-share and Foreign Market Listed Foreign Currency-share. A-share is invested to by domestic general investors deal in RMB basis, A-share is listed in Shanghai and Shenzhen Exchanges. Originally only domestic investors can invest to A-share, however, as mention later, foreign investors can also invest to A-share after introducing QFII.

B-share is issued for foreign investors, is also listed in Shanghai and Shenzhen Exchanges. The face values are in RMB basis, but are dealt in foreign currency basis. After February 2001, domestic investors can also invest to B-share. Lastly, Foreign Market Listed Foreign Currency-share indicates shares is issued for foreign investors and are listed in foreign capital market. These shares are named H-share (Hong Kong Exchange), N-share (New York Exchange) etc. by the exchange markets listed.

A-3-2 Regulation for stock issuance

The stock issuance (IPO and capital increase) by listed companies is regulated by The China Securities Regulatory Commission (CSRC), which belong to the State Council. Before 1998, government decided annual value of issuance (quota) and the number of issuing companies and recommended the companies to CSRC. But in 1989, *Securities Law* took effect, the system, the formation of quota and recommendation by government, was abolished.

From then on, *Corporate Law* and *Securities Law* regulate the issuance of share. In 2006, both laws are revised, share issuance related rules integrated in revised *Securities Law*. Today the company which wishes to issue shares and list in Stock Exchange is recommended by the undertaking securities company, and then applies to CSRC and Stock Exchange. "Share Issuance Reviewing Commission" of CSRC finally decides to permission. The review items in permitting process are current state of corporate governance, management condition, financial condition, and risk disclosure items.

As mentioned above, although IPO is gradually deregulated, authorities are taking a final power to make decisions. So actual operations depend on the market environment, the introduction of new system etc. As recent example, from April 2005 to May 2006 IPO is prohibited with conducting reform of non-tradable shares (Nomura Institute of Capital Markets Research 2008, p.51).

Furthermore, on June 25, 2004 "board for small and medium enterprises" is opened as a part of the main board of Shenzhen Exchange. After that this board become to be an independent market. The companies of listing on "board for small and medium enterprises" are demanded to fill special requirements such that the improvement of transparence in trading, decreasing of price variation risk, the strength of corporate disclosure etc.

A-4 Bond Market in China

A-4-1 Instruments traded

There are five major types of instruments traded in Chinese bond market: (i) Ministry of Finance-issued China Government Bonds, (ii) People's Bank of China Central Bank (PBC) Bonds, (iii) Financial Bonds issued by government-backed policy banks and financial institutions, (iv) Corporate Bonds issued by domestic corporations, and (v) Commercial Papers issued by either securities firms or private corporations. Table3 describes the number and volume of these instruments in 2008. Firstly, Central Bank Bonds shows the largest

Table 3 Bond Issue Volume in China (100 million RMB, 2008)

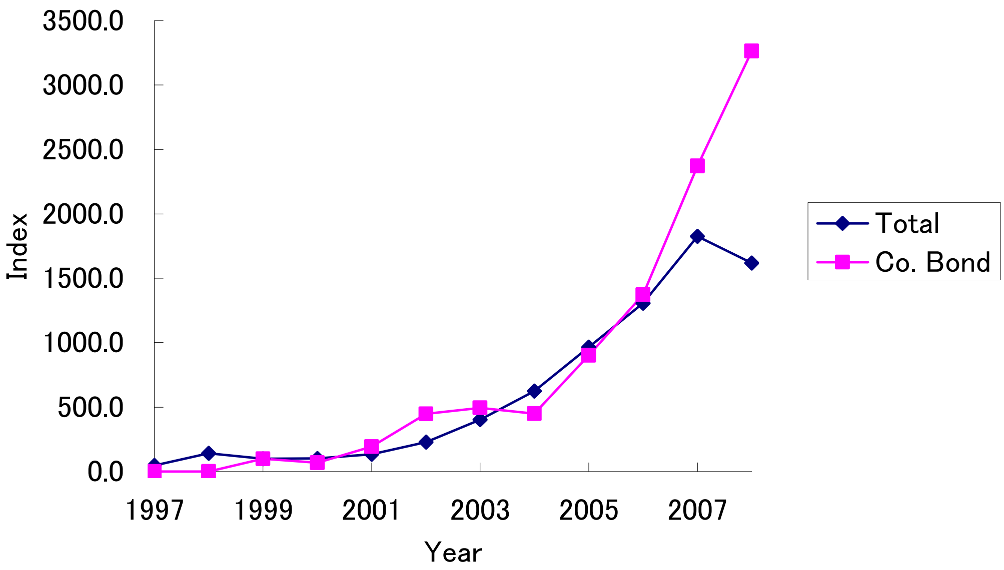
	Number	Volume	% of Vol.
Total	642	70,727.11	100.0
Government Bonds	29	7,246.39	10.2
Treasury Bonds	26	6,665.00	–
Savings Bonds (Electronic)	3	581.39	–
Central Bank Bonds	122	42,960.00	60.7
Financial Bonds	85	11,783.30	16.7
Policy Bank Bonds	58	10,809.30	–
China Development Bank	24	6,200.00	–
Export-Import Bank of China	14	1,793.70	–
Agricultural Development Bank of China	20	2,815.60	–
Commerial Bank Bonds	27	974.00	–
Non-bank Financial Institution Bonds	0	0.00	–
Corporate Bonds	71	2,366.90	3.3
State-owned Corporate Bonds	27	1,683.00	–
Local Corporate Bonds	44	683.90	–
Commercial Papers	268	4,331.50	6.1
Asset-backed Securities/Mortgage-backed Securities	26	302.01	0.4
Middle Term Notes	41	1,737.00	2.5

Source: www.chinabond.com.cn

proportion among others (60.7%). This kind of bonds is introduced by PBC for open market operation in 2003. Secondly although as mentioned below corporate bonds market is growing rapidly, but the volume of it still relatively small, the proportion in total is only 3.3 percents. Thirdly Corporate Bonds consist of two types—one issued by state-owned corporations and another issued by local corporations, the former accounts for 70 percents over in volume.

Figure2 indicates the recent trend of bond market from 1997 to 2008 (Index, 1999=100). From this figure2, we can know recent development of total Chinese bond

Figure 2 Trend of Bond Issue Volume in China (Index, 1999=100)



Source: www.chinabond.com.cn

market is remarkable. Although as saw in Table3 the volume of Corporate bonds market is still small, however, Figure2 shows the growth of this market is more rapid than total in resent year (total issue volume is decreasing in 2008 because Treasury Bonds is decreasing).

Corporate bonds in Table3 and Figure2 mean "Qiye zhai" (企業債) in Chinese. This type of bonds is issued by state-owned enterprises or state-owned institutions. But in Chinese corporate bonds market there is another type of bonds—"Gongsi zhai" (公司債, "Enterprise bonds"). "Enterprise bonds" are not included in Table3 and Figure2. This types of bonds is issued by "Limited liability corporations" and "Share-holding corporations limited" which are provided by *Corporate law*. In China, the institution which is not corporation provided in *Corporate Law* issues the bonds for financing the national projects. This is also a kind of "Enterprise bonds". The issuance of "Enterprise bonds" is regulated by "Management regulation of enterprise bonds" (August 3, 1993). The issuance of "Corporate bonds" is regulated by *Corporate Law* and *Securities Law*.

A-4-2 Regulation to bond issuance

The National Development and Reform Commission (NDRC)—formerly the State Planning Commission—approves and regulates the issuance of corporate bonds. At first the company which intends to issue corporate bonds are required a checkup of the scale of corporate bonds issuance. State-owned enterprises through the supervisory authorities and local enterprises through the local branches of NDRC apply for issuance quota. After approval of quota, each enterprise must receive the verification and the approval of the issuance by NDRC. PBC and the China Banking Regulatory Commission (CBRC) examine the application.

As mentioned above, the authorities' tendency to control bonds issue had been strong until recent time. It was reason why the large volume of bonds was issued from 1980's to the middle of 1990's, the defaults happened frequently. Recently, however, the policy gradually changes to promoting the issuance (wide sense) corporate bonds. About the issuance of "Enterprise bonds", the CSRC promulgated "Trial Regulation on the Issuance of Enterprise Bonds" on August 14, 2007. This regulation, which regulates only the issuance by the listed companies, provides that "Enterprises bonds" by the listed companies are issued under supervision of *Corporate Law* and *Securities Law*.

On the other hand, on January 2, 2008, as approved by the State Council, NDRC announced *the Notice on Matters Concerning Pushing forward Corporate Bond Market Development & Simplifying Issuance Examination and Approval Procedures.* This notice treats the issuance of "Enterprise Bonds" by unlisted enterprises and "Corporate Bonds" by the enterprises established under *Corporate Law*. This notice streamlined the previous "two-step" procedure into a "one-step" procedure of straight-through examination and approval of a corporate bond issuance.

A-5 Investors of bonds

Major investors in Chinese bond market are state-owned commercial banks, share-holding commercial banks, nonbank financial institution, which includes securities companies, credit cooperatives, securities investment funds, and cooperatives. On the other hand, the weight of households (individuals) as investors is not large still now. Table4 describes the structure of financial transaction flow in households. From

Table 4 The Structure of Financial Transactions in Households (1992–2006)

a. Value (100 million RMB)

Items	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Currency	857.1	1133.0	1066.8	447.0	783.1	1221.6	850.8	1868.6	993.7	873.9	1319.1	2048.0	1434.2	2128.0	2524.0
Deposits	2693.9	3369.1	6169.9	7722.7	8515.2	7496.0	9257.1	7280.5	6609.9	9973.3	14251.7	16560.0	15678.2	21053.0	21284.0
Securities[a]	845.4	497.9	473.3	608.0	1566.1	2188.6	2179.3	2491.6	2223.4	1907.7	1514.8	1307.0	511.1	1086.0	6017.0
Insurance Technical Reserves	52.5	61.6	56.5	90.7	127.3	278.2	298.3	572.9	1247.0	1155.9	2543.1	3036.0	3515.8	4202.0	4365.0
Total	4448.9	5061.6	7766.3	8868.3	10991.7	11184.5	12585.4	12213.6	11073.9	13910.7	19628.7	22951.0	21139.4	28469.0	34190.0

b. Proportions (%)

Items	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Currency	19.3	22.4	13.7	5.0	7.1	10.9	6.8	15.3	9.0	6.3	6.7	8.9	6.8	7.5	7.4
Deposits	60.6	66.6	79.4	87.1	77.5	67.0	73.6	59.6	59.7	71.7	72.6	72.2	74.2	74.0	62.3
Securities[a]	19.0	9.8	6.1	6.9	14.2	19.6	17.3	20.4	20.1	13.7	7.7	5.7	2.4	3.8	17.6
Insurance Technical Reserves	1.2	1.2	0.7	1.0	1.2	2.5	2.4	4.7	11.3	8.3	13.0	13.2	16.6	14.8	12.8
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

[a] "Securities Investment Funds" and "Margin Deposits with Securities Trading Accounts" are included after 2005 and 2006.
Sources: *Almanac of China's Finance and Banking* (various years)

this table4, we can see that deposits cover very large part of financial structure in households. On the other hand, the proportion of securities (share, bonds etc.) is limited ("Securities" includes "Securities Investment Funds" and "Margin Deposits with Securities Trading Accounts" after 2005). The proportion of Insurance Technical Reserves tends to increase rapidly in recent years.

We focus, in turn, our attention on the corporate bonds. Table5 describes the holding structure of the corporate bonds in end of 2008. The main investors of the

Table 5 Corporate Bonds Holding Structure (End of 2008)

	Value (100 Millions RMB)	Proportions (%)
Sum	6803.45	100.0
Special Members	51.88	0.8
Commercial Banks	1856.18	27.3
National Commercial Banks	1489.1	21.9
Foreign Banks	0	0.0
City Commercial Banks	129.58	1.9
Rural Commercial Banks	176.31	2.6
Rural Cooperative Banks	61.19	0.9
Others	0	0.0
Credit Cooperative Banks	391.44	5.8
Non-bank Financial Institutions	141.11	2.1
Securities Companies	161.99	2.4
Insurance Institutions	3106.41	45.7
Funds Institutions	578.78	8.5
Non-financial Institutions	77.47	1.1
Inter-bank Market	76.86	1.1
OTC Market	0.61	0.0
Individuals	0.66	0.0
Exchanges	434.74	6.4
Others	2.78	0.0

Source: www.chinabond.com.cn

corporate bonds are insurance institutions, national commercial banks, credit cooperative banks etc. As expected, the proportion of individual is negligible small.

A-6 Cross-border Financial Transaction

RMB is not fully convertible. In July 2005, the exchange rate was revalued to 8.11 RMB per USD1. From then on, a managed floating-rate system is maintained. Under this scheme RMB is allowed to move against the USD within a narrow 3 percents parity range published daily by PBC.

In China cross-border capital account transaction is not also fully liberalized. But it is said that the restriction of capital inflow from abroad relatively ease. Firstly the domestic investment by foreign Chinese is allowed. Secondly general foreign investors are also allowed to invest B-share. On the capital outflow, the loophole through current transaction, which is liberalized, exists. For example, foreign trading agency may declare lower export price than actual level, using the difference for investing abroad (Imai and Watanabe 2006, pp.279-280).

After November 2001 China joined WTO, however, the reform that reduces inside-outside difference in capital transaction progresses. After December 1, 2002, foreign investors approved as Qualified Foreign Institutional Investors (QFII) from CSRC was able to invest to domestic shares and bonds within the quota approved from State Administration Foreign Exchange (SAFE). But the investment in interbank bond market, which is almost large part of bond trading, still is not open for foreign investors. The investors approved under QFII system have been limited by investment trust operation company, insurance company, securities company, commercial banks etc.

On the other hand, April 13, 2006, putting out the notice, PBC allowed domestic banks and fund managing companies that approved as Qualified Domestic Institutional Investors (QDII) to invest foreign securities. Recently because PBC is continuing to intervene currency market by selling RMB and purchasing Foreign Currency for stabilizing exchange rate, enormous amount of foreign reserve has been accumulated. QDII system was introduced for softening this unbalance.

A-7 Obstruction Factors for Bonds Finance

The main impediment to exponential development in Chinese bond market, albeit its huge potential is the inadequacies of bankruptcy law, relevant court experiences and professionals. Because of this limitation, issuance still be restricted to relatively high investment grade insurers because there are uncertainties for investors to protect their interests.

The government's macro economic control policy targets on curtailing growth of bank loans and it stimulates strong growth in commercial paper issuance. However, longer term corporate bond issuances are still hindered by more stringer regulatory requirement. As such, it cannot help Chinese corporate to lengthen the maturity of their debt structures, which are highly skewed to short term bank loans and CP.

China bond market has several regulators and different corporate debt products have different regulators. Thus, it has complicated regulatory structure and the development of bond and rating market will be hinged on co-ordination among various regulators.

In November 2005, Xiaochuan Zhou, governor of PBC pointed out some problems in Chinese corporate bond market at the BIS/PBC seminar on "Developing corporate bond markets in Asia" held in Kunming, China. Although several reforms have been implementing according to his remarks, basic problems, however, have been still remained. Zhou's main points are as follows (Zhou 2005):

1) The administrative allocation of quotas for issue size and number of issuers was mandated by governments, often used as a relief measure for bad performance enterprises. 2) The absence of a credit rating system made it impossible for investors to obtain a clear idea of risks. 3) There was a lack of information disclosure to investors. 4) Administrative pricing of corporate bonds and price controls. 5) Authorities required bank guarantees for corporate bond issuance. 6) Bond issues were targeted at retail rather than institutional investors. 7) Effective market discipline was not established. 8) Investor education was not sufficient. 9) The current Bankruptcy Law did not provide investors with effective liquidation. 10) The underwriter's role was not properly defined. 11) Administrative intervention was even stronger in cases of corporate issuer default.

Governor Zhou adds to two maybe more fundamental points as follows (Zhou 2005): Firstly because the savings rates are high and liquidity are abundant in China, corporations with good credit status, that also can easily obtain loans from commercial banks in advantageous terms, don't have strong motivation to issue bonds. Secondly since the RMB is not a fully convertible currency, although QFII started, the access to the market by foreign institutions has been basically limited.

B. The Credit Rating System in China

B-1 Historical Overview of Development in Credit Rating Industry

Jingxiong Li proposes the good historical overview of development in Chinese credit rating industry (Li 2007, pp.11-15). He divides whole history of credit rating industry in China into three stages—first stage (1987-1997), second stage (1997-2003) and third stage (2003-2007). We briefly summarize his each stage for our purpose.

i) First stage (1987-1997):

"Tentative Ordinance Enterprise Bonds Management" (now "Management Regulation of Enterprise Bonds") was promulgated in 1987, and the government came to execute united management to enterprise bonds. PBC and the State Planning Commission (now, NDRC) proposed the plan to establish "the Credit Rating Institutions" in local place. Consequently, about 20 credit rating institutions under PBC were established one after another.

From then on, the State Council, however, decided to close such credit rating institutions because the economy was over-heated in 1988. In 1989 all of the credit rating institutions that PBC and Special Banks established were closed. Their task was transferred to "Credit Rating Committees" as the internal institution of Bank.

Meanwhile, from 1988 to 1994 the credit rating agencies independent to the bank were continuously established. After 1995 through the institutional reform "Credit Rating Committees" changed into semi-independent credit rating institutions.

ii) Second stage (1997-2003):

By the impact of Asian financial crisis, Chinese credit rating institutions needed to reduce their business. Under such condition, the East-China Credit Rating Coordinating Association (Huadong Zixin Pinggu Lianxihui), that is the first national wide industrial association in credit rating industry in China, was founded by Shanghai Far East Credit Ratings Co., Ltd. etc. in April 1997. In March 1998 this association became to Chinese Credit Rating Coordination Association (Zhonghua Zixin Pinggu Lianxihui) that had 20 over members. On the other hand, in this period new business that assesses the credit condition of loaned company started. The local offices of PBC instated this business.

December 1997, PBC recognized the qualification of 9 Credit Rating Agencies to serve credit rating business in national wide (PBC [1997] No.547). The end of 2000, in The Fifteenth Five-Year Plan advocated rapidly development of credit system. After that, the importance of credit rating became to be recognized widely. The establishing of credit rating institutions started to increase again. In this stage, the related research institutes, such as Shanghai University of Finance and Economics, Credit Research

Center, were established.

iii) Third Stage (2003-2007)

November 2003, the Credit Information System Bureau (征信管理局) of PBC was established, the policy for establishing social credit system officially started. In 17 provinces and cities, the trial of credit rating to loaned companies began. End of 2003, Shanghai Far East Credit Ratings Co., Ltd. (SFE, 上海遠東資信評估有限公司) received the qualification of the member of The Association of Credit Rating Agencies in Asia (ACRAA). Then Dagong Global Credit Rating Co., Ltd. (Dagong, 大公国際資信評估有限公司) also received the qualification of the member of ACRAA. Now the members of ACRAA are discussing the unified standard of credit rating in Asia, the establishing of Asian Common Bond market etc.

B-2 Supervisory Authorities and Appointments

The supervisory authorities to credit rating industry are PBC, NDRC, the China Insurance Regulatory Commission (CIRC) etc. In July 2003, CIRC approved five Credit Rating Agencies. Insurance companies can invest to only corporate bonds rated highly by these five rating agencies (Baojianfa [2003] No.92). In September 2003, the same five rating agencies also were approved by NDRC (Fagaicaijin [2003] No.1179). Furthermore, June 2005, Credit Management Bureau of PBC recognized the same five credit rating agencies to be institutions in carrying out inter-bank bond credit rating.

March 29, 2006 the PBC issued a comprehensive regulation for the credit rating industry―"Zhongguo renmin yinhang xinyong pingji guanli zhidao yijian" ("PBC guiding ideas on regulating credit rating" PBC No.95). It requires credit rating agencies to demonstrate they have a qualified staff and a system in place to avoid conflicts of interest, to report their ratings and default rates to regulators, and not to engage in unfair practices (Kennedy 2008, p.79).

B-3 Market Structure of Chinese Credit Rating Industry

There are five accredited agencies in Chinese credit rating industry: China Chengxin International Credit Rating Co., Ltd. (CCXI, 中誠信国際信用評級有限公司), SFE, Dagong, China Lianhe Credit Rating Co., Ltd. (Lianhe, 聯合資信評估有限公司) and Shanghai Brilliance Credit Rating & Investors Service Co., Ltd. (SBCR, 上海新世紀資信評估投資服務有限公司). According to an official estimates, there are an additional

68 domestic rating agencies operating in niche markets (Kennedy 2008, p.71, footnote 21).

Foreign credit rating agencies have had to access the market through partnerships. In 1999, Fitch and China Chengxin started a joint venture, China Chengxin International (collapsed in 2003). Moody's had a technical co-operation agreement with Dagong in 1999. Moody's replaced Fitch in 2006 and started CCXI. SFE and Hong Kong-based Xinhua Finance created a joint venture, Xinhua Far East China Credit Ratings (Xinhua Yuandong 新華遠東), which provides individual stock ratings and publishes stock market indices.

Table6 indicates rating volume and value, and market share of big five in 2007 and 2008 for corporate bonds. In corporate bond market, CCXI, Lianhe and Dagong

Table 6 The Credit Rating for Corporate Bonds by Agencies

	2008				2007			
	Volume	Market Share of Vol (%)	Value 100 million RMB	Market Share of Val. (%)	Volume	Market Share of Vol. (%)	Value 100 million RMB	Market Share of Val. (%)
Lianhe	24	39.3	804.9	34.0	33	40.7	519.9	30.4
CCXI	20	32.8	1152.0	48.7	27	33.3	928.5	54.3
Dagong	12	19.7	268.0	11.3	18	22.2	201.0	11.8
SBCR	4	6.6	127.0	5.4	3	3.7	60.0	3.5
SFE	1	1.6	15.0	0.6	0	0.0	0.0	0.0
Total	61	100.0	2366.9	100.0	81	100.0	1709.4	100.0

Source: Lianhe (2009), olliginaly www.chinabond.com.cn

occupy a large share, SBCR and SFE are very small.

B-4 Rating Definition and Methodology

Rating definitions vary from agency to agency, but within big five the difference is not large. So we indicate in Table7 SBCR's rating symbols of the long-term bond rating as example. Big five use rating methodology similar as major international credit rating

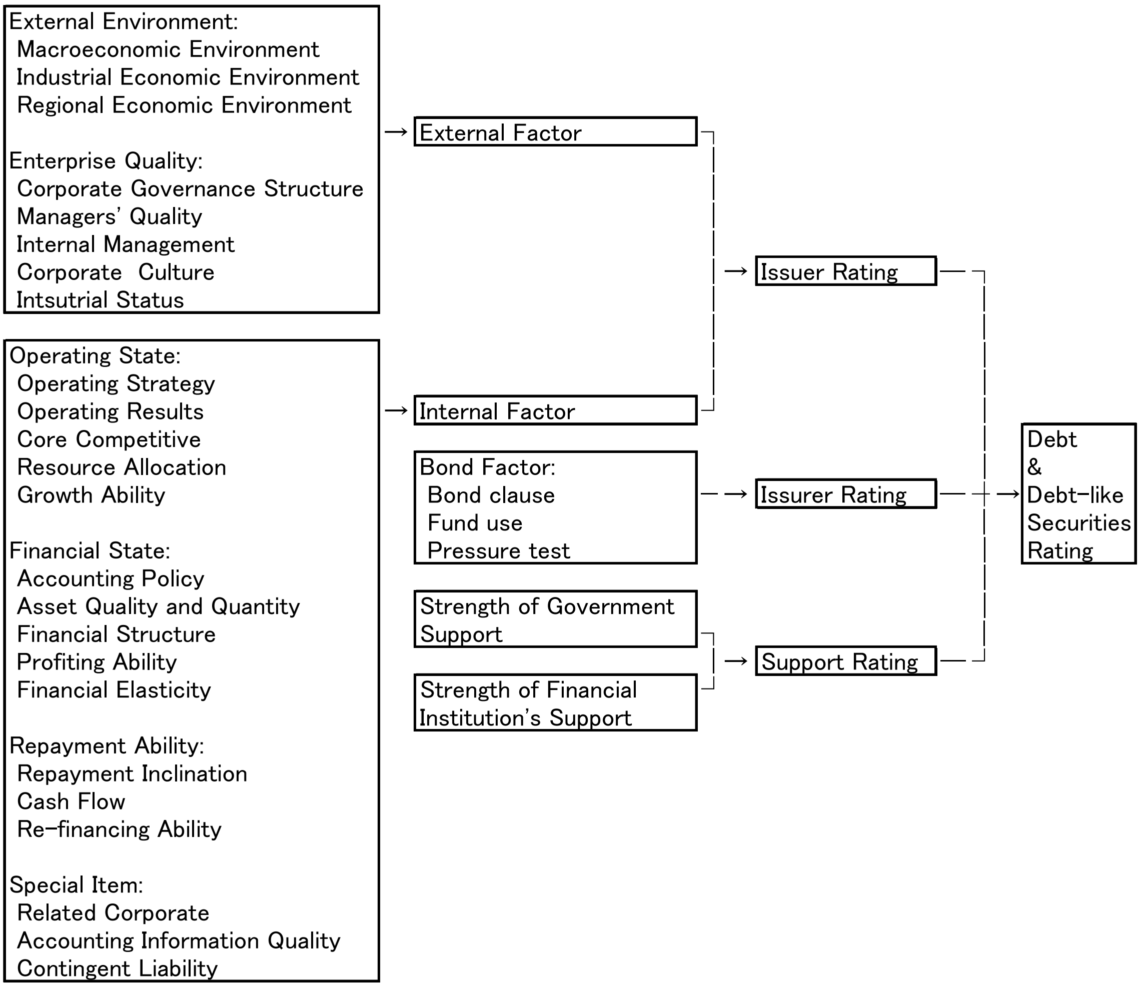
Table 7 Rating Symbols of the Long-term Bond Rating

Investment Grade	AAA	The corporation has highest credit, highest solvency, and has lowest risk.
	A	The corporation has very high credit, very high solvency, and has very low risk.
	AA	The corporation has high credit, high solvency, and has low risk.
	BBB	The corporation has good credit, good solvency, and has low risk.
Speculative Grade	BB	The corporation has bad credit, bad solvency, and has the defaut risk.
	B	The corporation has worse credit, worse solvency, and has high defaut risk.
	CCC	The corporation has very bad credit, very bad solvency, and has the possibility of defaut.
	CC	The credit is too bad, and the solvency is trustless.
	C	The corporation has worst credit, has no solvency, and has the real possibility of defaut.

Source: SBCR's web-site

agencies, such as Fitch, Moody's and S&P. Here in Fiuger3 we indicated SBCR's rating methodology as an example.

Figure 3 Rating Methodology



Source: SBCR's web-site

B-5 Rating Distribution

In China as a condition of corporate bond issuance, mortgage of bank (principal and interest payoff guarantee) had been needed until recent time. Because to this rule the credit risk is imputed to bank, there is opposition that bond finance (direct finance) is not difference from the indirect finance (bank loan finance). October 12, 2007 CBRC released Guidelines on Effectively Warding off Risks Inherent from Guarantees of Enterprises' Debts to Commercial Banks (Yinjianfa [2007] No.75), basically prohibited that the bank adds mortgage to corporate bond and enterprise bond. Responding to these regulation in bank side, NDRC on January 2, 2008 announced *the Notice on*

Matters Concerning Pushing forward Corporate Bond Market Development & Simplifying Issuance Examination and Approval Procedures, stipulated that the companies were allowed to issue unsecured corporate bonds.

The issuance of unsecured corporate bonds has an important implication for credit rating. In the previous time, because bond issuing companies are the super excellent companies and bonds were secured by bank, almost all bonds are rated 3As. Table8 indicates rating distribution of all corporate bonds issued in 2000-2008 on the first two rows.

Table 8 The Distribution of Credit Rating

items	year of issuance		rating								Total
			AAA	AA+	AA	AA−	A+	A	A−	non	
Corporate Bonds	2000-2008	volume	288	19	26	1	0	0	0	1	335
		proportion(%)	86.0	5.7	7.8	0.3	0.0	0.0	0.0	0.3	100.0
	2008	volume	46	17	24	0	0	0	0	0	87
		proportion(%)	52.9	19.5	27.6	0.0	0.0	0.0	0.0	0.0	100.0
Enterprise Bonds	2007-2008	volume	11	4	3	2	0	0	0	0	20
		proportion(%)	55.0	20.0	15.0	10.0	0.0	0.0	0.0	0.0	100.0

Sources: CCXI (2009), originally Wind Information, CCXI.

From this table, we can understand 3A-rated "Corporate Bonds" occupies 86 percents of total 335 items. On the other hand, in 2008 single year, only 46 items received 3A, the proportion declined to 53 percents. On the "Enterprise Bonds", situation is similar to "Corporate bonds". In 2007 and 2008, recent two years, 3A-rated "Enterprise Bonds" were only 55 percents of total issued 20 items. After that, the bond issuance by small and medium enterprise that have relatively weak credit status, is expected to gradually increase, the role of credit rating may be important more and more.

B-6 Rating Performance

China has no official default study still now. As mentioned above, before 2006, virtually all corporate bonds were required to be cover with guarantees from state-owned banks. State-owned banks are strong and quasi-government risks. There have been no defaults reported for their guaranteed bonds. On the other hand, bonds without guarantees have short history and so far no defaults have happened too although in 2 or 3 cases, the regulators have intervened to help the financial distress issuers in making CP repayment (via urging banks to give bridging loans) so as to avoid contagion in the market.

B-7 Response to Basel II

Basel II on banking supervision has defined six criteria that should be satisfied by rating agencies: i) Objectivity, ii) Independence, iii) International access/Transparency, iv) Disclosure, v) Resources and vi) Credibility. China's responses to each criterion are as follows:

(i) The tie-up and the joint management of internationally renowned credit rating agencies with domestic credit rating agencies became to be active after around 2000. As a result, the rating policy and methodology of domestic rating agencies are becoming to fill international standard, and to meet the objectivity criterion by Basel II. On the other hand, in 2006 PBC issued "PBC guiding ideas on regulating credit rating" (PBC No.95), intended to establish management system based on default rate.

(ii) Almost all local credit rating agencies are established by local government or commercial banks, so their independency are weak and their market limit to local area. On the other hand, a few big national agencies do not receive the investment of government and banks, fill independence criterion. These rating agencies, however, also have relatively weak management basis, tend to suffer from the market power of big customers. Furthermore, under severe competition in order to acquire customer, rating agencies tend to apply a high rate. These activities ruin independency and objectivity required by Basel II.

(iii) On the international access, Chinese domestic rating agencies have not rated foreign company still now and rating methodology and standard for rating foreign company do not exist. On the transparency, domestic rating agencies have already opened rating methodology world widely.

(iv) The domestic rating agencies have already opened rating methodology, process, definition of rating symbol, expiration date of rating and rating result, in that sense, it is said that disclosure criterion required by Basel II is filled. But, as mentioned above, default rate and transition matrix have not been opened still now.

(v) Now domestic rating agencies as an important rating process conduct the hearing to high level managers and persons in charge of important sectors, and site investigations of entities assessed. Through these processes, rating agencies can gather primary source information and improve rating level.

(vi) Credibility can be caught from two aspects. One aspect is credibility of investors to rating results. Another is credibility of entities assessed to rating agencies with respect to protection of inside information. For the former, although the skeptic view to the relevancy of Chinese credit ratings remains sill now (Kennedy 2008), as rating agencies accumulate rating experience and risk conscious of investors, the influence of a few big domestic rating agencies are increasing.

For the latter, before rating process, the rating agency contracts with the company assessed for the agreement concerning the confidential nature that prohibit to leak any obtaining information to the third party without the agreement of this company. Furthermore, inside of rating agencies, managers contracts with the employee for the agreement concerning the confidential nature that prohibit that employee leak any information of customers to the third party in service and after resignation. These treatments meet the requirements of Basel II.

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Appendix: Profiles of Credit Rating Agencies in Mainland China

	CCXI	SFE
1 Year of establishment	October 8, 1992	1988
2 Status/nature	Associate of Moody's (since August 15, 2006)	
3 Ownership structure	CCXI (51%), Moody's (49%)	Shanghai Academy of Social Sciences (SASS)
4 Major activities		
Credit ratings	(1) Rating of Fixed-Income Financial Products Corporate bonds, Short-term financing bonds, Public listed company convertible bonds, Commercial bank financial bonds/overlying bonds/mixed capital bonds, Insurance company financial bonds/overlying bonds/mixed capital bonds, Securities company short-term financing bonds/medium & long-term bonds, Financial	(1) Rating of corporate debts Corporate short-term financing bonds, Convertible enterprises bonds, Corporate bonds, Notes
	(2) Rating of Objectives Industrial and commercial enterprises, Fund companies, Commercial banks: Insurance firms, Financial companies, Trust & investment companies: Securities companies	(2) Rating of financial institution objectives and Commercial bank financing bonds, Enterprise consolidated financial company financing bonds, Commercial bank overlying bonds, Fund management company, Securities company bonds, Money market funds, Securities company short-term financing bonds, Leasing company, Mortgage institution, Insurance company overlying fixed-term bonds
	(3) Rating of Structure Financing Non-performing Loan Securitization, Collateralized Loan Obligation, Residential Mortgage-Backed Securities, Asset-Backed Securities, Asset-Backed Commercial Paper	(3) Rating of Structure Financing various structure financing products
Others	Credit information service, Credit management consulting	Credit information service, Enterprise consolidated credit risk management consulting, Credit research training service

Appendix: Profiles of Credit Rating Agencies in Mainland China (continued)

Dagong	Lianhe	SBCR
1994	1995 (antecedent, Fujian Province Credit Rating Committee)	July,1992
		Shanghai University of Finance & Economics and China Finance & Education Foundation (CFEF)
(1) Debt Credit Rating and Evaluation medium-term bond, long-term bond, short-term bond, convertible bond, municipal bond, bank loan (credit evaluation), structured finance products (2) Non-debt Credit Rating Borrowers, Insurance Organizations, Guarantee Organizations, Bank: Enterprise Consolidated, Contract Credit Rating for Bidding Enterprises	(1) Rating of Debts Corporate bonds, Enterprise bonds, Convertible bonds, Corporate short -term financing bonds, Commercial bank financial bonds, Commercial bank overlying bonds, Commercial bank mixed capital bonds, Insurance company overlying bonds, Securities company bonds, Securities (2) Rating of Objectives various entities	(1)Credit Rating: Corporate Bond, CP, Convertible Bond, Loaned Corporation, Bidding and Bidden Corporation, Insurance Company, Commercial Bank, Securities Company, Fund, Leasing Company, Financial Company
Credit Risk Research and Information Service, Credit Risk Management Consultancy	Credit risk consultancy	Credit Management Consulting, Credit Inquiry