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Defaults Can Strengthen Credit Culture In China

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SINGAPORE (S&P Global Ratings) Aug. 29, 2016--China's central government is making its third major attempt since the global financial crisis to rein in credit risk in the country, said S&P Global Ratings today in a report titled, " Chinese Bond Investors Have To Pay If Financial Stability Is To Strengthen Is To Strengthen".

In allowing state-owned enterprises (SOEs) to default on their bonds since 2015, the government likely aims to instill a stronger credit culture.

In the first six months, four local SOEs and one central SOE's subsidiary have defaulted in onshore bonds--the largest being Shanghai Yunfeng, an energy company, with US$6.6 billion in private placement notes.

Predictably, investors used to the certainty afforded by implicit government support behind SOE borrowings are unhappy. If the government gives in to their pressure tactics, however, it risks weakening credit fundamentals for the sovereign credit ratings.

"In our view, behavior won't change without investors suffering losses," said S&P Global Ratings analyst Kim Eng Tan. "If bondholders are always made whole, bond defaults will not lessen the moral hazard problem significantly in China. SOEs pursuing uneconomical projects will continue to be funded by the market at low costs."

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In recent months, creditors of defaulted bonds issued by two SOEs--Dongbei Special Steel and Shanghai Yunfeng--have suggested that the respective shareholding governments of these companies cover their losses. If that fails, the creditors asked that some SOEs owned by the governments involved (Liaoning province and Shanghai municipality) be denied the right to issue bonds.

"These threats are likely intended to embarrass the respective governments. It is unlikely that defaults by individual companies would lead regulators to stop bond issuances by other companies owned by the same shareholders," Mr. Tan said.

If these creditors get their way, it would be a setback for the central government's latest attempt to slow a further buildup of financial risks in China. The effort to reduce moral hazard in the Chinese financial system and slow credit growth is unlikely to succeed anytime soon. China's sovereign credit fundamentals are likely to continue weakening in this scenario.