Orient Capital Research

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Huatong's Near Bond Default

The Long Tail of Chinese Debt

Summary: The Shanxi Government has rescued 429 million of bonds near default owned by Huatong Road and Bridge. At first glance, the last minute deal is another example of a government bailout. But the bigger question is who is really involved in these bonds? As defaults occur with more frequency among bonds, trust and wealth management products, assigning responsibility is going to get more difficult and will pose a systemic risk.

Whose Debt is it Anyway?

The most interesting sentence in the article in the South China Morning Post about the 11th hour rescue of Huatong's 429 million yuan in bonds came from Kevin Lai, an economist at Daiwa:

"This is a very intricate part of a credit chain," he said. "If you chase the chain all the way to the end, it might be a lot bigger than anyone expected."

Arguably, that chain of debt poses the biggest risk to the Chinese financial system. Worried foreign investors have pointed to the potential illiquidity of the interbank market as a source of potential trouble. But the PBOC, although it doesn't always act quickly, can inject liquidity into the interbank market and to avoid meltdowns. Another area of concern has been a default of a series of Trusts, which now total over 12 trillion yuan of debt. But trusts are issued by Trust companies, of which almost 90 percent are owned by provincial governments are Beijing. They can – and will step in – to prevent default.

The real risk to the system is all the related entities that are provide collateral, are guarantors, or are co-investors in many of these Shadow Banking products issued by the Trusts and the banks (in the form of Wealth Management Products). These related entities are not examined or counted (as far as I have seen) by any of the regulators – the People's Bank of China, the China Banking Regulatory

Commission, or the China Securities Regulatory Commission.

What's shocking about the Huatong case is that these are publicly traded bonds issued by a private company. But the project was clearly so important to the local government that they were obligated to step in. As Reuters noted:

Huatong had previously told media it expected strong support from the local government in rounding up overdue accounts receivable and in delaying collection of outstanding loans coming due. Analysts said many receivables involved other local government bodies that had hired Huatong to build real estate projects, then delayed payment due to their own financial difficulties.

We have no idea if there was a legal connection between Huatong's bonds and the Shanxi government or any other local company. But it's not clear if the legal connection matters anyway. What is a "guarantee" by a local government investment company for a loan issued by a Trust product? Does it have any legal standing?

Can a Government in China Sue Itself?

The complexities of local debt came up in another recent case. A few weeks ago, Qilu Bank, based in the city of Jinan in the coastal province of Shandong, said that it was suing the Urban Construction and Comprehensive Development Company of Licheng District over unpaid debt. The bank said the company had failed to make payments on a 35.4 million yuan ($5.71 million) outstanding loan, along with 6.1 million yuan in unpaid interest.

But as Lynette Ong of the University of Toronto noted, Qilu bank may be owned by the Jinan City government. In which case, Jinan is suing one of its local towns.

So what is the legal status of all this debt? According to Don Clarke of George Washington University Law School, one of the leading scholars of Chinese law,

"Art. 8 of the Guarantee Law (担保法) states 'government agencies cannot act as guarantors, except in the case of sub-lending loans from foreign governments or international economic organizations, and approved by the State Council of the Peoples Republic of China.' The guarantees, if they exist, are simply invalid."

Any non-central government guarantee of LGFV debt is invalid and legally worthless, full stop. And this is over and above the fact that even if the guarantees were legally valid, a creditor could not win a case and enforce a judgment against an unwilling guarantor government. What is remarkable is that creditors still continue to believe in these guarantees, and possibly quite improperly carry these loans on their books as if they were guaranteed."

If you look at the Trust WMP products you will find a host of guarantees built in. None of these are likely to be enforceable – or will be enforced – in court. The real question is whether there is enough money in the Provinces to allow them to continue to backstop all these defaulting credits. I have my doubts.