

# Research on the Problems and Countermeasures of China's Urban Investment Bond Market "Sixth Division SCP001 of the Corps" Default Event as an Example

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## ABSTRACT

Urban investment bonds are a series of debt financing instruments issued by local governments to alleviate financial pressures with local government financing platforms as the main body. The purpose of issuance is mainly to promote infrastructure construction or public welfare construction. For a long time, urban investment bonds have played an important role in making up for the capital gap of local governments, but there are many remaining issues. Under the background of central bank deleveraging and strict supervision, the risk of default of urban investment bonds were frequently exposed in 2020, breaking the previous rigid payment convention. Market awareness has triggered heated discussions in the market. This article takes the socially influential "Sixth Division SCP001" urban investment bond default incident as the starting point, analyzes and summarizes the problems and deep-seated reasons in the Chinese urban investment bond market from different perspectives. It also puts forward countermeasures and suggestions on how to resolve the risk of urban investment debt, which has a certain reference significance for our bank's urban investment debt-related business.

**Keywords:** *Urban investment debt, Default, The Sixth Division of the Corps*

## 1. REVIEWING THE BREACH OF CONTRACT

### 1.1. The Event

"Corps Sixth Division SCP001" was the first breach of contract event in the Chinese public issuance of the city investment bond market. August 13th, 2018, Shanghai Clearinghouse declared that Sixth Agricultural Division State-Owned Assets Management Co. Haven't pay back the principal and interest payment to the custodian, and that was substantive breach of the contract. Later, Sixth Agricultural Division State-Owned Assets Management Co. announced that "Corps Sixth Division SCP001" did breach the contract due to the funds problems on August 14th. And they were actively raising funds to pay the contract. Although Sixth Agricultural Division State-Owned Assets Management Co. payed the principal and interest payment successfully on August 15th, this event exposed many hidden risk and issue of the city investment bond market.

### 1.2. Enterprise Overview

Sixth Agricultural Division State-Owned Assets Management Co. is a nationalized business that Agricultural Construction Sixth Division of Xinjiang Production. Construction Corps has 92.73% shareholding, and China Agricultural Development Key Construction Fund Co. has 7.26% shareholding. Xinjiang Construction Corps is working on the party, government, military and enterprise integration system as a provincial-level units listed separately in the State Council's plan. Sixth Agricultural Division State-Owned Assets Management Co.'s operating business concludes state-owned assets management, agriculture, coal, restaurant, tourism, medical R&D... which contains quasi-public welfare, and has the property of investment platform of local government. Moreover, Sixth Agricultural Division State-Owned Assets Management Co. is close relative to the local financial and have received subsidy from government for a long time, so it is a legally Urban Investment Company.

### ***1.3. Combing the Breach of Contract***

Before the breach of contract happened, July 28th 2018, New Century Ratings Corporation had set the credit rating of bond of Sixth Agricultural Division State-Owned Assets Management Co. into AA level. But it had already begun to expose its credit risk by these following clues [1].

## **2. WEAK ON PROFITABILITY AND DEPEND TOO MUCH ON GOVERNMENT SUBSIDIES**

Before 2016, the majority way of Sixth Agricultural Division State-Owned Assets Management Co. to get profit is agriculture, coal, and restaurant. Net profit long time depended on the high government subsidies. 2015, by the asset restructuring of its subsidiary Baihua Village, Sixth Agricultural Division State-Owned Assets Management Co. paddle away the coal subsidiary and get all share of Warwick Pharmaceutical which is a medical R&D enterprise. This event improved the profitability of Sixth Agricultural Division State-Owned Assets Management Co. for a short time. Later in 2017, by the government restriction on the medial R&D and technology transfer, Baihua Village had a performance decline. Moreover, because of the goodwill impairment and the sharp decline of government subsidies, Sixth Agricultural Division State-Owned Assets Management Co.'s net benefits got a bad deterioration [2].

### ***2.1. Blindly Increase the Investment Spending Cause a Big Gap on the Free Cash Flow***

Sixth Agricultural Division State-Owned Assets Management Co. is doing blindly investment and not able to make correct marketing strategy during its down period. 2017, the outer business investment had up to 67.58 million dollars, and most of them were government project that cannot pay back in time, so these investments drag the money flow. Besides, during the downturn period of the stock market, Sixth Agricultural Division State-Owned Assets Management Co. still put 34.64 million dollars into the stock market. The big increasing of cash flow and weak financing capability of the enterprise increase the gap of cash flow, and make a potential risk of breach the contract [3].

### ***2.2. Assets are Transferred to Reduce Debt, Artificially Hiding Debt Repayment Risks***

Sixth Agricultural Division State-Owned Assets Management Co. reducing debt ratio by transferring asset into the enterprise, but this way didn't help a lot on the debt service. 2015, during the asset restructuring of Baihua Village, high debt subsidiary on coal rowed away to light asset medical company in order to highly decrease the debt. 2017, Sixth Agricultural Division

State-Owned Assets Management Co. transferred in all shares of Junggar Agricultural Group, and transferred out 60% shares of Qing Investment Company by doing asset transferring [4]. This move increased the total asset by 1.32 billion and only increase the debt by 0.62 billion. Debt ratio get another decreasing. Good looking debt ratio can help the rating of enterprise that good rating would be easier to do investment, but frequently transfer the asset made a big potential risk on the debt service.

### ***2.3. Funds Outstanding of Government Restraint the Liquidity, and High Pressure on Bond Redemption***

Sixth Agricultural Division State-Owned Assets Management Co. had problems on managing the cash flow, it caused them hardly to pay the short-term debt by using flowing asset. Firstly, the majority accounts receivable was from five channel Economic Management Committees and funds outstanding on government. The not in time retrieving restraint the liquidity. Secondly, almost 40% stocks are relative to many land development cost and infrastructure cost. It is poor on short-term liquidity. Moreover, the financial structure of Sixth Agricultural Division State-Owned Assets Management Co. had serious long-term using short-term debt problems. Around 0.308 billion dollars' bond are due on second-half of 2018 and first-half of 2019. It caused high pressure on debt service [5].

After the breach of contract happened, August 14th, New Century Ratings Corporation rapidly set the credit rating of bond of Sixth Agricultural Division State-Owned Assets Management Co. from AA to C. At the same time, Xinjiang Construction Corps and five Channel Helping Companies around it actively raised money. August 15th, they successfully make the full payment of principal and interest.

## **3. THE PROBLEM AND THE RISK OF CITY INVESTMENT MARKET**

### ***3.1. The Existence of Risk and Problem of Local Government***

The main purpose of implicit guarantee is to increase the credit of the issuance of urban investment bonds, reduce the interest rate and the cost of funds, and improve the success rate of the publishing. However, from the perspective of risk, this kind of market distorting behavior will blur the boundaries between local governments and urban investment companies, breach market rules, and lead to inefficient in funds using, which may leads to potential systemic risks. The majority maneuver of implementation are oral commitment or letter of guarantee, financial subsidies, and breach of contract. In this case, with the weak profitability of the main business, the Sixth Division improves the financial indicators

through asset transfer several times as records, and even relies on financial subsidies for a long time to improve the net profit and repay the interest. After the Sixth Division broke the contract, the Finance Bureau of the Sixth Agricultural Division, which is Wujiaqu Finance Bureau, to raise funds. In the case of high government debt and serious fiscal deficit, the actual ability of government implicit guarantee will be largely reduced.

### ***3.2. Problems and Risks of Intermediary Agencies***

City investment bond assurer did not play a role as consultants, which are in charge of investigating and tracking the investment of raised funds. In this case, the bond assurer failed to provide effective guidance on the allocation for not only long-term but also short-term debts of the Sixth Division, and did not have an effective control over investigating and the report [7]. Assurers still assisted the Sixth Division in issuing three 1.5 billion yuan ultra-short-term financings in 2017, which lead issuer needed to face the pressure of repayment in 2018. At the same time, the assurer did not supervise the use of the funds raised by the Sixth Division during the duration, did not track and disclose the risk and problems of their fiscal funds in a timely manner, and failed to provide a feasible plan for repayment, which ultimately led to credit crisis happened [8].

### ***3.3. Problems and Risks in the Market System***

#### ***3.3.1. The Missing and Low Reliability of Explicit Guarantees Of City Investment Bonds***

Explicit guarantees include self-guarantees and third-party guarantees. The self-collateral of China City Investment bonds is mostly land utility rights and accounts provided by the local government, and it not easy to assess the value and difficult to convert into currency. The third-party guarantee lacks standard measures such as bond insurance, and is still controlled by other city investment companies or financing platforms associated with the local government [9]. Its operating conditions are often similar to those of the assuring company, and its actual guarantees are limited. In this case, in addition to obtain a certain amount of credit from the bank, the Sixth Division did not have any credit enhancement guarantee tools. After the crisis happened, the creditors' interests are only maintained by the implicit guarantee of the local government with serious deficits, which poses too much risks.

#### ***3.3.2. Incomplete Information Disclosure System***

The "Regulations for Information Disclosure of Debt Financing Instruments of Non-financial Enterprises in the Interbank Bond Market" implemented in 2012 require issuers to disclose 15 items including credit rating

reports, financial audit reports for the past three years, reports for the first three quarters, and guarantor's credit status file. At present, most city investment companies in China fail to make full disclosures in accordance with regulations, especially documents involving internal operating status and credit status, which companies often do not disclose. The Sixth Division issued three short-term financing bonds in 2017, but none of the relevant information was fully disclosed, which resulted in investors not being able to accurately grasp the risks of city investment bonds, and the credit risk was further aggravated [10,11].

## **4. MEASURES TO BE TAKEN IN THE MARKET SYSTEM**

### ***4.1. Actively Build a Credit Enhancement and Guarantee System***

The need in promoting collateral and pledge guarantees need to be consider. At present, the credit enhancement methods for China City Investment's bond issuance are mainly guarantees, including bank guarantees, third-party guarantees, and mortgage guarantees. During the issuance of city investment bonds, the corresponding credit enhancement and guarantee measures should be improved; While the land, equity and other assets should be used for collateral and pledge guarantees, and the credit rating of the bonds should be improved, and the issuers should be restrained [12]. In the event of a default, collaterals are used to provide investors with protection, reduce panic when the default occurs, and improve the ability to deal with the aftermath of the default and crisis.

The need in establishing an insurance system for urban investment bonds. China's bond market insurance system is relatively underdeveloped. It is possible to learn the practice of buying bond insurance in US municipal bonds, which is the way of increasing credit through the intervention of insurance institutions [13]. The issuer pays insurance premiums in advance to the insurance institution. When the bond defaults, the insurance institution will repay the principal and interest in accordance with the contract to achieve credit enhancement and bond liquidity, and make up for the information asymmetry defects of investors. China can promote the development of bond insurance business by those insurance companies and establish relatively complete bond insurance credit enhancement measures. Meanwhile, it is necessary to improve the risk isolation mechanism when introducing the bond insurance system to prevent the occurrence of systemic financial risks like the subprime mortgage crisis in the United States[14-18].

#### ***4.2. Strengthen the External Supervision of Rating Agencies, and Apply Supervisory Measures According to Different Economic Environments***

Strengthening the constraints of external market supervision, in the perspective of the designing of the macro-rating agency system, improving the entry and exit mechanism of the rating market to allow third parties to obtain business licenses to enter the market competition, which is very important and necessary for future development. Effectively improve the rating quality of agencies, who are required to fully consider the economic cycle when rating urban investment bonds. During the economic upswing, the supervision of rating agencies should be stricter to avoid the lack of constraints of rating agencies to overestimate ratings [19].

#### ***4.3. Improve the Information Disclosure System and Enhance Market Transparency***

At present, most of China City Investment bonds are issued in the inter-bank bond market, which is adequate to apply mandatory requirement of information disclosure of the inter-bank market. City investment bonds have the nature of quasi-municipal bonds, and local governments are one of the actual financing entities. Compared with general corporate bonds, the degree of information opacity is higher [20]. Therefore, it is necessary to formulate stricter information disclosure standards for city investment bonds, and ensure the authenticity, comprehensiveness and timeliness of information through detailed disclosure standards and implementation links, and strengthen the supervision and punishment of violations.

### **5. CONCLUSION**

The default event of the "Sixth Division of the Corps" is a microcosm of the huge risks in the China Urban Investment bond market. While exposing the urban investment company's own problems, it also reveals China Urban Investment bond market deeper issues such as local governments, intermediaries, market systems, and macro-supervision. However, the state-owned assets default of the Sixth Division is the first publicly-raised urban investment bond default event, which just broke the market's expectation of rigid redemption of urban investment bonds, which will help all parties in the market pay attention to the reform of the urban investment bond market and promote local governments and financing platforms, the risk isolation between them and promote the further improvement of China's urban investment bond market.

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