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## The Chinese Credit Rating Industry: Internationalisation, Challenges and Reforms

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### Highlights

- The modern Chinese rating industry faces several challenges, e.g. irrelevance and acute conflicts of interest.
- China embraced a new era of internationalisation in its rating industry, which plays a key role in China's economic reforms and the bond markets modernisation.
- China's current legal reform improved the law governing the Chinese rating industry significantly.
- This framework offers a robust civil liability protection for investors or issuers.
- China started to discipline imprudent domestic Credit Rating Agencies and allowed failing SOEs to default in more recent times.

### Abstract

Chinese credit rating agencies play a key role in China's economic reforms and the modernisation of the Chinese bond markets at a time when the Chinese bond market holds the second largest position in the world. This article provides a critical analysis of the internationalisation and challenges of the Chinese credit rating agencies in order to provide an updated understanding of the Chinese credit rating system. It evaluates the legal framework of the Chinese credit rating system and its recent reforms, with a view to providing some critical evaluation of the weaknesses and strengths of China's approach in dealing with major problems facing the Chinese rating industry. In order to boost the bond market, China embraced a new era of internationalisation, which was set to change the landscape of the Chinese rating industry. China showed new momentum in tightening the discipline of its domestic credit rating agencies and started to allow SOEs to default in more recent times. Moreover, the current legal framework governing the Chinese rating industry provides a robust protection for rating

victims, although it lacks strength in dealing with other major defects of the industry, such as conflicts of interest and lack of transparency.

Keywords: K220, K230

Financial Market Regulation, Regulated Industries

## 1 Introduction

The Chinese credit rating agencies (CRAs) play a key role in China's economic reforms and the modernisation of the Chinese bond markets at a time when the Chinese bond market held the second largest position in the world at a value of US\$19.8 trillion in August 2020 (ICMA, 2020). Establishing a social credit system constitutes a key element for the development of the Chinese market economy in the modern day because it connects other financial players within the market economy. This article provides a critical analysis of the internationalisation and the recent development of Chinese CRAs and the bond market in order to provide an updated understanding of the Chinese credit rating system. It evaluates the challenges and the legal framework of the Chinese credit rating system, with a view to providing some critical evaluation on the weaknesses and strengths of China's approach in dealing with major problems facing the Chinese rating industry and the bond market.

The China State Council established the rating system in 1987 during the period of China's 'Opening-up' policy and the market modernisation from a traditional planned economy to a market economy. Compared to the Western rating industry, the Chinese credit rating industry has a very short history and remains at the burgeoning stage (Lee, 2016, p 352). China's rating industry possesses several characteristics, including acute conflicts of interest, a lack of independence and credibility, an oligopolistic

structure and a limited relevancy to the bond markets (Pieter, 2003, p 18-20; Kennedy, 2003, p 36-40; Kennedy 2008, p 65). Due to its short history the current Chinese rating industry is far from comparable to its overseas counterparts with regard to their methodologies' sophistications, corporate governance and international competitiveness. Unlike the Western credit rating market, the most influential international CRAs (the international 'Big Three'), namely, Moody's, S&P and Fitch, never achieved the majority market shares in China's rating market due to the previous 49% of ownership limitation on foreign companies. China embraced a new era of internationalization of the credit rating industry following the recent Chinese investment law reforms, which opened the Chinese credit rating market to foreign CRAs from 2018. As a result, S&P China officially became the first wholly international owned CRA in China with a China Securities Regulatory Commission (CSRC) registration in 2020. The new era of internationalisation should serve to transform the Chinese rating industry and bond markets by bringing in international standards and practice. Meanwhile, the entry of the international renowned CRAs would intensify competition and change the landscape of the Chinese rating market. China recently took a new approach in dealing with the failures of its domestic CRAs and the state-owned entities (SOEs), such as imposing heavy sanctions on unscrupulous domestic CRAs and allowing high-profile SOEs as well as non-SOEs to default. The new approach is likely to contribute to the strengthening of its domestic bond market and the rating market in order to support China's economic reforms and modernization.

The Chinese legal framework experienced three distinct generations. The first two generations were criticised for being overly complicated and fragmented with many regulators being involved in passing rules and measures and carrying out supervisory work in the past (Lee, 2016, p 354). They enhanced the regulation to some extent, although they lacked comprehensiveness in dealing with the inherent shortcomings of the industry systemically and substantively. The Chinese regulators embarked on a new reform by implementing the Interim Measures for the Administration of the Credit Rating Industry 2019 (the Interim Measures 2019) and the Measures for the Administration of the Credit Rating Business in the Securities Market 2021 (the Administration Measures 2021). The new reform represents the most comprehensive regulation on CRAs operating in China, although some provisions are still more lenient, and the scope remains narrow in the areas of reducing conflicts of interest and

increasing transparency. The new record-filing system can be a viable alternative to replacing the U.S. Nationally Recognised Statistical Rating Organisation (NRSRO) registration systems for improving competition and reducing a high barrier to entry. Moreover, the Chinese legal system made a significant improvement on the CRAs' accountability under the civil liability regime with the burden of proof being placed on CRAs.

The remainder of this article is set out as follows: Part 2 analyses the internationalisation of the Chinese CRAs and China's most recent strategic approaches in modernising its bond market and the credit rating industry. It analyses the Chinese regulators' new tough measures towards the failing domestic CRAs and corporate bond defaults as well as the implications of the increased state influence on the domestic rating industry. Part 3 analyses the major challenges facing the Chinese rating industry, which impede the development of this industry. These challenges include the irrelevance issue, rating inflation, lack of proper competition, conflicts of interest and lack of independence. It also evaluates the development and reforms of the Chinese legal system on CRAs. The divergences of legal reforms on CRAs in China and the West offer new perspectives on the issues of conflicts of interest, the lack of transparency and the lack of robust protection for market participants. Part 4 concludes the article.

## **2 Internationalisation of Chinese Credit Rating Agencies and New Development**

### **2.1 Internationalisation**

The Chinese bond markets consist of two segments, the inter-bank market and the exchange securities market. The PBOC is the main regulator for the former and the CSRC, the latter. The inter-bank market is the dominant market out of these two, holding 89% of the outstanding bonds in China in 2018, in contrast to 11% of outstanding bonds, which were in the exchange markets (Amstad and He, 2020, p 2-5). China's bond market slowly developed in the 1980s and 1990s under the strict control of the central government. It experienced leaps and bounds of growth from the mid-2000s after the government's change of policies, which reduced the restrictiveness of the bond market and standardised the activities of issuing financial bonds. A functional and robust bond market can support the smooth operation of China's macro-economy, the effective transmission of monetary policy and the

effective allocation of financial resources (Monetary and Economic Department, BIS, 2005, p 57). China started to promote innovation in the bond market by allowing commercial banks and other financial institutions to issue subordinate bonds from 2005. At the same time it initiated a pilot scheme for mortgage-backed securities (MBSs) and asset-backed securities (ABSs). This reform led to a considerable reconstruction of the bond market during the following 10 years with more innovative types of credit bonds being introduced, such as ABSs, non-banking financial institution bonds and commercial bank bonds. Although the Chinese bond market still consisted largely of the government or central bank related bonds, the bond market witnessed an increase of other types of bonds, following China's vigorous promotion and reforms.

The establishment of the Chinese CRAs has a close link to the State Council and its regulation on the bond markets, especially to regulate the issuance of corporate bonds. In general, the Chinese bond market pursues the goal of financing the SOEs, accompanied by China's economic reform and its financial market modernisation. The development and maturing of the bond market accelerated the development of the Chinese rating industry (Zhang and Luo, 2012, p 26; Livingston et al, 2018, p 218). To start with, Chinese CRAs struggled to survive with no substantive impact because the size of the bond market remained small before 1993. After a period of massive corporate defaults and forced public bailouts in the 1990s, Chinese regulators adopted an approval and licensing system for the formal establishment of CRAs operating in the rating market (He and Jin, 2010, p 17; Jin, 2016, p 4-5). Chinese CRAs started to gain more recognition from regulators and market participants following China's plan to open the rating market and to improve the credit rating system from 2003.

One important phase of the development of the Chinese rating industry was internationalisation, marked by establishing joint ventures with other foreign CRAs from 1999. The trend of forming global partnerships with the 'Big Three' aimed to modernize the Chinese rating industry and to improve the domestic CRAs' market competitiveness. The partnership with the international 'Big Three,' was no less than a roller-coaster with collapses and reconstructions. For example, in 1999, China Chengxin became the first Chinese CRA to form a joint-venture with Fitch, although the joint-venture broke up in 2003. Dagong had a technical cooperation agreement with Moody's in 1999 and ended the agreement in 2002.

The 'Big Three' never succeeded in taking the majority of ownership through these partnerships. Chinese restrictive rules led to the absence of the foreign 'Big Three's' dominance and created a rating market which is unique from the rest of the world. Up to May 2017, the Chinese rating industry remained as a restricted sector to foreign CRAs because of the policy to limit foreign ownership to minority stakes (General Office of the State Council, 2017; Livingston et al, 2018, p 220). Previously, S&P and Fitch attempted to enter the Chinese rating industry independently, however, they were unsuccessful in establishing any market shares in this way. The foreign CRAs could not assign ratings independently without a joint venture in the early 2000's because the Chinese rating industry was only limited to local CRAs. Foreign CRAs must obtain a Chinese legal entity for carrying out rating activities. As a result, the only way to establish market shares for foreign CRAs was to form a successful partnership while retaining a minority ownership.

It is worth noting that the bonds rated by global-partnered CRAs have significantly low yield spreads than bonds that were rated by the Chinese domestic CRAs, meaning that the international CRAs' credibility provides a stronger certification effect than the domestic CRAs (Livingston, et al, 2018, 217 & 225). These partnerships include S&P and Shanghai Brilliance, Moody's and Chengxin, and Fitch and Lianhe. To date only Moody's currently has minority shareholdings at 30% as of August 2018 in Chengxin after both S&P and Fitch sold their shareholdings in their joint partnerships in 2018. The international CRAs showed a level of resistance compared to the domestic CRAs, such as refusing to assign ratings, assigning lower ratings than domestic CRAs or only rating premier companies, sovereign bonds and Chinese overseas bonds (Baglole, 2004, p 41). In comparison, the Chinese domestic CRAs did not gain sufficient reputational capital for providing creditable ratings (See Section 3.1.1).

That being said, the reputation capital of the international CRAs did not always withstand the temptations from China's lucrative and fast developing capital market back in the 2000's. Evidence showed that international CRAs were willing to assign ratings to China's companies, even when the assessments had very limited and often inaccurate information (Baglole, 2004, p 39). The international CRAs faced considerable challenges when assessing the creditworthiness of Chinese corporations, including the lack of sufficient consolidated historical or operational data on industries, lack of cooperation from corporations, poor corporate governance and strong

government interference (Baglole, 2004, p 39-40). As a result, these criticisms contributed to the conclusion that investors hold little faith in credit ratings in China in general. Therefore, Chinese regulators should investigate ways of improving the performance of the domestic CRAs and the international joint-ownership CRAs to enhance the robustness of the Chinese credit rating industry.

## **2.2 New Era of Internationalisation**

Internationalising the Chinese rating industry took a further leap forward under the recent Chinese investment law reform, which intended to open the credit rating market to foreign CRAs by abandoning the former restrictions. The Special Management Measures for Foreign Investment Access in the Pilot Free Trade Zone (the Negative List) 2017 eliminated restrictions on foreign investments in the Chinese rating industry (General Office of the State Council, 2017). The new reform allows foreign CRAs to establish wholly foreign owned rating companies in China. In January 2019, the People's Bank of China (PBOC) permitted S&P China to establish the first wholly internationally owned CRA in China, rating issuers and issuances from financial institutions and corporates, SFIs and Renminbi denominated bonds. S&P China became one of eleven CRAs which filed with the CSRC in 2020 and became qualified to carry out credit rating activities in the Chinese bond and securities market. By May 2020, Fitch Bohua became the second international CRA to obtain an official registration with the PBOC for rating bonds issued in the Chinese inter-bank bond market.

The Chinese authorities allowed the wholly foreign owned CRAs to enter the domestic market. This was also a response to the US-China 100-day Economic Cooperation Plan under the Trump Administration (US Department of Commerce, 2017). The Economic and Trade Agreement between China and the US, enacted on 16th of January 2020, represented the latest development of China's unequivocal intention to allow the US CRAs to enter the Chinese domestic rating market (The Government of the People's Republic of China and the Government of the United States of America, 2020). Under Article 4.3.1 China should approve any pending license applications of the US CRAs within 3 months of the enactment of this Agreement to allow the US CRAs to rate all types of domestic bonds sold to domestic and international investors and to allow the foreign CRAs to acquire a majority ownership stake in a joint-



ownership CRA. These three elements should eliminate all barriers for US CRAs, which either operate in joint-ownership with the Chinese CRAs, or in sole ownership, or intend to enter the Chinese market. In exchange, under Article 4.3.3 the US shall accord the non-discriminatory treatment to Chinese CRAs. Ironically, the US's response fell short in matching up with the openness provided by the Chinese government.

The complete openness on China's part is peculiar in comparison to the SEC's strictness in granting NRSRO status to CRAs from other jurisdictions. The current 9 NRSROs consist of 6 US companies, one Japanese company, one Canadian company and one Latin American company. The US's NRSRO's system contributed to the higher barrier to entry and the lack of competition in the international rating industry (White, 2010, p 217; Langohr and Langohr, 2008, p 509). As far as the US CRAs are concerned, the current Agreement further cleared their way to enter the Chinese rating market and to serve the 'Big three's long-term goal of internationalisation. As a result, they are now set to proliferate the oligopoly of the international rating market and change the landscape of China's rating industry. The Chinese rating industry may have become an attempt for President Xi's administration to descale the escalated political and economic pressure from the US-China Trade War. Given the current size of China's bond market, it makes sense for the US government to facilitate an open access to this market so that the US's investors can tap into it for more investment opportunities and better capital resources. The entry of international CRAs, as financial gatekeepers and informational intermediaries into China's domestic market, should meet the needs of both local and international investors in understanding the credit risk of the Chinese financial market.

After three decades since the first creation of the Chinese CRAs, the opening-up of the rating industry signified that China embraced a new era of internationalisation, which was set to intensify the competition of the Chinese rating market from the international players. It aimed to meet the needs of foreign investors' demands for various Yuan-denominated assets and boost the credibility of China's bond market (South China Morning Post, 2019). At this point, the local CRAs do not possess the required creditability at the international and domestic levels (see Section 3.1.1). An open market should change the landscape of the Chinese rating industry, for example,

to increase market transparency, the financial gatekeeper's integrity and professional standards.

Moreover, the strategic development of China's domestic bond market to encourage foreign investment in recent years constituted a driving factor for the move to a more open credit rating market in China. It should modernise the Chinese bond market and innovate the products' segments, such as the securitisation instruments, which have an enormous market to grow. Currently, China's bond market is dominated by traditional financial products, e.g., government bonds took up 57.06%, financial bonds, 18.44% and corporate bonds, 24.5% in 2018 (Amstad and He, 2020, Chapter 6, table 1). The international players should bring the international rating standards and advanced rating methodologies to the Chinese market, which would push the other domestic CRAs to adopt international standards, hence, improve the comparability and the quality of ratings for Chinese bonds.

Despite this, a complete openness for foreign CRAs to enter is not near to being achieved. For instance, how far the central and local governments would allow the bond market to be operated under the market economy and refrain from rescue defaulting companies with public bailouts. This question remains an important one to understand how foreign CRAs conduct risk assessment in China's bond market. Moreover, the international CRAs would need to deal with the bond and stock markets with a tight state control and their inherent problems such as the lack of transparency, conflicts of interest, speculation by market manipulators and corruption. S&P uncovered the existence of US\$ 6 trillion worth of 'hidden debts' held by local governments (South China Morning Post, 2019). The political uncertainties in China's central government can also exert pressure on the Chinese rating market and affect the operation of the international CRAs.

In addition, foreign CRAs face considerable challenges to compete with domestic companies, which have already held the dominant market position in the last three decades. The domestic CRAs use rating scales, which are incompatible to the rating scales of the international CRAs, e.g., allowing 40% of domestic corporate bonds to be rated AAA in contrast to only 2% in the US (Anstey and Tu, 2019). Concerns continue to exist as to whether the international players would give in to commercial considerations by following the rules already delineated by domestic players.

Inevitably, foreign investors prefer to follow ratings assigned by international CRAs who continue adhering to international standards. Despite this, S&P China has so far indicated that it planned to develop a rating methodology and use the national rating scales specific to China to meet the needs of China's bond market. Hence, investors must take extra care when comparing S&P China's ratings in order to avoid any underestimation of the credit risks of the bond investments.

Undoubtedly the race to compete for market shares is never an easy task for foreign CRAs, given the dilemma of upholding their international reputation and avoiding dejection under the lax rating standards in China. The CSRC's accreditation over overseas bonds with ratings assigned by international CRAs confirm that international CRAs gained recognition in the Chinese securities market (Jiang and Packer, 2017, p 8). This recognition should lend a level of reputation capital for them to compete with the domestic CRAs. Rigorous standards of the rating process accompanied by international credibility, objectivity and independence of a financial gatekeeper remain the determining factors if the international CRAs were to win the rating market in China.

### **2.3 Further Development**

Following several waves of intensive financial reform, particularly over the past 10-15 years, the Chinese bond market made a significant improvement, providing opportunities for investors and a financial market with better capital resources. China has been rigorously promoting the innovation of the bond market by allowing commercial banks and other financial institutions to issue subordinate bonds from 2005. The PBOC subsequently opened China's interbank bond market to overseas institutional investors in 2016 by abandoning the quota allocation to foreign investors and removing restrictions for foreign investors for participating in the Chinese bond market (PBOC, 2016, Articles 2-4). Additionally, the Negative List 2018 sets to eliminate the 49% foreign ownership cap in securities companies, stock companies and securities investment fund management companies by 2021 (NDRC, People's Republic of China Ministry of Commerce, 2018, Article 21).

A further development of the Chinese bond market with a more open access for foreign investors places CRAs at the centre of the financial market. Foreign investors would bring to the Chinese bond market more sophistication and a higher-risk appetite. This reform led to a considerable reconstruction of the bond market with additional

innovative types of credit bonds. In 2006, the Chinese bond market only comprised of four types of bonds, including treasury bonds (27.4%) and central bank notes (37.4%), financial bonds (26.8%) and corporate bonds (2.2%) (Huang and Zhu, 2009, p 17). The landscape of the bond market changed to some extent by 2016 with government bonds, central bank bills and government-backed agency bonds being reduced considerably. Although the Chinese bond market still consisted of a large portion of the government or central banks-related bonds, the bond market witnessed an increase of other types of bonds, such as ABSs, non-banking financial institution bonds and commercial bank bonds, etc., which were the types of bonds promoted under China's recent reforms.

Moreover, alongside the opening and innovation of the bond market, China took a different approach in developing a competitive bond market, particularly towards its SOEs by allowing some failing SOEs to default, in contrast to the approach taken in the last two decades. Previously, the State would rescue the SOEs with public bailouts in order to stabilize the bond market and the major SOEs. Despite this, China experienced an incremental number of corporate issuers, which defaulted on bonds in recent times, both with non-SOEs and SOEs: 4 in 2014, 21 in 2015, 30 in 2016 and 45 corporates defaulted on bonds with a value of \$17bn in 2018 (Livingston et al, 2018, p 223; Lockett and Jia, 2019). China also experienced a high number of high-profile SOE defaults in 2020, which sent a shockwave on the corporate bond market and sparked concerns in debt levels on the mainland. The severity of corporate bond defaults reached a record high in the first half of 2021 at RMB 62.59 billion, involving 25 firms and more than half of the defaulting amount attributing to SOEs (Murugaboopathy and Galbraith, 2021). Notably, in contrast to the incremental default rate in the bond market, Chinese CRAs had ten times more upgrades than downgrades between 2014 until mid-2018, driven by fierce rating industry competition (Amstad and He, 2020, Chapter 6 [5.3]). For this reason, Chinese CRAs had taken some of the blame, in some cases being subject to a joint investigation for assigning high ratings and failing to correctly assess the credit risks of the defaulted corporates and bonds.

The most recent SOE defaults suggest the Chinese government gradually lost its appetite to bail out failing companies as before in order to strengthen the Chinese bond market. In general, the Chinese SOEs enjoy a wide range of governmental

support, including subsidies, tax exemptions, below-market rate loans, debt-forgiveness and direct financial support from state-owned banks (Lee, 2020, p 191; Du, 2016, p 123-124). Nonetheless, China could not completely shelter corporate bonds from the risk of default, even after a string of safeguards had been put in place. When defaults happen, China is now willing to shift the liability to the SOE or non-SOEs to enhance the credit risk management of the bond market. A functional and robust bond market can support the smooth operation of China's macroeconomy, the effective transmission of monetary policy and the effective allocation of financial resources (Monetary and Economic Department, BIS, 2005, p 57). Therefore, China's recent efforts intended to increase the competitiveness and influence of the domestic financial market at an international level. This is in line with China's current strategic reforms in other key sectors, such as the financial sectors, particularly at the time when Chinese capitalism gradually shifts from being industrial capital dominated to being financial capital dominated (Cash, 2020, 423).

Lastly, China also stepped up to improve the business standard of the rating industry and put tough discipline on domestic CRAs if they failed to comply with the basic legal requirements. In 2018, both the NAFMII and the CSRC suspended Dagong's licence for one year for breaching the basic standards of the rating industry and acute conflicts of interest. Dagong allegedly inflated 19.16% of its ratings from 2017 (Zhang and Wei, 2018). This was the most serious penalty imposed on a high-profile Chinese CRA in modern times. It brought Dagong's business operation to a halt since Dagong was barred from any rating activities during the suspension. According to the NAFMII, Dagong provided rating services for the issuers and charged high fees for consultancy services for the same issuers; it submitted fake statements and untruthful information to the NAFMII during its investigation; it lacked sufficient underlying assets data and rating model data (NAFMII, 2018). At the same time, CSRC issued warnings to three other CRAs, including Shanghai Brilliance, Oriental Jincheng and China Chengxin. It highlighted the problems existing in the Chinese rating industry, including an acute conflict of interest, a lack of independence and a poor rating quality.

China's tough approach in dealing with the major problems of its CRAs intended to improve the performance of the domestic rating industry and to prevent financial crises. It should serve at least two purposes. First, a domestic rating industry with high credibility should support China's pledge to further open the bond market and attract

more foreign investors. Despite China's pledge to further open its bond market since 2017, foreign investors only held a small percentage of Chinese bond investments. Therefore, the strengthening of the Chinese bond market is pivotal to attract more foreign investors. The first obvious method is to allow some corporate bonds to default, ie, to eliminate the lemons. This may explain why the Chinese government gradually lost its appetite to bail-out failing companies as before. Secondly, toughening the rules on financial gatekeepers was a response to a string of corporate bond defaults in more recent times, such as the unprecedented measure to punish the most imprudent CRA, Dagong, despite it being the national brand. Improving the understanding of credit risks should work to enhance the performance of the domestic corporate bonds. Since the CRAs' ratings primarily communicate the credit risks of investment and improve the effective allocation of capital, building a strong bond market constitutes a resounding cause for the Chinese securities regulators to toughen their approach towards the domestic CRAs.

Apart from the strengthened credit rating industry, China gained control of Dagong by turning it into state ownership in 2019. Dagong was heavily criticised for representing the Chinese government's interests at an international level and issued ratings which were politically biased (Radu and Cosmin, 2007-2013, p 162; Zheng, 2012, p 48; Fuchs and Gehring, 2015, p 28). The state-ownership can exacerbate Dagong's geopolitical characteristics and diminish the role of financial gatekeeper, particularly when China's bond market is largely state controlled. Alternatively, the Chinese government may intend to gain control over the distressed national brand CRA, through which it can continue to exert the government's influence on the economic and political issues at an international level. Inevitably, China will support Dagong through financial and non-financial means as it did for many other SOEs. This new ownership is likely to push Dagong to become a loyal servant of China and to fulfil China's increasing power in the financial world more than before. As a result, this would eventually increase the China's state influence on the credit rating market.

In general, the SOEs play a key role both in China's domestic economy for the promotion of key industries and in pursuit of the government's 'Go Global' policies and industrial goals (Lee, 2020, 159; Du, 2016, p 119). The Western countries have long been cautious and critical about China's SOEs expansion at the international foreign investment market for concerns about national security, fair competition, reciprocity

and the function of the free market at home (Gloudean and Salidjanova, 2016, p 19). This suspicion of the SOEs led to the tightening of the national security review and increased political resentment from the West in response to China's SOEs overseas operation and expansion (Chao, 2015, p 115-116). For this reason, the increased state influence in the Chinese rating market would impede the rating industry's future development at an international level, particularly when the Chinese CRAs must first and foremost meet the basic standards of being a financial gatekeeper and informational intermediary, as in Dagong's case.

### **3 Challenges and Legal Reforms of Chinese Credit Rating Industry**

#### **3.1 Challenges**

The challenges of Chinese CRAs consist of the conflicts of interest, rating inflation and the lack of proper competition. It is worth noting that these challenges also exist in the international CRAs. In addition, the Chinese domestic CRAs were previously criticized for the lack of credibility and independence, and their ratings were irrelevant in the market (Pieter, 2003, 18-20; Kennedy, 2003, 36-40). The irrelevance remains a concurrent issue for Chinese CRAs for reasons such as their weak informational intermediary role in an underdeveloped and overprotected securities market. This issue is unique to the Chinese CRAs in contrast to the international CRAs, which were criticized for generating overreliance that led to systemic failure in the international financial market.

##### **3.1.1 Irrelevance**

First, China previously had a relatively small bond market under the tight control of the Chinese government. The underdeveloped credit bond market constrained the growth of the credit rating industry at the beginning and made the rating industry less relevant. After its establishment China's bond market developed rapidly, although its size was small and less open with only a few classes of financial products in need of credit ratings compared to other matured bond markets in more developed countries. Before 2004, corporate bonds were the only type of financial products needed for ratings, with annual new bonds issued at the value of RMB 33 billion in 2004 (Zhang and Luo, 2012, p 27; Kennedy, 2008, p 72). At the same time, they lacked sophistication and were low risk orientated. By the end of 2007, the outstanding value of the bond market remained small at US\$1.2 trillion, accounting for 35.3% GDP, much lower than other

mature bond markets; Japan's bond market accounted for 201% GDP, the US 188.5% and the UK 140.5% respectively in 2006 (Ding, 2013, p 174). By 2015, 75% of the Chinese bond market comprised of government or government-related bonds and the remaining 25% were non-government bonds dominated by SOEs (Livingston et al, 2018, p 218). The small bond market with a dominant governmental connection meant the need for the CRAs' informational role being captured on a small-scale. Nevertheless, following several waves of intensive financial reforms, the Chinese bond market currently stands as the second largest bond market with added sophistications and a high-risk appetite. This change should signal a renewed demand for credit risk information on bond investment. An open access for foreign investors should highlight the informational role of CRAs in bridging the informational gap in the financial market. As a result, the significance of the Chinese rating market should increase alongside the new development in China's bond market.

Secondly, the Chinese bond market had been relatively stable with a few bonds being defaulted in the past. It even maintained a steady growth during the last Global Financial Crisis and the Euro Sovereign Debt Crisis. China's local currency sovereign rating received a stable upgrade from BBB to A+ on average from international CRAs from 1999 to 2010 in contrast to the sharp deterioration in the major developed market sovereigns. CRAs would find less relevance in the market as investors have less credit risk awareness when the bond investments are incredibly safe. The low riskiness of the bond market is unique to the Chinese bond market because Chinese regulators pursued the goal to protect investors and adopted a strict approval process for bond issuances, only allowing low-risk bonds to be issued. The regulator sets a much higher barrier for bonds to enter the markets, leading to a low risk but inefficient bond market as high-risk bonds are automatically excluded from the bond market (Yang, 2005, 73). For example, the bond issuers must have guarantees from banks or parent companies, a rule introduced in the mid-1980s (Livingston et al, 2018, p 217). The corporate bonds must receive AA ratings if they have been guaranteed; AAA ratings if not (Zhang and Luo, 2012, p 27). The cumulative bond issuance must not be more than 40% of the company's net assets (CSRC, 2007, Article 7(6)). In any case, the approval process would have made sure that the bonds are less likely to default because each bond must have a guarantor to pay the debt if the bond were to default.



Thirdly, apart from these protection measures for the bond market, the authority would rarely allow bonds to default in the past. The need for understanding the credit risk of the corporate bonds become redundant because of the implicit state guarantee when a corporate company fails to meet its debt obligations. The Chinese stock exchange markets are categorised as state-owned because 84% listed companies have state ownership (Ding, 2013, 155). Governments at various levels would strive to set a troubled company on a bailout deal in order to secure social stability. According to Ding (2013, p 159), a bailout deal in fact creates an opportunity for rent-seeking for the local government officials and even corruption for sizable financial gains. This could create moral hazards in public bailout deals with taxpayers' money, leading to the deterioration of the bond markets. Before 2014, no actual domestic bond defaults happened usually after a last-minute deal by the government to save a defaulting company, such as the bailout for Shandong Helon in 2012 (Livingston et al, 2018, p 222). Nonetheless, the recent incremental number of corporate bonds defaulted showed the change of attitude of the Chinese government. Therefore, a well-developed credit rating system, which reduces the information asymmetries, becomes more important to protect investors' interests, and to facilitate the health growth of the bond market than before.

Beside the interference in saving defaulting corporations, the Bond Pricing Joint Committee would fix the bond prices following the principle of China's planned market (Zhang and Luo, 2012, p 529; Livingston et al, 2018, p 217). This pricing process has limited scope and lacks transparency with some irregular behavior from some parts of the Committee and the issuers. The bond price is not open for market determination, but fixed under a closed-door policy, rendering the informational function of CRAs irrelevant. The CRAs' function only comes into play after the NDRC and the State Council's approval. This price fixing problem should be alleviated to some extent from 2006 because China started to issue non-government bonds without a third-party guarantee, the prices of which were determined by the market (Livingston et al, 2018, p 217). In addition, the lack of transparency is a general problem in China's credit market due to the lack of the well-established information sharing system. This problem constitutes a cause for the CRAs' irrelevancy, since, currently, they are placed in a weak position as an informational intermediary to obtain adequate information advantage from banks, governmental institutions and industrial and

commercial enterprises (Shanghai University of Finance and Economics Credit Rating Research Center, 2016, p 64). In any case, the market could nevertheless bypass the need of understanding credit risks since most bonds are rated AA or above.

### **3.1.2 Rating Inflation and the Lack of Informational Value Debate**

The rating inflation problem of Chinese ratings sparked a debate as to the credibility of the Chinese CRAs in the capital market. The Chinese domestic CRAs lack sufficient capacity to rate complex financial instruments, whilst the data establishment for credit risk evaluation is generally lagging (Guo and Zhang, 2012, p 17). Back in 2006, the Chinese CRAs focused on establishing their market shares at the cost of sacrificing their financial gatekeeper's integrity by assigning an overly optimistic view (Lee, 2006). The weak informational quality of CRAs in an underdeveloped and overprotected securities market meant that the market participants often ignore Chinese CRAs. Studies conducted in the 2000s revealed a huge quality deficit in the Chinese domestic CRAs. Both Pieter (2003, p 18-20) and Kennedy (2003, p 36-40) concluded that the domestic CRAs lacked credibility, independence and their ratings were irrelevant in the market. In 2006, Dagong assigned AAA ratings to all bond issues with no speculative-grade ratings (Poon and Chan, 2008, p 790). Kennedy (2008, p 65) argued that the Chinese CRAs had little influence over issuers' and investors' behaviour and they represent the private authority, which was merely dependent on government mandate. In pragmatic terms, Kennedy's proposition was correct since Chinese CRAs gained their regulatory function before establishing their informational function. The same line of argument still exists nowadays, showing the domestic agencies taking a consistently generous view of Chinese issues and rating almost 80% of issuers AA or above (Lockett and Jia, 2019; Jin, 2016, p 32-33). Compared to the global CRAs headquartered outside of China, the Chinese domestic CRAs assigned 6-7 notches higher on bonds issued overseas by Chinese corporations (Jiang and Packer, 2017, p 2).

Despite the negative perspective of the Chinese CRAs and their rating relevance, a number of empirical studies proved that Chinese credit ratings carried informational value. Livingston et al (2018, p 217) showed that Chinese bond ratings contain relevant public information about default risks, hence being informative. Nonetheless, the Chinese CRAs' rating scales are incompatible, and the AAA rated Chinese

corporate bonds have the same yield spreads as the A rated corporate bonds according to the international rating scale. Chinese rating scales are very broad with significantly different risks within one rating category, leading to most Chinese bonds receiving the top three ratings. Poon and Chan (2008, p 790) revealed that the Chinese domestic ratings had a certification effect, although their informational content only existed in speculative-grade ratings but not investment-grade ratings. He and Jin (2010, p 27) concluded that the Chinese credit ratings had a significant impact on the bond market and the domestic CRAs had established their credibility. Zhang et al (2014, p 59) concluded that the credit ratings both for issuers and bonds have the function of revealing the bonds' credit risks, so that banks should incorporate the external credit ratings into their credit risk management. In terms of the information value of Chinese domestic credit ratings and the global credit ratings, Jiang and Packer (2017, p 29) tentatively suggested that both types of ratings had an explanatory power to predict spreads, although once again confirmed that the demand for a domestic Chinese rating for overseas Chinese firms had not been materialised since the international CRAs had met this need so far. Hence, these studies suggested that the Chinese CRAs' ratings carry sufficient information value in general. Nonetheless, the incompatible rating scales would create an overly optimistic impression of the bonds and bond issuers' creditworthiness, resulting in impeding their role of a financial gatekeeper which signifies the default possibility of the lenders. China should continue to develop the domestic credit rating industry and deal with the rating inflation issue, which is likely to relate to the incompatible rating scale used by Chinese CRAs.

### **3.1.3 The Oligopolistic Structure and Lack of Proper Competition**

The Chinese credit rating industry operates under an oligopolistic structure. Dagong, Chengxin-Moody and Lianhe-Fitch take nearly 90% of the market shares. There are two reasons attributing to this oligopolistic structure. First, global-partnered CRAs with large local market shares are more competitive compared to the local Chinese CRAs. Livingston et al (2018, p 230) found that issuers were more likely to choose the global-partnered CRAs if these CRAs had a larger local market share in the previous year. These joint ventures with Moody and Fitch clearly gave a significant boost of competitiveness to the top two CRAs with international partnerships, China Chengxin-Moody and Lianhe-Fitch, both of which have more stringent rating standards.

Secondly, for the first 20 years of the Chinese rating industry, the strict designation or approval system constituted the main cause of the lack of proper competition and the oligopolistic structure in the Chinese credit rating industry (Yang, 2005, p 72). Chinese CRAs must have obtained approvals and registrations before operating in the rating market in China from regulatory bodies, such as the CSRC, the NDRC and the PBOC. The CSRC adopted the designation system and approved CRAs for issuing cooperate bond ratings since 1990. Upon the NDRC and PBOC' s notice (2004, Article 7(1)), only five CRAs which started rating activities from 2000 were qualified to rate corporate bonds, among which Dagong, China ChengXin and Lianhe are the three leading CRAs in China. Dagong and Shanghai Brilliance were the two CRAs which received full accreditation to rate all types of bonds by 2018.

Likewise, the Chinese Securities Law 2005, Article 226(2) states that the CRAs must be approved by the CSRC to legally undertake any securities trading services. The CSRC status gives legal recognition and competition advantages to CRAs operating in the Chinese securities market. Under the Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market 2007 (the Interim Measures 2007) the CSRC had the centralised competence of registration, supervision and regulatory functions for CRAs and the securities market (Articles 6 and 7). It is worth noting that this registration system has since been replaced with the record-filing system under the new Securities Law of China 2019 and the Administration Measures 2021. More discussion on the record-filing system is in Section 3.2.1.

The Chinese registration system led to the same result as the US's NRSRO system as the new registration system merely extends the previous designation system and discourages necessary competition (Xu and Weng, 2011, p 222). The Interim Measures 2007, Article 7(1) required the applicant CRA to have net asset no less than RMB 20 million. The CSRC registration system heightened the economic costs of competition and created the dominance of the 'Big Five' in the Chinese credit rating market. This criterion diverges from the criteria under the US Credit Rating Agency Reform Act 2006, P.L. 109-291, 15 U.S.C. 78o-7. The SEC did not set clear cuts for the financial resource requirements, but it would reject an application if the applicant does not have adequate financial and managerial resources to produce credit ratings with integrity and to materially comply with the procedures and methodologies under

15 U.S. Code § 78o–7(a)(2)(C)(ii). The divergence exists in these two systems only in form, but not in substance as both require any applicant to have already established a high level of strength before its application. This barrier could be more problematic for the Chinese CRAs given it has an extremely short history compared to its Western counterparts.

### **3.1.4 Conflicts of Interest and Lack of Independence**

A lack of independence and conflicts of interest are two major problems of the Chinese credit rating industry. First, commercial considerations became the main reason for conflicts of interest in the Chinese rating market. This problem would grow out of control given that the Chinese CRAs had not established the necessary reputation capital and credibility in the financial market. It would make the Chinese CRAs more superfluous and irrelevant, lowering the professional standards of financial gatekeepers. The Chinese CRAs struggled to survive financially in the early 2000's because of the small size of China's bond market (Lee, 2016, p 356). Due to the irrelevancy of the Chinese domestic ratings, the institutional investors and managers of the Chinese and foreign investment houses discarded the need to buy rating reports (Kennedy, 2008, p 73). The other incoming sources for Chinese CRAs includes selling annual loan certificate ratings and ratings for the overall loan portfolio of local bank branches. Like the conflicts of interest in the Western rating markets, the issuers in China would threaten to take business elsewhere unless they obtained a higher rating. The need to secure a market share forced the CRAs to deprioritise professional integrity and to avoid a boycott from the securities issuers in the 2000's (Xu and Weng, 2011, p 225; Poon and Chan, 2008, p 790).

Secondly, the lack of independence has another layer of meaning for the Chinese rating industry because the Chinese stock market and the bond market consist of major players with state ownerships, which involve the listed companies, the securities companies and the fund management companies. Many of the Chinese major CRAs' big-profile clients are also SOEs, to which CRAs 'rely primarily on political power as the basis of credit ratings' (Lee, 2016, p 356). The annual aggregated number of issues of the central SOEs at RMB 997 billion and Local SOEs at RMB 1740 billion were much larger than the issues of the Non-SOEs at RMB 944 billion in 2015 (Livingston et al, 2018, p 221). The rating process for those clients is far from transparent and

independent from the state's influence. As a result, the Chinese CRAs do not simply deal with the creditworthiness of issuers, but with the Chinese stock/bond market of state-ownership and the unique characteristics thereof, including the state guarantee, institutional rent-seeking by SOEs, speculation and financial repression (Ding, 2013, p 162).

### **3.2 Development of the Chinese Legal System for CRAs and Recent Reforms**

The Chinese legal framework consists of three generations of regulations, being enacted in the 1980s-1990s, 2000s and 2019-2021. Unlike the self-regulation regime in the West, the Chinese State Council had been actively regulating this industry, resulting in a relatively stricter legal regime. Nonetheless, the legal framework of the first two generations was no more than piecemeal with many regulators implementing batches of legislation and approval systems, including the NDRC, the CSRC, the PBOC and the CBRC, together with the policies and standards issued by the Chinese rating industry (Lee, 2016, p 353). The provisions under these two generations were extremely narrow and mostly out of date in dealing with the problems of the Chinese rating industry in general.

The third generation represented by the two recent enactments, the Interim Measures for the Administration of the Credit Rating Industry 2019 (the Interim Measures 2019) and the Measures for the Administration of the Credit Rating Business in the Securities Market 2021 (the Administration Measures 2021) is the most comprehensive version of the legal framework in China to provide a systematic regulation on any CRAs operating in China, including foreign wholly owned CRAs. The Interim Measures 2019, which was enacted by the PBOC, made several major improvements on the supervision system and the independent, transparency and accountability of CRAs. It granted national treatment for any approved foreign owned CRAs operating in China. This provision is significant for the opening and improvement of the financial market as it further encourages international CRAs to enter the market.

The Administration Measures 2021, enacted by the CSRC, aimed to enhance the legal framework for CRAs who operate in the securities market credit rating business for securities and ABSs issued under the CSRC's authority. It is touted for making a substantive improvement on eight major areas, including replacing the licensing system with a recording-filing system for CRAs, increasing transparency and

independency of CRAs, prohibiting acts that disrupt market order and increasing punishment for violation of laws (CSRC, 2021a, Sections 3.1, 3.7, 3.8). This section analyses both two enactments to evaluate the strengths and weaknesses of the new system in dealing with the major issues existing in the Chinese rating industry in comparison with the US and EU law.

### **3.2.1 Record-filing System**

The Interim Measures 2019, Article 9 and the Administration Measures 2021, Article 3 adopted the record-filing system. CRAs need to file a record with the filing institution to carry out rating business in China. The record-filing system for CRAs is the first in kind compared to the US's and the EU's registration systems, such as the NRSRO system, which was criticised for causing a high barrier to entry for small CRAs. The new record-filing system follows the approach under the Chinese Securities Law 2019, Articles 34 and 160, which require issuers and the CRAs to file a record with the filing agencies before carrying out relevant business operations. It aims to encourage CRAs, which meet the requirements and have established a sound internal management system to enter the rating market (CSRC, 2021a, Section 3.2). This approach fits well with the strategy adopted by the Chinese regulators of facilitating a more open and competitive rating industry in recent years. These two enactments did not specify the clear qualification, but only listed the requisite documents needed for filing.

At the same time, the new system aimed to work for the benefit of the regulator, which enhanced its oversight requirements by specifying more detailed information for CRAs to file with the CSRC. The information required under the record-filing system is much more comprehensive than the old law by including some extra information about the CRAs' shareholding structures, internal control policies and the CRA's independency information (Administration Measures 2021, Articles 39 & 41). The record-filing system should be a viable solution for improving competition in the rating industry. For this system to work, the regulator should also keep the CRAs under strict surveillance by enhancing oversight and transparency.

### **3.2.2 Reducing Conflicts of Interest and Improving Independence**

Both enactments place weighted emphasis on increasing the independence of CRAs to reduce conflicts of interest. CRAs must carry out three levels of independent credit assessments in order to arrive at a final rating (Interim Measures 2019, Article 23;

Administration Measures 2021, Article 20). The credit analyst's rating must not be influenced by commercial considerations (Interim Measures 2019, Article 33; Administration Measures 2021, Article 34). The analyst's salary should not relate to ratings and the performance of financial products (Interim Measures 2019, article 33 & 37; Administration Measures 2021, Article 31 & 34). Moreover, the analyst should not take a part-time job where a conflict of interest exists (Interim Measures 2019, article 61.1; Administration Measures 2021, Article 35). Lastly, the Interim Measures 2019, Article 15 requires that CRAs should look into the ratings which were issued by an analyst to an issuer two years before leaving the job if the analyst took the new post at the same issuing company, i.e., the two-year 'looking-back' policy. This provision should work the same way as the 'look-back' policy under the US law to deal with the revolving door problem. Under the US law, NRSROs must have a look-back policy to assess any conflicts of interest that the employee of an issuer, obligor, and underwriter subject to a credit rating of the NRSROs was employed by the NRSROs and participated in determining such a rating during the one-year period (Pub. L. No. 111-203, § 932(a)(4); 15 U.S.C. § 78o-7(a)(4)). It should increase the transparency and integrity of the CRAs' rating process and alert the potential risk of using the CRAs' ratings for investment decisions.

The new enactment made great progress compared to the previous regulations in order to reduce the conflicts of interest and to improve the independence of CRAs. Nonetheless, it still permits the rating committees and analysts to take part in securities transactions after rating the same securities, providing the value of transactions does not exceed RMB 500,000 (Interim Measures 2019, Article 35.4; Administration Measures 2021, Article 33.4). The CRAs can also take part in the same securities transactions 6 months before the credit assessment work (Interim Measures 2019, Articles 34.4; Administration Measures 2021, Article 32.5). In contrast, the Credit Rating Agencies Regulation (EU) No 1060/2009, Annex I, Section C.1 prohibits the rating analysts of a CRA within their area of primary analytical responsibility from engaging in any transaction in any financial instrument issued by the rated entities. Moreover, a CRA or persons who are directly involved in the issuing or approving of credit ratings cannot directly or indirectly own financial instruments of the rated entity under the EU law (Regulation (EU) No 1060/2009, Annex I, Section B.3a). The retention of these two provisions under the Chinese recent reform would lead to acute



conflicts of interest between the CRAs and the issuers, rendering them weak in dealing with this problem of the Chinese rating industry.

### 3.2.3 Transparency Issue

These latest two enactments increased the transparency of the basic information of a CRA as well as the CRA's rating symbols, rating methodologies, models and key assumptions for corporate bonds and for the asset-backed securities (Interim Measures 2019, Articles 39 & 44; Administration Measures 2021, Articles 39 & 40). Previously, the Interim Measures 2007 did not require the disclosure of any key rating models and assumptions adopted by CRAs. For this reason, the new laws are more specific and should increase the understanding of each of the CRA's rating methodologies. The Interim Measures 2007, Article 11 increased the level of disclosure by requiring a mandatory public disclosure of the rating scale and definition, the rating methodologies and rating process, but the scope of compulsory disclosure was very limited. It specified that CRAs should establish a policy for the publication of the rating result, which encompasses the ratings and the rating report (Interim Measures 2007, Article 18). In terms of the content and format of the credit rating reports, the detailed requirements follow the Standards for Credit Rating Reports on Bonds of the Securities Companies by Credit Rating Agencies 2003, Articles 8-14. CRAs must disclose at least the rating conclusion and rating conclusion analysis. These Standards provided the basic requirements for the credit rating reports, although the level of details does not match up with the disclosure requirements under EU law since the disclosure only needs to be brief.

The EU law aimed to achieve two goals by increasing information disclosure on SFIs, ie, enhancing the investors' ability of creditworthiness assessment and reducing over-reliance on external credit ratings. This disclosure requirement under Article 8b, Regulation (EU) No. 462/2013 has a wide scope, including 'the credit quality and performance of the underlying assets of the SFIs, the structure of the securitization transaction, the cash flows and any collateral supporting a securitization exposure... (and) any information that is necessary to conduct comprehensive and well-informed stress tests on the cash flows and collateral values supporting the underlying exposures.' The EU regulator also incorporated the Regulatory Technical Standards (RTSs) to specify the scope, frequency and presentation of the information in

Commission Delegated Regulation (EU) No. 2015/3. It also elaborated the requirement of mandatory disclosure in Regulation (EU) No. 2017/2402, which created a specific framework for simple, transparent and standardized securitisation.

In comparison, the Chinese new laws did not make any change on the level of disclosure for a rating report, i.e., the rating report only consisted of the final rating and a clear explanation for the rating (Interim Measures 2019, Article 26; Administration Measures 2021, Article 23). The Interim Measures 2019 requires the CRAs to disclose the main data used in the rating process, but it does not give any detail on how this information is disclosed. Leaving too much flexibility to the CRAs is likely to cause the disclosed information to be unclear or lacking in comparability to the public. Therefore, the new enactments make some attempt to increase the transparency of CRAs, their rating process and the data used for arriving at a rating. Nonetheless, these provisions lacked detail and strength to enhance the investing public's self-assessment ability of the credit risk of the investments.

Historically the Chinese law did little to bridge the information gaps and enhance investors' credit risk ability based on the level of disclosure imposed on CRAs. The contour of the Chinese legal system gradually converges with the Western laws accompanied by many added disclosure requirements, although it still lacks clarity about the disclosure format and details. The counter argument for this is that Chinese CRAs face some unique challenges compared to their Western counterparts, such as a lack of relevancy and credibility. Instead of dealing with the over-reliance issue, Chinese regulators took a different approach, i.e., by boosting the Chinese CRAs' creditability and competitiveness, as being witnessed in the joint ventures with the 'Big Three' and allowing foreign CRAs to enter the domestic rating market.

### **3.2.4 Legal Liabilities of CRAs**

The Administration Measures 2021, Article 30 listed a number of prohibited acts in association with anti-competition behaviours, directly and indirectly seeking improper benefits and other behaviours that disrupt market orders. The CSRC identified several types of illegal activities in the bond market, such as insider trading, online distribution of false information and market manipulation (CSRC, 2007a, p 67). This problem was pervasive and the CSRC brought 405 cases to investigation in 2007 (ibid, p 68). This list aims to curb illegal conduct existing in the Chinese rating industry, particularly

abusive behaviour against competitors and issuers. At the same time, the regulatory authorities can invoke administrative sanctions, such as fines and revocation of business licenses, or criminal sanctions if CRAs violate any provisions under these two new enactments. Moreover, Article 61 Interim Measures 2019 imposed a due diligence on CRAs where CRAs intentionally or with gross negligence cause damage to the investors, issuers and issues.

For civil liability, the injured parties can rely on Article 163 of the Securities Law 2019 in order to seek compensation from CRAs. The civil liability regime of CRAs under Chinese law possesses similar features like the US and EU law, although it has a unique robustness with the burden of proof being shifted onto the CRAs. Article 163 states: the CRA must exercise due diligence to verify the authenticity, accuracy and completeness of the contents of the documents on which they are based; if the document that it prepared and issued contains false or misleading statements or material omissions, causing others to incur a loss, it shall bear joint or severed liability for damages with the issuer, unless it can prove itself faultless.

Article 163 confirms that a CRA must exercise due diligence in two areas; first, checking and verifying the information upon which it relies; secondly, preparing and issuing the rating documents. The first prong is in line with the US and EU regulations that CRAs must rely on information that is truthful, accurate and complete, although the other two laws emphasise the use of all available information that is relevant according to its own rating methodology (taking EU law as an example) (Regulation (EU) No 462/2013, Annex III No. I 42). When preparing and issuing rating documents, CRAs should follow the standards set out in Article 8 of the Interim Measures 2019, which states that CRAs must adhere to the principles of independence, objectivity, impartiality, and prudence and follow the disclosed rating standards and procedures when carrying out rating activities (Interim Measures 2019, Article 8). Therefore, the second prong of due diligence should be interpreted as: CRAs must follow their implemented rating methodologies with due diligence and care. The criteria for an infringement under the three jurisdictions have significant similarities. That is to say, whether the CRAs breach their duty of care or not under the Chinese legislations does not depend on whether the ratings are wrong or incorrect, but on the CRAs' fulfilment of their due diligence in relying on analytical information and applying rating methodologies.

Article 163 Securities Law 2019 states that CRAs must 'bear joint or severed liability for damages with the issuer for losses caused to others unless the CRA can prove itself faultless.' Compared to US and EU law, Article 163 reversed the burden of proof and CRAs must prove that they are not at fault. Unlike their Western counterparts, the Chinese CRAs have an additional due diligence to verify the authenticity, accuracy and completeness of the contents of the documents on which they are based. In contrast, the EU law requires the claimants, usually the investors and issuers, to provide accurate and detailed information to prove that the CRAs have committed an infringement and that such an infringement has an impact on the credit ratings (Regulation (EU) No 462/2013, Article 35a(2)). Likewise, the claimant needs to prove that the rating contained an untrue statement or omission of material fact under the US law (Grishteyn, 2011, p 959; Lehmann, 2016, p 69). Claimants usually bear the burden of proof in civil claims such as defamation, misrepresentation and negligence cases. As a result, this burden of proof constitutes a major cause for unsuccessful claims in the West.

Under the Chinese civil law, the party who bears the burden of proof has more risk of losing a case for reasons such as if they cannot prove the falsity of an allegation or the falsity of an allegation simply cannot be proved, they would face the risks of losing the case and the negative consequences for failure in discharging his duty of burden of proof (Judicial Committee of the Supreme People's Court, 2015, Article 90). As a result, by specifying that CRAs have the responsibility to prove their faultlessness, Article 163 imposes higher risks and more burdens on CRAs in civil litigations compared to US and EU law.

It is worth noting that the same civil liability regime already existed in Article 173 Securities Law 2007. Critics argued that the strength of this due diligence provision only has a much diluted effect in practice (Xu and Weng, 2011, p 227). So far, Chinese CRAs bore limited liability risks for false statements as the civil liability provision was seldom used (Lee, 2016, p 356). The civil liability regime lacks clear principles and standards because the courts' interpretation can lead to uncertainties as to how citizens and legal persons can succeed in civil claims under Article 163 Securities Law 2019. The first Chinese CRA case, Duanrong Net V Rong 360, illustrated this point that the Chinese courts' narrow interpretation could nevertheless frustrate the robustness of the civil liability provision in practice (Haidian District People's Court

Beijing, 2016; Jin, 2016, p 37). In this case, the district court judge rejected the claim and emphasised that the claimant bore the burden of proof to prove that the defendant subjectively and maliciously defamed the claimant's reputation. The case outcome showed that the Chinese civil liability regime shares a similar challenge with the US and the EU laws, whereby the claimant has to overcome the high burden of proof challenge despite the legal provisions. Therefore, the Chinese legal framework only improves the accountability of CRAs and protection for rating users in theory. The unique robustness by way of placing the burden of proof on CRAs could have little impact in practice if the courts apply the same narrow interpretation and ignore the existing law.

#### **4 Conclusion**

This article analyses the internationalisation, challenges, and recent legal reforms of the Chinese rating industry. The Chinese domestic CRAs underwent a series of internationalisation by forming partnerships with global players. China's recent foreign investment law and securities law reforms signify a new phase of internationalisation, which would intensify competition and change the landscape of the Chinese rating market as well as the bond market. Chinese regulators adopted a strict approach to deal with the defects of the rating industry and the bond market by imposing heavy sanctions on the unscrupulous CRAs and allowing high-profile SOEs to default. Nonetheless, the strategy of increasing state influence in the Chinese rating market would impede the industry's future development at an international level and increase the geopolitical bias of an individual Chinese CRA. The recent new developments would fit into China's strategic reform plan given that the central government has a dominant influence over the bond market. China focused on developing a workable credit rating system and robust bond market, which is fit for purpose and in line with China's economic development. While facing challenges like any other countries, China is likely to continue reforming and strengthening its domestic bond market and the rating market in order to support China's economic reforms and modernization.

Moreover, the modern Chinese rating industry faces several challenges including the irrelevancy issue, conflicts of interest, rating inflation and the lack of proper competition. Regulators should address these major issues facing Chinese credit ratings because of the increasing role played by the domestic CRAs in China's rapidly growing bond

market. The current legal framework governing this industry in China improved the law substantively in dealing with the major defects of the Chinese rating industry, although the provisions for reducing conflicts of interest and increasing transparency has less strength compared to the US and the EU law. The record-filing system should offer a valid solution of improving competition in the rating industry. The Chinese law places stricter legal liability regimes on CRAs under the administrative, criminal and civil liabilities branches. Its civil liability regime with a reversed burden of proof should improve the CRAs' accountability and investor's protection. Like any other jurisdictions, the true effectiveness of this civil liability regime depends on the interpretation of local courts.

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