Research on the Causes of Bond Defaults of State-owned Enterprises and Regulatory Recommendations: A Case Study of Brilliance Auto Group's Bonds

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Abstract: The first default of Shanghai Chaori Solar's bonds in 2014 marked the end of the "zero-default era" in China's bond market. By 2020, bond defaults in China peaked, with a notable increase in defaults among highly-rated state-owned enterprises. Among them, Brilliance Auto Group, a major state-owned enterprise in Liaoning Province, had long maintained a AAA rating and held a significant position in the traditional automotive sector. However, it experienced a massive bond default of RMB 17.2 billion within a short period, revealing a stark contrast in its operational performance. This paper provides an in-depth analysis of Brilliance Auto Group's bond default case, examines the underlying causes, and proposes effective strategies to mitigate bond default risks based on the findings.

***Keywords*:** bond; default; regulation

1. Introduction

China's bond market, after nearly 40 years of development, has seen its system increasingly refined, its scale significantly expanded, and its product types increasingly diversified. It has become a core component of the domestic capital market, playing a key role especially in corporate financing. However, with market maturity, corporate bond defaults have become increasingly severe, with both the frequency and amounts of defaults continuously rising. Since 2018, multiple bond default incidents have occurred frequently, involving substantial amounts and severely damaging investor interests. In-depth research on bond default early-warning is therefore crucial. To this end, it is necessary to conduct a thorough analysis of corporate operations and financial conditions, identify key issues, select predictive indicators, and establish an early-warning system to help investors effectively prevent default risks and mitigate the impact of defaults on their interests.

2. Literature Review

The effectiveness of financial regulation and the integrity of market mechanisms are central to the stability and healthy development of capital markets. Scholars have examined these issues from various perspectives within the context of China's evolving financial system.

Regarding the fundamental role and design of regulation, Wang Lin[1] established a critical distinction between "regulation" and more intrusive "control". Analyzing the development of China's fund industry, they contended that a regulatory approach is superior to strict control in mitigating moral hazard and fostering shared market beliefs, thereby promoting a higher level of market equilibrium and unlocking developmental momentum. Extending the analysis to the banking sector, Wu Junlin[2] provided empirical evidence on the impact of specific regulatory tools, demonstrating that capital adequacy pressure significantly enhances bank stability, with a more pronounced effect on systemically important banks.

Shifting the focus to institutional frameworks within the bond market, specific weaknesses have been identified as major impediments. Wu Xiaoqiu, Tao Xiaohong, and Zhang Tun[3] highlighted two critical problems: structural imbalances among different bond types and the constrained independence of credit rating agencies, arguing that these issues severely hinder market development. Further examining market conduct, Yang Yang[4] pinpointed misconduct by information disclosure obligors as a primary cause of market distortion, concluding that such improper profit-seeking behaviors lead to an unhealthy developmental trajectory for the bond market.

In summary, the existing literature underscores the importance of a sound regulatory framework, effective prudential tools, and transparent market institutions. These studies provide a valuable foundation for understanding market dynamics. However, a gap remains in applying these insights cohesively to the context of bond default prevention and resolution, particularly following high-profile cases involving state-owned enterprises. This study aims to address this gap by integrating these regulatory and market-integrity perspectives into a focused analysis of bond defaults.

3. Relevant Concepts

3.1 Concepts Related to Financial Regulation

Financial regulation, encompassing both supervision and governance, is categorized into narrow and broad senses. In the narrow sense, it denotes the operational oversight and regulatory governance imposed by central banks or dedicated financial regulatory authorities. Grounded in statutory mandates, this oversight aims to safeguard monetary stability and uphold orderly financial markets through industry-wide supervision of institutions' operational conduct. In the broader sense, it extends beyond formal regulatory oversight to integrate multi-layered governance mechanisms, including internal control and audit systems within financial institutions, self-regulatory oversight by industry associations, and external monitoring by social intermediaries.

3.2 Related to Bond Default

Bonds, as contractual debt instruments, inherently carry default risk. Bond default is defined as the failure of the bond issuer to fulfill its contractual obligations, specifically the timely payment of coupon interest or principal. Default risk varies across bond types: sovereign bonds are generally considered risk-free due to their backing by national fiscal revenue and sovereign credit, whereas corporate bonds—classified as credit bonds—exhibit higher default risk. Credit bonds are debt securities issued by non-governmental entities, characterized by predefined cash flows for principal and interest repayment. A key distinction between credit bonds and sovereign bonds lies in the presence of credit risk, which supersedes interest rate risk as the primary risk factor. To compensate investors for this elevated credit risk, credit bonds typically offer higher yields compared to sovereign bonds.

4. Causes of Bond Default

4.1 High Short-term Debt Pressure

Brilliance Auto Group exhibited a notably high proportion of short-term debt, reflecting a suboptimal debt structure. In recent years, the rapid growth of its short-term liabilities led to a significant expansion in total debt. By the end of 2019, short-term debt amounted to RMB 47.887 billion, comprising RMB 17.53 billion in short-term borrowings, RMB 22.513 billion in notes payable, and RMB 7.844 billion in current portions of non-current liabilities. The proportion of short-term debt to total debt remained consistently above 75% over multiple years, even reaching 84% and 87% in 2015 and 2016, respectively. Furthermore, the company's liquid assets were insufficient to cover its current liabilities. In 2019, the current ratio stood at only 0.98, and the quick ratio — excluding inventory — dropped to 0.75. By the first half of 2020, short-term debt had risen to RMB 43.987 billion, accounting for 69% of total debt.

4.2 Overreliance on Joint Ventures and Weak Indigenous Brands

As an automotive manufacturer, Brilliance Auto Group managed several indigenous and joint venture brands, including its self-developed "Huachen Zhonghua" series and joint ventures such as "Brilliance BMW" and "Renault Jinbei." However, the company's indigenous brands have long underperformed. For instance, the Huachen Huasong sedan sold only 300 units in 2020. Weak market competitiveness and low sales made these brands particularly vulnerable during industry downturns.

4.3 Insufficient supervision of information disclosure and multiple instances of non-compliant information disclosure

In 2020, Brilliance Auto Group experienced multiple incidents of non-compliant information disclosure, highlighting issues of untimely disclosure and concealment.

Firstly, from March to October 2020, the group failed to disclose over 50 instances of its inability to repay maturing debts in a timely manner, with a cumulative amount of 6.601 billion yuan. Secondly, as of October of the same year, the group failed to disclose 17 major litigation and arbitration cases in a timely manner as required, involving a total amount of 4.888 billion yuan. Then, within 2020, the group did not promptly announce three significant equity transfer actions that had a major impact on its controlling stake, involving a total shareholding ratio of 42.32%, with all of the high-quality assets of Brilliance China being transferred. Finally, 5.53% of the shares held by Brilliance Auto Group in Shen Hua Holdings were judicially frozen, reaching the threshold for disclosure of shareholder share freezes, but no announcement was made.

5. Impacts of Bond Default

5.1 Impact on the Company

The bond default triggered rapid downgrades of Brilliance's credit ratings by agencies such as Dongfang Jincheng and Dagong Global. The incident not only exposed deficiencies in the company's financial management and risk controls but also severely damaged its market reputation. The ensuing debt crisis raised concerns about its future solvency, potentially undermining investor confidence and impairing its ability to secure financing and sustain operations.

5.2 Impact on the Bond Market

Brilliance's case reflects common characteristics among defaulting entities in 2020, including deteriorating financing conditions, sectoral downturns, sharp declines in profitability, insufficient short-term liquidity, and severe cash flow shortages. As a representative case, its default may lead investors to sell off bonds issued by firms in similar industries or with comparable operational profiles, causing abnormal price volatility and reduced secondary-market liquidity for such bonds.

5.3 Impact on Investors

Firstly, investors holding Brilliance Auto Group's bonds face direct financial losses. Their investments cannot be repaid as scheduled, preventing them from obtaining expected principal and interest returns. The uncertainty surrounding the redemption timeline for the defaulted bonds also disrupts investors' long-term financial planning.

Secondly, the bond default adversely affects investors outside the bond market. The Group's operational deterioration has triggered a vicious cycle, leading to a sustained decline in its stock price. This has resulted in substantial losses for equity investors.

Lastly, this series of bond defaults undermines overall market confidence, dampening investment willingness across the board. Concurrently, it elevates the requirement for professional knowledge and risk assessment capabilities in investment decision-making. Frequent bond defaults may heighten investor caution and sensitivity to risk.

6. Conclusions

To reduce bond default risks, the following approaches can be implemented: Regulatory Recommendations .A robust information disclosure system must be established. The Brilliance case revealed failures in timely and adequate disclosure by issuers and underwriters, as well as delayed regulatory responses. Standards should be unified, the definition of significant events clarified, and reporting requirements — both periodic and ad hoc — specified. Enhanced on-site inspections and frequent reviews are necessary to ensure compliance.An effective post-default mechanism is essential for investor protection and maintaining financial stability. A compensation framework tailored to China's bond market should be established, implementing principles of the revised Securities Law through concrete policies. It is recommended to set up a dedicated investor protection fund and introduce efficient collective litigation mechanisms, including representative actions and centralized jurisdiction, to streamline dispute resolution and compensation procedures.

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