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Cross sectors – China

Defaults confirm that keepwell deeds are not guarantees

Recent default exposes limitation of keepwell deeds. The current restructuring of Peking University Founder Group Corp. (PUFG) is the latest example highlighting the limitations of keepwell deeds, a structure used by some Chinese companies to support and facilitate financing of their subsidiaries, such as their issuance of offshore bonds. As of 17 June, Moody's rated bonds with keepwell deeds issued by 38 offshore subsidiaries of Chinese companies. The providers of keepwell deeds are generally parent companies of issuers.

There are significant constraints to the credit support under keepwell deeds because they do not ensure that support from their providers would be forthcoming when the issuers are in distress. The case of PUFG highlights issues regarding legal enforceability and priority of claims and contrasts with a debt guarantee under which guaranteed bondholders have direct recourse to parent companies providing such guarantees.

Willingness and timeliness of support from keepwell providers are key notching considerations. We have rated keepwell-backed bonds below the rating of the keepwell providers. This takes into account the associated legal and regulatory uncertainties that limit keepwell providers' ability and willingness to provide sufficient and timely financial support and the risk that these bonds may rank lower in the priority of claims in cases of default or debt restructuring. The strategic importance of these bonds' issuers to their keepwell providers is a key consideration in our assessment of the latter's willingness to support.

Uncertain priority of claims leads to at least a one-notch rating difference. We have rated bonds with keepwell deeds one notch below the credit ratings of the keepwell providers, especially in the investment grade, because we consider that a keepwell provider has a strong willingness to provide support. This reflects our expectation that the default of the bonds will be highly correlated with the default of their keepwell providers because it will mean a failure of the keepwell provider to provide support despite their willingness to do so. The rating gap largely reflects the risk that these bonds could have higher loss given default than those of the support provider's senior unsecured creditors as a result of uncertainties over the priority of claims. We could widen the notching between the keepwell-supported bond and the support provider when the bond is closer to default to reflect higher probability of default and loss given default.

We will rate bonds with keepwell deeds more than one notch below the keepwell providers if we believe the latter is less willing in providing support because of weaker strategic importance of the issuers. A rating gap higher than one notch can also be driven by a large gap between the underlying credit quality of the keepwell provider and the issuer.

Recent default exposes limitations of keepwell deeds to provide credit support

Current restructuring of Peking University Founder Group Corp. (PUFG) is the latest example highlighting the limitations of keepwell deeds in protecting investors' interest, an issue that will gain relevance as China's economic slowdown continues.

A keepwell deed is a structure used by some Chinese companies to support and facilitate financing of their subsidiaries, such as issuance of the offshore bonds (Appendix I). As of 17 June 2020, Moody's rated bonds with keepwell deeds issued by 38 offshore subsidiaries of Chinese companies (Appendix III).

Keepwell deeds demonstrate the intention of the keepwell providers to support the issuing entities. The credit support can come from additional financial resources – such as commitments to maintain a certain level of ownership, a level of minimum net worth, deed of equity purchase undertakings and cross-border standby intercompany facilities – the keepwell providers agree to use to support the servicing of issuers' liabilities. (see Appendix II)

However, there are significant constraints to the credit support under keepwell deeds. Keepwell deeds do not ensure that support from their providers will be forthcoming in a distressed situation. For example, a keepwell deed may not provide direct legal recourse to the onshore provider if it fails to transfer funds in a timely manner to the offshore issuer. This contrasts with a debt guarantee under which guaranteed bondholders have direct recourse to the guarantors.

While these issues regarding bonds backed by keepwell deeds are not new, recent bond default by PUFG warrants attention because of its complex group structure and the multiple groups of onshore and offshore creditors involved. As we highlighted in Chinese corporates: [FAQs on Credit-Support Structures in China Using Keepwell Agreements: An Update, 10 April 2014](#), keepwell deeds are subject to much greater legal and regulatory uncertainties in respect of their effectiveness than guarantees.

The current case of PUFG – which is now under court-led restructuring with a debt administrator appointed by the court – highlights several issues that are at the core of these uncertainties.

First is whether bonds with keepwell deeds will be considered debt obligations of their keepwell providers and legally enforceable in an event of debt restructuring or default. While the debt administrator has recognized offshore bonds guaranteed by PUFG as its obligations, it is unclear whether the court will recognize claims of holders of offshore bonds backed by keepwell deeds in the same way. If these keepwell-backed bonds are not recognized as obligations of PUFG, their holders will lack direct recourse to PUFG. In this case, their recovery from their holdings is likely to be lower than holders of PUFG's senior unsecured bonds or senior unsecured bonds guaranteed by PUFG, reflecting much higher loss given default on bonds under keepwell deeds than that on guaranteed bonds.

Another issue is the position of PUFG's bonds backed by keepwell deeds in the priority of claims. Even if these keepwell-backed bonds are eventually recognized as obligations of PUFG, if these bonds are ranked at a lower priority of claims than that of PUFG's senior unsecured debts, their recovery will be lower than that of PUFG's senior unsecured bonds issued or guaranteed by PUFG.

Willingness and timeliness of support from keepwell providers are key notching considerations

The rating approach we apply to bonds supported by keepwell deeds reflects the limitations and uncertainties discussed above regarding such structures.

We typically rate bonds with keepwell deeds below the keepwell providers' rating, with a few exceptions. This takes into account legal and regulatory uncertainty associated with keepwell deeds. While the legal enforceability of keepwell deeds is uncertain, we assess the keepwell providers' ability and willingness to provide sufficient and timely financial support to help the issuer with bond payments. We also incorporated the risk that these bonds may rank lower in the priority of claims and suffer recovery rates lower than senior unsecured bonds or senior unsecured bonds guaranteed by the keepwell providers.

In a few exceptional cases, we have assigned these bonds the same rating as their keepwell providers and guarantors. In these cases, the bonds backed by keepwell deeds are also guaranteed by their offshore intermediate parents that carry a rating and have a credit profile

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as strong as that of the parent, in which case the rating of these bonds primarily reflects that of the guarantor and also consider that of the keepwell provider.

When assessing support from the keepwell provider, which is a key component in our rating of keepwell deeds, we take a holistic, case-by-case approach in our assessment of such support, focusing on:

- » The keepwell provider's ability and willingness to provide support.
- » The keepwell provider's ability to obtain necessary regulatory approval in a timely manner to transfer funds from onshore to repay holders of offshore bonds with keepwell deeds.
- » Any feature in the structure that would exacerbate or mitigate risks of timely provision of support.

The strategic importance of bond issuers to keepwell providers is a key consideration in our assessment of the latter's willingness to support. In particular, we focus on four areas:

- » Reputation/brand risks. The keepwell provider is more willing to provide support if a default of the issuer results in significant reputational risk of the keepwell provider and hamper the latter's ability to access offshore or even onshore capital markets.
- » Economic risk. This refers to potential operational or financial disruption to the group as a whole from a failure of the issuer. The potential disruption could be significant and justify strong willingness to support if there is a high degree of integration – operationally or financially – between the keepwell provider and the issuer.
- » Strategic fit/event risk. If an issuer's activities are key to the business strategies of the keepwell provider and the whole group, the keepwell provider is more willing to provide support to ensure the integral part of its business strategy is intact.
- » Track record. A keepwell provider's history of support demonstrates its willingness to provide future necessary support in times of need.

For example, some bond issuers being subsidiaries of large leasing companies exhibit strategic importance to their respective keepwell providers from the perspective of these four areas.

Large and strong state-owned enterprises (SOEs) generally have stronger incentive than privately owned enterprises to honor keepwell deeds because of the greater reputation risk at stake and the potential spillover such default could trigger on SOE peers. Nevertheless, we expect government support will continue to be selective depending on their strategic importance to government initiatives and policy goals.

Uncertain priority of claims leads to at least a one-notch rating difference

We typically rate bonds backed by keepwell deeds one notch below the rating of keepwell providers because we consider that there is strong willingness to provide support. This reflects our expectation that the default of the bonds will be highly correlated with the default of their keepwell providers because it will mean a failure of the keepwell providers to provide support despite their high willingness to do so. The one-notch difference largely reflects the risk that these bonds could have higher loss given default than keepwell providers' senior unsecured creditors because of uncertainties over the priority of claims.

One example is the offshore Medium-term Note (MTN) program issued by Charming Light Investment Ltd with a keepwell deed provided by [China Orient Asset Management Co., Ltd](#) (A3 stable) (China Orient AMC), one of China's four state-owned distressed asset management companies. Apart from the keepwell deed, the offshore securities under the MTN program are also guaranteed by China Orient Asset Management (International) Holdings Ltd, which is an offshore platform wholly owned by China Orient AMC. The MTN program is rated one notch below China Orient AMC's long-term issuer rating. This is because keepwell deeds are different from explicit guarantees in terms of the nature of the judgment and procedures of enforcement.

At the same time, we rated another MTN program issued by China Orient AMC's another offshore entity, United Wealth Development Ltd, on par with China Orient AMC's issuer ratings because the program is irrevocably and unconditionally guaranteed by China Orient AMC (guarantor). The guarantee will constitute the guarantor's direct, unconditional and unsubordinated obligations, ranking *pari passu* with all of the guarantor's other unsecured and unsubordinated obligations.

By the same token, we would rate bonds with keepwell deeds more than one notch below the keepwell providers if we believe the latter is less willing in providing support because of weaker strategic importance of the issuers. A rating gap higher than one notch could also be driven by a large gap between the underlying credit quality of the keepwell provider and the issuer.

One example is bonds with keepwell deeds issued by Coastal Emerald Limited, which is supported by a keepwell deed and an equity interest purchase undertaking deed from [Shandong Hi-Speed Group Co., Ltd](#) (SDHG, A3 negative) and guaranteed by China Shandong Hi-speed Financial Group Ltd (SHFG). The keepwell-supported bonds are rated Baa2, two notches below the rating of keepwell providing parent company SDHG. In this example, the credit rating of the bonds with a keepwell deed is primarily based on SHFG's standalone assessment of caa1; the affiliate-backed level of support from SDHG; and an uplift from a high level of support from the [Government of China](#) (A1 stable), via SDHG, in times of stress.

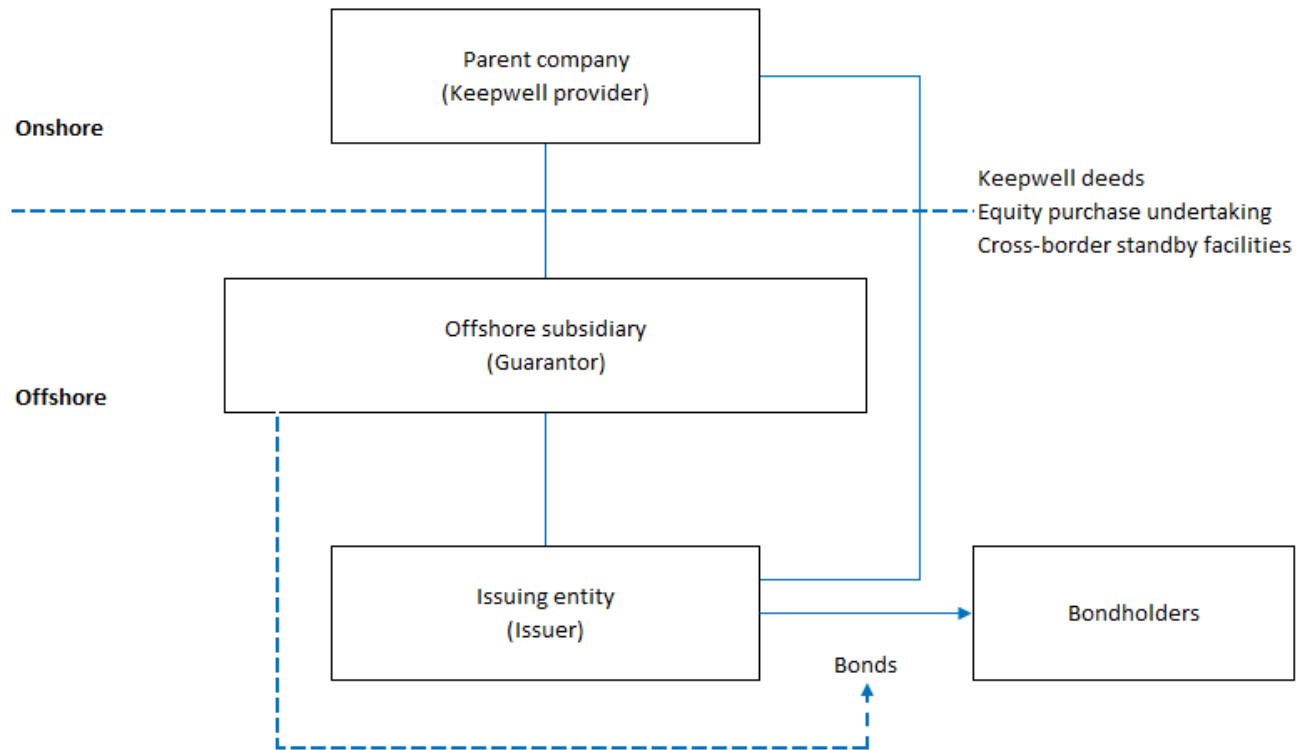
The affiliate-backed support takes into account the keepwell deed, which mandates SDHG's ownership at more than 40% and the cross-default provision.¹ The support also considers SDHG's ownership in and control over SHFG, the operational and financial links between the two entities and reputational risk to SDHG.

Our credit assessment can start top down with the support provider, or bottom up with the offshore issuing entity or the offshore guarantor. The top-down approach focuses on the support provider as an active and timely provider of support to the issuer. The bottom-up approach starts with the standalone credit quality of the issuers of bonds with keepwell deeds and/or their offshore guarantors, and then adds on the top rating uplift to reflect the likelihood of parental support. Both approaches are consistent with the above principles which result in ratings on keepwell-backed bonds typically below the rating of their support providers. We have used the bottom-up approach when the issuer of offshore bonds with keepwell deeds has meaningful operations in its own right. But we have tended to start top down when the issuer of offshore bonds with keepwell deeds is mainly a funding vehicle that provides important treasury function for its parent, rather than a standalone entity, or is highly integrated with its parent, serving important offshore functions but not commercially oriented.

As examples, we apply a top-down approach to assess the MTN of [Beijing Infrastructure Investment Co., Ltd](#) (BII, A1 stable) and a bottom-up approach to assess bonds with keepwell deeds issued by [Greenland Hong Kong Holdings Limited](#) (Ba2 stable). In the former case, we rate the MTN one notch below the issuer rating of BII, taking into consideration of BII's ability and strong motivation to provide support as we expect there will be serious reputational damage to BII and its parent with 100% ownership, Beijing Municipal Government, if the issuer fails to honor obligations under the MTN. In the latter case, we start with Greenland Hong Kong's corporate family rating and consider the legal and structural subordination risk from priority claims and the extent of support from the keepwell provider [Greenland Holding Group Company Ltd](#) (Ba1 stable). We eventually rate the bond with keepwell deeds one notch lower than Greenland Hong Kong's corporate family rating and one notch lower than the keepwell provider's, senior unsecured rating.

Appendix

I. An example of keepwell structure



1. A keepwell deeds is a contractual agreement between parent company, its offshore subsidiaries and the bond trustee, to maintain solvency and financial backing, and aims to increase the creditworthiness of offshore debt instruments
2. Keepwell deeds are sometimes accompanied by equity purchase undertaking agreement and cross-border standby facilities, but not in all scenarios
3. In some cases, there is an offshore intermediate parent providing guarantee to support the bond issuance, but not in all scenarios
4. Issuer can be a special purpose vehicle set up for bond issuance purpose or entities with operations.

Source: Moody's Investors Service

II. Overview of credit-support structures used by Chinese companies issuing offshore bonds

Keepwell deeds are used by China-incorporated companies to support offshore subsidiaries issuing debt. The deed is a contractual agreement between a parent company and its subsidiary to maintain solvency and financial backing, and aims to increase the creditworthiness of debt instruments issued by subsidiaries. While bonds guaranteed by onshore parent company have registration with the State Administration of Foreign Exchange (SAFE) and have capital flow quota that allows the onshore parent company to repatriate funds to repay the guaranteed bonds, bonds with keepwell deeds are not required to register with SAFE. While regulatory approval to guarantee a bond issuance is usually less problematic for large state-owned enterprises, one of the goals in using a keepwell structure is to establish an offshore fund-raising vehicle to minimize possible delays in garnering approval for each issuance.

Equity purchase undertaking provides a mechanism for onshore parents to divert funds from onshore to offshore to support the issuers with bond payments. For example, the parent could buy equity stakes in onshore assets owned by the offshore entity, which typically guarantees the offshore bonds. The agreement typically specifies that the price paid for the equity stake will result in sufficient funds being available to the offshore entity to cover guaranteed obligations under the bond. Exercise of the equity purchase is subject to regulatory approval from the Ministry of Commerce, and registration with the State Administration of Foreign Exchange and the State Administration for Industry and Commerce. However, many regard such approvals as easier to secure because the transactions involved are essentially of an intragroup transfer nature with the target being onshore assets.

Irrevocable cross-border renminbi standby facilities could be granted to the issuer by the support provider as a form of liquidity support. This allows the support provider to remit, through an onshore commercial bank, an amount of renminbi funds sufficient to satisfy the issuer's offshore payment obligations if the issuer does not have sufficient liquidity to service its offshore payment obligations. This standby facility is not a guarantee by the support provider of the payment of any obligation of the issuer. Rather it is typically used as a source of offshore liquidity and bridge financing while the onshore parent is arranging expatriating of funds (for example, obtaining regulatory approvals) to support the offshore issuers.

In some cases, a **debt guarantee** is provided by an offshore entity of the group (the guarantor) to support the issuance of offshore bond, in addition to the keepwell deed provided by the onshore parent. The offshore entity generally acts as an offshore investment and financing platform of the group and also an intermediate parent of the offshore bond issuing entity.

III. Summary of rated outstanding bonds with keepwell deeds

As of 17 June 2020

Sector	Issuer	Keepwell provider	Guarantor (if any)	Bond rating	Keepwell provider rating	Guarantor rating
Financial institutions	Bocom Leasing Management Hong Kong Company Limited	Bank of Communications Financial Leasing Co., Ltd.	-	A3	A2	-
Financial institutions	CCBL (Cayman) 1 Corporation Limited	CCB Financial Leasing Corporation Limited	CCB Leasing (International) Corporation Designated Activity Company	A2	A1	-
Financial institutions	CCBL (Cayman) Corporation Limited	CCB Financial Leasing Corporation Limited	CCB Leasing (International) Corporation Designated Activity Company	A2	A1	-
Financial institutions	CDBL Funding 1	China Development Bank Financial Leasing Co., Ltd.	CDB Aviation Lease Finance Designated Activity Company	A1	A1	A1
Financial institutions	CDBL Funding 2	China Development Bank Financial Leasing Co., Ltd.	CDB Leasing (International) Company Limited	A2	A1	-
Financial institutions	Charming Light Investments Ltd.	China Orient Asset Management Co., Ltd.	China Orient Asset Mgmt (Int'L) Hldg Ltd	Baa1	A3	-
Financial institutions	China Cinda Finance (2014) Limited	China Cinda Asset Management Co., Ltd.	China Cinda (HK) Holdings Company Limited	A3	A3	A3
Financial institutions	China Cinda Finance (2015) I Limited	China Cinda Asset Management Co., Ltd.	China Cinda (HK) Holdings Company Limited	A3	A3	A3
Financial institutions	China Cinda Finance (2017) I Limited	China Cinda Asset Management Co., Ltd.	China Cinda (HK) Holdings Company Limited	A3	A3	A3
Financial institutions	China Great Wall International Holdings III Limited	China Great Wall Asset Management Co., Ltd.	China Great Wall AMC (Int'L) Hldgs Co Ltd	Baa1	A3	-
Financial institutions	CMB International Leasing Management Limited	CMB Financial Leasing Co., Ltd.	-	Baa1	A3	-
Financial institutions	Coastal Emerald Limited	Shandong Hi-Speed Group Co., Ltd	China Shandong Hi-Speed Financial Group Limited	Baa2	A3	-
Financial institutions	Huarong Finance 2017 Co., Ltd	China Huarong Asset Management Co., Ltd.	China Huarong International Holdings Limited	Baa1	A3	-
Financial institutions	Huarong Finance 2019 Co., Ltd.	China Huarong Asset Management Co., Ltd.	China Huarong International Holdings Limited	Baa1	A3	-
Financial institutions	Huarong Finance II Co., Ltd	China Huarong Asset Management Co., Ltd.	China Huarong International Holdings Limited	Baa1	A3	-
Financial institutions	ICBCIL Finance Co. Limited	ICBC Financial Leasing Co., Ltd.	-	A2	A1	-

Sector	Issuer	Keepwell provider	Guarantor (if any)	Bond rating	Keepwell provider rating	Guarantor rating
Non-financial corporates	Bright Food Singapore Holdings Pte. Ltd.	Bright Food (Group) Co., Ltd.	Bright Food International Ltd.	Baa3	Baa2	Baa3
Non-financial corporates	Champion Sincerity Holdings Limited	China Communications Construction Group (Limited)	Greentown China Holdings Limited	Ba3	-	Ba3
Non-financial corporates	China Clean Energy Development Limited	China General Nuclear Power Corporation	CGNPC International Limited	A3	A2	-
Non-financial corporates	CNPC (HK) Overseas Capital Ltd.	China National Petroleum Corporation / China Petroleum Finance Co., Ltd	CNPC Finance (HK) Limited	A2	A1 / NA	A2
Non-financial corporates	CNPC General Capital Limited	China National Petroleum Corporation / China Petroleum Finance Co., Ltd	CNPC Finance (HK) Limited	A2	A1 / NA	A2
Non-financial corporates	Eastern Creation II Investment Holdings Ltd.	Beijing Infrastructure Investment Co., Ltd.	Beijing Infrastructure Investment (Hong Kong) Limited	A2	A1	-
Non-financial corporates	Fuqing Investment Management Limited	Ping An Real Estate Company Ltd.	Pingan Real Estate Capital Limited	Baa3	Baa2	Baa3
Non-financial corporates	Gemdale Ever Prosperity Investment Limited	Gemdale Corporation	Famous Commercial Limited	Ba3	Ba2	Ba3
Non-financial corporates	Greenland Hong Kong Holdings Limited	Greenland Holding Group Company Limited	-	Ba3	Ba1	-
Non-financial corporates	Greentown China Holdings Limited	China Communications Construction Group (Limited)	-	Ba3	-	-
Non-financial corporates	Guangzhou Metro Investment Finance (BVI) Ltd.	Guangzhou Metro Group Co., Ltd.	Guangzhou Metro Investment Finance (HK) Ltd.	A2	A1	-
Non-financial corporates	Honghua Group Limited	China Aerospace Science and Industry Corporation Limited	-	B1	-	-
Non-financial corporates	Poly Real Estate Finance Ltd	Poly Developments and Holdings Group Co., Ltd.	Hengli (Hong Kong) Real Estate Limited	Baa3	Baa2	Baa3
Non-financial corporates	Rail Transit International Development Company Limited	Tianjin Rail Transit Group Co., Ltd.	Tianjin Rail Transit Group (Hong Kong) Co., Limited	Baa1	A3	-
Non-financial corporates	Rail Transit International Investment Company Limited	Tianjin Rail Transit Group Co., Ltd.	Tianjin Rail Transit Group (Hong Kong) Co., Limited	Baa1	A3	-
Non-financial corporates	Scenery Journey Limited	Hengda Real Estate Group Company Limited	Tianji Holding Limited	B2	B1	B2
Non-financial corporates	Shanghai Port Group (BVI) Holding Co., Limited	Shanghai International Port (Group) Co., Ltd	Shanghai International Port Group (HK) Co. Limited	A2	A1	-
Non-financial corporates	State Grid Europe Development (2014) Plc	State Grid Corporation Of China	State Grid International Development Limited	A2	A1	A2
Non-financial corporates	Twinkle Lights Holdings Limited	China Communications Construction Group (Limited)	Greentown China Holdings Limited	Ba3	-	Ba3
Non-financial corporates	Vanke Real Estate (Hong Kong) Company Limited	China Vanke Co., Ltd.	-	Baa2	Baa1	-
Non-financial corporates	Wanda Properties International Co. Limited	Dalian Wanda Commercial Management Group Co., Ltd.	Wanda Commercial Properties (Hong Kong) Co. Limited	Ba3	Ba1	Ba3
Non-financial corporates	Wanda Properties Overseas Limited	Dalian Wanda Commercial Management Group Co., Ltd.	Wanda Commercial Properties (Hong Kong) Co. Limited	Ba3	Ba1	Ba3

Source: Moody's Investors Service

Moody's related publications

» [Chinese Corporates - FAQs on Credit-Support Structures in China Using Keepwell Agreements: An Update](#), April 2014

Endnotes

¹ The default of the bond with a keepwell deed will cross-default the guaranteed bond and constitute an event of default of SDHG, the keepwell provider.

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