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29 June 2015

# VIEWPOINT
# CROSSING THE RIVER WITH CHINESE LOCAL GOVERNMENT BOND REFORM

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## KEY POINTS:

- China has adopted a pragmatic approach to help local governments roll over their debt
- New local government bonds are a cheaper form of financing than commercial bank loans and have a longer tenor
- By conservative estimates, the Chinese local government bond market could grow to CNY 10 trillion

"摸着石头过河" – the Chinese phrase for crossing the river by feeling the stones – was used by Deng Xiaoping to describe China's economic reforms in the 1950s. Sixty years later, this quote continues to serve as China's guiding principle as the nation forges ahead to make the economy more market oriented.

Lately, news of banks swapping local government debt to bonds has dominated the headlines. This came on the heels of a new directive allowing local governments to issue bonds in their own name; a sequel to a previous pilot program that has been running for a year. Within weeks, the swap program was doubled from CNY 1 trillion to 2 trillion despite banks' push-back that the new local government bonds (LGBs) were yielding too little.

## TAX REFORM OF 1994: THE ROOT OF LOCAL GOVERNMENT INDEBTEDNESS

China's local government indebtedness has roots in tax reforms of 1994. Prior to the introduction of the "tax sharing system" [分税制], China's central government was close to insolvency. On two occasions, it borrowed from the local governments and subsequently defaulted on these loans. The new tax code gave the central government a larger share of the tax revenue and the proportion grew as the central government became more powerful while the local governments' role was reduced to that of administrative and economic units.

As China modernised and urbanisation accelerated, the financial burden of infrastructure spending ballooned beyond the revenue of local governments. Officials borrowed aggressively to meet Beijing's growth targets. They soon learnt that land sales were a quick way to finance infrastructure projects. To skirt around strict budget laws, as many as 10,000 Local Government Financing Vehicles (LGFVs) were created. These LGFVs borrowed from banks as well as shadow banks. When the massive CNY4 trillion stimulus package was announced to repel the 2008 global financial crisis, some took the opportunity to leverage more.

Source: AsiaCreditMarkets

As property-cooling measures were rolled out, land prices dipped with demand. The land sale model broke down and some local governments went into fiscal-shock adding to concerns of a hard landing.

## THE A NEW STANDARD: OPENING THE FRONT DOOR

China spends around 15% of its GDP (Gross Domestic Product) on debt servicing. Even in the private sector, the leverage at some state-owned enterprises have reached unsustainable levels and SMEs (small and medium-sized enterprises) without government connections are being crowded out from affordable financing. With defaults on the rise and bank balance sheets looking unsteady with non-performing loans, China began dealing with local government debt issuance with greater urgency.

China experimented with LGB issuance with 10 wealthy localities and in October 2014, the State Council issued Circular 43, a new directive to manage the local debt issues. Key features of Circular 43 include:

- Local governments (only provinces) are now able to issue bonds in their own names. From 2016, projects can only be financed by provincial level municipal debt, stripping LGFVs of their role
- Current local government debts have to be classified as direct local government debts, contingent local government debts or debts that are non-local government. LGFVs cannot pass on their debts to local governments
- All direct local government debts, including guarantees have to be incorporated into the fiscal budget and approved by the State Council and the National People's Congress. The amount of debt is capped and additional borrowing through financing vehicles is banned from 2016
- Central government will not bail out local government debt and local governments have to control investment, cut expenditure and dispose of assets to repay debt

In March 2015, the Ministry of Finance announced its first CNY 1 trillion bond-for-debt swap for commercial banks to replace direct local government debt maturing this year with LGBs. The size of the program was subsequently increased to CNY 2 trillion which is enough to cover the amount of such loans due to mature this year. These debt swap programs can be expected to be regular features as local government debt matures year after year.

While closing the back door on off-balance-sheet financing such as LGFVs, the new directive has opened the front door of financing via bond issuance. Lou Jiwei, China's Finance Minister, estimated that local governments could potentially save around CNY 40-50 billion this year in debt servicing as local governments replace short-term, high cost debt with longer tenor, low cost debt. The LGBs which yield 3-4% are cheaper than commercial loans which could cost as much as 7%.

## COMMERCIAL BANKS: LACKLUSTRE RESPONSE DESPITE BENEFITS

Banks have responded with little enthusiasm, primarily because LGBs yield less than loans, thereby crimping their margins. Furthermore, the Peoples' Bank of China (PBoC) has put a cap on how much the LGB can yield to help the local governments roll over their debt cheaply. When some of the bond auctions did not go well, banks were told to at least subscribe to a portion of an issue that matches their loans to the local governments. To cushion the blow, the central bank allowed these LGBs to be used as collateral for the main lending facilities through which it provides liquidity to the financial system.

On balance, with proper risk ownership and lower default risk, banks have little basis for complaint. At the very least, they know which portion of the debt will be covered by the budget and there is now a cap on how much each local government can borrow. Also, as the capital charge is lower in LGBs, banks can potentially earn a better return on capital. Banks can also deploy the freed-up loan quota for SME and retail loans, since the bond-for-debt swap has an effect of lowering the loan to deposit ratio.

Admittedly the central bank appears to be back-pedalling somewhat from creating a market-driven onshore bond market. It is clear that measures focus on providing liquidity more than tackling the issue of solvency. The mountain of debt will remain and the market would be disappointed if it was looking for haircuts, write-offs or markdowns. While the directive is fairly detailed in how bonds can be issued, some have highlighted that it is not clear how they will be repaid.

## CENTRAL BANK: A PRAGMATIC LIQUIDITY APPROACH

To provide perspective, debt swaps are an acceptable tool used for debt management in many economies including the United States and Japan. China now has a concrete plan backed by the strong balance sheet of the central bank. Their approach is commendable for finally taking the bull by the horns after years of rising indebtedness.

In return for zero defaults on the loans, banks have been asked to settle for lower interest margins while the central bank will use its balance sheet to provide cheap funding to the banks. In all debt reform, there are winners and losers. In this case, the PBoC is picking up the tab and the

commercial banks are paying a small price to keep their balance sheets sound. Banks will continue propping up local governments with the hope that their borrowers become stronger in future.

With the economy slowing down to its weakest pace in six years, this is not the time for difficult decisions. Furthermore, as mentioned earlier, the local government indebtedness has its roots in a tax code that left the local governments with too little money to build infrastructure. The new directive is part of the on-going fiscal and tax reform that is needed to eradicate the root cause of the problem.

Until then, the poorer local governments are in fact borrowing on the central government's credit. By intervening in the pricing of issues, the central government has identified itself as the ultimate backstop lender. Hence, unlike the United States, the central government in China can be expected to step in and bail out its local governments when needed.

## THE FUTURE OF LOCAL GOVERNMENT BOND MARKETS

For capital markets to allocate capital efficiently, risks have to be properly priced. That can be achieved with improved disclosure of public accounts, stricter enforcement of covenants, greater independence of rating agencies and wider heterogeneity in the investor base. More importantly, in the case of China, a few real-life defaults would be helpful in reminding investors that higher yielding bonds come with greater risk, while rewarding better quality credits with a lower cost of financing.

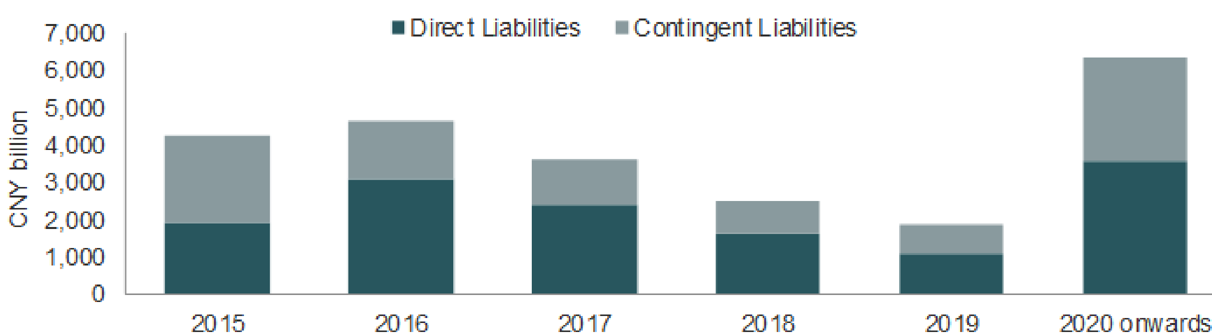
At the moment, few expect the Chinese LGB market to match the size of the US municipal market which is 22% of US GDP. By that measure, the LGB market in China would be around CNY 15 trillion. According to CITIC Securities, the amount of local government debt is around CNY 23 trillion at the end of 2014.

It is therefore conceivable for the LGB market to leap beyond CNY 10 trillion if just half of the debt is converted to LGBs, bearing in mind that not all debt is classified as direct liabilities and some debt may end up as corporate bonds. Considering that China spent an average of CNY 8-9 trillion on infrastructure in the last five years, CNY 10 trillion is a conservative estimate of Chinese LGB market's prospects.

That would substantially add to China's CNY 35 trillion onshore bond market, which is fairly small compared to China's economic stature as the world's second largest economy. China desperately needs to develop its onshore bond market to fund its growth as over-reliance on bank financing is a serious threat to the soundness of the banking system. However, the roadmap ahead is far from clear. The recent initiative to step up local government debt reform is only one of the many stones to help the PBoC cross the river.

*"Until further reforms are implemented, poorer local governments are borrowing on the central government's credit. By intervening in the pricing of issues, the central government has identified itself as the ultimate backstop lender."*
- Frank Lim, CFA, Product Specialist

Projected local government debt repayment schedule




Source: CITIC Securities, Lion Global Investors, as at December 2014.



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