ShoreVest 新岸資本

China Debt Dynamics

Local Government debt burden could "disappear"

Volume 2 | Issue 6
28 August 2018

Andrew Brown CFA
Partner, Macro & Strategy

CBIRC may move to reduce municipal bond risk weightings to -0-% risk-free status
According to a report last week by Caixin, which sourced the China Securities Journal, the CBIRC may reduce the risk weighting on local government bonds (municipal bonds) to -0-% from the current 20%. This move should not go unnoticed by the capital markets community, and if implemented, is significant in three primary ways:

A -0-% risk weight implies explicit backing by the Chinese central government
First, a move to a -0-% risk weight implies that the municipal bonds will no longer be "implicitly" backed by the central government, rather they would – by definition - become "explicitly" backed by the full faith and credit by the Chinese government, as is the requirement for -0-% risk weight status in OECD countries. Indeed, securities that are "conditionally" guaranteed by the central government of an OECD country is currently assigned a 20% risk weight, as is the existing case with Chinese municipal bonds. Importantly, a move toward -0-% risk weighting and an explicit guarantee by the central government would therefore completely remove the overhang of what has been viewed by capital markets and critics of China's debt burden as one of the most systemically risky parts of the economy; that being the size of local government debt. Industry estimates for the total amount of outstanding local government debt is between RMB 25-30 trillion ($3.7-$4.4 trillion), equivalent to as much as 33% of GDP. While this development would not actually lower leverage within the system, it would transfer the burden to the central government's balance sheet. It is a form of quantitative easing while simultaneously reducing systemic risk in the financial system.

A -0-% risk weight encourages banks to buy local government bonds
Second, this is clearly intended to encourage banks to buy and hold more municipal bonds, which is both consistent with funding the impending re-instatement of certain infrastructure projects to offset slowing economic growth, as well as another move to reduce risk on banks' balance sheets as it would improve their capital ratios, improve their liquidity, and expand their qualifying collateral base for borrowing from the central bank. It is another example of a deliberate measure to offset the negative impacts from the clampdown on shadow credit and shadow liquidity (as we have written in previous CDDs), and regulations requiring restating mis-classified credit exposures (see "Circular 46" CDD). Importantly, the source of funding for holding more of these bonds is already in place. There have been three cuts so far in 2018 in the Required Reserve Ratio (RRR – i.e., the percentage of deposits that are "locked-up" on reserve at the central bank), and there will almost certainly be more to come.

For context, at 16% (larger banks) and 14% (smaller banks), China has by far the highest RRR in Asia and remains at elevated levels even compared to its own history. China's RRR was at 6% pre-crisis. For illustration, to move from the current 16/14% back to 6% (it will arguably be lower as interest rates become fully liberalized and the RMB becomes internationalized), would release $2.5-3 trillion back onto bank balance sheets to offset the removal of shadow interbank liquidity (approximately $1 trillion), buy Local Government

municipal bonds (i.e., about $2 trillion in “valid” municipal bonds), and participate in the continued issuance in the overall bond market. And, of course, to fund some level of direct lending as the shadow banking system is shrunk.

Risk-free status would lower borrowing costs materially

Third, a move to a -0-% risk weighting will lower borrowing costs for local governments. With five-year Chinese government bond yields now at 3.4%, local government should realize as much as a 200bp decline in borrowing costs from current levels, or approximately RMB 785 billion if applied to the entire (approximate) US$4.4 trillion in local government debt. Admittedly this is a best-case scenario, but it is equivalent to about 1% of GDP, which is material given slowing economic growth.

As we recently wrote, we do not view these moves as “stimulus”, rather they are deliberate offsets to the significant negative effects of the deleveraging campaign and clampdown on shadow liquidity and credit in order to reduce systemic risk in the system.

Background to LGFVs

As a result of China’s stimulus program that began in 2009 in response to the global financial crisis (GFC), local government debt swelled to fund infrastructure projects to promote urbanization and economic growth. Local governments are not allowed to directly borrow from banks, so they set up Local Government Financing Vehicles (LGFV), as project-finance special purpose vehicles (SPVs) which then borrowed from the banks to fund their infrastructure projects. This led to excess investment as banks were happy to extend credit given the “implicit” guarantees extended by the government. However, beginning in 2015, slowing economic growth and measures authorities put in place to temper the property market revealed the over-reliance on land sales as the primary source of funding for the local governments, and brought default risk to the forefront. Since then, the LGFV debt burden has become a primary concern as policy makers and market participants evaluate systemic risk within the economy.

On 8 March 2015, authorities put in place an LGFV debt swap program, starting with a RMB 1 trillion quota for (qualifying) maturing LGFV bank debt to be refinanced by being swapped into lower-yielding municipal bonds. Essentially the banks were being told to swap out of corporate loan yields of approximately 8-10% to quasi government yields of approximately 5-6%. And to offset the lower yields, the banks were allowed to assign a risk weighting of only 20% on the municipal bonds vs. as much as 100% on LGFV corporate loans. The banks have been busy swapping the LGFV debt into municipal bond holdings, and by some industry estimates, the banks now hold approximately 80% of outstanding municipal bonds.

Sourcing – recent events ensure steady flows of NPLs into marketplace

As we wrote in our last China Debt Dynamics, by reducing systemic risk through the provision of liquidity into the banking system, regulators are ensuring a continued flow of NPLs off of banks’ balance sheets and into the marketplace while reducing systemic-event risk. We have seen no slowdown in the de-leveraging campaign, particularly the “disclose & dispose” framework constructed by regulators only a few months ago and being increasingly implemented to encourage banks to appropriately account for NPLs and remove them from their balance sheets (see "Disclose & Dispose" CDD). This new development of potentially introducing a -0-% risk weighting for municipal bonds, presumably by implementing an explicit guarantee by the central government, is yet another example of how Chinese authorities are intent on ensuring an orderly and well-synchronized implementation of the de-leveraging campaign.

Given the sheer magnitude of the distressed debt in China (we estimate $3 trillion), further “easing” actions will be necessary over a prolonged period of time, primarily surrounding the provision of liquidity to the banking system, and should ensure a steady flow of NPLs off of banks’ balance sheets, reflecting the continued deleveraging of the economy. We at ShoreVest welcome these combined activities as it keeps the banks and the overall economy on a glide-path of deleveraging while reducing overall systemic risk.

Legal Information and Disclosures

This letter expresses the views of the author as of the date indicated and such views are subject to change without notice. ShoreVest Capital Partners has no duty or obligation to update the information contained herein. Certain information contained herein concerning economic trends is based on or derived from information provided by independent third-party sources. ShoreVest Capital Partners believes that the sources from which such information has been obtained are reliable; however, it cannot guarantee the accuracy of such information and has not independently

verified the accuracy or completeness of such information or the assumptions on which such information is based. This letter, including the information contained herein, may not be copied, reproduced, republished, or posted in whole or in part, in any form without the prior written consent of ShoreVest Capital Partners.

Our contact details:
International Finance Center
Suite 3601
5 Zhujiangxi Road
Tianhe District
Guangzhou, China

inquiries@shorevest.com

Copyright © 2017
All rights reserved.