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China's 1 Trillion Bond Swap Deal

China's Bond Swap Program Is a Step in the Right Direction but Won't Solve the Problem of Local Debt

China's Ministry of Finance has announced program swap 1 trillion renminbi of local debt for bonds. The bonds will be tradable instruments and offer transparency to replace opaque forms of bank and other debt. This a piece of a broader policy to clarify the amount of debt held by local governments and try to restrain China's growing 17 trillion renminbi in local debt. The plan is a step in the right direction. However, it falls significantly short of offering a remedy for China's underfunded fiscal economy, fails to assign responsibility for the majority of debt and does not address the cross-collateral relationships in local debt. It also implicitly relies on banks as a backstop, which could be negative for their asset quality.These problems are not widely understood among investors and analysts.

The Ministry of Finance's March 12 announcement cites a State Council decision to "strengthen local government debt management, standardize local government bonds" and to "limit debt borrowing." It cites Document Number 43, issued in October 2014, that ordered local governments to "establish a standard of local government debt financing." Document 43 was the flag bearer policy statement that put local governments – and their off-balance sheet companies -- on notice that they had to curtail spending. This was to be achieved principally by capping local borrowing and preventing new contracts from being rolled over.

The Ministry of Finance statement shows that new local government bond issuance will be 600 billion renminbi in 2015 (500 billion regular and 100 billion "special"). The total bond issuance will be 1 trillion renminbi to refinance debt coming due in 2015. A larger 3 trillion reniminbi figure apparently refers to the total over several years. The purpose is to lower the debt service costs by refinancing at a lower rate.

Local Debt Much Higher Than Stated

According to the latest survey by the National Audit Office (NAO) in mid-2013, there is 17.9 trillion renminbi of local debt. This is divided by the NAO into three categories: Official local debt (10.9T), government guaranteed local debt (2.7T), and contingent debt

(4.3T). It is not clear exactly what these categories mean. The contingent debt I assume is related to Local Government Financing Vehicles (LGFVS), the off-balance sheet companies local governments used to inject stimulus money into the economy.

Local Debt (2013)	RMB Bln	% Total
Govt Debt	10,886	60.8%
Govt Guarantee	2,666	14.9%
Contingent Debt	4,339	24.3%
	17,891	

There are a couple of problems with these numbers that are going to make it very difficult for the Ministry of Finance, along with the PBOC and the State Banks, to try to resolve the local debt problems through the bond market.

First, total debt is understated. The guaranteed and contingent debt is most likely multiples of these numbers. Some economists expect the Ministry of Finance to reevaluate total local debt upwards by about 30%, pushing it to around 23 trillion renminbi. The local governments purposely borrowed off their books to avoid a debt burden so much of the debt has not been officially recorded as local debt. However, in October 2014, Beijing imposed a debt ceiling on local governments. They seem to be using the existing official debt numbers as the maximum under the cap. As a result, local governments are busy *putting back on balance sheet* the off-balance sheet debt, in order to raise the level of their existing debt to increase the total cap.

Second, the legal guarantees are unclear. Beijing has not said exactly which debt will be swapped, but we have to assume it is the 60.8% that is categorized in the NAO survey as government debt. But even this assumption is suspect. It's not clear governments -- and certainly not non-governments -- can guarantee bond debt. As noted by Don Clarke, a Chinese law professor at George Washington Law School, the bonds are legally not able to obtain a valid provincial government guarantee without a revision of the Security Law (Article. 8) and the Budget Law (Article. 28). The legal basis for provincial government support for the bonds becomes even murkier when you consider the non-government bonds. They have complete orphan status. The prospectus for many loans to the LGFVs from Trusts and other Shadow Banks often refer to guarantees but there is no real legal basis for this.

Moody's makes the hopeful assumption that "The credit strength of upper-tier Regional and Local Governments (RLG), consisting of 31 provinces and 5 centrally planned cities, is supported by their close ties with the sovereign government. While we do not currently rate China's upper-tier RLGs, their ratings would likely be in a tight range, and no more than

two notches below that of the sovereign government, if we were to apply our global rating methodology to them." But what does it mean to say they are "closely aligned?""

Third, who will buy the bonds? Beijing has been stressing that the bond swap program will be based on market principles. At a conference on March 19, Finance Minister Lou Jiwei told reporters the trillion-yuan (HK$1.26 trillion) local government debt-for-bond swap programme would be carried out based on market demand with no help needed from the central bank. Recently, analysts interviewed by the South China Morning Post that there should be plenty of demand for the bonds among private investors. Jurgen Conrad, the head of the Economic Unit at the Asian Development Bank in China, told the *Post* the pool of potential investors would be large, including domestic commercial banks, other institutional investors, and possibly also foreign buyers.

This is currently anyone's guess, but it is unlikely that foreign investors or domestic institutions will be big buyers. This would be a bet on a risky tranche of debt, that may or may not be backed by the government, for low yields. It's also a bet on the renminbi at a time when capital flight may reduce its value. Meanwhile, domestic investors generally can obtain higher yield through the Shadow Banking market.

So we're probably talking about the banks stepping in to fill the gap. The banks currently account for about 70% of China's bond market. If they are the major buyers, then we're basically switching from commercial bank debt to bonds. There's an advantage to the transparency afforded by bonds over bank debt-- but not much. As state owned entities, the Big Four banks suffer from a case of "moral hazard" -- are they really going to force local governments or LGFVs into bankruptcy if they don't pay interest? Doubtful. That means the banks will be holding worthless paper -- while pretending these are valuable assets.

Fourth, what about the rest of the debt? Beijing is not resolving the overall problem of excessive local debt. Much of the local debt has been loaned by wealthy individuals and institutions through Shadow Banking channels. The chart below outlines the problem. Only about one-third is provincially held; the rest has been borrowed by sub-provincial governments. Where is this debt and how can it be handled? Beijing consolidates debt all local debt to the province but leaves the messy details of lower governments to the provinces to figure out.

Fifth, who are the lenders and will they all get paid? There is a lot of confusion about the source of the debt. Official numbers cited below say banks account for only half of outstanding local debt. The rest comes from the private and corporate sector. Does Beijing plan to bail out these lenders? Will Beijing allow local governments (both provincial and

below) issue bonds to pay back wealthy Chinese citizens and Trust companies? Who would buy these bonds? Would they carry a state backing or would they be more "orphans?"

Breakdown of Chinese Local Debt by Source and Destination

Geography			
RMB Tln	**2010**	**2013**	**% Total**
Province	3.20	5.19	29.0%
City	4.67	7.29	40.8%
County	2.85	5.04	28.2%
Township	NA	0.365	2.0%
	10.72	**17.89**	**100.0%**
Borrower (RMB Tln)	**2010**	**2013**	**% Total**
LGFV	4.97	6.97	39.0%
Local Govt Agency	2.5	4.06	22.7%
Non-administrative Govt Agency	1.97	2.72	15.2%
SOE	1.28	4.14	23.1%
	10.72	**17.89**	
Lender (RMB Tln)	**2010**	**2013**	**% Total**
Bank	8.47	10.12	56.6%
Other (Bonds, Trusts, etc.)	2.25	7.77	43.4%
	10.72	**17.89**	

Source: National Audit Office

Banks on the Hook. At the end of the day, it is likely that most local debt will end up on the balance sheets of the state banks -- not just the one-third borrowed by Provinces. Even LGFV debt loaned by private individuals through the Trusts and Banks, may end up on bank balance sheets. Why? Otherwise, Beijing may be facing thousands of unhappy middle class citizens marching in the streets demanding payback. Many of the loans were made in the conference rooms of the state banks as so-called "Wealth Management Products." Not surprisingly, the lenders assumed all this Shadow Banking had implicit government backing.

Last February, a 3 billion renminbi Trust product called "Credit Equals Gold" almost defaulted. After a delay of several months, ICBC bailed out the loan. The recapitalization -- which took months to negotiate -- is an example of how these deals are worked out behind closed doors. We could be facing many more bailouts by the banks. Bonds won't solve that problem. This could cause problems for bank solvency. In 2013, Chinese banks had 1.7 trillion Renminbi in profits and 6.13 trillion in equity. Adding 3 trillion Renminbi in bonds (the total size of the expected program), and assuming many of these bonds default, that would be a substantial writedown for banking assets, eventually wiping out equity. Then

China's new bond program would be a a finger in the dike of bad debt. At that point, the Ministry of Finance would have to step in to support the banks.

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