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April 30, 2015

China Bond Swap – Next Steps

More Bank Debt

I've just completed a number of conversations with investors globally who expressed interest about the impact of China's 1 trillion Renminbi bond swap program on China's economy and its banks. It's a quickly changing scenario. It's clear the PBOC threw the bond swap out as a massive policy measure to solve the local debt problem and is now letting all the parties fight it out.

Rapid Changes

The initial program has changed radically since it was announced in March. In statements by Premier Li Keqiang at Davos and Finance Minister Lou Jiwei, both said the bond swap program would be a private sale of bonds and that Provinces would be responsible for the debt. Neither statement now appears to be accurate. Both Jiangsu and Anhui Province delayed bond sales because of a lack of buyers, indicating that the program is having trouble getting off the ground. Nor is it likely the central government will be uninvolved. The latest changes in the government's response suggest several conclusions about how this massive recapitalization of local debt will work out.

First, the delay by two provinces says a lot about the increasing fragmentation of control over the financial system. Under Premier Zhu Rongji twenty years ago, the state banks were revamped to eliminate the requirement to report to local Party officials. Instead, they reported directly to Beijing headquarters, eliminating much local interference. My conversations with local banks (and my experience at BOC) suggests this has been very effective in maintaining relatively stricter control over lending. And this lending has been guided at the top by the PBOC. However, the delay by the two provinces means the banks basically told the PBOC and the Ministry of Finance "no" — a surprising indication of market power by an important cog in China's financial wheels.

Second, after the announcement of the program, the PBOC appears to have gotten cold feet — not surprising given the bank's response. The PBOC has come up with a possible agreement to allow the banks to use the bonds they purchase as collateral for additional loans from the central bank. The Wall Street Journal reported that the bulk of the assets held by the PBOC is foreign currency, a result of its effort to control the yuan's value, with only a small share in government debt. As a result, analysts say, the central bank has significant room to increase its holdings of government securities as it seeks to further expand its balance sheet. This has been misinterpreted as a form of QE but in fact the PBOC's intention appears to be simply to replace the banks' lost liquidity due to the bond purchases in order to speed up the local debt recapitalization program.

Third, this is another example of a central government recapitalization of the financial system -- without explicitly adding to central government debt. The PBOC and the State Council - for reasons of pride more than anything else -- are adverse to increasing the government debt and instead prefer to use outside channels. The recapitalization of the four state banks a decade ago is

an example of this financial sleight-of-hand. The "bad banks" — the Asset Management Companies — took the banks' bad loans, turned them into bonds, and sold them right back to the banks, where they stayed on the balance sheet at par. Only over a couple of years with little financial disclosure did the MOF and SAFE quietly repurchase the bonds, centralizing the debt. But they prefer to do this without notification. We are seeing a similar process going on here through different vehicles. But eventually this debt will be centralized.

Fourth, in line with the last point, Beijing is starting to utilize "accessible" pools of capital for debt recapitalization or fiscal stimulus. Instead of monetary policy or Keynesian stimulus in the western sense through central government mechanisms, Beijing prefers to pull the fiscal trigger in less obvious ways. The state banks are an obvious — and the largest — source of capital, and are being used as described above. But we have also seen massive purchases of apartment blocks by the policy banks, and more recently as we have reported in our research, the insurance companies have become among the largest buyers of local debt and land via the LGFVs. (http://www.orientcapitalresearch.com/wp-content/uploads/2015/04/Chinas-Insurance-Shadow-Banks.pdf). We can only guess but it is likely the insurance company participation was driven not only by yield but also by central government "suggestions" that they help out struggling local governments by purchasing LGFV debr. Insurance companies have become the largest investors in infrastructure in China. This is a relatively risky use of insurance capital and looks more like central government policy than efficient investment.

Fifth, the local debt recap program via bond swap completely ignores the "flow" problem of local fiscal finance. Local governments amassed debt for two reasons: 1) To spend money during the 2009 fiscal stimulus; 2) To fill a fiscal gap between revenue (taxes, fees and land income) and spending (social security). The IMF has stated that local governments posted a revenue shortfall of 18 trillion yuan between 1998 and 2012; 13 trillion was filled through land sales and 5 trillion through shadow banking loans (mainly to LGFVs). Land sales fell 36% in the first quarter of 2015, while government edicts and a declining property bubble have slowed land sales. That gap has to be filled somehow. The likely candidates are the state banks. So while the banks are struggling to figure out a way to purchase bonds, they are likely to be asked in the coming months to provide ***additional banks loans*** to cash-short local governments, loans that will probably not be repaid.

In 2013, the four state banks had total equity, profits and provisions of 4.5 trillion renminbi. Revenue shortfalls averaging 1.3 trillion renminbi per year (which may be higher at this point giving rising social service payments) if put on bank balance sheets would have a significant impact on liquidity. This may be a bigger threat to the stability of the banking system — and also to the country itself — than the debt problem.

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