Expected Intensified Transformation and Integration in LGFV Sector as China Tightens Regulation on LGBs

Hong Kong, 6 May 2021 -- A report titled "LGBs Require Normative Management to Steadily Expand, Expected Faster Integration and Transformation in the De-leveraging Context in LGFV Sector: Q1 2021 Review and Outlook of the LGB and UCIB Industry (Policy Chapter)" has been recently published by the Research Institute of China Chengxin International Credit Rating Co. Ltd. ("CCXI Research Institute"). According to the report, the economic recovery is accompanied by the phasing-out of large-scale policy options, but the overall tone of the proactive fiscal policy will continue. In this context, special-purpose bonds remain important for pursuing a proactive fiscal policy. Directly allocating budgetary funds to prefecture and county-level governments is becoming a normal practice, with a view to helping these primary-level governments stabilize economic growth. The Report also reminds us that risk prevention is still the focus of the post-pandemic policy. Local government bonds (LGBs) are brought under a more sophisticated information supervision mechanism. Local governments make continuous strides in controlling new hidden debts and phasing out existing ones. Local Government Financing Vehicles (LGFVs), as the primary holders of hidden debts, may face the tightened financing environment or prospect, which will prompt them to further intensify business integration and transformation.

The report examines the policy environment facing LGB operation in the first quarter of 2021 systematically. With the further implementation of pandemic control measures and growth stabilizing policies, China's economy continued to recover in the first quarter. In order to better ensure stability on six major fronts and security in six major areas, central government have repeatedly emphasized the importance of ensuring the continuity, consistency, and sustainability of macro policies as well as the necessity of proactive fiscal policy in high-level meetings to boost quality and efficiency enhancement and become more sustainable. In this context, **special-purpose bonds are still crucial for China to stabilize economic growth**. China plans to issue RMB3.65 trillion of special-purpose bonds in 2021, which is a slight decrease of RMB0.1 trillion from 2020. When it comes to the use of such bonds, priority needs to be given to funding for key projects already under construction, major projects for facilitating coordinated development among regions, new infrastructure and new urbanization initiatives as well as major projects, and projects that help significantly improve the people's wellbeing. **At the same time, the over-the-counter (OTC) issuance of LGBs keeps advancing**, with the issuance channels further expanded, a move which brings about many benefits: diversifying types of LGB investors and attracting LGB investors in lower-tier markets, encouraging the participation of non-government capital from the more extensive scope in the development of local economies, and helping stabilize economic growth after the pandemic. In addition, **China makes a normal practice to directly budgetary funds to prefecture- and county-level governments and places more funds under this mechanism**. In response, local governments introduce relevant policies to manage these directly allocated funds properly. They work together to stabilize economic growth, by improving the use efficiency of fiscal funds.

According to the report, while policies are intensified to stabilize growth, risk prevention is still the focus of the post-pandemic policies. LGBs are brought under a more sophisticated management mechanism. Under the de-leveraging background, local governments make continuous strides in controlling new hidden debts and phasing out existing ones. LGFVs may face both tightening of regional supply and entity eligibility. The report makes a detailed repertory of important LGB policies in the first quarter: Firstly, the Ministry of Finance issued the *Administrative Measures for Information Disclosure Platforms of Local Government Bonds* to further increase the transparency of LGB information, and require the special-purpose bonds expanding issuance scales sharply to come under the look-through project monitoring, with a view to guarding against project building risks. Secondly, the *Interim Measures for the Administration of Credit Rating of Local Government Bonds* refines the credit rating management of LGBs, thus further regulating local government's financing and borrowing mechanisms and strictly preventing systemic risks. It is particularly worth mentioning that in the context of lowering government leverage ratios, there have come out a string of policies aimed at controlling new hidden debts and phasing out existing ones. LGFVs, as important hidden debt holders, may see their financing facing both tightening of regional supply and entity eligibility. On the one hand, the regions exposed to high debt risks are restricted from issuing LGFV bonds. On the other hand, weakly qualified issuers are subject to the tightened review standards, with more quantitative indicators added to manage their financing activities. Thirdly, in the process of phasing out hidden debts, the State Council requires regulating the operations of local financing platform companies, by stripping away their government financing functions and reorganizing or liquidating those declared insolvent according to law. Local governments intensify the accountability of hidden debts, continue to transform LGFVs towards market-oriented operation, and hence help mitigate debt risks effectively.

The report predicts that more detailed, standardized management policies may come out in the next stage, as LGBs continue to expand steadily. At the same time, LGFVs, as important hidden debt holders, will see more quantitative management policies regulating financing activities to be introduced, while the process of controlling new hidden debts and phasing out existing ones continues to advance. Coupled with the de-leveraging drive, LGFVs are expected to step up their business integration and transformation. Meanwhile, the policies related to the bankruptcy reorganization of such companies and the stabilization of market expectations will continue to be improved as well. The report holds that infrastructure investment will probably not feel the driving force until the second half of the year, given that the issuance of new special-purpose bonds for the first quarter has lagged far behind the schedule of previous years and that related funds are not used as project capital. It is likely that supporting policies will be rolled out in the next stage to speed up the issuance of new bonds and drive the growth rate of actual investment. For key areas suitable for capital use, policies are expected to direct more special-purpose bonds as project capital. At the same time, more supporting policies may be unveiled to regulate the management of special-purpose bond projects, since they are still exposed to such risks as idle funds and lower-than-expected returns. The Report comes up with three conclusions. First, looking into the subsequent process of controlling new hidden debts and phasing out existing ones, more detailed policies and initiatives can be expected to prevent and control LGFV-related risks, which include restricting high-risk companies from financing activities through dynamic supervision based on financial indicators and boosting the non-standard asset management and control capabilities. Second, considering the stark fiscal pressure after the pandemic, more local governments are on track to reduce their existing hidden debts by ways of roll-over loans and extended loans. For example, they may expand the scope of a pilot program to defuse the risks of LGBs and step-up efforts to replace loans of financial institutions with LGBs. Third, as the reform of state-owned enterprises continues to proceed, there will be more policies to promote the market-oriented transformation of LGFVs. The reorganization, integration, and clean-up of LGFV sector will be further intensified as well. However, it is worth noting that in the law-based bankruptcy reorganization or liquidation of LGFVs, investors may lose confidence in the redemption of some weakly qualified LGFVs. This possibly requires introducing policies to deal with the bankruptcy reorganizations of LGFVs and stabilize the market's expectations for them.

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