## The Management of Local Government Bond is Becoming More Normalized， Local Government Finance Vehicle May Face a Further Tightened Financing Environment

Hong Kong, 3 August 2021 -- A report titled “The Budget System Reform Keeps Going Deeper and Local Government Bonds Come under Increasingly Normalized Management: 2021 H1 Review and Outlook for the Next Stage of Local Government Bonds and LGFV” (hereinafter referred to as “the Report”) has been recently published by the Research Institute of China Chengxin International Credit Rating Co. Ltd. (“CCXI Research Institute”). According to the Report, 2021 will be the year when the Chinese economy continues to recover from the COVID-19 pandemic and the 14th Five-Year Plan gets off a good start. As a modern fiscal and taxation regime is coming in place, the reform of the budget management system goes deeper. In this context, China makes it a normal practice to directly allocate fiscal funds to prefecture- and county-level governments, and ensures this practice can function well. At the same time, with the economy continuing to recover, risk prevention and control efforts have resumed somewhat, local government debt control has returned to normal, and special bond management policies have got improved constantly. Furthermore, great headway has been made towards decreasing old implicit debts and curbing new ones. As the primary holders of implicit debts, LGFV may face the further tightened the financing environment.

**The Report firstly examines the policies on the reform of the fiscal and taxation systems and mechanisms in the first half of the year. Spearheaded by the requirements for establishing a modern fiscal and taxation regime, the reform of the budget management system went deeper in the first half of the year. China managed to make it a normal practice to directly allocate fiscal funds to prefecture- and county-level governments, a move that functioned well and made sure the proactive fiscal policy could operate with quality and efficiency further assured.** Due to the impact of the COVID-19 pandemic, local governments generated a slower revenue growth but faced the unabated pressure on fiscal expenditure in 2020. China’s finances remain tightly balanced and face the stark contradiction between revenue and expenditure. This state may continue for some time in the future. In this context, **the State Council issued the *Opinions on Further Deepening the Reform of the Budget Management System*** (hereinafter referred to as “the Opinions”) to strengthen management from both ends of revenue and expenditure, improve the efficiency of the allocation of financial resources and the use of funds, press ahead with the reform of the budget management system, and address the deep-seated problems in budget management. The Opinions highlighted a series of requirements such as making overall planning of budget revenue, regulating budgetary management of government revenue, and collecting budgetary revenue in full and in time. To implement these requirements, **four national departments such as the Ministry of Finance jointly issued a document, which stipulated those four non-tax government revenues including revenue from transfers of state-owned land use rights shall be collected by the taxation authority** with a view to improving collection efficiency. As an important part of the efforts to deepen the reform of the budget management system, regulate budget expenditure management, and standardize fiscal expenditures, **a mechanism where fiscal funds are directly allocated to prefecture- and county-level governments has been upgraded to a normal practice and functioned well** with all types of funds directly channeled to where they are needed most efficiently. This, therefore, provides a strong financial guarantee for local governments to maintain securities in six key areas.

**As the economy continues to recover, there emerges a "window period" when China faces the limited pressure from stabilizing economic growth. Under this circumstance, risk prevention and control efforts have resumed somewhat, government debt management has become further tightened, and great headway has been made towards decreasing old implicit debts and curbing new ones, according to the Report.** The Report also indicates that the management of local government bonds was continuously regulated in the first half of the year. The Ministry of Finance issued the *Interim Measures for the Administration of Credit Ratings of Local Government Bonds* and the *Administrative Measures for the Information Disclosure Platforms of Local Government Bonds*, both of which have helped improve the information disclosure mechanism and the credit rating management measures fit for local government bonds. At the same time, the *Fund Performance Management Measures for Local Government Special Bond Projects* was released officially, which stipulates the performance management of special bond projects through the entire process (pre-event, in-event, and post-event), with an aim to further improve the efficiency of bond funds. The Report also mentions that since the beginning of this year, the regulation of implicit debts incurred by local governments has returned to the right track. Under the de-leveraging background, local governments have made remarkable headway towards decreasing old implicit debts and curbing new ones. As important holders of implicit debts, LGFV may see both regional and issuer qualifications tightened in raising funds. On the one hand, LGFV from regions exposed to relatively high debt risks are restricted from issuing bonds. On the other hand, poorly-qualified issuers are held to rigid review criteria. Cash wealth management products are restricted from investing in bonds rated below AA+. Additionally, in the process of phasing out implicit 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 implicit debts, regulate financing platform management, and hence help to mitigate debt risks effectively.

**The Report predicts that more detailed, standardized management policies may come out in the next stage, as local government bonds continue to expand in size. At the same time, LGFV, as important hidden debt holders, will see their financing activities further tightened by policies. Considering some weakly-qualified urban construction investment bonds lose investors' confidence over time, the policies related to the bankruptcy reorganization of such bonds and the stabilization of market expectations may be on course to be introduced.** The Report holds that infrastructure fails to feel the driving force as expected, given that the issuance of new special bonds for the first half of the year has lagged far behind the schedule of previous years and that related funds are seldom used as project capital. It is likely that supporting policies will be rolled out in the next stage to speed up the reserve of high-quality projects and improve the project quality. For key areas suitable for capital use, policies are expected to direct more special bonds as project capital. At the same time, more supporting policies may be unveiled to regulate the management of special bond projects, since they still have such problems as "emphasizing issuance over management". Moreover, policies are likely to be introduced to adjust the purpose of funds raised by special bonds. The Report also points out that in order to ensure regional financial stability and safeguard the bottom line of risk prevention, more regions are expected to hold meetings to emphasize the prevention of defaults on maturing bonds this year. Policies may be issued to further restrain financing activities of urban construction investment bonds in the process of continuously decreasing old implicit debts and curbing new ones. At the same time, local governments may continue to introduce policies to resolve their implicit debts in stock, and step-up efforts to reorganize, integrate and liquidate debts. However, it is worth noting that in the lawful bankruptcy reorganization or liquidation of LGFV, investors may lose confidence in some weakly-qualified urban construction investment bonds. This possibly requires introducing policies to deal with the bankruptcy reorganizations and stabilize the market's expectations.

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