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Special Comment

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The 4th round of local bond replacement: Helping to mitigate the risk of local government short-term debt, but credit differentiation still exists

In order to alleviate the financial pressure on local governments, the central government has launched a new round of local bond swaps this year, issuing special refinancing bonds, with an estimated market size of nearly 1.5 trillion yuan. Based on the experience of previous three rounds of debt swaps, this issuance is likely to be based on the principle of limits redistribution, which will help address the implicit debt problem in regions with less explicit debt pressure, optimize the debt structure to reduce costs and alleviate local debt pressure. But for areas where the explicit debt to liability ratio is already high, such as areas where the utilization rate of local debt limits is close to 100%, their available special debt limits are low or cannot be significantly improved. Meanwhile, this local bond swap may increase investors' preference for good regions, and the benefits of the tail region may be weaker than expected.

1. Impact on the local finance structure

There were three rounds of local bond swaps in history. The first round of debt swaps occurred in 2015, marking the first attempt by the central government to improve local liquidity through debt swaps, which lasted for three years. For the first time, the government has helped regionalize debt through debt replacement, making implicit debt explicit, reducing the financing cost of government generalized debt, and optimizing debt structure. In 2019, the second round of swaps began, with a much smaller scale than the first round, only targeting areas with high debt repayment pressure, alleviating their liquidity pressure. However, due to the relatively limited amount of debt swap this time, some regions still experienced credit risk events after completing the swap, and there was no substantive improvement in the corporate fundamentals and regional credit environment.

In 2020, due to the economic downturn and the outbreak of the epidemic, local finances were generally under pressure. Refinancing bonds took over replacement bonds as the main tool. Compared to ordinary refinancing bonds used to repay the principal of maturing old bonds, special refinancing bonds can be used to repay existing local government debts. The third round of replacement lasts for one and a half years, and the process was divided into two stages: (1) pilot implementation in the first nine months; (2) the central government began attempting to clear implicit debts in some regions and regions in the following six months. This debt redemption has completed the evolution of debt redemption tools from simple replacement bonds to special

refinancing bonds, successfully clearing the implicit debts of Beijing and Guangdong.

Exibit1: Historical rounds of debt restructuring

Time	Background	Objectives	Amount	Effect
2015-2018	The central government proposes to screen for implicit local debts and authorizes local governments to issue replacement bonds.	Replacing implicit debt by standard governmental bonds.	12.2 trillion RMB	The replacement has basically completed.
2019	Local debt tends to become implicit. The macroeconomic policy change is more on risk control. Pilot programs set up by the central government in some regions.	Relieve short-term liquidity pressure in weak areas with high debt repayment pressure.	0.16 trillion RMB	Due to credit limits, some regions still experience credit risk events after completing the replacement.
2020-2022	The economic downturn is compounded by the impact of the epidemic, and local finance is generally under pressure. Local refinancing bonds have become an important tool for transforming debt.	Repayment of existing government debts; Attempting to clear implicit debt in multiple cities.	1.13trillion RMB	Significant improvement in the debt situation of regions with large scale issuance of special refinancing bonds.

2. Characteristics of the fourth round of debt replacement: focusing on pressure areas and reallocating limits

Compared to previous rounds, the fourth round of debt swap is expected to reach approximately 1.5 trillion, which is similar in size to the previous round. The difference lies in that the third round of special refinancing of local bonds focuses on areas with lighter debt problems and stronger market confidence, such as Beijing, Guangdong, and Shanghai, with the aim of clearing their implicit debts; In the fourth round of debt swap, the focus of limits allocation will be shifted to 12 provinces including Tianjin, Shanxi, Guangxi, Yunnan, and Guizhou, with a greater focus on the tail regions with high debt pressure, poor liquidity circulation, frequent credit risk events, and gradual loss of market confidence. Due to the need to use the previous balance of local government debt limits for issuing special refinancing bonds, and China implements limit management on local government debt balances, the local government limit space is the upper limit for issuing special refinancing bonds, and the allocation of special refinancing bond limits is closely related to the degree of use of local

debt limits. For example, the proportion of Beijing's credit limit usage, where implicit debt has been cleared to zero, is only 59%, and there are 345.2 billion special refinancing bonds available. However, the proportion of limits usage in both Hunan and Guangxi provinces exceeds 95%, and the available special refinancing bond limits does not exceed 20 billion yuan. This round of refinancing bonds may continue to be allocated across regions through the "limit recovery and redistribution" mechanism. Beijing and Guangdong have achieved zero clearing. Shanghai and Hebei, are under less pressure and have sufficient limit and may release approximately 500 billion in balance limits for cross regional redistribution, providing support for redistribution limits in areas with less limits space. In addition, limits allocation should also consider the level of explicit and implicit debt. From the records of 2020, for regions where implicit debt has been cleared or is close to zero, such as Beijing, Guangdong, Shanghai, or regions where implicit debt is higher than explicit debt, such as Tianjin, Jiangsu, Chongqing, etc. The feasibility of guiding implicit debt to become explicit through special refinancing bonds is strong, and limits allocation is also at the forefront of the country; However, for regions with an explicit debt ratio exceeding 100%, such as Gansu and Guangxi, large-scale implicit debt swaps or significant increases in the level of explicit debt exacerbate the risk of subsequent local explicit debt repayment. Therefore, the allocation of limits in these provinces is relatively low, ranking bottom nationwide. In this round of limits allocation, in 2022, provinces such as Tianjin, Chongqing, Jiangsu, Jiangxi, Yunnan, Shaanxi, Hunan, Shandong, Guizhou, Fujian, Henan, and Guangxi, which have a more stressful situation to deal with, may have a greater need to obtain special refinancing debt limits. Among them, regions such as Tianjin, Jiangsu, and Chongqing with a significantly higher broad debt ratio than the explicit debt ratio and a larger space for explicit implicit debt, or as key support targets, may receive more limits.

In addition, the focus of limits allocation should be on areas with high short-term debt repayment pressure and high interest payment costs. From the perspective of debt repayment ability, Qinghai, Gansu, Guangxi and other provinces have weak debt guarantee capabilities. Provinces such as Guizhou, Hainan, and Jilin have a relatively high proportion of new and old urban investment bonds. Gansu, Guizhou, Yunnan, and Liaoning have negative net financing of urban investment bonds from January to August this year. These provinces with weakened debt repayment ability may obtain more refinancing bond limits. From the perspective of debt structure, provinces such as Ningxia, Shandong, Xinjiang, Tianjin, Jiangsu, and Yunnan that have a relatively high proportion of short-term urban investment debt may require significant support, while provinces such as Inner Mongolia, Tianjin, Qinghai, Yunnan, Hainan, and Gansu that have a relatively high proportion of urban investment debt due this year and next, and have a high pressure on short-term concentrated maturity, are more likely to receive more refinancing debt limits support. From the

perspective of financing costs, the comprehensive financing costs of urban investment in provinces such as Shanxi, Sichuan, Tianjin, Chongqing, Shaanxi, Qinghai, and Yunnan are relatively high, all exceeding 6%. Cities such as Jiangsu, Zhejiang, Sichuan, Shandong, and Hubei have large debt interest payments, and these provinces are expected to receive support from refinancing bonds to replace high interest debt with low interest debt, achieving the goal of reducing debt costs.

3. Differentiation of the impact of special refinancing bonds on urban investment enterprises

Through the experience of three previous debt swaps, it can be seen that the resumption of special refinancing bonds has a certain positive significance for localized bonds. Firstly, for urban investment enterprises in most regions, especially those with low debt repayment pressure and high credit quality, this special refinancing bond can replicate its efficient performance in the third round of debt replacement. For urban investment enterprises in areas with abundant credit lines and good economic development level, this special refinancing bond can optimize debt structure, reduce repayment pressure, and even inspire market sentiment. According to the CAIR risk index of urban investment, the overall index showed a significant decline in July and August. With the official implementation of the special refinancing bond quota, the urban investment bond market in provinces that have received support may be greatly boosted, and credit spreads may continue to narrow, and the scale of early redemption is also expected to increase. Especially for some provinces that are not low in risk and have not received the expected quota support before, if they receive exceeding the expected quota support, the regional credit environment may accelerate improvement. However, it remains to be seen whether a sustained positive market can be formed.

However, this refinancing bond may continue to be allocated regionally through the mechanism of available limit space, and this balanced approach may have little effect on alleviating the situation for tail end urban investment enterprises. The issuance of special refinancing bonds will occupy the remaining space of explicit debt. Under the explicit debt limit management system, the limit space of some areas with high debt pressure is limited, and the scale of special refinancing bond issuance will be greatly restricted, which will have relatively limited benefits for local urban investment enterprises. From the perspective of the recent bond market, regions with strong regional endowments and overall abundant chemical bond resources are expected to accelerate the repair of credit qualifications and significantly compress credit spreads after receiving higher amounts of special refinancing bond support. Against the backdrop of Tianjin's continued active integration with financial institutions and the expectation of obtaining higher amounts of special refinancing bonds in the market, there has been a significant improvement in the primary and secondary

markets of urban investment bonds recently, with some bond subscription multiples as high as 70 times. Regional credit spreads have also continued to converge, and provinces such as Anhui, Heilongjiang, Jiangsu, and Hunan have also seen significant improvements. However, some provinces with high debt pressure, poor provincial mobilization ability, and lower than expected special refinancing quotas may face substantial improvement and still face pressure from valuation fluctuations. In the context of overall limited available limits, the available limits in some regions may be relatively limited. For regions with weak financial resources and high debt pressure, special refinancing bonds can only mitigate the debt risk of the tail regions and counties, and the overall credit repair effect is limited. Especially, if the limit obtained in the tail regions is lower than market expectations or even fails, it may further exacerbate the risk of bond valuation fluctuations. These enterprises that are unable to improve their debt situation and repay short-term principal and interest through special refinancing bond financing may seek other higher cost channels for financing.

4. Overseas financing of urban investment has a certain positive impact

We anticipate that this refinancing of bonds will have a supportive effect on the recovery of domestic bond valuations for urban investment, and may also be beneficial for their overseas financing, especially for urban investment enterprises in better regional conditions. Since 2020, under strict government control over the increase of domestic debt, the issuance of domestic bonds by urban investment has significantly decreased, while overseas financing activities have significantly increased. In the second half of 2022, to prevent foreign debt risks, policies raised the issuance threshold for urban investment bonds and foreign debt, requiring issuers to meet certain credit rating conditions, resulting in a decline in related financing activities. As of the end of October 2023, the scale of urban investment's existing foreign debt equivalent to 115.4 billion US dollars, an increase of nearly 35% compared to the end of 2020. Among them, 55 urban investment companies entered the overseas bond market for the first time in 2023, with approximately 56% of the urban investment companies issuing bonds coming from Shandong, Jiangsu, and Zhejiang, all of which are economically prosperous provinces in China. However, the majority of new issuers are mainly district and county level urban investment. In the future, attention needs to be paid to the maturity risk of overseas bonds of urban investment enterprises. In addition, fluctuations in overseas markets may increase the financing costs of urban investment enterprises overseas.

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