BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

Chi on China

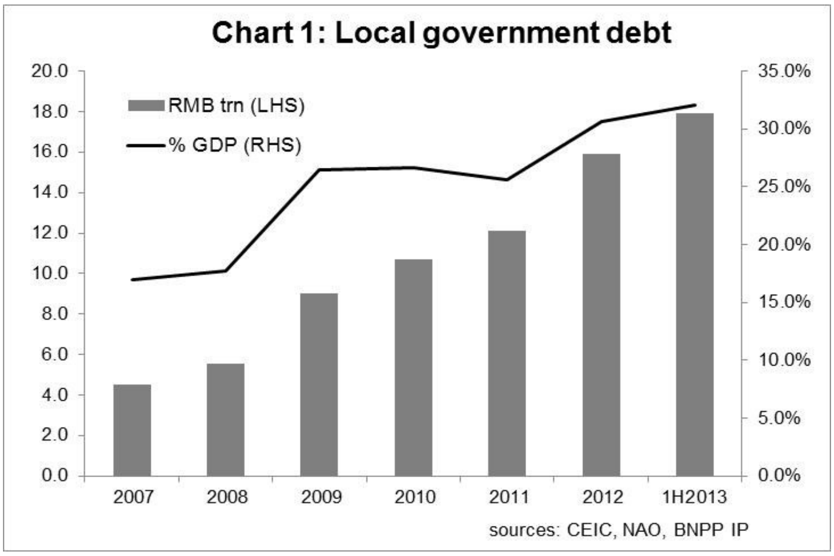
China's Systemic Risk (II/II): Local Government Debt

SUMMARY

- The problem with China's local government debt (LGD) is the combination of its rapid rate of growth, its opaque nature and the extent to which banks are exposed to it. But it is not yet a fatal problem, thanks to China's financial strength, closed capital account and 'implicit guarantee' policy.
- Official data shows a sharp fall in banks' exposure to LGD, but in fact this results from banks disguising their LDG exposure as other types of lending. However, systemic risk remains under control, with banks' average bad-debt coverage amounting to almost 300% and Tier-1 capital at 7.0%.
- Beijing is employing a two-prong approach to address the LGD risk. Short-term measures include debt roll-over and 'selective implicit guarantee', although it will have to exit such policy eventually. Longer-term measures include capital market liberalisation and fiscal reform.

Estimated at 32% of GDP, LGD is not yet a problem (Chart 1). Even when the debts of the central government and policy banks are added, China total public debt is still about 53% of GDP, well within the 60% safety threshold according to international norms. However, most LGD has been issued through local government financing vehicles (LGFVs), which are off-balance-sheet special purpose vehicles with hidden ownership structures to eschew the restriction on the local governments' direct borrowing from the capital market. Such opacity is a concern.

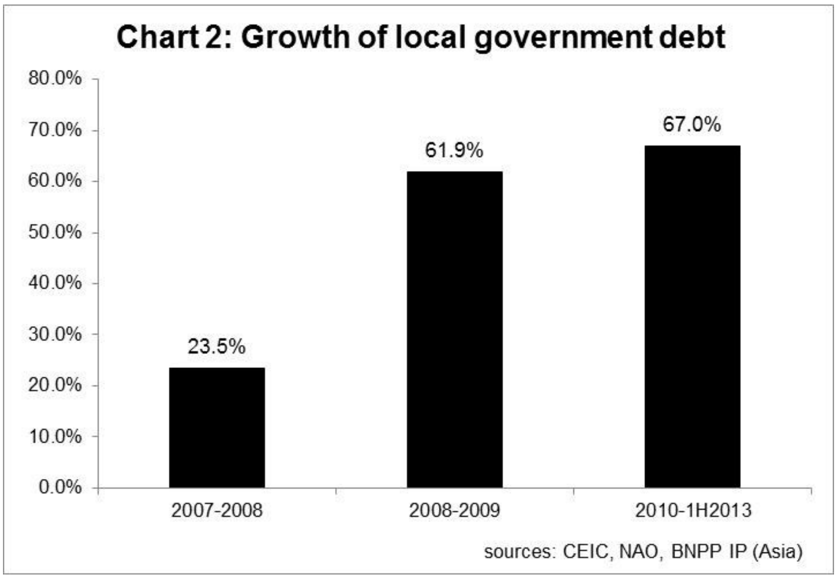
Moreover, over half of LGD has a maturity of less than three years and almost all of it is invested in long-term (10-year plus) infrastructure and social projects that do not generate sufficient cash flows to service it. So the LGD aggravates the balance-sheet mismatch risk in the banking system by enlarging both the mismatch and the pool of poor-quality assets. In a special audit by the National Audit Office (NAO) prior to its comprehensive audit between August and December 2013, the NAO reported that 37.6% of all LGFV assets were 'illiquid' and these could be a disguise for non-performing loans (NPLs).

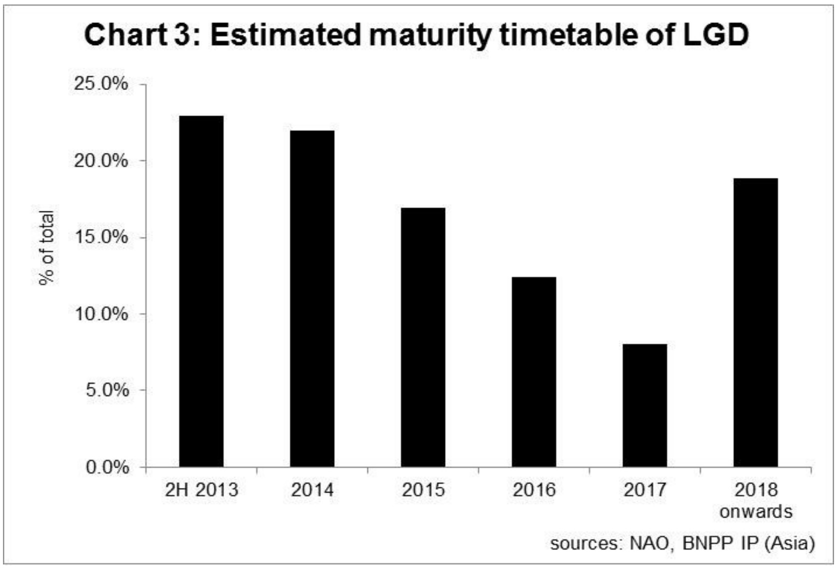


Rampant LGD growth and liquidity squeeze

On the back of opacity, the rampant rate of LGD accumulation has become a major concern (Chart 2). From RMB10.7 trillion in 2010, LGD rose by 67% in only two-and-a-half years to RMB 17.9 trillion in 1H 2013, despite the increase in restrictions on bank loans to local governments since 2010. The short-term nature of LGD suggests that its rapid accumulation is creating a liquidity squeeze in the LGD sector, with 40% of LGD coming due this year and next (Chart 3). Reportedly, the amount of LGD that matured in 2013 was rolled over.

The balance-sheet mismatch problem is no more than one of liquidity for now, as the extent of the structural mismatch loans on the banks' balance sheets is not too serious, with only about 40% of total LGD debt maturing in the coming two years. A systemic shock is unlikely given the government's massive financial resources and ability to borrow to manage the risk.





The potential systemic shock

Although the NAO report said that the share of LGD funded by bank loans fell to 57% in 1H 2013 from 78% in 2010, the true banking exposure is likely to be much higher. This is because local governments have been using off-balance-sheet funding sources to bypass Beijing's regulatory restriction on their borrowing. In particular, the share of LGD accounted for by build-and-transfer (BT) loans and trust financing has each risen to 8% from negligible levels.

BT loans are those raised by private companies to fund local government projects, while trust financing is direct and indirect lending to local governments. These are forms of indirect bank lending to local governments and should be included when assessing the true level of banking exposure to LGD. So the true share of bank loans in LGD may be at least 73% (i.e. 57% + 8% + 8%), which suggests very little improvement on the 78% share in 2010.

So the banks are still heavily exposed to the LGD risk. Recent data from the NAO and the China Banking Regulatory Commission helps shed some light on the potential systemic risk. Reported NPLs in the system amounted to 0.96% of total loans (or RMB539.5 billion) at the end of Q2 2013, with loan loss reserves at RMB1.5 trillion. The average loss provision ratio in the system amounted to 292.5% and the bad debt recovery rate stood at 25% in 1H 2013.

With this information[1], we estimate that the potential losses to the banks stemming from the LGD risk would cut the average risk-weighted Tier 1 capital ratio in the system from 10.6% in 2012 to 7.0% in 1H2013 (Table 1). While this would still meet the 7% Basel III minimum requirement, it is still a concern as in just over a year, the increase in the LGD has threatened to erode the system's Tier 1 capital by 360 bps.

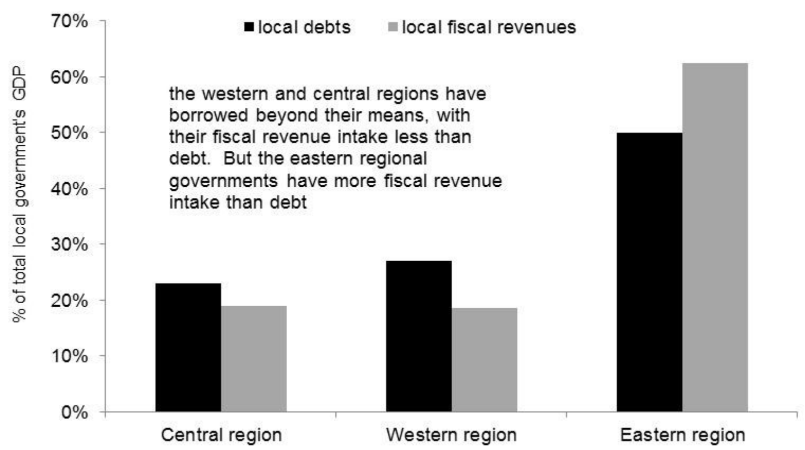
[1] To be conservative in our estimation, we used the NAO special audit report's 37.6% of 'illiquid assets' as our NPL assumption, instead of accepting the NAO official report's 0.96%.

Table 1: Estimate systemic risk of LGD on banks (1H2013)

	From the official data (2012):			
a	Tier 1 capital	RMB	6.43	trn
b	Risk-weighted (RW) assets	RMB	60.60	trn
==>	Tier 1 capital to RW assets ratio (= a/b)		10.6%	
	From the new NAO audit report (1H2013)			
	Total LGD	RMB	17.90	trn
	72.5% funded by banks	RMB	12.98	trn
	Assume 37.6% NPL	RMB	4.88	trn
c	Est. loss to banks (assuming 25% recovery rate)	RMB	3.66	trn
d	NPL provisions	RMB	1.50	trn
e	Est. net loss to banks (= c - d)	RMB	2.16	trn
	Estimated hit on the banking system			
	New Tier 1 capital to RW assets ratio (= [a-e]/b)		7.0%	
==>	Tier 1 capital to RW assets ratio drops by btwn 2012 and 1H2013		3.6	ppts

sources: NAO & CBRC data, BNPP IP (Asia) estimates

Chart 4: Local government debts & fiscal revenues*



* 2009-2013 averages

sources: CEIC, BNPP IP (Asia)

The debts of local governments in the central and western regions are the most risky. They account for 23% and 27%, respectively, of total LGD (Chart 4), but only 18.9% and 18.6%, respectively, of all local fiscal revenues. The interior regional governments have borrowed beyond their means to pay and, thus, are more susceptible to credit or interest rate shocks than the eastern regional governments.

The root problem

The crux of the structural flaws behind LGD lies in the asymmetrical budget structure of the central and local governments. On aggregate, the local authorities pay for some 80% of the country's fiscal spending, but they only get 40% of the tax revenues; the rest goes to the central government. Beijing offsets some of the local fiscal shortfall by transfers from the central coffer. If this root problem remains unresolved, local governments will always struggle for funding and, thus, have the incentive to find "creative ways" to raise capital.

This "creativity" in skirting restrictions is also seen among the banks. For instance, to eschew the PBoC's loan tightening rules, the banks move loan assets off their balance sheets by selling them to the trust companies. The latter then repackages the loans into wealth management products, sells them to depositors and uses the proceeds to fund local government spending.

Another "creative practice" is through margin deposits. Firms make margin deposits at banks in exchange for bank acceptance bills (BAs), which are then are then discounted for cash. The margin deposits can also be used to back letters of credit (LCs), which are normally used for trade finance but have been abused to fund non-trade investment. The margin deposits are also a key way for banks to evade the regulatory deposit interest-rate cap to attract more deposits to boost lending.

Short-term muddle-through

Without a sustainable mechanism for resolving the LGD problem in place, forcing the banks to call back their local government loans at a time of economic stress would trigger systemic instability. Rolling over these loans helps diffuse this risk and will be instrumental in resolving the LGD problem in the short-term by enabling the local authorities to issue bonds for funding.

The central government is also increasing bond issuance on behalf of the local governments to augment fiscal transfer to fund their spending. It is also starting to tighten local government budget constraints through increased transparency and stricter budgetary management.

Long-term solutions

Ultimately, Beijing needs to resolve the asymmetrical budget structure of the central and local governments through fiscal reform to give the latter more tax revenues and the former more spending responsibility. Local fiscal income can also be raised by establishing local tax revenue sources, such as property tax, resource tax and consumption tax, and by requiring the local state-owned enterprises to pay dividends to the local government budgets.

Local governments are barred from borrowing directly, unless they receive Beijing's approval. Since 2011, when a pilot programme for local borrowing was started, only six local governments (Shanghai, Zhejiang, Guangdong, Shenzhen, Jiangsu and Shandong) were approved to issue bonds. This programme will likely be expanded gradually soon. Beijing is starting to facilitate this implementation by exiting the "implicit guarantee" policy slowly by allowing defaults so that China's capital market can re-price credit risk properly.

In a nutshell, Beijing has started to address the LGD problem gradually but surely. A closed capital account and selective "implicit guarantee" (as Beijing exits the policy slowly) will prevent the LGD problem from getting out of hand. It is a serious problem, but not yet fatal.

Chi Lo
Senior Economist, BNPP IP

BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

DISCLAIMER

This material is issued and has been prepared by BNP Paribas Investment Partners Asia Limited*, a member of BNP Paribas Investment Partners (BNPP IP)**. The content has not been reviewed by the Hong Kong Securities and Futures Commission.

This material is produced for information purposes only and does not constitute:

1. an offer to buy nor a solicitation to sell, nor shall it form the basis of or be relied upon in connection with any contract or commitment whatsoever; or
2. any investment advice.

Opinions included in this material constitute the judgment of BNP Paribas Investment Partners Asia Limited at the time specified and may be subject to change without notice. BNP Paribas Investment Partners Asia Limited is not obliged to update or alter the information or opinions contained within this material. Investors should consult their own legal and tax advisors in respect of legal, accounting, domicile and tax advice prior to investing in the Financial Instrument(s) in order to make an independent determination of the suitability and consequences of an investment therein, if permitted. Please note that different types of investments, if contained within this material, involve varying degrees of risk and there can be no assurance that any specific investment may either be suitable, appropriate or profitable for a client or prospective client's investment portfolio.

Investments involve risks. Given the economic and market risks, there can be no assurance that the Financial Instrument(s) will achieve its/their investment objectives. Returns may be affected by, amongst other things, investment strategies or objectives of the Financial Instrument(s) and material market and economic conditions, including interest rates, market terms and general market conditions. The different strategies applied to the Financial Instrument(s) may have a significant effect on the results portrayed in this material. Past performance is not a guide to future performance and the value of the investments in Financial Instrument(s) may go down as well as up. Investors may not get back the amount they originally invested.

The performance data, as applicable, reflected in this material, do not take into account the commissions, costs incurred on the issue and redemption and taxes.

* BNP Paribas Investment Partners Asia Limited, 30/F Three Exchange Square, 8 Connaught Place, Central, Hong Kong.
** "BNP Paribas Investment Partners" is the global brand name of the BNP Paribas group's asset management services. The individual asset management entities within BNP Paribas Investment Partners if specified herein, are specified for information only and do not necessarily carry on business in your jurisdiction. For further information, please contact your locally licensed Investment Partner.