Fiscally strong regions' LGFVs less impacted by recent tightening fundraising policies

HONG KONG, 19 July 2021. The China Banking and Insurance Regulatory Commission (CBIRC) recently issued a directive on precautions and resolutions in relations to hidden debt risks from local governments. 《银行保险机构进一步做好地方政府隐性债务风险防范化解工作的指导意见》（银保监发 [2021]15 号）. The CBIRC stated prohibitions for these financial institutions, including banks and insurance companies, on any new working capital loans to borrowers who have presumed hidden debt from local governments, while at the same time prioritise resolving hidden debt with short durations, high interest rates and debts with strong repayment expectations. According to the guidelines, financial institutions are required to strengthen their compliance and due diligence procedures, and shall not in any form increase the hidden debt burden of local governments. It also demands the financial institutions to properly resolve existing hidden debt, and shall not expect any unconditional bailouts from the local governments.

Through governing local government financing vehicles' (LGFVs) funding activities, we believe the CBIRC's directive aimed at preventing the hidden debt risks of local government from potentially developing into systemic risks of China's banks. We believe the CBIRC's tightening directive should have less impact on bond issuance by the strong LGFVs' platforms controlled by higher-tier governments or those from economically strong regions. Instead, we see the directive to further push banks to distinguish LGFVs that enjoy key government mandates as their primary financing platforms, and favour those LGFVs from more fiscally strong regions compared to their debt burden.

Nevertheless, we believe banks are likely to be more refrained from lending to LGFVs owned by weaker governments in the second half of 2021. In our view, recent tightening measures may lead to higher risk aversion of investors in the short term, arising from increasing funding difficulties for weak LGFVs amid government restriction on funding policies. We believe the measures could reduce weaker LGFVs' net financing and their refinancing ability, especially those owned by lower-tier local governments with high financial leverage relative to their economic strength, those with a significant portion of businesses operating commercially, or those from regions that already have SOE default history. Local governments with tight liquidity are expected to be more selective in supporting LGFVs' debt, as they tend to weigh on the costs and benefits of such continued bailouts.

Earlier in April 2021, both Shenzhen and Shanghai Stock Exchanges issued guidelines for the issuance and listing of corporate bonds. LGFVs with total assets of less than RMB10 billion, or with domestic ratings of AA or below, should assess and enhance their repayment ability by taking into account of their profitability, balance sheet and cash flow positions, while proceeds of bond issuance from these LGFVs should be for repayment of outstanding corporate bonds. The two exchanges also require issuers to strengthen the quality of corporate bond information disclosure on issuer conditions that require special attention, such as restrictions in the use of proceeds.

Overall, we see the recent series of tightening measures imposed by various regulatory bodies help to prevent any system-wide defaults by LGFVs, as the oversight of systemic risk remains a priority for the regulators. Current offshore USD bonds by LGFVs are much smaller in terms of outstanding issuance amount than those from the onshore markets, and refinancing risks should therefore be controllable. We continue to believe any high-profile defaults by LGFVs are unlikely.

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Date of Relevant Rating Committee: 16 July 2021

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