中証鵬元國際 CSPI Ratings

Assessing the Overall Debt Risk of Chinese Local Government Financing Vehicles

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Summary

Total outstanding debt of Chinese Local Government Financing Vehicles (LGFVs) could have reached RMB60 trillion, yet remains within manageable bounds.

Through data consolidation and analysis, we estimated that the aggregate interest-bearing debt of Chinese LGFVs with bond issuance practices amounted at approximately RMB56 trillion by the end of 2022. Considering the unaccounted portion of LGFVs that have not issued bonds or lack sufficient data, a reasonable projection places the total size of interest-bearing debt for LGFVs nationwide at around RMB60 trillion. Notably, a significant portion of this debt, nearly 80%, constitutes long-term liabilities, aligning with the inherent operational nature of LGFVs. While LGFV debt is classified as corporate debt under regulatory policies, implying that the government is not obligated to provide direct support, the substantial importance of LGFVs to the government and their close affiliation inherently embed a strong expectation of government support. Consequently, the magnitude of LGFV debt carries potential implications for the Chinese government's financial landscape.

However, despite the substantial scale of RMB60 trillion, we maintain a measured perspective and do not perceive an immediate cause for alarm. Firstly, even without considering the debt-servicing capacity of LGFVs, incorporating the total LGFV debt in the broad debt of Chinese government, the ratio of China's broad government debt to GDP stood at approximately 100% by the end of 2022, which remains relatively manageable. Furthermore, the Chinese government exhibits robust control over monetary policies and possesses the ability to manage risks due to the creditor structure of LGFVs, primarily dominated by local banks. Secondly, recent years have witnessed tightened regulations on LGFV financing, resulting in a significant deceleration in the growth rate of interest-bearing debt. In 2022, the scale of LGFV interest-bearing debt expanded at a more moderate pace of 7.5%. Looking ahead, we anticipate that the overall policy stance of "deleveraging existing debt while restraining additional debt" will persist, allowing LGFV debt to maintain a gradual, single-digit growth trajectory in the upcoming years.

The eruption of systemic risks stemming from LGFV debt is highly improbable, although localized risks warrant close attention.

Firstly, the regulatory policies governing LGFV debt exhibit a relatively low level of policy risk. Through the introduction of comprehensive regulatory measures, subsequent policy adjustments, and market assimilation over the past few years, the policy landscape has progressively stabilized, fostering a stable predictability among market participants. Secondly, the macro-level refinancing risk associated with LGFV debt remains reasonably manageable. Currently, domestic banks represent the primary creditors of LGFVs, and China's robust savings rate facilitates the continuous expansion of banks' balance sheets. As long as policy stability endures, banks' risk appetite towards LGFVs is expected to remain stable. Furthermore, the deceleration in the growth rate of LGFV debt to single-digit figures allows incremental bank facilities to adequately cater to the overall refinancing needs of LGFVs. Thirdly, LGFVs face notable interest payment

pressures, yet overall, they are capable of maintaining a relatively balanced financial position. Analysis of the average coverage ratio of EBITDA plus government subsidies against interest expenses for the period spanning 2017 to 2022 reveals an average coverage of 105%. This underscores LGFVs' ability to sustain a tight balance in their debt repayment cash flow. However, some LGFVs with weaker liquidity may necessitate additional borrowing to fulfill interest obligations. It is worth noting that the average financing interest rates for LGFVs in recent years have hovered around 5%, significantly surpassing the average issue yield of approximately 3% for Chinese local government bonds. The relatively elevated interest costs amplify the burden of interest payments for LGFVs and inadvertently increase the pressure on local governments to extend support. Fourthly, while the macro-level LGFV debt risk remains controllable, the overall constrained cash flow and divergences in economic, fiscal, and debt conditions across different regions underscore the significance of localized risks.

The "Package of Debt Resolution Policies" can be seen as a strategic approach aimed at effectively tackling the underlying challenges of LGFV debt

The "Package of Debt Resolution Policies" introduced by the central government is a targeted measure to address the current debt issues of LGFVs and alleviate implicit pressures on local governments. It demonstrates a strong focus on resolving these challenges effectively. By utilizing low-interest, long-term local government bonds to replace high-interest, relatively short-term LGFV debt, this policy aims to achieve several key objectives. Firstly, it contributes to reducing the scale of implicit local government debt, facilitating a shift towards more transparent and visible debt obligations. This increased transparency enhances the understanding and oversight of the debt landscape. Secondly, the policy helps alleviate the debt repayment and interest burden on LGFVs, thereby enhancing their financial liquidity and reducing the associated debt risks.

However, it is crucial to acknowledge that the debt resolution approaches focused mainly on debt replacement may not result in a substantial reduction of the overall local government debt ratio. Moreover, it may introduce moral hazards and concerns about the potential for a continued expansion in the LGFV debt scale even with the resolution approaches. Nonetheless, it is important to note that significant efforts have been made in recent years to implement effective financing controls, aiming to strike a balance between managing debt levels and facilitating sustainable development. These measures have helped curtail the growth rate of LGFV liabilities. Consequently, the possibility of a significant expansion of LGFV debt following the debt conversion process is low.

Furthermore, the August report from the State Council explicitly emphasizes the need to prevent a simultaneous increase in hidden debt scale while implementing the debt resolution plan. This indicates a commitment to maintaining discipline and prudence in debt management practices. Looking ahead, it is anticipated that further measures will be introduced to complement the debt resolution policies, particularly in regions with higher debt ratios and greater debt conversion intensity. These measures are expected to tighten LGFV financing of these regions.

What Is the Total Amount of LGFV Debt of China

LGFVs are vital participants in China's bond market, serving as key entities responsible for local infrastructure development and state-owned asset operations. As of the end of August 2023, the cumulative outstanding amount of LGFV bonds exceeded RMB13 trillion, accounting for a substantial portion of approximately 30% of the overall Chinese credit bond market. The majority of the big LGFVs in China have participated in bond market financing.

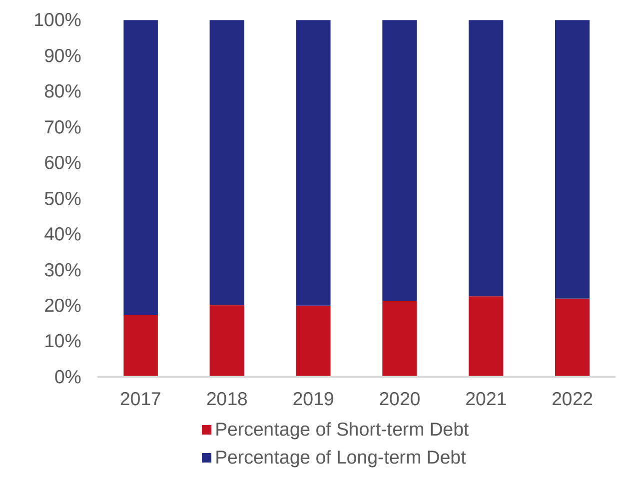
To provide a comprehensive assessment, we have conducted an analysis of LGFVs with bond issuance and publicly available data. By excluding data from subsidiary companies within the consolidation scope to avoid duplication, we have identified a total of over 2,700 LGFVs involved in bond issuance. Notably, district and county-level LGFVs constitute the majority, exceeding 1,500 entities and accounting for more than 55% of the total issuers. Following that, prefectural and municipal-level LGFVs represent a significant segment, comprising 675 entities and accounting for approximately 25%. The rest are provincial-level LGFVs and LGFVs for various industrial parks. This statistical analysis provides a robust representation of the LGFV landscape in China, in our opinion.

In 2022, the aggregate interest-bearing liabilities of LGFVs, encompassing bank borrowings, bonds, bills, and other forms of financing, reached a substantial amount of RMB56 trillion. It is important to note that this figure accounts only for the LGFVs that have issued debt and for which data is available. Considering the presence of LGFVs that have not yet issued bonds or lack reported data, it is plausible to infer that the total magnitude of interest-bearing liabilities for LGFVs nationwide lies in the range of approximately RMB60 trillion.

The maturity structure of LGFV debt has been predominantly characterized by long-term obligations, with the ratio between long-term and short-term debt consistently maintaining an 80:20 proportion in recent years. This composition aligns with the inherent nature of LGFVs' business operations, and there have been no discernible shifts in the maturity structure. Furthermore, the distribution of interest-bearing liabilities across different administrative levels of LGFVs has exhibited relative stability. The majority of LGFV debt is borne by district and county-level as well as prefectural and municipal-level entities, each accounting for approximately 30% of the total (Exhibits 1 and 2).

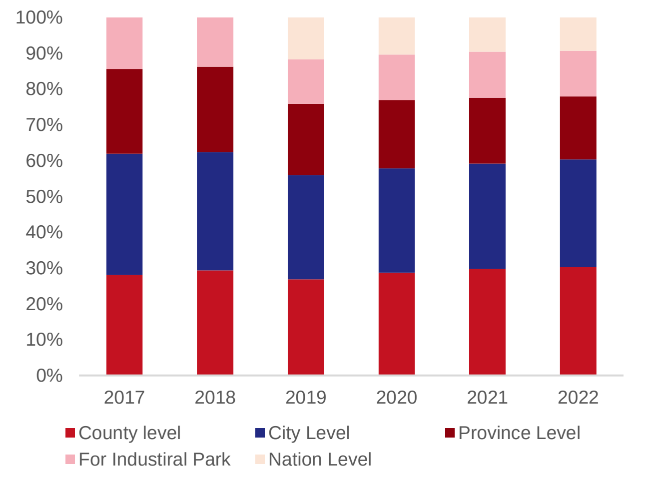
To summarize, while the overall volume of LGFV debt continues to expand, the structural composition remains stable.

Exhibit 1: LGFV debt maturity proportion



Sources: Wind, CSPI Ratings

Exhibit 2: The proportion of LGFV debts at different administrative levels



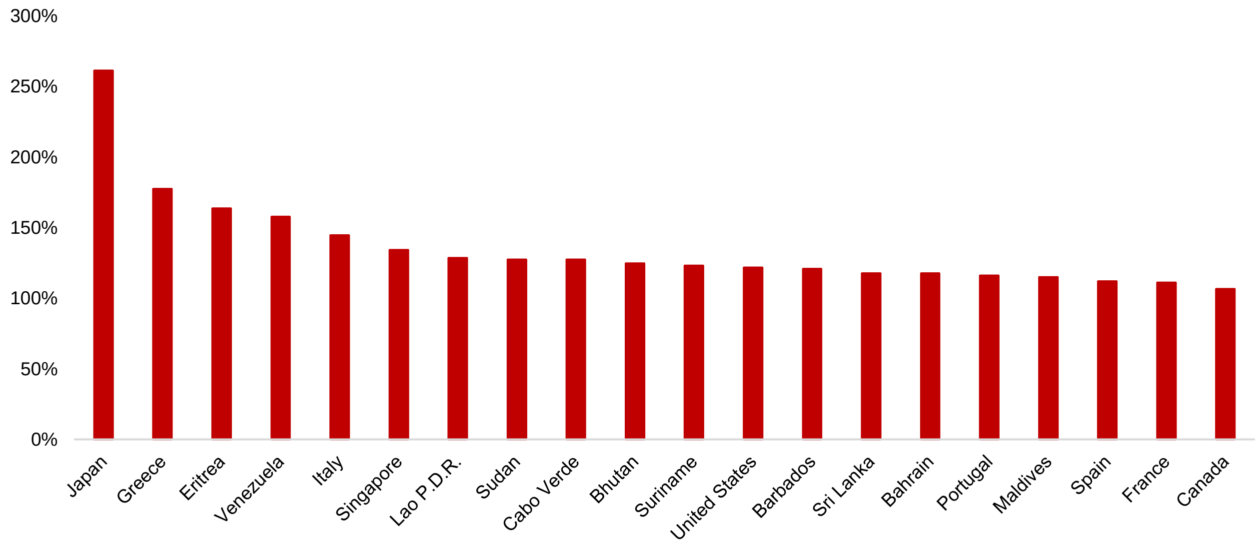
Sources: Wind, CSPI Ratings

What Does the Magnitude of 60 trillion Mean

Firstly, from a static perspective, as of the end of 2022, the outstanding central government debt amounted to RMB25.9 trillion, while local government debt stood at RMB35 trillion. The cumulative RMB60 trillion of interest-bearing liabilities for LGFVs represents the combined total of these two categories. It is important to note that LGFV debt is considered corporate debt according to the Chinese government's consistent policy stance, emphasizing the need for clear demarcation between government and corporate liabilities, with the government not assuming direct responsibility for LGFV liabilities. Nonetheless, due to the significant role of LGFVs in supporting local infrastructure construction and their close association with the government, robust government support is implicitly expected. As a result, the creditworthiness of LGFVs is widely perceived to be closely tied to the government's credit standing. Consequently, LGFV interest-bearing debt, to a certain extent, is still regarded by many market participants as "quasi-government debt," which may exert tangible or intangible pressures on the governments.

However, we estimate that the scale of RMB60 trillion, although substantial, does not reach a level of immediate concern. On one hand, LGFVs generally possess quality regional state-owned assets and resources, providing them with a certain capacity to fulfill their debt obligations. On the other hand, even in an extreme scenario where the entire RMB60 trillion of LGFV debt is integrated into the calculation of broad government debt, China's debt-to-GDP ratio at the end of 2022 was approximately 100%, which remains in the manageable range. Based on IMF data for 2022, the debt-to-GDP ratios of the top 20 countries in terms of government debt exceeded 100%, with the United States at 121.7% and Japan reaching a staggering 261% (Exhibit 3).

Exhibit 3: The 20 countries with the highest public debt to GDP in 2022



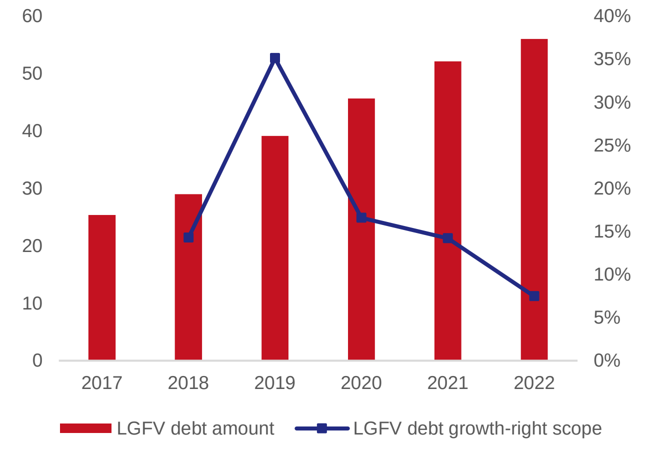
Sources: IMF, CSPI Ratings

In our analysis, the debt characteristics of the Chinese government exhibit limited comparability with those of the United States and European countries, but share certain similarities with Japan. Firstly, both government debt and LGFV debt in China are predominantly denominated in the domestic currency, and the government possesses strong control over monetary policy. Secondly, akin to Japan, the primary creditors of local government debt and LGFV debt in China are domestic banks. These banks, whether state-owned major institutions or local state-owned banks, are ultimately under government control, suggesting a significant degree of linkage between debtors and creditors. Consequently, the government possesses substantial influence and management capacity over these debts.

Moreover, Japan's low-interest rate environment has mitigated the burden of interest payments for the government, and despite its high broad government debt ratio of 261%, it is widely perceived as carrying low government debt risk. In contrast, China's current level of broad government debt remains significantly lower than that of Japan, indicating relatively lower macro-level debt risk. However, while the issuance interest rate for local government debt in China has decreased to approximately 3%, the relatively higher financing costs associated with LGFV debt inadvertently exert additional fiscal pressure on the government. Accordingly, it becomes increasingly crucial to pursue avenues for further reducing the cost of broad government debt.

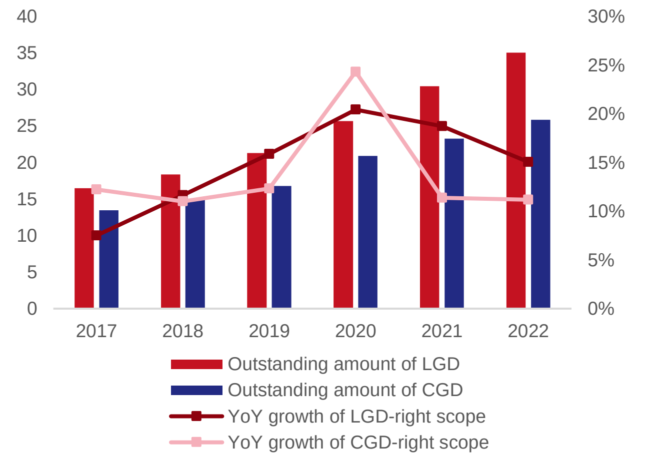
Secondly, considering a dynamic perspective, there has been a clear deceleration in the growth rate of interest-bearing liabilities for LGFVs due to tighter regulatory control over LGFV financing in recent years. The growth rates for such liabilities were 14.2% and 7.5% in 2021 and 2022, respectively (Exhibit 4). Our projections indicate that the regulatory control over LGFV financing is unlikely to be relaxed, with the overarching policy objective of " deleveraging existing debt while restraining additional debt " remaining unchanged. Simultaneously, local government debt (LGD) has maintained a relatively high growth rate, with increases of 20%, 19%, and 15% during the period from 2020 to 2022, while the scale of central government debt (CGD) has sustained a growth rate of over 10% (Exhibit 5). Over the long term, the trend of increasing explicit government debt while curbing implicit debt is expected to persist. Consequently, the growth rate of LGFV liabilities is anticipated to remain at a modest single-digit level in the forthcoming years.

Exhibit 4: LGFV debt growth witnesses a slowdown (RMB trillion)



Sources: Wind, CSPI Ratings

Exhibit 5: LGD and CGD experience a steadfast increase (RMB trillion)



Sources: MoF, CSPI Ratings

How Is the Overall Risk of LGFV Debt

Firstly, there has been an enhancement in the predictability of LGFV debt management policies, resulting in relatively low policy risk. The trend of tightening control over LGFV financing has been firmly established, reducing the likelihood of significant policy reversals in the future. Instead, policymakers are expected to focus on fine-tuning the existing policies. Through a combination of policy guidance, adjustments, and market adaptation observed over the past few years, the market has developed a relatively stable expectation regarding LGFV regulatory policies. This has fostered resilience and the ability to absorb policy changes and risks.

Secondly, the macro-level refinancing risk is relatively manageable. Currently, domestic banks serve as the primary creditors for LGFVs. As of 2022, bank loans accounted for a substantial proportion of 60% within the debt structure of LGFVs, while bond financing accounted for approximately 29%, and other forms of borrowing represented about 11% (Exhibit 6). Although there have been slight shifts in the financing structure of LGFVs, with a slight increase in bond financing and a modest decrease in the proportion of bank loans, the overall changes have been marginal. It is worth noting that a significant proportion of LGFV bondholders are also banks, underscoring the critical role of bank funding in facilitating LGFV refinancing activities. China's high savings rate ensures the availability of substantial bank funds, with total domestic and foreign currency deposits reaching RMB264.5 trillion by the end of 2022 (Exhibit 7). The consistent increase of deposit volumes at a rate of around 10% in recent years reflects the sustained demand for balance sheet expansion of banks. As local state-owned enterprises, LGFVs typically maintain close relationships with various types of local banks. Consequently, in the long term, barring any significant disruptions to regulatory policies, the risk preference of banks towards LGFV debts is expected to remain relatively stable. With the growth rate of LGFV debt declining to single digits, the incremental bank funds are anticipated to adequately meet the overall refinancing needs of LGFVs, thereby minimizing the likelihood of systemic refinancing risks.

Exhibit 6: Interest-bearing liability structure of LGFVs

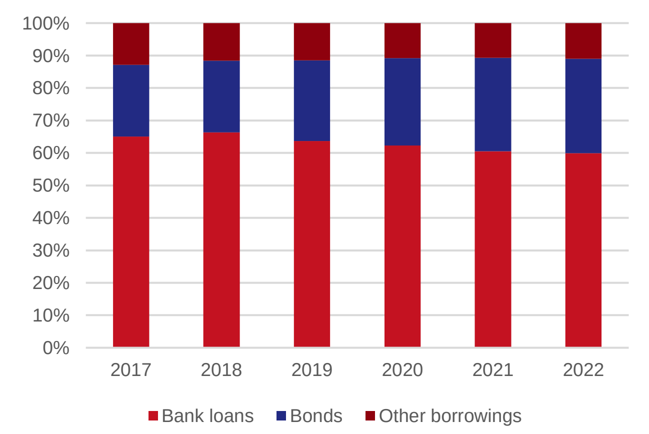
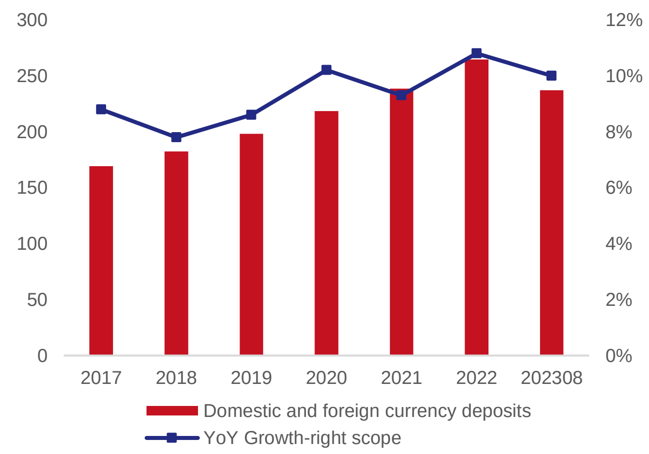


Exhibit 7: China's total deposit is steadily expanding (RMB trillion)



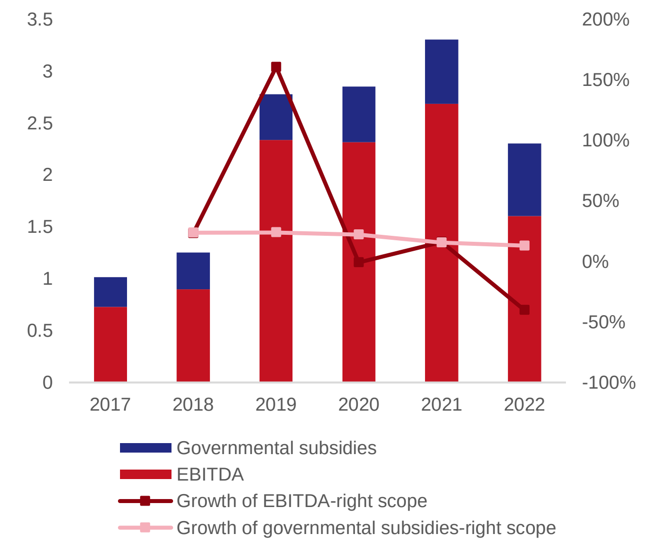
Sources: Wind, CSPI Ratings   Sources: Wind, CSPI Ratings

Thirdly, the LGFV sector as a whole is confronted with considerable interest payment pressure, although it is able to maintain a relatively stable financial equilibrium. Given the substantial capital investments and extended settlement cycles associated with urban development projects, LGFVs face challenges in generating sufficient profits and maintaining strong cash flows. To support the operational and developmental needs of LGFVs' projects, local governments typically provide financial subsidies to alleviate the burden of debt repayment and interest obligations. These consistent government subsidies serve as crucial sources of cash flow for LGFVs.

Our analysis indicates that the total EBITDA of LGFVs with bond issuance amounted to approximately RMB1.6 trillion in 2022. However, this figure has displayed some fluctuations in recent years. In contrast, government subsidies have exhibited a steady upward trend, reaching nearly RMB700 billion in 2022 (Exhibit 8). By calculating the ratio of LGFVs' EBITDA plus government subsidies to their interest expenses over the past few years, we observe that this significant income segment of LGFVs provides a moderate level of coverage for interest payments. The average coverage ratio from 2017 to 2022 stands at 105%, underscoring the overall tight balance of LGFVs' debt repayment cash flow. Nonetheless, some LGFVs with weaker liquidity may need to seek additional borrowing to fulfill their interest payment obligations.

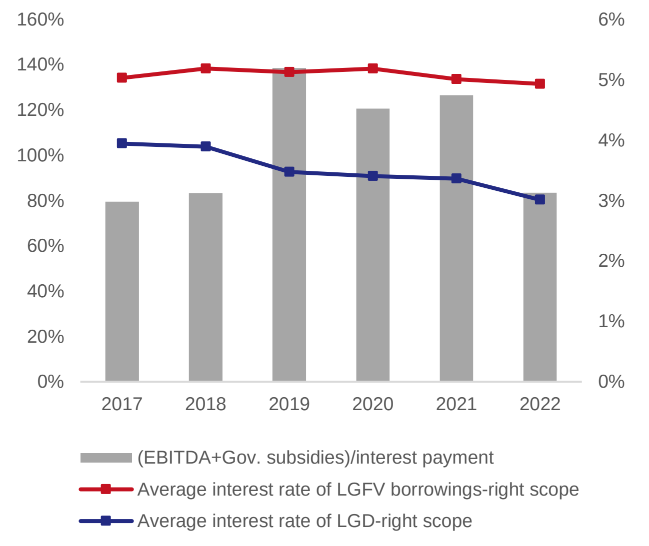
Regarding financing costs, our calculations reveal that the overall financing expenses for LGFVs have remained relatively stable in recent years, with an average interest rate of approximately 5% (Exhibit 9). In comparison, the average interest rate of local government bonds has experienced a consistent decline. In 2022, the average financing rate for LGFVs was 64% higher than the average financing cost of local government bonds, which stood at 3%. This indicates a relative increase in the overall financing costs for LGFVs, primarily attributable to its heavy reliance on bank loans as the primary financing source. The elevated interest costs not only intensify the pressure on LGFVs' interest payments but also indirectly heighten the support burden on local governments. Moreover, it is worth noting that the growth rate of nationwide local government fiscal revenue has decelerated in recent years. For instance, calculations for 2021 and 2022 indicate that the aggregated fiscal revenue of local governments across the country grew by a mere 3.6% and 2%, respectively, falling short of the expansion rate of LGFV debt. The sustained increase in interest payment pressure may test the future debt and cash flow management capabilities of LGFVs, while simultaneously challenging the overall risk management capacity of local governments.

Exhibit 8: LGFVs' EBITDA sees volatilities (RMB trillion)



Sources: Wind, CSPI Ratings

Exhibit 9: LGFVs' borrowing cost stands at around 5%



Sources: Wind, CSPI Ratings

Last but not the least, from a macro-level standpoint, we believe that the LGFV sector is not likely to experience systemic risks in the coming years, as indicated by our analysis. However, it is crucial to acknowledge the substantial regional disparities that exist, which give rise to regional risks. Variances in economic conditions, fiscal capacities, debt levels, financial resources, and management capabilities across different regions cannot be ignored. Consequently, it is imperative to remain vigilant regarding localized risks associated with interest-bearing liabilities of LGFVs.

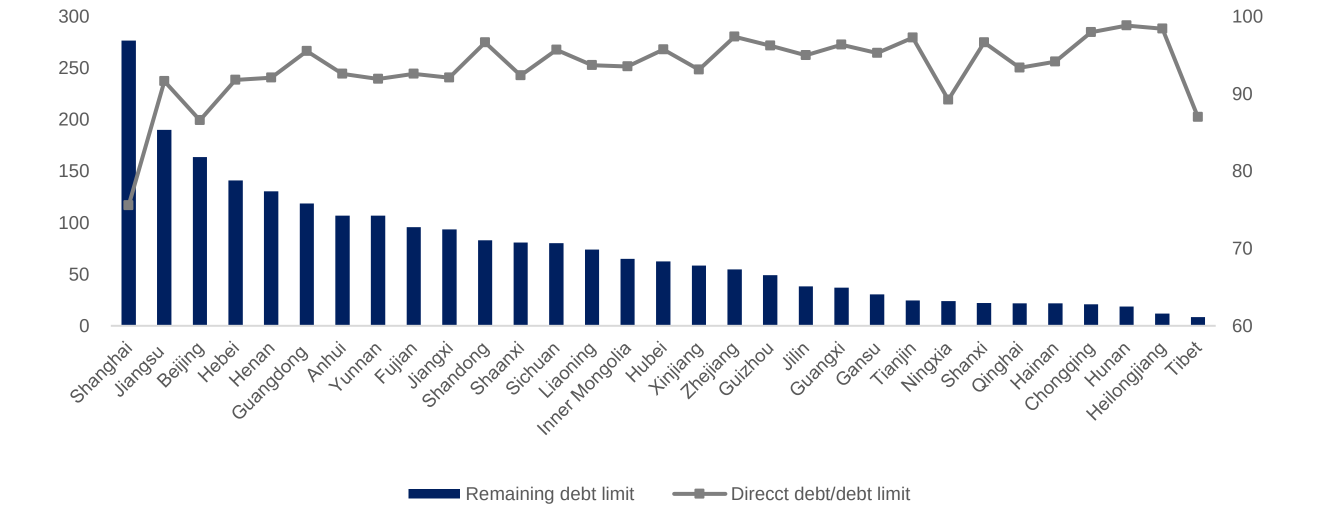
The Targeted “Package of Debt Resolution Policies”

Based on the previous analysis, it is evident that while the overall risk associated with LGFVs is currently manageable, there is an urgent need to address certain critical issues. These include the significant regional disparities and the challenges posed by the overall tight liquidity and substantial interest payment pressures of LGFV debts. In response to these concerns, the central government has promptly introduced the "Package of Debt Resolution Policies", which exhibits strong targeting and effectiveness in addressing the present challenges. We assert that the proposed strategy of substituting high-interest, relatively short-term LGFV debts with low-interest, long-term local government bonds yield several key benefits. Firstly, it facilitates a reduction in the scale of implicit debt, rendering it more transparent and enhancing overall financial transparency. Secondly, it alleviates the burden of debt repayment and interest payments for LGFVs, thereby enhancing their liquidity, reducing debt-related risks, and relieving the management pressure on local governments.

Under the debt substitution scheme, the new issuance of replacement bonds will remain within the prescribed debt limits of local governments. However, it is worth noting that, as of the end of 2022, there exists substantial variation in the remaining cumulative debt limits among provincial-level local governments. Regions with larger remaining debt limits tend to exhibit robust economies and lower broad debt ratios. Conversely, regions with higher broad debt ratios and a greater demand for debt substitution face limitations in their remaining available debt limits (Exhibits 10 and 11). In anticipation of this, we expect the central government to adopt measures to reclaim and redistribute the debt limits of local governments, with a focus on regions characterized by higher broad debt ratios and a significant magnitude of implicit debt. Such an approach will effectively contribute to the reduction of liquidity disparities among local governments.

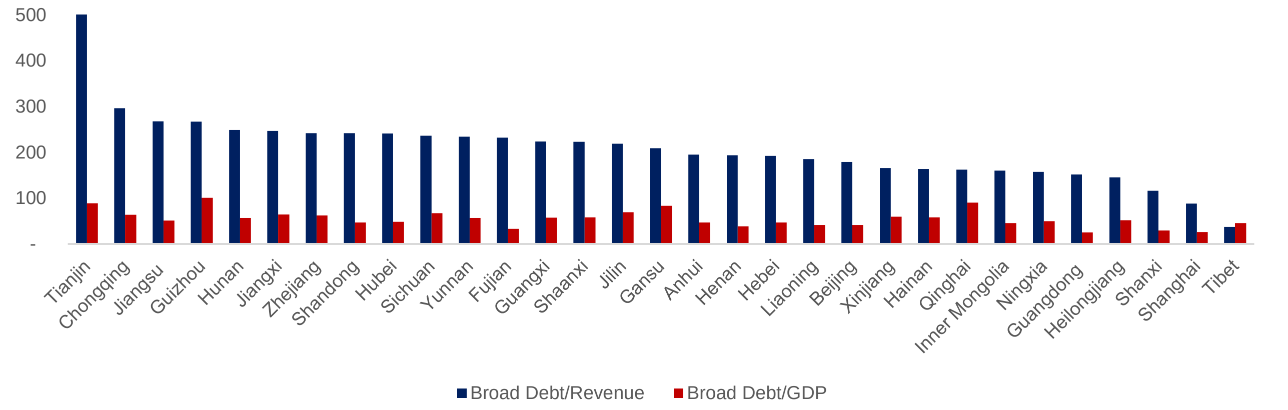
However, debt replacement, as the primary measure of the debt resolution policies, may not substantially reduce the debt ratio of local governments and could potentially give rise to moral hazards, leading to concerns about a subsequent debt surge after the debt resolution. Nevertheless, we believe that after several years of financial control measures aimed at "closing the front door and blocking the back door" of LGFV financing, the growth rate of LGFV debt has been effectively contained. Therefore, the likelihood of a significant expansion of LGFV debt following the debt resolution is relatively low. Additionally, the State Council's report in August explicitly emphasizes the need to prevent tandemly debt increase following the debt resolution. It is anticipated that with the subsequent introduction of supportive control measures, the financing for LGFVs in regions with higher debt ratios and substantial debt resolution efforts may face further tightening in the future.

Exhibit 10：Developed regions generally have more remaining debt limits (RMB billion)



Source: Local government financial departments, CSPI Ratings

Exhibit 11：The debt levels of provincial level governments in China at the end of 2022 (%)



Sources: Wind, Local government financial departments, Bureau of Statistics, CSPI Ratings

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