Fix to $3 Trillion Debt Tab Triggers Questions: China Credit

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By Bloomberg News

(Bloomberg) -- China's government has a creative solution to address repayment concerns hanging over more than $3 trillion in regional debt. It will deal with it later.

The Finance Ministry issued a 1 trillion yuan ($160

billion) quota for local governments to convert maturing high- cost debt into lower-yielding municipal notes to be repaid at a future date, according to a March 8 statement. Questions left unanswered include whether investors will be forced into the swap, how much transparency there will be over assets involved and whether the liabilities will strain the nation's finances.

China's bond risk rose the most in a month on March 9 even as debt-rating companies welcomed the government's plan to address regional debt, which Mizuho Securities Asia Ltd.

estimates may have reached 25 trillion yuan, bigger than German's economy. The ministry's 500 billion yuan municipal bond trial and the auction of 100 billion yuan of special bonds is insufficient to meet local-government financing vehicle debt due this year while funding budgets, Moody's Investors Service said.

"It will buy time for the government to solve the local debt problem, as the transition period takes three to five years," said Ivan Chung, a senior vice president at Moody's in Hong Kong. "The 1 trillion yuan debt-swap plan will be able to cover the refinancing needs of the maturing bonds this year, as municipal bond issuance is not enough."

Growth Target

The government is seeking to rein in local-government borrowing while accelerating infrastructure spending to defend a

7 percent economic growth target. Regional authorities set up thousands of funding units to finance projects from sewage systems to subways after a 1994 budget law barred them from issuing notes directly. Their fundraising helped liabilities jump 67 percent from the end of 2010 to 17.9 trillion yuan as of June 2013. The ministry of finance's media office didn't respond to a faxed request for comments Tuesday.

The following are among questions that haven’t been addressed by the debt-swap program:

1. Will investors be forced to convert LGFV bonds into lower- yielding municipal debt?

The swap is a way to ensure a “stable transition” as local governments change to a more transparent fundraising system, Vice Finance Minister Zhu Guangyao said March 10, without giving details of how the debt will be exchanged.

To swap existing off-budget liabilities -- including loans, corporate bonds or shadow-banking credit -- into regional government bonds is a sensible step and will mitigate liquidity risks faced by local authorities in the near term, said Yao Wei, a Paris-based China economist at Societe Generale SA.

“For some small LGFVs, which are financially weak and involved in both government and commercial projects, their destiny is uncertain,” said Moody’s Chung. “Yield premiums of bonds issued by these entities are likely to widen.”

Five-year AA rated corporate securities, the most common grade for LGFVs, yield 2.3 percentage points over the sovereign, down 34 basis points this year. By contrast, Shandong sold five- year municipal notes at 3.75 percent in July, 20 basis points below MOF bonds of similar maturity.

2. Will transparency improve or worsen after the swap?

The Finance Ministry has been working since 2011 to set up a municipal bond market. It expanded a pilot program for such sales to 10 cities and provinces last year, asking them to disclose basic financial information and get credit ratings.

“The disclosure for munis will conform to the standards set by the ministry, and we expect it only to improve in the next few years,” said Wang Ming, chief operations officer at Shanghai Yaozhi Asset Management LLP, which oversees 2 billion yuan of fixed-income investments. “Rome wasn’t built in a day.

At least the direction, with more disclosure and transparency, is being welcomed by the market.”

3. What types of LGFV debt can be converted into municipal bonds, and are the projects they finance appropriate?

LGFVs will no longer be allowed to raise funds for local authorities, and governments have no obligation to repay debt that wasn’t taken on to fund public projects, the State Council said in October. As much as 30 percent of LGFV liabilities will be considered government borrowings, according to a China Chengxin International Credit Rating Co. estimate.

“Projects that are of public interest will probably be classified as local government debt,” said Guang Fei, an analyst at Chengxin in Beijing. These include highways, subways and public utilities, he added.

4. What type of sovereign guarantees will the new municipal bonds carry?

The credit strength of upper-tier regional and local authorities, consisting of 31 provinces and five centrally planned cities, is supported by their close ties to the central government, Moody’s analysts Debra Roane and Nicholas Zhu wrote in a March 10 note. Their ratings will likely be in a tight range, and no more than two notches below that of the sovereign, which is Aa3 -- if Moody’s were to apply its global rating methodology -- the analysts said.

5. Will transferring corporate debt into public liabilities strain China’s fiscal strength and creditworthiness?

The nation plans to increase its budget deficit to 2.3 percent of gross domestic product this year from 2.1 percent in 2014, according to the 2015 budget. Counting new disposable spending, the actual gap would be 2.7 percent, Finance Minister Lou Jiwei said at a press conference on March 6. That compares with India’s 2016 fiscal year budget deficit target of 3.9 percent.

China’s credit-default swaps, which insure its sovereign debt against non-payment, jumped 2.5 basis points on Monday, the biggest increase in a month, to 87 basis points, according to prices from data provider CMA. Debt in China was equivalent to

251 percent of GDP, according to a June estimate from Standard Chartered Plc.

“Restructuring helps facilitate repayment of the outstanding debt, but cannot help support strong growth in debt” to finance 2015 investments which are more relevant to GDP growth, Zhang Zhiwei, a Hong Kong-based economist at Deutsche Bank AG, said in a March 6 note. “It is not clear to us whether this means the central government will take the debt onto its balance sheet.”

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