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China's Revised Corporate Bond Rules May Increase Risks For Lower-Tier LGFVs

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HONG KONG (S&P Global Ratings) Sept. 8, 2016--The financing vehicles (LGFVs) of China's lower-tier local governments could face increased refinancing and policy risks following recently revised regulations. The Shanghai Stock Exchange has stipulated that LGFVs that generate more than half their revenue from local governments will no longer be allowed to issue corporate bonds. S&P Global Ratings believes the risks could particularly intensify for lower-tier vehicles if there's a liquidity crunch in the domestic bond market.

"Chinese LGFVs are highly reliant on banks and the domestic bond market to refinance their huge amount of debt maturities. Under the revised rules, therefore, some lower-tier LGFVs may no longer be able to secure an important funding source," said S&P Global Ratings credit analyst Gloria Lu.

However, for higher tiers, the increased threshold for corporate bond issuance will have a limited impact on refinancing. Corporate bonds traded in the exchange only account for less than 10% of the outstanding debt issuance of LGFVs as a whole.

"We believe the impact on large-scale and higher-tier LGFVs could be moderate because those LGFVs usually have sufficient banking facilities and diversified financing channels, and benefit from strong local government support and debt replacement," said Ms. Lu.

The new rules prohibit corporate bond issuance by LGFVs and companies that engage in land development and government-project construction and have derived more than 50% of their revenue from the local governments in the past

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two to three years. Previously, LGFVs could still issue corporate bonds even if they breached the 50% revenue threshold, provided their cash flow from local governments was less than 50%.

The new rules would now affect those LGFVs that planned to raise funds through corporate bonds while undertaking significant government projects, if they breach the revenue threshold. Most LGFVs have issued domestic bonds through the National Association of Financial Market Institutional Investors (NAFMII) if they meet the 40% cap of issuance to net assets, along with other conditions. LGFVs with diversified businesses and cash flows typically have access to both the corporate bond and interbank markets.

In our opinion, Chinese regulators are attempting to contain the credit risks of issuers and at the same time balance this against the LGFVs' desire to secure better funding costs through increased market access. The government regards infrastructure investment led by LGFVs as an important engine for stable economic growth. NAFMII recently lifted its controls over the issuance of enterprise bonds in the interbank market by district- and county-level LGFVs. However, potential issuers still need to meet or exceed a required rating level. Many lower-tier LGFVs therefore may not benefit from the new rules.

Under the State Council's "No. 43 Article" outlined in late 2014, regulations and policy aim to gradually strip the government financing function from the LGFVs. In our view, this has heightened the policy risk for LGFVs.

China's economic slowdown has intensified the difficulties for industrial issuers that are experiencing overcapacity and weak demand, as indicated by more "credit events," such as defaults. However, investors continue to have higher confidence in issuers with government support, easing their access to credit. But LGFVs are still subject to refinancing and policy risks.