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MOF's Latest Statement Reiterates Concern Over Rising Local Government Debt In China

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HONG KONG (S&P Global Ratings) Nov. 8, 2016--S&P Global Ratings said today that China's Ministry of Finance (MOF)'s press statement on Nov. 4, 2016, reiterates its concerns on rising local government debt. It is also consistent with the MOF's efforts to distance local governments from the debt of local government financing vehicles (LGFVs).

According to the statement, effective Jan. 1, 2015, all new debt of Chinese LGFVs is not part of government debt and shall be repaid by the LGFVs on their own. The MOF reiterated that local governments will only bear limited responsibility for LGFVs to the extent as shareholders. This indicates that investors shall bear the risk for investing in non-government debt of LGFVs. There will be no direct bailout from the government in case of a default.

In our opinion, the recent statements of the MOF in different occasions are consistent with the No. 43 circular and the new budget law. With the latest statement, the MOF aims to: (1) warn local governments to not make any guarantee or undertakings on LGFV debt in breach of the new budget law; (2) remind the market that the risks of investing in LGFV debt should not be regarded as the same as government risk; and (3) prompt business transformation of LGFVs to make them financially independent from local governments.

"We believe the untangling of LGFVs' financial relationships and operations from local governments is a bumpy and protracted process," said S&P Global Ratings credit analyst Gloria Lu. "Local governments and LGFVs are likely to only gradually reduce their close relationship because LGFVs still play a

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leading role in ramping up infrastructure investments and undertaking various social economic policies to support economic growth."

For the LGFVs that we rate, most if not all of their businesses are still under the mandate of local governments and they continue to incur debt for infrastructure projects.

In the meantime, the funding of local governments is constrained by the new debt quota set by the MOF each year. For 2016, MOF approved a total of Chinese renminbi (RMB) 1.18 trillion in new debt to all local governments, or an average of about RMB40 billion per province. This amount falls short of the continued capital needs for infrastructure and other developments.

"The mismatch in revenue and expenses of local governments is a structural issue that requires a reform of the institutional framework, including the revenue and expense sharing with the central government," said Ms. Lu. "Until this is addressed, we continue to see local governments using off-budget funding vehicles such as LGFVs to plug the fiscal deficit gap."

Although the MOF's statement does not have any immediate rating impact on LGFVs that we rate, we believe the transition risks of LGFVs for which we have considered strong support from governments in times of distress may increase if the central government enforces its stance strongly. However, the risk is not substantial because significant defaults by LGFVs could destabilize the financial system. Also, any significant number of defaults could derail the central government's plan to reduce the default risk of local governments through the new budget law and the debt swap program. LGFVs, taking into account their development role for local governments, are closely linked to the government reputation and are more strategically important than most other local SOEs. We believe local government support to LGFVs continues to be evolving with high policy risk and subject to the game of benefits between central and local governments.

We expect the business transformation, coupled with unfolding public-private partnership in funding infrastructure and China's economic rebalancing, to weaken the primary development role of LGFVs for local governments. Business transformation is an enduring and painful process for LGFVs that they cannot avert. Improvement in transparency, governance, and financial management are equally important for LGFVs exploring cash-generative businesses with reasonable returns. Some LGFVs are making use of the current break of easing liquidity to accelerate business transformation. However, we don't expect them to improve their stand-alone credit profiles any time soon, and we will continue to see most LGFVs having high debt leverage, meager profitability, volatile cash flow, and illiquid assets.

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