CCXI & CCXAP – Research & Commentary

Special-Purpose Bonds for Fighting COVID-19 Grow Steadily, Diversified LGFV Bonds Hedge against Risk

Hong Kong, 20 July 2020 -- China Chengxin International Credit Rating Co., Ltd. ("CCXI") released a report entitled "*Special-Purpose Bonds for Fighting COVID-19 Grow Steadily, Diversified LGFV Bonds Hedge against Risk—Features of Local Governments and LGFV Industry under Impacts of the COVID-19 Pandemic*", analyzing the policies on LGFV industry and local government debt in the first half of 2020 and predicts policy trends in the future.

In the first half year, in order to cope with the pandemic and bolster economic repair, the government continuously strengthened counter-cyclic macro-regulation and substantially expanded special-purpose bonds. While the financing environment for LGFV enterprises was bettering and policy for stabilizing economic growth was stepped up, policy and measures for regulating market development and mitigating risks were also put into place. As the pandemic is stabilizing and performance of economic indicators is improving in China, policies will gradually return to normal within the year, to maintain an effective balance between securing growth and guarding against risk.

In response to the pandemic, the scope of areas supported by special-purpose bonds was expanded to cover new infrastructure and new urbanization initiatives and major projects to help stabilize economic growth. Meanwhile, due to such preferential policy as the registration-based system, financing of LGFV enterprises is becoming more and more convenient. In the first half year, with rising economic downward pressure under the influence of the COVID-19 pandemic, special-purpose bonds, as one of the important positive fiscal measures, expanded continuously. From January to June, a total of RMB2.23 trillion worth of such bonds were issued, more than the total amount issued in 2019. The range of use of money raised was enlarged and more targeted, with a focus on supporting new infrastructure and new urbanization initiatives and major projects. Money raised through special-purpose bonds was allowed to be used to replenish capital of small and medium-sized banks, indirectly facilitating financing of small and micro-enterprises and thus further stabilizing growth. Against such a backdrop with a series of favorable factors, e.g. the registration-based system for credit debt in full implementation, the launch of new bond varieties like COVID-19 Control bonds and corporate bonds dedicated to new urbanization of counties, financing convenience of LGFV enterprises has been further enhanced, and their financing environment has been bettering. Moreover, a pilot program on REITs (Real Estate Investment Trusts) in the infrastructure field has kicked off, helping with putting idle assets to better use and alleviating pressure of local government debts.

While measures for stabilizing growth were implemented, policy and measures for regulating market development and mitigating risks were gradually put into place. The information disclosure template for special-purpose bonds has launched, standardizing the disclosure process. Meanwhile, some local governments successively disposed of high-interest-bearing debts and pressed forward with LGFV bond swap. In the first half year, fiscal strength of local governments was affected to varying degrees by the pandemic. To realize the goals of stabilizing investment and employment, local governments may take on higher debt burden. This year's *Report on the Work of the Government* explicitly states that strong measures will be taken to prevent and control major risks in the financial and other sectors and to forestall systemic risks. **On the one hand,** to guard against risks accumulated as a result of rapid expansion of special-purpose bonds issued, in accordance with the *Notice of the Ministry of Finance on Launching Information Disclosure Template for Special-Purpose LGFV Bonds Newly Issued* released in the first quarter, the information disclosure template for special-purpose bonds has been put into use in April to standardize the information disclosure process. **On the other hand,** some local governments accelerated debt disposal. Jiangsu, Yunnan, etc. have launched policy with respect to high-interest-rate debt disposal to improve the debt structure and mitigate risks in local government debts. At the same time, many LGFVs continuously carried out debt disposal in more diversified ways including debt swap under the syndicated loans and LGFV bond swap that was debuted.

In addition, CCXI also points out that special-purpose bond, as one of the focal areas for stabilizing growth, will continue to be enhanced in both quality and performance in the second half year, but investors need to pay heed to such risks as idle capital and returns less than expected. Meanwhile, inter-region divergence of strength as a result of the pandemic and floods, policy supports for new infrastructure and new urbanization initiatives and major projects will to some degree aggravate the divergence of faith in LGFV among regions and fields, so we need to pay attention to risk evolution in this regard. In terms of local government debt, LGFV bonds, especially special-purpose bonds, will continue to expand with higher efficiency, playing an important role in stabilizing growth. While supporting new infrastructure and new urbanization initiatives and major projects, LGFVs will actively explore new ways to replenish capital of small and medium-sized banks. However, it is necessary to stay vigilant towards such risks as idle money, less-than-expected returns of special-purpose bonds, keep rigorous risk control throughout a bond's life cycle, step up supervision and management of using special-purpose bond funds to replenish capital of small and medium-sized banks, hold all parties involved accountable and prudently advance the capital replenishment mode under the "One Policy for One Bank" principle. **In terms of the LGFV industry,** with a series of financing-friendly policy and measures launched in the first half year, the financing environment of LGFV enterprises will continue bettering in the second half year. In particular, LGFV enterprises from districts and counties entitled to more policy supports and those undertaking special-purpose bonds dedicated to new infrastructure and new urbanization initiatives and major projects, will see liquidity squeeze caused by the pandemic be alleviated, or embrace new opportunity for transformation and better support steady growth of construction in key fields. Given that the delayed resumption of work after the Spring Festival holiday and debt extension due to the pandemic have deferred the exposure of credit risk to some degree, improvement made by and in LGFVs themselves is actually quite limited. With marginal adjustment in policy, default risk of bonds and risks of non-standard financing may mount in the second half year, which requires our particular attention. Moreover, it is also worth paying heed to influence on credit strength of LGFVs brought about by divergence of fiscal strength among local governments under the impact of the pandemic.

To obtain the full report, please call our Customer Service Hotline +852-2860 7111.

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