Bond Case Briefs

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China Still Has Work To Do On The Municipal Bond Market.

China has just taken another step down the long road to a domestic municipal bond market. On May 19, 2014, the Ministry of Finance (MOF) expanded a trial that allows selected local and regional governments (LRGs) to tap the bond market. Standard & Poor's Ratings Services views this as an important step toward establishing a transparent LRG bond market. Such a market is vital to reducing the risks to China's sovereign creditworthiness stemming from local governments' use of off-balance-sheet debt. But a municipal bond market similar to those in developed economies and containing the risks of local government financing will need many more important changes, in our view. These include changes to the legal framework and greater restrictions on LRG off-balanc--sheet borrowing.

- The latest LRG bond market trial shows increased emphasis on transparency.
- Despite the latest changes, the central government retains significant control over LRG bond issuances.
- Developing the municipal bond market requires careful management on various fronts such as ensuring fiscal stability and improving information disclosure.

A New Year, Another Municipal Bond Trial

The MOF's latest move granted increased debt-issuing responsibilities to more LRGs than it did in 2013. In addition to organizing the process of bond issuance, the selected LRGs also take on the responsibility of making interest and principal payments to bondholders. The 2014 trial is extended to the Beijing municipality, Jiangxi province, Ningxia province, and Qingdao City. The LRGs of the six regions included in both the 2013 and 2014 trials are Shanghai municipality, Zhejiang province, Guangdong province, Shenzhen City, Jiangsu province, and Shandong province.

The latest LRG bond trial shows increased emphasis on transparency. A new requirement in the 2014 trial is the need for greater disclosure. The MOF requires the LRGs involved in the trial to publish news relevant to the bond issues–including the government debt situation as well as economic and fiscal developments–on a timely basis. The announcement on the trial also warned against inaccurate or misleading submissions as well as material omissions of information; this could be a reflection of the public's doubt on the reliability of LRG data.

Still No Full Freedom To Borrow

Despite the latest change, the selected LRGs are still some way from having full freedom to sell bonds. The central government continues to control the LRG bond issuance process in a few ways. Most importantly, the amount of bonds LRGs are allowed to issue are subject to annual quotas assigned by the State Council (the Chinese cabinet). The LRGs are also only allowed to issue fixed-rate bonds with maturities of five, seven, and 10 years in the proportion 4:3:3.

Some investors could inevitably read the significant influence of the central government over this process as implying sovereign support for the LRG bonds. Bonds issued by local governments in the past few years were priced close to central government bonds. Secondary market activities also show LRG bonds trading at lower yields than the highest rated nongovernment bonds. The effort to develop the Chinese municipal bond market can only be considered a success if investors price debts of different LRGs according to their individual credit characteristics rather than the perception that the bonds have central government support.

More Changes Needed To Further Develop Municipal Bond Market

Getting investors to price bonds based on the LRGs' differentiated credit metrics isn't easy. Not least because it is difficult for the central government to absolve responsibility if an LRG defaults on its debt in a unitary state. A default by an LRG could also hurt confidence across the sector and affect the financing of other LRGs. Therefore investors will expect the central government to come to the rescue if an LRG comes close to defaulting.

Also, from the experience of other more developed bond markets, our view is new indirect restrictions to ensure fiscal stability may have to be in place before removing direct controls such as annual bond issuance quotas. Otherwise, there is the risk of a sudden uncontrolled growth in LRG debt. Measures to achieve this in other countries include public finance laws or rules that limit annual net bond issuances to a proportion of capital spending and prescribed ceilings on total LRG debt levels. These measures are effective if the government regularly publishes regional economic and fiscal indicators that are generally regarded as reasonably accurate. Changes to laws or rules governing government public finance may have to happen before the municipal bond market in China develops further.

Even a well-developed municipal bond market does not ensure fiscal stability. This objective is likely to be the main impetus for the MOF's efforts but it requires off-balance-sheet LRG borrowing to be insignificant. Otherwise, allowing LRGs significantly more freedom to sell bonds will simply add to their borrowing capacity. Consequently, it is also likely that the municipal bond market development will not move far ahead unless the MOF is able to reduce LRGs' access to off-balance-sheet financing.

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