PPIAF Helps the Chinese Government Move toward Credit-Based Borrowing by Sub-National Entities

China’s sub-national finance reform process that began in 2009, with support from Public-Private Infrastructure Advisory Facility (PPIAF)’s Sub-National Technical Assistance (SNTA) Program, took a major step forward in September 2014. After 20 years of prohibiting bond issues by local and regional governments, the Chinese National Peoples’ Congress approved legislation that enables sub-national governments to return to the Chinese bond market. This transformative change broadens the sources for local infrastructure financing while making it more transparent and based on institutional creditworthiness.

Starting in 1994, Chinese budget law prohibited sub-national governments from direct borrowing, but many did so indirectly and off-budget, by using Urban Development Investment Corporations (UDICs). As many as 8,000 UDICs exist in China where this kind of financing accounts for 80-90% of urban infrastructure finance. UDICs help account for off-budget sub-national liabilities that are estimated to equal up to 34% of GDP and accounted for 30% of record new bank lending in 2009.

Central government officials have been concerned about contingent liabilities that might be lurking among the massive amounts of UDIC debt. UDICs in large coastal cities are well-funded, and many are public-ly-traded subsidiaries that can raise capital from the markets and rely less on bank loans. But UDICs in the poorer areas of northern and western China are of particular concern because they rely more heavily on bank loans backed primarily by implicit sub-national government guarantees rather than assets or future project revenues. The new regulations established in 2014 reduce the need for indirect, off-budget borrowing from commercial banks by sub-national governments through Urban Development Investment Corporations (UDICs). Moving to direct, on-budget borrowing by sub-national governments enables Chinese authorities to better track and regulate local and regional government infrastructure financing.
Special purpose vehicles to repay debts in a timely fashion. Municipal parents regarding the willingness and ability of these lenders, as well as realistic assessments by the UDICs and their borrowing is fully vetted via creditworthiness assessment by credit-based borrowing practices. The idea is to ensure that UDIC open-ended guarantees by parent municipalities, and toward recommendation of this work was to move UDICs away from do not generate cash flows sufficient to cover their costs. A key rating documented the fact that UDICs often borrow more debt than they can service with their own revenues and rely on guarantees from parent municipalities to finance projects that debt than they can service with their own revenues and rely on guarantees from parent municipalities to finance projects that do not generate cash flows sufficient to cover their costs. A key recommendation of this work was to move UDICs away from open-ended guarantees by parent municipalities, and toward credit-based borrowing practices. The idea is to ensure that UDIC borrowing is fully vetted via creditworthiness assessment by lenders, as well as realistic assessments by the UDICs and their municipal parents regarding the willingness and ability of these special purpose vehicles to repay debts in a timely fashion.

On the second day of the Forum, the Chinese participants held all-day internal discussions reflecting on the international experiences presented on the first day, and put together a list of questions on policy, regulatory and institutional frameworks. A follow-up meeting focusing on these questions was held in Beijing on September 25, 2009. Participants included senior officials of the MOF, the World Bank, and all of the international experts who had participated at the International Forum.

A second parallel focus of SNTA assistance has been to help central and municipal officials better understand the financial situation of UDICs by sponsoring credit ratings of six of these entities by international credit rating agency Standard & Poors. The ratings documented the fact that UDICs often borrow more debt than they can service with their own revenues and rely on guarantees from parent municipalities to finance projects that do not generate cash flows sufficient to cover their costs. A key recommendation of this work was to move UDICs away from open-ended guarantees by parent municipalities, and toward credit-based borrowing practices. The idea is to ensure that UDIC borrowing is fully vetted via creditworthiness assessment by lenders, as well as realistic assessments by the UDICs and their municipal parents regarding the willingness and ability of these special purpose vehicles to repay debts in a timely fashion.

Donor Coordination

The Forum was jointly financed by the Chinese MOF, PPIAF’s SNTA program, and the China Country Management Unit. It was also supported by the Guangdong Provincial Government and Zhuhai municipality.

Outcomes

In a meeting with banking regulators on February 25, 2010, the MOF announced its intention to prohibit local government guarantees for UDIC borrowing, as a way of restricting local non-credit-backed borrowing until a comprehensive regulatory framework can be put in place. At the opening of the annual parliamentary meetings a week later, then-Premier Wen Jiabao announced that the central government would sell 200 billion yuan ($30 billion) of bonds for a second year to on-lend to local governments for infrastructure projects. This kind of financing was also discussed with the international experts in Zhuhai and represents an intermediate way of controlling local borrowing, while creating a situation where these entities must plan investments, pay back debts and operate according to the basic tenets of a credit culture.

Impacts

The regulatory and institutional frameworks presented at the 2009 PPIAF SNTA International Forum on Sub-National Debt Management held in Zhuhai, China are now more relevant than ever to China’s continuing reform process. The Chinese government’s move to lift the ban on local and regional government borrowing allows the government to track indebtedness and restrict risky borrowing behavior that threatens to increase default rates and possibly wipe out the paid-in capital of many of China’s largest banks. The budget law revisions also involved a list of other positive changes, such as requiring that local governments do more long-range financial planning and that they embrace accrual accounting, which involves recognizing revenues and expenses as they are incurred, instead of waiting for them to show up in cash transactions.

Related Activities in China

2006: Reform of the Regulatory Environment for Private Sector Participation for Chongqing Municipal Government, $300,000
2007: Ningbo Municipal Finance Capacity Building (SNTA), $68,000
2007: Maintenance of Rural Roads under the Mechanism of Community-Based Micro-Enterprises, $156,450
2008: Urban Development Investment Corporations Credit Ratings (SNTA), $350,000
2009: Sub-National Borrowing and Debt Management (SNTA), $75,000

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