Manulife Asset Management

China's local government debt:
Moving out of the shadows

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Key highlights

- China's bond market is evolving rapidly and investors need to tread lightly as we expect credit quality and pricing differentiation to increase. We believe independent, bottom-up analysis of debt issuers is the key to determining whether potential returns in the market adequately compensate for the risk involved.

- China's aggregate government debt is estimated to have reached about 55% of GDP, with roughly 60% of that amount arising from local governments[1]. Much of this debt was issued via local government funding vehicles (LGFV) with relatively low transparency and it is uncertain who is ultimately responsible for the debt.

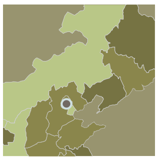
- With concern over China's economy and debt levels mounting, the central government has:
  1. initiated a series of audits to clarify the level of debt outstanding and how much of it local governments are directly responsible for;
  2. introduced a debt swap program to shift certain LGFV debt to the local bond market; and
  3. allowed local governments to begin issuing bonds.

- This could represent a significant step forward in the maturation of China's fixed income market as it should:
  1. drive further bond market growth;
  2. clarify the level of systemic risk and reduce moral hazard in China's local government debt, particularly as related to LGFVs;
  3. increase bond market credit quality and pricing differentiation; and
  4. pave the way for orderly defaults.

- Key risks in the process of pulling LGFV debt out of the shadows and improving China's bond market include:
  1. policy risk;
  2. liquidity risk;
  3. default risk; and
  4. pricing risk.

- While things will not change overnight, we expect the gradual shift of local government debt to the formal bond market to ultimately help better align risk and reward, potentially making China's onshore bond market an attractive investment destination for international investors as the nation's capital account opens.

1. 55% as at the second quarter of 2014. Mckinsey Global Institute. *Debt and (not much) deleveraging*. February 2015.



Introduction: Moving out of the shadows

If you have read a news story on China over the past year or so, it was likely about one of two things: its slowing economy or the country’s mountain of outstanding debt. Neither of these issues should be taken lightly, with China’s economic growth having fallen to 7.3% in 2014 after remaining in the double digits for much of the past two decades and its aggregate debt level currently standing at about 282% of GDP[1].

In the years since the global financial crisis, one category of debt in particular has attracted attention. Chinese government debt has ballooned to about 55% of GDP from 42% in 2007[1]. This may not seem significant compared to US government debt, for example, which currently stands at roughly 89% of GDP[1]. However, what is unique about China is that roughly 60% of outstanding government debt arises from local government (ie, municipal) obligations compared to just 15% in the US[2].

Adding to concern over the sheer volume of local government debt is the structure of that debt. Local governments in China have historically been banned from raising debt in their own names, so much of the funds have been raised through local government funding vehicles (LGFV; see Appendix for an introduction to LGFVs and their role in China’s development). LGFVs are often opaque, meaning it can be anyone’s guess where the money actually comes from, what interest rates are due and how ultimate responsibility for the debt has been apportioned.

Several near defaults by LGFVs during 2014 and 2015 have drawn attention to the potential for a significant local government default to initiate a debt crisis in China. This has prompted calls for clarification of the true level of risk inherent in local government debt in China. The central government responded with a series of reforms that enable local governments to raise and pay back debt under their own names in China’s domestic bond market.

While this may seem just a change of venue – same debt level, different market – we believe it is a potential game changer for China’s bond market as it will drive significant growth in the municipal debt segment and the bond market as a whole. It is also an opportunity for regulatory reforms – and enforcement – to increase financing transparency, strengthen bond covenants to clearly signal credit risk, establish a standard default procedure and better align risk and reward.

As China continues to open its capital account, we believe that these developments are necessary for the nation’s bond market to emerge as a reliable source of long-term financing for Chinese companies and an attractive investment destination for local and international investors.

2. HSBC. *China’s local government debt: The move towards transparency.* March 2015.

Cleaning up: Shifting LGFV debt to municipal bond market

While there has been no default in the sector to date, RMB3 to 4 trillion in LGFV debt is set to mature in 2015 alone[3], suggesting there is no time to lose in addressing the issue. Indeed, the central government recently announced a package of reforms that, in a multi-step process, could pull another large chunk of Chinese debt out of the shadows. Key provisions include:

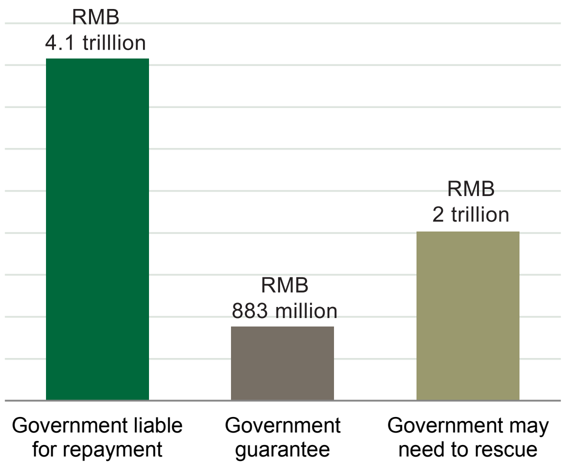
Clarifying responsibility for existing LGFV debt – The central government has held three audits of LGFV liabilities, and results have been finalised for the first two (2011 and 2013). The 2013 audit classified a total of about RMB7 trillion in LGFV debt into three categories:

- RMB4.1 trillion that local governments are liable for repaying;
- RMB883 million that local governments have guaranteed;
- About RMB2 trillion that may or may not need to be rescued.

There is anecdotal evidence that LGFV debt has continued to grow since the 2013 audit, so the aggregate amount could currently be anywhere from RMB9 to 11 trillion.

The results of the third audit, carried out in 2014, are expected to be announced in the fourth quarter of 2015. The results are widely anticipated to fine-tune the classification, grouping the first one or two categories as debt that will be recorded on government books and factored into budgeting decisions. Remaining debt will likely have to rely on revenue from underlying projects, when available, or could be reincorporated as public-private partnerships (PPP). However, we cannot rule out the possibility of continued indirect government support.

Figure 1: Breakdown of local government debt



Note: Based on 1H13 local government debt audit.
Source: CLSA. *LGFV debt: A tug of war.* 7 May 2015.

Winding down LGFVs – In October 2014 the central government prohibited the establishment of new LGFVs or other intermediaries to facilitate borrowing and required existing LGFVs to be ring fenced to stop them from accruing further liabilities. These measures essentially initiated a wind down of existing LGFVs and pointed to their eventual disappearance from China's government debt market. However, as China's economy slowed over the subsequent quarters, the provisions were watered down. In May 2015 the government announced that banks may extend further loans and renegotiate existing loans to LGFVs that were initiated prior to end-2014 and still have projects underway[4]. (See "LGFVs receive a lease on life," page 5, for more details.)

Initiating swaps for maturing debt – In early 2015, the central government announced a RMB1 trillion debt swap program to refinance a portion of the RMB3 to 4 trillion in debt maturing in 2015 via onshore bond market issuances. In June the debt swap program was expanded to RMB2 trillion and in August to RMB3.2 trillion.

Allowing local governments to issue municipal bonds – This is the centrepiece of the plan to clean up local government finances and, in our view, will ultimately draw local government financing in China out of the shadows. In 2014, China's central government announced the first revision to its budget law in 20 years, lifting the ban on direct borrowing by upper-level local governments (ie, at the provincial level). Following the announcement, a trial program was launched under which a RMB400 billion direct bond issuance quota was extended to 10 provinces.

3. Morgan Stanley. *China Financials.* 6 March 2015.
4. Bloomberg. *China Doubles Local Government Debt Swap Quota to Ease Risks.* 10 June 2015.

In early 2015, the trial was expanded, with all provincial level governments being permitted to issue bonds in their own names and to take on direct responsibility for payments – the wider program is subject to a RMB500 billion quota for general obligation bonds and RMB100 billion for revenue bearing bonds. We expect this program to eventually be opened to all levels of local government in China.

Figure 2: Local government debt issuance regulation timeline

Date	Policy / event
1 November 2013	Third Plenum policy statement announces government initiative to improve local government financial disclosures, reduce reliance on special purpose transfers, implement tax and budget reform to improve fiscal balance, establish risk management framework and allow local government bond issuance
1 December 2014	National Audit Office (NAO) report shows total local government debt, including direct/contingent liabilities, was RMB17.9 trillion at end-June 2013, 67% higher than in December 2010
20 May 2014	Central government launches pilot program to allow 10 local governments to sell municipal bonds*
14 October 2014	State Council’s new borrowing guidelines pave the way for local governments to borrow in their own names rather than via intermediaries
12 December 2014	State Council approves phased introduction of accrual-based comprehensive financial statements for local governments over 2015 to 2020
30 December 2014	Ministry of Finance (MOF) announces the third expansion of the pilot local government bond issuance program. Expansion extends the program to more provinces, allowing the issuance of special-purpose bonds and the participation of international investors
14 March 2015	2015 budget raises local government bond issuance ceiling and lays foundation for a debt-for-bond swap program
12 May 2015	Officials greenlight local bonds as collateral for central bank lending
18 May 2015	Jiangsu Province issues first local government bond under new program, extending some of its debt maturity schedule and lowering the average interest rate
27 May 2015	National Development and Reform Commission (NDRC) relaxes bond issuance requirements for LGFVs, allowing higher leverage for LGFVs
August 2015	National People's Congress caps local government debt at RMB16 trillion for 2015**

Source: Moody’s except * Reuters and ** Standard Chartered Research. August 2015.

The debt swap program and allowing local governments to issue bonds in their own names have significant implications for local government financing. It should:

- **Increase local government debt transparency** – The debt swaps and new issuances will essentially exchange LGFV debt which may have been raised via opaque channels and with unclear responsibility for onshore bonds that are registered to a specific issuer and are subject to clear issuance criteria, established interest rates and covenants.
- **Lower funding costs** – Whether local government debt raised via LGFVs was raised in the enterprise bond market, via bank loans or in the shadow banking sector, it generally has one common characteristic: relatively high interest rates, with an average of about 8.0%[5]. Swapping maturing debt for more transparent bonds and issuing new municipal bonds means that rates will generally fall significantly, improving the debt profile of many local governments.

5. Morgan Stanley. *China Financials*. 6 March 2015.

- **Clarify government debt guarantees** – LGFV debt, like a significant portion of corporate debt in China, has to date been subject to a relatively high level of moral hazard among issuers due to explicit or implicit government guarantees. However, this is already changing as debt swaps and new municipal bond issuances have disclosed the level of guarantees that apply. This does not mean that the central government will never again step in to bail out a troubled LGFV or local government, but suggests that this would be a last resort in the event of a potentially destabilising default.

Together, these provisions should help allay concern over existing local government debt in China while laying the foundations for a well-regulated municipal bond market that gives local governments access to reliable funding at reasonable interest rates and longer-dated maturities. At the same time, heightened transparency should provide local and international investors with the information required to evaluate the risk associated with local government debt and to judge whether that risk is adequately compensated by the yield on offer.

LGFVs receive a lease on life

With the May 2015 announcement that banks can extend further loans and renegotiate existing loans to certain LGFVs, it seems that they have been given a lease on life. That being said, we believe the exception to the rule represents a concession to reality rather than a change of government policy.

This is further supported by the August 2015 National People's Congress approval of an RMB16 trillion cap on local government debt. Given that total direct local government liabilities were estimated at RMB15.4 trillion at end-2014 with an additional RMB8.6 trillion in contingent liabilities (see Figure 3), this leaves little wiggle room for debt repayment or new borrowings to fund infrastructure spending this year. In this light, it becomes obvious LGFVs will actually remain important sources of local government funding at least in the near term.

While a select number of LGFVs are allowed further access to bank loan financing, we are already seeing some others take more creative approaches to fund raising. One recently exploited avenue is China's offshore bond market, which has seen an increase in LGFV bond issuance since late 2014. This emerging trend raises several key concerns:

- **Credit quality** – In our view investors in offshore LGFV debt need to be doubly vigilant of credit quality as offshore bond holders have a lower claim on assets than onshore bond holders.
- **Credit ratings** – While most offshore bond issuances, including LGFV issuances, carry credit ratings from one of the three major international rating agencies, still-evolving corporate transparency in Mainland China mean that the accuracy of these ratings cannot be taken for granted.

Figure 3: Breakdown of local government debt

RMB trillion	2012	June 2013	End-2014	2015 (forecast)
Direct liabilities	9.6	10.9	15.4	16.0 (official)
Contingent liabilities*	6.3	7.0	8.6	8.6 (assuming unchanged)
Total liabilities	15.9	17.9	24.0	24.6
Local government debt ratio	68%	65%	86%	86% (official)

*Contingent liabilities include liablilities guaranteed by local governments and debts that may receive government relief.
Source: National Audit office, Chinese government, Standard Chartered Research. August 2015.

Although LGFV issuance in the offshore market is a relatively new phenomenon and the level of debt issued remains limited, investors should be aware of the trend and should undertake rigorous due diligence when investing in related bonds.

Key benefits of local government financing reform

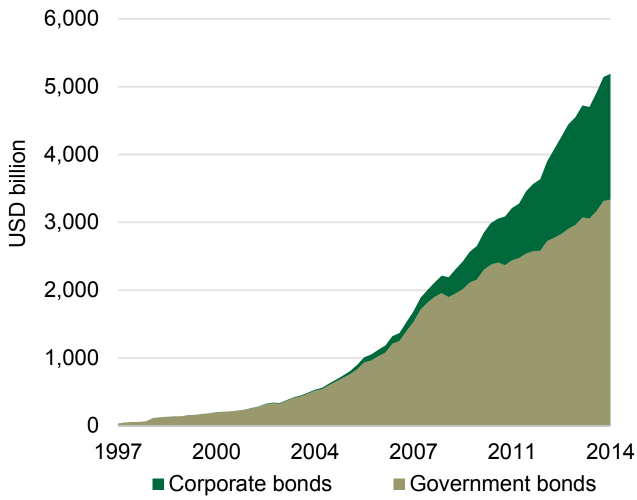
We see the potential for numerous benefits to emerge from the formation of a transparent and well-regulated municipal bond market in China. In particular, we expect the process to:

Drive further growth in China's bond market – At the simplest level, shifting local government debt from LGFVs will drive further growth in China's onshore bond market, which is already Asia's largest (ex-Japan). In 2015 alone the debt swaps and newly issued municipal bonds will add roughly RMB3.8 trillion in government debt to the aggregate onshore bond market. This will give Chinese investors access to a new supply of debt and should help develop the long end of China's yield curve in particular, as local governments move to match their debt maturity profiles with project timelines.

Clarify level of systemic risk and reduce moral hazard – By removing a large chunk of liquidity from China's shadow banking sector by channelling local government borrowing into the bond market, local government financing reform should help increase transparency in China's financial system. In particular, the ongoing local government debt audit should separate the wheat from the chaff, clarifying the amount of debt local governments are responsible for and illuminating the level of systemic risk it poses. Clarifying the amount of debt that local governments are responsible for should also have the knock-on effect of ameliorating moral hazard, as the idea of implicit government guarantees for bonds would diminish.

Increase credit quality and pricing differentiation – Clarifying what portion of LGFV debt is backed by explicit government budget allocations or guarantees should somewhat lessen moral hazard in China's debt market while simultaneously increasing the potential for defaults on debt without such explicit support. At present moral hazard continues to hamper the emergence of China's bond market as a viable international asset class as it fosters a significant mismatch between credit risk and investment returns. Clarification of what LGFV debt carries explicit government guarantees should engender a more realistic appreciation of risk among investors and begin the lengthy process of aligning bond market risk and returns.

Figure 4 : China's aggregate bond market growth trend



Source: Asian Development Bank, 31 December 2014.

Pave the way for orderly credit defaults – Clarifying the level of systemic risk associated with bonds and increasing credit quality and pricing differentiation is likely to increase the incidence of defaults. While this may sound like a negative, it is actually positive as it would signal the real level of risk associated with investing in lower-quality debt while also showing that defaults can occur without the market freezing up or the wider economy being affected. That being said, the central government is still likely to step in and bail out issuers that are systemically important in order to prevent contagion to the wider financial system.

All of these factors should make the Chinese bond market an increasingly attractive investment option. For local individual and institutional investors who are slowly learning to appreciate the true relationship between risk and reward, it will provide more transparent investment opportunities across a wide array of investment horizons. Meanwhile, it should continue to align China's bond market with global bond markets in terms of the offerings available and the legal framework that underpins it. As China's capital account opens we expect this to increase the flow of international capital into Chinese debt.

Pricing risk in the municipal bond market

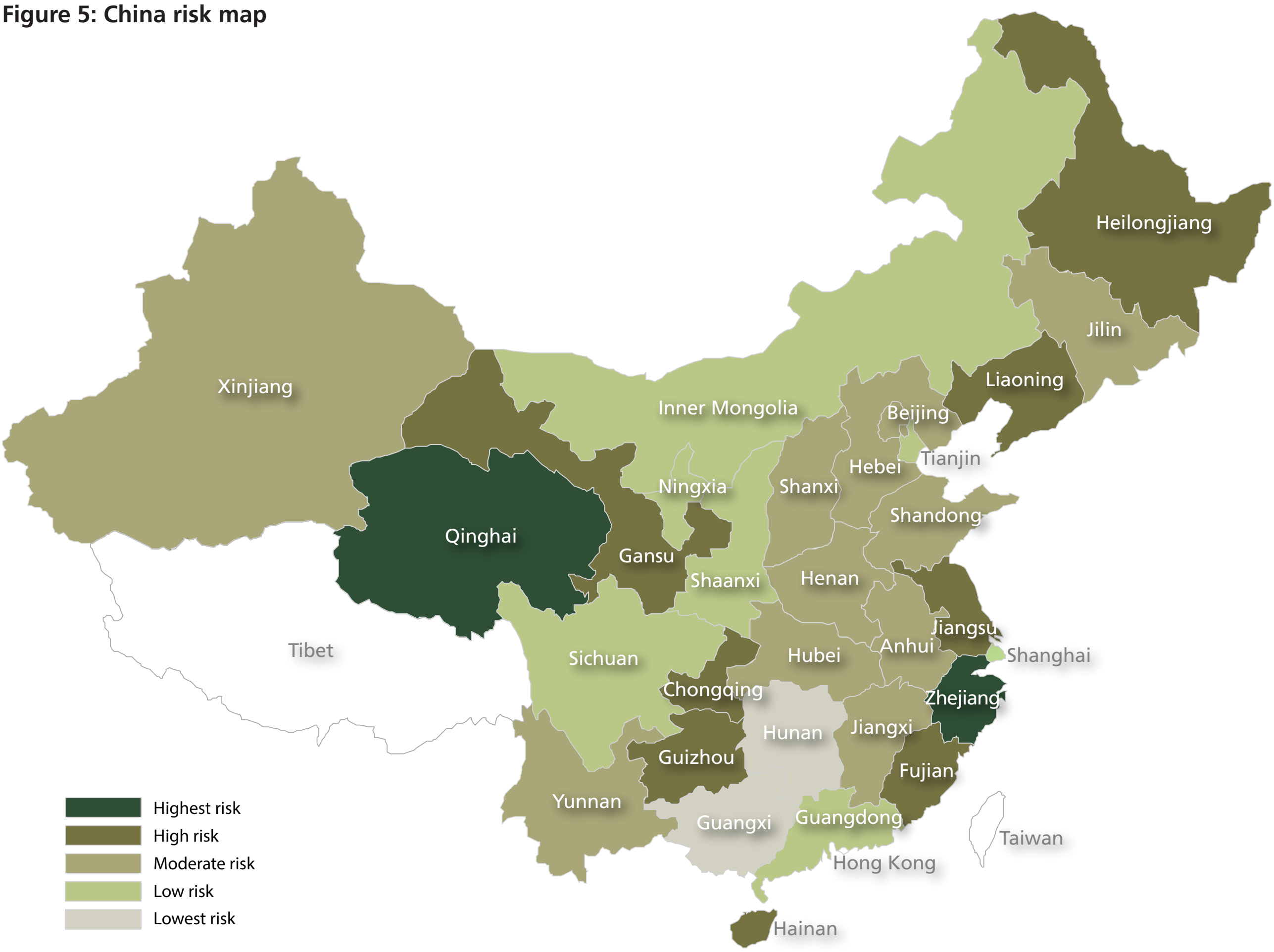
While the transfer of local government debt from LGFVs to China's rapidly evolving bond market is positive, it does leave unanswered questions. Perhaps key among these is how to price risk in the emerging municipal bond market.

To date, direct municipal bond issues have offered yields at or near Chinese Treasury Bond (CTB) yields. In April-May 2015, for example, Jiangsu Province issued three-, five-, seven- and 10-year bonds at a two-basis-point premium to similar-maturity CTBs and the Xinjiang autonomous region auctioned bonds with the same tenors at equivalent maturities to CTBs[6].

This is problematic as municipal bond issues at these rates – under the swap program and as municipal bonds – have not been received enthusiastically by investors. Indeed, the central government has had to sweeten the pot to incentivise local banks to purchase the bonds. This has included establishing a municipal bond yield floor at the rate for equivalent maturity CTBs, setting a yield cap at a 30% premium to the equivalent CTB and allowing banks to use municipal bonds as collateral for repo funding from the People's Bank of China (PBoC).

So what is the appropriate yield for municipal bonds issued by China's highly indebted local governments? Are bonds issued by Jiangsu Province, which Nomura evaluates as a "high risk" province based on its current financial health (see Figure 5), really as safe as CTBs with similar maturities?

Figure 5: China risk map



Note: Tibet was not included due to its special fiscal relationship with the central government.
Source: Bloomberg, Nomura Global Economics. June 2015.

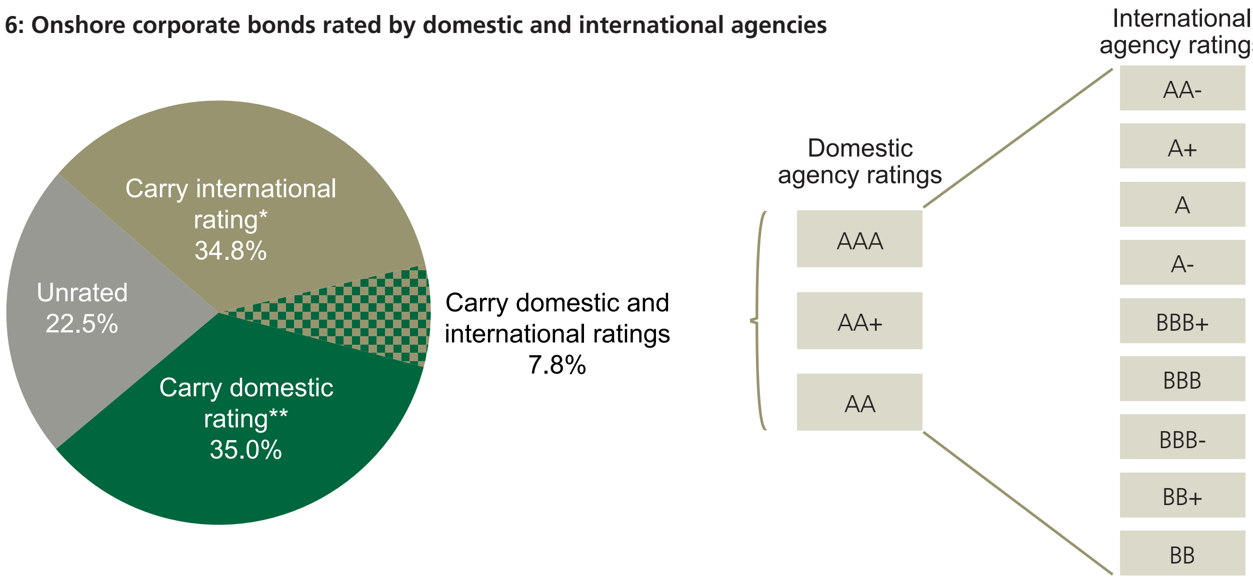
6. Bloomberg, *China Yield Curve Steepest in 13 Months as Muni Debt Saps Demand*, 25 May 2015.

There are two key ways to evaluate the risk inherent in the RMB3.8 trillion worth of municipal bond issuances that are forecast to come to market during 2015:

1. **Third-party credit ratings** – The most common means of evaluating creditworthiness in the bond market is credit ratings assigned by independent, third-party credit rating agencies. Unfortunately, these ratings can be less than enlightening in the context of China's on-shore credit market and, by extension, its emerging municipal bond market. This is because about 97% of all ratings issued by domestic credit rating agencies in China are between AA and AAA[7], suggesting that the actual range of credit worthiness within this span is significant and that the level of guidance investors can get from them is limited.

   As Figure 6 – previously published in Manulife Asset Management's June 2015 report *Chinese bonds: Laying a foundation for long-term growth* – illustrates, 8.4% of onshore Chinese bonds carry ratings from at least one of the three major international rating companies and a domestic Chinese rating company. Whereas the international ratings assigned to these bonds range from BB to AA (ie, covering nine rating grades) the ratings assigned by domestic agencies range from AA to AAA (ie, covering three rating grades). While both provide relative rankings of credit risk, the wider range of international ratings provides a level of credit quality differentiation that is not available for the 56% of onshore Chinese bonds that are not rated by any of the international agencies.

Figure 6: Onshore corporate bonds rated by domestic and international agencies



Note: * Fitch, Moody's, S&P; ** China Chengxin (Asia Pacific) Credit Rating Co. Ltd., China Lianhe Credit Rating Co. Ltd., Dagong Global Credit Rating Co. Ltd., China Credit Rating Co.
Source: Manulife Asset Management based on data from the Bank of America Merrill Lynch China Broad Index and international * and domestic ** rating agencies. April 2015.

2. **Independent, bottom up analysis** – With local ratings in China apparently providing a relatively low level of credit differentiation, the most effective alternative is independent, bottom-up analysis of debt issuers. This has historically been difficult in China due to the generally low level of transparency among government and corporate issuers, many of which have some exposure to the shadow banking sector.

   However, the current move to shift outstanding local government debt – including LGFV debt – to the bond market represents a potentially significant step toward boosting transparency. Both the debt swaps and direct municipal bond issuances will pull a large portion of local government debt out of the shadows and subject them to listing requirements that necessitate higher levels of disclosure and are subject to covenants, giving investors a higher degree of insight to the true financial position of the issuing entity.

   As local government bond issuance picks up and related financial data becomes more available, we believe that the best approach to evaluating the risk/reward associated with new issuance will ultimately be a hybrid of the two. Investors should always be aware of local credit rating agency ratings, but should never invest without first conducting independent, bottom-up analysis to confirm or enhance their evaluation.

7. http://www.wsj.com/articles/can-all-chinese-debt-be-rated-a-1437942674.

Key risks of local government financing reform

1 Policy risk

China's highly centralised governance structure is a double-edged sword as policy decisions can be made and reversed at the stroke of a pen. Indeed, with China's economic slowdown worsening in the first and second quarters of 2015, the government has already revised its LGFV reform measures, directing banks to continue issuing loans to select LGFVs[8]. While the near-term economic rationale for this move is clear, it does raise questions as to what further changes could come.

2 Liquidity risk

Liquidity is king in bond markets, with investors needing to know that there will be buyers in the market when they exit their positions. Chinese banks initially baulked at purchasing municipal bonds because they were issued at what many consider artificially low interest rates. As the level of transparency in China's debt markets increases, we expect the bond market to mature and yields to increasingly come in line with their true levels of credit risk. That being said, the issue remains a concern in the near term and meaningful changes are only likely in the longer term.

4 Pricing risk

That being said, the emergence of an investment culture that better matches risk with reward could entail a widening of spreads on some bonds, with municipal bonds being a prime candidate as many believe that those issued to date pay artificially low yields. This represents the potential for near-term capital losses for holders of outstanding municipal debt.

3 Default risk

Default risk in China's formal bond and shadow banking markets has been in the spotlight for some time. While there have been no actual LGFV defaults to date, we believe that current reform measures pave the way for the first default. When local government debt was all tied up in a knot of opaque LGFVs there was a high incentive for the central government to bail them out as it was often not clear how toxic the actual assets were and who would be left holding the bag.

Once the results of the 2014 audit are announced, however, we see a high chance that the central government will allow LGFV enterprise bonds or loans that are not explicitly guaranteed to default. As a result of the higher potential for default, we see a need for yields on some of this debt to increase and for selective credit ratings to fall. Again, we see positive implications as this adjustment would help foster an investment culture that better matches risk with reward.

8. Bloomberg, *China Backpedals on Fiscal Reform*, 29 May 2015.

The bigger picture: LGFV reform and China's financial system

Like so much in China today, we believe that local government financing reform is a short-term negative but a long-term positive. As explained in our March 2015 report, *A fine balance: Investing in China A-shares amid reform and stimulus* – the Chinese government is attempting to achieve an appropriate balance between reforms that lay the foundation for future economic growth and stability and stimulus to offset the short-term pain that often accompanies these reforms.

The 15 May directive that banks should continue extending loans to certain existing LGFVs is an excellent example of this balancing act as the government realises that cutting funding channels to ongoing projects before a stable municipal bond market emerges to displace it could have serious implications for the wider economy. Therefore, we consider this short-term reprieve of LGFVs to be in the interest of economic stability rather than a reversion to "business as usual" in terms of local government debt.

Similarly, we expect a degree of volatility in China's onshore bond market as the 2014 audit results are announced, the debt swap program expanded and an increasing number of fresh municipal bonds come to market. As mentioned above, there is a higher likelihood of bond or loan defaults among the LGFVs that are excluded from government guarantees. We believe that the central government will react to these in proportion to their likelihood to throw off the fine balance of reforms and stimulus – relatively small defaults that could cause ripples in the market are likely to be allowed, while the government would step in and bail out borrowers in the case of a potentially systemically disruptive default.

This is where "the rubber meets the road", with current reforms potentially setting in motion a chain of virtuous events:

1. A stable, transparent municipal bond market is formed via debt swaps and new issuance to clarify debt sources, interest rates, payment responsibility and guarantees, if any;
2. Enhanced transparency helps price government debt at yields which reflect their default risk;
3. Defaults occur, teaching market participants that they cannot count on implicit government guarantees;
4. Defaults are dealt with in an orderly manner, ensuring investors that entire markets will not be moved by a run-of-the-mill default;
5. Investors come to expect this level of transparency and stability in capital markets and these conditions spread to the corporate bond market.

This chain of events must play out repeatedly if retail and institutional investors in China are to abandon the shadow banking market in favour of the formal bond market.

LGFV reform and opening China's capital markets

Perhaps the most significant result of this virtuous chain would be the potential for increased participation of foreign investors in China's onshore bond market. While access to onshore bonds is currently limited to professional investors who hold Qualified Foreign Institutional Investor (QFII) quotas, China's capital market is opening to the world. For example, the 1 July 2015 launch of a mutual fund mutual recognition scheme between Mainland China and Hong Kong is just the latest in a string of opening measures.

However, this ongoing opening process will only yield fruit – in the form of increased capital flow to help further finance economic development in China – if international investors trust that the market is transparent and well regulated. This means pulling all capital market transactions, be they government or corporate, out of the shadows and convincing international investors that risk is disclosed and adequately compensated for and that defaults, when they occur, will be dealt with in an orderly fashion.

Conclusion

China’s central government is well aware of the risks associated with the high level of local government debt in the nation and that increasing transparency is the key to addressing the issue. We have already seen action to address the issue by implementing an audit program to clearly establish payment responsibility for LGFV debt, initiating a debt swap program to shift maturing LGFV debt to the municipal bond market and allowing local governments to issue bonds under their own names for the first time.

All three of these developments have one thing in common: they take a potentially significant amount of liquidity out of China’s shadow banking system and shift it to a regulated bond market where it is subject to disclosure requirements to increase financing transparency, strengthen bond covenants and help establish a standard default procedure.

It will take some time for existing local government debt to emerge from the shadows, especially as some LGFVs have already been given a temporary lease on life. However, over the long term we believe these actions will relegate LGFVs to a smaller part of the market, in the process ameliorating moral hazard in the local government funding space.

These changes are welcome and signal the increasing maturity of China’s onshore bond market. That being said, we are most interested in how they contribute to better aligning risk and reward in the market – and in China’s capital markets in general. As we have said before, we see a time when virtually all well-diversified global investment portfolios will contain Chinese bonds. However, this will not happen until bond yields accurately reflect associated investment risk.

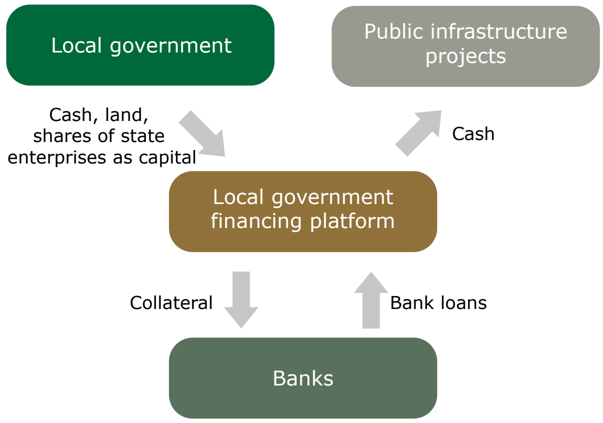
Appendix: An introduction to LGFVs

LGFVs first emerged in China in 1994, when changes to the revenue sharing model between the central and local levels of government shifted a higher percentage of funding to the central government. Local governments were granted the right to sell land in compensation for a portion of the lost funding but, lucrative though this was, it was insufficient to support the level of infrastructure investment necessary to support China's rapid industrialisation over the ensuing two decades.

With few other funding sources at their disposal, local governments had to be creative to source financing. Separate laws prohibiting direct fund raising by local governments eliminated most traditional funding channels, leading to the birth of LGFVs.

Under a typical LGFV structure, a local government will inject assets – usually land or cash – to capitalise a legal entity that will subsequently raise funds via bank loans, the onshore bond market or high-interest trust products that are sold in the loosely regulated shadow banking market (see Figure 7).

Figure 7: Typical LGFV structure



Note: In addition to bank loans, funds are also often raised via the on-shore bond market or the shadow banking market.
Source: IMF

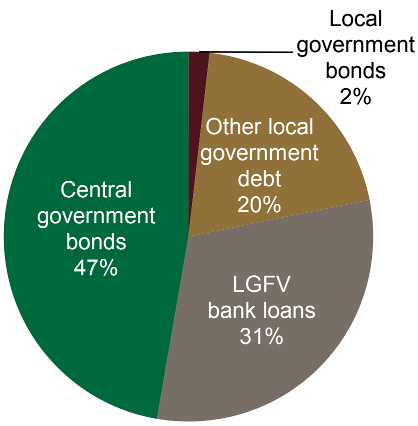
The capital needs of local governments soared in the years following the global financial crisis, as local governments were called on to provide economic stimulus via increased infrastructure spending. Against this backdrop, the number of active LGFVs quickly climbed to reach the current roughly 8,700[9] and the portion of total government debt arising from LGFVs grew rapidly to its current outsize level (see Figure 8).

A necessary evil – LGFVs fill a funding gap

As alluded to above, LGFVs have played an important role in China's industrialisation and development over the past 20 years as local governments had few other fund raising options. It is equally important to keep in mind that the opaque nature of LGFVs is by no means unique to China.

Developments in the shadow banking sector can in some ways be considered a preview of what is occurring with LGFVs. As shadow banking sector growth peaked in 2013, a string of near defaults highlighted the lack of regulation in the sector, raising fear of systemic contagion and prompting the central government to step up oversight. Since then, a string of reforms have begun to introduce a higher level of transparency and increase appreciation of the real risk associated with assets in the sector.

Figure 8: China's government debt by funding source



Note: As of 2Q14
Source: Manulife Asset Management, People's Bank of China; National Audit Office; IMF; McKinsey Global Institute analysis via Bloomberg. *China's Very High Mountain of Debt*. 8 May 2015.

In fact, the campaign to clean up LGFVs can actually be considered a further step in the process of cleaning up the shadow banking market as investment trusts that raise funds in the shadow banking sector were estimated to account for about 8% of LGFV debt as of 2013[9]. While a select number of LGFVs have been given a lease on life in 2015, we remain confident that they will ultimately be eliminated as a source of local government funding.

9. HSBC, *China's local government debt: The move towards transparency*, March 2015.

Manulife Asset Management in China: Analysis and execution

Manulife Asset Management was a pioneer in RMB bond investing, having entered the market at its genesis some 16 years ago. During this time we have become adept at uncovering investments which do not expose investors to more risk than is warranted by the level of return on offer.

Our on-the-ground investment management capability enables us to do this. We have six fixed income specialists working on the ground in China via two Manulife joint ventures – Manulife TEDA Fund Management Co[10] in Beijing and Manulife-Sinochem Life Insurance Co Ltd[11] in Shanghai – and 25 in total dedicated to the Greater China.

This includes ten China-focused credit analysts covering more than 175 corporate bond issuers in China. They visit most of these companies at least once per year to evaluate management effectiveness and undertake rigorous bottom-up, fundamental analysis to assign proprietary, in-house credit ratings. This extensive research is essential as more than 60 of these companies do not carry international credit ratings. This gives our portfolio managers a degree of insight which we believe translates into a market advantage – particularly as many international fund houses have little or no on-the-ground credit research representation in China.

What differentiates our in-house ratings from those of the domestic and international ratings agencies is the fact that we put our analysis and ratings into action – our credit analysts sit with our portfolio managers and traders and we make daily market decisions based on their independent credit ratings. This allows us to move very quickly to help capitalise on opportunities as they arise in the complex Chinese bond market – and underpins our ability to seek opportunities to maximise alpha generation.

We currently manage US$3.8 billion in China fixed income assets, US$324 million of which is invested in the CNH – offshore or "dim sum" – bond market and the remainder under our QFII license and via our Mainland China joint ventures[12].

10. Manulife TEDA Fund Management Co. Ltd. is a joint venture between Manulife Financial and Northern International Trust, part of Tianjin TEDA Investment Holding Company Co. Ltd. (TEDA).
11. Manulife-Sinochem is a joint venture between Manulife (International) Ltd and Sinochem Finance Co., Ltd (a member of the Sinochem Group).
12. Manulife Asset Management, 30 June 2015.

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