China Banking Flash

Domestic banks allowed to buy time by rolling over local government loans

The Financial Times and other media outlets reported yesterday that the Chinese authorities plan to "instruct" banks to roll over their credits to local governments. If confirmed, such a move would both ease the debt burden on local governments and prevent a possible wave of defaults on bank balance sheets as these loans come due over the next 1-3 years (banks have been forbidden from rolling over or extending new loans to local governments). The policy would not be a complete surprise, as the CBRC hinted last October that a move of this kind was under consideration. For details on the origin and magnitude of the local government debt burden, please see our note from last July, *Who will pay the bill for local governments' fiscal stimulus*?

The FT report indicates **that banks may extend the maturity of their loans by up to four years**. We estimate that outstanding local government debt amounts to RMB 14.7 trillion, of which one-fifth may come due this year (based on figures reported by the National Accounting Office), and the remainder through 2014.

Allowing for such rollovers would enable Chinese banks to buy time, although it may not solve the problem over the medium term. To address this problem, according to the FT, guidelines have reportedly been issued, "instructing banks to review maturing loans to see which are supporting viable investments and can thus have their maturities safely extended."

News of the policy is the latest in a series of recent initiatives by the authorities to shift to a **more growth supportive policy stance**, including through **regulatory forbearance**. For example, at the beginning of this year the CBRC indicated it would delay implementation of more stringent capital regulations which were to be phased in by the end of 2013 (the original schedule was already well ahead of the Basle III timetable). In this regard, there were news reports yesterday that the CBRC is considering exempting banks, other than the top 5, from a 2.5% provisioning requirement on total loans that was to go into effect this year (reported yesterday in the *First Financial Daily*, a leading Chinese financial newspaper). According to the news report, the authorities worry that the provisioning requirement might have a perverse incentive for banks to retain impaired loans on their books, instead of writing them off in a timely manner (since the provisions on impaired loans would count toward the overall 2.5% requirement).

Assessment

The rollover plan described above, if implemented, would buy time for banks and local governments to address the obligations coming due. In doing so, it would help to alleviate a mismatch between the maturity structure of local government liabilities and the future cash flows generated by ongoing infrastructure projects financed by the loans. Depending on the terms of the rollovers, it is possible that the plan could result in a reduction in the net present value of banks' loans portfolios, amounting to an effective write-off. However, it may also be that the size of the problem grows due to an increase in moral hazard among Chinese banks.

In the final analysis, the rollover policy, even if beneficial to some degree, would be **only a temporary and partial solution**. A more permanent solution would still need to be found, which we believe would most likely consist of **a combination of bank write-offs (whose cost banks and their shareholders would need to bear) and central government bailouts.**

Criticism of the plan could be levelled that it would jeopardize the long-term health of the banking system by encouraging a rollover of problem loans. However, based on previous experience with regulatory forbearance in China, we would expect the policy to be implemented on a case-by-case basis, in which only loans supportive of viable projects would be rolled over. Moreover, the CBRC, through its regional branches, would safeguard the process by monitoring the negotiations between banks and the local government borrowers on the terms of the rollovers (including the maturity, collateral, and interest rates).

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