

CHINA BANKS

10 questions on the LGFV debt swap programme

Latest progress of debt swap programme

There is a lot of investor interest in the debt swap programme – we answer 10 key questions using our analysis plus comments from the banks. So far, local governments from 21 provinces have issued cRMB654b of bonds, around 35% of LGFV debt due to mature by end-FY15. Issuance parties now must be provincial governments, meaning higher credit ratings (AAA) and bonds typically priced on a par with treasuries of the same maturity. Major buyers have been commercial/policy banks, insurance companies and the National Council for Social Security Funding (NSSF). Of the banks, the big five banks and Industrial Bank have been more active. Banks are using released loan quota for retail loans (eg, mortgages), infrastructure projects and policy-favoured sectors (eg environmental-friendly ones).

Profitability analysis for debt swap programme and implication on banks

We calculate a much higher ROE for local government bonds (81.7%) than LGFV loans (21.6%) given a more favourable risk weighting for local government bonds (20%) than LGFV loans (100-300% based on cash coverage). If we assume: 1) 60% of local government debt is swapped via private placement and the rest via public offering, and 2) local governments first repay LGFV trusts then LGFV loans (given their higher funding costs), we estimate just a 0.29% boost to China banks' earnings (without considering asset quality improvement on LGFV loans). However, the impact on valuation could be much greater: we estimate P/B multiples could re-rate as much as 7.4% if asset quality concerns on LGFV loans are allayed.

Key concerns on debt swap programme

We note two main concerns: 1) weak demand may mean banks are less keen to participate in the programme; and 2) the programme simply delays the debt problem without solving cash flow problems on local government projects. Our view is that the programme is supplementary to on-going fiscal and tax reform which constrains the financing capability of local governments and rebalances the income/expenditure dynamic between central and local governments. The central government needs to ensure local governments don't default on bonds in this transitional period by lowering their interest burdens and improve the sustainability of their debt. We expect more incentives for banks to participate such as: 1) lower Pledged Supplementary Lending (PSL) costs; 2) banks being able to use local government bonds/loans from policy-favoured sectors to pledge at central banks for cheaper funding via PSLs; 3) banks having more freedom to price risky loans; 4) fiscal deposits and infrastructure projects of local governments being linked to how much debt has been swapped into bonds; and 5) monetary easing measures to fund bond subscriptions.

Who are the major beneficiaries?

We expect most bond subscriptions via public offerings to be funded by RRR cuts and/or PSLs. We assume local governments first replace LGFV loans, which are typically from smaller banks which should thus benefit first. Among our coverage, CRCB, Minsheng and Citic have the most exposure to LGFV loans. We reshuffle our top picks to Citic, Minsheng and BOC given these banks should benefit more from LDR relaxation and easing asset quality concerns on local government debt.



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Key questions on local government debt swap programme

We recently met clients in Asia and Europe, and were asked many questions about the debt swap programme. In this report, we discuss the key questions (10 of them) and provide feedback based on our analysis and comments from the banks.

1. What is the current progress of the debt swap programme?

As at 23 June 2015, the total local government bond issuance quota, as announced by the MOF, stood at RMB2.6t comprising: RMB2t for the debt swap programme (RMB1t for both the first and second batches), RMB500b for new general local government debt and RMB100b for new special local government debt. The quota can only be used to swap local government direct debt maturing by end-2015. We expect the government to launch a third batch of the debt swap programme this year to help refinance Local Government Financing Vehicle (LGFV) debt maturing by end-2015. Going forward, MOF intends to grant debt swap quota for local governments based on how much of their debt matures each year. According to the latest Audit report in 1H13, there is Rmb1.9t local government direct debts to be matured by the end of FY15 (For detail, please refer to appendix).

In addition, we expect local governments to incur additional direct debt of RMB7.3t between 1H13 and FY14. We estimate the figure by assuming all bonds that matured between 2H13 and FY14 were rolled over via new bond issuance and that new local government direct debt grew at the same pace (22%) as TSF during the same period. We assume 10% (RMB0.7t) of the new local government direct debt matures by FY15. As such, we estimate RMB2.6t of local government direct debt will mature by end-FY15 in total, and will need swapping into local government bonds.

The quota has been distributed to provincial governments based on the market share of direct debt due in 2015 for each province as of 1H13. According to the latest statistics, 21 provincial and municipal governments have issued in aggregate RMB654b of local government bonds, or 25% of the total issuance quota up till now.

Exhibit 1: Local government debt statistics as of 1H13

	---- Total local debts as at 1H13 ----			----- Debt due in 2015 -----			--- Debt due in 2015 as % of total ---			Total debt (RMB b)	GDP FY14 (RMB b)	Total debt / GDP (%)
	Govt's direct debt	Govt guarantee	Contingent debt	Govt's direct debt	Govt guarantee	Contingent debt	Govt's direct debt	Govt guarantee	Contingent debt			
	(RMB b)	(RMB b)	(RMB b)	(RMB b)	(RMB b)	(RMB b)	(%)	(%)	(%)			
Jiangsu	764	98	616	150	17	109	19.7	17.8	17.7	1,477	6,509	22.7
Hubei	515	78	175	111	6	13	21.6	8.3	7.2	768	2,737	28.1
Sichuan	653	165	105	109	21	17	16.7	12.7	16.6	923	2,854	32.3
Guangdong	693	102	221	104	9	58	15.0	8.8	26.1	1,017	1,966	51.7
Zhejiang	509	33	151	97	5	24	19.0	14.2	15.8	693	4,015	17.3
Beijing	651	15	90	93	1	7	14.3	9.8	8.0	755	2,133	35.4
Shanghai	519	53	273	91	8	27	17.6	14.8	9.8	846	2,356	35.9
Guizhou	462	97	73	89	5	13	19.3	4.9	17.3	632	925	68.3
Shandong	450	122	139	78	20	26	17.4	16.1	18.6	711	5,943	12.0
Liaoning	566	126	67	76	14	8	13.5	11.3	11.6	759	2,863	26.5
Henan	353	27	174	64	3	18	18.0	11.6	10.4	554	949	58.4
Yunnan	382	44	169	62	3	34	16.2	7.0	20.2	595	1,281	46.5
Chongqing	358	230	149	62	41	22	17.2	17.9	14.6	736	1,427	51.6
Hebei	396	95	260	61	10	27	15.3	11.1	10.5	751	2,942	25.5
Anhui	308	60	162	60	9	28	19.4	15.1	17.1	530	2,085	25.4
Hunan	348	73	353	57	11	40	16.3	15.6	11.5	774	2,705	28.6
Fujian	245	24	168	51	5	13	20.7	21.4	7.8	438	2,406	18.2
Inner Mongolia	339	87	28	45	6	3	13.3	7.3	11.5	454	1,777	25.6
Jiangxi	243	83	67	45	11	7	18.3	13.3	9.7	393	1,571	25.0
Shaanxi	273	95	241	44	8	21	16.0	8.3	8.7	609	1,769	34.4
Jilin	258	97	69	43	8	6	16.7	7.9	8.6	425	1,380	30.8
Guangxi	207	123	103	43	13	14	20.6	10.9	13.4	433	1,567	27.6
Tianjin	226	148	109	33	17	11	14.8	11.7	10.0	483	1,572	30.7
Heilongjiang	204	105	50	28	7	7	13.6	6.6	14.7	359	1,504	23.9
Xinjiang	164	81	30	25	7	6	15.4	8.5	19.6	275	926	29.6
Gansu	122	42	132	24	3	13	20.0	6.5	9.9	296	684	43.3
Shanxi	152	233	32	23	37	6	14.8	15.9	19.8	418	1,276	32.7
Hainan	105	23	14	15	2	1	14.2	7.5	3.9	141	350	40.3
Qinghai	74	16	15	14	1	3	18.3	5.4	18.1	106	230	46.0
Ningxia	50	18	11	7	1	1	14.1	6.1	6.5	79	275	28.7
Others	295	71	94	55	9	19	18.7	12.6	20.0	460	2,669	17.2
Total	10,886	2,666	4,339	1,858	320	599	17.1	12.0	13.8	17,891	63,646	28.1

Sources: WIND; BNP Paribas estimates

Exhibit 2: Progress of debt swap programme

	Local govt's direct debt due in 2015	Quota in the RMB1t swap	Quota in the RMB2t swap	Quota in the RMB600b new bond*	% of total	--- First batch issued ---		- Second batch issued -		Total	Bonds issued / total debts due	Bonds issued / total local govt bond quota
	(RMB b)	(RMB b)	(RMB b)	(RMB b)	(%)	Swap bond	New bond	Swap bond	New bond	(RMB b)	(%)	(%)
Jiangsu	150	81	162	49	8.1	30.8	21.4			52.2	34.7	24.8
Hubei	111	60	120	36	6.0	20.0		20.0	16.4	56.4	50.6	36.2
Sichuan	109	59	117	35	5.9	45.0				45.0	41.3	29.5
Guangdong	104	56	112	33	5.6	13.3	17.7			31.0	29.9	21.4
Zhejiang	97	52	104	31	5.2	40.0				40.0	41.3	29.5
Beijing	93	50	101	30	5.0					-	-	-
Shanghai	91	49	98	30	4.9					-	-	-
Guizhou	89	48	96	29	4.8	28.7	4.9			33.6	37.8	27.0
Shandong	78	42	84	25	4.2	20.5	15.5	35.7		71.7	91.5	65.4
Liaoning	76	41	82	25	4.1	29.0	7.4			36.4	47.8	34.1
Henan	64	34	68	21	3.4	27.4	15			42.4	66.6	47.6
Yunnan	62	33	67	20	3.3	28.6				28.6	46.1	32.9
Chongqing	62	33	66	20	3.3	26.5				26.5	43.0	30.8
Hebei	61	33	65	20	3.3	47.0				47.0	77.5	55.4
Anhui	60	32	64	19	3.2	19.2	12			31.2	52.1	37.3
Hunan	57	31	61	18	3.1					-	-	-
Fujian	51	27	55	16	2.7					-	-	-
Inner Mongolia	45	24	48	15	2.4					-	-	-
Jiangxi	45	24	48	14	2.4					-	-	-
Shaanxi	44	24	47	14	2.4	6.7	11			17.7	40.4	28.9
Jilin	43	23	46	14	2.3	11.9	11			22.9	53.2	38.0
Guangxi	43	23	46	14	2.3	20.0				20.0	47.0	33.6
Tianjin	33	18	36	11	1.8	6.8	6.4			13.2	39.5	28.2
Heilongjiang	28	15	30	9	1.5					-	-	-
Xinjiang	25	14	27	8	1.4	5.9				5.9	23.4	16.7
Gansu	24	13	26	8	1.3					-	-	-
Shanxi	23	12	24	7	1.2	5.8	10.9			16.7	74.1	52.9
Hainan	15	8	16	5	0.8	8.1				8.1	54.4	38.9
Qinghai	14	7	15	4	0.7					-	-	-
Ningxia	7	4	8	2	0.4	2.0	5			7.0	99.1	70.8
Others	55	30	59	18	3.0					-	-	-
Total	1,858	1,000	2,000	600	100.0	443	138	56	16	654	35.2	25.1

Note: * estimated by the local govt debt due as % of the whole country as at 1H13.

Sources: WIND; NAO; BNP Paribas estimates

Duration of new local government bonds

The typical duration of new local government bonds is 3yr, 5yr, 7yr and 10yr, and the distribution of local government bond duration for most provinces is 10%, 30%, 30% and 30% respectively. This implies that most repayment responsibility falls on the next local government.

Yield of new local government bonds

The yield of local government bonds usually depends on four factors: 1) treasury bond yields; 2) credit risk premiums; 3) liquidity premiums and 4) capital consumption allowances. We believe a reasonable yield of local government bonds is 60-70bp above that of treasury bonds reflecting:

1. A 0-10bp credit risk premium: In the past, all local government bonds issued were rated AAA, the same as treasury bond credit. However, China started allowing

local governments to issue bonds rated AAA- (prior AAA) this year. Thus, credit risk premiums will gradually be reflected in the yield based on different local government bond credit ratings. We note the government is already giving different risk weightings between central and local governments, and we expect a credit risk premium of 0-10bp on local government bonds in the future.

2. A 30bp liquidity premium: In the past, the credit rating of local government bonds has been almost equal to that of treasury bonds. Thus any yield difference can be deemed a liquidity premium. According to our statistics, the yield difference between local government and treasury bonds in 2014 was c30bp.
3. A 30bp capital consumption allowance: assuming a China banks average ROE of 15.9%, tier-1 CAR of 9.5% and risk weighing of 20%, we estimate a capital consumption allowance of around 30bp ($15.9\% \times 9.5\% \times 20\%$).

According to the regulations, the minimum interest rate of a special local government bond should be no less than the average treasury bond yield with the same maturity in the past five working days prior to bond issuance, and it can't be at more than a 30% premium to treasury bond yields with the same maturity. In practice, the demand and supply dynamics seem quite favourable for new issued local government bonds, such that most have been priced equivalent to the treasury bond yield with the same maturity.

Issuance party and credit rating

The issuance party of the new local government bonds must be the provincial government. If the borrower is a prefecture-level government or below, the provincial government must issue the bonds on its behalf. We believe this could effectively lower the funding cost of local governments given the good credit and sound fiscal strength of provincial government compared to city level and county level.

Government bond types and issuance methods

The new bonds are classified as general local government bonds or special local government bonds. The general local government bonds are similar to municipal bonds in developed countries. That is, they are usually issued for the purpose of financing the infrastructure needs of the issuing municipality. Principal and interest are secured by the full faith and credit of the issuer and usually supported by either the issuer's unlimited or limited taxing power. The specific local government bonds, on the other hand, are more like self-supporting revenue bonds, in that the principal and interest are secured by revenues derived from tolls, charges or rents from the facility built with the proceeds of the bond issue. Urban construction bonds are issued by urban development companies and usually secured by implicit guarantees of the local government. However, we expect urban construction investment bonds to soon fade away given their high credit risk and funding cost.

Exhibit 3: Comparison between general local govt bond, special local govt bond and urban construction investment bond

	General local govt bond	Special local govt bond	Urban construction investment bond
Projects	Public projects without any income	Public projects with income	Backed by corresponding projects by LGFV
Repayment source	General public fiscal budgetary revenue	Corresponding government-managed funds or special projects income	Implicit guarantees by the local government
Issuance and repayment	Local government	Local government	LGFV
Risk weighting (%)	20	20	100
Nature	Quasi interest rate bond	Quasi interest rate bond	Credit bond
Tax	Interest income tax exemption	Interest income tax exemption	no exemption

Source: BNP Paribas estimates

According to the regulator, the debt swap programme may adopt a combination of private placement and public offering schemes. Private placement schemes apply to local government debt with a clear purpose/ownership and no cash flow will be involved during the swap process. The allocation of amount is based on each bank's market share in the corresponding LGFV loans. Under the public offering scheme, however, all qualified investors (banks, brokers, insurers and personal investors) may purchase the local government debt via the interbank market and exchanges and the bidding is market-driven.

We expect 60% of the RMB2t quota will be implemented via private placement and the remaining 40% will be implemented via a more market oriented method. Actually, we have noted that c59% local government bonds of Jiangsu Province were issued via private placement.

2. How will the debt swap programme impact banks' profitability and valuation multiples?

We think the market under-estimates the potential profitability of local government bonds. They don't seem a bad deal for the banks based our profitability analysis.

Assuming a risk weighting of 120%, we estimate the release of RMB100m in LGFV loans can free up to RMB120m of RWA. According to our checks with Chinese banks, the new issued bonds will be tax free with a risk weighting of 20%. In other words, the RMB120m of RWA can be used to issue a maximum of RMB600m of LGFV bonds ($120m/20\% = RMB600m$). Other key assumptions include:

1. A bond yield of 3.58% (the 10-year LGFV bond issued by Jilin Province recently) and funding cost of 1.62% (return of required reserve) assuming the bond subscription will be financed by an RRR cut.
2. No fee income derived from the LGFV bond issuance business.
3. A credit cost of 0.016% (0.08% provision charge, amortized over five years).
4. A cost-income ratio of 20%

As such, we expect the RORWA and ROE of a 10-yr LGFV bond to be 7.8% and 81.7%, respectively.

We calculate the same ratio of LGFV loans in a similar way. Key assumptions include: 1) loan yield: 6.8%, or 20% above the benchmark rate for 5-yr loans; 2) risk weighting: 120% (actual risk weighting of LGFV loans ranges from 100-300%, depending on the cash flow coverage situation); 3) fee income: 25% of net interest income; 4) credit cost: 0.2%. According to our estimate, the RORWA and ROE of LGFV loans are 2% and 21.6%, respectively.

Exhibit 4: RORWA analysis of LGFV loans and LGFV bond

			LGFV loans	Local govt bonds
RWA	RMB m	f	120	120
LGFV loans/ local govt bonds	RMB m	$g=f/a$	100	600
Tier 1 CAR	%	h	9.5	9.5
Equity	RMB m	$i=f*h$	11.4	11.4
Loan/bond yield	%	j	6.8	3.6
Funding cost	%	k	2.5	1.6
Spread	%	$l=j-k$	4.3	2.0
Interest income	RMB m	$m=l*g$	4	12
Fee income	RMB m	$n=m*b$	1.07	-
Total revenue	RMB m	$o=n+m$	5	12
1-CIR	%	$p=1-c$	65	80
Credit cost (RMB mn)	RMB m	$q=d*g$	(0)	(0)
1-tax rate	%	$r=1-e$	75	100
NPAT	RMB m	$s=(o*p+q)*r$	2	9
ROA	%	$t=s/g$	2.5	1.6
RoRWA	%	$u=s/f$	2.0	7.8
ROE	%	$v=s/i$	21.6	81.7
Key assumptions				
Risk weighting	%	a	120	20
Fee income % of interest income	%	b	25	-
CIR	%	c	35	20
Credit cost	%	d	0.2	0.016
Tax rate	%	e	25	0

Source: BNP Paribas estimates

We conducted a scenario analysis to illustrate the potential impact of the debt swap programme on China banks. We assume LGFV loans maturing by end-2015 (stripping out LGFV trust/BT projects maturing by end-2015) are replaced with new bonds at a lower yield this year. We assume 60% of the RMB2t quota is implemented via private placement, which could drag down banks' FY15 earnings by 0.7% without taking into consideration any asset quality improvement.

For local government debt swapped via public offering, we expect local governments to: 1) repay higher-funding-cost LGFV trusts/BT projects first (RMB0.8t remaining debt swap quota + RMB600b for new local government bonds this year – RMB292b repayment for trust and BT), and 2) use the remaining bond proceeds to repay LGFV loans. We have conducted a scenario analysis for local government debt swaps via public offering based on:

- **Our worst case scenario:** If local governments use public offerings to swap local government debt, our worst case scenario is that banks have to replace local government debt with the new bonds using existing liabilities. In other words, part of the banks' balance sheets will effectively be frozen by taking bond investments with lower returns than LGFV loans. With the ROA of an LGFV bond of 1.6% and the opportunity cost of LGFV loans (or the ROA of LGFV loans) of 2.5%, we estimate the banks' FY15 earnings could fall 0.65% without taking into consideration any asset quality improvement.
- **Our best case scenario:** If local governments use public offerings to swap local government debts, our best case scenario is that the government provides cheap funding to banks by RRR cuts to subscribe to the new bonds, and the banks can

release loan quota to lend to more commercially-viable projects. With a bond loan yield of 3.58% (the yield of 10-yr local government bond issued by Jilin Province on 11 June) and an opportunity cost of 1.62% (return of required reserve), we estimate the banks' FY15 earnings could rise 1.41%.

We think our best scenario is highly likely and so assume an 80% possibility of the best case and 20% of the worst case. Thus, we estimate the debt swap programme and the RMB600b new local government bonds approved this year will improve the FY15 earnings for the whole system by 0.29% (without taking into consideration any asset quality improvement).

Exhibit 5: Earning impact of debt swap programme – FY15E

FY15E		----- Public offering^ -----		Private placement*	Weighted avg earning impact
		Best case (80% possibility)	Worst case (20% possibility)		
Return	%	3.6	1.6		
Opportunity cost	%	1.6	2.5	2.5	
Spread	%	1.96	(0.91)	(0.91)	
Swap amount via banks	RMB b	1,108	1,108	1,200	
Additional NPAT	RMB b	22	(10)	(11)	
FY15E earning impact	%	1.41	(0.65)	(0.70)	0.29

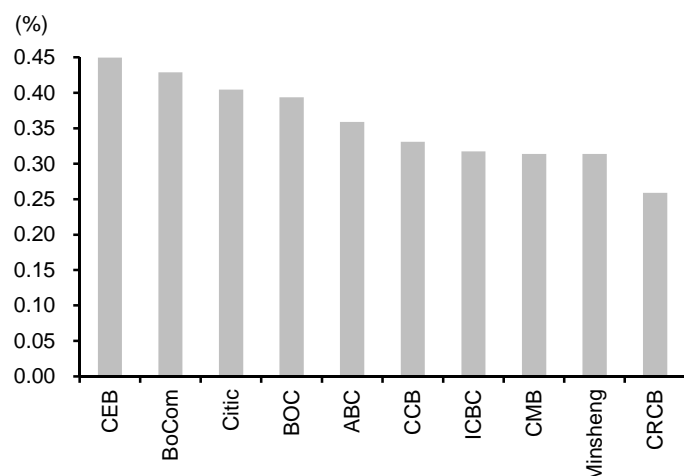
Note: *Assuming 60% of the debt swap programme quota (RMB2t) will be conducted via private placement.

^Assuming the remaining 40% of the debt swap programme quota (RMB2t) and new local govt bond issuance quota of RMB600b will be conducted via public offering. We also excludes the repayment for trust and BT of RMB292b.

Source: BNP Paribas estimates

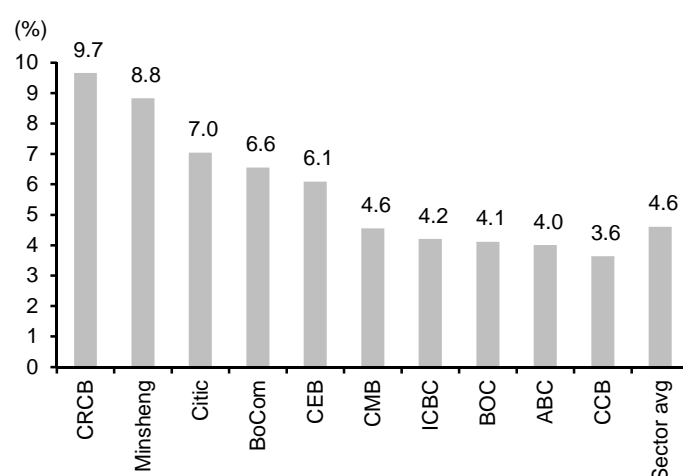
If we also consider the potential positive impacts on asset quality improvement on local government debt, the positive earnings impact could be more significant. For every 1bp decline in credit cost, we estimate China banks' FY15 earnings increase by 0.36% on average.

Exhibit 6: Earning sensitivity to 1bp credit cost change, FY15



Sources: Company data; BNP Paribas estimate

Exhibit 7: LGFV loans as % of total loans, FY14



Sources: Company data; BNP Paribas

Compared to impact on earnings, we think the impact on China banks' valuation multiples is more important. Our P/PPOP analysis suggests the China banks have a current valuation-implied NPL ratio of 12.4% on average. Despite the current credit cost of LGFV loans being relatively low, investors price in relatively high NPL ratios for LGFV loans. Many clients think LGFV loans have NPL ratios >20% give the weak cash flow support. As at FY14, LGFV loans accounted for c4.6% of the loan book of the H-share banks. Since the debt swap programme can remove investors' asset quality concerns on LGFV loans, we estimate the debt swap programme could raise the average China banks valuation multiple by c7.4% ($4.6\% \times 20\% / 12.36\%$), or increase the H-share listed China banks' FY15 P/PPOP multiple by 0.3x and FY15 PB by 0.1x.

Exhibit 8: P/PPOP analysis for China banks

----- P/PPOP -----									
Since listed (2005-14)	Average	2015E	Implied provision charged	Implied additional NPL	Implied additional NPL ratio of total loan	Implied additional NPL ratio of risky loan	Implied additional NPL as % China GDP	2015E NPL ratio	Valuation implied NPL ratio
	(x)	(x)	(RMB m)	(RMB m)	(%)	(%)	(%)	(%)	(%)
ICBC	7.0	4.2	1,637,778	1,637,778	13.79	57	2.5	1.20	14.99
CCB	6.5	4.1	1,174,236	1,174,236	11.34	55	1.8	1.30	12.64
BOC	5.9	4.2	672,769	672,769	7.14	26	1.0	1.25	8.39
ABC	4.5	3.4	527,399	527,399	5.81	22	0.8	1.40	7.21
BoCom	6.1	4.5	210,346	210,346	5.57	18	0.3	1.25	6.82
CMB	7.5	3.9	592,613	592,613	21.33	70	0.9	1.30	22.63
Citic	5.5	2.9	294,399	294,399	12.23	34	0.5	1.72	13.95
Minsheng	4.5	3.2	169,239	169,239	8.25	35	0.3	1.20	9.45
CRCB	5.4	3.5	32,469	32,469	11.31	43	0.0	1.00	12.31
CEB	5.9	3.2	199,851	199,851	13.95	42	0.3	1.27	15.22
Average/Total	5.9	3.7	5,511,098	5,511,098	11.07	41	8.5	1.29	12.36

Note: Priced at June 22, 2015

Sources: Bloomberg; BNP Paribas estimates

3. What's the main rationale for the debt swap programme?

More sustainable local government debt given longer durations and lower borrowing costs

We think the debt swap programme can improve the sustainability of local government debt during transitional reform periods, such as fiscal reform, tax reform and No.43 document to constrain the financing capabilities of local governments. Since the issuance party will be at a provincial government level, the creditworthiness should be much better than at a county- or city-level. The credit rating of the new issued bond should be higher, resulting in lower borrowing costs. The financial cost is generally 7-8% for current financing trusts and non-standard and standard loans, but will be only 3-4% for new local government swap bonds. We estimate this can help local governments save interest expenses of RMB40b-50b. In addition, the new bond durations are >5 years, longer than the current LGFV loans/trusts (<3 yrs), which should improve debt sustainability. More importantly, it will force local governments to better prepare their balance sheets, implying some contingent liability of local governments can be made explicit and accounted for in government budgets, thereby helping lower the banks' balance sheet risks and improve their balance sheet transparency.

From the perspective of financial institutions, they will suffer some loss in the near term because of high yield debt replaced with low yield debt. In the long run, however, the swap programme should be beneficial to financial institutions given the swaps reduce the financial burdens of local governments, lowering their default probability and thereby improving the financial institutions' asset quality.

Restoring banks' lending capability and enabling banks to leverage up

The risk weighting of local government bonds is 20% vs LGFV loans at 100-300% based on various cash coverage ratios. So, banks can save capital by swapping LGFV loans into local government bonds. As such, the debt swap programme can help banks restore lending capability by saving capital and releasing loan quota to lend on commercially-viable projects. The lower risk weighting of local government bonds enables banks to leverage up without consuming additional capital (asset growth > RWA growth). In addition, after the LDR shift from 'regulatory requirement' to 'supervision indicator', we expect banks will be able to grant more loans which may increase the incentive to release loan quota and capital from higher-risk-weighted LGFV loans.

4. Who will be the buyers of the debt swap programme? Were banks forced to subscribe? What kind of loans will banks lend using released quota?

We believe the banks (commercial banks and policy banks), insurance companies and NSSF will be the main investors in the debt swap programme. According to our channel checks, out of the banks, the big five and Industrial Bank are likely to be key participants.

The demand for the new bonds is likely to not be as bad as people expected, as banks think the bonds can help release capital and lower credit risks, and have decent profitability and that the banks could benefit from cheaper funding via fiscal deposits and PSLs. The banks may sacrifice NIMs in the short term by swapping LGFV debt into bonds, but should be compensated with larger fiscal deposits and better local government projects (we believe the government, when choosing banking partners, will take account of how much local government debt banks have taken). In addition, local government bonds can help the banks save capital and lower credit costs.

Beside commercial banks, we expect policy banks and SSF to play an important role given the PBOC can't invest directly in bonds. We think this will be especially evident with local government bonds that have unattractive yields and which commercial banks will have little incentive to buy it. In addition, we believe social security funds could become a major investor in local government bonds. In Apr 2015, the State Council raised the local government bond cap for social security funds from 10% to 20%.

According to our channel check with China banks, banks are using the released loan quota to lend to retail loans (eg, mortgages), infrastructure projects and policy-favoured sectors such as the environmental-friendly sectors, high-end machinery, consumption-related sectors and new technology sectors. While the banks now can't lend to LGFVs, they still seem to like lending to infrastructure projects backed by local government creditability.

5. Did banks use the existing liabilities or new funding to fund bond subscriptions? If new funding, where can they get funding to subscribe to the new bonds?

A key misunderstanding of the debt swap programme is that banks have to use existing liabilities to fund the debt swap programme. We believe that as well as direct placements not having to involve cash flow (using existing liabilities to swap), debt swaps via public offerings will be mainly financed by additional funding provided by the PBOC. As banks don't have much excess funding to subscribe to the local government bonds, we expect 80% of local government issuance via public offering to be funded by additional liquidity provided by the PBOC. We believe there are three funding sources for bond subscriptions: 1) RRR cuts, the most favourable source given a funding cost of 1.6%; 2) Pledged Supplementary Lending (PSL) – we expect the PSL scheme to be expanded from policy banks to commercial banks; the cost of funding is 3.1%; 3) the PBOC can also use policy banks as middle men to subscribe to local government bonds. In Apr 2015, the PBOC injected USD62b of capital into policy banks (USD32b for China Development Bank and USD30b for Export-Import Bank of China). All three ways are base money injections into the market.

Assuming 60% of the debt swap programme quota of RMB2t is conducted by private placement, and 40% by public offering. If we assume the municipal bond quota of RMB600b is also conducted via public offering, this implies the market needs RMB1.4t more funding to support the subscription of new local government bonds. Since the introduction of local government bonds, the PBOC has released additional funding of RMB1.6t via RRR cuts of 100bp and conducted PSL for policy banks with a total of RMB131b. If there is another batch of debt swap quota announced, it may require additional base money injection from the central bank.

6. Why didn't the market react very positively to the programme?

Investors have two concerns on the debt swap programme which triggered the mild reaction:

First, despite the banks being able to release loan quota after swapping debt into bonds, the loan demand from sectors that banks are willing to lend is quite weak. Thus, investors think the banks would rather keep LGFV loans with high loan yields and low risk (as perceived by the banks). The fear is thus that progress on the debt swap programme will be relatively slow and may not fulfil the government's purpose of restoring banks' lending capabilities and lowering funding costs in the real economy by using the official banking channel to grant loans.

BNPP comment: We agree that loan demand from banks' favoured sectors is relatively weak. However, loan demand from infrastructure projects and the SME and private sectors, which used to rely on shadow banking to finance, remains robust. We believe the banks need more incentives to lend to these areas: for example, allowing banks to use local government bonds or loans to these policy favourable sectors as collateral with the PBOC in exchange for PSLs with lower-funding costs. So far, the swapping process for the first batch of debt has been smooth. We expect more incentives for banks to swap may be introduced in 2H, such as lower PSL costs for commercial banks to get cheaper funding by pledging local government bonds or allowing banks to use loans to policy-favoured sectors to pledge with the central bank to get cheaper funding via PSLs.

Secondly, investors are concerned the debt swap programme will simply delay the debt problem, but not resolve the LGFV debt problem of non-commercially-viable projects backing up repayments.

BNPP comment: We believe the debt swap programme is supplementary to the fiscal reform (which will constrain the financing capabilities of local government) and tax reform (which will reallocate expenditure and revenue between the central and local governments). As such, the government needs to buy time to ensure a smooth transitional period during which it needs: a) to ensure no local governments default, and b) to increase the debt sustainability by lengthening the duration period and lowering the interest burden for local governments. Therefore, we believe the reforms will be meaningful in resolving the local government debt problem.

7. What could drive banks to more actively participate?

Pledged Supplementary Lending (PSL)

So far, PSL can only be granted by the PBOC for policy banks. If commercial banks are allowed to use local government bonds or loans for policy-favoured sectors as collateral to pledge at central banks in exchange for PSL at cheaper funding, commercial banks would be incentivised to do so as they are facing rising funding cost pressure. The cost of PSL was lowered from 3.5% in 2014 to 3.1% in 2015.

We compare LGFV loan profitability to the profitability assuming banks swap LGFV loans to local government bonds/SME loans by using PSL at a cost of 3.1%. Since the risk weightings of SME loans (75%) and local government bonds (20%) are much lower than of LGFV loans (120% on average), this would enable China banks to leverage up. Also, the ROEs of SME loans/local government bonds are 25.1% and 20.2%, higher than or close to the ROE of original LGFV loans (21.6%). However, we estimate the leverage of banks would increase by 5x and 0.6x if China banks swap LGFV loans to local government bonds/SME loans using PSL. Despite leveraging up, we estimate China banks' leverage would still be fine compared to the minimum requirement of 4%.

Exhibit 9: Leverage ratio for China banks – FY14

	Leverage ratio	vs minimum requirement
	(%)	(%)
ICBC	6.50	62.5
CCB	6.51	62.8
BOC	6.18	54.5
ABC	5.73	43.3
BoCom	6.10	52.5
CMB	4.96	24.0
Citic	4.88	22.0
Minsheng	5.01	25.3
Minimum requirement	4.00	0.0

Note: Leverage ratio= (Tier 1 capital minus Tier 1 capital deductions)/On- and off-balance sheet asset balance after adjustment.
CEB and CRCB didn't disclose the FY14 leverage ratio
Source: BNP Paribas estimates

Exhibit 10: ROE comparison: LGFV bonds vs SME loans

			Local govt bonds	SME loans	LGFV loans
RWA	RMB m	f	120	120	120
Bond/loan balance	RMB m	g=f/a	600	160	100
Tier- 1 CAR	%	h	9.5	9.5	9.5
Equity	RMB m	i=f*h	11.4	11.4	11.4
Bond/loan yield	%	j	3.6	7.7	6.78
Funding cost	%	k	3.1	3.1	2.5
Spread*	%	l=j-k	0.5	4.6	4.3
Interest income	RMB m	m=l*g	3.0	7.4	4.3
Fee income	RMB m	n=m*b	-	2.2	1.1
Total revenue	RMB m	o=n+m	3.0	9.6	5.4
1- CIR	%	p=1-c	80	60	65
Credit cost	%	q=d*g	(0.1)	(1.9)	(0.2)
1- Tax rate	%	r=1-e	100	75	75
NPAT	RMB m	s=(o*p+q)*r	2.3	2.9	2.5
ROE	%	t=s/i	20.2	25.1	21.6
Key assumptions					
Risk weighting	%	a	20	75	120
Fee income % of interest income	%	b	0	30	25
CIR	%	c	20	40	35
Credit cost	%	d	0.016	1.2	0.2
Tax rate	%	e	0	25	25

Note: Assuming both LGFV bonds and SME loans are financed by PSL
Source: BNP Paribas estimates

More freedom to price risk loans

So far the government has given many incentives for banks to lend SME loans, such as: 1) a favourable risk weighting on SME loans (75%) vs normal loans (100%), 2) RRR cut for banks with higher exposure to SME/rural related loans, 3) loans to policy-favoured sectors are easier to be securitized into ABS. However, many banks are still reluctant to lend to SMEs as their pricing power has been constrained by regulators. The max loan yield for banks to price at SMEs is 30-40% above the benchmark rate, and many banks have been charging fees to compensate for the higher risk of SMEs. However, the recent campaign against inappropriate fee charges closed this 'loophole', and banks now have even less incentive to lend to SMEs. If banks regain loan pricing power on SMEs, we think they may become more willing to lend to SMEs.

Bundling fiscal deposits and favourable local government projects with the debt swap programme

According to our channel check with banks, the fiscal deposit and future infrastructure projects of local governments will be linked to how much debt has been swapped into bonds. In other words, banks that are willing to participate in the debt swap programme will be compensated with more fiscal deposits at cheaper costs and entitled to more good quality infrastructure projects. By end-May 2015, the Chinese government deposit balance was RMB23.6t (RMB3.9t of fiscal deposit and RMB19.7t of government institution deposit).

8. If the local government debt problem is delayed, could any fundamental changes help resolve the LGFV debt problem?

To completely resolve local government debt problems, the Chinese authorities need to establish a long-lasting system for local government debt management, including a tax revenue-sharing system, a government debt constraint mechanism, a government debt risk alert system, etc. We believe the debt swap programme is supplementary to on-going fiscal and tax reform and No.43 document, as the China government needs to buy time to ensure local government debt does default during the transitional period.

On 2 October 2014, the State Council published its "Opinion on Strengthen the Management of Local Government Debts", ("Document No 43", 《国务院关于加强地方政府性债务管理的意见》), which is regarded as a flagship policy statement for handling local government debt and which we summarise below.

Overview of Document No 43

The document aims to establish a standardized mechanism for debt financing by local governments, which combines both general debt and special debt.

- Local governments can't borrow loans via LGFVs, and can only get financing via bond issuance (general bond or special bond) and PPP.
- If projects are not commercially viable and repayment relies on the general public budget, related loans will be accounted for as "general debt";
- If projects are partially commercially-viable and repayment relies on corresponding government fund revenue or special revenue, the loans will be accounted for as "special debt";
- If projects are partially commercially-viable but related revenue can't fully cover repayments, the uncovered part will be accounted for as "general debt" and the rest as "special debt".
- If the LGFV projects have transformed into PPPs, related loans will not be accounted for as LGFV debt;
- All local government debt will be included in local government budget plans, which need to be authorized by the state council and approved by the NPC standing committee. Local governments can't raise debt above the cap of the budget. The government will establish an alert system if a local government's debt is approaching the cap with emergency disposal plans for local government debt repayments. In other words, once the early warning is activated, the local government may have to liquidate some government-owned assets, such as SOE equities or government-owned land. When local government is really unable to repay maturing debt, it needs to report to a superior government and relevant personnel may be investigated. On 25 May 2015, the General Office of NDRC issued "the Notice on Giving Full Play to the Financing Function of Corporate Bonds to Support Major Projects Construction and Promote Stable and Rapid Economic Development" which raised the warning level (outstanding balance of enterprises bonds, mid-term notes, and etc. in responding regions to the region's GDP) from 8% to 12% of GDP.
- The bond issuance party will be restricted to the provincial level; but provincial governments can issue bonds on behalf of inferior governments such as city level and county level governments.
- The proceeds of local government bonds can be used to repay parts of existing local government debt or fund public welfare projects. They can't be used to fund local government operating expenses.

- Strengthening supplementary systems/accountability: local governments need to disclose debt details to the public, and strengthen appraisal systems/accountability mechanisms for local governors, who will face severe punishments if they fail to repay local government debt.
- Local government debts incurred due to major policy measures introduced by the central government should be accounted and reviewed independently.

Additional reform momentum

Besides confining new debt, the China central government is also trying to rebalance the revenue/expenditure of local governments. In July 2014, the Political Bureau of CPCCC approved the overall plan for deepening reform of the fiscal and tax systems. Major progress has been made after that. The NPC passed the revising of the Budget Law in September 2014. And China has been extending the trials of replacing business tax with value added tax (VAT) on a national scale.

We believe on-going reform will have a meaningful impact on local government debt and ease investor concerns on the same. We think fiscal reforms will probably include:

- Redefining central and local government spending responsibilities: a key problem causing rising local government debt is the imbalance of local government income and expenditure. We expect the central government will allow more expenditure at the central government level so it can ease the burden on local governments and reduce local governments' incentive to add debt.
- Increasing local tax revenues to offset shrinkage in land-based income: we expect local governments will have more flexibility to introduce new tax items and increase the share of certain tax items along with the central government so that they can strengthen their repayment capabilities for existing debts.
- Unifying and making transparent the budgeting system of local governments: we believe this will help constrain local governments' borrowing capability under public supervision.

9. Did the launch of Document No.40 overthrow Document No.43?

On 11 May 2015, the General Office of State Council transferred an opinion addressing follow-on financing for ongoing projects within local government financing companies (Document No.40).

We don't think Document No.43 has been overthrown by Document No.40. The basic principle of Document No.40 is to secure on-going construction projects and ensure their completion. The principle for existing financing is financial institutions should not withdraw financing on existing LGFV projects but should not increase the financing size. Additional financing can only be supported with PPP or local government bonds. This is totally consistent with Document No.43.

Key relevant highlights of Document No.40 are:

- The break point between existing and additional loans under Document No.40 is 31 December 2014, which is same deadline as for reviewing local government debt under Document No.43.
- If the existing borrowing contract doesn't expire, creditors should not withdraw existing loans.
- If a contract expires and the LGFV has difficulty repaying the principal and interest, related parties may consider restructuring the loans via extending the loan duration and requiring more collateral.

- If additional financing is required, the PPP model is preferred. If this is not suitable, it should issue local government bonds to finance, and the bonds need to be included into local governments' budget plans.

10. Which banks will benefit more from the debt swap programme?

Local governments are likely to first replace higher funding cost LGFV trusts (mainly "Build-and-Transfer" projects (BT) followed by LGFV loans with higher costs (mainly from smaller banks). Therefore, we expect LGFV loans from smaller banks to be swapped first place, and for them to benefit more than the large banks from improved asset quality.

Compared to impact on earnings, we think the impact on China banks' valuation multiples is more important. Our P/PPOP analysis suggests the China banks have a current valuation-implied NPL ratio of 12.4% on average. Despite the current credit cost of LGFV loans being relatively low, investors price in relatively high NPL ratios for LGFV loans. Many clients think LGFV loans have NPL ratios >20% give the weak cash flow support. As at FY14, LGFV loans accounted for c4.6% of the loan book of the H-share banks. Since the debt swap programme can remove investors' asset quality concerns on LGFV loans, we estimate the debt swap programme could raise the average China banks valuation multiple by c7.4% ($4.6\% \times 20\% / 12.36\%$), or increase the H-share listed China banks' FY15 P/PPOP multiple by 0.3x and FY15 PB by 0.1x.

Among our coverage, CRCB, Minsheng and Citic have the most exposure to LGFV loans which should enable them to benefit more than its peers.

Valuations and risks

We value the Chinese banks on an EVA model. Our target P/BV for Chinese banks is based on an EVA model using a 3.68% risk free rate, 10.48% market risk premium and 1.15-1.53x beta.

We reshuffle our top picks to Citic, Minsheng and BOC given these banks should benefit more from LDR relaxation and easing asset quality concerns on local government debts:

- We expect CRCB, Minsheng and Citic to benefit more from the local government debt swap programme given their higher exposure to LGFV loans.
- We expect BOCOM, Citic and BOC to benefit most from the removal of LDR requirements given their higher-than-peers LDR.

Combined with their valuation/catalysts, we believe Citic, Minsheng and BOC present the best risk/reward profile.

Citic: We like the stock because: 1) we expect the bank to pay good interim dividends to compensate existing shareholders especially the new shareholder China Tobacco (not listed) after it forfeit the dividend payment last year. As such, the interim dividend could be a positive surprise; 2) Citic has the cheapest valuation with the largest H- to A-share discount among dual-listed China banks, 3) as its new management has claimed to have completed its 'kitchen sinking' efforts this year, we expect its credit cost to peak this year with a higher buffer that will allow it to smooth out earnings growth going forward; 4) it should be a key beneficiary from the debt swap programme and LDR relaxation; and 5) BBVA's (BBVA SM) divestment could remove an overhang on the stock.

Minsheng: We like the stock because: 1) its capital constrain overhang was removed by redeeming the CB of RMB20b; 2) the settle-down of new management will help the bank re-focus on the core business; 3) we expect the new president to be internally promoted, implying Anbang (not listed) will have limited influence on its daily operations; 4) it should be a key beneficiary from the local government debt swap programme given its large exposure to LGFV loans; and 5) the discount to CMB is not justified given similar risk profile.

BOC: We like the stock because: 1) it should be a key beneficiary from LDR relaxation; 2) it should be less vulnerable to the rate cut cycle in China and should benefit from a rate hike cycle in the US; 3) it is an active participant in China's "one belt, one road" projects; 4) it will be next to do a mixed ownership trial; and 5) it has a relatively-attractive valuation.

We find the valuations of our H-share listed Chinese banks universe offer a very attractive risk/reward profile: the sector, on average, is trading at 6.6x FY16 P/E, 0.9x FY16 P/BV, 3.8x FY16 P/PPOP with a dividend yield of 4.8% and ROE of 14.3%.

Exhibit 11: China banks' valuation summary

	BBG code	Rating	TP	Target P/BV '16E	Price	Mkt cap (HKD) (USD b)	P/BV			P/E			P/POP			Div yield			ROE			ROA			NPAT growth-					
							'15E	'16E	'17E	'15E	'16E	'17E	'15E	'16E	'17E	'15E	'16E	'17E	'15E	'16E	'17E	'15E	'16E	'17E	'15E	'16E	'17E	'15E	'16E	'17E
							(x)	(x)	(x)	(x)	(x)	(x)	(x)	(x)	(x)	(x)	(x)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
ICBC	1398 HK	BUY	9.00	1.3	6.63	299.2	1.1	1.0	0.9	6.8	6.9	7.2	4.3	4.1	3.9	4.8	4.8	4.6	16.7	14.6	12.9	1.3	1.2	1.1	(0.3)	(1.6)	(3.3)			
CCB	939 HK	BUY	10.00	1.2	7.40	239.7	1.0	0.9	0.8	6.4	6.4	6.4	4.0	3.8	3.7	5.1	5.2	5.2	17.1	15.1	13.8	1.3	1.2	1.2	1.2	0.6	0.4			
BOC	3988 HK	BUY	6.50	1.1	5.40	218.5	1.0	0.9	0.8	7.1	7.2	7.2	4.4	4.0	3.8	4.4	4.5	4.5	14.4	13.1	12.1	1.1	1.0	0.9	2.6	1.3	(0.3)			
ABC	1288 HK	HOLD	4.80	1.0	4.21	191.9	0.9	0.8	0.8	5.9	5.9	6.0	3.5	3.4	3.2	5.6	5.6	5.5	16.6	14.7	13.2	1.1	1.0	0.9	3.0	(0.0)	(1.2)			
BoComm	3328 HK	BUY	9.60	1.0	8.10	86.7	0.9	0.8	0.7	7.3	7.5	7.7	4.6	4.4	4.2	4.2	4.0	3.9	12.7	10.9	9.9	1.0	0.9	0.9	(0.3)	(3.0)	(3.0)			
CMB	3968 HK	HOLD	24.60	1.2	24.25	77.1	1.4	1.2	1.0	7.7	6.9	6.3	4.0	3.8	3.5	3.9	4.4	4.8	18.9	18.4	17.6	1.3	1.3	1.4	15.1	12.6	8.8			
CITIC Bank	998 HK	BUY	9.40	1.0	6.51	52.1	0.7	0.6	0.6	6.0	5.8	5.7	3.0	2.7	2.6	5.1	5.2	5.3	13.7	11.5	10.8	1.0	0.9	0.9	5.9	3.5	1.4			
Minsheng	1988 HK	BUY	13.90	1.1	10.40	50.3	0.9	0.8	0.8	6.1	5.8	5.6	3.2	3.0	2.8	3.3	3.4	21.2	17.1	14.9	14.8	1.1	1.0	1.0	5.3	4.1	3.3			
CRCB	3618 HK	BUY	8.00	1.1	6.18	7.4	1.0	0.9	0.8	6.0	5.5	5.0	3.5	3.1	2.7	4.5	5.0	5.4	17.3	16.8	16.2	1.1	1.1	1.1	12.0	10.1	8.8			
CEB	6818 HK	BUY	6.40	1.0	4.69	39.0	0.8	0.7	0.6	5.8	5.6	5.6	3.2	3.0	2.8	5.2	5.3	5.4	14.9	12.9	12.0	1.0	1.0	0.9	5.2	2.7	1.1			
Average							1.0	0.9	0.8	6.5	6.4	6.3	3.8	3.5	3.3	4.6	4.7	6.6	15.9	14.3	13.3	1.1	1.1	1.0	5.0	3.0	1.6			
Weighted average							1.0	0.9	0.8	6.7	6.6	6.7	4.0	3.8	3.6	4.8	4.8	5.5	16.1	14.3	13.0	1.2	1.1	1.0	2.7	1.0	(0.3)			

Note: Priced at 23 Jun 2015

Sources: Bloomberg; BNP Paribas estimates

We believe key sector-wide downside risks are:

- Faster-than-expected asset quality deterioration and interest rate liberalization.
- Sharp declines in property prices: if prices decline sharply, this may cause asset quality risk in the property sector with a chain effect in other sectors; and
- Worse than expected economic growth.
- Liquidity crunch.

The key company-specific risks to our views are as follows:

ICBC: Key downside risks are rising competition undermining its market-leading position, and negative impact from interest rate liberalisation and bank disintermediation.

CCB: Key downside risks are more intense competition from private banks and Internet lenders; higher-than-expected operating costs and funding costs; and negative impact from interest rate liberalisation and bank disintermediation.

BOC: Key downside risks are slower export growth; slower-than-expected RMB internationalisation; and negative impact from interest rate liberalisation and bank disintermediation.

ABC: Key downside risks are demand deposit hikes; loss of deposit market share due to interest rate liberalisation; and factors leading to slower economic growth in rural areas. Key upside risks: the introduction of rural land reform, better than expected NIM and asset quality trends; and earnings beats.

BoCom: Key downside risks are a disappointing final result on the mixed-ownership plan; delayed implementation of the plan; vulnerability to economic downturn; and accelerating asset quality deterioration.

CITIC: Key downside risks are rapid loan growth during the credit boom in 2008-10 and large loan exposure to manufacturing loans making it vulnerable to an economic downturn; further delay to the launch of virtual credit card business with Tencent (700.HK); divestment overhang from BBVA (BBVA SM).

CMB: Key downside risks are Anbang (not listing) may divest its shares in secondary market; the core business may be distracted by Anbang Insurance; further scrutiny on fee collection; an earning miss; accelerating interest rate liberalisation. Key upside risks are better-than-expected earnings growth; management successfully finding a strategic position for CMB and let CMB regain operating and funding cost advantage; and the introduction of preferred shares.

Minsheng: Key downside risks are uncertainties from new management change and future business strategy and potential business distraction from Anbang Insurance; less buffer to smooth out earnings growth given lower-than-peer excess provisions; vulnerability to an economic slowdown, given the bank's large loan exposure to micro-finance companies; and capital pressure.

CRCB: Key downside risks are accelerated interest rate liberalisation putting pressure on the bank's funding cost; concerns about LGFV loans; vulnerability to an economic slowdown, given poorer asset quality than peers; and earning misses.

CEB: Key downside risks are an economic downturn given CEB's high risk loan profile and below-peers provision coverage; delay in spin-off of wealth management business; and delay in the potential parent company listing.

Appendix

Exhibit 12: Local govt's direct debt breakdown by underlying assets

	1H13						% of total local govt's direct debt				
	Local govt's direct debt	Bank loans	Bonds	Trust	BT	Others	Bank loans	Bonds	Trust	BT	Others
	(RMB b)	(RMB b)	(RMB b)	(RMB b)	(RMB b)	(RMB b)	(%)	(%)	(%)	(%)	(%)
Jiangsu	764	395	97	77	57	138	51.7	12.6	10.1	7.5	18.0
Hubei	515	237	62	45	50	122	46.0	12.0	8.7	9.8	23.6
Sichuan	653	256	51	26	130	190	39.1	7.8	4.0	19.9	29.1
Guangdong	693	464	51	31	84	63	67.0	7.4	4.4	12.1	9.1
Zhejiang	509	283	79	78	13	55	55.7	15.5	15.3	2.6	10.9
Beijing	651	386	38	46	6	174	59.4	5.8	7.0	1.0	26.8
Shanghai	519	370	36	9	83	22	71.3	6.9	1.7	15.9	4.2
Guizhou	462	123	25	29	183	103	26.7	5.4	6.2	39.5	22.3
Shandong	450	187	50	31	43	138	41.6	11.1	7.0	9.5	30.8
Liaoning	566	356	72	20	34	84	62.9	12.8	3.5	6.0	14.9
Henan	353	129	41	42	59	82	36.6	11.6	12.0	16.7	23.1
Yunnan	382	198	35	14	40	95	51.7	9.3	3.6	10.5	24.9
Chongqing	358	188	22	60	32	55	52.5	6.3	16.9	8.9	15.4
Hebei	396	155	31	44	45	122	39.1	7.8	11.1	11.4	30.7
Anhui	308	129	73	2	40	64	42.1	23.6	0.5	13.1	20.7
Hunan	348	157	45	24	31	89	45.3	13.1	6.9	9.0	25.7
Fujian	245	106	35	11	58	35	43.2	14.2	4.6	23.6	14.4
Inner Mongolia	339	100	37	21	11	170	29.4	10.9	6.3	3.3	50.1
Jiangxi	243	109	39	17	43	35	45.1	15.9	6.8	17.6	14.6
Shaanxi	273	124	33	17	28	71	45.3	12.1	6.2	10.3	26.0
Jilin	258	139	27	26	22	44	53.7	10.5	10.2	8.5	17.1
Guangxi	207	110	19	9	51	17	53.3	9.1	4.5	24.8	8.3
Tianjin	226	175	7	19	1	24	77.4	3.2	8.3	0.5	10.6
Heilongjiang	204	122	28	7	4	44	59.7	13.5	3.5	1.8	21.6
Xinjiang	164	75	33	4	9	43	45.7	20.3	2.6	5.4	26.1
Gansu	122	35	27	11	13	36	28.7	21.9	9.3	10.3	29.8
Shanxi	152	74	20	12	7	39	48.7	13.3	7.9	4.3	25.8
Hainan	105	68	9	0	19	9	65.0	8.5	0.0	17.7	8.8
Qinghai	74	43	17	3	1	11	58.2	22.2	4.1	1.2	14.3
Ningxia	50	18	10	-	1	21	36.6	19.9	-	2.2	41.3
Others	295	211	18	26	17	22	71.7	6.0	8.9	5.8	7.5
Total	10,886	5,525	1,166	762	1,215	2,218	50.8	10.7	7.0	11.2	20.4

Sources: WIND; BNP Paribas estimates

Exhibit 13: Local govt guaranteed debt breakdown by underlying assets

	----- 1H13 -----						-----% of total local govt guaranteed debt-----				
	Govt guarantee	Bank loans	Bonds	Trust	BT	Others	Bank loans	Bonds	Trust	BT	Others
	(RMB b)	(RMB b)	(RMB b)	(RMB b)	(RMB b)	(RMB b)	(%)	(%)	(%)	(%)	(%)
Jiangsu	98	69	6	12	2	8	70.9	6.6	11.8	2.5	8.2
Hubei	78	57	4	5	1	12	72.7	4.6	5.8	1.1	15.8
Sichuan	165	113	15	13	5	18	68.7	9.2	8.1	3.1	10.9
Guangdong	102	69	17	7	2	7	67.9	16.7	6.6	1.7	7.1
Zhejiang	33	14	11	2	2	4	41.3	34.3	6.0	6.7	11.6
Beijing	15	12	-	-	-	3	81.0	-	-	-	19.0
Shanghai	53	30	11	-	3	10	56.6	20.3	-	4.8	18.3
Guizhou	97	83	4	1	2	7	85.2	4.1	1.1	2.1	7.5
Shandong	122	100	2	12	-	8	82.4	1.4	9.8	-	6.4
Liaoning	126	104	2	3	11	7	82.4	1.2	2.2	8.5	5.6
Henan	27	14	1	2	0	10	51.4	4.8	6.6	0.1	37.1
Yunnan	44	28	0	1	2	12	62.8	1.0	2.6	5.6	28.0
Chongqing	230	152	14	41	2	21	66.0	6.3	18.0	0.7	9.0
Hebei	95	68	3	10	3	11	71.8	3.3	10.2	2.8	11.8
Anhui	60	40	6	2	3	10	66.0	9.4	2.8	4.5	17.3
Hunan	73	46	8	5	0	13	62.5	11.6	7.3	0.6	18.1
Fujian	24	12	3	1	1	8	47.7	10.3	5.8	4.6	31.7
Inner Mongolia	87	76	2	1	-	9	87.1	2.3	0.6	-	10.0
Jiangxi	83	58	8	8	-	9	69.2	9.9	9.7	-	11.2
Shaanxi	95	74	3	7	0	11	77.6	3.4	7.0	0.1	12.0
Jilin	97	86	4	2	-	5	88.5	4.2	2.0	-	5.3
Guangxi	123	98	5	7	0	12	80.0	4.4	5.9	0.1	9.6
Tianjin	148	110	11	7	-	20	74.1	7.4	4.8	-	13.7
Heilongjiang	105	85	8	5	-	7	80.5	8.0	4.5	-	6.9
Xinjiang	81	73	0	2	-	5	90.8	0.2	2.9	-	6.2
Gansu	42	26	7	0	0	9	61.6	17.6	0.5	0.0	20.3
Shanxi	233	113	7	96	3	15	48.5	2.9	40.9	1.3	6.3
Hainan	23	20	0	-	-	2	89.8	2.0	-	-	8.2
Qinghai	16	15	-	-	-	1	95.6	-	-	-	4.4
Ningxia	18	12	-	-	-	6	66.4	-	-	-	33.6
Others	71	53	3	2	4	10	73.5	3.6	2.9	6.3	13.9
Total	2,666	1,909	167	253	47	290	71.6	6.3	9.5	1.7	10.9

Sources: WIND; BNP Paribas estimates

Exhibit 14: Local govt's contingent debt breakdown by underlying assets

	1H13						% of total contingent debt				
	Contingent debt	Bank loans	Bonds	Trust	BT	Others	Bank loans	Bonds	Trust	BT	Others
	(RMB b)	(RMB b)	(RMB b)	(RMB b)	(RMB b)	(RMB b)	(%)	(%)	(%)	(%)	(%)
Jiangsu	616	323	93	93	34	73	52.4	15.2	15.1	5.5	11.8
Hubei	175	126	10	8	4	27	72.1	5.6	4.4	2.3	15.6
Sichuan	105	49	13	17	9	17	47.2	12.1	15.9	8.4	16.5
Guangdong	221	126	23	3	49	21	56.8	10.2	1.4	22.1	9.5
Zhejiang	151	95	12	19	12	13	63.0	7.7	12.7	8.0	8.7
Beijing	90	56	16	5	-	12	62.8	17.7	5.7	-	13.8
Shanghai	273	242	12	5	-	14	88.7	4.5	1.8	-	5.0
Guizhou	73	33	7	22	2	9	44.9	9.5	30.8	2.1	12.8
Shandong	139	78	14	11	2	33	56.3	9.8	8.2	1.8	24.0
Liaoning	67	48	7	4	2	6	71.5	10.6	5.8	2.4	9.6
Henan	174	115	12	16	2	28	66.3	7.1	9.2	1.1	16.3
Yunnan	169	85	11	29	6	38	50.2	6.6	17.4	3.4	22.5
Chongqing	149	64	32	9	20	24	42.8	21.5	6.0	13.5	16.2
Hebei	260	189	8	31	8	24	72.5	3.2	11.8	3.1	9.3
Anhui	162	90	37	11	5	19	55.5	23.0	6.8	3.0	11.6
Hunan	353	239	45	27	10	32	67.7	12.7	7.7	2.8	9.0
Fujian	168	129	14	9	3	14	76.4	8.3	5.2	1.9	8.2
Inner Mongolia	28	11	3	0	1	13	38.6	10.4	1.4	2.0	47.6
Jiangxi	67	35	14	6	3	10	52.1	20.0	9.3	3.9	14.6
Shaanxi	241	175	38	13	2	14	72.6	15.7	5.3	0.7	5.7
Jilin	69	37	9	10	4	9	53.8	12.3	14.8	5.5	13.6
Guangxi	103	58	15	18	9	3	56.0	14.4	17.9	8.5	3.2
Tianjin	109	59	10	15	2	24	54.3	9.2	13.5	1.4	21.6
Heilongjiang	50	25	15	1	1	7	50.2	29.7	2.5	2.9	14.7
Xinjiang	30	18	4	2	0	6	61.0	12.1	5.5	0.2	21.2
Gansu	132	76	19	8	20	8	58.0	14.5	6.2	15.2	6.2
Shanxi	32	13	6	6	1	6	40.6	17.0	19.8	4.1	18.5
Hainan	14	8	5	-	1	0	57.9	33.2	-	7.5	1.3
Qinghai	15	13	2	1	-	1	82.4	9.8	3.3	-	4.5
Ningxia	11	8	2	-	-	1	72.2	21.2	-	-	6.5
Others	94	62	8	10	6	7	66.4	8.6	11.0	6.0	8.0
Total	4,339	2,685	512.466	410.467	215	516	61.9	11.8	9.5	5.0	11.9

Sources: WIND; BNP Paribas estimates

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Unless otherwise specified, these recommendations are set with a 12-month horizon. Thus, it is possible that future price volatility may cause a temporary mismatch between upside/downside for a stock based on market price and the formal recommendation.

** In most cases, the target price will equal the analyst's assessment of the current fair value of the stock. However, if the analyst doesn't think the market will reassess the stock over the specified time horizon due to a lack of events or catalysts, then the target price may differ from fair value. In most cases, therefore, our recommendation is an assessment of the mismatch between current market price and our assessment of current fair value.*

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