China Debt Dynamics

China refocuses on financial risk – and ramps up NPL disposals

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China's banks have disposed of a record amount of nonperforming loans (NPLs) over the past four years. That's set to ramp up further in 2024.

This year, the People's Bank of China (PBoC) has said writing off NPLs will be part of its campaign to "revitalize the inefficient stock of credit." Meanwhile, the National Financial Regulatory Administration (NFRA) – China's banking and insurance regulator – has ranked increasing NPL disposals as its number 2 goal for 2024. The NFRA has also said it wants to encourage foreign distressed debt investors to come to China.

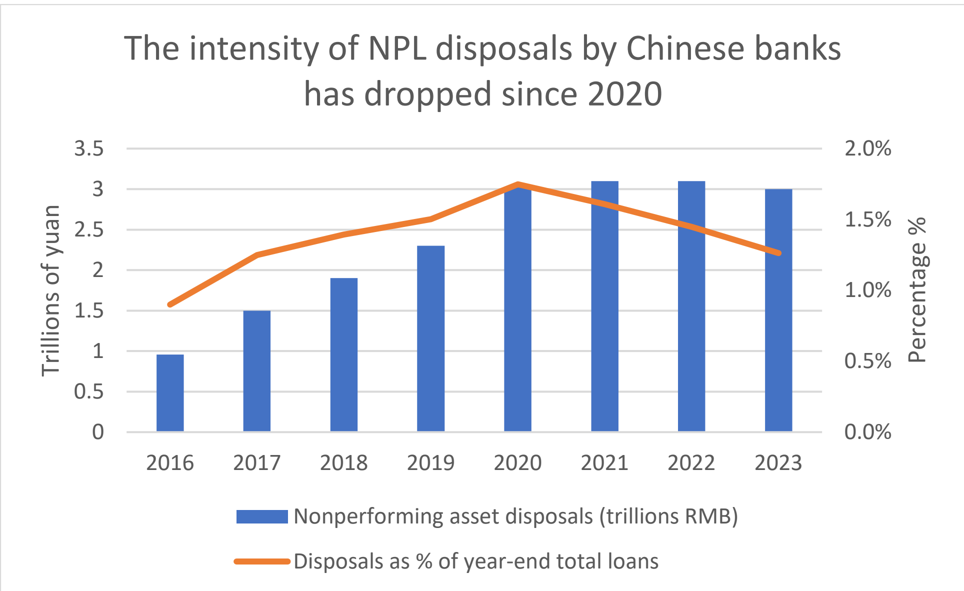
That was echoed in our recent meeting with PBoC Gov. Pan Gongsheng who said he strongly encourages long-term experienced foreign investors like ShoreVest to be part of the country's debt cleanup ecosystem. In a rare one-on-one meeting with foreigners – we believe the last was in October when Pan met with US Treasury Secretary Janet Yellen – Pan said the volume of distressed and special situations opportunities is likely to be very high for the near- to mid-term.

At first glance, it seems odd China's financial authorities want to ramp up NPL disposals. The banking sector's NPL ratio is currently at its lowest level since 2016. Moreover, banks have disposed of about 3 trillion yuan worth of NPLs annually for the last four years, a massive amount in absolute terms.

However, between 2020 and 2023 lending by China's banks expanded by almost 40%. Consequently, while RMB 3 trillion was impressive in 2020, it wasn't in 2023 **[Fig. 1]**. The relative decline in disposals casts doubt on the feasibility of NPLs being able to fall during that period, particularly given mounting financial stress among property developers and local governments, and weak business confidence.

What has likely happened is that, in spite of the large amount of disposals in absolute terms, China's banks have allowed NPLs to accumulate unrecognized on their balance sheet over the last four years.

Fig. 1



Source: NFRA, Chinese media

Specifically, it's likely banks have slowed the pace at which they recognize and dispose of NPLs in order to boost profits. Those profits have then been used to replenish banks' capital.

Prioritizing capital over NPL recognition

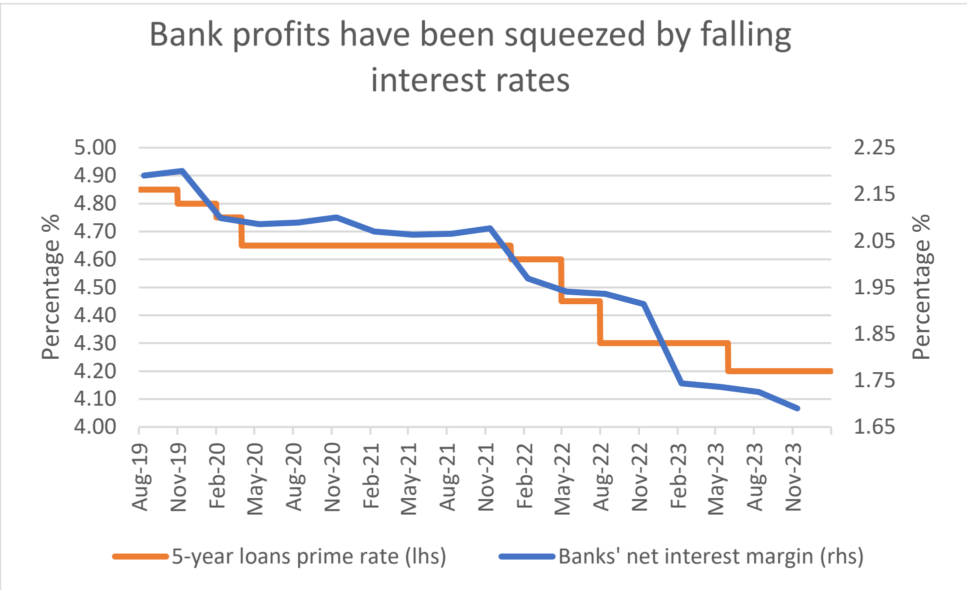
Banks are required by regulators to maintain a minimum amount of risk-adjusted capital against their loans. As bank lending expands, so does the amount of capital they need to hold.

Banks can accumulate core tier-1 capital – the highest quality type of capital – by retaining earnings, or by selling new shares to investors. In China, banks aren't permitted to sell new shares at a price less than net-assets-per-share. However, the market value of all but a small handful of banks has been less than net-assets-per-share for years. Consequently, private sector investors have been unwilling to buy newly issued bank shares.

Banks have been able to sell new equity to state buyers at inflated prices, but many overstretched local authorities have found it increasingly difficult to muster the resources. Hence, banks are mostly dependent on their own profits to sustain their capital.

However, bank profits have been squeezed in recent years by narrowing net interest margins (NIMs), the result of the PBoC supporting the economy with lower lending rates **[Fig. 2]**. With new loans typically growing by about 10% a year, it's becoming increasingly difficult for banks to generate enough new capital.

Fig. 2



Source: PBoC, NFRA

One way banks can boost profit – and generate capital – is by recognizing fewer NPLs.

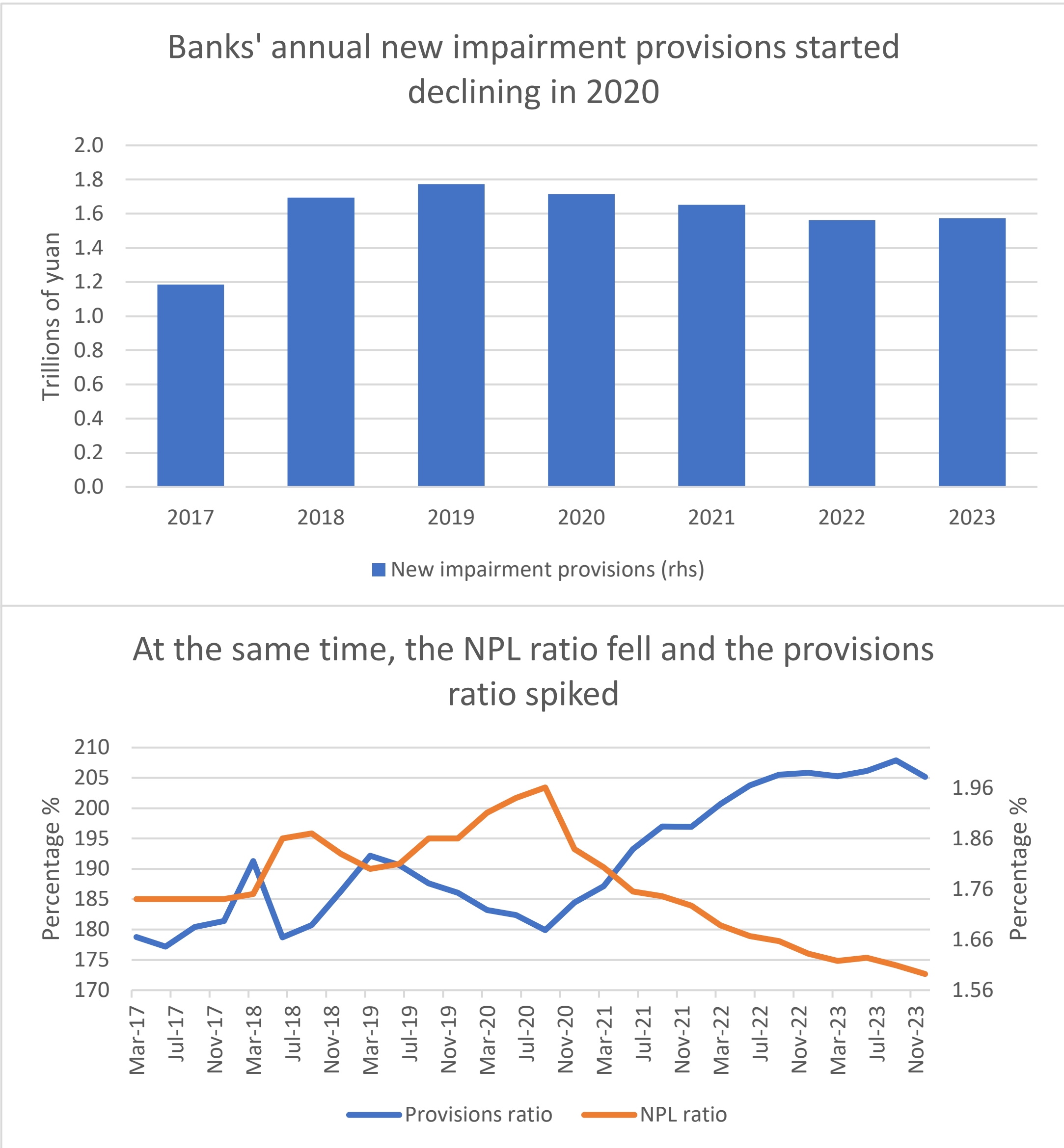
NPLs erode bank profits. Banks are required to make loan loss provisions every time they recognize a new bad loan. China's regulators require most banks to make provisions equivalent to one-and-a-half times –

150% – the value of their NPLs. When a bank writes down a bad loan, the banks' accumulated provisions decline by the size of the write-down.

The provisions are an expense. Every yuan that goes toward provisions is one less yuan that would otherwise go toward profits. Consequently, recognizing fewer NPLs means a bank needs to set aside fewer provisions – and can record higher profits.

Banks appear to have started prioritizing capital over NPLs in Q4 2020. After almost a year of COVID, bank profits were falling. But loan growth remained strong, making it difficult for banks to generate enough new capital. The NPL ratio – which had been rising since 2012 – suddenly started falling. Meanwhile, the provisions ratio shot up even though banks set aside fewer provisions than the year before **[Fig. 3]**.

Fig. 3



Source: PBoC, NFRA

Since then, the NPL ratio has continued to fall and the provisions ratio rise, even as banks have set aside fewer provisions. That's allowed banks to generate more profit than would otherwise be possible. But it also means NPLs have likely been accumulating on banks' balance sheets.

Given banks' capital needs, it's not immediately clear how the PBoC intends for banks to increase NPL disposals.

One potential approach would be to allow banks to maintain lower provision levels. The banking sector's provisions ratio at end-2023 was 205.14%. If it declined by a third – to about 140% – banks could write-off RMB 2.2 trillion worth of NPLs without impacting bank profits. By recent standards, that's equivalent to about two years' worth of write-offs.

(Between 2020 and 2023, banks disposed of about RMB 3 trillion worth of NPLs annually. However, write-offs were about RMB 1 trillion annually. The difference is the amount banks clawed back from delinquent loans, either by selling the underlying collateral, selling them to a third party, or securitizing them.)

However, provisions rates vary significantly between banks. While the big six banks – a group that accounts for about 40% of all banking assets – typically have provision ratios around 200%, the average for rural commercial banks is below 140%. Hence, while the large banks can probably deliver a bump in NPL disposals on their own, smaller banks will need state support.

For small banks, the state might have to intervene to replenish their capital directly, thereby freeing the banks to deploy more resources toward writing-off bad loans.

Conclusion

Between 2017 and 2020, regulators were laser-focused on cleaning up the financial system. Since then, cleanup efforts have taken a back seat to ensuring banks are adequately capitalized.

That trade-off has come at a cost. The volume of undisclosed NPLs held by China's banks have undoubtedly been increasing and will continue to mount as property sector woes persists, overcapacity issues in key industries (like electric vehicles and solar components) result in bad assets, and local government financial stress remains unresolved.

Authorities are now refocusing their attention back on NPLs. That will create new opportunities for ShoreVest as banks look for ways to offload greater volumes of bad debts.

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