China Debt Dynamics

Dealing With a Coming Surge in Nonperforming Loans

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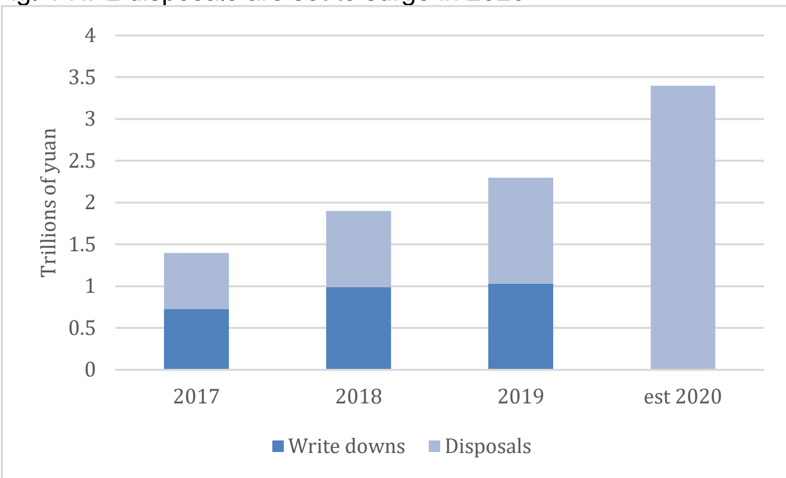
In mid-August, China Banking and Insurance Regulatory Commission (CBIRC) chairman Guo Shuqing warned of a coming surge in nonperforming loans. In order to deal with it, he said, banks must urgently replenish their loan-loss provisions and more aggressively dispose of their bad loans. Specifically, he said that he expects banks to dispose of 3.4 trillion yuan worth of nonperforming loans (NPLs) in 2020, up almost 50% from RMB 2.3 trillion in 2019.

“Next year, the intensity of disposals will be even greater,” Guo went on to say. “Many loans have been extended, and only next year will their problems be exposed.”

This new wave of NPLs arrives while China’s banks are still trying to clean up after the last wave, efforts that are now in their fourth year. The process of disposing of bad loans accumulated in the wake of the global financial crisis has been deliberately slow, designed to minimize economic disruption and the cost to the state by spreading it out over as long a period as possible. By our estimates, resolving the post-GFC debt hangover (a process which began only five years ago) was on track to take at least a decade.

The pandemic has complicated that approach. By suddenly creating a new wave of bad loans, it has significantly set back efforts by financial regulators to clean up the banks according to the previous timetable. But rather than draw out the cleanup process even longer, the regulators have decided to accelerate its pace well beyond what had been considered feasible up until now. Prior to the pandemic, China’s distressed debt market was already one of the biggest in the world. The acceleration of disposals promises to push it into a league of its own.

Fig. 1 NPL disposals are set to surge in 2020



Source: CBIRC, local media

However, so far the pandemic has had only a limited impact on bank NPLs. At the end of June, the banking sector's NPL ratio was 1.94%, up only marginally from 1.86% at the end of last year. That's in large part due to forbearance policies. Banks have been instructed by the authorities to extend the maturity of loans to borrowers that are struggling due to the pandemic. During the early days of the pandemic, banks were allowed to delay loan repayments until June 30, but in early June the regulators pushed the date back to March 31, 2021.

The authorities could extend the forbearance program further, but it seems unlikely. The financial regulators are moving toward ending the extraordinary measures implemented to deal with the pandemic and have already allowed interbank lending rates to return to pre-pandemic levels. Guo's warning of a coming surge of NPLs and a worsening of debt problems next year seems to signal that forbearance policies will be allowed to end on schedule.

The increase in NPL disposals will cause a significant but not untenable burden on the banks, with disposals this year and next likely amounting to about 4.3% of total outstanding bank loans, based on Guo's projections. China's banks are well provisioned, allowing them to ramp up write-downs well beyond current levels. However, write downs are expensive, eating into bank profits and ultimately requiring banks to raise fresh capital. To minimize the amount of capital banks need, it is necessary to ensure that they can extract as much value as possible from their bad loans.

In recent years, China's authorities have made it easier for banks to dispose of bad loans and have provided new tools for them to do so. However, existing NPL disposal channels are unlikely to be sufficient to meet Guo's target. The banking regulator recognizes as much and has said that it plans to broaden the disposal channels for banks.

The rest of this report will outline the current NPL disposal channels available to banks, why they're not sufficient to accommodate a significant increase in disposals, and what new channels for disposal are emerging to make up for the shortfall.

Liquidation

Upon deciding to dispose of a loan, liquidation through courts is the disposal channel likely to deliver the highest absolute return for banks—but take the longest time. For those loans that are secured by collateral—whether it be real estate, equity, or some other asset—banks can ask the courts to recognize their claim, auction the asset on their behalf, and then transfer to them the proceeds of the auction up to and including the value of their legal claim. In recent years, the process of resolving NPLs through the courts has been streamlined and made far more predictable in order to help banks with their disposals and encourage the involvement of investors like ShoreVest.

However, the volume of cases a bank can pursue at any given time is limited by the size and expertise of its legal team, which may prove difficult to expand quickly at a time that other banks are doing the same. Moreover, based on ShoreVest's experience, pursuing enforcement of a loan through the legal system typically takes 18 months or more. With banks now under political pressure to dispose of bad loans quickly, that's likely to be too long for most banks.

Asset management companies (AMCs)

AMCs are the single most important channel for banks to spin-off bad loans. There are four national AMCs, and about 60 provincial AMCs which, as a group, have the exclusive right to acquire portfolios of three or more NPLs from banks (there are no limits on the sale of individual or pairs of bank loans). In dealing with AMCs, banks sell their NPLs at a discount to their residual value, and so consequently receive less than if they resolved the loans internally. However, AMCs allow banks to spin off large volumes of bad loans from their books quickly, which is useful when banks are trying to improve asset quality in time for regulatory reviews or earnings disclosures.

In recent years the big four national AMCs—which account for the lion's share of all NPL purchases—have been under significant political pressure to acquire bank NPLs, sell them onward to third party investors as quickly as possible, and then go back and buy more bank NPLs. Consequently, they are already operating at the limits of their capacity. Of course, were the AMCs to raise new capital their capacity to absorb NPLs would increase. Alternatively, selling off non-core assets would have the same effect, as Cinda did earlier this year when it raised 7.5 billion yuan from the sale of its life insurance subsidiary. As yet there hasn't been any public discussion of significantly boosting the AMC's financial resources, without which it will be difficult for them to absorb the coming surge in NPLs.

Securitization

Banks have been allowed to package NPLs into asset backed securities (ABS) since 2016. However, they've primarily been used by banks to dispose of retail loans, that is credit card debt, home mortgages, consumer loans, and personal loans for small businesses. Traditionally, banks had been barred from transferring retail loans in bulk to AMCs—a rule designed to protect the rights and privacy of individual debtors—leaving securitization as the only way for banks to dispose of retail NPLs in large volumes.

However, ABS have remained a relatively fringe tool because they're seldom used for corporate NPLs. That's because securitization requires each loan and its collateral to be individually and independently appraised, which is expensive and time consuming. In contrast, credit card debt is unsecured—that is, there's no collateral to appraise—and the risk profile of the debtors is assessed as a group based on the issuing bank's historical data, making their securitization relatively cheap. Hence, while ABS are a useful tool for dealing with certain types of NPL—and could well grow in issuance as households come under more financial pressure—they're unlikely to play a meaningful role in helping resolve the coming surge in NPLs.

Debt-to-equity swaps

Since 2016, banks have been permitted to exchange loans for equity in the borrowing firm. In the last couple of years, these debt-for-equity swaps have surged. Based on incomplete data, banks used swaps to convert at least 220 billion yuan worth of NPLs into equity in 2018 and 2019. So far, almost all the swaps have been carried out by the Big 5 banks, so there's certainly scope for expansion if smaller banks become more involved.

The main limitation on debt-to-equity swaps is that they're primarily funded by third party investors—insurance companies, local government investment funds, private equity funds, and retail investors. These investors typically expect a return after about three years, which means the company either needs to get bought out by a competitor or launch an IPO, or for the investors' shares to get bought out by the company's parent. As yet, debt-for-equity swaps haven't existed long enough to have a proven record of success. Until they do, investment will be driven by state and not market entities, limiting the potential to ramp up volume.

Where to from here?

To help banks increase their disposals, the CBIRC has promised to broaden the channels for NPL disposal. As yet, the only change to be officially announced by central authorities has been a trial program recently launched by the People's Bank of China (PBoC) allowing certain banks to sell retail loans to AMCs in bulk. That would free them from having to rely solely on ABS and is no doubt a welcome change given rising stress on households to repay their loans. However, given that AMCs have almost no experience dealing with retail loans, it remains to be seen whether they embrace the reform.

Meanwhile, changes announced earlier in the year are yet to have an effect. For example, Beijing launched a fifth national AMC, China Galaxy, but it's still gearing up—it's recruiting staff, its website is only half complete and, to the best of our knowledge, it has yet to start acquiring NPLs. It's unclear whether Galaxy's role will differ from that of the other major AMCs, and how quickly it will be able to make a meaningful contribution to NPL disposals. Also, under phase one of the US-China trade deal, foreign investors have been granted the right to set up AMCs. As yet none have, but the concession reflects Beijing's willingness to experiment with NPL disposal channels, and a desire to attract more foreign capital.

Of greater note is the emergence over the past year of non-AMC state institutions acquiring large volumes of NPLs. Most notably, Deposit Insurance Fund Management (DIFM)—the PBoC's deposit insurance arm—acquired 150 billion yuan of Baoshang Bank's NPLs during its restructuring. Meanwhile, as part of the Bank of Jinzhou's bailout plan, Chengfang Huida agreed to acquire 150 billion yuan of the bank's bad loans. (Huida is a throwback to China's last bank cleanup at the turn of the century. It was set up in 2005 by the PBOC to acquire bad loans the central bank had previously bought from commercial banks. Huida is technically a subsidiary of Cinda—the PBOC can't be an equity investor in a vehicle designed to acquire its own bad loans—but in practice Huida is controlled entirely by the PBOC.)

So far, such vehicles have only been mobilized to help facilitate bank bailouts, instances where the AMCs' capital hasn't been sufficient to absorb the sheer volume of bad loans that needed to be spun off. Moreover, given that AMCs are supposed to acquire NPLs under commercial conditions based on market prices, it makes sense for them to play less of a role in bailouts where NPL pricing might be inflated to help prop up flailing banks.

That's not to say that AMCs have been sidelined entirely. In the last few weeks of 2019, Hengfeng Bank, one of China's 12 joint stock banks, spun-off 143.89 billion yuan worth of NPLs to Shandong Financial Asset Management—Shandong's provincial AMC—which paid 79.96 billion yuan for them. The acquisition quadrupled the size of the Shandong AMC and was only made possible by a massive capital injection from the provincial government for the purpose. Still, to the extent that more banks need bailing out, it's likely that Beijing will involve non-AMCs in the NPL disposal process.

The final development of note involves efforts by small banks to dispose of their NPLs. AMCs have traditionally been reluctant to acquire NPLs from small banks, preferring to concentrate their resources on institutions with large volume—and higher quality—bad loans. This has been a frustration for small banks for some time, all the more so given that small banks typically have higher levels of NPLs than their larger counterparts. Consequently, some small banks have come up with a creative solution—they've packaged NPLs with new shares as part of private placements designed to raise new capital.

The NPLs operate as a sweetener to encourage investors to acquire the shares. Chinese banks aren't allowed to sell new shares at a price less than the value of net assets per share at the time of the last audit. Currently, there are about 50 publicly traded Chinese banks and all but a small handful trade below net assets per share. Anecdotally, non-listed banks are seldom able to sell equity above net assets per share as well.

To comply with the restriction, some small banks have sold shares above net assets per share by including NPLs in the deal. In short, investors receive NPLs as compensation for purchasing the shares at above market price. On one hand they overpay for the shares, but on the other they can claw back their loss by selling or resolving the NPLs. Clearly the practice violates the spirit of the rules. Nonetheless, such deals have been approved by the securities regulator and so have official sanction.

Conclusion

China's main NPL disposal channels have been insufficient to meet the existing needs of banks, resulting in improvised solutions to make up the gap. With banks under pressure to significantly increase their disposals it's likely that similarly ad hoc solutions—both bottom-up and top-up—will emerge. Based on previous experience, banks may also try to artificially inflate their disposal numbers, but the CBIRC has already warned that the use of off-balance-sheet tools and shadow banking institutions to help facilitate fake NPL disposals will not be tolerated. However, what is likely to be a time of stress for the banks will be one of great opportunity for investors. With a wider range of NPLs to choose from, at lower prices, Beijing's drive to accelerate NPL disposals will further improve the attractiveness of investing in Chinese distressed debt.

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