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China Debt Dynamics

New Regulations Set to Accelerate NPL Disposals

Volume 7 | Issue 1
March 2023

Banks' disposals of nonperforming assets are set to accelerate this year.

On February 11, the China Banking and Insurance Regulatory Commission (CBIRC) issued new measures that require banks to tighten up their disclosure of bad assets. Starting from July 1, many of the loans the banks have hitherto recognized as normal will need to be recategorized as nonperforming. If banks hope to keep their nonperforming loan (NPL) levels low, they'll need to significantly increase the pace of disposals.

Implementation of the new rules have been a long time coming. CBIRC originally circulated the measures for public comment back in April 2019 and decided to adopt them during an internal meeting in March 2020. However, that coincided with the spread of COVID-19 and it was increasingly clear that the virus posed a major threat to the economy. Rather than implement the new measures – which would put pressure on bank capital and profitability – regulators held off.

With China now having abandoned its zero-COVID policy, China's economy can return to normal – and these long-awaited measures can finally be implemented.

What's new?

There are three key changes to the way banks currently assess asset quality that we believe will have a significant impact on China's distressed debt market.

First, the new measures will greatly expand the range of bank assets that must be given a risk classification. Currently, all loans must be classed as being normal, special mention, substandard, doubtful, or loss. The last three are collectively considered to be nonperforming. In the future, banks will have to allocate all on-balance sheet and off-balance sheet financial assets that bear credit risk – including bond holdings and interbank lending – to the same five categories.

Second, traditionally some banks have kept their NPL levels low by not recognizing loans with sufficient collateral as nonperforming. The rationale was that if the full value of an overdue loan could be recouped from the sale of assets the borrower had put up as security, then there was no need to treat the loan as distressed.

That will no longer be tolerated. In future:

- Loans overdue by 90 days must be classified as special mention.
- Loans overdue by 270 days must be classed as substandard or doubtful.
- Loans overdue by more than 360 days must be recognized as loss.

Third, if more than 10% of a borrower's loans are nonperforming, then under the measures a bank must recognize all of its loans to that borrower as nonperforming. Moreover, if more than 20% of a borrower's total banks loans – from all banks – is overdue by more than 90 days, the banks should classify all the borrower's loans as being nonperforming.

Under the new measures, banks are required to update their loans' risk classification at least once a quarter. Although the rules take effect from July 1, banks have until the end of 2025 to reclassify existing financial assets.

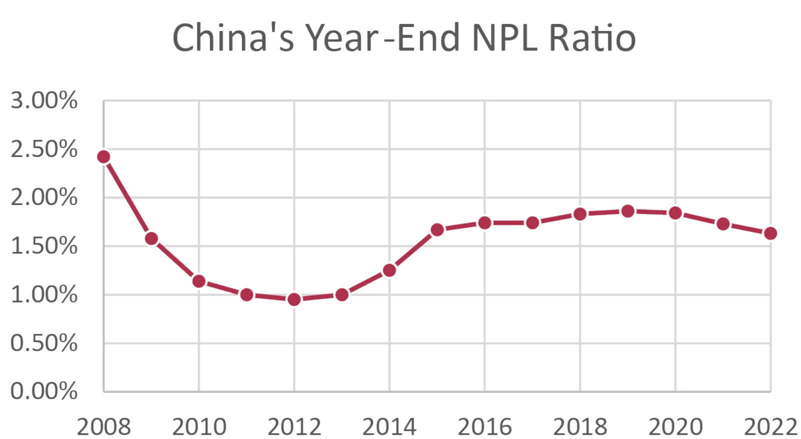
We believe the rules are already having an impact on banks' behavior. ShoreVest has seen a surge in NPL portfolios being disposed of by banks in Guangdong and other provinces this year. We suspect it might be an effort to get ahead of the new regulations**.**

To what extent will this result in an acceleration of disposals?

Recognizing more NPLs requires banks to raise more capital. Ideally, banks replenish their capital from retained earnings. However, failing that it falls upon the state – either through state-owned firms, local government financing vehicles, other financial institutions, or even local government finance bureaus – to recapitalize banks (the private sector hasn't played a meaningful role in banks' core tier 1 capital replenishment for at least five years).

We think it unlikely that regulators will push banks to disclose NPLs to a point at which the pressure on local governments to maintain banks' capital at adequate levels is unsustainable. Nonetheless, we expect loan disposals to increase significantly.

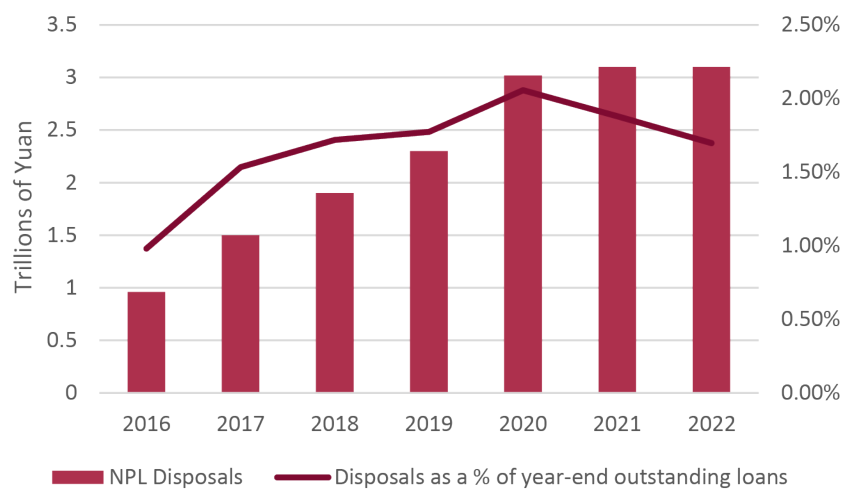
This is a uniquely opportune moment for regulators to call on banks to accelerate their recognition of nonperforming assets. The official NPL ratio for China's banking sector was 1.63% at the end of 2023, the lowest level since end-2014. China's banks can comfortably recognize marginally higher NPL ratios without it being too much of a burden.



Meanwhile, although banks' disposal of nonperforming assets is large in absolute terms, it's been gradually declining as a share of total outstanding loans.

In 2022, China's banks disposed of 3.1 trillion yuan worth of nonperforming assets, the same level as 2021, and up from 3.02 trillion yuan in 2020. While these volumes make clear that China is the largest NPL market in the world, 2022's figure represents only 1.70% of total outstanding loans at the end of the year, the lowest level since 2017.

Bank's annual disposals of nonperforming assets



Source: CBIRC

Banks accelerated their nonperforming asset disposals in 2020 as they rushed to become compliant with wealth management product (WMP) rules that took effect at end 2021. Banks had to move NPLs that had been packaged into WMPs back on their balance sheets, resulting in a surge of disposals. By 2022, the effects of the WMPs-related regulation were not so acute and disposals as a percentage of total loans declined. But the absolute volume has still persisted above 3 trillion yuan. Regardless of where future years stand as a percentage of overall loans, the new measures will undoubtedly generate a significant increase in the supply of distress assets.

Conclusion

We expect that both disposals and banks' recognition of NPLs will increase over the next couple of years, after which they'll likely remain at sustained, elevated levels. China's banks will need to work through large volumes of distressed debt for years to come.

Over the last couple of years, banks have exercised forbearance on overdue loans to small, private sector firms. However, with zero-COVID over, we expect forbearance policies will soon be phases out, which means overdue loans will have to be recognized as nonperforming. Moreover, the decline in housing sales is creating delinquent debtors among property developers. And weakening local government finances is making it more difficult for many local government financing vehicles – state firms used by local authorities to fund public works – to service their debt.

The new measures are designed to prevent banks from allowing bad loans to accumulate. The overall effect will be to further expand the supply of distressed debt, creating better opportunities and lower pricing for ShoreVest.

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