China Debt Dynamics

Stimulus? Not really; More of a Fine-Tuning Balancing Act…

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Recent "easing" is a counter-balance to the last two years of "tightening"
Against the backdrop of China's de-leveraging campaign, slowing economic growth, and the escalation of the trade dispute with the US, the recent initiatives by the PBOC and the CBIRC to inject liquidity into the banking system and loosen certain macroeconomic policies has been interpreted by many market commentators as the beginning of a stimulus campaign and a reversal of the deleveraging initiatives.

In this article, we clarify these initiatives, and market interpretation thereof, rather as a necessary counter-balance to the de-leveraging initiatives by replacing risky and unregulated liquidity (i.e., shadow banking) with proper, regulated liquidity. We believe all of the initiatives – both "tightening" and "easing" – are a synchronized, deliberate, and well-orchestrated process to deflate the credit excesses which will be administered for years to come given the size of the rebalancing that is necessary.

We believe the authorities are thoroughly committed to ridding the system of systemically-risky, "non-standard" credit and other untoward practices by banks to warehouse, or otherwise not report, NPLs. And nothing in the recent activities by the PBOC derails this directive. In fact, it is quite the opposite; these recent actions are entirely necessary and complementary and are wholly consistent with the de-leveraging and de-risking of the economy and the continued flow of non-performing loans (NPLs) into the marketplace.

China cannot simply and immediately eliminate the "shadow" credit and liquidity in the system without simultaneously replacing it with proper liquidity. It is a process; not an event. Otherwise there would be increased probability of "event risk" that could occur from a liquidity event in the banking system (e.g., a "Lehman event"); an outcome that none of us would welcome.

There is a sequencing element to this critical path. First establishing targeted regulations (last two years), then the enforcement of these regulations (last one year), then a tactical re-balancing as-and-when necessary (current).

As we have written multiple times, there have been several important regulations implemented in the last two years by the CBIRC to address the buildup of systemically-risky shadow credit and liquidity, including issuing Circular 46, creating a super-regulator and instituting penalties and fines for prohibited activities, cracking down on ill-conceived domestic RMB funding structures, and more recently, requiring that all loans past due greater than 90 days be accounted for as NPLs.

These initiatives have profound implications on bank capital, liquidity, and on overall credit creation and money supply as it requires significant restatements of credit exposures, and re-classification and disclosure of NPLs. Therefore, monetary and quantitative offsets are necessary to rebalance these effects and reduce the probability of a liquidity event in the banking system.

Let's review some of the "tightening" measures, and then the recent "easing" measures to put the process into context:

<u>THE "TIGHTENING":</u>

The "Tightening" – Circular 46
The CBIRC issued Circular 46 in April of 2017 and specifically listed over 50 prohibited accounting practices that the banks have been employing to warehouse problem credits and create a shadow system of interbank liquidity, whereby the banks were borrowing from each other and using illiquid loans (in many cases NPLs) as collateral, thereby increasing counterparty risk in a systemic way. We believe that these activities are more prominent among the joint-stock banks and second tier banks, with an estimated exposure of over $1 trillion. The CBIRC required audits of the banks throughout 2017, with the findings still being revealed as a matter of public record. See more here.

The "Tightening" – fines and penalties
Circular 46 required internal audits by the banks as well as on-site audits by the CBIRC. The results of these audits are still being made public with fines and penalties for infractions. There have already been over 3,000 fines and penalties on banks and financial institutions just since November 2017, including 477 so far in 2018 totalling RMB3.2 billion (US$491 million). We believe there are still more penalties to come given the significance of accounting breaches we believe have yet to be exposed and addressed by the CBIRC. These enforcement exercises are resulting in banks' behavior being more focused on restating exposures rather than being focused on new lending, at least partially exacerbating the reduced availability of funding in the economy.

The "Tightening" – "Disclose & Dispose" with stricter accounting requirements
As we wrote a month ago, we understand that the CBIRC recently put in place a requirement for banks to classify all loans that are past due greater than 90 days as NPLs. This will have negative implications for non-compliant banks, including lower net interest margins, lower Tier 1 ratios, and higher provision expenses. Recognizing this, and in a deliberate effort to encourage NPL recognition and sales, the CBIRC also put in place a framework to allow for reduced provisioning coverage ratios based on certain minimum targets surrounding NPL recognition, the pace of NPL disposals, and capital adequacy levels. This was an early example of regulators "easing" as a counter-balance to the negative effects of "tightening". See more here.

<u>THE "EASING":</u>

The "Easing" – recent actions to replace liquidity
More recently, the PBOC has focused on providing liquidity to the banking system in a deliberate fashion to offset the negative effects of the de-leveraging campaign, specifically targeting liquidity injections into the banking system, including three cuts to the Required Reserve Ratio (RRR), direct injections via the Medium-Term Lending Facility (MLF), and just last week announcing rules being placed on the opaque Wealth Management Product (WMP) industry which were less aggressive than anticipated by most.

The "Easing" – three RRR year-to-date, and more to come
As a result of the significant capital inflows into China post GFC, the central bank necessarily sterilized these inflows by requiring the banks to keep an increasing amount of the deposits on reserve at the central bank so that they could not be lent or otherwise invested into the economy at too-rapid of a pace. Even after the recent cuts, Chinese banks are required to hold 16% of their deposits on reserve at the central bank (14% for the smaller banks). This is known as the RRR.

The latest 50bp RRR cut on 24 June was the third cut this year, releasing RMB700 billion ($106 billion) in liquidity back onto bank balance sheets. The PBOC estimates that RMB500 billion will be freed up at the five state-owned banks and 12 joint-stock banks, and another RMB200 billion at the smaller provincial, state, and local banks.

The use of these proceeds, however, is unusually being state-directed to accelerate debt-for-equity swaps and increase lending to SMEs that is being crimped due to the clampdown on shadow banking. And the PBOC and CBIRC will use their quarterly Macro Prudential Assessment (MPA) to ensure funds end up in the intended areas, further highlighting their move to focus on enforcement of regulations.

Given the clampdown on shadow interbank liquidity and shadow lending, the RRR cuts are a necessary release of liquidity to offset the negative effects of the clampdown. We estimate over $1 trillion in mis-classified credit exposures (including warehousing of NPLs) and it is our opinion that there are many more RRR cuts to come as these exposures are re-classified more appropriately and assigned the proper risk-weighting and provisioning requirements.

For context, at 16% (larger banks) and 14% (smaller banks), China has by far the highest RRR in Asia. The next highest RRR in Asia is Indonesia at 6.5% RRR. The rest of Asia is at or near -0-%. Indeed, in the case of Japan and the Eurozone, not only is the RRR essentially 0%, but if a bank desires to place excess customer deposits on reserve at the central bank, it must pay an interest rate to do so (i.e., negative interest rates).

China's RRR was at 6% pre-crisis. For illustration, to move from the current 16/14% back to 6% (it will arguably be lower as interest rates become fully liberalized and the RMB becomes internationalized), would release $2.5-3 trillion back onto bank balance sheets to offset the removal of shadow interbank liquidity (approximately $1 trillion), buy Local Government issued bonds (i.e., about $2 trillion in "valid" municipal bonds), and participate in the continued issuance in the overall bond market. And, of course, to fund some level of direct lending as the shadow banking system is shrunk.

The "Easing" – MLF
Shortly after the RRR cuts, the PBOC also announced the injection of RMB502 billion ($74 billion) through the MLF with a one-year maturity. While this is the biggest injection since the MLF was introduced in 2014, it seems no coincidence to us that it matches the approximate amount of the RRR cut that was directed toward the debt-for equity swap program, thereby providing much needed liquidity that is unrestricted.

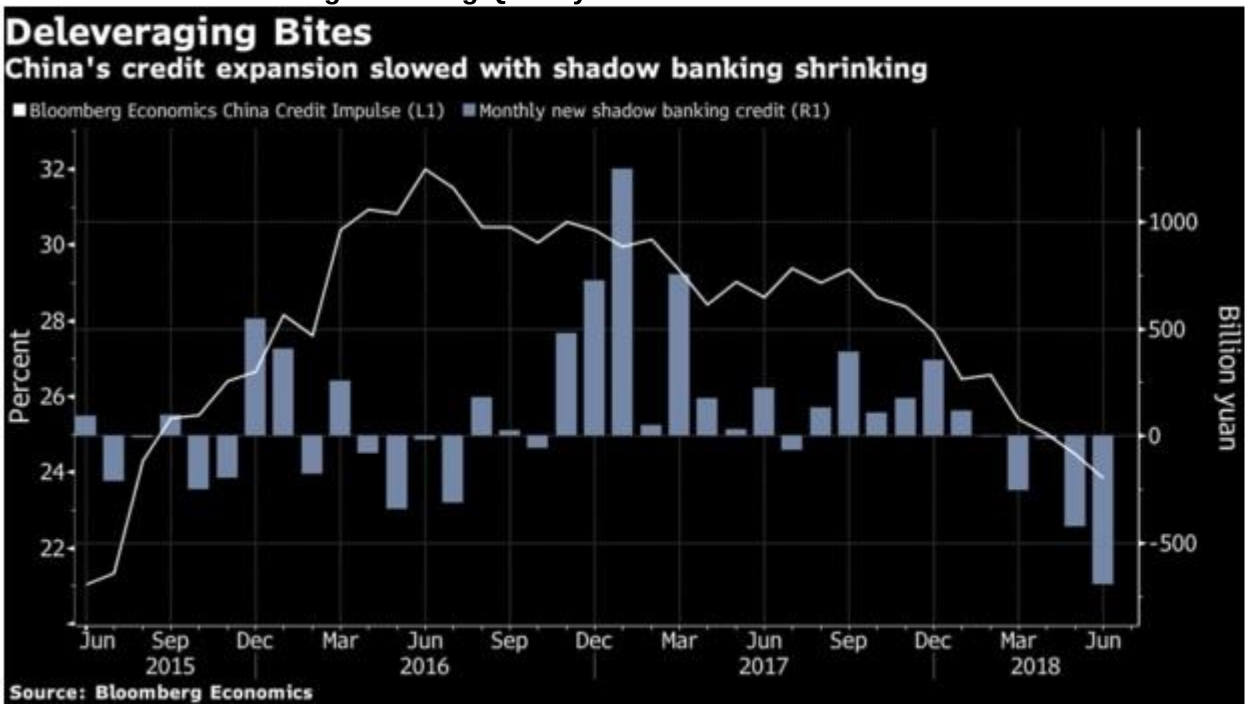
The "Easing" – softer WMP regulations
There was a fear among analysts and market commentators that WMP would be severely regulated, thereby cutting off funding for many "non-standard" credit projects. However, the 20 July update to WMPs was less stringent than feared. As an example, publicly sold products can be allowed to invest in non-standard credit assets (loans to riskier borrowers or projects), but must comply with limits on duration, asset size, and balance sheet allocation of the bank. But repurchases and implicit guarantees by the bank are no longer allowed as they were before, shifting the risk directly onto the investor in these products. We expect WMP regulations to tighten further going forward, but in the meantime, it appears the regulators are aware of the need to slowly regulate WMPs to reduce risk in an orderly fashion and not exacerbate the funding shock that has been occurring as a result of the clampdown on shadow banking.

<u>CONTEXT:</u>

The offset – shadow banking shrinking quickly, so counter-balances increasingly needed
As a result of Circular 46 enforcement, shadow banking has been declining on a monthly basis for the last four months, with the largest drop on record occurring in June, according to Bloomberg data (see Table 1 below). This highlights the delicate balancing act that the authorities are navigating. We believe this trend will continue as China continues to "de-leverage" and "de-risk" the economy, necessitating further RRR cuts, MLF injections, and other actions to counter-balance the deleveraging campaign. But

this is not a stimulus cycle at this point. Rather, this is a necessary filling of a funding and liquidity “vacuum” that is being created by de-leveraging and de-risking the economy.

Table 1: Shadow Banking Shrinking Quickly



DEAL SOURCING:

Sourcing – recent events ensure steady flows of NPLs into marketplace
By reducing systemic risk through the provision of liquidity into the banking system, regulators are ensuring a continued flow of NPLs off of banks’ balance sheets and into the marketplace while reducing systemic-event risk. We have seen no slowdown in the de-leveraging campaign, particularly the “disclose & dispose” framework constructed by regulators only a few months ago and being increasingly implemented to encourage banks to appropriately account for NPLs and remove them from their balance sheets. The recent counter-balancing actions by regulators is a necessary development to ensure an orderly and well-synchronized implementation of the de-leveraging campaign.

And given the sheer magnitude of the distressed debt in China (we estimate $3 trillion), further “easing” actions will be necessary over a prolonged period of time, primarily surrounding the provision of liquidity to the banking system, and should ensure a steady flow of NPLs off of banks’ balance sheets, reflecting the continued deleveraging of the economy. We at ShoreVest welcome these combined activities as it keeps the banks and the overall economy on a glide-path of deleveraging while reducing overall systemic risk.

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