China Debt Dynamics

What a Difference a Year Makes – *"de-risking"* as well as *"de-leveraging"*

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ShoreVest's Pipeline – 449 portfolios with $53.3 billion in asking price, and growing quickly

About a year ago, we wrote on whether now is the right time to invest in Chinese NPLs, and predicted that through additional measures by the Chinese government, we would see an increased flow of NPLs into the market place. In this issue, we provide a summary of key developments we've seen over the last year, all of which has culminated in a rapid growth of deal-flow into ShoreVest's pipeline of NPL portfolios.

ShoreVest's pipeline *is expanding at approximately $3-4 billion per month in asking price (which is at a meaningful discount to Original Principal Balance (OPB)), and is currently tracking* ***449 portfolios with an asking deal price of $53.3 billion.*** *This is up dramatically from 203 portfolios with an asking deal price of $18 billion only a year ago. Both the number of deals and the incremental size of deals are growing at an increasing pace. It is the right time to invest in Chinese NPLs.*

What a difference a year makes – President Xi's deliberate market infrastructure build-out

In the last year alone, a confluence of developments has combined to drive NPL deal flows. As we expected, and have written on multiple times, the **infrastructure to facilitate the transfer of NPLs into the overall marketplace has been - and continues to be – methodically built and sequenced in such a fashion so as to encourage "market-based" solutions.**

We believe it is a **well-orchestrated infrastructure intended to "de-risk" while at the same time "de-leverage" the economy** including, broadly:

- **Financial progress and reserve accumulation in order to mark-to-market NPLs and allow for market clearing prices;**
- **Expanding AMC conduits to facilitate NPL deal flow (Asset Management**

Companies – originally China's "bad banks" set up to manage NPLs, but now the "conduits" to distribute NPLs into the overall marketplace);

- **Conducive legal and regulatory framework to accelerate enforcement and "de-risk" economy**

FINANCIAL PROGRESS – continued provisioning and transfers to AMCs

- **Reserve Accumulation** – **In 2017 alone, banks took another $157 billion in provision expenses** and wrote-off $92 billion in NPLs, which resulted in an increase of $65 billion in loan loss reserves. **Loan loss reserves now stand at $469 billion. The banks have now taken in-excess of $725 billion in provision expenses in the last five years.** While we believe provisioning will remain high for the foreseeable future, this cumulative mark-to-market of NPLs now allows for clearing prices such that banks can sell NPLs more easily into the marketplace;

- **Transfers to AMCs** – after transferring $77 billion of NPLs to AMCs in 2016, market estimates are that **another $83 billion of NPLs were transferred in 2017** (*source: Deutsche Bank*). And through our discussions with the management of AMCs, this number should be higher yet again in 2018. For context, according to UBS Research and Deutsche Bank Research, **over the last five years 2013-2017 there has been approximately $333 billion in NPL transfers to AMCs**.

CONDUITS ESTABLISHED – AMCs are the "plumbing" for NPL disposals into the marketplace

- **AMCs' conduit role** – The AMCs do not have unlimited capital, and therefore have regulatory- and management-imposed quotas and targets for both the *purchase* of NPLs from banks, and for the *distribution* of these NPLs into the marketplace, which then allows for further purchases again. Of course AMCs also retain and work-out some level of NPLs, but this flow-based, "conduit" role by the AMCs is necessary given the sheer magnitude of NPLs. It ensures a steady flow of NPLs to end-buyers such as ShoreVest;

- **AMCs are increasing in number –** To continue to establish this network of conduits, there is an increased pace of establishing more provincial level and local AMCs. **There are now 174 AMCs (53 local) as compared to 156 AMCs (35 local) a year ago, an increase of 18 in only one year** (*source: Deutsche Bank*).

POLITICAL SUPPORT FOR REFORM – President Xi's reform initiatives achieving better structure

- **Unlimited Presidential Tenure** – While some market commentators have expressed concern over the removal of the two-term limit (each 5 years) for the presidency, we view the removal of tenure constraints as positive for the foreseeable future, given the **time needed to continue to develop market-based reforms to ensure de-risking and de-leveraging the financial system appropriately.**

- **Super-regulator established** – As of November 2017, the State Council of the Financial Stability and Development Committee (FSDC) now sits above and coordinates the four (now three; see below) financial regulators, and is **led by the**

newly named Vice Premier, Liu He, and oversees RMB388 trillion (US$61 trillion) in total financial assets;

- **PBOC gets enhanced power** – in addition to setting monetary policy, the People's Bank of China **(PBOC) will now be the lawmaker for both the banking and insurance sectors** (previously the responsibility of the China Banking Regulatory Commission (CBRC) and the China Insurance Regulatory Commission (CIRC) separately), and is also headed by Vice Premier Liu, who is known as a reformist and sees the credit-driven economic growth model as unsustainable and risky;

- **Regulatory merger of CBRC and CIRC into the CIRBC** – China also announced last week the merger between the CBRC and the CIRC into the CBIRC (China Banking Insurance Regulatory Commission). It will oversee insurance assets of RMB19 trillion (US$3 trillion) and banking assets of RMB311 trillion (US$49 trillion), according to Deutsche Bank estimates. **The CBIRC's new head is the former head of the CBRC, Guo Shuqing. As we wrote last year, the appointment of Mr. Guo as head of the CBRC in February 2017 was a clear sign of the Chinese authorities' intent on accelerating NPL resolutions and unwinding excess debt in the economy.** Mr. Guo is another reform-driven leader, reflecting President Xi's intent.

CONDUCIVE LEGAL/REGULATORY FRAMEWORK

- **Regulatory Push** – Mr. Guo didn't waste any time when he took the helm of the CBRC, quickly issuing "**Circular 46" in April 2017 (**see our prior CDD issue on the topic**), which accelerates enforcement on prohibited accounting practices that banks use to hide NPLs, and institutes fines** for infractions as a matter of public record;

- **Fines and penalties accelerating** – as we recently wrote regarding the highly publicized fines and public criticism of Shanghai Pudong Development Bank by the CBRC, the regulator is serious about addressing prohibited accounting practices and concealment of NPLs, and there are likely many more fines to follow. That's exactly what is happening. As a result of findings from Circular 46 audits performed on the banking sector, in the **fourth quarter of 2017 alone, the CBRC levied 2,451 fines totaling RMB2.7 billion (US$427 million). And in only the first two months of 2018, there have already been 497 fines levied totaling RMB1.0 billion (US$160 million).** In our view, there are still more to come, and it is one of the drivers of the accelerated flow of NPL portfolios into our pipeline as banks strive to remedy Circular 46 infractions that are used to warehouse NPLs.

- **Crackdown on leveraged conglomerates** – consistent with an approach of "de-risking" in unison with "de-leveraging", authorities have implemented a crackdown on leveraged conglomerates, including "encouraging" asset sales by HNA and more recently the government takeover of the Anbang Insurance conglomerate. Anbang's 2017 accounts are not yet disclosed, but even in 2016, liabilities had almost doubled year-on-year to RMB1.4 trillion (US$228 billion). **We view the government takeover of Anbang very positively, and as a good example of the government stepping-in to keep stability when a financial group is taking undue risk which could lead to a build-up in systemic risk (as opposed to allowing a Lehman-like failure event).** This reflects the authorities' commitment to managing financial risk in a prudent fashion.

- **<u>Courts continue to implement new rules on enforcement</u>** – As we discussed in a 2017 CDD issue, in the beginning of 2017, China implemented new rules on court enforcement of NPLs, requiring additional transparency and speed. We have seen a growing number of courts implementing these new rules.

On the back of these initiatives, there are increasingly-willing sellers of these exposures (and of NPLs overall), and we fully expect this flow to accelerate further in 2018. ShoreVest is well positioned to play an active role as a solution provider in the context of these necessary reforms initiatives.

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