The Economist

Special report: Finance in China

Banks

Breaking bad

With dud loans much higher than reported, banks must brace for trouble

May 7th 2016 | From the print edition

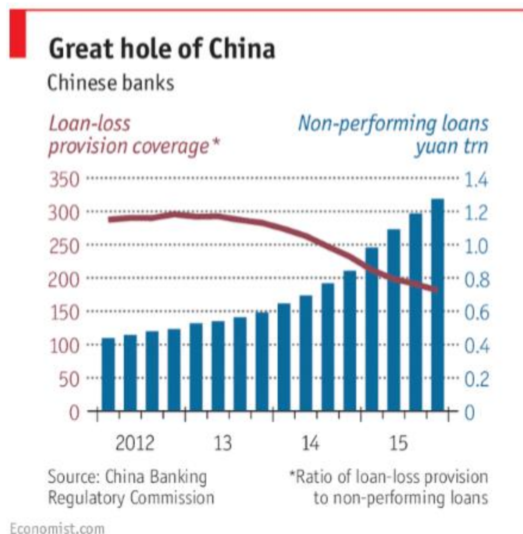
THE VIDEO PANS from the empty lot outside the factory to the interior, where metal parts lie in a heap, detritus of a bankrupt steel company. Playing cards litter the ground. Over the desolate scene, soft piano music plays and a narrator describes the floor plan and location: “An exceptionally good choice to set up an office.”

It is an advertisement of sorts. The factory was collateral on a loan made to Hanquan, a steel company that went bust. A court in Tianjin, the northern city that was home to Hanquan, is auctioning it off on a local bank's behalf. As defaults go, it was not a particularly big one; the asking price for the property is 77.6m yuan ($12m). But just two years earlier the government had praised Hanquan as a pillar of its industrial zone. Then a nationwide construction slowdown did for the company, and its loan soured.

For China’s banks, this is a small pointer to a much bigger concern. Non-performing loans (NPLs)—those which borrowers cannot repay—have reached a total of 1.3 trillion yuan, doubling in just two years (see chart). Even so, official data show that dud loans amount to only 1.7% of total loans, well within accepted safety margins. The problem, a familiar one in China, is that no one much believes these figures. How lenders deal with the bad debt piling up on their books is the most urgent question hanging over Chinese banks. If this is mishandled, the country’s hard-earned financial stability could evaporate.

Dodgier than it looks

There is plenty of evidence that bad loans are higher than the banks have disclosed, probably much higher. Alongside the steep rise in NPLs, there has been an even larger increase in “special-mention loans”, which in theory are still good but not cast-iron. Added together, NPLs and special-mention loans already make up 5.5% of the banks’ loans. At a recent conference in Shanghai an investor with Oriental Asset Management, a distressed-debt buyer, said the NPL ratio at smaller banks was as high as 10%. That might have shocked the crowd a few years earlier, but on this occasion it barely raised an eyebrow.



Given China's explosive lending growth since the global financial crisis of 2008, this outcome was drearily predictable. The economy's debt load has more than tripled over the past seven years. It is implausible that so much credit could have been prudently allocated in such a short time; large amounts were bound to be wasted or stolen.

What happens now is far from clear. Bad loans, even lots of them, do not automatically translate into a crisis, especially not in a country where the government has so much control. In normal markets banks might slow their lending; in China the government directs banks to continue lending and provides them with the liquidity to do so. This gives it flexibility to solve the problems, but does not magically make them disappear.

Broadly speaking, China has three options for tackling its banks' NPLs. The first and most seductive choice is to suppress the bad news. This is the most damaging in the long term, but it has been China's default mode for the past five years. Methods include booking loans as investments or classifying them as "overdue but not impaired" for months on end. The most widespread practice—and one not confined to China—is to refinance bad loans with new ones in the faint hope that business might improve. If it does not, this "extend-and-pretend" banking only makes the debt burden worse.

China is nearing this point. Interest payments swallowed about two-fifths of all new credit issued in the past three years. In 2014 some 16% of China's 1,000 biggest companies owed more in interest than they earned before tax, according to *The Economist*'s analysis of S&P Global Market Intelligence data. Bad debt, though superficially contained, is thus becoming a millstone around the economy's neck. Less credit is going to good firms for productive uses, clogging the gears of growth.

The second option is to clean up the bad loans, with the government taking charge and spreading the cost around. Many investors think China will eventually adopt this solution, as past form suggests. In the late 1990s two-fifths of loans in China had gone bad and banks were technically bust. The finance ministry pumped fresh capital into the banks, which carved off large chunks of their dud loans and sold them at par to "bad banks". The effect was salubrious, freeing the banks to resume lending and preparing them for stockmarket listings.

China is trying something similar now, though only in part. In the past two years the government has handed licences to more than 20 new regional bad banks. It has also orchestrated a swap whereby banks will exchange up to 15 trillion yuan of high-yielding local-government loans, many of which might have gone bad, for low-yielding, safe bonds.

However, a full-blown bail-out would be more damaging this time. To fund the rescue 15 years ago the government imposed a hidden tax on households, pushing deposits into banks at artificially low interest rates. That held back consumption. Roaring growth acted as a palliative, boosting incomes and shrinking the relative size of bad debts.

Today the trade-offs would be starker. A tax, hidden or not, to fund the bail-out would set back China's efforts to encourage consumption. It could monetise the costs, but that would add to capital-outflow pressures, which it has been trying to resist. Moreover, a second big rescue within two decades would make it harder for China to modernise its banks, leaving them reliant on the state. "If things go really bad, we can do it again. But we want to avoid it," says Li Daokui, a former central-bank adviser.

A third option is for banks to recognise the bad loans on their books and replenish their capital themselves. This would be best for China's long-term development, even if it hurt to begin with.

Some quiet progress has been made. The Tianjin auction of the loan to Hanquan, the bankrupt steel company, is one of many that banks have attempted over the past year. Some have started bundling NPLs into securities to speed up their disposal. The government is also encouraging banks to convert bad debt into equity in their troubled borrowers.

Benjamin Fanger of Shoreline Capital, a fund company that invests in Chinese distressed debt, has been through this before. He set up his firm in 2004 when assets from the previous credit blow-up were just going on the market. Despite all the worries about the economy now, he thinks the bad assets tell a different story. "Last time the debt was garbage," he says. "Now it's companies with real business." Loans are better secured, collateral is worth more and the financial ecosystem—banks, courts and investors—is more developed, if not quite mature yet.

Encouraging though that is, most NPLs sold so far consist of loans to private enterprises. Yet the biggest share of bank lending—nearly 50%—goes to state firms, and banks are more likely to roll these over than push them into default. Besides, the final tally of NPLs is sure to exceed investors' appetite. Huarong, the largest of China's bad banks, has publicly called for cheap funding from the government to help it digest the distressed debt coming its way.

To prepare for write-offs, banks have been raising equity; their loss-absorbing capital is about 11% of assets. But the pressure on them is increasing. Their cash set aside to cover impairments fell from nearly three times their NPLs in 2013 to less than double last year—and that was based on the artificially low official NPL level, not the real one. In short, there is no easy way out for China's banks. Sooner or later they will need to take big losses, and the government will have to help repair the damage.

Degrees of pain

How bad will things get? Some expect little short of Armageddon. Kyle Bass, founder of Hayman Capital, a hedge fund, made headlines this year with his estimate that China would need $10 trillion—almost 100% of its current GDP—to recapitalise its banks. Implicit in this doomsday prediction is the view that NPLs are gargantuan: some think that, as in the 1990s, nearly half of all loans will go into default.

But that is an extreme assumption. A more realistic assessment is that half of banks' assets—their reserves at the central bank, government bonds, loans to the biggest state firms and liquid money-market funds—are lower-risk. The fact that banks are already disposing of bad loans shows that China is further ahead than in the late 1990s. And thanks to a national savings rate of nearly 50%, banks still have a strong funding backstop from plentiful deposits. That gives them time to deal with their problems—a luxury they need to use well.

Analysts at China International Capital Corp, a local investment bank, predict that the worst outcome would be bad loans of $1.5 trillion—still a lot, though an order of magnitude smaller than the ultra-bearish view. But as David Cui at Bank of America Merrill Lynch argues, specific estimates are beside the point. Investors have little faith in China's banks, pricing their stocks at a 30% discount to the stated value of their assets. The government, Mr Cui reckons, must recapitalise them on a scale to win over investors; the exact size will, in effect, be determined by the market's reaction.

As though this were not difficult enough, Chinese banking is getting more competitive. The "big four" banks' share of sectoral assets has fallen from 54% a decade ago to less than 40% today as smaller institutions nip at their heels. For many years the central bank enforced a spread

between lending and deposit rates that provided banks with a handsome guaranteed profit. Last year it liberalised interest rates. It is phasing in deregulation to give the banks time, but the trend is clear: interest margins, which five years ago were about 3%, are heading towards 2%. At the same time the government has allowed several private companies, including deep-pocketed tech giants such as Tencent, to establish banks. For now they are constrained by regulations, but hope soon to join battle with lumbering state-run ones.

All this is putting Chinese banks under pressure to find new ways to generate profits. On balance this ought to be a good thing, nudging them to lend to private companies and consumers who are willing to borrow at higher interest rates than state firms. It is also forcing them to improve their services to attract more customers.

At the headquarters of Shanghai Rural Commercial Bank (SRCB), which despite its sleepy-sounding name is one of China's 30 biggest lenders, with some 600 billion yuan in assets, employees are drawing up plans to expand the banks' offerings. Some branches now stay open until 8pm to cater to people who work late. But the quest for profit is also pushing banks to take on new risks. Xu Li, the SRCB's president, says one idea is to make better use of its balance-sheet—code for investing more aggressively. "Before, we mainly invested in government bonds. Now we want to get into corporate bonds in a big way," he adds.

Many smaller banks are racing to expand, using volume to make up for thin margins. Whereas the assets of big national banks grew by 10% last year, those of city-focused banks increased by 25%. Risks could ripple through the sector. Smaller banks have started to turn to the interbank market for funding if they cannot get it from deposits, and big banks often end up providing it. "Interconnectedness among banks is increasing," says Frank Wu of Moody's, a rating agency.

Regulators are still trying to swaddle the banks, forcing them to keep plenty of cash in their vaults and limiting their loans to weak industrial sectors. Yet banks are straining to break free. They have devised a mixture of off-balance-sheet solutions to get around the rules. The products are not as complex as the subprime debt securities in America that sparked the financial crisis in 2008, yet there is much toxic bilge swirling around China's banks. And as global investors learned almost a decade ago, what lurks in the shadows can come back to haunt them.

This article has been corrected for an error that appeared in the print edition, where we stated that Agricultural Bank of China had lent money to Hanquan, a steel company. We were wrong: Hanquan borrowed from other banks, not Agbank. Sorry.

From the print edition: Special report

Source: http://www.economist.com/news/special-report/21697979-dud-loans-much-higher-reported-banks-must-brace-trouble-breaking-bad