China Debt Dynamics

CBRC Stepping-Up Enforcement on Prohibited Accounting Practices

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CBRC stepping up enforcement:

As one of key topics we highlighted in our inaugural China Debt Dynamics "Why Now is the Optimal Time to Invest in NPLs", dated 1 March 2017, we believe the recent appointment of Mr. Guo Shuqing as the new head of the China Banking Regulatory Commission (CBRC) was a clear sign of the **Chinese authorities' intent on accelerating NPL resolutions and unwinding excess debt** in the economy.

Mr. Guo hasn't wasted any time since his 24 February 2017 appointment. In "Circular 46" issued on 10 April 2017, the**CBRC has stepped-up its enforcement of prohibited accounting practices** that banks have been employing to understate credit exposures and/or warehouse problem loans -- particularly regarding interbank exposures and wealth management products (WMPs) -- culminating in what we believe will be an **increased flow of NPL portfolio sales as we progress through 2017.**

CBRC Notice contains four new developments:

While these practices have been banned for a while now, the CBRC Circular stated four key pieces of new information:

- **Details** – the notice listed out numerous specific examples of prohibited practices in a highly-detailed fashion (see Exhibits 1-3 below);
- **Examinations** – CBRC is requiring the banks to conduct internal self-audits, reporting back to them **by 12 June 2017**;
- **Enforcement** – in parallel with internal self-audits, the CBRC is launching extensive on-site examinations, and will require that the banks re-classify any mis-classifications of credit exposures by **30 November 2017**;
- **Penalties** – CBRC has already, and will continue to institute penalties for non-compliance, and is disclosing these as a matter of public record. As an example, there were **25 penalties issued on 29 March totaling Rmb43.1mn.**

We believe there are five meaningful impacts from this CBRC initiative:

1. **Increased recognition/sales of NPL**

To the extent these prohibited accounting measures have been used to warehouse problem loans, any required re-classifications back as more appropriate loan exposures on balance sheets should result in higher recognition of non-performing loans (NPLs). In anticipation of this, and on the back of internal audits now underway, **we fully expect banks to be increasingly-willing sellers of these exposures before the 30 November 2017 CBRC deadline** in order to reduce the "reporting risk" of disclosing higher NPLs on their balance sheets.

Importantly, we at ShoreVest have long-been on top of these creative accounting techniques, with granular estimates at the individual bank level, and have been anticipating such a move by the CBRC. In fact, **almost one year ago we began developing (and have continued to update) a detailed, institutionalized, predictive-sourcing database on the back of irregular accounting practices, which allows us to predict and act quickly on this CBRC initiative**. Indeed, we have already been actively sourcing NPLs from banks ahead of these measures by providing solutions for individual banks through purchasing NPLs that have yet to be recognized on their balance sheet.

2. **Lower Capital Ratios**

One of the accounting benefits of these prohibited practices was achieving lower risk weightings on credit exposures for the purposes of calculating regulatory capital ratios, thereby **increasing Tier 1 ratios**.

As an example, by reclassifying a loan (high risk-weight, say 75-100%) as an interbank asset (low risk-weight at only 20%) through creative accounting structures, banks were able to achieve a lower level of risk-weighted assets (RWAs), and therefore report higher capital ratios. In the case of WMPs (or "Non-Standard Credit Assets" NSCAs), many loan exposures were completely removed from balance sheets altogether, completely removing those RWAs.

By re-classifying back from low risk-weighted assets (e.g., interbank assets) into higher risk-weighted assets (e.g., loans or NPLs), RWAs will rise **causing regulatory capital ratios to decline**.

Again, this process may **prompt bank managements to consider simply selling these portfolios** rather than re-classifying them into higher risk-weighted categories and thereby reporting lower capital ratios. Granted, this may cause them to take increased provision expenses (and therefore lower profits) to write-down portfolios for sale, but reporting a lower profit is arguably more palatable than reporting a lower capital ratio -- especially given that balance sheet strength is more highly valued in the current environment than is profitability, in our view.

3. **Lower Liquidity Ratios/Higher Funding Cost**

Similarly, by requiring certain loan exposures be brought back onto bank balance sheets, or by re-classifying from what was considered a liquid asset (e.g., interbank) into an illiquid asset (e.g., loans), **liquidity ratios will deteriorate**.

Importantly, **it is our understanding that many of these structures were used to *create* liquidity** among banks, particularly among the second-tier and smaller banks which have a higher reliance on the interbank activities that are under scrutiny by the CBRC. By unwinding these structures, these banks are likely to face liquidity pressures and therefore higher funding costs on their deposit franchises. Therefore, **in coordination with the CBRC examinations, we expect the PBoC to employ various market intervention activities in coming months to ease funding pressures in the interbank market** in order to prevent extreme volatility or even a negative liquidity event.

4. **Better Transparency**

There are several key positives from this CBRC initiative. Through unwinding these irregular accounting and structuring practices - particularly the opaque disclosures on NSCAs, off-balance sheet WMPs, and certain interbank assets – bank balance sheets will be more transparent and comparable for investors. And perhaps more importantly, counterparty risk within the banking system will be more able to be properly assessed. **The result is a far more transparent banking system where risks will be more measurable and able to be appropriately priced.**

5. **Reduced System Leverage/Better Capital Allocation**

We believe this Circular is yet another example of the Chinese regulators' concerted efforts to work collaboratively to reduce system leverage and reign-in excessive credit growth that has been occurring through non-traditional avenues. While this may result in slower credit growth overall (and therefore lower GDP growth), it will also result in a better capital allocation toward more sustainable, productive GDP growth in the longer term.

We point out that while we view reduced system leverage as a necessary (and positive) development, from a public markets perspective it is likely to withdraw liquidity and result in a sell-off in both equities and bonds. This is already happening, particularly regarding WMP activities, as banks cut back on issuance of these products during their internal audit phase required by Circular 46. This is likely to accelerate in coming months as internal audits are implemented and banks work towards meeting the CBRC enforcement deadline of 30 November 2017.

It is also probable that by reducing non-traditional sources of leverage, any previous mis-allocations of credit will be exposed, thereby producing yet **another catalyst for the emergence of NPLs**.

Again, ShoreVest is well-positioned to efficiently source NPL portfolio deals on the back of our predictive-sourcing database, having already identified and quantified those banks that are most likely to be affected by this Circular.

Exhibit 1 Details of prohibited activities under "Regulatory Arbitrage"

Sub-Category	Metric	#	Activity
Arbitrage via regulatory metrics evasion	Credit Risk	1	Transferring NPL off balance sheet via asset management plans
		2	Falsify NPL and coverage data via adjustment of loan category
		3	Insufficient collateral
		4	NSCA as % of WMP exceeding requirement
		5	Interbank funding higher than 1/3 of total liabilities
	Capital adequacy	1	Insufficient risk weighting in interbank, discounted bills, WMP in accordance with underlying assets
		2	Transferring financial assets off balance sheet via repurchase agreement
		3	Insufficient risk weighting for sale of interbank discounted bills
		4	Lower risk weighted asset consumption via purchase and resale of discounted bills at separate occasions
		5	Transform discounted bills into asset management plan via third party, with lower risk weighting
		6	Transfer higher risk weighting interbank assets to PBOC at period end, and adjust risk weighting artificially
		7	Categorize non-eligible companies as small and micro enterprises to lower risk weighting assets
	Liquidity Risk	1	Artificially boost loan and deposit base via issuing discounted bills to increase deposit base
		2	Transfer interbank deposits to be regular deposits
		3	Assist other banks to transfer interbank deposits to be regular deposits
		4	Irregular WMP business with funding pool, duration mismatch, separate pricing, etc
		5	Account NSCA as standard assets
		6	Transfer WMP funds to be regular deposits
	Other	1	Cross-trading of WMP and proprietary business to avoid loan quota or lower RWA
		2	Hide credit scale by conducting irregular interbank discounted bills
		3	Account NSCA in off BS WMP as standard assets
		4	Adjust Credit amount via "Outright sale + purchase and resale + outright purchase upon maturity", "false outright purchase, false outright sale"
		5	Artificially boost fee income by misrepresentation of business type
		6	Multiple account opening, borrowing and cross guarantee to evade customer concentration requirement
		7	Adjust net profit via reclassification of bond investment, inaccurate evaluation of bond value, insufficient provision
		8	Purchase WMP via banks' own funds
Arbitrage via regulatory policy evasion	Macro policy	1	Loans to property, high pollution, high energy consumption and over capacity industries
		2	Lend to property, high pollution, high energy consumption and over capacity industries via interbank, WMP or small amount loans
		3	Lend to zombie companies, high-pollution and non-viable companies via interbank NSCA and WMP
		4	Enlarging government debt via industrial funds and entrusted loans, or investing in NSCA via industrial funds, in violation of new Budget Low and State Council's requirement on local government debt
		5	Loans lent to invest in equity or WMP
		6	Categorize non-eligible companies as small and micro enterprises to meet MSE loan targets
	Risk manageme nt policy	1	Relaxing credit lending standards
		2	Relaxing settlement management of letter of credit
		3	Mismatch letter of credit with business demand
		4	Repo business for three parties or above
		5	Repo business for non-eligible financial assets
		6	Provide credit financing via NSCA within interbank assets or WMP
		7	Bank-led trust projects with implicit repo agreement with trust companies
	Unfair competitio n	1	Lending business based on false contracts / invoice / receipts
		2	Working capital loans for companies not qualified for fixed asset loan standards
		3	Sign debt-offset contract with corporate to provide corporate benefits in accounting treatments
		4	Work with agencies to conduct discounted bill business without actual trade background
		5	Provide channels for other banks to hide credit assets via discounted bills
		6	Under-the-table agreement to provide guarantees for non-principal guaranteed WMPs
		7	Delegate bill business to third party non-financial institutions
	Increase corporate funding costs	1	Compulsory terms turning part of loans into deposits
		2	Deposits as precondition for loan approvals
		3	Unfair fee charges
		4	Separate part of interest income to be fee income in order to charge higher de facto interest rates
		5	Compulsory sale of other financial products upon issuing loans
		6	Float up loan yields to maximum limit across all types
		7	Transfer operating expenses to customers
		8	Charge commitment fees or fund management fees from MSEs
		9	Charge higher than necessary financial advisory fees from MSEs
		10	Whether the bank bears collateral registration fees

Source: Sohu Finance;
Morgan Stanley Research "CBRC launches compresensive examination of interbank and WMP risk management", Richard Xu, 11 April 2017.

Exhibit 2: Details of prohibited activities under "Idle Funds Arbitrage" (i.e. funds not used to support real economy)

Sub-category		Irregular practice
Loan	1	Complicate financing process for corporates in order to enlarge deposit base and fee income
	2	Swap on and off balance sheet credit assets with other banks, in order to facilitate corporates to borrow new loans to repay old loans
	3	Mis-use loans to invest in entrusted loans, WMP, trusts and securities market
	4	Irregular bridge loans for underground lending
Discounted Bills	1	Discounted bills without actual trades repeatedly to falsify higher deposit base and fee income
	2	Evade credit quota via "outright sale + purchase and resale + outright purchase upon maturity" of discounted bills
	3	Invest in discounted bills via WMP in cooperation with trusts' /brokers' channel business
	4	Interbank discounted bills without face-to-face signing, actual bills, funds or endorsement
	5	Discounted bills without actual trades or risk exposure at clients' requests
WMP	1	Purchase WMP via WMP
	2	Non-bank FIs increase leverage, duration and risks via bank entrusted funds
	3	Supporting regulatory arbitrage with WMP
	4	Purchase the banks' own CD with interbank WMP
Interbank	1	Increase interbank assets via interbank placement and repo, then invest in WMP or asset management plans
	2	Provide channels for other banks via interbank investment
	3	Falsely increase balance sheet, reduce risk weighting and covers up risks via interbank
	4	Issue excessive CDs to engage in interbank WMP investment, entrusted funds investment, bond investment, leading to duration mismatch and liquidity risks

Source: Sohu Finance

Exhibit 3: Details of prohibited activities under "Connected Party Arbitrage"

Sub-category	Irregular practice
Lending, transfer assets or other services with connected parties	Lower pricing, subsidize loan yield, or other preferred treatment
	Written or implicit guarantees for connected parties' financing
	Provide credit via other banks, trusts or brokers to connected parties
	Transfer credit assets via funds or JV's set up by connected parties
Evade concentration limit for connected parties	Cover up or inadequate due diligence on relationship of connected parties
	Not fully reflecting risk exposure
Ownership	Ownership in the bank or change of ownership of above 5% via hiding connections, transfer holding, etc
	Deliberate low priding to provide benefits for connected parties or management in equity placements, strategic investments, employee shareholding or stock incentives.
	Accept the bank's own shares as collateral
	Deliberate high collateral ratio when shareholders use the bank's own shares as collateral in obtaining financing; Connected subsidiaries hold bank shares while the bank provides financing
Consolidation	Avoid capital or risk weighting requirement by not consolidate controlled entities via WMP, interbank or complicated structures.
	Transfer assets to affiliated entities to adjust business scale, NPL, reserve and capital metrics
	Invest in restricted areas (such as non-listed companies' equity, property, LGFV) via on and offshore subsidiaries
	Unfair benefits provided to connected customers via bank's group subsidiaries, especially trusts, financial leasing, securities, insurance and asset management companies
	Financial invest in Chinese property companies' bond via QDII

Source: Sohu Finance; Morgan Stanley Research,
"CBRC launches compresensive examination of interbank and WMP risk management", Richard Xu, 11 April 2017.

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