South China Morning Post 南華早報

China has a bold plan to tackle bad bank loans and its first deadline is closer than you think

PUBLISHED : Friday, 02 June, 2017, 8:31am
UPDATED : Friday, 02 June, 2017, 10:35pm
Business
OPINION

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Chinese banks face a crucial first deadline on June 12, when they are required to report the results of an internal self-audit to the CBRC

Chinese authorities continue to get more serious in addressing unproductive debt in the economy and banks' understatement of bad debts.

The recent appointment of Guo Shuqing as the new head of the China Banking Regulatory Commission (CBRC) is a clear sign of Beijing's intent on accelerating non-performing loan (NPL) resolutions and unwinding excess debt.

Guo hasn't wasted any time. In Circular 46 issued last month, the CBRC stepped-up its enforcement of prohibited accounting practises that banks have been employing to understate credit exposures and warehouse problem loans, particularly regarding interbank exposures and wealth management products (WMPs), culminating in what we believe will be an increased flow of NPL sales throughout 2017.

While these practises have been banned for a while, this Circular stated four key pieces of new information.

Details – The notice listed numerous specific examples of prohibited practises in a highly-detailed fashion for the first time.

Examinations - The CBRC is requiring banks to conduct internal self-audits, reporting back by June 12 on areas of infraction.

Enforcement - In parallel with internal self-audits, the CBRC is doing extensive on-site examinations, and will require banks to reclassify any misclassifications of credit exposures by November 30.

Penalties – The CBRC will continue to institute penalties for non-compliance and disclose these as a matter of public record. As an example, there were 25 penalties issued on March 29 totaling 43.1 million yuan (US$6.33 million).

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

Firstly, increased recognition and sales of NPLs. To the extent these prohibited measures have been used to warehouse problem loans, any required re-classifications back as more appropriate loan exposures should result in higher NPLs. In anticipation of this, and on the back of internal audits now underway, we expect banks to be willing sellers of these exposures before the November 30 deadline. We are already witnessing increased sales of NPL portfolios.

China Banking Regulatory Commission chairman Guo Shuqing. Photo: Simon Song

Secondly, another accounting benefit is achieving lower risk weightings on credit exposures for the purposes of calculating regulatory capital ratios, thereby increasing the reported ratios and appearing to have better balance sheet strength. Regulators require minimum capital ratios, which take into account the “riskiness” of their assets. By classifying exposures as “less risky”, banks can show a better regulatory capital ratio, and appear to have better capital strength. Many of these practises are now explicitly prohibited under Circular 46.

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

Under Circular 46, 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 banks to consider simply selling these portfolios rather than re-classifying them into higher risk-weighted categories and thereby reporting lower capital ratios – in some cases breaching regulatory minimums.


Chinese banks are likely to active in restructuring or unwinding non-performing loans this year. Photo: AP

Granted, this may cause them to take increased provision expenses to write-down bad loans, but reporting lower profit is arguably more palatable than reporting lower capital ratios -- especially given that balance sheet strength is more highly valued in the current environment than is profitability.

Thirdly, by requiring certain loan exposures be brought back onto 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 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 deposits. 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.

Fourthly, by unwinding these irregular accounting and structuring practises - particularly the opaque disclosures of off-balance sheet WMPs and certain interbank assets – bank balance sheets will be more transparent. 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.

Fifthly, 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. While this may result in slower credit growth overall (and therefore lower GDP growth), it will also result in better capital allocation toward more sustainable, productive GDP growth in the longer term.

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 concluded and banks work toward meeting the CBRC enforcement deadline.

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