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China crackdown on bad debt forces wave of loans on the market

Banks under pressure offload portfolios just as liquidity tightens

Don Weinland in Hong Kong AUGUST 1, 2018

A tightening of credit and a crackdown on bad debt at banks in China has led to a flood of non-performing loans hitting the market at increasingly low prices.

The supply of bad debt in China, estimated at $3tn last year, is expected to grow significantly in 2018, as regulators force banks to deal with bad assets after years of unbridled lending.

Insiders struggle to quantify the volume of increase in loans on offer for this opaque market. However, James Feng, founding partner at Beijing-based Poseidon Capital Group, suggested the increased supply has meant debt in China's Pearl and Yangtze river deltas that would have sold for 60-70 cents on the dollar at the end of last year might now sell for 40-50 cents.

"There is a lot of pressure to recognise NPLs and that means there are a lot of loans on offer right now," said David Mahon, executive chairman of Beijing-based distressed debt investor Mahon China. "As the quarters tick by there will be more and more deals on offer as [asset management companies] sell on some of their NPLs in the secondary market."

Since last year China's banking regulator has pushed banks to move much of their so-called shadow loan books — or lending classified as investments— back on to their balance sheets. The process has forced banks to recognise a far higher rate of non-performing loans.

At the same time, new rules from June require banks to classify loans that have been due for more than 90 days as non-performing. Until recently banks were allowed to hide such debt in a separate category of loans that did not require the same level of provisioning.

Four state-controlled asset management companies — Huarong, Cinda, Orient and Great Wall — have for nearly two decades been the primary buyers of bad debt in China. Dozens of regional AMCs have also been set up in recent years to swallow increasing levels of NPLs.

The AMCs often sell loan portfolios in the secondary market, and as recently as a year ago a surge in private investors in that market had led to what was described as a bubble in distressed debt prices.

“About two years ago there was a lot of renminbi that became excited about NPLs,” said Benjamin Fanger, managing partner at Guangzhou-based distressed debt investor ShoreVest. “Much of this was raised by retail funds and we saw pricing in first-tier cities get really unreasonable.”

But the secondary market shifted in 2018, Mr Fanger said. Loose monetary conditions that allowed private funds to raise capital quickly have been tightened as Beijing seeks to lower China’s leverage. Regulators have also cracked down on the use of retail funds to buy NPLs.

The falling prices of bad debt in China is one of many signs that China’s banking system is under pressure, said Xia Le, chief economist for Asia at BBVA. The greater the supply and lower the prices, the more difficult it will become to recover value when selling off assets, he said.

“If they push all of this distressed debt on to the market, it could have a very negative impact on the price,” Mr Xia said. “But the regulators don’t have much of a choice right now.”

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