ShoreVest 新岸資本

# China Debt Dynamics

***"Disclose & Dispose" – Stricter Accounting Requirements To Push Up NPLs Further***

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**Now ALL loans that are past due greater than 90 days are to be classified as NPL**
As we have been describing in many of our previous articles, China continues to develop the regulatory infrastructure and enforcement procedures to require banks to more appropriately "disclose and dispose" of non-performing loans (NPLs). There has now been another very important development in this process which is resulting in a material increase in the flow of NPLs into the marketplace.

We understand from recent local media reports, as well as from our discussions with industry contacts, that the China Banking and Insurance Regulatory Commission (CBIRC) has very recently requested commercial banks to account for ALL loans that are overdue for 90 days or longer as NPL.

Previously, banks had a bit of leeway in accounting for loans that were past due greater than 90 days depending on the level of underlying collateral. If a bank determined that a loan's collateral was in-excess of 100% of the outstanding principal and interest owed, then a loan could be *past due as long as one year and still be classified as "performing"*. Meaning that the loan would continue accruing interest and the bank would recognize interest income although no payments were being made on the loan, thereby overstating the bank's earnings and understating the risk profile of its balance sheet. The authorities are now stopping this accounting practice.

Although no specific regulation has been announced publicly, and no deadline has been officially disclosed, from what we are told, all major commercial banks will be required to make the classification adjustment as soon as 30 June 2018, with the exception that city and rural commercial banks may have until the end of 2019 to adopt the new accounting policy. We further are told that the big-4 state-owned banks (ICBC, CCB, ABC, BOC) are already compliant with this standard, leaving the joint-stock banks and second-tier provincial-level banks most at risk of this new policy. We do not have specific data at this point, but we understand that at some banks, more than half of loans that are currently past due greater than 90 days are NOT currently classified as NPL.

**This accounting change has many challenging implications for noncompliant banks**
While this change would simply bring China's NPL accounting standards in-line with most other countries globally, the adjustment process has material implications for the banking sector. Once a loan is classified as an NPL, there are three important negative implications on earnings and capital:

1. **Net interest margin declines** – an NPL is a negative-spread asset. When a loan is classified as an NPL, the loan stops accruing interest, such that there is a cost of funding the loan but no income recognition. This lowers the bank's recurrent earnings;
2. **Provision expense rises** – depending on the classification status (see table 4 below), additional provision expenses will be required to be held against the NPL, thereby lowering the bank's earnings;
3. **Tier 1 ratio drops** – NPLs generally carry a risk weight of 150% versus a performing loan of, say, 60-100%, so a change from performing status to non-performing status will dilute a bank's Tier 1 capital ratio as risk-weighted assets increase.

**The CBIRC wants to soften the blow while also incentivizing NPL recognition and sales**
Recognizing the negative implications for banks, and in a deliberate effort to encourage NPL recognition and sales, the CBIRC had recently lowered provisioning requirements on the back of Circular 46 implications (see CDD on Circular 46), and apparently in preparation for this accounting change related to loans past due greater than 90 days.

As seen below from a notice issued by the CBRC on 28 February 2018, depending on certain conditions surrounding (1) NPL recognition; (2) NPL disposals, and; (3) Capital Adequacy levels, the required loan-loss reserve coverage ratios have been softened from a flat ratio of 150% to a range of 120%-150% of NPLs, and from 2.5% of total loans to a range of 1.5%-2.5% of total loans in an effort to incentivize banks to accurately report NPLs, dispose of NPLs, and carry adequate levels of loss absorbing capital:

**(1) NPL Recognition -** This first condition is a measure of how diligently a bank has been categorizing its past-due loans as NPLs. The CBIRC uses a ratio of "NPLs/loans past due 90 days+" to gauge this topic. A value of 100% means that all debts past due more than 90 days are accounted for as NPLs and implies greater disclosure and accuracy of reporting, thus warranting a reduced provision ratio. Going forward, we understand that all banks will be required to classify ALL loans past due greater than 90-days as NPL, meaning that all banks will be required to maintain a ratio of at least 100%.

**Table 1 – NPL Recognition – Percentage of NPL/PD 90+**

| % of non-performing / past due 90+ days debts | Minimum Provision Coverage required as % of NPLs | Min. Loan Provision Rate required as % of total loans |
|---|---|---|
| 100% | 120% | 1.5% |
| [85%,100%） | 130% | 1.8% |
| [70%,85%） | 140% | 2.1% |
| Below 70% | 150% | 2.5% |

*Source: China Banking and Insurance Regulatory Commission*

**(2) NPL Disposals -** This is a ratio of a bank's rate of disposal of NPLs to its rate of recognition of new NPLs. A higher value implies the bank may have new NPLs on its books for a shorter period of time, thus warranting a reduced provision ratio. We should note that we are not clear on the timing element of this measure but presume it to be applied annually. Regardless, this measure clearly incentivizes banks to dispose of NPLs from their balance sheets, and rewards them with lower provisioning requirements for compliance. It is one of many reasons we are seeing an increasing flow of NPLs into the marketplace.

**Table 2 – NPL Disposals – Percentage of NPL sold/ new NPL:**

| % of NPL sold / new NPL | Minimum Provision Coverage required as % of NPLs | Min. Loan Provision Rate required as % of total loans |
|---|---|---|
| >=90% | 120% | 1.5% |

| [75%,90%） | 130% | 1.8% |
|---|---|---|
| [60%,75%） | 140% | 2.1% |
| Below 60% | 150% | 2.5% |

*Source: China Banking and Insurance Regulatory Commission*

**(3) Capital Adequacy -** This is a measure of how much total capital, meaning both Tier 1 (un-encumbered capital such as core equity) and Tier 2 (encumbered capital such as bonds issued) that the bank holds against its risk-weighted assets – keeping in mind that NPLs tend to be 150% risk-weighted; meaning that an NPL requires higher capital to be held against it. A higher CAR value provides a greater capital cushion to absorb potential losses, thus warranting a reduced provision coverage ratio.

**Table 3 – Capital Adequacy – Total Capital Adequacy Ratio (CAR):**

| CAR (Systematically important banks) | CAR (Non systematically important banks) | Minimum Provision Coverage required as % of NPLs | Min. Loan Provision Rate required as % of total loans |
|---|---|---|---|
| >=13.5% | >=12.5% | 120% | 1.5% |
| [12.5%,13.5%） | [11.5%,12.5%） | 130% | 1.8% |
| [11.5%,12.5%） | [10.5%,11.5%） | 140% | 2.1% |
| Below 11.5% | Below 10.5% | 150% | 2.5% |

*Source: China Banking and Insurance Regulatory Commission*

**Importantly, we understand that banks are held to the highest provision requirement of any of these three criteria, meaning that if they fall short on any one of these individual measures, then they are subject to the higher provision ratio as determined by that weakest measure.**

These events are the latest in a progression of measures related to classification and provisioning, all of which are increasingly designed to get the banks to recognize, classify, provide for, and dispose of NPLs:

**Chronology of key events for recognition of NPLs:**

- **2004 - Loan Classification:** China adopts the international 5 tier system of loan classification as "Performing", "Watch-List" (some jurisdictions call this "Special Mention"), "Substandard", "Doubtful", and "Loss", *with the latter three classifications requiring a loan to be classified as non-performing.*
- **2007 - Clarification:** on 3 July 2007, the CBRC clarified how to use the 5-tier system. They specifically tried to clarify "Watch-List" and "Substandard" loans. They stated that loans to be classified as "Watch-List" loans are those that have "delayed payment of principal or interest" and "Substandard" loans are loans that are "past due after a certain period". However, this 2007 regulation did not stipulate a clear time period for either classification, allowing significant leeway for banks to determine classification status, with the net result that many loans past due greater than 90 days were able to remain as performing and still accrue interest.
- **2011 - Minimum Provisioning:** on 27 July 2011, the CBRC set out minimum provision coverage ratio requirements of 150% of total NPLs and 2.5% of total loans.
- **2018 - Past Due 90 days+ as NPL and Provision Tiering:** on 28 February 2018, the CBRC issued a notice to all banks relaxing the loan loss reserve (i.e., provision) ratio based on the three criteria mentioned above. And now we understand that the CBIRC is requiring ALL loans past due greater than 90-days to be classified as NPL.

**Requiring ALL loans PD 90 days+ as NPL will involve much higher provisions for some…**
This latest development is also important from a single-loan provisioning requirement, based on its classification in the 5-tier system. The provision requirements mentioned in the tables above are <u>minimum</u> requirements applied at the "portfolio" level, whereas provisioning required at the single-

loan level is determined by its classification status within the 5-tier system. As a result, for those banks that currently account for loans past due greater than 90-days as performing (i.e., many joint-stock banks and second tier, provincial-level banks), this new accounting requirement will have significant negative earnings implications as higher provision expenses will be required as these loans are re-classified into NPL status.

Essentially, this new requirement that ALL loans that are past due greater than 90-days be accounted as NPL means that they must now be classified as either "Substandard", "Doubtful", or "Loss" category, whereas previously many were classified as "Performing" or "Watchlist". This re-classification into NPL status will require substantially higher provisioning at the individual loan level for those banks that are currently non-compliant. As a loan's quality deteriorates and migrates through the classification status, it requires an increasing provision as follows:

**Table 4: Classification Status and Required Provisioning**

| Classification Status for Individual Loans | Required Provisioning |
|---|---|
| Performing | 1% |
| Watch-List | 2% |
| Substandard | 25%* |
| Doubtful | 50%* |
| Loss | 100% |

**For "Substandard" and "Doubtful" loans, provisions can be 20% above or below the base requirement depending on each loan's risk profile (e.g., collateral coverage, etc.). Source: China Banking and Insurance Regulatory Commission*

**Net result is that the flow of NPLs into the marketplace is increasing at an increasing pace**

In essence, the CBIRC continues to develop the infrastructure to clear the banking system of NPLs. This new requirement for all loans past due greater than 90 days to be accounted for as NPL, and the tiering of provisioning requirements based on recognition, disposal, and capital cushion are important steps in this process. They are essentially putting in place a "carrot-and-stick" approach to incentivize banks to appropriately recognize NPLs and then dispose of those NPLs.

***The net result is a continued flow of NPLs into the marketplace at an increasing pace. ShoreVest is very well-placed as an important part of this government-driven process to clear NPLs from banks' balance sheets, and is expecting the flow of NPL portfolios into our pipeline to continue to increase substantially for the foreseeable future. We now have 551 portfolios in our database with an asking price (not principal balance) of US$64 billion, which has been growing at about US$3 billion per month so far this year, and now appears set to potentially accelerate from here on the back of these new regulatory-driven rules.***

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