ShoreVest 新岸資本

China Debt Dynamics

A look at the tools being deployed to help China's banks dispose of their NPLs

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Over the last few years, China has developed a diverse range of tools to help banks dispose of their nonperforming loans (NPLs). On the face of it, most of those tools—asset management companies (AMCs), debt-to-equity swaps (DES), and asset-backed securities (ABS)—look not unlike those commonly deployed in other countries following a banking crisis. China hasn't had a banking crisis, but rather has embraced those devices preemptively in order to avoid a crisis. Consequently, these tools are being used in ways different to common practice. Shaped by China's unique circumstance, the financial ecosystem that has evolved to deal with China's NPLs is unique and complex—and poorly understood.

This *China Debt Dynamics* aims to provide a brief outline of that ecosystem. Unquestionably, the most important channel for NPL disposal is that which funnels bank bad loans through the major AMCs to investors—which is also the main conduit through which foreign investors acquire NPLs. The other channels discussed in this report don't detract from either the flow or the quality of assets that are disposed of this way. Nonetheless, the alternative channels play an important role in improving banks' asset quality, and they help shed light on Beijing's strategy for returning China's financial system to health.

While Beijing recognizes that the nation's banks urgently need to reduce their NPLs—which are far greater than what official data acknowledges—it also recognizes that it can deal with the problem over time. While a country dealing with a banking crisis might need to prioritize speed and the scale of NPL disposals above all else, Beijing can afford to give other considerations greater weight.

As a result, the cleanup of the banking system is being pursued at a rapid, albeit measured, pace. Rather than push banks to acknowledge the full extent of their NPLs at once, Beijing prefers that they incrementally recognize more each year, thereby spreading out of the cost of write-offs and recapitalizations over time. At the heart of the strategy is a desire to minimize any disruption to the broader economy, and to avoid, where possible, any cost to the government—and in particular the central government. It is designed to enable the banks to take responsibility for their own problems where possible, without the authorities needing to mobilize state resources.

To that end, the ecosystem of NPL disposal is geared toward both maximizing both the volume of disposals and the value that the banks can extract from their NPLs. Beijing has embraced a diverse—and sometimes unconventional—range of disposal channels in order to expand the universe of potential funds available to invest in NPLs. It has promoted a market-oriented approach, championing competition and transparency as key to lifting NPL prices. But it has also reserved a role for the state in dealing with potentially sensitive assets.

This report doesn't deal with all aspects of the system, but rather focuses on China's idiosyncrasies. It's designed to function as a primer, and as such avoids going into great detail about any given channel.

Asset Management Corporations (AMCs)

AMCs are a fixture of banking crises around the world. They're usually deployed so that a specific bank or group of banks are able to spin-off large volumes of NPLs quickly and efficiently, and are typically wound down once they've resolved or disposed of those NPLs. Seldom are there more than one or two—or at most a small handful—in operation in an economy at any given time.

However, China currently has about 60 AMCs. Together they share the exclusive right to acquire from banks portfolios of three or more NPLs (banks can sell loans individually or in pairs to whomever they so choose). Four of them—a group that was set up in 1999 to deal with an earlier banking crisis—are permitted to acquire NPLs nationwide. The remaining AMCs—the first of which gained regulatory approval in 2014—are allowed only to acquire NPLs solely from the single province in which they are licensed to operate. Most provinces have at least two local AMCs, and some have three.

The proliferation of AMCs is designed to jump start a marketplace that did not previously have many NPL investors, as well as foster competition. They are encouraged to bid against each other for NPL portfolios in the hope that it will drive up NPL sales volume and prices, thereby reducing stress on the banks. Competition wasn't unusual in 2017 when rising NPL prices, funded by shadow banks or inexperienced market entrants, drove AMCs to outbid each other on certain portfolios, but shadow banking has since contracted, NPL prices have retreated to more rational levels, and the logic of competitive bidding for NPL portfolios has somewhat diminished. This year, in their discussions with ShoreVest, AMC executives have indicated they are now avoiding competition where possible, and even agreeing with other AMCs on how to divide up markets in order to buy at low enough prices that the AMCs can more easily resell the NPLs.

National AMCs: The four national AMCs—Huarong, Cinda, China Orient, and Great Wall—are best understood as being clearing houses for bank NPLs. While technically they can hold the NPLs they acquire and resolve them internally, in reality they are under pressure from the authorities to dispose of them as quickly as possible, with employee compensation closely linked to that goal.

When the four AMCs were first set up, the intention was that they would be wound down after 10 years. Instead, they acquired additional licenses in securities, leasing, futures, and banking among others, and transformed themselves into financial holding companies. They subsequently evolved into shadow banks, making outright loans to Chinese companies. To the extent that they remained actively involved with NPLs, it was primarily in the acquisition of distressed trade receivables, whereby the AMCs made short-term loans backed by trade receivables as collateral.

Over the last couple of years, they've been forced to re-embrace their original NPL-focused purpose, and abandon their shadow banking activities. We estimate that the national AMCs paid the banks about 360 billion yuan for NPLs in 2018. Sadly, we lack comparable date from previous years. However, given that Great Wall and China Orient only ramped up their bank NPL activities in 2017 and 2018 respectively, the figure represents a significant increase.

Local AMCs : Cinda and Huarong are publicly traded on the Hong Kong stock exchange, but along with the two other legacy AMCs, are controlled by the Ministry of Finance. In contrast, the local AMCs conform to no single ownership model. Some are controlled by local governments, others by state-owned firms, some by banks and the national AMCs, and some by private-sector interests. The first local AMCs were set up at a time when it was still unclear what role the legacy AMCs would play in the NPL cleanup process. However, it was clear that the nature of the NPL problem was significantly different from the previous debt crisis. At the turn of the century, almost all bank loans—and, by extension, most NPLs—were concentrated in four national banks. Since then, China's financial system has diversified, and the banks with the heaviest NPL burden are the thousands of small local banks that operate at a provincial, municipal, or county level. Consequently, the authorities felt it necessary to create AMCs capable of operating at a grassroots level.

The contribution of the local AMCs to NPL resolution has been mixed. The Southwestern University of Finance and Economics in Chengdu found that the 40 local AMCs it surveyed earlier this year acquired 142 billion yuan worth of NPLs in 2018. That's about 40% of the volume acquired by the four national AMCs, although that figure likely includes some loans purchased by the local AMCs from the national AMCs. Only about six local AMCs are particularly active, one each from Zhejiang, Anhui, Jiangsu, and Shandong provinces.

The local AMCs operate under certain constraints. Many lack expertise in dealing with NPLs. Most are lightly capitalized. Moreover, unlike the national AMCs, they can't borrow from the interbank market, the cheapest source of credit. Some get around their funding difficulties with bank loans—that they then use to acquire the lending bank's NPLs. And others (along with the national AMCs) have engaged in seller-financed transactions to help banks hide their NPLs (although this practice is now banned – forcing banks to only engage in true sales). Clearly, while local ACMs are making a meaningful contribution to keeping banks' NPL growth in check, it's unclear whether that contribution is sustainable.

Asset-Backed Securities (ABS)

While in aggregate AMCs are the most important channel through which banks dispose of their NPLs, that doesn't apply to all types of NPL equally. In 2012, China's authorities issued rules barring banks from including loans made to individuals in any mass transfer to the AMCs. That forced banks to deal in-house with delinquent retail loans, a group that includes home mortgages, consumer loans, small business loans, and credit card debt. That changed in 2016, when the authorities allowed NPLs to be packaged into ABS. Subsequently, NPL ABS have become almost exclusively a channel for disposing of retail loans, and in particular credit card debt (the PBOC claims that while the securitization of credit card debt is a global phenomenon, China is the first country to securitize delinquent credit card debt specifically).

Early on, China's banks experimented with packaging corporate loans into ABS, but found it more practical to sell the loans to AMCs than go through the costly and time-consuming process of valuing the diverse range of industrial and commercial property companies use as collateral. In contrast, home mortgages proved cheaper to securitize, as the housing used as collateral was easier to price. Easier still were credit cards. Rather than vet each individual borrower—an impossible proposition, given that credit card-backed ABS typically pool together tens of thousands of borrowers—credit card debtors are assessed as a group, with appraisers using the banks' historical rate of return on delinquent credit card pools to value the securities.

As is the case elsewhere in the world, by converting NPLs into highly-rated, tradable securities, it opened NPL investing to a new pool of capital, in particular funds from domestic insurers and fund management companies. However, the volume of funds flowing into NPL ABS is relatively small. That's largely because banks' level of retail NPLs is relatively low. In 2018, 69.9 billion yuan worth of NPLs were packaged by China's banks into 33 ABS, which sold for 15.0 billion yuan. Only two of those ABS were packaged with corporate loans, while 18 were backed by delinquent credit card debt.

Online Auction Platforms

Of all the tools deployed by China to deal with NPLs, the most uniquely Chinese are online auction platforms. Sellers of NPLs post details of a loan or loans online, including a valuation from an independent appraiser, and then, after registering and paying a bond, potential buyers can make bids at an appointed time.

The platforms broadly fall into two categories: established e-commerce platforms like JD.com and Alibaba's Taobao, and financial asset exchanges, which sell everything from wealth management products, to private bonds, to antiques. The financial asset exchanges are typically owned by provincial or city authorities, although some have AMCs as shareholders.

The auction houses play two distinctly different roles. The first is as window dressing. NPL portfolios sold by AMCs must be open to competitive bidding, a requirement designed to avoid sweet-heart deals made behind closed doors. However, the sale of large portfolios of NPLs requires extensive due diligence and negotiations between buyers and sellers, and is hence ill-suited to the auction process. Consequently, AMCs typically line up a buyer before announcing an auction. The auction notice is then typically posted just weeks in advance, insufficient time to attract any other serious buyers.

However, for individual or small groups of loans, the auction platforms are a legitimate disposal channel, opening up NPLs as an asset class to small buyers that would otherwise not have an opportunity to invest. Sadly, we have very little data on the volume of NPLs disposed of through online auction platforms. Most platforms don't publish aggregate sales data or disclose auction prices. The exception is Taobao. According to data from The Paulson Institute, AMCs sold 33.0 billion yuan worth of NPLs on Taobao in 2018, and banks sold 10.9 billion yuan worth. The price of NPLs sold on Taobao is significantly higher than what banks can get from AMCs, likely due to the fact that Taobao only works well for sales of single loans or simple pools backed by collateral that can be readily priced without requiring extensive due diligence on the part of would-be investors. Certainly, most banks still prefer to deal primarily with AMCs because this allows for bulk sales (which, as opposed to selling loan-by-loan on Taobao, is much less time consuming). Mid-tier banks with more sophisticated internal NPL disposal operations—in particular Ping An Bank and some of the other joint stock banks—tend to be more active on Taobao than their peers.

Taobao plays another important role in the NPL ecosystem. In 2017, China required its courts to begin migrating judicial auctions online in an effort to promote transparency and tap a larger pool of potential buyers for court-ordered asset sales. Taobao has been the biggest beneficiary, hosting the lion's share of judicial auctions, which are dominated by the sale of assets posted as collateral for loans in default. The increased use of online auctions by courts has produced greater liquidity and efficiency when enforcing collateral, a development that helps NPL investors, such as ShoreVest, to more quickly exit NPLs.

Debt-To-Equity Swaps (DES)

When employed by China's banks, debt-to-equity swaps (DES) are primarily used for dealing with the debt problems of large, state-owned firms, and particularly those that claim some strategic importance. Early in China's deleveraging process they were used to help deal with industrial overcapacity issues. In some industries (most notably coal), large state firms rolled-up smaller, struggling competitors—typically in the private sector—and in return their debt was converted into equity. However, DES are not a silver bullet, but rather offer firms temporary relief. DES agreements are routinely signed on the understanding that the indebted company will buy back its equity after a few years.

At the moment, DES are mainly used by China's biggest five commercial banks, which have set up asset investment companies (AICs), wholly owned subsidiaries that are independently capitalized and are specifically tasked with facilitating DES. According to the Peterson Institute for International Economics, the volume of debt-to-equity swaps carried out in 2018 was largely unchanged from 2017 (228 billion yuan vs 230 billion yuan). However, it has since accelerated, roughly doubling in the first four months of this year.

Volume of NPLs Disposed by Channel Type, in 2018

Paid to acquire NPLs	
Big Four National AMCs	360 billion yuan
Local AMCs	142 billion yuan
Converted via	
Debt-to-Equity Swaps	228 billion yuan
Raised by the sale of	
Asset-Backed Securities	15 billion yuan
Raised in sales on	
Taobao (banks only)	11 billion yuan
Financial Asset Exchanges	???
Total	**756 billion yuan**

Source: AMCs, media, PIIE, Paulson Institute.

With new court rules allowing a creditor to turn a loan into an asset, ShoreVest has begun to use debt-to-equity/asset agreements or "deed in lieu" court enforcements to turn NPLs into asset ownership. This has produced a new fourth exit channel, beyond the three legacy exit channels ShoreVest's team has used for over a decade (court auctions, settlements with obligors, or loan sales).

Conclusion

As the economy slows and the pace of NPL formation accelerates, attempts to minimize the cost and disruption of NPL disposal is likely to become more difficult to achieve. Furthermore, ShoreVest has begun to see additional non-bank NPL sellers, such as shadow banking institutions that have their own NPLs, or private NPL buyers who overpaid for NPLs around 2017 and are now being forced to liquidate.

Complicating matters is that NPL disposal efforts aren't evenly distributed throughout the banking system. While the largest banks have been extremely active in disposing of their bad loans, small banks have found it harder to keep their NPLs under control. In fact, the tools described here are ill-suited to helping the thousands of rural financial institutions that are widely recognized as having the heaviest NPL burden. Such institutions don't have the brand recognition to successfully issue ABS, or the sophistication to market a large number of individual loans on Taobao, or sufficient loans to strategic state firms to warrant DES. And the AMCs—both the big four and local varieties—have proven reluctant to source NPLs from the fringes of China's banking system.

That is likely to result in further experimentation and creativity as the authorities try to come up with new ways to deal with the problem. While the unique financial ecosystem that has sprung up to support NPL disposal in China has worked fairly well thus far, the real challenges will come in the years ahead.

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