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ShoreVest: China Aims at ‘Orderly Deflating of the World’s Largest Credit Excess’

January 25, 2018, 9:00 am EST / Shasha Dai

(Andrew Brown, partner of ShoreVest Capital Partners. Photo credit: ShoreVest)

Since the dawn of the new year, China’s top banking regulator has issued a series of notices aimed at clearing up banks’ balance sheets – a development that a distressed assets investor said could create an opportunity set for years to come.

So far this month, China Banking Regulatory Commission has issued at least three statements, and its chairman Guo Shuqing spoke to the official People’s Daily newspaper. The overall message: the government is serious about enforcing regulatory oversight focused on containing risks on banks’ balance sheets and in the so-called shadow banking system.

In a Jan. 5 notice, the commission said it is seeking public input on a contemplated regulation of large credit exposures in line with the Basel Committee framework.

In an official interpretation of the notice, the commission said loans to a single borrower will be capped at 10% of the bank’s Tier 1 capital, and total credit exposure including loans to a single borrower will be capped at 15% of Tier 1 capital. Credit exposure to a group of connected entities is capped at 20% of Tier 1 capital, while credit exposures to other banks are capped at 25% of Tier 1 capital. Currently, interbank credit exposures are above the cap, and banks have a three-year grace period to pare those back.

A separate notice from the same date stipulated obligations of large shareholders of commercial banks with a focus on disclosure and accountability, and a Jan. 16 statement related to the counterparty risk in derivatives trading, again largely in line with the Basel framework.

In his Jan. 17 interview with the People's Daily, Mr. Guo, the commission's chairman, said that in 2017, the regulatory scrutiny had focused on three areas: interbank credit exposure, wealth-management products, and off-balance sheet lending. As a result, more than 100 banks' balance sheets had shrunk, said Mr. Guo. While total new loans increased 12.6% year-over-year, banks' total assets expanded at a slower 8.7%, a 7.1 percentage point decrease from a year earlier, he said. Interbank loans posted their first year-over-year decline since 2010, and off-balance sheet lending has been contracting for months in a row.

While calling the risk "controllable overall," Mr. Guo told the newspaper that several areas are still under pressure such as nonperforming loans on banks' balance sheets, the outstanding credit at shadow banks, and illegal or irregular practices for extending loans. He reiterated the government's focus on "preventing and mitigating financial risk."

"What you are seeing with this flurry of statements is part of a bigger picture of putting in place the infrastructure to facilitate an orderly deflating of the world's largest credit excess," said Andrew Brown, partner at Chinese distressed debt-focused ShoreVest Capital Partners.

China is implementing the regulations "in such a fashion that it reduces systemic risk, improves transparency for better risk assessment [until] it gets to a point where capital is better allocated in the economy to the most productive uses," said Mr. Brown.

Mr. Brown said the government's statements this year are part of a multi-pronged approach that includes determining the reserve pricing, or the mark-to-market levels that banks carry their loans at; improving creditor rights protection; and establishing asset management companies (AMCs) as conduits for nonperforming loan disposal.

According to Mr. Brown, China currently has 156 AMCs, up from four first set up by the Chinese government by the early 2000s. Over the last 18 months alone, 35 new AMCs have launched, he said.

The AMCs act as a central repository of information for the government to track nonperforming loan transactions: identities of the seller and the buyer, location and sector of the underlying borrower, value of the collateral, and the transaction price.

"You can engage with the bank to do your diligence, but you've got to go through the AMC for closing," noted Mr. Brown.

New regulations this year also add on top of major rules unveiled last year, including a March 28 circular from the banking regulatory commission's general office. Among other things, the circular detailed more than 50 irregular accounting practices, and called for internal audit and self-reporting by banks, as well as reclassification of credits that were inappropriately classified.

"All this is very serious," said Mr. Brown. "The government is very aware, very astute and very deliberate about how they are producing a multi-pronged approach to deflating the credit excesses."

For investors such as ShoreVest – run by a team spun out from Shoreline Capital, which has been investing in Chinese distressed debt and special situations since 2004 – and Oaktree Capital, the heightened regulatory scrutiny promises to bring more assets to the market.

"We are enthusiastic about the opportunity set that will be measured in years," said Mr. Brown. "Foreign capital in the form of distressed and special situations investment solutions is critical and necessary to what China is implementing."

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