Non-performing loans (NPLs) at China’s leading state banks continue rising to levels last seen in the early years of the new century. To close observers of the world’s second largest economy, this will come as little surprise, given the fervent lending to state-run institutions in the years after the global financial crisis.

China’s decelerating growth plays a key role in the rise of its NPLs. At the height of its double-digit growth ambitions, companies levered up to fuel the expansion of business operations and infrastructure needed to cater to a sustained period of increased domestic demand, in line with the government’s large-scale modernization plans. This coincided with soaring demand for Chinese exports as the country positioned itself as the world’s factory, manufacturing and shipping out generally low-cost and low-skilled parts and end-products around the world.

With China’s current slowdown, whole industries—especially those related to construction, infrastructure, real estate, and shipping—have tipped into overcapacity, a problem amplified by the low commodities price environment and protracted low global demand. Under strains to their profit margins, companies finding it difficult to keep up with overhead and operating costs may end up taking out more loans, which they may eventually become incapable of servicing.

Snowballing bad debt

Top line data reveals the scale of the problem. China’s commercial banks’ NPL ratio hit 1.67% at the end of 2015, according to data from the China Banking Regulatory Commission (CBRC), marking the 17th consecutive quarterly increase. That pushes the total quantity of failed loans to US$196bn (RMB1.27tn). An NPL ratio of 1.67% implies a total debt of US$11.7tn, a far cry from the Financial Times’ estimate of US$25tn (RMB163tn) in Q1 2016.

As economic growth decelerates, pushing more onshore corporates, private and state-run, closer to bankruptcy, or to defaulting on loans and bonds, the official level of NPLs is likely to rise further and faster, with deterioration in asset quality set to accelerate. The NPL ratio is expected to reach 3.1% by the end of 2016, according to a 2016 Standard & Poor’s publication.

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Analysts believe the real number to be many times higher. It has been argued that the true rate of NPLs at China’s banks could be as high as 20%. In China, a delinquent loan is not necessarily recognized as a NPL as long as the value of the collateral backing it is sufficient to pay off the loan, even if the loan is more than 90 days past due. Additionally, there is the temptation to channel loans to clients via trust companies and other shadow finance vehicles, which shifts the burden of debt but does not flush it from the system.

According to the Financial Times, the country’s debt pile is high and rising, registering 237% of GDP in Q1 2016. While this is comparable to debt loads in the United States and Europe, it represents a quantum leap from the 148% of GDP less than 10 years ago, at the end of 2007. Profitability at the country’s largest five commercial lenders “appears to have peaked”, PwC said in its China Banking Newsletter released on April 20. The Industrial and Commercial Bank of China (ICBC) is not the only major bank to fret publicly that its bad-loan coverage ratio is dangerously close to the regulatory minimum. The Beijing-based lender has urged banking regulators to ease the requirement. Global headlines recently conveyed a warning that the mainland banking
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system could wind up facing losses that would dwarf those incurred by US lenders in the wake of the 2008 credit crisis.

Securitization, then and now

To deal with the problem of NPLs, China has been contemplating various solutions, with asset disposal being the fastest way. Huarong and Cinda have been selling bad loans they acquired via Alibaba Group’s Taobao marketplace since 2015, with Huarong stating it would put US$8bn (RMB51.5bn) worth of NPLs up for auction in December.

NPL securitization or a form of structured sale is another method that could help resolve the issue. Neither the problem nor method is new, with China’s banks having been riddled with soured loans since the country began opening up in the late 1970s. Authorities have in the past announced their intent to sell tranches collateralized by soured or failing loans to local and foreign investors, only to rein in their ambitions, or scrap their plans entirely. Huarong, Cinda, Orient, and Great Wall, the four national-level asset management companies (AMCs) set up in 1999 to absorb and process bad loans from the country’s big-four state lenders, have all sought, at one point or another, to sell tranches of NPLs to investors, again with mixed success.

For years, one of the biggest stumbling blocks was the lack of a coherent legal framework to facilitate securitization. The desire to package and sell bad loans was there—but the rules were not. Then in November 2014, Beijing moved to approve rules permitting banks and institutions to sell asset-backed securities (ABS), so long as they were registered and approved by the central authorities.

That provided the market with the impetus it needed. China’s securitization market is now the largest in Asia, outpacing both Japan and South Korea. Having experienced exponential growth since 2012, the Chinese market accounted for US$65.8bn of issuance in 2015, a 30.7% rise from 2014, according to SIFMA Securitization Group.

In February, the government said it would allow six domestic lenders, including ICBC, Bank of China, and China Merchants Bank, to issue up to RMB50bn worth of ABS collateralized by distressed debt on their books. While the packages of bad loans would not be rated, they could allow some of the stronger assets to be sold, proponents noted. A weaker Chinese yuan might also attract distressed-debt dollar, euro, and Japanese yen investors.

While the government has begun to let market forces play a greater role in influencing the fate of domestic companies, labor protection and the avoidance of social distress remain high on the government’s list of priorities. On the legal and regulatory front, the country’s bankruptcy case law is still in its early stages of development, while regulatory procedures retain a high degree of opacity, especially to offshore investors unfamiliar with the workings of the system, denying investors the security of a predictable outcome on the road towards resolution.

A way forward: Partnerships and co-investments

Foreign investors looking to catch the boat in search of distressed opportunities as China embarks on its arduous but necessary journey of deleveraging need to take into consideration several factors. To minimize their exposure to political risk, AMCs or domestic banks tend to avoid engaging in the direct sales of NPLs to foreign investors. At the same time, the need for foreign investors to gain approval from multiple regulatory bodies could generate transactional delays, as could the unfamiliarity of foreign investors with China’s legal, regulatory, and commercial processes.

Top-down trials: Debt-to-equity swaps vs NPL securitization

The Chinese government has been experimenting with multiple solutions, aiming to reduce corporate leverage ratios and NPLs. It makes sense to experiment as there is no cure-all solution here, and proposed debt-equity swaps and NPL securitizations are a good start. Both the debt-equity swaps and NPL securitizations have pros and cons, and neither is applicable to all situations. A debt-equity swap approach could simply be a continuation of the “extend and pretend” scheme if it is utilized on a weak company with grim prospects in an out of favor industry. Alternatively, if utilized in the right context, it could not only serve to diminish NPLs, but also help restructure distressed companies into healthier ones. Similarly, NPL securitization may help get the NPLs off of books much faster, but unless the investors in the securitization have a say in how to resolve NPLs in a manner that maximizes value, it may actually be less attractive than a debt-equity swap. The common requirement for success in either approach is to maximize value to the investors, even if that means taking actions that may not be viewed favorably by all parties involved.
Navigating China’s NPL market: Risks and potential

Cindy Ma, Director for Financial Advisory Services Gunes Kulaligil, and Vice President for Asia Pacific Financial Advisory Services Ethan Ma discuss various methods of approach.

The nascent opportunities arising in China’s dynamic NPL market can be at once attractive and daunting. Mapping out the market’s potential risks and challenges can help increase the certainty of seeing timely returns on an investment. Houlihan Lokey’s Global Head of Portfolio Valuations Cindy Ma, Director for Financial Advisory Services Gunes Kulaligil, and Vice President for Asia Pacific Financial Advisory Services Ethan Ma discuss various methods of approach.

What are some of the key risks—commercial, regulatory, legal and political—of investing in China’s NPL securitization market?

While there are many legal obstacles to a viable Chinese NPL securitization, the main one is whether bankruptcy remoteness can be achieved. The details of specific funding and loan sale/purchase arrangements between selling banks, AMCs and other financial institutions involved in the process are not well understood by foreign investors due to the opaque nature of these transactions. Therefore, any foreign buyer will likely demand that the vehicle is bankruptcy remote.

It is of course hard to predict and quantify political risks, potentially more so in China. What is understood, however, is there is considerable political pressure on AMCs to resolve NPLs in a manner that not only minimizes the risk to the banking system, but also retains the upside within the country. In other words, if a foreign investor were to acquire an NPL portfolio and realize double digit unlevered returns in a short period of time, it is likely that the AMC would be frowned upon for selling such low hanging fruit to foreign investors. One unintended commercial consequence of this political pressure may be local investors being allowed to cherry pick NPLs and, potentially, leave only harder to collect loans collateralized by lower quality collateral for foreign investors. While this may seem to benefit AMCs in the short term, the medium to long term effect could be a lack of interest from foreign investors, potentially exacerbating the situation in a distressed period when local buyers may take a break. The extent to which the Chinese government may have to make concessions to NPL buyers remains an open question, given the capital outflows which have occurred over the past several quarters and the depletion of foreign currency reserves by the central bank to defend the yuan.

What is the current situation like in China’s real estate market, and what impact does it have on the Chinese NPL market?

There was another housing price surge in tier 1 cities in 2015, partially believed to be fueled by the capital outflow from the equity market. In 2016, the government has tightened policies aiming to curb the overheated housing market. However, in tier II and III cities, large housing inventories continue to suppress prices. As a large amount of both personal and corporate loans are collateralized by real estate, a bearish real estate market will certainly cause more NPLs to surface as the collateral values diminish.

Is it time to enter or re-enter the Chinese NPL securitization market? How should investors, both domestic and foreign, approach the process of loan valuation, acquisition and recovery?

We have seen investors follow the NPL trade across different geographies over time, from North America to Western Europe and the Balkans in the last few years. The path is usually defined by not just the current supply but the backlog, ease of doing business, legal certainty and opportunity to partner with a reputable local servicer or asset manager. There is certainly no shortage of NPLs in China, though many investors would rate the ease of doing business as low and describe the legal system as opaque and favoring locals. Given the immense size of the opportunity, and the plethora of complexities, it would make sense to scale into the trade; and perhaps soft enter through a partnership or a co-investment scheme with local buyers.

The process of loan valuation, acquisition and recovery is where the partnerships and co-investments come into the picture. The fastest and most reliable way to gain access to historical performance data of NPLs, recovery percentages and timelines is by reviewing the servicing and resolution experience of investors, servicers, and asset managers active in past NPL sales. While every NPL situation is different, having advisors who have witnessed and dealt with the myriad issues that can come out of the woodwork while managing NPLs can be invaluable.

How will China’s NPL situation unfold in 2016 and beyond?

In the US, even eight years after the financial crisis, we are still working on resolving NPLs, whether it’s through outright sales, modifications or securitizations, despite having many of the legal, regulatory and commercial components in place to facilitate these transactions. Therefore, we do not expect any kind of quick progress. In fact, the resolution of Chinese NPLs may indeed take a decade or longer, given how decelerating economic growth in China is influencing developments in its NPL securitization market. While decelerating economic growth would reduce the recovery percentage and lengthen the time to recoup value, it has a much larger impact on commercial and industrial collateral. Given the majority of the Chinese NPLs owned by AMCs are commercial and industrial, economic deceleration is bad news for securitization. While Bank of China’s debut issuance of NPL backed securities on May 26 is a step in the right direction, we understand that a majority of the subordinate tranche was sold to a state-owned asset manager, thus defeating the purpose of removing these distressed assets from the banking sector’s balance sheet.

What we do expect in 2016 however, is for large global distressed funds to start testing the waters, potentially through partnerships or co-investments with on the ground entities at a small scale. Once the investment thesis is tested and proven to be a viable strategy, we would then expect rather large investments by a small number of investors or even dedicated funds.

Houlihan Lokey is an international investment bank with expertise in financial restructuring, mergers and acquisitions, capital markets and valuation.
As such, a more realistic approach may be for foreign and domestic investors to test the waters by entering into strategic partnerships. In 2013, Oaktree Capital Group entered into a joint venture with China Cinda Asset Management Co, earmarking US$1bn with an aim of capitalizing on China’s distressed debt market. In January 2016, KKR & Co joined hands with China Orient Asset Management Corp.

According to PwC’s “Portfolio Advisory Group Market Survey 2015”, market participants expected unlevered internal rates of return of 18%-21% on average for NPLs in Europe. It would follow, then, that investors of similar mandates and return targets are likely to find a foray into the Chinese market attractive only if Chinese NPLs offered higher rates of return than the equivalent from more developed distressed debt markets in the United States and Europe. In the same survey, respondents point to data quality as one of the most important factors that play into considerations for an investment, as inferior or incomplete data can undercut valuations and frustrate transactions.

**Cautious optimism**

The problem of bad loans is an intractable one, and stripping NPLs out of any financial sector has never been easy or quick. The problem is as much political as it is commercial or regulatory—European lenders are locked in an ongoing struggle to reduce the level of NPLs held on their balance sheets, while the United States has been fighting a long battle since 2008 to resolve NPLs that originated in the years leading up to the global financial crisis.

For China, the journey of deleveraging is a painful but inevitable one. Securitization offers a viable way for banks to improve their asset quality in an efficient and cost effective way, but there are policy, regulatory, and legal hoops to jump through. The Chinese distressed debt market also faces challenges when it comes to valuation, pricing, competition, and investment demand in a finite universe of buyers for securitized products. Partnerships between foreign investors and domestic AMCs will help chart the way forward.

Dealing with distressed debt will require the government to face up to some unpalatable truths: to recognize the true value of bad loans held at the nation’s commercial lenders, and to encourage an expedited yet orderly resolution of distressed assets that may take years yet, with foreign investors encouraged to become viable, responsible owners of a mountain of distressed mainland debt.