Non-performing loans in China

Yunzhi Wang

Introduction

China's non-financial sector debt has grown rapidly in recent years. The lurking NPL risk in the system is self-evident. According to the Bank for International Settlements (BIS) data, the credit owned by households, government agencies and non-profit organizations are 29,593 billion USD dollars as of Q2 2017. The total credit comprising 225.9% of GDP has made China with one of the highest leverage ratios in developing countries.[1]

The latest non-performing loans ratio in China is maintained at 1.74%, according to the data from CBRC, nearly unchanged from the previous 2 quarters. This is a positive sign showing the progress in eliminating banking risks and a solid performance on clamping down overcapacity.

This paper will seek to identify the current solutions for non-performing loans in Chinese economy, first understanding the occurrence of a large amount of non-performing loans and then examining the effects it has on China and available solutions.

The Emergence of NPLs in China

One important factor that contributes to the debt binge is China's consistent expansionary monetary policy from 2008. China has always been enacting the expansionary monetary policy as a stimulus to push the economy, which results in a pretty lax regulation and control on the loans, keeping the loan amounts mounting. Although the relaxation of restrictions and low-interest rate did lead to a surge in the economy and helped China keeping pace in growth in past few years, however, as the economy continues to slow down, the hidden problems behind the spree also surfaced. Up to now, the M2 money supply in China reached a 172,910 RMB (27316.32 USD) billion[2] and the GDP growth rate in China is 11199.15 USD billion in 2017. United States has a 13838.30 USD billion in M2 money supply and 18624.48 USD billion in GDP. The M2/GDP in China is 2.44, while the United States has a 0.74 ratio. The M2/GDP ratio is constantly rising in China and the great burden is dragging it. Beijing has to wean the economy off the heavy reliance on bank lending, develop direct financing and carefully keep an eye on any other alternative financing methods.

Many Chinese banks channel loans to those inefficient state-owned enterprises (SOEs), which lead them to a vulnerable status in the economic climate. This also hinders the country from achieving its stated regulatory goals. The Chinese government has always treated stability as the top priority in the country, which warrants the banks that bailout would happen should the need arise. However, instead of grilling the banks by forcing them to lend to unproductive SOEs, it would make a real difference to the economy if banks can lend more productively.

Local governments in China have long been barred from borrowing in China, so they turned to establish government-owned corporations to raise money for local infrastructure through borrowing. These corporations are called China's local government financing vehicles (LGFVs). To meet the requirement of banks and insurance companies (e.g., reasonable debt-to-equity ratio),

[1] See Bank for International Settlements, https://www.bis.org/statistics/totcredit.htm

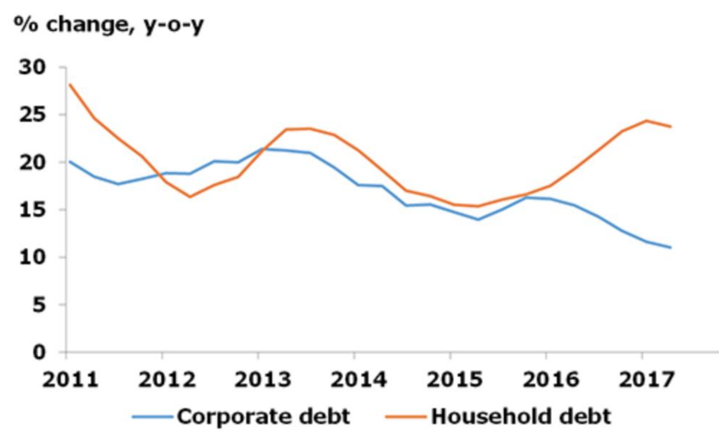
[2] See TRADING ECONOMICS

governments will transfer high-quality assets to LGFVs to improve their credit. The sources of these high-quality assets include public land (e.g. local governments can grant the right of using the land for several decades through licensing); shares of public utility companies (e.g., electricity, water) owned by local governments. The land and the cash flow from the utility companies can be utilized as collaterals in government borrowing. These LGFVs, however, are sometimes utilized by local governments to build vanity projects, which ran up large amounts of debt.

The high leverage ratio is one of the reasons why NPLs are booming. High leverage becomes not only a problem for the corporates in China but also an emerging problematic issue regarding consumer loans. Due to the prudential measures implemented by the government to control the debt expansion, corporate debt growth has been decelerating in recent months.

In contrast, household debt growth mounted after 2016, as shown in the graph below.

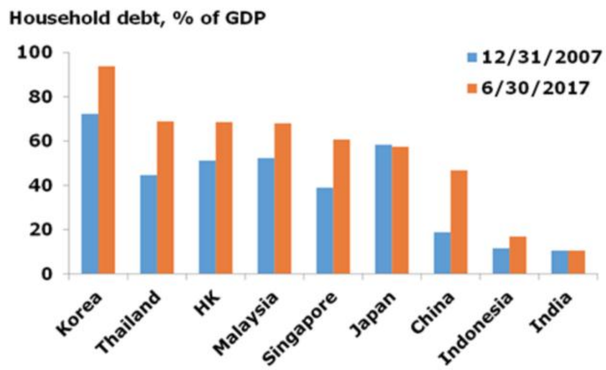
Growth of China’s corporate and household debt



Source: Bank for International Settlements.

Although considering the current proportion of mortgage debt in China GDP, it is not unduly leveraged. Given the proportion in GDP, China’s household debt is much less than other Asian economies such as South Korea, Thailand, and Malaysia. But the point is that the lurking boom in mortgage loans may add to the frothiness of the economy. According to official figures, the value of mortgage loans increased 22% last year, much faster than the 12.7% rise recorded for whole credit.

Furthermore, the chain effect aroused by the household leverage is not simply a loan owned by the household, but also made up of sub-loans owned by many households. In China, the home price to income ratio reached a point of 25 to 1, so high that many young households rely on their relatives, families, and friends to pay the debt. Once they cannot pay back, the chain effect will soon collapse in these loops. The risks are emerging for highly leveraged households with relatively weak loan repayment capability. Restrictions on mortgage lending have been implemented with some success achieved, but consumers have come up with ideas to bypass those lending limits. Some consumer loans categorized as non-mortgage debt were used for household purchases, while shadow banking sector also made it easier for average households to finance high-value items such as real estate purchases.



Source: Bank for International Settlements.

The rapid growth of consumer loans conflating with the advanced mobile platforms in China has also accelerated the growth of shadow banking in China. Although the Chinese government has set up clearinghouses for the online lenders in 2017, the fast growth of consumer loans[3] in particular necessitates close monitoring and more advanced, granular due diligence conducted by lenders.

Shadow banking refers to those non-bank credit intermediary agents that convert savings into investments, with barely any monitor or oversight from regulators, thus involving higher risks.[4] Chinese commercial banks, which are mostly state-owned, have concentrated mainly on serving Chinese state-owned enterprises, ignoring the growing financial needs of small-to-medium-sized enterprises (SMEs) and ordinary Chinese people with rapidly accumulating wealth. Tech giants like Alibaba, Tencent, and other online firms, noticing this great amount of underserved individuals and SMEs, have stepped in to fill the niche. According to the statistics from People's Bank of China, China's mobile payments business has grown at a three-digit annual rate over the

[3] The People's Bank of China (PBoC) classifies household loans into two categories: loans for consumption purposes and operational loans. The former category includes household mortgage loans and consumer loans.
[4] Asian Development Bank, Local Debt in the People's Republic of China: Local Government Financing Vehicle's Debt Management and Risk Control -Replacing Shadow Bank Financing with Local Government Bond. October 2013

last five years. The transaction volume made online reached 198.86 RMB trillion in 2017, deriving from the explosive growth in 2015 with 108.22 RMB trillion and 157.55 trillion in 2016.[5]

Some online lenders have licenses to issue microloans. But most online lenders, including P2P lending platforms, do not hold a license to lend. Rising household leverage will be a pressing concern for the Chinese economy if it keeps growing at this pace.

Disposals of NPLs in China

The Chinese government has been carefully designing strategies to choke off the NPL risks. The top priority of staying stable required the government to adopt a considerate and prudential method to reduce ballooning debt levels.

China, using its own way to recognize NPLs, defined many non-performing loans as "special-mention loans". NPLs are just a part of "special-mention loans" that will only be addressed when the banks expect that they would incur a loss, otherwise they wouldn't make any specific notes about the loan, nor would the loan be regarded as an NPL [6], which would inhibit the country in accurately sizing up the risks.

Traditionally, the way that the government disposes of the NPLs is selling them to the national-owned asset management companies. There are four large national asset-management companies and many small local asset management companies to receive the loans and help to restructure them. However, those asset-management companies do not accept all problematic problems. They typically prefer large loans with relatively high recovery rates in order to control servicing costs.

NPL securitization is a much smaller loan disposal program in magnitude, which allows the banks to transform their diversified pool of portfolios into securities that qualified investors can purchase. However, behind the securitization, rampant practices to remove loans off their own balance sheets and then peddle them as high—yield products to individuals has been noticed by the authorities. Even though such strategies help freed up bank capital and made it available to extend new loans, the risks are not eliminated but disguised. To stem the risks, the regulators in China last year have forced banks to adopt more rigorous risk controls and require banks to come clean on off-book lending.

In October 2016, the Chinese government formally launched a debt restructuring program. This is designed to help banks to transfer loans to special purpose vehicles (SPVs) to be converted to equity. [7] The main difference between securitization and debt-equity conversion is that securitization removes the debt off banks' balance sheets while conversion transforms the assets that remain with the banks. However, the key of the NPL securitization and debt-equity swap is

[5] Wei Wang, David Dollar. What's happening with China's Fintech industry? Brookings Institution, February 8, 2018.
[6] PricewaterhouseCoopers. China's Non-Performing Loans are rising fast. December 2015
[7] See Cindy Li

the same: strict solvency and viability eligibility criteria for corporates and successful corporate governance should be provided to support operational restructuring.[8]

The CBRC also established creditor committees nationwide to address the potential problem loans. Multiple bank lenders will be able to coordinate credit extension and debt restructuring of troubled corporates with high debt burdens.

As for the LGFV debts that add up to the risks of the wobbling economy, the government has taken various measures to control the rapid increasing debts. For example, the 2014 revision of the budget law lifted the prohibition on government borrowing limitations. The provincial governments are now allowed to borrow up to a ceiling set by the central government for capital spending only, including from the domestic municipal bond market.

But more importantly, after prudential consideration, the central government may stop the function of LGFVs, let along their guarantees to local banks and insurance companies. Recently, the rating of LGFV in China has been downgraded, which suggests that the control was not in place at all and Beijing just sat idly by. Chinese governments' tolerance for the debt levels have faded and they might let the big default of the local government happen.

Another approach that recently rolled out to skim the frothiness is the government's taking over the company. China Insurance Regulatory Commission (CIRC) announced on Feb 23th that they will take over Anbang Insurance Group Co, one of China's biggest insurance conglomerates for a whole year. The action taken by the government is intended to solve Anbang's potential solvency, and regulators will also undertake approaches for equity restructuring, which will remain private, CIRC said. The crackdown on Anbang signaled that Chinese regulators are alarmed by the pressuring risks and determined to control financial risks, braking their spree of making acquisitions worldwide. In the past few years, Anbang has snapped a lot of deals worth over $30 billion worldwide.[9]

Anbang has been recognized as an insurance company selling risky "insurance products" in China. Their short-term products claim to have a high-yield in short-term, which, however, have been used to fund risky investments in illiquid assets such as mortgages. The defaults are few though, but once it breaks out, it might endanger the stability of the country. The selling high-yield products behaviors seemed to serve the purpose of funding their surging purchasing in foreign countries. Last year, the Chinese government has already banned Anbang from selling some of their insurance products.

The clampdown on Anbang signaled that government is placing preventing systematic risk as the top priority, and it is certain that Anbang alike groups like HNA groups might be quiet for a while. These recent actions taken by the Chinese government in tackling with financial risks stated that

[8] See James Daniel, José Garrido, and Marina Moretti
[9] See Areddy

the authorities have realized the deleterious effects financial risks will bring about and are trying their best to amend.

Conclusion

The continuing piling up pressure from a slow economy, higher housing prices and aging population is pushing China to the edge of reform. The magnitude of the NPLs has conveyed the urgency and seriousness of the problem and raised national concern.

The Chinese government seems to realize that there is no way to eliminate the debt binge while keeping the pace of growth rate, so they now turned to a strategy of controlling the debt and cut the borrowings. For example, from November 2017, Beijing has stopped new projects in construction, including two $4 billion subway projects in Inner Mongolia.

Furthermore, to supplement the NPL risk elimination process, the Chinese government is also working on cutting overcapacity. The effort to withdraw zombie companies out of the industry improves the efficiency of industry and promotes the health and sustainability of the whole sector. In 2018, there will be a reduction in steel capacity by around 30 million tonnes and coal output by about 150 million tons.

Aside from this, China also tightens rules to restrict the amount of government borrowing limit. The China Insurance Regulatory Commission (CIRC) and the Ministry of Finance published a notice on January 8th, saying that insurers cannot finance the local government via any illicit and risky lending practices. The insurance regulation authority said that they will also come up with a plan to establish a credit risk assessment system to provide risk warnings to insurance companies. Meanwhile, the authorities have shown the determination to resolutely kept local governments from violating central bank rules. The action also includes a close monitor and inspection of cities and provinces that falsifies fiscal revenues. The misleading statements or major omissions occurred in law firms or accountancy services would also be held accountable.

These austerity measures taken by Chinese authorities indicate their awareness of the looming risk. The Chinese government is also using some strategies to cushion against the loan losses. There is a certain amount of cash reserves held by Chinese corporations, for the sake of a potential crisis. [10]The cash hoard has been kept rising for past years. These cash holdings may be utilized to help industry consolidation, in order to reduce overall repayment risk.

The point of these combined deleveraging strategies is that they will not lead to too much pressure on the Chinese economy, which requires subtle tweaks and balances in the policy design and execution process. How to efficiently allocate capital to support the slowing economy and enact structural reform is what concerns China most. A smooth transformation not only challenges China's effort but also time and patience.

[10] Kana Nishizawa, China Inc. Has $1 Trillion in Cash that It's too scared to spend, https://www.bloomberg.com/news/articles/2016-08-02/china-inc-has-1-trillion-in-cash-that-it-s-too-scared-to-spend

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