ECONOMIC ANALYSIS

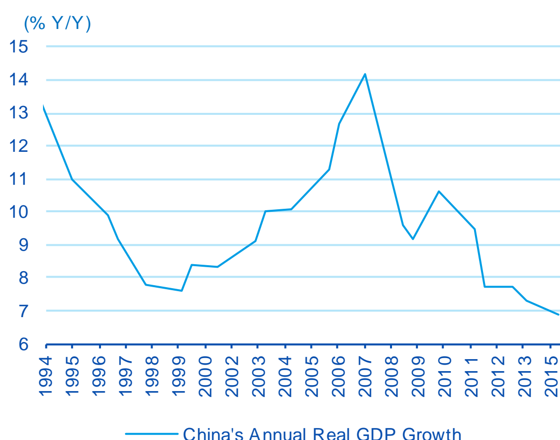
ASIA | Equity-for-Debt swap – A Pareto-optimal solution to China's banking sector woes?

Sumedh Deorukhkar / Le Xia

Summary

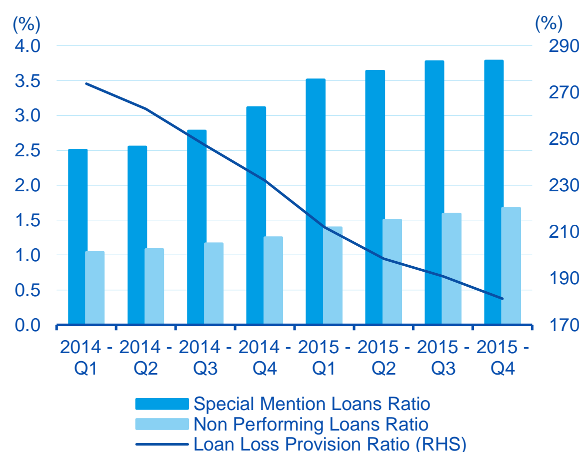
- China's banking sector faces the pressure from rising NPLs. Banks' profit margins are narrowing and asset quality deteriorates on the back of a sub-optimal credit culture characterised by credit growth far outpacing nominal GDP growth, and rising corporate default risk as industrial overcapacity and a glut in property sector weakens cash flows and hurts debt servicing ability of corporate borrowers.
- To address the NPL problem in the banking sector, China's authorities has recently proposed Equity for Debt Swap (EDS) program, aiming to reduce stressed assets across China's commercial banks and lessen firms' debt burden. However, significant lack of clarity clouds China's new EDS program, ranging from the eligibility of distressed firms, to the time limit for banks to offload newly acquired equity stakes.
- We believe the new EDS scheme is unlikely to be a painless Pareto-optimal[1] solution, at least in the short term. The risk profile of stressed corporates won't materially improve unless the new promoters implement an effective restructuring program. Further, liquidity profile of banks may come under pressure while investor's ability to judge the intrinsic riskiness of newly acquired equity will be tested.
- Meanwhile, the authorities need to draw on other countries experience in designing its own version of the EDS scheme. Indeed, there exist some precedents in this respect from 1980s in Latin American economies to as recent as one currently underway in India. Although not all alike, these could provide important cues for China's EDS program.

Figure 1
China's GDP growth moderation to continue



Source: BBVA Research, CEIC database

Figure 2
Rising asset quality concerns of Chinese banks



Source: BBVA Research, Haver Analytics Data

1: Pareto-optimality is a state of allocation of resources in which it is impossible to make any one individual better off without making at least one individual worse off. It is an allocation of economic resources that produces the greatest good.

Challenges facing China's banking sector

Declining debt servicing ability of corporates, an overhang of property inventory and an uncertain policy outlook are impinging upon Chinese banks' credit performance, profitability and capitalization levels. Industrial overcapacity and slowing demand is affecting cash flows of Chinese corporates while weak pricing power due to low commodity prices is dragging on profit margins. Growth woes, protracted deflation in producer prices, a supply glut and over-capacity in industries, particularly in commodity dependent sectors, has undermined the debt repayment capacity of Chinese corporates, bulk of which are burdened by high leverage. With the pace of debt increase offsetting corporate efforts to cut costs and capex, Debt-EBITDA ratios of China's broad corporate sector have edged higher over recent years. Credit distress has spread from specific sectors such as chemicals, shipbuilding, metals and mining to a broad set of manufacturing companies. Given China's sub-optimal credit culture, where credit growth far outpaces nominal GDP growth (by 2X times); and banks' credit expansion is faster than internal capital accretion, lower bank profitability can squeeze bank capitalization.

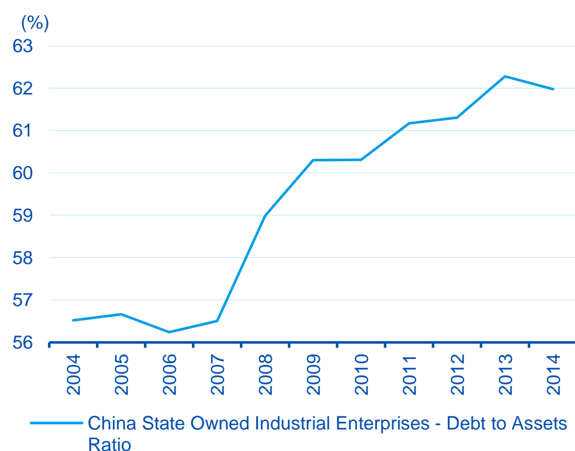
Chinese banks ability to withstand credit shocks is disparate

While extra-ordinary government support would cushion the mega-banks and other large banks from such credit risks, smaller banks remain highly vulnerable. Aggressive expansion of interbank lending, complex funding arrangements of leveraged positions have exposed the weaker and smaller Chinese banks to significant counterparty risks. The pace of deterioration in asset quality of Chinese banking sector is expected to rise in 2016. While NPLs rose, averaging 2.2% last year, Chinese banks aggressively scaled back their bad loans coverage ratios in the wake of declining profitability. Besides NPLs, special mention loans (still performing loans but on the verge of slipping) are rising as well.

Chinese policymakers taking steps to underpin its banking sector

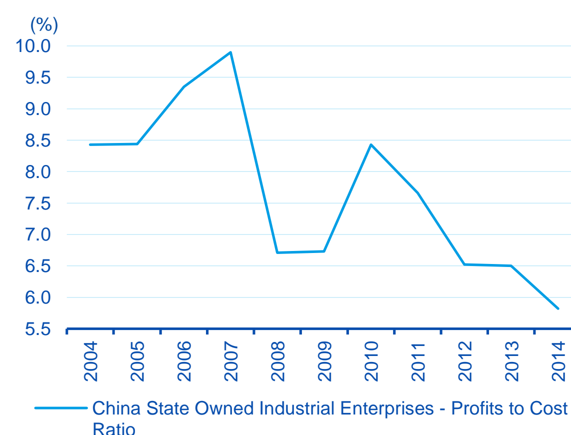
Key steps announced by Chinese authorities to aid its banking sector include: 1) measures to dispose banks' non-performing loans through Equity for Debt Swap (EDS) and Securitization of NPLs; and 2) Local Government Debt Consolidation, which aims to replace local government debt incurred through Local Government Financing Vehicles (LGFVs) with provincial government bonds. While we focus on the EDS in

Figure 3
SOE debt levels have accelerated since 2007…



Source: BBVA Research, Haver Analytics Data

Figure 4
… While their profitability have declined sharply



Source: BBVA Research, Haver Analytics Data

this watch, we believe that Local Government Debt consolidation is a particularly positive step given that bulk of the LFGV debt constitutes bank loans. Meanwhile, securitization of NPL's raises several issues such as the prospective buyers who would invest in such kind of products or whether it would turn out to be just a cross-holding of Chinese banks, which would mean that NPLs continue to remain in the Chinese banking sector.

China's proposed Equity for Debt Swap scheme lacks necessary clarity

Significant lack of clarity clouds China's proposed Equity for Debt Swap (EDS), which empowers China's commercial banks to swap the bad loans on their books for equity stakes in the stressed corporates. It is unclear, 1) whether the swap scheme would be handled by commercial banks/creditors themselves or through the Asset Management Companies (AMCs) setup at the four big state owned banks to handle bad loans, 2) the eligibility of distressed corporates for equity for debt swap, 3) provisioning requirements for banks to tide over possible loss in newly acquired equity, 4) minimum shareholding requirements in the distressed corporate, 5) the time limit for banks to hold on to such equity stakes and 6) the policy norms for banks to successfully offload its non-financial equity stakes to a capable new promoter. Experience from China's old Equity for Debt Swap scheme, which was enacted in 2000 exclusively for SOE debt owed to its four main commercial banks or to its State Development Bank, suggests that AMCs have faced significant challenges in effectively exercising their ownership rights and restructure the SOEs. In this context, we believe that the new EDS scheme, which would involve all commercial banks, can succeed if the banks own a majority stake in the stressed corporate and effectively sell its equity stake to a capable promoter, who is empowered to restructure the bad asset. Finding the right buyer, who adopts good corporate governance practice and adopts effective over-sight, is a challenge in today's tough environment. While NPLs per se will decrease, the risk profile of corporates does not materially change in the short term owing to the risk of possible loss in value of equity acquired in lieu of debt and residual loans. Also, liquidity profile of Chinese banks comes under pressure in the short term with bank capital ratios taking a one of hit as they make sufficient provisions for the loan value to offset possible loss in newly acquired equity. Furthermore, China's capital markets are not deep enough to absorb the size of bad debts and investors are less likely to ascertain the risks involved in buying low quality assets.

In the longer term, the new scheme would help banks maximize their recovery and get bad-loans off banks' books, in turn reducing the need to provision for loan losses and thus aid capital levels. China may allow commercial banks to convert in excess of 1.3 trillion Yuan (USD 154.4 billion) of bad loans into equity in less than three years. For starters, the new scheme is expected to be availed by China Minsheng Bank, Bank of China and The Export-Import Bank of China to swap their stake of 14%, 11% and 10% respectively in Huarong Energy, which will avail the swap facility to settle a USD 2.2 billion debt with its creditors. The aggregate NPLs of China's 5 biggest banks – Bank of China, Agricultural Bank of China, Industrial and Commercial Bank of China, China Construction Bank and Bank of Communications – were 1.27 trillion Yuan in 2015, the highest in a decade.

Learning's for China from past and present EDS programs by other countries

Equity for Debt swaps date back to the 1980s, when some creditor banks and equity investors co-operated with debt-laden Latin-American governments, namely Chile, Brazil, Mexico and Argentina, as well as the Philippines[2] in Asia, to convert banks' loans to these governments into equity stakes in domestic public sector corporations. The 1980s Equity for Debt swaps were used to retire a significant part of overall debt of sovereigns, e.g. Chile retired USD 1.2 bn or 7% of its total debt in 1986 with Bankers Trust (US) converting its own USD 60 million loan to Chilean government into 51% equity stake in Chile's largest pension fund and

2: In Philippines, American Express (US) swapped its USD 10 mn of public sector loans into 40% stake in International Corporate Bank of Manila in late 1980s.

97% in an insurance company. Learning's from these sovereign swap deals provide important cues for China's EDS program. On the positive side, such swap deals improved the ability of debtor nations to service remainder of the debt with creditors not having to sell their loan papers at a deep discount. On the flipside, policymakers need to check for 1) 'Round-tripping', where such swap deals are used by acquired corporates for tax evasion and money laundering, 2) while they helped liquidate fixed amortization outflows, future liabilities may be greater for corporates if newly acquired equity capital is not wisely invested,

Meanwhile, in a recent, more topical example, the Reserve Bank of India, over the past couple of years has taken several initiatives to address India's Banking sector risks emanating from high NPLs and capital adequacy concerns, particularly amongst India's public sector banks. RBI's SDR initiative, which was introduced in June 2015, is aimed at empowering banks to take over the management of a beleaguered firm after debt restructuring efforts have failed or are near failure. The joint lenders forum (JLF), a consortium of bankers and financial institutions, can take the SDR route to recover the loan extended to the company. The SDR scheme aims to revive stressed companies and provide an option to the JLF to initiate change of management in companies, which fail to achieve the milestones under Corporate Debt Restructuring (CDR). The JLF acquires the majority stake in the company by converting a part of the outstanding loan into equity. At a later date, it transfers the control to a new promoter, who has the ability to turn around the company. Banks can hold the equity for 18 months and, in the interim, sell assets or look for a new management for the company.

The Reserve Bank of India (RBI) has asked lenders going in for the strategic debt restructuring (SDR) scheme to make sufficient provisions to the tune of at least 15 per cent of the loans value, to tide over possible loss in the value of the equity they acquire in lieu of debt and residual loans. While banks may still have to acquire at least 51% of the shares of the borrower by conversion of loans, may sell only minimum 26% out of the 51%, and retain the remaining holding, with intent to cause a sale of the remaining holding later. However, the banks have to be still successful in causing a change of management with the 26% divestment. As regards the remaining stake, banks may, upon the unit turning around, either sell the stake to the incoming management (with whom the banks will have a right of first refusal), or to any new acquirer. To meet the 18 month deadline, Indian bankers are working on three options: selling the assets to PE funds that have stressed asset or special situation funds; pitching lower-value assets to domestic funds; and looking for strategic buyers who, in turn, may be backed by PE firms to fund the purchase. Since RBI's announcement, Indian banks have taken majority equity control in fifteen defaulting companies so far. While banks may have to sell their stakes for less than they would have liked to, they will still get more than what liquidation of the assets would have fetched. On the contrary, if these assets were to be classified as NPAs and they were to start recovery, it is unclear how much capital banks would be able to get back on their books.

DISCLAIMER

This document and the information, opinions, estimates, forecasts and recommendations expressed herein have been prepared to provide BBVA Group's customers with general information and are current as of the date hereof and subject to changes without prior notice. Neither BBVA nor any of its affiliates is responsible for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, to undertake or divest investments, or to participate in any trading strategy. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. Other than the disclosures relating to BBVA Group, the contents of this document are based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA or any of its affiliates and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. To the extent permitted by law, BBVA and its affiliates accept no liability of any type for any direct or indirect losses or damages arising from the use of this document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, derivatives, options on securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances, investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying securities. Investors should also be aware that secondary markets for the said instruments may not exist. Before entering into transactions in futures, derivatives, or options, investors should review all documents on disclosures for risks of investing in options and/or futures at the following websites:

Options - http://www.finra.org/Industry/Regulation/Notices/2013/P197741

Futures - http://www.finra.org/Investors/InvestmentChoices/P005912

BBVA or any of its affiliates' salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates' proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. More specifically, this document is in no way intended for, or to be distributed or used by an entity or person resident or located in a jurisdiction in which the said distribution, publication, use of or access to the document contravenes the law which requires BBVA or any of its affiliates to obtain a licence or be registered. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

The remuneration system concerning the analysts responsible for the preparation of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

In the United Kingdom, this document is directed only at persons who (i) have professional experience in matters relating to investments falling within article 19(5) of the financial services and markets act 2000 (financial promotion) order 2005 (as amended, the "financial promotion order"), (ii) are persons falling within article 49(2) (a) to (d) ("high net worth companies, unincorporated associations, etc.") of the financial promotion order, or (iii) are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the Financial Services and Markets Act 2000) may otherwise lawfully be communicated (all such persons together being referred to as "relevant persons").

This document is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is available only to relevant persons and will be engaged in only with relevant persons.

BBVA Hong Kong Branch (CE number AFR194) is regulated by the Hong Kong Monetary Authority and the Securities and Futures Commission of Hong Kong. In Hong Kong this report is for distribution only to professional investors within the meaning of Schedule 1 to the Securities and Futures Ordinance (Cap 571) of Hong Kong.

This document is distributed in Singapore by BBVA's office in this country for general information purposes and it is generally accessible. In this respect, this document does not take into account the specific investment goals, the financial situation or the need of any particular person and it is exempted from Regulation 34 of the Financial Advisors Regulation ("FAR") (as required in Section 27 of the Financial Advisors Act (Chapter 110) of Singapore ("FAA")).

Garanti Securities headquarters is in Istanbul, Turkey and is regulated by Capital Markets Board (Sermaye Piyasası Kurulu - SPK, www.spk.gov.tr)

BBVA, BBVA Bancomer, BBVA Chile S.A., BBVA Colombia S.A., BBVA Continental, BBVA Securities and Garanti Securities are not authorised deposit institutions in accordance with the definition of the Australian Banking Act of 1959 nor are they regulated by the Australian Prudential Regulatory Authority (APRA).

General Disclaimer for Readers Accessing the Report through the Internet

Internet Access

In the event that this document has been accessed via the internet or via any other electronic means which allows its contents to be viewed, the following information should be read carefully:

The information contained in this document should be taken only as a general guide on matters that may be of interest. The application and impact of laws may vary substantially depending on specific circumstances. BBVA does not guarantee that this report and/or its contents published on the Internet are appropriate for use in all geographic areas, or that the financial instruments, securities, products or services referred to in it are available or appropriate for sale or use in all jurisdictions or for all investors or counterparties. Recipients of this report who access it through the Internet do so on their own initiative and are responsible for compliance with local regulations applicable to them.

Changes in regulations and the risks inherent in electronic communications may cause delays, omissions, or inaccuracy in the information contained in this site. Accordingly, the information contained in the site is supplied on the understanding that the authors and editors do not hereby intend to supply any form of consulting, legal, accounting or other advice.

All images and texts are the property of BBVA and may not be downloaded from the Internet, copied, distributed, stored, re-used, re-transmitted, modified or used in any way, except as specified in this document, without the express written consent of BBVA. BBVA reserves all intellectual property rights to the fullest extent of the law.