



Bridging the Gap

Global Private Sector Capital as
One Solution for NPLs

做为不良资产和全球资金的桥梁

BENJAMIN FANGER, FOUNDER - SHOREVEST PARTNERS

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FINANCIAL STABILITY SEMINAR ON MANAGING NPLS IN ASIA AND EUROPE
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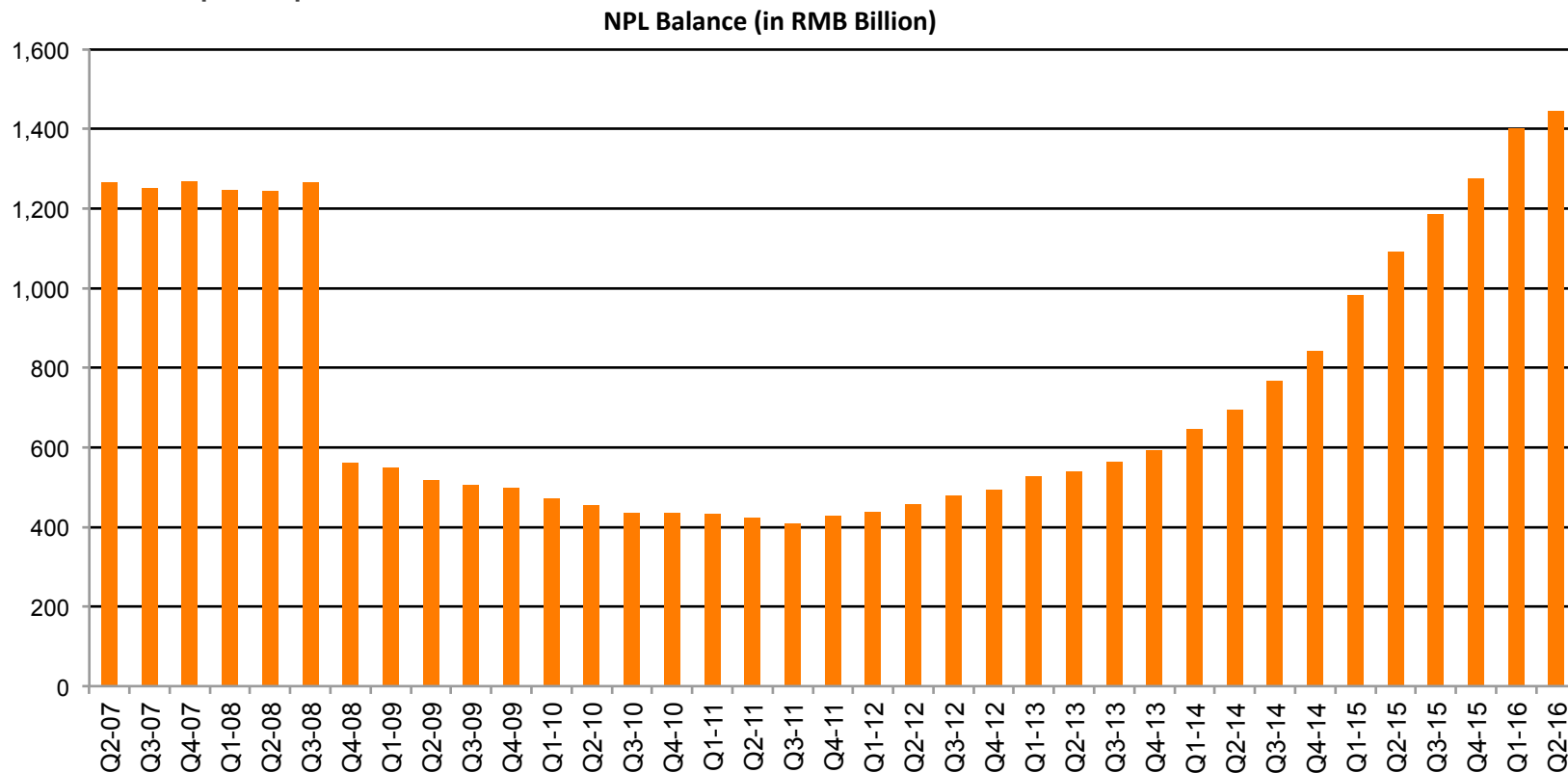
Alternative Paths – (1) Government Bailout

(1) Government Bailout (e.g., China 1990's)

- Government Bailout (China 1990's)
 - Taxpayers bailout equity holders (including foreigners)
 - Moral Hazard – no change in risk behavior
 - Cycle repeats quickly; bubbles re-emerge
- Pros:
 - Removes systemic risk quickly
 - Recaps banks quickly so can continue lending straight away
 - Ensures social stability (jobs/employment/income), so politically palatable
- Cons:
 - Embeds moral hazard – “Sovereign Put” promotes reckless behavior
 - Allows continued mis-allocation of capital
 - Excess capacity builds; un-economic business models persist
 - Very inflationary short term; deflationary medium/long term
 - Poor quality GDP
- Conclusion:
 - Acceptable for short term goals; Not acceptable long term

(1) Gov't Bailout - China NPL Balances Accelerating Again

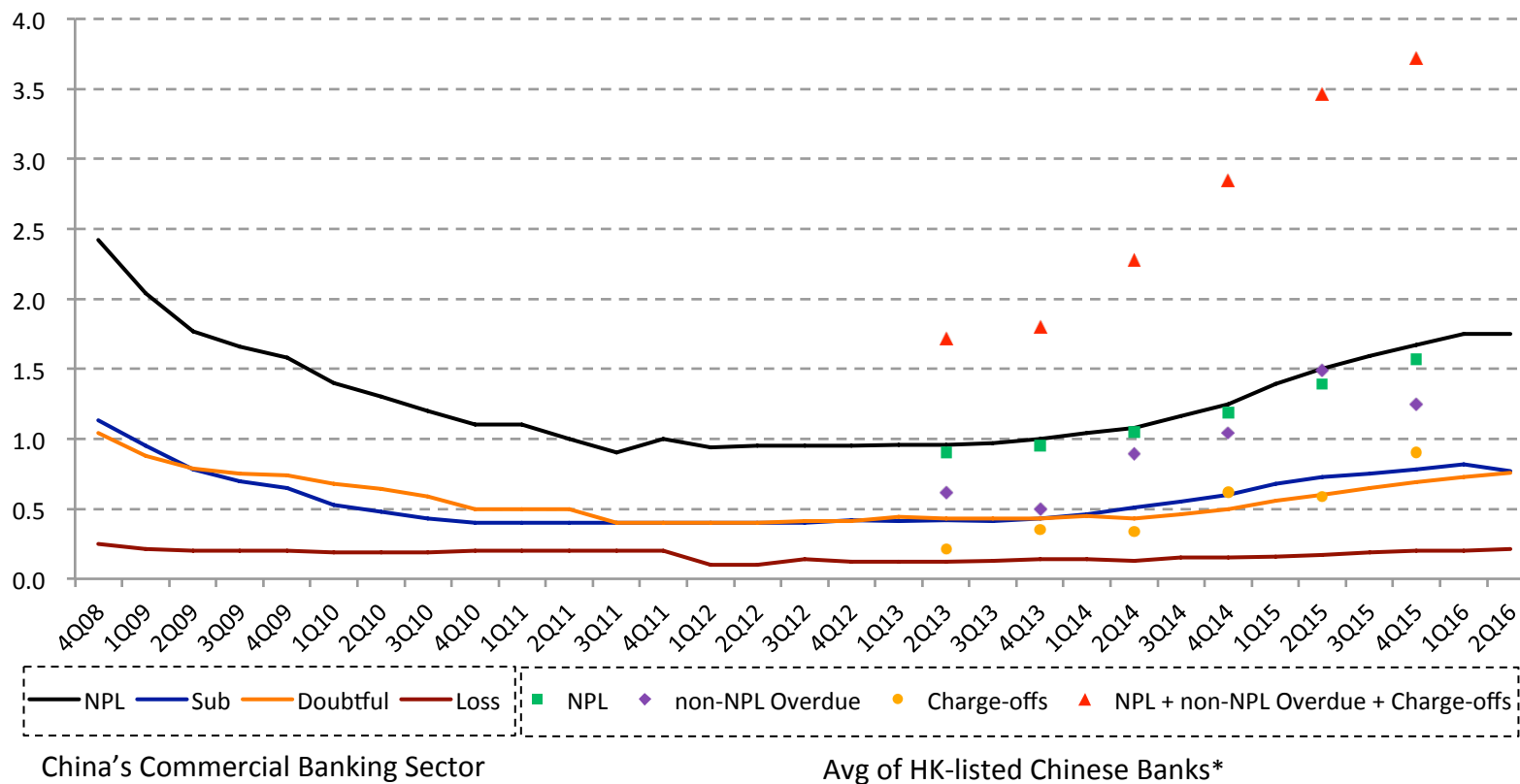
Gov't Bailout had NPLs removed from banks immediately. But now growing quickly and above prior peak as the credit boom's loans come due.



(1) Gov't Bailout - China NPL Ratio inflecting upward fast

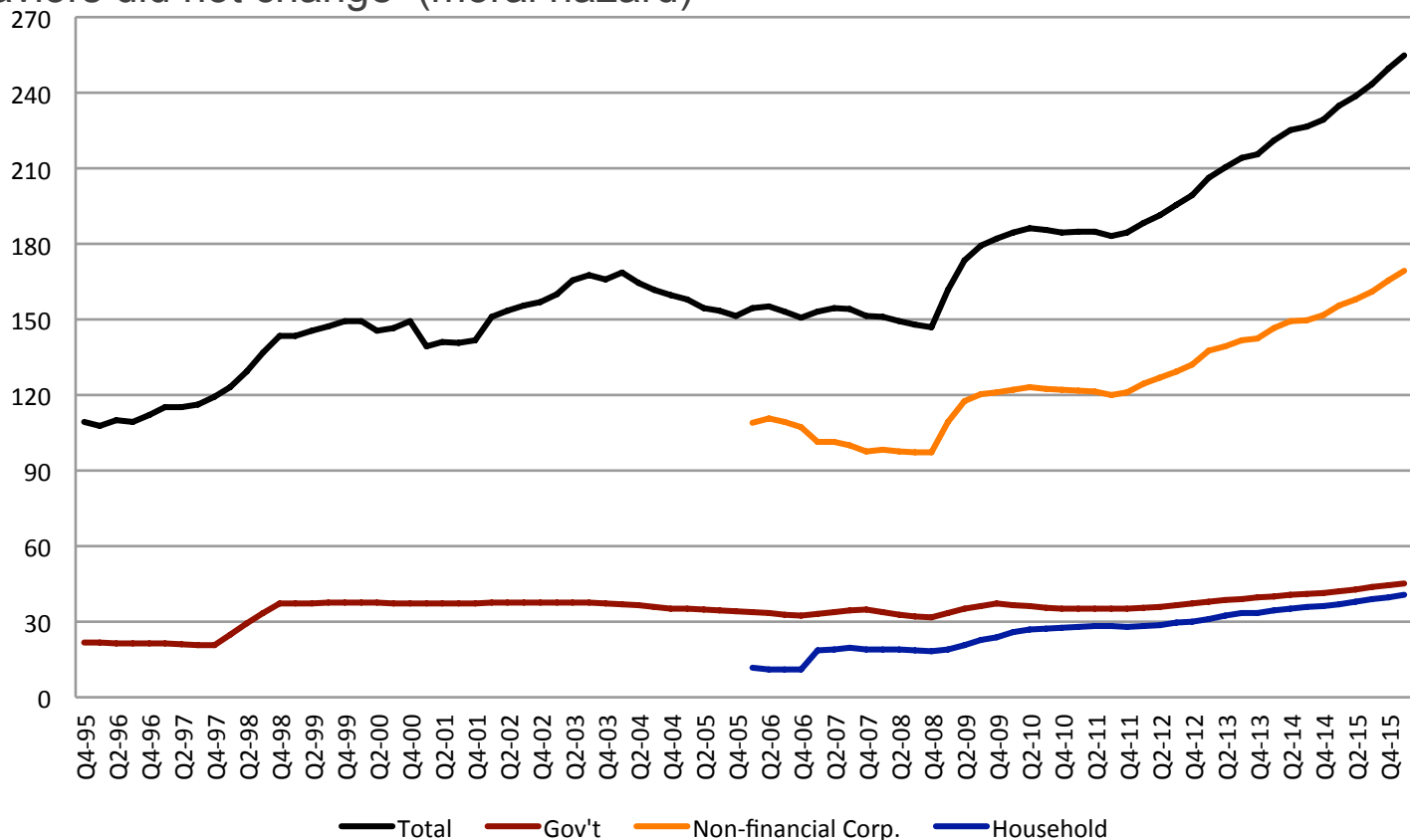
China's NPL ratio is starting to rise, and total problem credits are accelerating, both in absolute terms and as a percentage of total loans

% of total loan



(1) Gov't Bailout – China's debt continues to grow rapidly

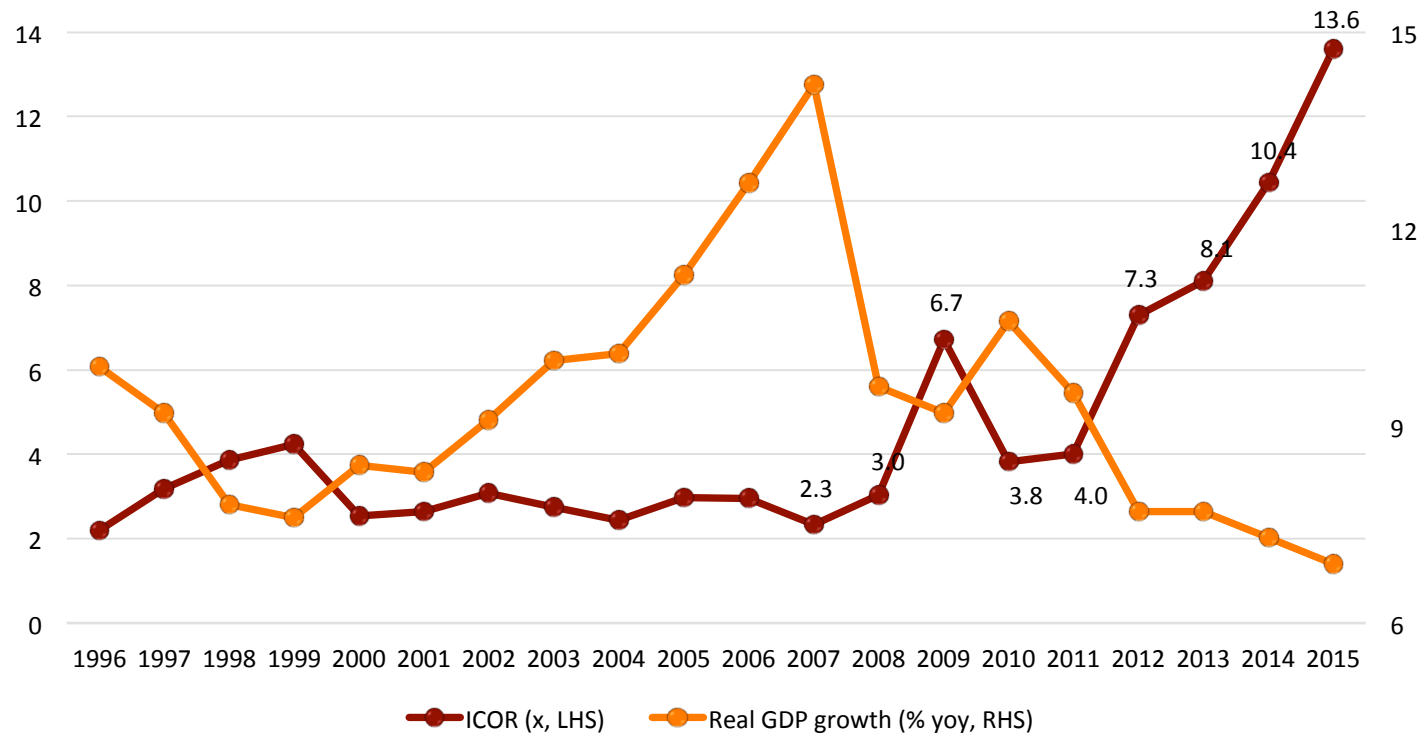
Despite the bailout in 2008, debt has continued to grow rapidly (particularly corporate) as behaviors did not change (moral hazard)



Sources: BIS

(1) Gov't Bailout – China's quality of GDP deteriorating

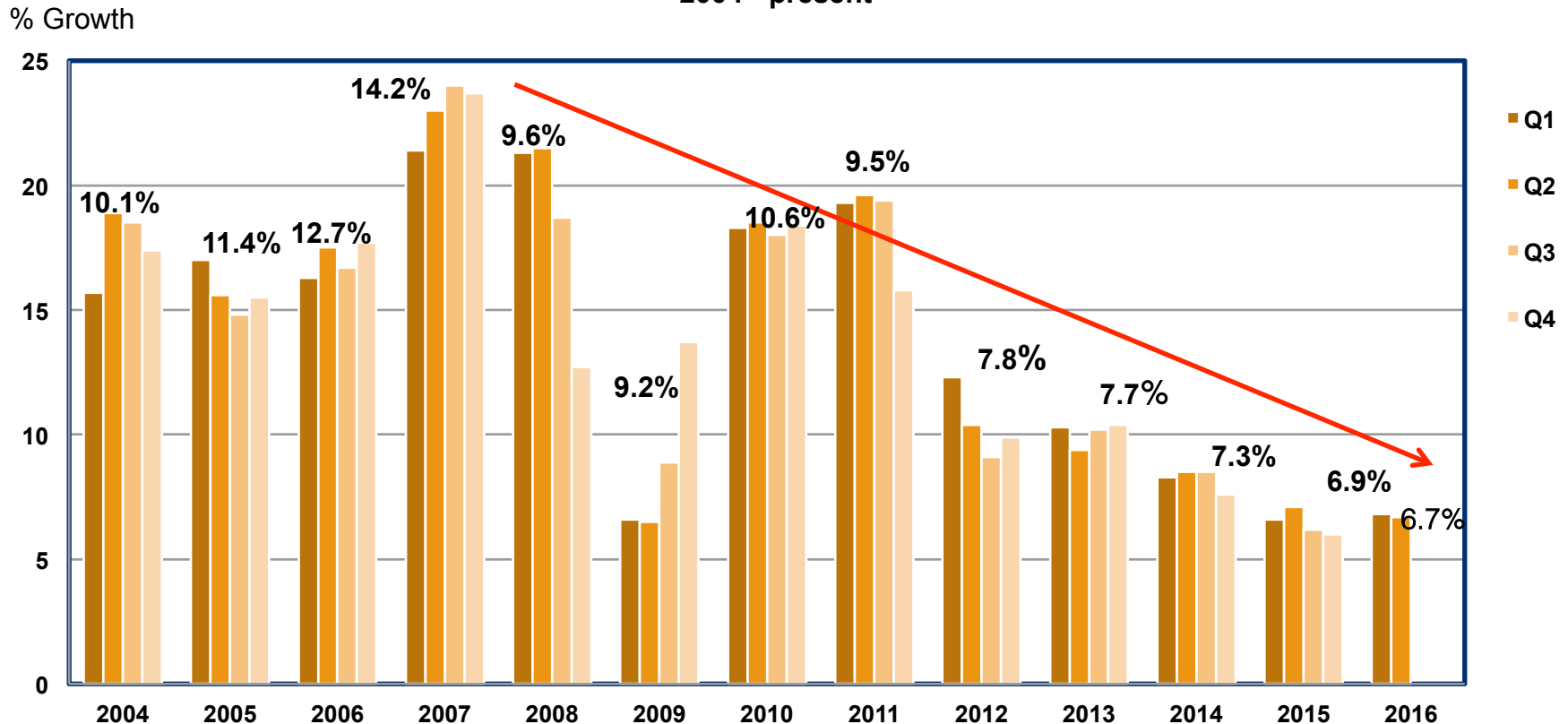
China's ICOR (Incremental Capital Output Ratio) shows rapidly declining investment efficiency. New credit is generating very little GDP.



Note: ICOR is the amount of investment needed to produce one unit of GDP (we use Fixed Asset Investment)
Sources: BIS

(1) Gov't Bailout –structural changes not made; GDP suffers

China Quarterly GDP % Growth (YoY)
Annual GDP Growth
2004 - present



Source: National Bureau of Statistics of China, The World Bank

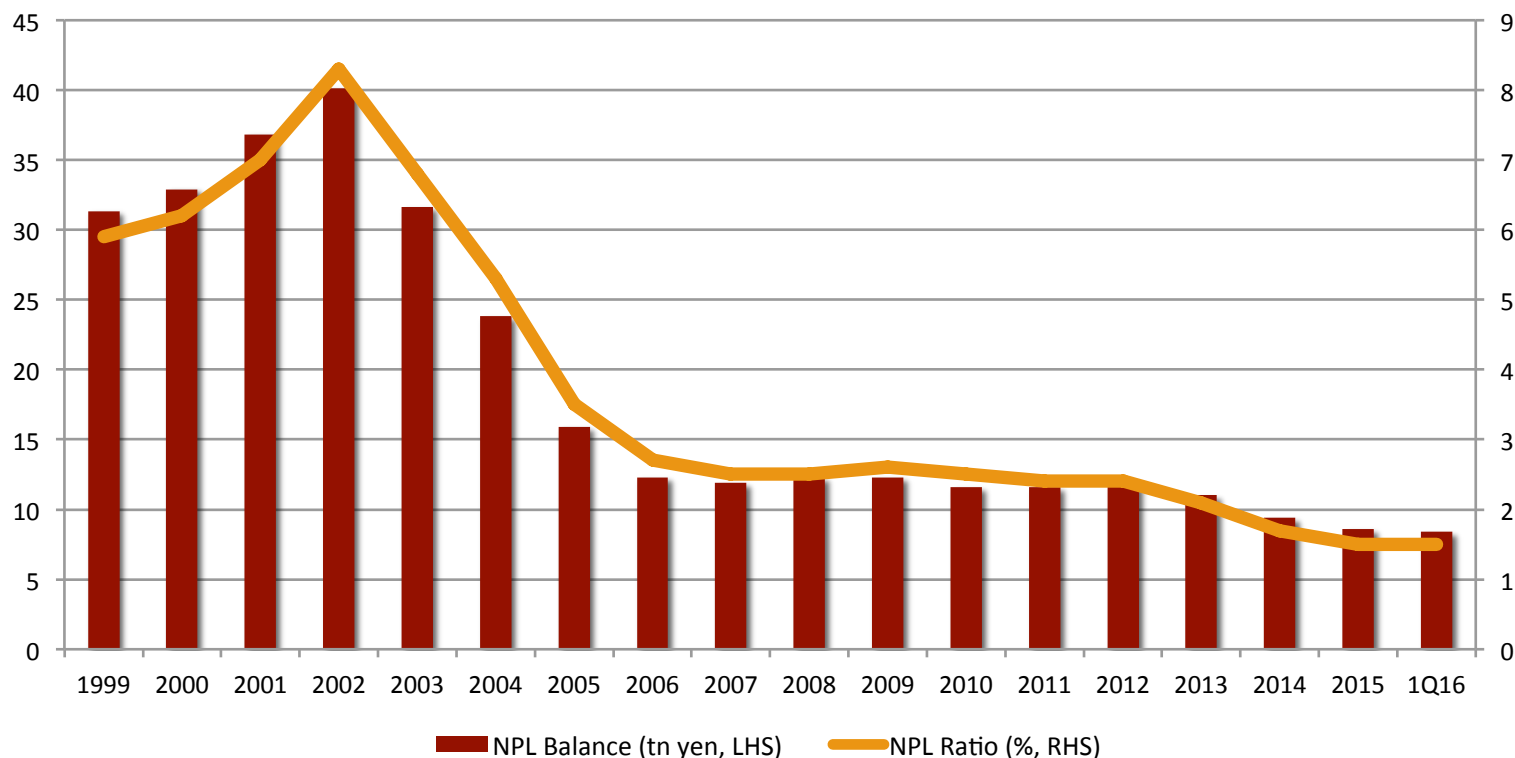
Alternative Paths – (2) Extend & Pretend

(2) Extend & Pretend (e.g., Japan 1990-2013)

- Extend and Pretend (Japan 1990 to 2013)
 - Rollover/evergreen to avoid mark-to-market losses
 - Keeps “zombie” companies alive; excess capacity persists
 - Very deflationary as no structural changes
 - Credit transmission mechanism breaks down
- Pros:
 - Short term ensures social stability so politically palatable
 - Optically appears no problem (short term phenomenon)
 - Promotes deposit growth as cash becomes safe haven
- Cons:
 - Unsustainable by definition
 - Asset values erode as deflation sets in (financial and physical assets)
 - Incomes stagnate; consumption declines
 - Bank profitability suffers and restrains new credit creation
 - GDP mired in prolonged slow (or no) growth
- Conclusion:
 - **NOT** Acceptable

(2) Extend & Pretend – NPLs only dropped 10yr after peak

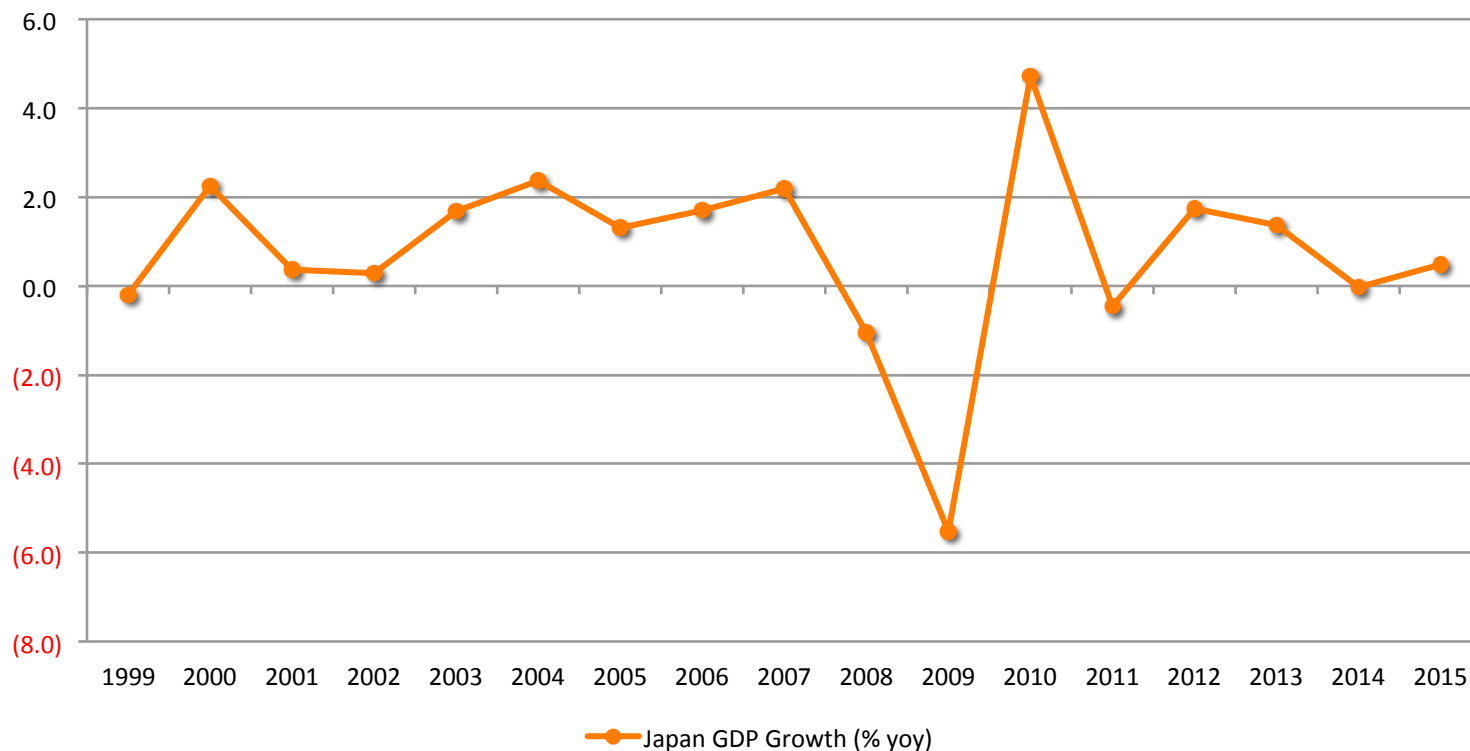
Japan's NPLs remained high for 13 years (from 1990-2003) before writeoffs and have been flat for 10yrs since



Sources: Japan Financial Services Agency

(2) Extend & Pretend – Japan's GDP prolonged stagnation

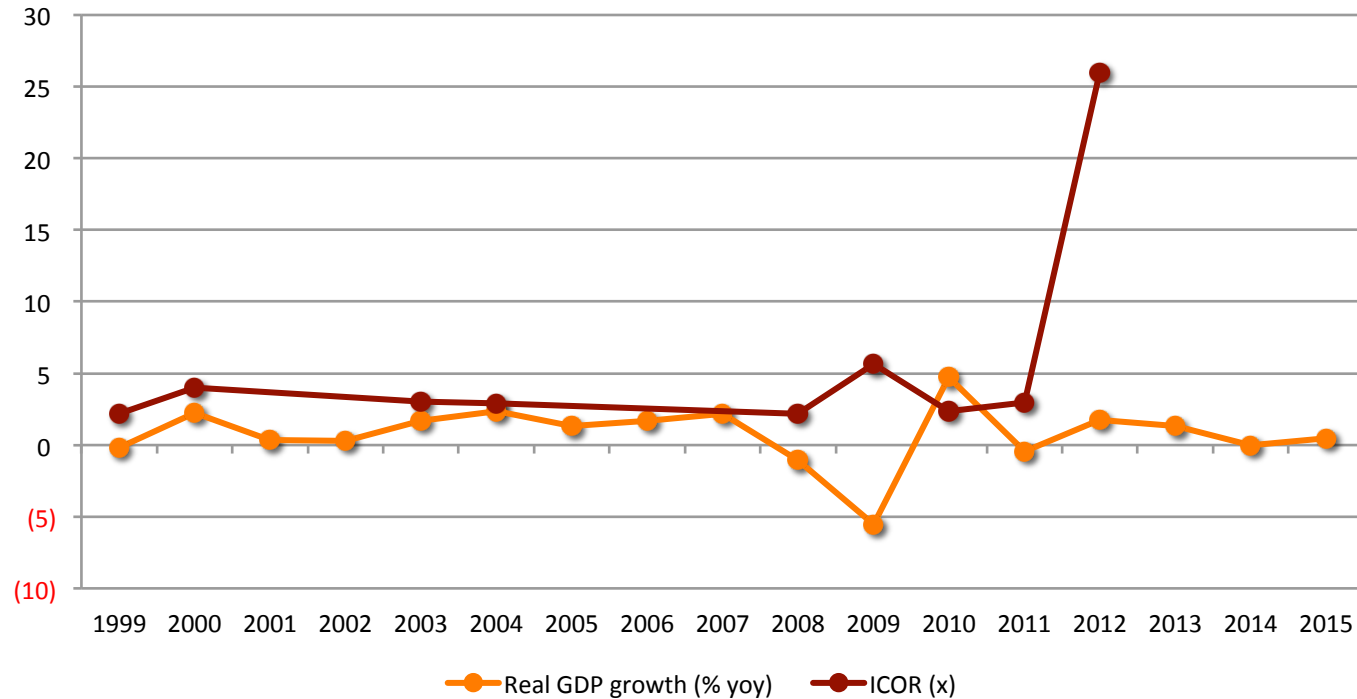
As a result of not writing off bad debts for so long, credit has not grown and the economy has stagnated at very low growth



Sources: World Bank

(2) Extend & Pretend – Japan’s investment efficiency lacks

Japan’s new credit creation has not resulted in GDP growth

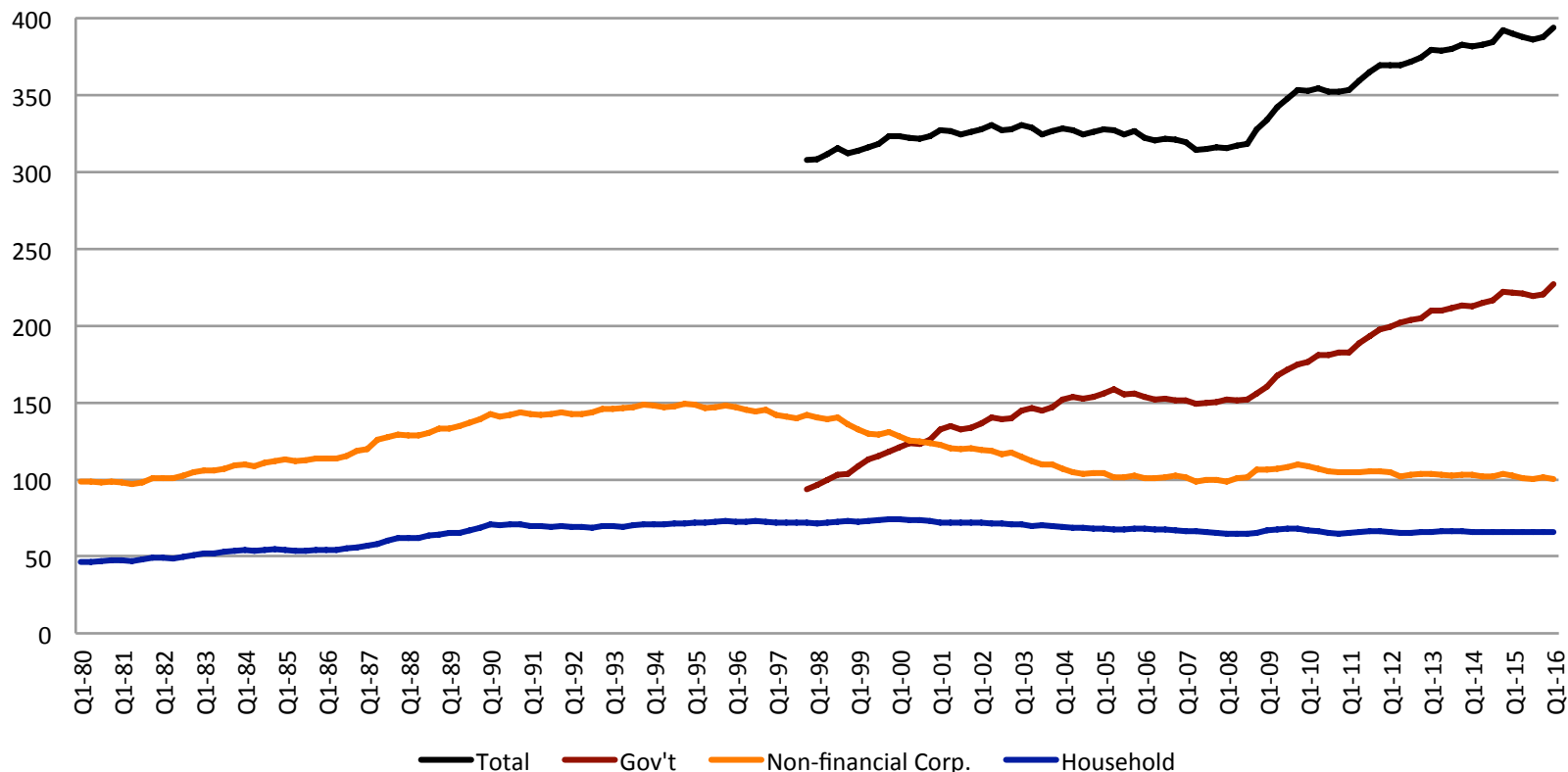


Note: ICOR is the amount of investment needed to produce one unit of GDP (here use Gross Fixed Asset Formation); Negative ICOR (which happens when nominal GDP declines) is left out here

Sources: World Bank

(2) Extend & Pretend – Japan’s only new credit is Sovereign debt (ineffectual effort to stimulate)

As a result of "evergreening" loans, debt/GDP in the real economy has remained essentially flat. Deflation has all but eliminated credit demand



Sources: BIS

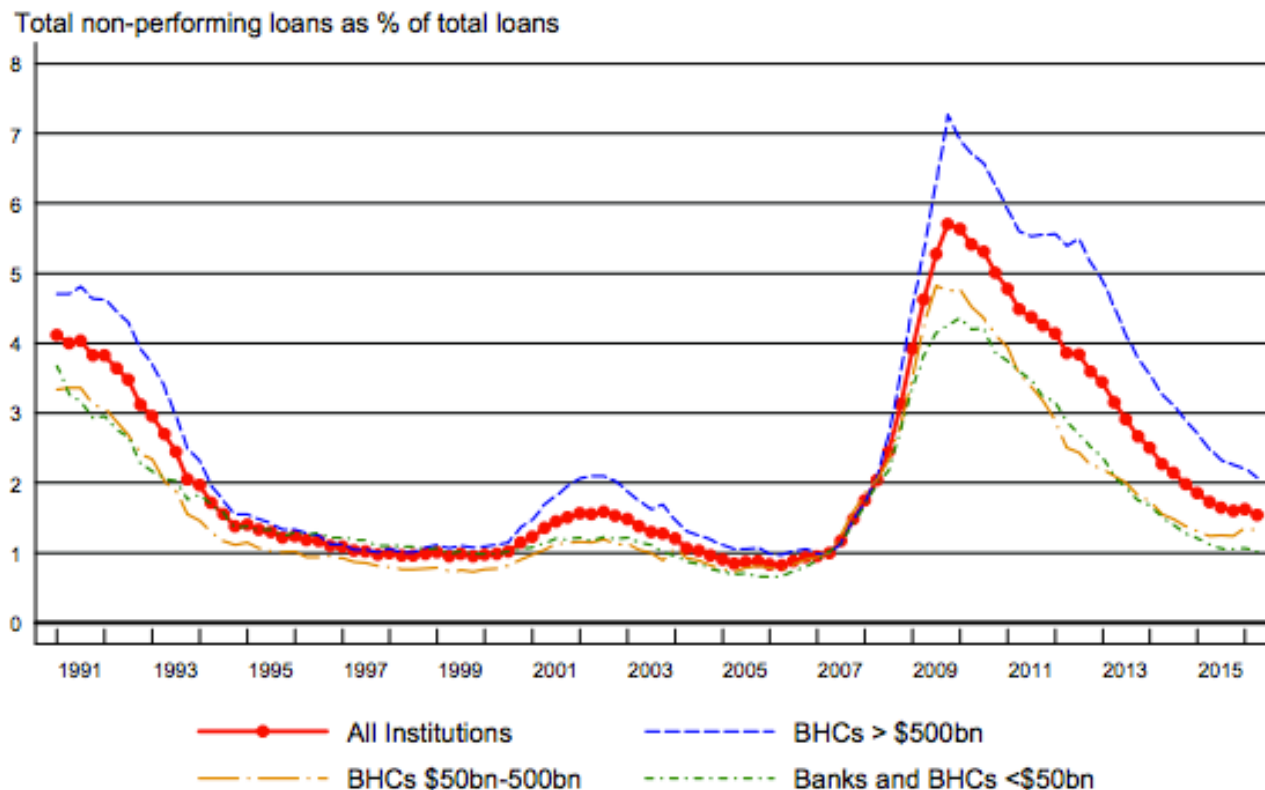
Alternative Paths – (3) Market Based

(3) Market-Based (US 2008-2011)

- Market-Based/Loss Recognition (US 2008 to 2011)
 - Banks write-off as quickly as can
 - Banks significantly recapitalize; equity holders incur loss
 - Restart lending with improved pricing and underwriting
 - Allocate capital to productive industries/business models
 - Structural changes required
- Pros:
 - Price discovery
 - Deflates “bubble” to realistic clearing prices/fundamental valuation
 - Eliminates un-economic business models/excess capacity
 - Re-aligns economy to value-add businesses
 - Ensures long-term, viable GDP growth
- Cons:
 - Unemployment spikes (temporary)
 - Incomes drop materially and quickly
 - Equity investors absorb losses
 - Creates relative political instability
- Conclusion:
 - **Short-term Pain; Long-term GAIN**

(3) Market-Based -- US NPLs peaked in a 2yr period

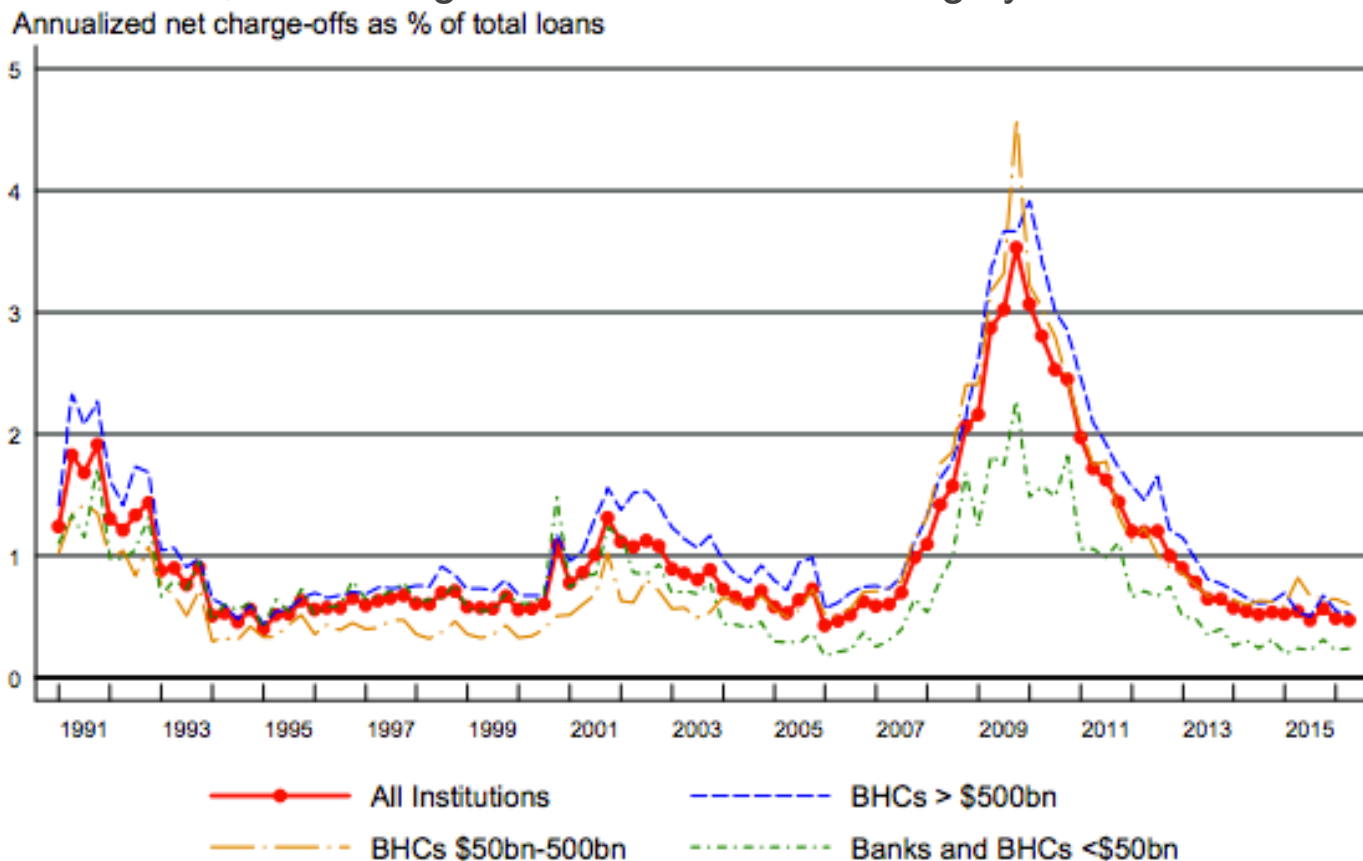
As US banks heavily wrote off bad debts and recognized losses, NPLs peaked within a 2yr period, allowing for a resumption in economic activity



Note: NPLs include loans that are 1) 90 days or more past due and still accruing or 2) non-accrual
Sources: Federal Reserve Bank of New York

(3) Market-Based -- US banks aggressively wrote-off NPLs

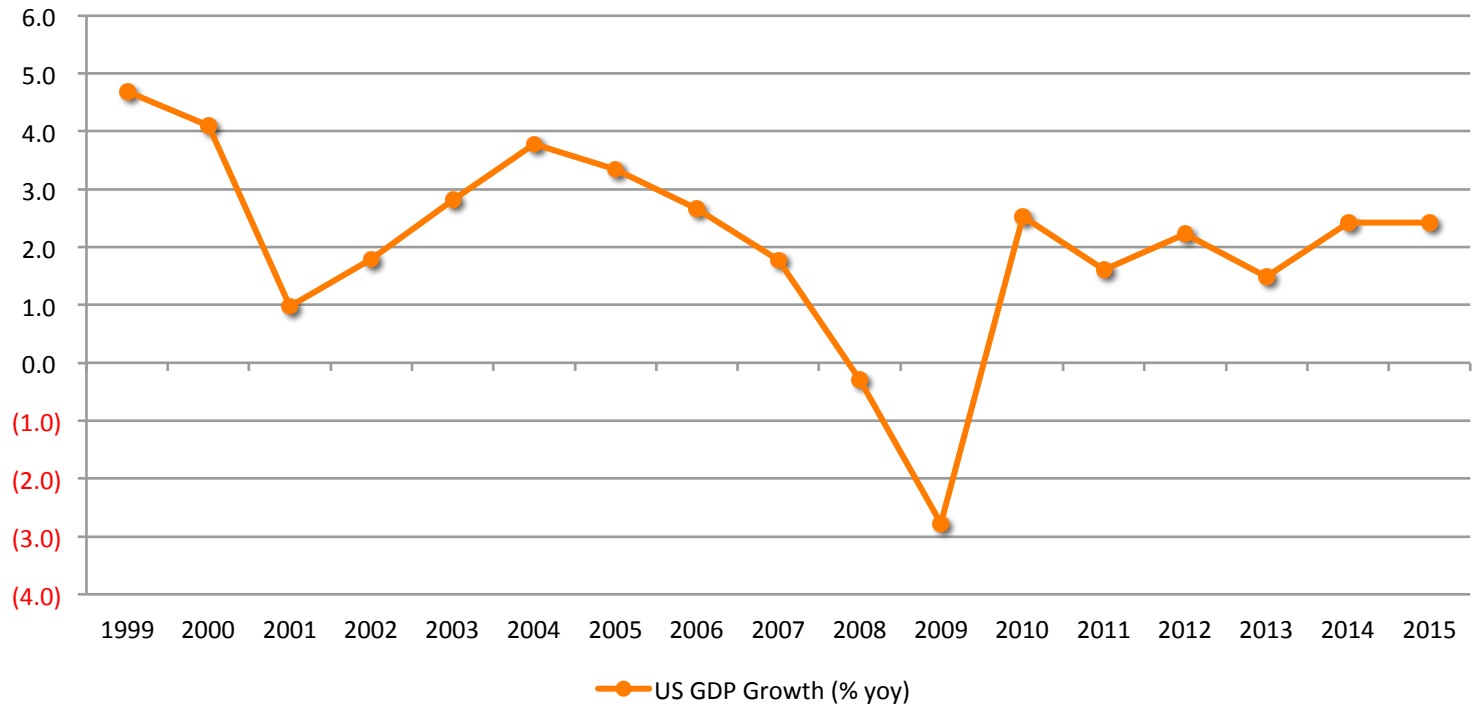
US banks incurred heavy losses for a 2-3yr period allowing for NPLs to normalize in a short period of time, reinstating the health of the banking system



Sources: Federal Reserve Bank of New York

(3) Market-Based – with heavy loss recognition, GDP recovered quickly

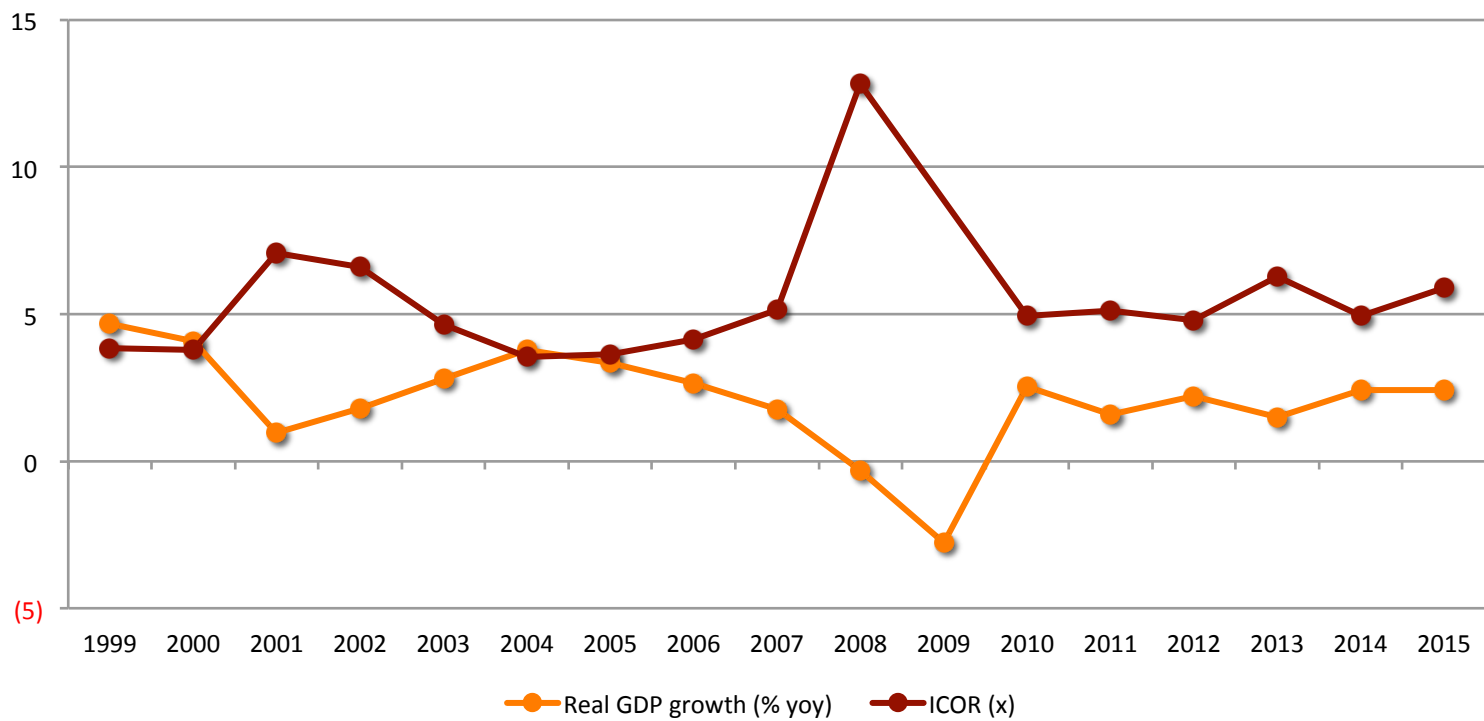
Reflecting accelerated write-offs, GDP recovered quickly as excess capacity and poor business models were eliminated



Sources: World Bank

(3) Market-Based – Investment efficiency returns quickly

Accelerated write-offs and reductions in excess capacity allow for the credit transmission mechanism to return quickly (i.e., investment efficiency) and GDP to grow

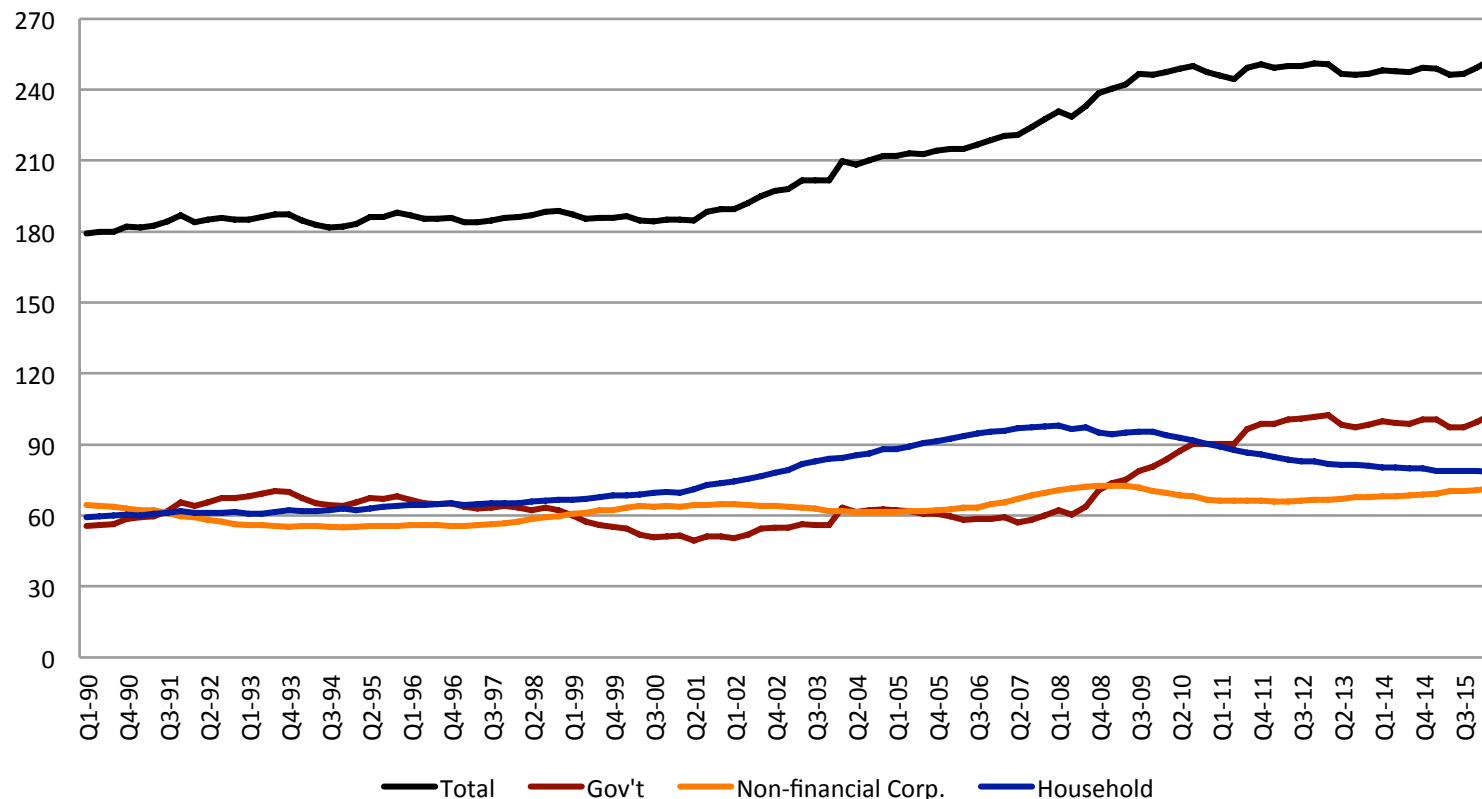


Note: ICOR is the amount of investment needed to produce one unit of GDP (here use Gross Fixed Asset Formation); Negative ICOR (which happens when nominal GDP declines) is left out here

Sources: World Bank

(3) Market-Based – debt/GDP drops to long term trend

Market based solutions write-off unhealthy levels of debt so that debt/GDP normalizes and the economy can recover (sovereign debt grows as a stimulus measure)



Sources: BIS

(3) Market-Based – China now stepping toward a government-facilitated market-based solution

CBRC published two administrative rules in short succession in March and April 2016, further restricting banks' off-balance sheet maneuvers to understate or “warehouse” NPLs:

- Encouraging Free Market resolution of NPLs*
 - AMC's are required to acquire NPLs at fair market value, restricted from pre-setting prices with selling banks. Furthermore, AMC's are prohibited from assisting banks in simulating transfers of NPLs off their balance sheets.
- Restricting NPL-Concealing Vehicles or Transfers**
 - Banks are prohibited from warehousing NPLs through transfers of beneficial rights or assuming any explicit or implicit repurchase obligations. To protect retail investors, CBRC further requires that such beneficial rights shall not be sold to individual investors and the selling banks shall not use any wealth management funds under their management to purchase such beneficial rights to credit facilities extended by themselves.

*(CBRC 2016 #56)

** (CBRC 2016 #82)

Role of the Private Sector

- FINANCIAL CAPITAL
- PRICE DISCOVERY
- EFFICIENCY
- HUMAN CAPITAL

Facilitating the Bridge from Private Capital to NPLs

- PREDICTABLE LEGAL PROCESS
- ASSET TRANSPARENCY
- FACILITATE PRIVATE CAPITAL (FOREIGN AND DOMESTIC)
- FACILITATE MORE EXPERIENCED HUMAN CAPITAL



Thank You

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