

Chinese banks seek profit boost through bad debts
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Major Chinese banks want to manage their own bad debts, attracted by the outsize profits being earned by recovery firms, in a sign of confidence that investments in internal risk assessment teams are set to pay off.

If they are right, it may mark the end of a buyer's market for a distressed debt pile that has topped US\$100 billion (RM322.35 billion), benefiting bank shareholders at the expense of asset-management companies such as China Cinda Asset Management Co.

But the phenomenon also poses a challenge for regulators as they push banks to lend more to stimulate growth; in retaining non-performing loans (NPLs) on their books in search of profit, the banks effectively limit their ability to make fresh loans.

"There are so many NPLs in China, there's a lot of room for information asymmetry, where assets get written off that actually have some value," said Benjamin Fanger, founder of Shoreline Capital, a Guangdong-based firm specialising in distressed debt investment in China since 2004.

It is a lucrative business at the moment. State-owned Cinda reported a 26% rise in net profit to 9.1 billion yuan (RM4.84 billion) last year and China Huarong Asset Management's net profit jumped 44% to 10.1 billion yuan.

"There are four major AMCs and they've been doing very well," said Stephen Long, managing director for financial institutions, Asia Pacific for Moody's Investor Service.

"It's been somewhat of a buyer's market so I can see how the banks would want to retain some of that profit for themselves."

At a recent analyst briefing, Industrial and Commercial Bank of China (ICBC) executives said they could recover NPLs at 50 to 60 cents on the dollar, around double what asset management companies would pay for them, said May Yan, Head of China bank research at Barclays, who attended the briefing.

And Bank of China chairman Tian Guoli told an analysts in March the bank would use its investment banking subsidiary to dispose of distressed assets, according to analysts who attended that briefing.

ICBC is China's largest listed bank, and Bank of China is the fourth biggest. Neither bank responded to calls from Reuters requesting comment.

The banks' drive to maximise profits is a positive for economic reform in the long run; policy-driven lending helped produce China's bad-debt headache, and a focus of managing bad debts is sign of a more market-attuned corporate culture.

But it carries risks. There is no guarantee the banks will be able to better the returns they get by selling NPLs at a discount, which also has the advantage of removing the debt from balance sheets.

"Taking into consideration the time value of money, the return from self-recovery may not be higher than selling the NPLs to AMCs," said Qiang Liao, banking analyst with Standard & Poor's.

A loan and compliance officer at a listed Chinese bank in Shanghai, speaking on condition of anonymity because he was not authorised to speak to media, said banks did not want to be seen giving away money by selling bad debts too cheaply.

"There are a lot of vested interests and if you turn over a loan that would have made money for the state to a private company – that state mistake leads to private profit," he said.

There's a lot at stake. Banks had 646 billion yuan worth of NPLs at the end of the first quarter, up 9.1% from the beginning of 2014 and almost one-third higher than a year earlier. By the end of 2014, Barclays expects NPLs to hit 700 billion yuan.

Average NPL ratios for commercial banks are at a three-year high of 1.04% in 2014, above the 1% red line for China's banking regulators. Given the opacity of the banking system, many analysts believe the real levels are much higher.

In the past the economy was effectively able to grow out of the bad debts, postponing the day of reckoning, but as China's economic model changes regulators have grown wary of letting bad loans roll over endlessly at the expense of fresh lending.

A banker at a state-owned bank said it can take as long as two years for a bank to dispose of a distressed asset on its own, and while it remains on the books it reduces the amount of capital banks have available for fresh loans.

Defaults by smaller firms and private companies have been common for some time and this year saw the first domestic bond default as Beijing moves to give markets the decisive role in pricing capital.

Shoreline Capital's Fanger said there was no obstacle to banks building their own bad-debt teams, but having one would not automatically translate into higher returns.

"I would presume the AMCs are much better positioned to maximise the value from pools of NPLs, because that's what they specialise in." – Reuters, June 23, 2014.

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