TECHNICAL NOTES AND MANUALS

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# Debt-Equity Conversions and NPL Securitization in China—Some Initial Considerations

**This technical note and manual (TNM) addresses the following issues:**

- It is welcome that the government is focusing on the problems of excessive corporate debt and the corresponding burden on banks of impaired assets.
- Converting NPLs into equity or securitizing them are techniques that can play a role in addressing these problems and have been used successfully by some other countries.
- But they are not comprehensive solutions by themselves—indeed, they could worsen the problem, for example, by allowing zombie firms (non-viable firms that are still operating) to keep going.
- Getting the design right is thus critical:
  - For debt-equity conversions, this includes converting debt only of viable firms in the context of operational restructuring for the firms (which may include changing management), at fair value, and with banks holding the equity for a limited period only.
  - For NPL securitization, this includes securitizing a diversified pool of NPLs, banks keeping some residual financial interest ("skin in the game"), and creating the legal and operational framework that will allow owners of distressed assets to force operational restructuring of firms and obtain best value from those assets.
- For these techniques to help address the systemic problem of excessive corporate debt and impaired bank loans more generally, they need to be nested within a comprehensive, system-wide, plan that should involve:
  - Assessing the viability of distressed firms and restructuring the viable and liquidating the nonviable;
  - Requiring banks to proactively recognize and workout NPLs;
  - Burden sharing among banks, corporates, institutional investors, and the government;
  - Enhancing the framework for corporate restructuring, including the Enterprise Insolvency Law;
  - Developing distressed debt markets.

## I. CHINESE CONTEXT

1. ***Corporate debt is high and increasingly under stress, which is mirrored in banks' asset quality.*** Corporate debt is some 160 percent of GDP and continuing to rise quickly. An increasing share of corporates show signs of being at risk, for example, the latest Global Financial Stability Report (GFSR) suggests that corporate loans potentially at risk (ie owed by firms with an interest coverage ratio less than one) amount to 15.5 percent of total commercial banks' loans to corporates, or $1.3 trillion (12 percent of GDP). This compares with about $1.7 trillion in bank Tier 1 capital (11.3 percent of risk-weighted assets), and $356 billion in reserves. Reported problem bank loans, including "special mention loans," amount to 5.5 percent of bank corporate and household loans ($641 billion, or 6 percent of GDP), up from 4.4 percent at the end of 2014.

2. ***In the last few weeks, some contours of an emerging strategy to deal with banks' NPLs have emerged.*** The two main ones seem to be: (1) converting NPLs into equity and (2) securitizing NPLs and selling them. The securitization program is reportedly being piloted by a handful of large banks, instruments can only be sold to institutional (presumably domestic) investors, and the program is reported to be capped at RMB 50bn (a tiny fraction of current NPLs).

## II. CONSIDERATIONS

### *Debt-equity conversion*

3. ***Debt-equity conversions can play a role in addressing the problems of excessive corporate debt and impaired bank loans.*** They reduce NPLs and the debt overhang of corporates, as well as provide a means to restructure/resolve the indebted firm by changing ownership and incentives. They have been used successfully in some countries, for example, by Sweden and the United States.

4. ***But they are not solutions per se and could backfire:***

   - They could allow weak/nonviable firms to keep going as conversions reduce firms' debt and borrowing costs. Banks may also not have the incentives to pro-actively restructure the firms, especially if they are minority shareholders and both banks and the firms are state owned.

   - Banks generally don't have expertise to run or restructure a business and may need to find competent interim management. Conversion into equity creates moral hazard and conflicts of interest—banks may keep lending to a now-related party, causing renewed indebtedness and hampering efforts to dispose of equity. State ownership of corporates may also increase.

   - Conversions may require a change in the law, which restricts (for good reason) banks from owning private equity investments in companies.

5. *Key conditions for success include:*

- ***Strict solvency and viability eligibility criteria for corporates.*** A decision to convert a senior (and possibly secured) claim into the most junior security in a firm should be taken only in cases where the upside for the bank is clearly large and the firm's equity stake has high probability to be sold in the near future. This requires an ex-ante assessment of business solvency (true economic value of their assets as compared to their liabilities) and viability (ability to generate an economic surplus). A firm that is solvent and viable, but has excessive leverage (too much debt as compared to equity), would be eligible for conversion. An independent process to assess the viability and solvency of the companies ahead of the launch of the debt-equity conversion program could help ensure the program is not abused.

- ***Sound corporate governance.*** Businesses should be well managed; if not, banks in their role as new equity holders should have the ability to replace management. This may require an explicit clause in the contract that gives sufficient weight to banks to change management even if they are minority shareholders. The corporate management should be subject to clear accountability toward the banks (and other shareholders, including the government), including on a plan to address existing problems and attract fresh investors given that the equity stake is expected to be sold.

- ***Bank ownership of equity should be limited in scope and time.*** Banks are ill-placed to understand or to exercise controlling influence and responsibility over entities that are unrelated to banking. Owning and trying to turn around businesses can distract banks from their intermediation function, and raise moral hazard and conflicts of interest issues (debt-equity conversion not only increases related party loans, but may also result in new credit extension that is not at arms' length). Hence, banks' holding of equity should be limited in time. In practice, different time frames may need to be applied depending on the industry where the firm is operating and its capacity to achieve recovery. Alternatively, if banks' ownership of equity is not limited, banks need to create teams or even subsidiaries to conduct active asset management of equity holdings.

- ***Conversion should be at fair value and losses recognized.*** This could be a significant challenge in the Chinese context as the temptation to convert the assets at an unrealistically high valuation of loans could be strong to avoid realizing losses. At the same time, higher equity holdings may, in certain circumstances (and under strict prudential standards), substantially increase risk weights and thus require additional capital from the banks.

- ***Robust regulatory treatment of equity holdings.*** Good practice dictates that a combination of concentration limits and punitive risk weights be applied to discourage equity holdings in non-financial entities. This is because of the high level of risk of these instruments—as equity holder, the bank is last, not first, in the line of creditors should the entity fail. Some jurisdictions, including China go further than advocated by the Basel Committee (below), and restrict banks from taking an equity stake greater than, for example, 10 percent of any commercial entity.

  – *Basel regulatory capital treatment for investments in commercial entities:* Significant investments in commercial entities that exceed certain materiality levels (i.e., 15 percent of the bank's capital for individual investments in commercial entities and 60 percent of the bank's capital for the aggregate of such investments) receive a 1,250 percent risk weight (analogous to full deduction from capital); the excess amount above the materiality levels attracts the risk weighting. Investments below these materiality levels should have a risk weight no lower than 100 percent.

  – *Large Exposure Limits/Concentration Risk:* The Basel standard on large exposures, which will come into force in January 2019, confirms the common practice that the maximum value of an exposure be limited to 25 percent of a bank's capital. The exposure can be to a single counterparty or a group counterparties connected to each other.

## Securitization

6. ***Securitization, like debt-equity conversions, can be a useful tool for debt restructuring if properly designed.*** The main difference with debt-equity conversion is that securitization moves the NPL to another entity while debt-equity conversions transform the NPL into a different asset that remains with the bank. Thus the ownership structure of the debtor firm is not directly affected in a securitization, but it is in a debt-equity conversion.

7. ***The main advantages of securitization vs debt/equity conversions:*** (1) gets asset off bank balance sheets quickly (rather than banks having to hold equity); (2) allows banks to receive cash (which could be used for lending); and (3) to transfer debt to privately managed specialist vehicles who could have a clearer mandate and expertise to engage in corporate restructuring. Only (3) has the potential to drive a faster restructuring of the debtor company as otherwise the securitization is merely a change in the ownership of its debt.

8. ***Main disadvantages:*** (1) may make debts harder to restructure (as they are not converted into equity, need to deal with many creditors, unclear insolvency framework, possible political "capture" of new creditors); (2) lack of depth in domestic institutional investor base (though existing and newly-created provincial AMCs may play a role); (3) difficult to create a viable securitization market (requires good supporting legislation and well-aligned market incentives); (4) may transfer risk outside regulated financial sector to entities less able to absorb losses.

9. *Key preconditions for a success include:*

- ***The pool of NPLs subject to securitization should be diversified.*** Ideally, the portfolio to be securitized should have a large number of debtors, low loan concentration ratios, and similar loan terms. In China, NPLs from SOEs account for about 60 percent of the total stock and are concentrated in a few distressed industries, making debtor and sectoral diversification a challenge. The terms of loan agreements may also vary widely, based on the borrower's financial condition.

- ***Credit enhancements are necessary to attract investors.*** It is good practice for banks to maintain some exposure to the products ("skin in the game") to attract other investors. In the case of NPL securitization, it is in fact quite likely that banks will retain relatively large tranches of the most junior exposures, if only because no one else will buy it—as witnessed in the aftermath of the East Asian crisis. As such, a large part of the credit risk will continue to be retained by banks, which could increase the attractiveness to investors of more senior tranches, but will be costly to banks in terms of regulatory capital (see below). Additional credit enhancements to mezzanine or senior tranches offered in the form of state guarantees (e.g., as offered recently in Italy) could also help attract investors and provide additional liquidity relief to banks and potentially stimulate lending. One issue to be considered in China is that explicit state guarantees could trigger uncertainty regarding the validity of the perceived implicit state guarantees on other existing financial products.

- ***Strong legal and operational capacity to manage distressed assets is required.*** Other countries' experience show that major impediments to distressed asset investment include complicated local and legal regulatory environments, opaque judicial processes, and a lack of debt restructuring and resolution skills in local markets, both at law firms and in the servicers themselves. Securitization of NPLs will fail (or require substantial liquidity enhancements from banks) in the absence of sufficient capacity to extract value and service the securities.

- ***Strong consumer protection safeguards should be put in place.*** First, securitized assets should be sold to qualified investors only—institutional investors, high net worth individuals, and other sophisticated investors. Second, strict disclosure requirements and high associated penalties for non-compliance should be imposed on further distributing such products. To avoid regulatory arbitrage and the potential understatement of credit risks, purchase of these assets by banks should only be undertaken under strict regulatory treatment. The regulatory agencies (CBRC, CSRC, and CIRC) would have an important role to play in this context.

- ***Robust regulatory treatment of securitized loans.*** Basel standards on securitization call for numerous operational and due diligence requirements that will increase further from 2018. Basel requires that a significant amount of loss, i.e., credit risk associated with the underlying exposures, be transferred to third parties such as investors in the SPVs. If these requirements are not met, the bank will need to maintain capital against the securitized exposures. Of course, the amount of credit enhancement provided by the bank will be taken into account when assessing risk transfer. Also, a bank that purchases a securitized asset will have to conduct due diligence on the risks of that exposure, absent which a 1,250 percent risk weight would apply to the securitized holding (analogous to a full deduction from capital).

## III. THE NEED FOR A COMPREHENSIVE STRATEGY

10. ***For debt to equity conversions and NPL securitization to succeed, they should be part of a comprehensive corporate restructuring strategy.*** Key elements include:

- ***The strategy should aim at improving the performance of viable companies and the exit of nonviable companies.*** Without addressing the fundamental problem of weak firms, any financial restructuring will only result in greater losses in the future. Thus a key prerequisite is that debtor firms undergo a viability test with those deemed viable being restructured, and those non-viable being resolved. Existing management of the firms should have the capacity and incentives to deliver a successful restructuring; if they cannot, they need to be replaced with a new team which can. Specialist private firms are well equipped to undertake and coordinate such work for individual firms.

- ***Regulatory and supervisory oversight should require banks to recognize and workout NPLs.*** Prudent regulatory policies support the accurate recognition of risks and provide incentives to banks for actively managing the distressed assets. Critical aspects in the bank supervisory and regulatory area include policies on loan classification and provisioning; bank capital; write off of uncollectible loans; collateral valuation; prudential reporting; and a supervisory review approach fostering more active NPL resolution (restructuring, write off, or sale).[1]

- ***A clear plan for burden sharing among banks, corporates, institutional investors, and the government.*** Recognizing the full extent of impaired loans will likely result in significant losses. A plan to allocate these losses, and if necessary backstop them with government funds, will be critical. For example, banks may be reluctant to recognize the full extent of their impaired assets for fear of eroding capital, and creditors may act strategically (or not act at all) so as to minimize their individual loss at the cost of increasing overall losses. This in turn calls for an active role for the state (as in Korea), which China is uniquely well placed to undertake.

[1] See IMF (2015), *A Strategy for Resolving Europe's Problem Loans*.

- ***Enhancing legal and institutional frameworks for corporate restructuring, including the Enterprise Insolvency Law.*** The effective operation of debt/equity conversions requires a comprehensive and robust legal framework for corporate restructuring. The Chinese Enterprise Bankruptcy Law provides a basic structure for corporate restructuring, including a reorganization procedure, but the use of reorganizations has been very limited, mainly because of constraints in the judicial system and the insolvency administrators' profession. Targeted reforms would strengthen the legal system's support for debt/equity conversions in distressed companies:

  – Debt/equity conversions require a specialized analysis of the financial situation and business prospects of the affected company to determine its viability. This analysis is typically conducted by an insolvency professional in the context of a reorganization process. Reinforcing the position of insolvency administrators, strengthening disclosure requirements and regulating the contents of viability reports and reorganization plans, would help increase the effectiveness of reorganizations.

  – The law should clarify the position and role of shareholders in the reorganization process, preventing the use of blocking tactics by shareholders, and the interference in debt/equity conversions by the abuse of their voting or pre-emption rights. The law should allow for the "cramdown" of shareholders in the approval of reorganization plans. This may require changes to other laws (e.g., corporate, securities law).

  – A clear insolvency framework would provide the adequate backdrop for the use of informal or hybrid solutions, such as pre-packaged reorganization plans. In the case of China, the use of solutions without full involvement of the court system can be explored.

- *Improve the market for distressed debt.* Access to timely financial information on distressed borrowers, collateral valuations and recent NPL sales are critical for the development of an active market for NPL restructuring. Facilitating the licensing of nonbanks for restructuring would lower the cost of entry into this market and allow for greater specialization. Use of specialist NPL servicing and legal workout agencies, and well functioning collateral auctions (i.e. widely advertised to attract a sufficient number of bidders, providing transparently detailed information about the auctioned collateral, etc.) would help raise recovery values. The role of the existing AMCs, provided they have the right incentives and independence from state interventions, in helping jump-start a market for distressed assets should be
  further explored.

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