

Is China approaching a Lehman moment?

'As the November 30 deadline draws near, the probability of event risk rises, and it is entirely possible that stock and bond markets could meaningfully sell-off'

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In previous columns, we estimated the excess debt in the Chinese economy to be approximately US\$3.1 trillion and still growing. This is of course an enormous figure, and represents the largest non performing loan aggregation in the world by far. It obviously constitutes a considerable overhang on the Chinese economy.

Therefore, the regulatory response must be equally profound in their attempt to orchestrate an orderly deflating of this credit excess. The Chinese authorities have already started addressing the topic in earnest, and in our view, will continue to push forward with a multipronged, market-based solution.

In the past year, the Chinese Banking Regulatory Commission (CBRC) has accelerated regulatory initiatives to address creative accounting practices employed by banks to understate credit exposure and warehouse problem loans. And most recently, the CBRC enacted Circular 46, which accelerates enforcement procedures against prohibited accounting practices and requires that they be reversed by November 30. These aggressive measures have caused some consternation within the Chinese banking community and significant volatility in the Chinese financial markets.

The global financial community has taken notice. There has even been speculation in the international financial press that we may be headed toward a Chinese "Lehman moment". This would be a liquidity event at a bank or substantial financial institution where it is unable to find the cash to honour its maturing debt obligations.

Has the rapid issuance of new regulation been too much, too fast? Why is the CBRC choosing now to accelerate regulations? Is this a policy mis-step, or can China handle it with a diverse toolbox?

The CBRC began accelerating its regulatory push about a year ago, with several key circulars issued in short succession to restrict balance sheet manoeuvres and prohibited accounting practices.

These include: Circular #56 (March 2016): Encouraging Free Market Resolution of NPLs. Asset Management Companies (AMCs), essentially China's "bad" banks, are required to acquire NPLs at fair market value and are restricted from pre-setting prices with the selling banks. Furthermore, AMCs are prohibited from assisting banks in simulating transfers of NPLs off their balance sheets.

Circular #82 (April 2016): 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 in the sale of such assets to one another. To protect retail investors, the CBRC further requires that such beneficial rights shall not be sold to individual retail 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.

Circular #46 (April 2017): Accelerating Enforcement and Instituting Penalties for Infractions. This circular contains four new key developments. Firstly, the notice explicitly lists numerous specific examples of prohibited accounting practices in a highly detailed fashion. Secondly, the CBRC is requiring banks to conduct internal self-audits, reporting back on areas of infraction. The original date for these audits was June 12 but we understand from local media that the CBRC has relaxed the timing of this deadline. Thirdly, in parallel with internal self audits, the CBRC is doing extensive on-site examinations, and will require banks to reclassify any misclassifications by November 30. Fourthly, the CBRC is instituting penalties for non-compliance, and disclosing these as a matter of public record. There have already been 25 penalties issued on March 29 totaling 43.1 million yuan.

The implications of Circular 46 are particularly important, as they could very well be too much, too fast. By our estimates, prohibited accounting at some banks has been substantial. Should the CBRC truly enforce the November 30 deadline requiring restatements and reclassifications, it has the very real possibility of creating a liquidity event (i.e., default on short term obligations) at some banks and revealing significantly undercapitalised balance sheets.

If this were to occur, it would create a significant disconnect in capital markets, and could quickly devolve into triggering fears over counter party risk within the banking system, thereby driving a crisis of confidence. A somewhat similar but less profound example would be the meltdown in the stock market in the summer of 2015 when the Shanghai Composite dropped over 30 per cent in one month after the authorities cracked down on shadow margin financing. A liquidity event in the banking system would be more problematic in our view.

Clearly, the Chinese government does not want to trigger a crisis. So why are the regulators choosing to accelerate these strict regulations on the banks at this time? We propose it is because the infrastructure now exists to allow for an acceleration in balance sheet transparency and repair, and provides for the increased flow of NPLs from banks into the market place.

For example, banks have taken over US\$325 billion in provision expenses in the past two years alone, meaning that NPLs are increasingly being marked-to-market to allow for sales. Total AMCs have increased by 24 to now 156 during this time, so there are many more conduits for NPL sales, and the legal system has continued to develop rapidly, and is conducive to enforce creditor rights far better than many foreigners tend to be aware.

Moreover, we suspect the CBRC is cognizant of the implication of the tight time frame for compliance with Circular 46. As the November 30 deadline draws near, the probability of event risk rises, and it is entirely possible that stock and bond markets could meaningfully sell-off.

As a result, we would not be surprised if this deadline is relaxed to avoid a Lehman moment. To our knowledge, authorities have not allowed any Chinese bank to go bust since the establishment of the People's Republic. But take notice, the CBRC has cracked the whip and the banks will be forced to

move toward compliance, which is positive for the longer-term development of the capital markets and overall economy.

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