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Local Asset Management Companies in China

The Next Frontier to Tackle China's Local Debt Problem

- **Local Debt is the Next Time Bomb.** There is an estimated 17.9 trillion RMB in debt in provinces and cities across China. Of this, 45.7% was lent to Local Government Financing Vehicles (LGFVs), of which almost two-thirds have operating cash flow less than the interest and principle on the debt. Solving the local debt crisis is high on Beijing's agenda.

- **Bold Local Debt Program.** Beijing is supporting a program to force China's 32 provinces and local municipalities to establish Asset Management Companies (AMC) to help sell local debt. Four AMCs have been set up so far but there are likely to be dozens more soon as the AMCs become the focal point to reduce local debt.

- **Japan and Other Asian Country AMCs.** We compare China with other countries in Asia that used AMCs for debt recovery after the 1997 financial crisis. We found that the median recovery rate was 21.4%, including China's own recap of the four state banks ten years ago.

- **Local AMCs Could Reduce Bad Loans.** Using a baseline estimate that 50% of local debt will become non-performing, we forecast that local AMCs could raise as much as 1.9 trillion RMB, or 10.7% of total local debt.

Summary

Beijing Tries to Reform Local Government Finances

Rising local debt has become one of the biggest threats to China's economy. In December 2013, the State Audit Office announced the results of a survey that estimates that total local debt is 17.9 trillion RMB. Almost half of this, 45.75%, was lent to local government's off-balance sheet investment groups, known as Local Government Finance Vehicles. Close to two-thirds of these are earning less income than they need to service their debt. As China's economy slows, and the effects of the country's 4 trillion RMB stimulus in 2009 wears off, local debt has become a time bomb. As a result, Beijing is now focusing on solving the local debt problem. They are using tools including encouraging the development of the municipal bond market, controlling investment, and slowing the property bubble. Inevitably, there will be have to be significant debt workouts as excessive investment turns sour. ***One important solution that is being promoted by Beijing is to establish local AMCs as a funnel through which bad debt will be transformed into cash***. In our view, this is likely to be an important piece of the debt workout.

In February 2012, Beijing approved one AMC per Province, with the first one launched in Jiangsu in May 2013. There are now four local AMCs with many more on the drawing boards. Beijing, Chongqing, Liaoning, Anhui, Hubei, Sichuan, Jiangxi, Tibet, Xinjiang, and Hainan are all in the process of setting up their own AMCs.

If these become significant debt recovery institutions in the future, as we expect, they could significantly reduce local debt through debt restructuring programs. Although current rules forbid it, they eventually could sell the debt to investors. However, on the flipside they also could simply become repositories for debt that will continue to weigh on the banking system. We estimated the amount of Non Performing Loans (NPLs) that could be recovered. We think the experience of other Asian nations may be a good guide. We forecast the expected rate of recovery using comparables from Korea, Malaysia, Japan, along with the results from the clean up ten years ago of the four State owned banks by the central AMCs. Two key variables are the amount of non-performing loans and the purchase price of them from local financial institutions. ***Using a baseline 50% rate of non-performing loans (NPLs), and the Asian median purchase price of 21.4%, we estimate the local AMCs could recapture 1.9 trillion RMB, or 10.7% of local debt.***

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New AMCs are Beijing's Attack on Local Debt

Regulators Set the Ground Rules

The local governments have been competing with each other on GDP growth, financed by a debt binge, and now have an estimated 17.9 trillion RMB in local debt, both direct and through related companies. Of this amount, LGFVs accounted for 4.1 trillion RMB in debt and another 2.9 trillion RMB in contingent liabilities, based on an audit of 7,170 LGFVs. So, each LGFV has approximately 972.5 million RMB in debt and contingent liabilities – a lot for a local AMC to absorb. National audits state that the majority of the debt has been invested in infrastructure, utilities, land bank, transportation and communications, social housing, irrigation, and other public good. These are assets that may not be easily liquidated.

In 2013, more than one-third of all taxes local governments collected – or 2.6 trillion RMB out of 6.9 trillion RMB – came from the real estate sector. More than 4.1 trillion RMB came from land transfers. In total, land transfers and taxes collected from developers accounted for 53.7 percent of the income of local governments last year. That income is drying up as the property bubble ends.

Given a slowing economy, the central government is warning local governments they should brace for hard times ahead and help local businesses through debt restructuring; the central government is determined to avoid using bankruptcy. One method for debt reduction is to take bad debt off the hands of local banks and governments and restructure it through local AMCs.

The establishment of the local AMCs has required agreement among different levels of the Chinese bureaucracy. The official stamp of approval came from the two top financial regulators, the People's Bank of China (PBOC) and the China Banking Regulatory Commission (CBRC), clearly with the backing of the State Council. In February 2012, the Ministry of Finance (MoF) and the CBRC jointly issued the "Administrative Measures on the Batch Transfer of Distressed Assets of Financial Enterprises," which stipulated that each province in China establish one distressed asset management company to engage in the batch transfer of distressed assets from financial institutions within their jurisdiction. The rules state:

1) A batch transfer of 10 or more accounts is allowed.
2) Provincial AMCs are not allowed to sell distressed assets to third parties.
3) Distressed assets can only be restructured, meaning that bankruptcy is off limits.

In December 2013, the CBRC released additional qualification for provincial AMCs:

1) 1 billion RMB in paid-up registered capital.
2) Professional teams with requisite experience.
3) Good corporate governance.

So far, four provincial AMCs have been established:

- **Jiangsu Asset Management Co.** Set up in May 2013, with 5 billion RMB in registered capital.
- **Zhejiang Zheshang Asset Management** Co. Set up in August 2013, with 1.518 billion RMB in registered capital.
- **Shanghai State-Owned Asset Operation Co**. Authorized in March 2014, with 5 billion RMB in registered capital.
- **Guangdong Yuecai Asset Management Co**. Authorized in January 2014, with 1.2 billion RMB in registered capital.

Slow Response from Local Governments

The Central government's promotion of local AMCs so far has met with a mixed response from local governments. Only four provincial AMCs have been established. Research conducted by the People's Bank of China suggests there may be local political opposition due to concerns about increased regulation or higher capital requirements.

In the past few years, local governments have set up their own "unofficial" AMCs on an ad-hoc basis. These companies – really investment arms of the government – have been responsible for handling bad debt among failing banks or state companies. According to a report on AMCs published by two researchers with the PBOC's Financial Stability Bureau, as of February 2013, there were 21 provincial state-owned assets management companies 18 provinces. Of these, 13 of them had participated in the disposal of distressed assets at financial institutions. Such deals are usually one-off, and these local government investment arms usually don't sell distressed asset as their main line of business. But local governments control them directly and may prefer that to new AMCs regulated by Beijing. In addition, these "ad hoc" AMCs most likely have limited capital, so the new rules would force the local governments to increase their capital base.

The new program for provincial AMCs authorized by the CBRC is designed to establish AMCs specifically targeting asset sales as their main line of business. With a dedicated team, backed up with adequate capital, the provincial AMCs could dispose of distressed assets in a much more efficient way. ***We believe the local AMCs will be a key part of local debt disposal as the property market continues to plummet and liquidity in the Shadow Banking market dries up.***

Challenges for Local AMCs

Provincial AMCs will have their work cut out for them. They have to overcome following challenges:

1) Operations Restricted to Debt Restructuring

Provincial AMCs are only allowed to conduct debt restructuring, which effectively rules out bankruptcy or further sale to third parties. This limited operational scope means that provincial AMCs have to become deeply involved in each piece of acquired distressed assets. They will only be able to recoup their investment if the distressed assets, through restructuring, become cash flow positive and regain their debt-service capability or become a promising business able to fetch a good sales price in the market, assuming debt-equity swaps are allowed.

2) Competition from the Four State-owned AMCs

Provincial AMCs will have to compete with the four state-owned AMCs, which are more experienced in this business, have stronger capitalization, and have a wider range of methods to apply to the acquisition of distressed assets. Among them, Cinda is listed on Hong Kong Stock Exchange (01359.hk), and is thus able to tap the stock market for financing, in addition to be allowed to issue financial bonds (over 10 billion RMB issued), and also boasts of the Ministry of Finance as its largest shareholder.

Compared with provincial AMCs, the four state-owned AMCs can deploy a range of methods, including debt restructuring, debt to equity swaps, further equity investments, bankruptcy proceedings, and the sale to other third parties. Moreover, the four-stated owned AMCs have evolved into financial conglomerates with diversified finance businesses, which could generate synergistic effects with its distressed asset business, providing them with another competitive advantage over provincial AMCs.

3) Interference from Local Governments

Local AMCs, as illustrated by the four established AMCs, are dominated by provincial governments. In fact, the four provincial AMCs established so far are all local SOEs. Many local financial institutions, such as city commercial banks, are majority-owned by local governments, while the LGFVs (and their debt) are indirectly owned by local governments.

In the case of a batch transfer of distressed assets, there is a strong chance that local governments would prevail over what could otherwise be a commercial business negotiation. Beijing-owned AMCs, however, are more more immune to local government pressure than provincial AMCs.

For example, the provincial AMC of Shanghai owns stakes in the Bank of Shanghai. Any transfer of distressed assets from the Bank of Shanghai to the provincial AMC of Shanghai is a connected transaction, replete with conflicts of interest. A similar potential for conflict of interest is apparent in Chongqing. Local firm **Chongqing Yufu** has a high chance of being authorized as the provincial AMC, but it is also the largest shareholder of the Bank of Chongqing – another conflict of interest.

Provincial AMCs do have one advantage over the four state-owned AMCs: their relationship with local governments. They are much closer to their government owners than the four Beijing state-owned AMCs, in which local governments hold no ownership stake, and therefore have access to deal flow and in some cases expedited processing.

Local AMCs are Beijing's Answer to Rising Local Debt

The establishment of local AMCs is a policy response to the economic slowdown, high financial leverage, and excess capacity in the industrial sector. China's officially reported GDP growth rate is 7.7% in 2013 and further declined to 7.4% in first quarter of 2014, a major step down from the average of around 10% annual growth achieved in the previous three decades. In the recently released Report on Monetary Policy Implementation in the First Quarter of 2014, the People's Bank of China suggested two factors were responsible: 1) tightening supply of cheap labor and 2) a change in the economic growth model.

Rapid Increase in Leverage and Excess Industrial Capacity

Leverage has risen significantly over the previous several years, partly due to the massive stimulus program launched in response to the global financial crisis. Using bank loans as a percentage of GDP as a proxy, leverage has risen from 121% in 2008 to 155% in 2012, up by 34% over just five years. Bond, trust loans, and entrusted loans further add to the leverage in the economy. Local governments, through local government financing vehicles, borrowed extensively from financial institutions, including city commercial banks. According to the report from State Audit Office, as of the end of 2013, local governments in China had a total of RMB17.9 trillion in debt and contingent obligations, of which RMB 10.1 trillion is bank loans. The corporate sector also has borrowed extensively. Also, various industries in China have been struggling under excessive capacity. The Ministry of Industry and Information Technology in May 2014 released its target for eliminating excessive and outdated capacities for the year of 2014:

Iron-making by 19 million tons, steel-making by 28.7 million tons, charcoal-making by 12 million tons, ferrous alloy by 2.343 million tons, calcium carbide by 1.7 million tons, aluminum by 0.42 million tons, copper by 0.512 million tons, lead by 0.115 million tons, cement by 50.5 million tons, flat glass by 35 million weight boxes, paper by 2.65 million tons, tannery by 3.6 million standard sheets, dyeing by 1.084 billion meters, chemical fiber by 30,000 tons, lead battery by 23.6 million kvh, rare earth oxides by 102,400 tons." (Source: MITT announcement as per its website)

Total social financing, a concept put forward by the PBOC to include all forms of Shadow Banking, has displayed a significant shift in its mix over the previous 12 years. Bank shares continue to drop, while new forms of financing are rapidly gaining traction. From an investor perspective, the central government owns five major state-owned banks, two policy banks, China Development Bank and China Postal Savings Bank, and some joint stock banks that are majority-controlled by SASAC-controlled SOEs. There are also 12 joint stock banks, 144 city commercial banks, and a myriad of rural commercial banks, and other credit providers, which are more the responsibility of local governments, which own stakes, large or small, in them. The rise of total lending – including Shadow Banking – has contributed to the increase in local debt the AMCs will address.

Total Social Financing in China (% Total)

Total Social Financing in China								
Year	**Total Social Financing**	**RMB Loans**	**Foreign Currency Loans converted into RMB**	**Entrusted Loans**	**Trust Loans**	**Un-discounted Bank Acceptance Bills**	**Enterprise Bonds**	**Equity Financing by Non-Financial Enterprises**
2002	100	91.9	3.6	0.9	——	-3.5	1.8	3.1
2003	100	81.1	6.7	1.8	——	5.9	1.5	1.6
2004	100	79.2	4.8	10.9	——	-1	1.6	2.4
2005	100	78.5	4.7	6.5	——	0.1	6.7	1.1
2006	100	73.8	3.4	6.3	1.9	3.5	5.4	3.6
2007	100	60.9	6.5	5.7	2.9	11.2	3.8	7.3
2008	100	70.3	2.8	6.1	4.5	1.5	7.9	4.8
2009	100	69	6.7	4.9	3.1	3.3	8.9	2.4
2010	100	56.7	3.5	6.2	2.8	16.7	7.9	4.1
2011	100	58.2	4.5	10.1	1.6	8	10.6	3.4
2012	100	52	5.8	8.1	8.1	6.7	14.3	1.6
9M 2013	100	52.1	3.7	13	11.3	4.6	10.9	1.2

Source: "Why the central bank utilizes total social financing as indicator", by Sheng Songcheng, head of Financial Survey and Statistics Department of PBOC.

Regulations Designed to Slow the Growth of LGFV Loans

At the end of 2009, the CBRC, People's Bank of China (PBC), and Ministry of Finance (MOF) conducted a survey to assess the indebtedness of local governments. As an initial requirement, banks had to set standards and classify LGFV loans by September 30, 2010. However, the strongest message came from the State Council in June 2010, when it issued measures to strengthen the management of LGFVs. The State Council launched four main policy measures:

1) Assess, verify, and properly manage the debts assumed by the LGFVs.

2) Classify and regulate the function and operations of existing LGFVs.

3) Strengthen the supervision of LGFVs' lending activities, as well as banks' and other financial institutions' lending practices to LGFVs.

4) Prohibit local governments from guaranteeing LGFV debts.

As a follow-up, the the Ministry of Finance, the National Development and Reform Commission, PBC, and CBRC jointly issued detailed implementation rules. In April 2013, the CBRC distributed guidance to further strengthen the supervision of loans to LGFVs:

1) The banks' stock of LGFV loans should not exceed the existing stock at end-2012.

2) Banks can grant new loans only to LGFVs with a cash flow coverage ratio above 100 percent, a liability-to-total asset ratio below 80 percent, and collateral that complies with regulations.

However, it's not clear how successful these rules have been in constraining the growth of LGFV debt.

The risks associated with LGFVs arise mainly from three areas:

1) Credit risk that may result in the inability of banks to collect part of their loans;

2) The potential fiscal risk in Chinese provinces;

3) Future collateral loss related to potential declines in land prices, which may constitute a

contagion channel across local governments, the banking sector, the real estate sector, and the central government.

City Commercial Banks are a Big Source of LGFV Loans

The city commercial banks have increased their lending to the highly risk area of LGFVs, often with the support of local governments. These LGFVs frequently invest in long-term property and infrastructure projects whose returns, at best, are likely to be meager, and at worst, will become bankrupt.

At the end of the first quarter of 2014, the 144 city commercial banks in China contained 15.9 trillion RMB in assets, 10.75 trillion RMB in deposits, and 6.58 trillion RMB in loans. The official NPLs of city commercial banks stood at 61.92 billion RMB although the actual number may be substantially higher. There are a number of city commercial banks listed on stock exchanges -- three on the A share market and three on the Hong Kong Stock Exchanges. We found some details in bank filings on their LGFV exposure.

Huishang Banks' IPO Shows 23.6 Billion RMB in Loans to LGFVs

In its IPO prospectus, Huishang Bank, a city commercial bank based in central China's Anhui Province, had 23.566 billion RMB of loans to LGFVs 1H 2013, representing 12.9% of its total loans and advances to customers. This is a significant portion of the bank's debt that could result in NPLs as China's economy slows. ***Moreover, the industry breakdown of these loans paints a picture of limited free cash flow generating capability and a heavy reliance on land value appreciation.***

Their loans to local government financial vehicles are:

Huishang Bank's LGFV Loan Breakdown

By Geography	
Provincial LGFV	10.1%
Municipal LGFV	44.9%
Below Municipal LGFV	45.0%
By Industry	
Infrastructure	43.0%
Industrial Parks	22.5%
Land Reserve	16.8%
Affordable Housing Projects	10.5%
Other Industries	7.2%

Source: Huishang Bank IPO Prospectus

Bank of Chongqing Struggles with Local Lending

Bank of Chongqing, a city commercial bank based in Chongqing, also has been lending heavily to local government financing vehicles. According to its IPO prospectus, the Bank of Chongqing's exposure to local government financing vehicles increased 46% from 13.8 billion RMB in 2010 to 20.1 billion RMB in 2013. However, its exposure as a percent of assets fell to 10.7% in 2013 from 12.7% in 2010, still a large number. If 50% of the bank's LGFV loans fail, those alone will be 5% of outstanding lending.

Bank of Chongqing's LGFV Loans

Year	LGFV Loans (RMB Bln)	LGFV Loans as % Total Assets	Total Assets (RMB Bln)
2010	13.8	12.74%	108.3
2011	NA	10.37%	NA
2012	NA	12.23%	NA
2013	20.1	10.67%	129.4

Source: Chongqing Bank Financials

Unlike Huishang Bank, Bank of Chongqing's exposure to LGFVs was conducted mainly through investment in Trust Beneficiary Rights, or through directional asset management plans. Trust Beneficiary Rights allocate profits to one entity while the liability remains on the balance sheet of another entity, usually a bank. As of June 30, 2013, around 25% of Bank of Chongqing's own investment funds was allocated to LGFVs through trust beneficiary rights and directional asset management plans, with another 9% to the real estate industry. Investment in trust beneficiary rights and directional asset management plans are usually made to circumvent state policy restrictions and also save on capital costs. As a result, these investments usually have a lower risk weighting than a plain vanilla loan. The convenience of these schemes is not lost on other banks.

Scenarios for AMC Recovery of Local Bad Debt

A look at China's Central AMCs and AMCs in Japan, Korea and Southeast Asia

If China institutes a countrywide system of local AMCs, how much capital are they likely to recover? To answer this question, we use two comparisons. The first is with China's historical experience more than a decade ago recapitalizing the state banks through the central AMCs. The second is a comparison with AMCs in other Asian nations during the Asian Financial Crisis (AFC), namely Japan, Korea, Thailand and Malaysia.

There are two key parameters that have to be understood for this analysis. They are:

1) Ratio of NPLs as a percentage of total bank loans.

2) Ratio of cash recovery from the NPLs.

Politics is Key to Successful Debt Recovery

One of the interesting aspects of debt recovery by AMCs elsewhere in Asia is that their success is a function of the political will of the government. It's easy to set up an AMC – but a lot harder to make it an effective channel for restructuring or disposing of debt. To give an example, in 1999 the Japan the Resolution and Collection Corporation was established to collect bad loans from failed housing loan companies, banks and credit cooperatives. It was the result of a merger of the Housing Loan and Administration Corporation and the Resolution and Collection Bank. It was granted a 12 trillion yen government guarantee. When it was first established, the RCC was not allowed to post a loss when it disposed of assets. "***As a result, it demanded steep discounts and thus was not an attractive option for banks." (Japan's Lost Decade, IMF).*** Due to the slow disposal of loans, in 2001 the government allowed the bank to purchase NPLs at "fair market value" and to participate directly in NPL auctions. With this example in mind, note that the comparisons we use below for collection rates by government agencies in Asia may reflect different rules for how the NPLs were purchased and how they were valued.

Ratio of NPLs to Total Loans – What is the Right Number?

Total local debt is estimated by Beijing's national audit in 2012 at 17.9 trillion RMB. Of this, 45.7% was lent to LGFVs, of which 68%, or 151 out of the 223 LGFVs surveyed, owed interest and principle higher than income. Among 15 Provincial capitals surveyed, 13 of them owed principal and interest accounting for 20% of their fiscal resources, with one location requiring 68%. In the sections below, we look at examples of AMCs in Beijing, Japan, Malaysia and South Korea.

The Central AMCs in China and the State Bank Recapitalization

The four Central AMCs were established in 1999 to recapitalize the four state banks. The chart below shows the outstanding NPLs of the banks prior to their transfer to the AMCs. The ratio of NPLs to total bank loans was quite high – 42%.

The NPLs of the Big Four Chinese Banks (RMB Billions, 2001)

NPLs still held by the big four banks	2,000	
Policy-based NPL transfers (headline number)	1,400	
Transfers from China Development Bank (not the big four banks)	(100)	
"Performing loans" carved out (partly overlapping with CDB Transfers)	(200)	
Non-policy stripping-out (ongoing informally)	300	
Total NPLs at the big four banks (carved out and remaining)	**3,400**	
As a percentage of big four banks' loans outstanding		42%
As a percentage of 2001 GDP		35%

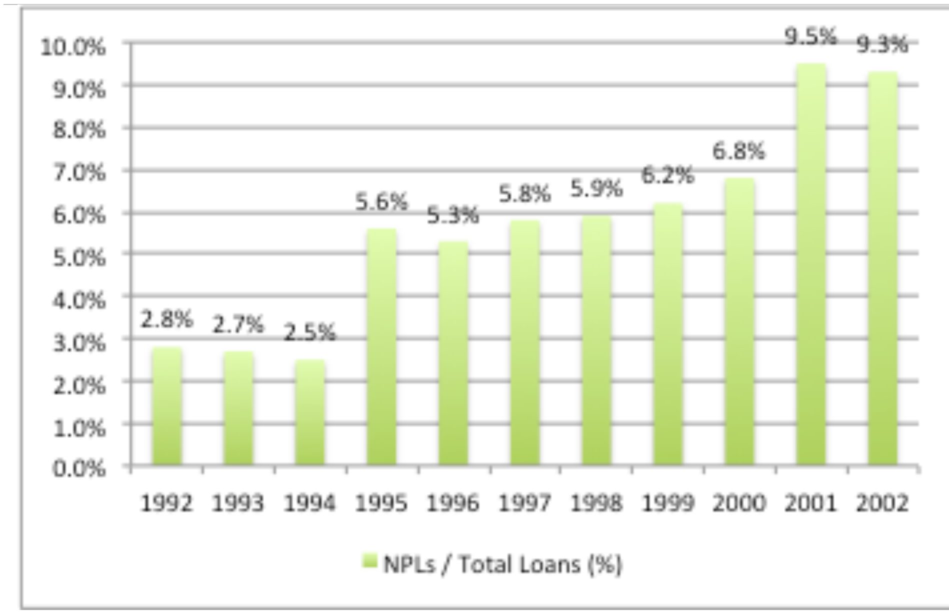
Source: China's AMCs (BIS)

Public AMCs in Asia (Ma and Fung, BIS, 2002)

Japan's Debt Crisis

Below, for Japan, we find a much lower ratio of NPLs to outstanding loans, topping out at 9.5% in 2001.

NPLs to Total Loans in Japan after its Financial Crisis

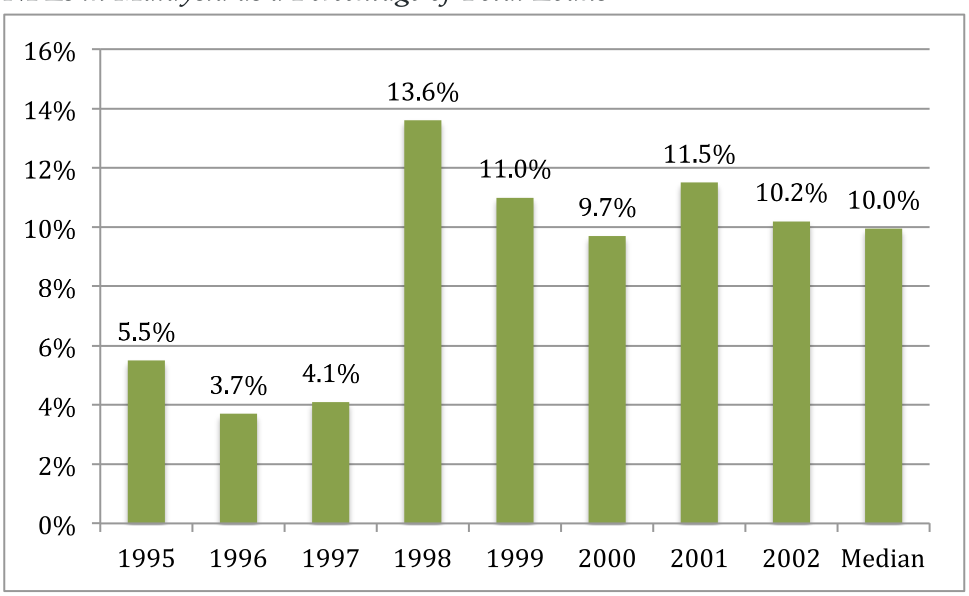


Public Asset Management Companies in Asia (BIS, 2004)

Malaysia's NPL Recovery

For Malaysia, the number of NPLs during the establishment of its AMCs post financial crisis was line with Japan, at a median of 10%.

NPLs in Malaysia as a Percentage of Total Loans



Source: Public AMCs in Asia (BIS)

Which NPL Recovery Number Should We Use for Local NPLs?

There are arguments for the higher of these numbers. The LGFVs across China were established a) to act as a Keynesian stimulus and b) to improve local infrastructure, in line with the argument made by policy makers that China needs to upgrade its physical assets to keep pace both with urbanisation and the country's rapid GDP growth. However, looking at the prospectuses for Wealth Management and Trust products, many of these LGFVs are residential and commercial property projects designed to reap quick profits through land sales and are of dubious economic value. In light of current data indicating what may be the end of the property bubble, it is doubtful that the majority of these will earn much revenue.

The two key numbers in our analysis for the ratio of NPLs to total bank loans are 10% (the experience of other Asian nations); and 41% for the NPLs of the Big Four banks at the time of their recapitalisation. However, although we provide a baseline 50% NPL ratio, we provide a range of outcomes in our final summary.

How Much Did Asian AMCs Recover from NPLs Post Asian Crisis?

Next, we look at the average purchase price paid by Asian AMCs to acquire bad debt from financial and other institutions. The assumption is that this was similar in scope to the actual recovery to other sources, although we do not have data on most of this as the workouts took place over an extended period of time after the bulk purchases. In our calculations, we are assuming this program will be rolled out nationally, although clearly this could take time. Chinese officials argue that the sale of state assets is one resource available to recapitalize the financial system, including banks, governments and other entities. (See Andrew Collier, The Financial Times, May 2, "Can China Bail Itself Out?"). The AMCs will be a key actor in this process. As above, we use domestic and global comparisons.

China's Central AMCs

Below is a breakdown of the NPLs acquired by the Central AMCs as a percentage of total loans. The AMCs acquired 20.7% of total loans, or about half of the four state banks' total NPLs.

China's four AMCs and big four banks: policy-based NPL transfers in 1999-2000 (RMB Bln)

AMC	Matched Bank	Assets Transferred	Share of Bank Loans Outstanding (%)
Orient Asset Management	Bank of China	267.4	20.4%
Great Wall	Agricultural Bank	345.8	24.6%
Cinda	China Constructic	373	21.7%
Huarong	ICBC	407.7	17.9%
Total		**1393.9**	**20.7%**

Public AMCs in Asia (BIS)

Japan AMCs

In Japan, the amount of NPLs purchased varied significantly according to type of institution. The country's agency in charge of the country's failed housing lenders bought the assets for almost half of their original price. The RCC, the bank in charge of asset disposals, paid 22 cents on the dollar, while the government bank loans used to help troubled banks paid only 7.7% of the original price.

NPLs Collected by the Resolution and Collection Corporation of Japan

FY2002 (JPY Blns)	Former Housing Loan Administration Corp.	Former Resolution and Collection Bank	Loans purchased under Financial Revitalization Law
Principals	10048	21437	3392
Transfer or purchase price	4656	4748	261
Transfer price as % of original	46.3%	22.1%	7.7%

Source: Public Asset Management Companies in Asia (BIS)

Korean AMCs

Korea's NPA fund had a high rate of purchase of NPLs relative to other countries in the region. On average, they paid 46.8% of book value for the NPLs they bought.

Korean NPA Resolution via the NPA Fund (KRW Trillion)

Year	Face Value	Purchase Price	Recovery Rate (%)
1997	-	-	-
1998	5.06	2.33	46.8%
1999	15.76	8.35	61.2%
2000	24.86	8.09	35.9%
2001	11.07	4.48	48.1%
2002	7.88	3.22	50.6%
Cumulative	64.63	26.48	46.8%

Sources: Corporate Planning Department, and Corporate Policy and Strategic

However, the Korean data shows large differences between financial institutions for the cost of bulk purchases. They range from a high for securities firms of 52.7% of book value, 40% for banks, and a low of 12.4% for desperate cases under the Korea Deposit Insurance Corp. This is quite a wide spread and reflects the disparate mandates granted to each loan workout group.

Cumulative NPA Acquisition by Type of Institution in Korea

Financial Institution	Face Value (KRW T)	Purchase Price Ratio	% Total
Banks	61.82	40.0%	56.1%
Merchant Banks	3.5	46.3%	3.2%
Guarantee Insurance	7.06	24.7%	6.4%
Life Insurance	0.3	22.6%	0.3%
Securities	0.14	52.7%	0.1%
Mutual Savings	0.53	39.4%	0.5%
Foreign Financial Institutions	5.01	41.9%	4.5%
Financial Resolution Entities under the KDIC)	6.78	12.4%	6.2%
Investment Trusts	22.3	37.6%	20.3%
Other	2.66	0.4%	2.4%
Total	**110.11**	**36.1%**	**100.0%**

Source: Corporate Planning Department, and Corporate Policy and Strategic Management Office, KAMCO. (In Public AMCs in Asia, BIS).

How Much will the China AMCs Receive After Their Bulk Purchases from the Banks?

Korea Is an Example of an Effective Workout

Although we have clear data on purchases of bad loans by AMCs across Asia, what is less clear is how much they recovered once they restructured or sold these loans. Most of the data refers to bulk purchases by the AMCs from financial institutions, and not to the income generated by the further sale of the NPLs to operating companies or other buyers, or to money earned after restructuring. However, there is a useful set of comparable data from the Korean debt workout that specifies the channels used to sell assets on to other institutions.

This may prove a guide to the future operation of local AMCs in China.

As the authors of a paper for the Bank of International Settlements note, Korea used four main methods for disposing of bad debt.

1) **Bulk loan resolution**. This involves international bidding for NPA pools and the issuance of asset-backed securities (ABS), with the former being partly motivated to attract foreign currency inflows. For ABS, selected NPA pools are transferred to special purpose vehicles, which in turn issue debts backed by the underlying assets.

2) **Foreclosure** and public auctions, and individual loan sales.

3) **Joint venture partnerships**. KAMCO enters into joint ventures with foreign investors, typically on a 50%-50% basis.

4) **Collection and payments by rescheduling**. This methodology involves debt workouts conducted outside of the legal system or restructuring under the court ordered programs. The final agreement with the debtor may involve an amendment of loan terms such as payment rescheduling, partial forgiveness of loan principal or accrued interest, and debt-for-equity swaps.

Overall, the purchase price ratio (meaning sales of NPLs outside of the government) ranged from a low of 26.4% for international bidding to a high 81.4% for NPLs acquired by Daewoo. The average was 44.3%.

Cumulative NPA resolution by Type of Sale (December 2002)

Type of Sale	Face Value (KRW T)	% Total	Purchase Price Ratio
Daewoo	3.28	5.1%	81.4%
ABS Issuance	8.02	12.4%	51.6%
Collection and Payment Schedule	12.65	19.6%	46.9%
Public Auction	8.3	12.8%	38.8%
Individual Loan Sale	2.59	4.0%	37.1%
Sale to Corporate Restructuring Company (CRC)	1.84	2.8%	36.4%
Sale to AMC	2.58	4.0%	35.7%
International Bidding	6.06	9.4%	26.4%
Subtotal	**45.36**	**70.2%**	**44.3%**
Recourse and Cancellation	19.27	29.8%	52.8%
Total	**64.63**		**46.8%**

Source: Corporate Planning Department and Corporate Policy and Strategic Management Office, KAMCO. (AMCs in Asia, BIS)

We Estimate Local AMCs are likely to Recover 1.9 trillion RMB

Since the amount of NPLs in local debt, along with the expected recovery rate, are unknowns, we used a range of estimates. The median recovery rate for NPLs purchased by the AMCs within our pan-Asian database is 21.4%.

Average NPL Purchase	Purchase Price Ratio
China Central AMCs	20.7%
Malaysia	10.0%
Japan - Housing Loans	46.3%
Japan - Resolution and Collection Bank	22.1%
Japan - Recovery Law	7.7%
Korean AMCs via NPA Fund	46.8%
Median	**21.4%**

Our baseline is a 50% rate of NPLs for local debt. As suggested earlier, this number could be substantially higher given how ineffective much of the LGFV construction has been. On capital recovered, we use the median of the estimates for other Asian countries post-AFN, of 21.4%. Our baseline recovery estimate is 1.9 trillion RMB, or 10.7% of local debt.

Local Debt Recovery - Scenarios

Total Local Debt (RMB T)	NPL Ratio	NPLs (RMB T)	Median Recovery Rate for Asian AMCs	Capital Recovered (RMB T)	% of Total Local Debt
17,900	20%	3,580	21.4%	766	4.3%
17,900	30%	5,370	21.4%	1,149	6.4%
17,900	40%	7,160	21.4%	1,532	8.6%
17,900	50%	8,950	21.4%	1,915	10.7%
17,900	60%	10,740	21.4%	2,298	12.8%
17,900	70%	12,530	21.4%	2,681	15.0%
17,900	80%	14,320	21.4%	3,064	17.1%
17,900	90%	16,110	21.4%	3,448	19.3%

Source: China National Audit Office, BIS, Orient Capital Research.

Recent Sales of Local Debt in China

How Has it Worked?

Alternate Debt Reduction Methods

Provincial AMCs may play an instrumental role in helping to reduce local debt. But the major issue of over-leverage in the economy, especially local government debt, may call for more drastic measures, a job probably beyond the capacity of provincial AMCs.

Generally speaking, there are two ways where over-leveraged local governments could relieve themselves of their debt load.

1) Swap Central Government Debt for Local Government Debt

Lou Jiwei, currently Minister of Finance, in the article "Six Systemic Reforms with which

China Must Press Ahead", pointed out that the central government accounted for 52% of total fiscal income in China, yet only pays for 20% of total fiscal expenditures. Although the central government has made a significant amount of transfer payments to subsidize local governments, the lopsided balance between central and local fiscal income and fiscal expenditure needs to be addressed in a systemic manner. It also suggests that central government should issue debt to replace some debt incurred by local governments, which is then utilized to finance public expenditure.

2) Asset Divestment

Local governments have a significant amount of resources under their control which they can divest and use the proceeds to pay back their debts. Encouraged by the central government, many provincial governments are working on plans to reform local SOEs; thus huge amount of capital could be raised by divesting a portion of ownership stakes there.

Other Examples of Debt Restructuring

There have been earlier debt workouts through the informal investment groups under local governments. These examples – although not as well capitalized and lacking the institutional backing of the regulators in Beijing – provide some clues to how these local workouts may occur in the future.

Chongqing Land Deal Required Central Support

Founded by the municipal Chongqing government in 2004, **Chongqing Yufu Asset Management Group Co**. ("Chongqing Yufu") is an example of a provincial government taking the initiative to restructure local distressed assets. The local government was aware of the bad debt in the banking sector and the difficulties among local state-owned enterprises struggling to service debt from state-owned banks. As a result, Chongqing Yufu negotiated with ICBC, and with the government's approval, purchased more than 10 billion RMB of ICBC Chongqing Branch's distressed loans, paying around 22 cents on the dollar. Chongqing Yufu was also instrumental in cleaning up the books of the Bank of Chongqing by taking over a big chunk of distressed loans weighing on the balance sheet of the bank, becoming in the end the largest shareholder in the bank.

The Chongqing Yufu deal was generally considered successful. ICBC had to take a significant write down, considering that the loans were not sold at face value, but again, the loans were distressed to begin with. The major trick in this deal was to get ICBC agree to sell the loans at a discount from face value, and to find the money to make the payment. It is likely that Chongqing appealed to Beijing for permission on the grounds that the debt weighed on local economic development: Local SOEs were struggling under a massive debt load, and the workout would provide a cash recovery. As a result, Chongqing was able to secure central government approval. Also, the value of land at prime locations gave China Development Bank the confidence to lend Chongqing Yufu 2 billion RMB.

In the end, the Chongqing government was able to relocate the SOEs and clear prime land for urban development. ***Arguably, much of the later hype about the so-called "Chongqing Model" can trace back the early Yufu-ICBC deal. But this arrangement required substantial capital from the central government via the CDB – capital not available to other local governments.***

Guangdong Government Provided Key Backing for Bank Recapitalization

The predecessor of **Guangzhou Finance Holdings Group** took over RMB17 billion of distressed assets from Bank of Guangzhou in 2009, paying face value. Guangdong Yuecai Asset Management Co. acquired 58 billion RMB of distressed assets from Guangdong Development Bank, paying 48 RMB billion plus a promise of 10 billion RMB in income tax refunds over a period of 5 years. According to its 2006 annual report, GDB had negative shareholder's equity of 35.5 billion RMB with an NPL ratio of 22.7%. The bank needed badly to clean up its books before it could attract new investors to boost its capital base and get into shape for an IPO. The Guangdong provincial government provided much needed help. The AMC paid 48.1 billion RMB plus another RMB10 billion in corporate income tax refunds over five years. After this financial cleansing, GDB was able to attract investments from Citigroup, China Life, State Grid, Citic Trust and Investment, and IBM Credit which combined controlled 85% of the bank.

How much did Guangdong Yuecai get for disposing of the NPLs? Information is sketchy about the actual cash recovery from the NPLs.

Jiangsu Asset Management Rescues the Steel Industry

Jiangsu Asset Management Co was a subsidiary of the Wuxi Municipal Government, Jiangsu Province. With registered capital of 8 billion RMB, it was brought in to rescue the city of Wuxi's troubled steel industry. Steel traders have been responsible for a spike in NPL in Yangtze River Delta, including Shanghai and Wuxi. During the 2009 4 trillion RMB fiscal stimulus, many steel traders borrowed extensively from banks using steel products as collateral. However, such loans were often diverted to other purposes, including real estate investment or something risky projects. Dai Yuming, a local official in charge of finance at the Wuxi municipal government of Wuxi was quoted as saying that loans in Wuxi's steel trading industry added up to RM20 billion in 2013, half of which would be wiped out in the end. NPLs at banks in Wuxi increased by RMB1.1 billion RMB in the first quarter of 2014, thanks in part to steel-trading related loans going sour. News reports say that Jiangsu Asset Management Company was quite involved in tackling the NPL related to steel trading.

So, provincial AMCs are not untried, which might explain the lack of enthusiasm among some Provinces to promote them. One of the factors holding them back cited by some provincial governments is the size of the funding needed for provincial AMCs, according to the report by the two researchers at the People's Bank of China.

Four State-owned AMCs Have Produced Mixed Results

Returns Have Not Always Been as High as Expected

The four state-owned AMCs were established in 1999 to dispose of distressed assets from the state-owned banks. As far as their business thus far, these AMCs have had mixed results -- even though one of them, China Cinda, managed to be listed in Hong Kong.

1) Meager Cash Recovery

Cash recovery is usually a major performance indicator for the AMCs. Cinda's IPO prospectus revealed that as of Dec 31,2012, the four AMCs had cumulatively acquired distressed assets with an original value of more than 3.1 trillion RMB and had recovered cash in the hundreds of billions of RMB. This vagueness on actual amount of cash recovered speaks volumes about their performance.

2) Decline in Property Values May Hurt Central AMC Performance

The performance of the four state-owned AMCs may have received a strong boost from the booming real estate sector in the previous decade. Cinda's story corroborates this point. Cinda pooled some of the real estate assets it acquired in the course of business and injected into them into a listed company and renamed it Cinda Real Estate (SSE: 600657). Cinda holds 54.75% of the listco. Due to the low cost of land, an advantage even more prominent when land prices getting increasingly expensive in China, Cinda Real Estate was able to enjoy a high gross profit margin in its main line of business, real estate development.

As can be observed from comparison below, during the previous four years, China Vanke (Shenzhen Stock Exchange: 000002), a leading developer in China, had witnessed a consistent decline in gross profit margins. But the main business of Cinda Real Estate, unlike China Vanke, had managed to hold its gross profit margin at the quite lucrative level of around 40%.

China Vanke (RMB Bln)				
	2010	2011	2012	2013
Revenue	47.8	67.7	96.9	127.5
Cost	29.5	43.3	65.5	92.8
Gross Profit Margin	38.2%	36.1%	32.4%	27.2%

(Cinda Real Estate annual reports)

Cinda Real Estate (RMB Bln)				
	2010	2011	2012	2013
Revenue	3,539.56	2,969.92	3,675.04	4,403.06
CoGS	2,375.01	1,725.78	2,268.68	2,557.57
GP Margin	32.9%	41.9%	38.3%	41.9%
Net Profit	418.45	562.96	613.78	703.90

3) Benefit from Other Types of Distressed Assets

In addition to distressed assets from financial institutions, Cinda was also issued the license to acquire account receivables from non-financial enterprises. According to the company's IPO prospectus, the total balance of accounts receivables acquired from non-financial enterprises accounted for 62.9% of the balance of distressed debt assets classified as receivables. This business generated income of RMB3,518.4 million in 2012, up from RMB180.9 million in 2011, due largely to the increase in accounts receivable acquired from non-financial enterprises, from RMB6,601.8 million to RMB30,256 million.

4) China is Imitating the U.S. Model

The establishment of four state-owned AMCs borrowed a page from the U.S. experience in tackling the savings and loans crisis during 1990s. The Resolution Trust Company was established by the U.S. government for the very purpose. However, unlike the US company which was wound up upon job done, the four Chinese AMCs went on a path of distinct Chinese characteristics. Rather than being wound up at the end of the original 10 year mandate, the four companies manage to extend their life and even branch out into many other activities unforeseen in there original mandate. Most noteworthy, they all went on a buy spree to grab as much as possible financial assets / licenses, such as financial leasing, securities brokerage, insurance, trust, futures, mutual fund, private equity, banking, etc. They become financial conglomerates.

The chances are high that other provincial AMCs will also be local government-invested and controlled. The provincial AMCs may also follow the footsteps of the four state-owned AMCs and turn themselves into financial conglomerates, a scenario incongruous with the Chinese government's official policy stance of cutting back the state presence in sectors of non-strategic importance. The state-owned sector in China is plagued by soft budget controls and a lack of commercial orientation. This assessment also applies to the financial licenses acquired by the four state-owned AMCs.

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