Guest post: China's fire sale of the century

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A decade ago, when China was struggling to clean up its banking system, regulators pulled a rabbit out of a hat. They set up a series of "bad banks" – called Asset Management Companies (AMC) – and took Rmb 1.4tn ($125bn) of debt off the hands of the four State Banks in Beijing. It was a big success, leading to the listing of the "Big Four" banks in Hong Kong and a healthier financial system.

Now, they're trying to pull the same trick again – this time across the country.

Regulators have quietly given approval for local governments to set up their own AMCs. As in Beijing ten years ago, these local AMCs would take non-performing loans (NPLs) from local banks, governments and other financial institutions and sell or restructure them. So far, four Provinces have signed on, but once the experiment gets rolling, it's likely there will be one for each Province across China.

They will have their work cut out for them. Beijing estimates that local governments have Rmb 17.9tn of debt. That includes the off-balance sheet debt that governments used to circumvent bank lending restrictions to invest in infrastructure and property projects. Between 1998 and 2011, there was an Rmb 18tn gap between local expenditures and fiscal revenue.

The central government takes the lion's share of local tax revenue but leaves increasingly expensive social welfare costs to the local governments. Strapped for cash, these local governments have made up the difference with Rmb 13tn in land sales and Rmb 4.97tn in bank debt. But the banks are becoming increasingly nervous about government loans. And these towns across China are gradually running out of land to sell.

Most of the projects indirectly funded by local governments will never make money — the famous "bridges to nowhere". Meanwhile, they've chewed up a tremendous amount of desperately needed capital. In its recent IPO prospectus, Huishang Bank, a city commercial bank based in Anhui Province, said 12.9 per cent of all of its loans, a total of Rmb 23.6bn, went to local government projects.

Most of this – 93 per cent – has gone to land, industrial parks, property

construction or infrastructure. These are the financially weak sectors of China's economy most likely to default as China's economy slows. Multiply this by hundreds of towns and cities across China and the country will be facing massive fiscal problems. Even more frightening to the leaders in Beijing, there is the possibility of demonstrations in the streets by unhappy retirees who suddenly discover their governments are too broke to pay them.

If the local AMCs are rolled out nationally, how much cash will they recover? While this is a new program, we do have two other precedents – the national AMCs set up in Beijing 15 years ago, and the AMCs of other Asian nations after the Asian Financial Crisis in 1997.

The Beijing AMCs cleaned up the big banks by purchasing Rmb 1.4tn of debt. This was 21 per cent of outstanding loans, and about half of the estimated NPLs on the banks' balance sheets. Elsewhere in Asia, including Korea, Malaysia, Thailand and Japan, the record was substantially more mixed. Recovery ranges from 7.7 per cent for Japan's to a high of 46.8 per cent for Korea's AMC fund. If we include China's central AMCs, the median recovery rate for pan-Asia is 21.4 per cent.

To use a ballpark estimate, if we take Rmb17.9tn of local debt, assume a 50 per cent NPL ratio and a recovery rate of 21.4 per cent, the AMCs eventually could salvage Rmb1.9tn. That would be a big help to cash strapped local governments.

How quickly is this fire sale of debt likely to occur? Government officials point to the country's thousands of debt strapped state firms as a healthy group of assets to sell. But turning bridges, highways and steelmakers into ready cash is not going to be easy. There is a school of hungry private equity funds in Hong Kong eyeing this pool of debt like sharks circling its prey. But they won't buy until sellers – mainly local banks and governments – bow to reality and stamp discount stickers on their loans. That may take a while. Domestic purchasers also may take their time.

China could learn from one of the more successful examples of debt restructuring: Korea. To unload bad debt after the 1997 financial meltdown, Korea relied on a combination of securitisation, foreclosures, joint ventures and debt rescheduling. One neat trick they used was a put option – the AMCs bought the debt but had the option to sell it back to the banks if nothing worked. This made them a lot more eager to tackle the problem in the first place.

In China, the big concern is if the local governments use the AMCs just to hide debt. Suddenly, Beijing could find itself trying shut down these new debt companies like a firefighter capping a giant field of burning oil wells. But China seems serious about getting rid of local debt. Let's just see if they have the tools to snuff out the fire.

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