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Hearing on "China's Quest for Capital: Motivations, Methods, and Implications"

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In the years following the Global Financial Crisis, China pursued a credit expansion unprecedented in its size and speed. Not all of the debt was well spent, resulting in a build-up of industrial overcapacity, empty housing, and underutilized infrastructure. China's financial system is now dealing with the fallout of that waste and excess.

Since 2016, China's banks have accelerated their disposal of nonperforming loans (NPLs). Nonetheless, the pace of disposals has remained slow and measured, a deliberate decision on Beijing's part to minimize economic disruption by spreading out the cost of resolving bad loans over an extended period of time. The approach hasn't been without merit. Banks have been able to accelerate the pace of NPL disposal while relying primarily on retained earnings to replenish capital eroded by write-offs. To the extent that banks have needed to sell bonds and equity to augment their capital, the market has proven up to task of absorbing the demand.

However, China may have already reached the limitations of that approach. In 2019, the government intervened directly to prop up five of China's 50 biggest banks. It's feasible to think there will be further interventions in the years ahead. The chairman of China's sovereign wealth fund recently said as much, noting that as the economy slows, the failure of financial institutions will become "a fact of life".[1] Certainly, it seems likely that the banking sectors' need for new capital will accelerate in the years ahead.

This paper will not seek to estimate just how much additional capital China's banks will need. Official data understates the extent of China's NPL problem, and the stock of NPLs is likely to swell as the economy slows further, complicating any calculations. Rather, this paper will attempt to outline the factors that will determine how large the banks' capital needs will be. Specifically, there are four aspects worth our consideration:

1. The degree to which debtors are able to repay their loans, either by having the burden of their outstanding debt reduced, or by drawing upon new funding sources with which to pay down their loans.
2. The degree to which banks are able to extract value from their NPLs, thereby reducing the amount of bad loans they need to write off.
3. The degree to which banks' profit growth is sufficient to meet capital needs without banks needing to sell bonds and equity.
4. The degree to which the state feels it is necessary to intervene directly in struggling banks, and the means by which the state intervenes.

It's worth noting that banks' loan growth also places demands on their capital. Despite having launched a 'deleveraging' campaign in 2016, the Chinese economy continues to rely on the rapid accumulation of debt in order to deliver politically acceptable levels of growth. That means China cannot deleverage at a macro level in the near term. But as long as lending expands, banks will need more capital. Banks' loan growth is further

[1] Sun Yu, "China sovereign wealth fund head signals more financial failures," *Financial Times*, September 20, 2019, https://www.ft.com/content/29e133dc-db73-11e9-8f9b-77216ebe1f17.

fueled by government efforts to repatriate shadow banking loans back onto the banks' books. To the extent that such repatriation continues to swell bank loans, banks will need more capital.

That said, we will focus here solely on the challenges posed by distressed debt. This paper will look at how Beijing is trying to clean up the financial system; the ways actors in the economy have attempted to mitigate NPL formation; how the state has tried to minimize the need for banks to raise fresh capital; the limitations of the current approach; and what we can expect from future government intervention in the banks.

China's Bank Clean-Up Strategy

According to Chinese government statistics, at the end of September 2019, only 1.86% of Chinese bank loans were nonperforming. It is widely accepted—both inside of China, and out—that the figure significantly understates reality. However, estimates of the actual level vary wildly. Further complicating efforts to arrive at a figure is that the degree of distress among various tiers of banks differ significantly. A researcher at Tsinghua University's National Finance Research Center[2] recently estimated that the NPL ratio for large state-owned commercial bank is between 5% and 8%,[3] joint stock banks between 8% and 12%, city commercial banks between 10% and 15%, and rural financial institutions between 20% and 30%. While I have no way of independently verifying whether those figures are a fair estimate, they nonetheless reflect the consensus on how distress varies between bank types.

It would be easy to mistake obfuscation of the data for denial of the problem, and believe that Beijing's failure to provide a fair and transparent accounting of the banks' NPLs reflects an unwillingness to deal with the issue. However, since 2016, Beijing has been pursuing a concerted—albeit moderately paced—cleanup of the banking system. Between 2016 and the end of the September 2019, Chinese banks disposed of 5.8 trillion yuan ($828.6 billion) worth of nonperforming loans, equivalent to about 4.6% of the total volume of outstanding loans at the end of the period.

The decision to understate the NPL data is strategic. It gives Beijing the freedom to deal with bad loans in its own way and at its own pace. If Beijing were to acknowledge a significantly higher NPL ratio, then the banks would have to immediately raise huge amounts of capital, all at once, and at fire sale prices. Companies would be forced into bankruptcy as delinquent borrowers who had previously enjoyed the banks' forbearance, are foreclosed upon. And the secondary market for bad loans would be hit by a glut of new supply, forcing down prices and reducing the value banks could extract from them.

Pursuing a slow-paced cleanup has allowed Beijing to minimize the disruption to the broader economy, and to reduce the cost to the central government. It allows banks to make write-offs from profits generated over multiple years, thereby reducing the need to raise fresh capital from the market. Moreover, banks can gradually drip nonperforming loans into the secondary market rather than dumping them en masse on disinterested investors. And by having banks exercise forbearance on delinquent loans, it gives the authorities time to find ways to help overstretched borrowers repay their debts.

China is able to take such an approach because its financial system functions differently from those in market economies. Market economies demand that banks offer an accurate accounting of their asset quality in order to ensure that they're adequately capitalized, which is necessary to ensure that the market retains faith in the banks. In China, the state stands behind the country's banks. That ensures that the market retains faith in the banks even if they're not sufficiently capitalized. As long as authorities ensure those banks have sufficient

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[2] Yang Xiaohai, "**如何化解不良资产"堰塞湖"**," (How to Resolve the "Railings Dam" of NPLs) *FT Chinese*, October 8, 2019, http://big5.ftchinese.com/story/001084431?adchannelID=&full=y&archive.

[3] The designation "large state-owned commercial banks" refers to ICBC, CCB, BOC, ABS, BoCOM, China Postal Savings Bank.

liquidity to meet their obligations, they can trundle along with higher delinquency levels than would be regarded safe in a market economy.

The approach is not without risk. While gradualism helps to avoid the trauma that would accompany a more sudden adjustment, the trade-off is that banks must tolerate a higher level of NPLs for a longer period of time. That leaves the banks more vulnerable to economic shocks, which has the potential to lead to far greater economic disruption down the line. So far Beijing has been able to manage those risks by ensuring that banks have sufficient liquidity.

But the measured approach Beijing has pursued thus far only works if the banks are able to dispose of bad loans faster than new ones are created. We have no way of knowing whether the banks have been able to maintain that balance over the past few years. However, it seems clear that in the coming years the balance will become far more difficult to maintain, requiring greater NPL disposals, greater capital raising, and more direct intervention on the part of government to support individual banks.

Mitigating the Creation of New NPLs

The first step toward managing banks' NPL burden is to mitigate the creation of NPLs in the first place, by ensuring borrowers have the resources to repay their loans. There have been a couple of efforts to this effect over the last few years, but they have been short-lived in their effectiveness. The following section will look at those efforts, as well as their limitations and potential for the future.

1. Inflation

One way to make it easier for struggling firms to repay their loans is to reduce the real cost of borrowing. That occurred in 2017 and early 2018 when producer prices surged, the result of Beijing's success in closing factories to deal with industrial overcapacity. The price of industrial commodities rose, reducing the relative cost of debt, and making it easier for firms to service their obligations. However, the Producer Price Index (PPI) has since plunged, even turning negative, which has exacerbated firms' debt repayment burden by pushing up the real cost of borrowing. While industrial overcapacity remains a problem in many industries, Beijing is increasingly concerned by unemployment, which likely lessens the political will to aggressively shut down more factories in the interests of boosting prices.

Alternatively, Beijing could just reduce interest rates. Despite the occasional five basis point cut to benchmark rates in 2019, the central bank has been reluctant to make more meaningful cuts, perhaps for fear of reigniting speculative investment in real estate. For similar reasons, Beijing is reluctant to resort to the type of pump priming stimulus it has fallen back on repeatedly over the past decade. Injecting more credit into the economy would boost profits for some firms, making it easier for them to manage their debt. However, it will create new bad loans, and when the stimulus has run its course, the economy will be no better off.

2. Asset Sales

For years, economists have argued that China's local debt problems are manageable if only local authorities were allowed to divest their huge asset holdings: land, forests, mining resources, and equity in companies. Land sales have long been central to local authorities' ability to borrow and repay loans, but with land sales sluggish in many parts of the country, land no longer seems sufficient to pay down the debt. A potentially important resource for local government—and state firms as well—to manage their loans is equity in companies they own. Nationwide, local governments own about 100,000 firms, with assets worth trillions of dollars.

Xi Jinping opened the door to the sale of state-owned equity when he launched mixed-ownership reform in 2013. At the time, he heralded mixed-ownership—which refers to the diversification of ownership of state firms—as a way to lift the efficiency and effectiveness of the state sector by diversifying ownership.

Governments would reduce their equity in state firms by selling their shares to other state firms, pension funds, and private equity investors, as well as private and foreign companies, in the hope that a greater range of shareholders would unleash companies' entrepreneurial spirits.

However, soon after, Beijing seemed to go cold on mixed-ownership reform, in part due to the enthusiasm of provincial governments, who saw it not as a way of boosting efficiency, but as a new channel through which they could raise capital. That said, mixed-ownership reform has bubbled along ever since, and even gained momentum in recent years, with local governments and state firms divesting equity they hold in non-core businesses. Regardless of mixed-ownership reforms' original intent, it has become a tool for the state sector to manage debt and capital needs.

Sadly, there is no aggregate data measuring the scale of funds raised through the sale of equity of state firms, or its impact on local government and state firm debt levels. While this could become a meaningful way for China to manage state-sector debt in the years ahead, for the time being it currently appears to be a marginal tool as best.

3. Delayed Payments

Throughout 2018, and at least the first half of 2019, one way that large companies were able to pay down their debt—or at least limit their accumulation of new debt—was by delaying payments to their suppliers. Private companies—the weakest political constituency in the economy—were most effected and had little scope to push back against large customers who insisted on paying later and later for goods and services bought on credit. The issue broke through into the public domain late in 2018 when Premier Li Keqiang called for an end to the practice.

"Government departments and state firms all must resolutely stop falling behind in making payments owed to private companies," the premier said at a State Council meeting in November that year.[4] "For government to do so violates the basic responsibility of the 'people's government serving the people.'"

The practice gained momentum for a number of reasons. The contraction in shadow banking that began in early 2018, meant that many firms—and local governments in particular—no longer had sufficient access to credit, and so they hoarded resources by pushing their financial stress onto their suppliers. Moreover, the slowing economy has forced firms in certain industries—notably construction—to consolidate. Consequently, many private companies—including multinationals—have found themselves dependent on a smaller pool of major customers who are able to use their concentrated market power to delay payment. However, there are limits to the extent that delaying payments can help reduce the NPL burden, with small firms likely already at the limit of stress they can absorb from their major customers.

4. Monetary Solutions

According to Bloomberg,[5] at a State Council meeting in 2019, the National Development and Reform Commission suggested that the People's Bank of China (PBOC) inject liquidity into the financial system for the express purpose of having banks use it to buy stakes in companies. Those companies could then use the capital injection to pay down their loans. According to the story, Premier Li Keqiang shot down the proposal. However, the suggestion wasn't outlandish. In fact, the PBOC had already done something similar the previous

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[4] "李克强：抓紧解决政府部门和国有企业拖欠民营企业账款问题" ("Li Keqiang: Grasp and Resolve the Problem of Arrears Owed by Government Departments and State Firms to Private Companies"), State Council, November 10, 2018, http://www.gov.cn/guowuyuan/2018-11/10/content_5339135.htm.

[5] "Inside the PBOC's Struggle to Balance China's Growth and Debt," *Bloomberg*, November 19, 2019, https://www.bloomberg.com/amp/news/articles/2019-11-19/inside-the-pboc-s-struggle-to-balance-china-s-growth-and-debt?__twitter_impression=true.

year. In mid-2018, the PBOC demanded that the liquidity released to large banks from a reserve requirement cut be used to fund debt-to-equity swaps, whereby loans to large, struggling firms were converted into shares in the companies, to be held by banks and other investors.

The ability to relieve pressure on debtors by changing the characteristics of their loans is one of the tools authorities can deploy to manage the debt burden. In addition to converting debt into equity, it can also convert debt into other types of debt with longer maturities and lower interest rates. That was part of the rationale behind permitting local government to issue bonds, which allowed local authorities to exchange bank and shadow banking loans for a cheaper source of funding that wouldn't need to be repaid as quickly. For many local governments, however, their debt burden is so heavy that swapping their debt into bonds has proven to be an insufficient solution.

An alternative could be for Beijing to mobilize the policy banks to warehouse local government loans. In mid-March, Bloomberg reported that China Development Bank (CDB) was set to play a role in helping ease the financial burden on overly indebted local governments.[6] Specifically, it reported that CDB was "leading an effort" to swap implicit short-term debts accrued by Xiangtan city in Hunan for 15-20 year loans. It also reported that CDB was talking to officials from Zhenjiang in Jiangsu, about making the city a test case for replacing existing debt with cheaper long-term CDB loans. The involvement of CDB and the other policy banks in resolving local government debt is a development worth watching. If the government uses the policy banks to monetize the loans (by having the PBOC fund the policy banks), it could lower interest rates on the policy bank loans below market rates on bonds. And by offering ultra-long maturities, the debt might ultimately be inflated away over time. As yet China hasn't taken this approach.

Maximizing the Value of NPLs

The need for Beijing to come up with a way to constrain the creation of NPLs is particularly important given that some loans are too politically sensitive to allow to default. However, contrary to what many observers assume, that doesn't apply to all loans made to state entities. Beijing has proven willing to allow loans to state firms to default, and for banks to pursue repayment in the courts. It has even allowed one major state-owned firm—Guangxi Nonferrous Metals Group—to pass through bankruptcy and into court-ordered liquidation. The firm was broken up and its assets sold at auction to an assortment of state- and private-sector buyers. However, that has so far proven the exception rather than the rule. State firms that can't repay their debts typically call upon other firms in their corporate group to repay their debt. In other cases, their debt has been dealt with via debt-to-equity swaps, or a white knight has appeared to take over the debt.

But for local governments in particular, the volume of debt is so large that none of these solutions seem feasible. Asset sales, or the shifting of the debt from commercial lenders to the state, loom as potential courses of action. In the meantime, loans that can't be written off will be a drain on bank resources—even if the banks' decline to officially recognize them as NPLs.

That said, there are still plenty of bad loans that banks are free to dispose of. Banks have two options when it comes to managing bad loans. They can write them off—which requires new capital to make up the capital that is eroded in the write-off process—or they can dispose of them in a way the allows the bank to recoup some value. The more that banks can earn from their disposal of NPLs, they less they need to write-off—and the less fresh capital they need to raise.

[6] "China Development Bank Leads Debt Fix in Another City," *Bloomberg*, March 17, 2019, https://www.bloomberg.com/news/articles/2019-03-18/china-development-bank-is-said-to-lead-debt-fix-in-another-city.

In order to maximize both the volume of disposals and the value that the banks can extract from their NPLs, Beijing has developed an ecosystem of financial institutions to help banks dispose of their NPLs. It has promoted a market-oriented approach, championing competition and transparency as key to lifting NPL prices. But it has also reserved a role for the state in dealing with potentially sensitive assets.

The main conduit for NPL disposals has been **asset management companies (AMCs)**, otherwise known as 'bad banks.' AMCs are a fixture of banking crises around the world. They're usually deployed so that a specific bank or group of banks are able to spin-off large volumes of NPLs quickly and efficiently, and are typically wound down once they've resolved or disposed of those NPLs. Seldom are there more than one or two—or at most a small handful—in operation in an economy at any given time.

Somewhat unusually, China has about 60 AMCs. Together they share the exclusive right to acquire from banks portfolios of three or more NPLs. Four of them—a group that was set up in 1999 to deal with an earlier banking crisis—are permitted to acquire NPLs nationwide. The remaining AMCs—the first of which gained regulatory approval in 2014—are allowed only to acquire NPLs solely from the single province in which they are licensed to operate. Most provinces have at least two local AMCs, and some have three. The AMCs are expected to operate on a commercial basis. And while they can hold on to the NPLs they acquire, they typically aim to sell them onward to third parties—Chinese entrepreneurs, dedicated distressed debt investors (both Chinese and foreign), and other firms. I estimate that in 2018, the banks sold about 500 billion yuan worth of NPLs to the AMCs.

Debt-to-equity swaps are the second most important NPL resolution channel. Debt-to-equity swaps are primarily used for dealing with the debt problems of large, state-owned firms, and particularly those that claim some strategic importance. Debt-to-equity swaps are not a cure-all, offering firms—and banks—only temporary relief. Debt-to-equity swap agreements are routinely signed on the understanding that the indebted company will buy back its equity after a few years. Nonetheless, they are a way of rapidly reducing NPLs. According to the State Council, China's banks conducted 228 billion yuan worth of debt-to-equity swaps in 2018.[7]

Since 2016, banks have also been able to package bad loans into **asset backed securities (ABS)**, which have mainly been used to dispose of loans to households and individuals. And finally, banks and AMCs post loans directly on Taobao, JD.com, and other online auction websites in order to market bad loans directly the public. The banks sold about 15 billion yuan of NPL ABS in 2018. There is no data on the volume of NPLs sold via auction, but banks raised 10.9 billion yuan from selling NPLs on Taobao alone in 2018.

Crucially, China's legal system has been broadly supportive of the NPL resolution process. They have been willing to freeze assets posted as collateral against loans, transfer rights to that collateral to investors who have acquired NPLs, and then auction those assets in a fair and transparent way, usually on Alibaba's Taobao platform. NPL investors, AMCs, and the banks themselves, use this process for extracting value from NPLs.

This supporting infrastructure has helped banks claw back significant value from their bad loans, and reduce the volume of bad loans they needed to write-off. According to the China Banking and Insurance Regulatory Commission, China's banks disposed of 1.9 trillion yuan worth of NPLs in 2018. Of that, 988 billion yuan was

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[7] Huang Tianlei, "Tracking China's Debt-to-Equity Swap Program: "Great Cry and Little Wool"," Peterson Institute of International Economics, June 24, 2019, https://www.piie.com/blogs/china-economic-watch/tracking-chinas-debt-equity-swap-program-great-cry-and-little-wool?utm_source=feedburner&utm_medium=email&utm_campaign=Feed%3A+ChinaEconomicWatch+%28PIIE+China+Economic+Watch%29?utm_source=feedburner&utm_medium=email&utm_campaign=Feed%3A+ChinaEconomicWatch+%28PIIE+China+Economic+Watch%29.

written off.[8] For the most part, the banking system has been able to sustain such levels of write-offs by replenishing their capital with retained earnings. However, that's been supplemented with equity and bond sales, at levels that haven't overwhelmed the market.

Traditionally IPOs have been limited to the biggest and best-managed Chinese banks, but in the four years from 2016 to 2019, there have been 29 initial public offerings by Chinese banks on the Shanghai, Shenzhen, and Hong Kong stock exchanges as smaller banks have been allowed to list. During that period, the number of publicly traded Chinese banks doubled from 25 to 50 (some of the IPOs during the period were by banks that were already publicly traded, but engaged in a secondary listing on another exchange). At least another 15 banks are currently waiting for approval to list. Meanwhile, bank issuance of tier two capital bonds has been rising aggressively since 2014. And the authorities have introduced perpetual bonds as a new tool for banks to replenish their capital.

Most fundraising, however, is difficult to track. Small, non-listed banks raise capital by selling equity in private placements and in auctions on financial asset exchanges. However, there's sufficient evidence to suggest that such sales have surged in recent years, and in 2019 in particular. Non-publicly traded banks with more than 200 shares must apply to the China Securities Regulatory Commission for approval if they want to issue new equity. In 2019, 46 banks made such applications, up from 26 in 2018, and only 3 in 2017.

Government Intervention in the Banks

In summary, over the past few years Beijing has attempted to cleanup China's financial system at a moderate pace. That has allowed banks to maximize the value they've been able to extract from bad loans, and so minimize the volume of bad loans needing to be written off. The elevated level of write-offs has required banks to replenish their capital, but the additional capital raising hasn't stretched the resources of China's financial markets. If Beijing could sustain this process for another decade, it could conceivably clean up the excess and distress in the financial system without undue disruption to the economy and with the authorities being required to mobilize the bare minimum of their own financial resources.

However, the approach is becoming less sustainable. As the economy slows, banks will need to dispose of bad loans more quickly. Moreover, the value banks have been able to extract from bad loans has been declining since the beginning of 2018 when a bubble in the secondary NPL market popped, bringing prices down precipitously. Hence banks, unable to sell NPLs for as much as they used to, will not only need to dispose of more NPLs, they'll also have to write-off a higher portion of those bad loans, putting pressure on bank capital. But the extent to which banks can replenish their capital from profits is diminishing as profit growth slows with the economy.

Where possible, Beijing will continue to rely on market mechanisms to recapitalize the banks, that is IPOs, private placements, and bond sales. However, government intervention is also likely to become more regular. That became clear in 2019 when five of China's 50 biggest banks received some kind of state support. That support took a number of different forms, reflecting the different circumstances of each bank. But it also signals that Beijing is still formulating a response to the issue of bank distress. The various types of state intervention over the past year offer interesting insight into what we can expect from Beijing as it works toward ensuring financial stability. The following section will look at the way the state has recently intervened in China's banks.

Receivership

[8] Guan Lidan, "银保监会发布数据：去年银行业处置不良资产近 2 万亿，风险总体可控," ("CBIRC Data Announcement: Last Year Banks Disposed of Almost 2 Trillion Yuan Worth of NPLs, The Risk is Under Control"), *Sohu*, January 11, 2019, http://www.sohu.com/a/288247855_100001551.

Baoshang Bank, a city commercial bank based in Inner Mongolia, was taken into receivership by the central bank and banking regulator in May. It's still unclear why Baoshang was singled out for special treatment—at the time, the authorities said it was due to "severe credit risk" without giving details—but it seems likely related to its chief shareholder. Baoshang was 89% controlled by Tomorrow Group, the investment vehicle of Xiao Jianhua, a politically connected billionaire who was abducted by Chinese security forces from the Hong Kong Four Seasons in 2017 and renditioned back to mainland China.

So far, the takeover hasn't involved the state injecting capital into Baoshang. That said, the bank has only been able to meet its obligations to creditors with the help of the PBOC's Deposit Insurance Fund, China's version of the US Federal Deposit Insurance Corporation (FDIC). The PBOC has been collecting dues to finance the Fund since 2015, but Baoshang is the first bank it has intervened in.

The fund has guaranteed Baoshang's obligations to deposit-holders and bondholders, albeit within limits. The Bank of Gansu recently disclosed that the Fund guaranteed 90.7% of the 1.45 billion yuan the provincial lender had deposited at Baoshang, forcing the Bank of Gansu to recognize losses on the remainder. This is the first time that banks have been forced to take a haircut on funds lent to another Chinese bank, and is a blow to the long-held assumption that all banks are implicitly—and entirely—backed by the state.

The financial authorities have said that receivership will last for a year, during which time, the actual running of the bank is the responsibility of a trustee, China Construction Bank. (In the US, that role would fall to the FDIC, but China's Deposit Insurance Fund currently neither has the staff nor expertise to do so). It seems fair to assume that at the end of the receivership period, the authorities will seek a buyer for the bank.

Forcing banks to take a haircut on their exposure to Baoshang has introduced a new element of risk into China's financial system, and raises the prospect that more banks will require state intervention in the further. Banks are now more cautious when lending to small banks, wary that their loans aren't entirely safe. That has raised the cost of borrowing for some banks, and raised the prospect that their funding may not be as secure as they'd previously assumed.

Bailout

Hengfeng Bank is the smallest of China's 12 joint stock banks. The management of Hengfeng—which was previously known as Evergrowing Bank—came under a cloud in May 2016 when a number of Chinese media outlets reported whistleblower accusations of fraud among the bank's senior management. In December, a former chairman of the bank was sentenced to death for financial crimes he committed while at the bank.

According to local media reports, the Shandong government had wanted to restructure Hengfeng Bank back in 2017. The bank eventually came under the management of the China Banking and Insurance Regulatory Commission (CBIRC) in March 2018, when the former party secretary of the Shandong banking regulator took over first as the bank's interim secretary, then as chairman. Other regulatory officials also took on senior roles at the bank.

In December, Caixin reported that the bank would raise 100 billion yuan by selling 100 billion shares, swamping the 11.2 billion shares that were outstanding at the end of 2016 (the last period for which we have data), and giving the new shareholders all but total control.[9] Central Huijin Investment, the subsidiary of China's sovereign wealth fund that holds the central government's bank shareholdings, will acquire 60 billion shares, not only bailing out the bank, but effectively nationalizing it. An asset management firm controlled by

[9] Liang Hong, Wu Hongyuran and Denise Jia, "China's Hengfeng Bank Gets $14.21 Billion Bailout," *Caixin*, December 19, 2019, https://www.caixinglobal.com/2019-12-19/chinas-hengfeng-bank-gets-1421-billion-bailout-101495712.html.

the Shandong provincial government will acquire 36 billion shares, and the remainder will be acquired by an assortment of other investors.

Whereas market economies typically use tax revenues to bail out financial institutions, when Beijing intervenes, it typically avoids using Ministry of Finance resources. Rather, intervention typically involves mobilizing state resources that don't appear on the government's ledger.

When in 2016, Beijing recapitalized Great Wall and China Orient—two of the four national asset management companies—it used the National Social Security Fund (NSSF). And in 2015, China Development Bank and China Export-Import Bank were recapitalized by the State Administration of Foreign Exchange (SAFE), using China's foreign exchange reserves. SAFE was also used to recapitalize ICBC, China Construction Bank, and Bank of China in the mid-2000s. It's likely that such state-controlled pots of money will be called upon again to recapitalize banks in the future. That said, given the decline in foreign exchange reserves from their peak in 2015, and the strict capital controls currently in place to prevent their further decline, Beijing might be reluctant to turn to SAFE again.

Restoring Market Confidence

The two other banks to receive significant media attention for receiving government support are the Bank of Jinzhou and Harbin Bank. Both are Hong Kong-listed city commercial banks from China's northeastern rustbelt provinces—Bank of Jinzhou is based in Liaoning, and Harbin Bank is from neighboring Heilongjiang.

In July, Industrial and Commercial Bank of China (ICBC), along with Cinda and Great Wall—two of China's four national AMCs—acquired a combined 18% in the Bank of Jinzhou from existing shareholders. Then in November, two state firms owned by the Heilongjiang provincial government acquired a combined 26% stake in Harbin Bank, similarly buying existing shares. While both banks are publicly traded in Hong Kong, the new investors acquired non-listed domestic shares. In neither case were the banks bailed out. The money spent acquiring shares didn't replenish the banks' capital, but rather went to existing shareholders. Soon after the acquisitions, both banks announced that they would raise fresh capital by selling new shares to the public.

These interventions seem aimed at bolstering confidence in the banks, by signaling that they have entered into a closer relationship with the state. In the case of the Bank of Jinzhou, the change in shareholders also resulted in a change in leadership—ICBC has supplied the bank with a new president and three other senior officials—signaling that the bank is now under the explicit guardianship of China's biggest bank.

Beijing may have assessed that the Bank of Jinzhou's primary problem was liquidity, and not capital. The bank ran into trouble soon after Baoshang was taken into receivership, when it found it difficult to borrow sufficiently from the interbank market. It appears that ICBC is being used as a means of permanently restoring market confidence in the Bank of Jinzhou—by sharing its credibility with the Liaoning bank—while also being made responsible for overhauling the way the bank is managed.

It's also worth noting that the Beijing thought it necessary to mobilize centrally controlled institutions to intervene in Bank of Jinzhou, but not Harbin Bank. Upon first glance that appears to be a fairly arbitrary decision given that, for all their other similarities, the two banks are also comparable in size. The Bank of Jinzhou is China's 30th biggest bank by assets. Harbin Banks comes in at around 35. However, the decision might be informed by Beijing's approach to dealing with global systemic risk guidelines.

Under Basel III guidelines, countries are expected to designate certain banks as being systemically important to domestic economies. China is yet to decide which banks qualify, but it recently said that the group will be drawn from the 30 biggest banks. So even though not all banks in that group will ultimately be considered systemically important, Beijing may have decided that they nonetheless warrant special oversight—and

assistance—from the central government. Notably, Hengfeng Bank falls within the 30, ranking as China's 20th largest bank. Baoshang Bank, however, is China's 36th largest.

Capital Solutions for Small Banks

The intervention to get the least attention involves the Bank of Jilin, a non-listed city commercial bank that ranks as China's 44th largest bank. In June, the bank announced that it would raise fresh capital by issuing new shares equivalent to 30% of the enlarged share base, in a private placement. It lined up the Jilin Province Finance Department, the Liaoyuan City Finance Bureau, the Baishan City Finance Bureau, as well as nine other investors. The bank had been having some trouble—its total assets declined in 2018—and it certainly appears that the mobilization of local government resources was a rescue.

In very few cases do banks sell shares directly to the government, as in Bank of Jilin's case. However, over the past year, local government entities—and in particular local government financing vehicles (LGFVs) and other local banks—have routinely been mobilized to acquire new shares being issued by non-listed banks. Particularly in cases where the banks have high NPL ratios, it seems likely that there may be no other potential buyers available.

However, the involvement of the state investors might be driven by other considerations as well. Over the past year there has been a glut of bank stocks put up for sale. According to Financial News, the PBOC's official newspaper, in the first nine months of 2019, there were almost 2000 judicial auctions involving banks stocks, up from 990 in 2018, and 630 in 2017. Judicial auctions occur when bank stocks have been posted as collateral against a loan, but the borrower subsequently defaults. The courts then auction the stocks, usually on Alibaba's Taobao platform. With so many banks' shares available for sale, banks needing to raise capital might find it easier to line up state buyers, rather than run the risk of there being insufficient commercial demand.

If any section of the Chinese financial system needs a sustainable solution to their capital shortfall, it's China's small banks—city commercial banks, rural commercial banks, and other rural financial institutions. Small banks were responsible for about 11.3% of write-offs in 2018, despite accounting for more than 30% of all bank assets. According to the CBIRC, all of China's banks wrote off 988 billion yuan worth of NPLs in 2018, up 35.5% from 729 billion yuan in 2017. But once the Big Five and joint stock banks are stripped out, the remaining banks wrote off only 111.8 billion yuan worth of NPLs that year, down 37% from 177.3 billion yuan in 2017.

Moreover, the local governments that are currently being called upon to provide the resources to recapitalize them are themselves financially overstretched. Local governments have long relied on land sales to repay loans borrowed to fund public works, but land sales are declining in some places. Meanwhile, tax cuts introduced at the beginning of 2019 to stimulate the economy are squeezing tax revenues, and much of what gets allocated by the central government to lower levels of government is earmarked, leaving local authorities with little in the way of discretionary funds with which to pay down their debt burden. The need to recapitalize local banks is a responsibility that will further stretch local resources.

Conclusion

It's difficult to determine how much capital China's banks will need to raise to deal with its bad loan problems. However, it seems that, despite Beijing's efforts to clean up the system over the past few years, the demands on the banks in the years ahead will likely grow. The stress will not be felt equally among banks. China's largest banks are in relatively good shape, and may be called upon to help deal with distress at smaller banks. The greatest challenge will be to recapitalize the small banks, and rural financial institutions in particular. While no single rural bank poses a systemic risk, as a group their stability presents a significant challenge.

As banks deal with the NPL burden, it will be important to watch for innovative solutions from Beijing. Will the authorities monetize local government debt, and if so, how? Will asset sales by state firms and local

governments accelerate as a means of paying down debt? Or will Beijing baulk at the prospect of state assets being sold too cheaply? It is early days in the process of China's debt cleanup, and we should expect that Beijing will experiment with new, creative approaches to reduce the potential capital burden on the banks.

Recommendations

During China's last banking system cleanup at the beginning of the century, foreign investment played an important role in the recapitalization of China's major financial institutions. US and European banks took strategic stakes in China's biggest banks prior to them listing in Hong Kong, lending credibility to the stock offerings. China's most important financial institutions aren't likely the need help this time round, but there could be scope for China's smaller banks to reach out for assistance. Certainly, recent moves by Beijing to relax foreign ownership controls over Chinese financial institutions potentially opens to door to foreign banks to play a role—at the margin—in the recapitalization process.

However, there will likely be little scope for US investment to play a meaningful role in China's recapitalization of its financial system. Moreover, the absence of such investment will not matter to China, which will strive to recapitalize its banks internally. Hence, there is little need for the US to formulate a policy position on whether it should seek to play a role in China's bank clean up, and if so, how. More significant for US policymakers is that the process of cleaning up China's financial system will be a further drag on the Chinese economy.

Globally, China's economic ascent is shrouded in an aura of inevitability. Access to China's markets are deemed essential not simply because of the size of those market today, but for what it's assumed they'll be in the near future. In reality, the challenges of cleaning up China financial system—paired with efforts to fundamentally overhaul the way the economy grows—means that China's economy is entering an adjustment period where growth slows further. The adjustment may only last a few years, but it may also last indefinitely. Regardless of its length, it will not only constrain China's ability to distribute financial resources around the world, it will also challenge the narrative of China's inevitability.

In the US, the default assumption is that China's rise is inexorable and that the US must plan for how to counter it. However, the US should also make contingencies for how to make the most of a period in which China is less economically assertive globally. Certainly, the US shouldn't try to exacerbate China's financial challenges. But much as China was emboldened by the US subprime crisis, the US should use a period of relative Chinese economic weakness rebuild relationships with countries that have felt that China's economic inevitability made it necessary to align their interests with China.