Comment on Ben Charonenwong, Meng Miao, and Tianyue Ruan “Hidden Non-Performing Loans in China”

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Summary

Main Question: Did the AMCs in China resolve NPLs or just hide them?

Answer: Banks use AMCs to hide NPLs

Supporting evidence:

1. Banks continue the collection efforts on NPLs after the sales to AMC
2. AMC uses the funds borrowed from the banks to buy their NPLs
3. AMC sells NPLs to the customers of the banks with premium
4. Stock (or Bond) market does not respond to the NPL sales events by banks

Amount of Hidden NPLs in China: As much as 2.05 trillion RMB (9.25% of the aggregate bank capital) (80% LGD and 50% pass-through)

Comments

Very good paper

I totally believe the results (AMCs were used to hide NPLs from the public)

Sounds very familiar to those who studied the NPL problem in Japan in the 1990s

Two types of comments

1. More explicit comparison to Japan's AMCs may be useful
2. Would like to know more details on several aspects of China's AMCs

1. Studies on Japanese AMCs

Takeo Hoshi and Anil K Kashyap (2010). “Will the U.S. bank recapitalization succeed? Eight lessons from Japan,” *Journal of Financial Economics*, 97, 398-417.

Frank Packer (2000). “The disposal of bad loans in Japan: the case of CCPC,” in Takeo Hoshi and Hugh Patrick (Eds.) *Crisis and Change in the Japanese Financial System*. Kluwer Academic Publishers, Boston, MA, pp.137-157.

Asset Management Companies in Japan

Name	Dates (purchases)	Target Purchases	Amount Spent (¥ Trillion)	Amount Collected (¥ Trillion)	Comments
Cooperative Credit Purchasing Co. (CCPC)	12/1992-3/2001	Non-performing loans with land collateral of contributing banks	5.8 (market) [=15.4 book]		Bank financed, created tax benefits by buying loans Liquidated in 3/2004
Tokyo Kyodo Bank	1/1995-4/1999	Initially assets of failed credit unions, later assets of any failed banks	4.718	5.362	Reorganized as Resolution and Collection Bank (RCB) in 9/1996
Housing Loan and Administration Corp. (HLAC)	7/1996-4/1999	Loans of failed *jusen* (specialty housing loan companies)	4.656 (market)	3.233	Financed with mix of public and private money
Resolution and Collection Corp.	4/1999-6/2005	Combined RCB and HLAC, mandate extended to allow purchases of assets from solvent banks	0.356 (market) [=4.046 book] (beyond earlier HLAC and RCB spending)	0.649	Starting in 2001 also reorganized loans, ultimately involved in restructuring 577 borrowers
Industrial Revitalization Corp. of Japan	5/2003- 3/2005	Buy non-performing loans through 2005, restructure them within 3 years	0.53(market) [=0.97(book)]	NA [0.094 surplus as of 5/2007]	Restructured 41 borrowers with 4 trillion total debt Closed in 5/2007

Japanese AMC Experience (i.e. Why they mostly did not work)

1. Limited scope of assets and financial institutions
2. Insufficient scale of operation
3. Warehoused bad loans without selling or restructuring them (especially in the 1990s)
4. Ultimately asset purchases did not remedy the capital shortage

China seems to have avoided at least the first two.

Chinese AMCs vs. Japanese AMCs

The paper finds:

2. AMC used the funds borrowed from the banks to buy their NPLs
3. AMC eventually sold NPLs to the customers of the banks with premium

CCPC was also financed by participating banks, and it was not the major problem. The problem was that CCPC did not get rid of the loans quickly.

In Chinese context, what happens when the AMC sells NPL with loss? Can AMC ask the bank to compensate for loss? If not, selling to AMC removes NPL from bank's balance sheet.

The most important incentive for Japanese banks to sell NPLs to CCPC was tax treatment. (Write-offs are generally not deductible, while sales losses to CCPC are deductible.)

2. Higher NPL haircut for banks with higher capital ratios

The paper just says this is inconsistent with the idea that the banks more desperate to offload NPLs are more likely to accept higher haircut (lower prices)

But, this may be because banks with high capital ratios can afford to compensate AMCs when they sell to AMCs but banks with low capital ratios cannot so they pay when they buy back the NPLs (in the form of re-sale premium)

Can we trust the capital ratios of these banks anyway?

We could not in Japan in the late 1990s.

Capital ratios and ratings of major Japanese banks in March 1998

Bank	Capital ratio (leverage ratio)	S&P rating
Nippon Credit Bank	3.69%	NR
Long-Term Credit Bank of Japan	3.01%	BBB-
Daiwa	2.84%	BBB-
Sanwa	2.73%	A-
Dai-ichi Kangyo	2.68%	BBB+
Asahi	2.58%	BBB+
Sakura	2.51%	BBB
Tokai	2.44%	BBB+
Industrial Bank of Japan	2.36%	A-
Tokyo Mitsubishi	2.28%	A
Fuji	2.23%	BBB+
Sumitomo	1.96%	A-

3. Want to know more about Chinese NPLs

Some naïve questions.

1. Why do banks need to come up with the elaborate mechanism to conceal NPLs? Can't they just under-report NPLs or "evergreen" problem loans?
2. AMCs are supposed to buy NPLs. What are their excuse for buying the NPLs at par (or with premium)?
3. Many tools to adjust to reward (bribe) AMCs: discounted sales price, resale premium, annual commission fee (to warehouse NPLs?), loan term (from bank to AMC), any other side payments? How about side payments to the ultimate buyers?

4. Who are fooling whom?

"Although bank supervisors may be aware of some concealment activity, ……, they may not know the quantitative extent to which banks engage in these transactions."

Really? Don't bank supervisors also want to hide NPLs from the public?

Who sets up local AMCs? Are bank regulators involved? Who are the managers of AMCs?

5. Is the amount of hidden NPLs large enough to jeopardize the financial stability?

Assuming LGD of 80% and 50% “pass-through”

Hidden NPLs = 2.05 trillion RMB = 9.25% of the aggregate bank capital

Tier 1 capital ratio (March 2021): 11.91% according to CBIRC

When this declines by 9.25%, the capital ratio becomes 10.81%

I would conclude that the banking sector can withstand the stress

(Although the aggregate numbers may hide serious heterogeneity)