Chi Time

CHINA'S DEBT-EQUITY SWAP AND INCENTIVE PROBLEMS

It's not that I'm so smart; it's just that I stay with problems longer.

Albert Einstein

To tackle the non-performing loan (NPL) problem, China's Big Five state-owned banks[1] have recently set up asset management companies (AMCs) to undertake debt-equity swaps. This is reminiscent of the last attempt in 1999-2000 when Beijing set up four AMCs[2] to take over RMB1.4 trillion of bad loans from the state-owned banks through various means including debt-equity swaps. China's equity market capitalisation, at 75% of GDP, is smaller than many other countries and the world's average (Chart 1). Thus, debt-equity swap seems a sensible solution for addressing the NPL problem. But the devil is always in the details when it comes to implementation in China.

Old wine in a new bottle

According to the State Council's announcement in October 2016, Beijing will not inject capital into the state-owned enterprises (SOEs) targeted by the debt-equity swaps; it will not force banks to swap debt for equity; and only SOEs that are deemed viable but face temporary problems will qualify for the swap programme. Despite Beijing's argument that this is a market-oriented approach, the same old incentive problems that hindered the progress of the previous debt-equity swap remain.

[1] The Big Five are Industrial and Commercial Bank of China (ICBC), Agricultural Bank of China (ABC), China Construction Bank (CCB), Bank of China (BoC) and Bank of Communications (BoCom).

[2] The four AMCs that were set up in 1999 are China Huarong, China Cinda, China Great Wall and China Orient.

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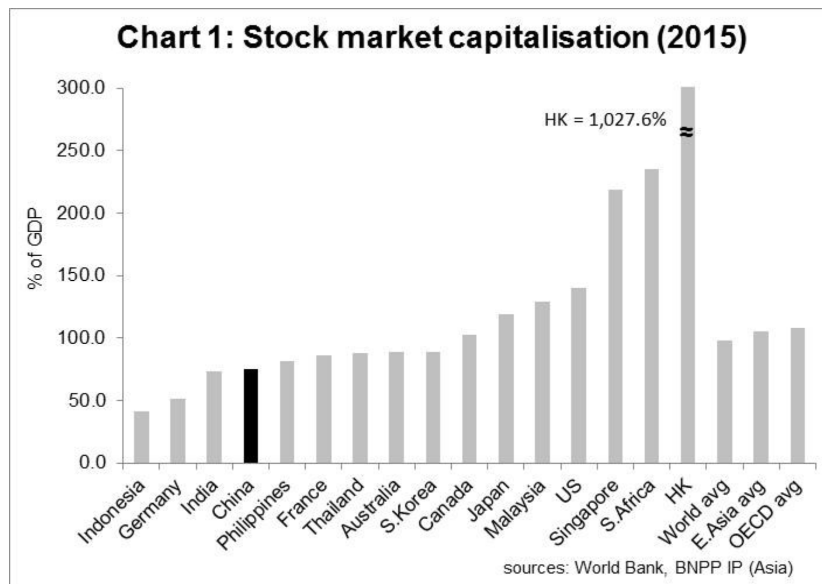

If a company is good and viable, it would not want to surrender its equity to the state-owned AMCs. Thus, the programme is creating an adverse selection problem by attracting bad companies. There is also a pricing problem of the equity. The AMCs will take over the banks' bad debt at face value and then swap the NPLs for equity at the same value in the SOEs[3]. In a market-oriented solution, the buyers always value the equity interest with a deep discount to the face value of the NPLs, which become equity after the swap. But the AMCs are trying to sell at face value. So there is no market-clearing. This highlights the problem for the AMCs' exit from the bad assets, many of which are still sitting in the books of the four AMCs since the previous debt-equity swap.

Crucially, there is an incentive problem inherent in China's programme. A debt-equity swap is a market selection process to pick "losers" for restructuring. The first thing the new equity holders should do is to restructure the company and replace its management. But in China's debt-equity swap scheme, the new equity owners are the bank-owned AMCs. So the swap is essentially changing the label of the state-owner from bank to AMC without serious restructuring incentives. The swap also increases the equity share of state-ownership in the companies, hurting corporate governance.

Despite its "supply-side" reform pledge and intention to address the NPL problem, Beijing's emphasis on preserving the SOEs in order to preserve stability risks aggravating this incentive problem and creating more moral hazard. Many state firms and banks still see the debt-equity swap as just another way to save the SOEs and socialising the banks' losses. As long as such a bailout mindset overwhelms the pulse of market discipline, it will remain an obstacle to genuine clean-up of the NPLs[4].

The short-term benefits

Under the current regulations, bad debt attracts a loan-loss coverage ratio of 150%. So by offloading NPLs to the AMCs, the banks can free up liquidity on their balance sheets for more loan expansion, which will benefit the economy. But instead of doing the debt-equity swap directly and holding the equity stake on their books, the banks set up AMCs to do the job.

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[3] This has been the practice of the AMCs since 1999.

[4] For more discussion on China's reform incentive problems, see "*China's Impossible Trinity: The Structural Challenges to the Chinese Dream*", chapter 4, Chi Lo, Palgrave Macmillan 2015.

This is because for banks, an equity stake in a company attracts a risk capital charge of 400% if it is a policy deal with State Council approval or a court order to swap debt for equity of the borrower. The risk charge goes up to 1,250% if the debt-equity swap is a commercial decision! So converting debt into equity is hugely punitive for banks. However, AMCs are only subject to a risk capital charge of 200% by holding an equity stake of a company. So creating AMCs to do the debt-equity swap will ease the banks’ capital burden significantly.

Buying time

This new good-bank bad-bank scheme will help re-liquefy bank balance sheets and stabilise the NPL ratio in the short-term, as bad loans are being shovelled off bank balance sheets into their AMCs at face value. However, without genuine SOE reform and private-sector involvement in the SOEs and the NPL market, China’s debt-equity swap programme will not solve the root problem. It is only a stop gap measure.

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