Debt for Equity Swaps, a solution to China's NPL problems?

By **ALESSANDRO NOLET** *and* **CAMILLA WONG**

China has been under increasing pressure to address its excessively high corporate debt levels in recent years. To that end, in March, 2016[1], Chinese regulators introduced a new debt-for-equity conversion framework — a promising approach, notwithstanding certain limitations and potential weaknesses.

Based on data from the Bank for International Settlements ("**BIS**"), China's total outstanding debt reached 260% of its gross domestic product ("**GDP**") by the end of 2016, up significantly from 160% at the end of 2008.[2] According to S&P Global Ratings, Chinese corporate leverage is the highest in the world, standing at approximately US$18 trillion.[3] While other countries, such as the U.S., may have experienced similarly high debt levels[4], there are growing concerns that this high credit-to-GDP ratio is not sustainable under the current institutional and regulatory framework in China.[5]

Indeed, the rising level of corporate debt, coupled with various market factors, including slowed earnings growth, industrial overcapacity and operating difficulties, has resulted in a growing number of corporate credit defaults.

China Debt Metrics

— Total Debt: 255% of GDP

— Corporate Leverage: $18 Trillion

— 'At Risk' Bank Loans: $1.3 Trillion

The challenges experienced by the corporate sector also mean that China's banking sector faces a growing number of non-performing loans ("**NPLs**"). The latest International Monetary Fund ("**IMF**") Global Financial Stability Report suggests that up to US$1.3 trillion of the total commercial banks' loans to corporations are at risk.[6] In addition, narrowing profit margins have increasingly challenged Chinese banks due to a significant loosening of monetary policy introduced by the People's Bank of China.[7] Together, deteriorating corporate-sector credit quality and a less favorable macro environment are putting the banking sector in China under significant stress.

In an effort to address the problems of excessive corporate debt and the growing number of impaired bank loans, the Chinese government and regulators have introduced various new measures, including a new debt-for-equity conversion scheme. The aim of this scheme is to reduce the number of NPLs weighing down on the banks' books and to alleviate the levels of debt burdening corporations. Through ownership restructuring and a re-alignment of each respective parties' incentives, it is believed that the indebted companies will receive a necessary lifeline to overcome their present challenges while enhancing banks' balance sheet liquidity and thereby releasing capital for new investments.

Debt-for-equity conversion schemes are not unfamiliar to China: in 1999, the government introduced a similar program by setting up four state-owned asset management companies ("**AMCs**") to exclusively purchase bad debts of state-owned enterprises ("**SOEs**") from four large state-owned commercial banks, and the AMCs then disposed of underperforming loans by converting them into equity with a strategy envisaging a 10-year holding and exit period. In this earlier program, a total of 580 companies entered into debt-for-equity swaps for an amount of approximately US$60 billion, representing around one-third of the total bad debt at the time.[8]

Contrary to its predecessor, however, the new scheme embodies a more market-oriented approach and envisages much less involvement by the Chinese central government. In particular, the scheme will not be solely limited to SOEs and commercial banks will be free to choose whether to participate in any given transaction. While investors around the world have generally welcomed the market-oriented approach of the new scheme, there are still some doubts as to how the scheme will be implemented and whether it will be successful in addressing the underlying NPL problem.

In a recent report, the IMF identified a number of features which are generally necessary in order to ensure the success of a debt-for-equity conversion scheme. However, investors and commentators alike have found China's new scheme to be lacking in each of these criteria to some degree or another.

IMF Criteria for Successful Debt-to-Equity Conversion

— Creating strict viability and eligibility criteria for corporations

— Sound corporate governance

— Limiting the scope and time of bank ownership of equity

— Converting debt at fair value and recognizing losses

Creating strict viability and eligibility criteria for corporations

The IMF stressed that banks should only convert debt to equity where there are clear advantages to do so and where there is an opportunity to exit the relevant position over the short-to-medium-term. This will require assessing potential targets to ensure that the scheme is made available only to companies with a high chance of success and filter out so-called "zombie" firms. Indeed, this was one of the Chinese government's stated goals. However, the new scheme does not provide any tangible guidance as to what the eligibility criteria should be. Instead, the scheme relies heavily on the principle of hinging on a market-oriented approach. In a recent directive issued by the China Banking Regulatory Commission ("**CBRC**")[9], "zombie" SOEs are expressly prohibited from participating

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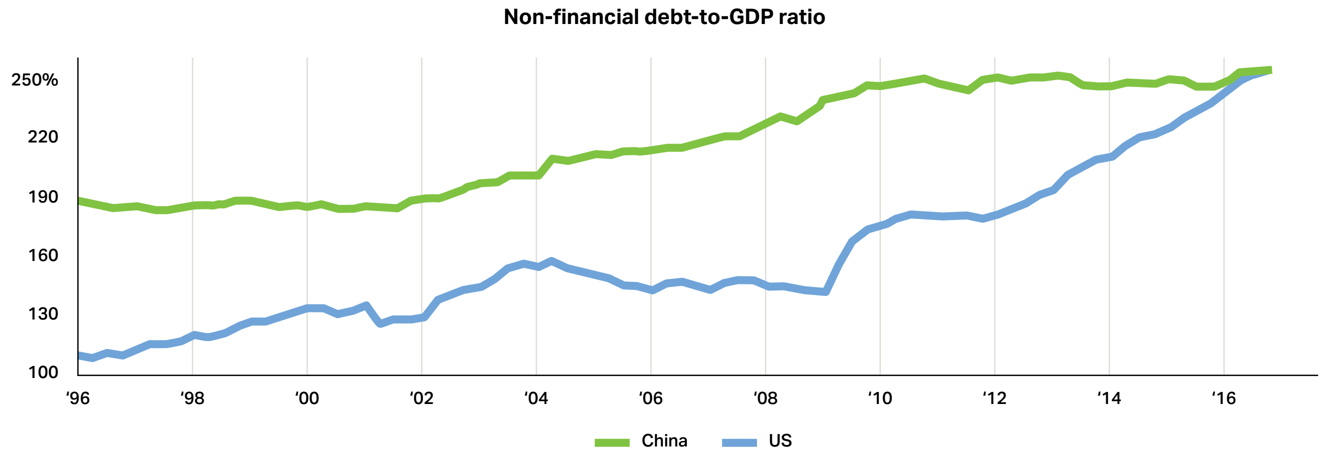

Data: Bank for International Settlements

in the scheme. While this directive supports the views that the scheme is intended only for firms with a high chance of success, it does not provide any guidance on the eligibility criteria for the scheme; short of clarifying that it should not apply to entities with "no hope of turning around their losses, and have already lost any prospect for survival and development". This is probably evidence of the Chinese Government's reluctance to interfere with such assessment and, instead, let market players draw their own conclusions on the prospect of success of any particular transaction (other than cases which are glaringly across the "zombie" line). This means, among other things, that the relevant investors will need to make their own assessment of potential targets. In turn, this may open the scheme to a wide spectrum of possible outcomes, considering also the range of potential participants which may seek to take advantage of this instrument (each with very different underlying agendas and appetite for risk).

Sound corporate governance

The proper management of a company is also a key element in optimizing a debt-for-equity conversion program. The IMF suggests that, in their role as new equity holders, the converted creditors should have the ability to replace management, even when they hold a minority stake only. The IMF reasons that this is likely to induce management to address existing problems and propose new strategies to attract fresh investors as well as enable former creditors to exit. The new Chinese regime does not expressly contemplate this option. There is no explicit right or obligation on the banks to manage the relevant distressed target. Nor is there an obligation on the distressed companies to manage their business in accordance with the directions of the creditors engaged in the swap. In practice, the actual involvement of the former creditors in the management of the debtor is likely to vary from case to case – depending also on the nature of the creditors in question. To an extent, the fact that banks and financial investors may not necessarily have the ability and expertise to run a company in a particular sector argues against this scheme. Nevertheless, they can always use their powers as shareholders to appoint new management. Moreover, it seems only natural that the debtor's management would cooperate with the former creditors in order to agree on any necessary reforms and discuss their potential exit strategies.

Limiting the scope and time of bank ownership of equity

While the IMF recognizes that a bank should only hold its equity stake in a company for a limited period of time, it acknowledges that this should be assessed on a case-by-case basis. The new Chinese scheme seems to share this approach even though it provides no specification as to what such a period of time should be.

Converting debt at fair value and recognizing losses

As part of a comprehensive strategy, the IMF suggests including regulatory and supervisory measures to ensure that banks proactively identify and manage impaired assets in an effort to flush out losses. However, the inherent desire to over-value loans in an effort to minimize the impact of realizing losses raises concerns that there will be a conflict of interest or, at the very least, minimal incentives to follow the market-oriented approach as suggested by the Chinese government. Without

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any guidance on how debt should be valued, there is a risk that the advantages of the debt-equity conversion will be utilized for short term gains without addressing the true underlying problems which initially contributed to the growing debt problem.

Conclusion

Despite these drawbacks, the new debt-for-equity conversion framework is still one of the few concrete measures introduced by the Chinese government to tackle the growing problem of NPLs and to free up liquidity on banks' balance sheets; indeed it has already been used in a number of high profile cases, with the aggregate value of such transactions already exceeding US$ 70 billion of bank debt at par value.

By way of example, China Construction Bank recently announced that it would carry out a debt-for-equity swap of RMB 2.35 billion (approximately US$ 340 million) with respect to its position in Yunnan Tin Group. Other high profile target companies include Sinosteel and China First Heavy Industries, while the list of banks which have started swapping debt for equity under the new scheme includes Industrial and Commercial Bank of China, Agricultural Bank of China, China Construction Bank, Bank of China and Bank of Communications.

Additionally, China Construction Bank recently launched Jianxin Financial Assets Investment Co., Ltd., the first market-based debt-to-equity swap vehicle with a registered capital of RMB12 billion[10]. The approval by the CBRC for the establishment of this vehicle is significant as it illustrates the nation's policy to support further deleveraging by way of a market-oriented based approach pursuant to the debt-for-equity swap program.

While the new debt-for-equity swap program represents a step in the right direction, the market perception is that it remains an interim solution only and that the Chinese government will need to introduce additional measures, likely based on the IMF guidelines, in order to optimize the benefits of the scheme. ■

1. *See* Financial Times, *China Explores Debt-for-Equity Swaps to Defeat Bad Debt Pile-Up*, available at: https://www.ft.com/content/c6e7ccc2-eb44-11e5-bb79-2303682345c8
2. The applicable BIS statistic is "total credit to the non-financial sector (core debt)," expressed as a percentage of GDP, available at: http://stats.bis.org/statx/srs/table/f1.1?p=20164&c=
3. S&P Global Ratings estimates China's current corporate debt-to-GDP ratio to be at 166%, up from 96% at the end of 2008.
4. The total outstanding debt in the US in 2015 amounted to 331% of its GDP. https://ycharts.com/indicators/us_total_debt_gdp
5. Sahay and others (2015) found that China's financial depending has been excessive relative to advancements in its institutions and regulations. See IMF report page3: https://www.imf.org/external/pubs/ft/wp/2016/wp16203.pdf
6. See page 16: https://www.imf.org/external/pubs/ft/gfsr/2016/01/pdf/text.pdf
7. In 2015 alone, the PBOC cut the deposit and loan interest rates five times.
8. See statistics from Xinhua news: http://news.xinhuanet.com/english/2016-10/10/c_135743737.htm
9. The Commercial Bank Newly Established Debt-Equity Swap Implementation Organization Administrative Measures (Trial) (商业银行新设债转股实施机构管理办法（试行) dated 7 August 2017.
10. Please refer to: http://www.chinabankingnews.com/2017/07/24/beijing-accelerates-deleveraging-state-owned-enterprises-debt-equity-swaps/ **AND** https://translate.google.com.hk/translate?hl=en&sl=zh-CN&u=http://www.ccb.com/cn/ccbtoday/newsv3/20170802_1501645390.html&prev=search **AND** http://www.ccb.com/cn/ccbtoday/newsv3/20170802_1501645390.html

▼ **Alessandro Nolet** is a senior attorney at Cleary Gottlieb Steen & Hamilton LLP based in Hong Kong. His practice focuses o n international finance and restructuring matters. Alessandro advises lenders, corporates and private equity clients globally on a wide range of debt instruments, including a variety of loan facilities, high-yield bonds and related derivatives. He received an LL.B. from King's College London in 2001, an LL.M. from the University of Nottingham in 2002 and a B.C.L. from the University of Oxford, Keble College in 2004. Alessandro is admitted to the Italian bar and is a Solicitor of the Senior Courts of England and Wales and a Solicitor of the High Court of Hong Kong.

▼ **Camilla Wong** is an associate at Cleary Gottlieb Steen & Hamilton LLP based in Hong Kong. Her practice focuses on international finance matters, advising international lenders, corporates and private equity clients. She received a J.D. from the Chinese University of Hong Kong in 2010 and a Post Graduate Certificate in Law also from the Chinese University of Hong Kong in 2011. Camilla is a Solicitor of the High Court of Hong Kong.