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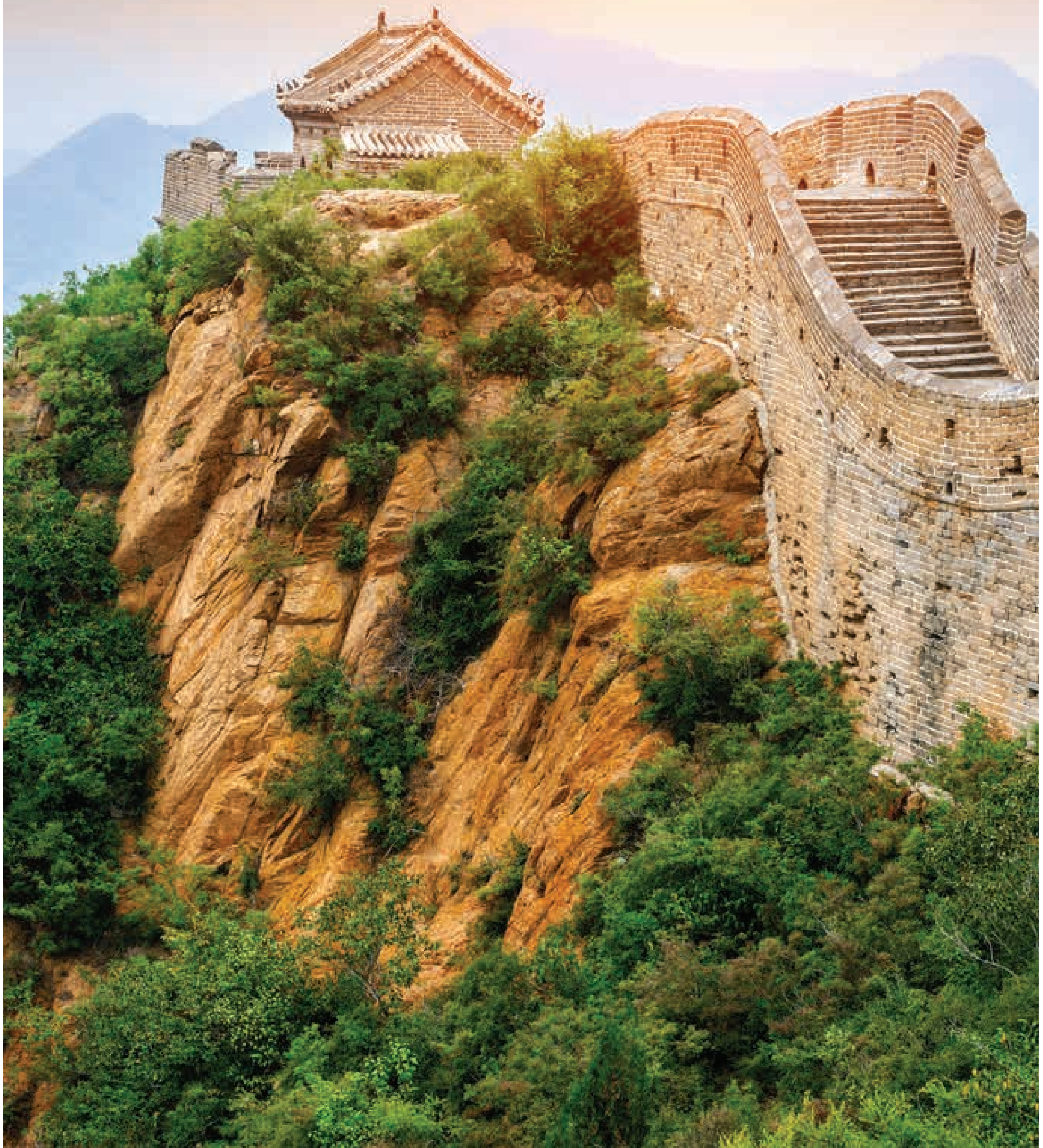
Has the time come?

Which nonperforming loan market — Italy or China — provides the best opportunity to deploy capital?

by Jack Rodman



For much of the past year, we have seen a steady stream of articles and predictions that the build-up of nonperforming loans in China and Italy will burst, wreaking havoc on global financial markets. As a bellwether of investor interest, Crosswater has had more investor consultations with distressed creditor investors this year than in the prior three years.

The ballooning amounts of NPLs officially reported (and not reported) has sparked investor interest that the long-awaited markets in those two countries will open to foreign investors. Distressed debt investors invariably want to understand the pros and cons as well as the differences that foreign investors in NPLs need to consider in evaluating distressed debt opportunities in both markets. The goal of this article is to summarise the differences between the opportunities in the two markets and to offer our insights as to which market might offer the best opportunity to make money in 2017.

NPL levels and the economic cycle

While both markets have reported rising levels of nonperforming loans and a slowing economy, there is no doubt that in terms of sustainable economic growth China's economic prospects, even under the "new normal", greatly exceed the economic prospects of Italy. Italy has one of the highest unemployment rates in the European Union and China, through its centrally-managed economy, focuses on maintaining high levels of employment at all costs.

This points to one of the major differences between the two economies: China is controlled by the Communist Party, which will do everything in its power (which is substantial) to maintain employment stability; whereas Italy finds itself constrained by the combination of the European Union, the European Central Bank and the strong outside interests of the economies of Germany and France that are dealing with their own economic and geopolitical challenges. Both economies seems to be waiting for an event to occur that will change the *status quo*. Neither Italy nor China seems to be willing and/or able to take aggressive steps to kickstart the NPL market, although both have been provided with ample suggestions for moving forward.

On the issue of government leadership and focus, China is in a far superior position to Italy in enacting policies to benefit its national interests. In adopting international best practices, one senior banking regulator told me that "whatever is in China's best interests is the best practice."

The different degree of transparency between the two economies is by far one of the greatest disparities that we have seen from our NPL work in both Asia and Europe.

While most countries drag their feet in disclosing and addressing the amount and severity of their NPL problems over many years, the information published and available on the Italian NPL and banking sector is impressive. China, on the other hand, continues to underreport the real level of its NPLs (pegged in Q3 2016 at 1.75 percent). Italy, under pressure from the ECB (stress testing), has reported NPLs of 18 percent (IMF estimates) of total loans outstanding in the banking system. Both countries have substantially understated the real level of NPLs by disregarding global reporting standards for 90-day delinquencies as well as unrealistic estimates of recoverable value. According to reliable sources, the actual level of NPLs in China ranges from 15 percent to 18 percent, a far more realistic estimate than the official government line of 1.75 percent. Greater transparency in Italy, though, has done nothing to further the development of an active NPL market there.

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Banks lack sufficient capital adequacy in both countries to fully recognise the extent of their nonperforming loans. Common to both economies is the potential for secondary losses, despite huge increases in "provisions" for NPLs. In the three years from 2013 to 2015, according to the China Banking and Regulatory Commission, China has written off $300 billion (€270 billion) of bad loans and yet there are estimates of unrecorded bad loans of $700 billion (€630 billion) or more still residing on China's balance sheet (although not necessarily in the banking system).

Both countries will require tremendous recapitalisation of the banking system to fully provision for bad loans. Comparatively, the hundreds of billions needed in China may be far easier to raise than the €30–40 billion required to recapitalise Italian banks. Given Chinese foreign exchange reserves and complete control of the regulatory bodies and judicial system, the prospects of China engineering a financial solution will be less difficult than for Italy, which has to deal with the ECB and its many constituents.

From an NPL investor's perspective, both legal systems leave much to be desired. Italy has a notorious judicial process in which it can take up to eight years for banks to produce results. The court system is terribly inefficient. In China, while the court system can move more expeditiously, courts are far more prone to local government influences, corruption and a predilection to being "debtor-friendly", especially in cases involving a domestic debtor and a foreign creditor. Neither system is likely to change in the near to intermediate term.

My NPLs are better than your NPLs. Really?

Another significant difference is the "asset quality" and composition of NPLs in Italy and China. Unlike Spain and Ireland, which had a large ratio of residential mortgages among their NPLs, Italy has a lower percentage of NPLs collateralised by residential mortgages. This has made it more difficult for distressed debt investors to establish a floor price or benchmark for much of the distressed portfolio in Italy. In Italy, the majority of NPLs consist of small loans to corporate borrowers (unsecured), many of which are already reported as "insolvent". The historical collection rate on unsecured corporate loans is as low as 10–20 cents on the dollar and collection often relies on the judicial system for resolution. Given inefficiencies in the Italian judiciary coupled with a higher concentration of poor-quality corporate loans, Chinese NPLs, frequently secured by real property, provide higher asset quality and better collateral as well as potential "guarantees" from related brother/sister (solvent) corporate entities.

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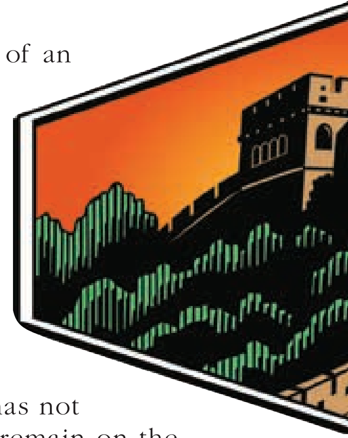
Special servicers are not so special

A key element of successful distressed asset investing is a strong local servicing platform. This is where the "rubber meets the road" and local special servicers get rewarded for timely resolutions. In China, only law firms can officially collect bad loans. However, many companies (investor sponsored) register as "loan servicing consultants" and can get capital onshore to collect NPLs. However, the lack of an officially authorised NPL special servicer law makes the process of resolution more difficult in China, which often relies on not-so-reliable local servicers (lawyers/consultants) that don't always place the interests of the creditors first.



In Italy, because of the dearth of transactions to date, the servicing industry has not evolved and many investors remain on the sidelines before bidding on portfolios and having to engage the needs (and overhead) of a special servicer. In this regard, China is at least one step ahead of Italy, having first begun disposing of NPLs more than a decade ago.

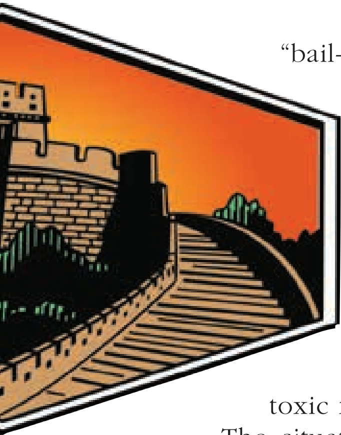
Bid-ask price differential a huge obstacle

Both markets suffer from the large bid-ask price gap that exists between the expectations of the seller and the buyer. The seller, who in most cases has taken substantial writedowns on its NPL portfolio (as much as 60 percent), is faced with secondary losses resulting from the investor's pricing of the assets at only 20 cents on the dollar. The difference is most often the "time value" of money and the high cost of capital that NPL investors (opportunity funds) have to pay to raise capital.

The selling banks in Italy that would like to rid themselves of these nonperforming assets are exposed to a "secondary" loss and possible capital impairment, which prevents them from accepting market clearing prices.

The situation in China is far different. The state-owned Big 4 banks and large state-owned asset management companies (AMCs), while independent and often publicly traded (as many as 75 percent plus are controlled by the state), often conspire to manipulate the market by purchasing defaulted corporate debts, failing trusts and wealth management products from the banks (and local governments) to prevent significant job losses resulting from a business failure and systemic risk to the financial system. An AMC can pay more for NPLs than a foreign investor, as its cost of capital is substantially lower. Most often, the AMC borrows new money from the selling bank to buy the bank's bad loans. China is the "master" of the off–balance sheet manoeuvre, with the implicit assurance that the regulatory authorities and accounting firms will turn a blind eye to the real economics of the transaction.

There is no doubt that Italy is negatively affected (at the time of writing) by the ECB requirement that in any government-funded



"bail-in" the junior subordinated investors as well as shareholders should bear losses before public monies are employed to recapitalise the bank. So far, the ECB rules have prevented Italy adopting a TARP-like solution (TARP is the US Troubled Asset Relief Program set up in 2008 to deal with toxic financial assets).

The situation in China is at the opposite extreme, where the interests of the state (social stability, harmony and employment) trump the interests of all stakeholders, although in both Italy and China depositors are ultimately protected and do not share in any loss. I would be much more comfortable owning shares of a large systemically important bank in China than being a shareholder in a large bank in Italy. With more than 600 banking institutions in Italy, allegedly more prevalent that pizzerias, it is likely that a number of banks will be allowed to fail and that the government will move to force mergers to improve bank efficiency as an alternative to a bank failure or nationalisation. Likewise in China we have recently seen debt-to-equity swaps and securitisation used as tools to bail out insolvent institutions all the while employing capital from the interbank system.

Individual banks (and shareholders) have little say in China's authority in imposing an "arranged marriage" to the detriment of individual institutions but to the betterment of the whole system. Quite to the contrary, the Italian pension association (ADEPP) recently tried to have the pension industry contribute to an NPL fund (Atlante 2) to kickstart the economy and get the NPLs out of the banks, so that they can raise capital and start lending again, supporting economic recovery. However, a number of the pension funds would not participate; after an initial fundraise, many individual pension plans baulked at buying NPLs from the oldest bank in Italy (Monte dei Paschi di Siena), citing "overpayment" at 33 cents on the dollar as contrary to the interests of their beneficiaries.

Making friends and influencing people

Last but not least are "barriers to entry". Legal and tax considerations concerning the efficiency of getting capital onshore and repatriating capital offshore are both relevant concerns. While this became slightly easier in China recently following the introduction on 1 October of new regulations, it still requires far more hoops to jump through than registering to do business in the EU. Much of the regulatory framework in China is not well documented and has to be "nuanced" by investors, while laws in Italy are more clearly enunciated.

Secondly, foreign exchange movements affect both countries, but China has far more influence over its FX policies than does Italy or for that matter those other 18 EU member states that share the common European currency. Along those same lines, evaluation of FX in China can be focused on the Chinese economy, whereas FX movements in Europe can be greatly affected by small member states such as Greece or Portugal.

Compounding this issue is the effect of Brexit and the possibility, however unlikely, of that kind of event spreading to other EU member countries such as Spain, where the concept of regional independence is gaining in popularity. From that perspective, China is a far safer bet. China will always do what is in its own best interests regardless of its trading partners.

In China, while the court system can move more expeditiously, courts are far more prone to local government influences, corruption and a predilection to being "debtor-friendly".

Biting the bullet

In conclusion, both markets offer equal opportunity and equivalent risks. Distressed debt investing is part rocket science (which part is well known and understood by savvy, experienced international investors) and part timing. Early transactions from Asia to Europe (Ireland and Spain) worked out well once a period of time had elapsed, barriers to entry had been broken and politicians, regulators and bank executives had been forced to "look hell in the face" and "do the right thing".

The follow-through and the economic growth that comes after must have strong political leadership and a conviction that market forces will prevail despite short-term pain. The concept of "your first loss may be your best loss" has to be understood, as it will start a process that will kickstart the economy, bring new capital to the market, re-energise languishing institutions and prevent the NPL debt burden from further eroding the financial system. ❖

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