Developments in the Chinese NPL Market

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Investors in non-performing loans ("**NPLs**") continue to look for new jurisdictions and opportunities to achieve attractive returns on capital. Much of the European NPL market is now in a relatively advanced state (particularly in the more mature parts of the market such as UK, Ireland, the Netherlands, Spain and, to a lesser extent, Italy). Funds are, therefore, looking further afield for NPL opportunities. One interesting jurisdiction, given the 1.71 trillion yuan (c.US $270 billion) of NPLs held by commercial banks, is China.

Whilst Chinese NPLs have been available for purchase by foreign investors since 2001, recent steps by China to streamline processes and broaden access to the market have made investment in Chinese NPLs more attractive and simpler than in the past. This includes the introduction of new channels for the acquisition of Chinese NPLs by foreign investors as well as changes to the process for cross-border transactions to foreign investors to increase efficiency. A significant number of European and US based investors including Lone Star, Blackstone and Oaktree have closed Chinese portfolio deals in the last 18 months which suggests that opportunities are opening up. However, there are a number of factors that investors and banks should be aware of in relation to Chinese NPL transactions.

While investors had initially been targeting IRRs of in excess of 20%, expectations have now been reduced to more achievable levels of 12-15%. Given that there has historically been no regulatory compulsion in China for NPL exposures to be addressed (in contrast to the position in Europe), reduced IRR expectations are also key to increasing the volume of activity in the Chinese NPL market.

Chinese NPL transactions

Historically, the acquisition of Chinese non-performing loan portfolios was facilitated by one of a number of onshore PRC asset management companies ("**AMC**"). These were originally established by the Chinese government in the late 1990s in order to purchase NPLs from the 4 largest Chinese banks. The 4 large AMCs (Cinda, Huarong, Orient and Great Wall), would acquire the underlying loans from Chinese commercial banks and package them up for on-sale to investors. However, as part of China's endeavours to make Chinese NPLs more accessible and attractive to foreign investors, recent pilot programmes have been initiated to enable foreign investors to purchase NPLs directly from Chinese banks. The pilot programmes are currently restricted to the acquisition of one or two loans only. Consequently, until expanded, it will likely only be relevant to situations involving single large loans or perhaps two connected loans.

In certain circumstances, investors are able to access exposure to NPLs by purchasing NPL asset-backed securities from the bond markets. Eligible foreign institutions investing into the PRC interbank bonds market (which is China's over-the-counter bond market) can buy NPL based bonds issued in that market. To be eligible, foreign investors previously needed to make an application through the Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Foreign Institutional Investor (RQFII) programmes, but the process has been simplified and investors may now make an eligibility application via the People's Bank of China. This

summer, the tax authorities confirmed that foreign investment into the interbank bonds market will be exempted from PRC withholding tax (all bonds in that market; normal debt or NPL) for 3 years. This decision results in an instant 10% to 20% boost for all foreign investors.

In May 2018, the State Administration of Foreign Exchange ("**SAFE**") announced enhancements to its existing pilot programme in Shenzhen for cross-border NPL disposals. AMCs and commercial banks can sell NPLs to foreign investors through the Shenzhen Qianhai Financial Assets Exchange ("**SQFAE**"). Although such disposals have frequently been conducted via a court administered process, it is open to sellers to a conduct private sale provided the following requirements are observed: (1) the AMC auctions the package and the winning foreign investor enters into an SPA with the AMC (2) the AMC publishes a transfer notice in the newspaper and arranges for a PRC legal opinion to be issued confirming the validity of the transfer (3) the AMC completes a filing with the National Development and Reform Commission (4) the AMC completes a filing with SAFE and pays the consideration cross-border. SQFAE is operated by a subsidiary of Ping An Insurance and can help streamline the sales process by providing a package service which includes an online auction, SAFE filing, payment processing and the necessary tax deductions. SQFAE claims they can effect a transfer in just 2 weeks, which would be a huge improvement over the traditional auction based process. Also, in May 2018, SAFE Guangdong received approval for its own pilot programme (which is similar to the Shenzhen program). SQFAE's counterpart in Guangdong is Guangdong Financial Assets Exchange ("**GFAE**").

However, despite these recent changes, portfolio sales (defined as being of three or more loans) must for now still be conducted by AMCs through a public auction process. While portfolios may consist of multiple asset classes (e.g. real estate and shipping), by far the most prevalent are secured real estate loans, where the pledged real estate drives the value. Portfolios are usually comprised of loans from a single Chinese province (there are 23), with typically 50-100 individual debtors, predominantly SMEs. Although there are regulatory restrictions on "prohibited sectors" as a matter of PRC law (in the real estate context, golf courses and villa development is one example), the AMCs will not include any such prohibited assets when packaging the NPLs that are available for purchase by overseas investors.

Sales process

A sale by an AMC will be conducted either by a public, auction basis or privately, through the pilot programmes noted above. The SPA for the acquisition of the NPL portfolio must be governed by PRC law and typically takes a relatively standard form, with minimal room for the successful bidder to negotiate changes. Adequate due diligence on the portfolio is therefore absolutely critical from an investor's perspective.

Deal Structuring

Overseas investors in Chinese NPL portfolios will generally not establish any onshore entity, instead incorporating a Hong Kong or Singapore registered SPV as the acquisition vehicle, due to a beneficial double taxation treaty between China and each of those countries. In relation to sales by AMCs, the offshore SPV will typically purchase the NPL portfolio directly from the onshore AMC. The sale is registered by the AMC with the National Development and Reform Commission, and with the State Administration of Foreign Exchange ("**SAFE**"). The overseas investor must also register the sale and the purchased debts with SAFE, to enable the collection proceeds to be repatriated.

If the investor does not have its own onshore collection team, the offshore SPV will hire a collection agent in the PRC. As is the case with any NPL portfolio acquisition, regardless of jurisdiction, the collection agent is crucial. However, in relation to Chinese NPLs, not only does the collection agent enforce the underlying loans and collect the realisations, it also converts and repatriates the collections, through its onshore account bank, to the investor's offshore account (the "**Collections Account**"). Since 2015, no approvals are required for such conversion and repatriation[1].

Financing Chinese NPLs

The financing of the acquisition of Chinese NPLs will be akin to financings in other jurisdictions. A lender will typically lend funds to the SPV making the acquisition and have signing rights over the Collections Account,

1 Circular 2015 No. 3 of State Administration of Foreign Exchange.

from which the debt will be serviced on each interest payment date. Similarly, the standard security package that a lender would expect to receive in respect of a Chinese NPL portfolio is similar to what is sought in European NPL deals and will include account pledges, assignment of contracts, assignment of rights under the SPA and a receivables pledge over the NPL portfolio and related security.

Enforcement of a Chinese NPL portfolio

Method of enforcement

When underwriting a Chinese NPL portfolio, investors will be focussed on methods and timeframes associated with enforcement of debts. In China, enforcement of a debt is entirely court-based; there are no self-help remedies available to a creditor.

To procure repayment of a debt (even where secured, as the vast majority of Chinese NPLs are), the creditor must sue the debtor in court, obtaining judgment for the amount due, and then taking enforcement action through a court-administered auction process. Whilst in China, the statutory limitation period in relation to taking action for the repayment of overdue debts is 2 years, that period can be reset by serving a demand for payment on the debtor (or guarantor/security provider, as appropriate).

Court-based enforcement is also by far the most common route in China, in sharp contrast to the usual "consensual" resolution for commercial real estate assets in Europe. While agreement can be reached by a debtor and creditor for some consensual route that would permit a private sale or appropriation, as a foreign investor is not permitted to own PRC real estate; it must always be sold to discharge the loan. Enforcement through the courts is therefore the most likely route to compel repayment.

The PRC court process is predictable, and recovery can be achieved in 6-12 months, although 24 months from commencement of lawsuit to receiving funds is, perhaps, a more conservative timeline.

Impact of an insolvency process

There are three insolvency procedures set out in the PRC Bankruptcy Law[2], being:

- bankruptcy liquidation (a winding-up procedure);
- reorganisation (a restructuring procedure); and
- composition (a court-sanctioned composition agreement).

Once a bankruptcy procedure commences (on the application of either a creditor or the debtor), an administrator is appointed by the Court, subject to the supervision of the creditors' meeting and creditors' committee. The Bankruptcy Law also imposes a moratorium upon insolvency. All civil litigation and arbitration proceedings in respect of the debtor's assets are suspended upon insolvency, although they are permitted to recommence after the administrator has taken possession of the debtor's assets.

During a reorganisation, secured creditors are prohibited from enforcing their security, subject to an exception if the secured assets are in jeopardy.

A composition is the only insolvency procedure which may only be applied for by a debtor (the other two processes can be applied for by either a debtor or a creditor). The debtor will be required to submit a draft composition agreement to the People' Court for approval, which if granted, will then be the subject of a creditors' meeting. The composition agreement will need to be approved by a majority in number and two-thirds by value of the unsecured creditors in each class. Each class of creditors needs to vote in favour of the plan, although the People's Court may cram down a dissenting class if certain conditions are satisfied.

A composition cannot, however, bind a secured creditor without its consent (much like a company voluntary arrangement in the UK). Secured creditors are able to enforce their rights from the date of approval of the composition by the People's Court. A composition therefore only imposes a temporary moratorium on enforcement by a secured creditor.

[2] Law of the PRC on Enterprise Bankruptcy, which came into force on 1 June 2007.

Conclusion

Although PRC law will be unfamiliar to many investors considering investments in Chinese NPLs (and those lenders considering financing them), many of the lessons learned from European NPL acquisitions remain acutely relevant. The importance of a reliable collection agent cannot be overemphasised. A relatively predictable court system and an established Bankruptcy Law in force for over 10 years as well as the recent changes by China to the methods by which foreign investors can purchase Chinese NPLs will be welcome to those investors who have historically been unsure about the processes for investing in Chinese NPLs. The pilot programmes, although currently of limited application will, if successful and expanded into portfolio sales, further develop the market for Chinese NPLs in a way that will force investors to consider pivoting their investment focus eastward.

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