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BANKING & FINANCE

Client Alert

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HOW TO INVEST IN CHINA'S NPLS

-- A LEGAL REVIEW

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NPL MARKET IN CHINA

As China's economic growth slows down, non-performing loans ("**NPLs**") continues to rise. According to the regulatory indicators released by the China Banking and Insurance Regulatory Commission ("**CBRC**"), the balance of commercial banks' NPLs reached RMB 2.03 trillion by the end of the third quarter of 2018. CBRC urges Chinese banks to make greater efforts to manage and dispose of their NPLs. As a matter of fact, supportive policies have been consecutively enacted by Chinese government in recent years so that more investors are given opportunities to participate in China's NPLs market.

The major players in China's NPLs market are the big four state-owned assets management companies ("**AMCs**"), which were established by the Chinese government in 1999 to purchase NPLs from the big four Chinese commercial banks. Since CBRC allows setting up of local AMCs to participate in NPLs disposal in 2012, over 70 local AMCs haven been established. In June 2018, CBRC further issued *Pilot Management Rules For Financial Assets Investment Companies (《金融资产投资公司管理办法(试行)》)*, encouraging commercial banks to set up a subsidiary to engage in swap of NPLs into equities.

HOW FOREIGN INVESTORS CAN ACCESS CHINA NPL MARKET

Foreign investors started to invest in Chinese NPLs since 2001. Over the years, Chinese government gradually opened up the NPLs market to foreigner investors. Below are the current major ways for foreign investors to access China's NPLs.

Purchasing NPLs from AMCs

Foreign investors can purchase NPLs in bulk (i.e. 3 or more loans at a time) directly from the AMCs since 2001. This is a well-established channel and has been widely-used by foreign investors. The purchase and sale of NPLs shall be made through a competitive bidding process. Restrictions on foreign debts shall be followed for foreign investors who become the creditors of domestic debtors after acquisition of the NPLs. The regulatory procedures have become simplified and more efficient.

Purchasing NPLs directly from Chinese banks under pilot program

Foreign investors were not permitted to purchase NPLs directly from Chinese banks before a pilot program being established in June 2017. It allows commercial banks in Shenzhen to sell NPLs directly to foreign investors for a testing period of one year[1]. During the one year pilot period, NPL of face value of RMB 6.8 billion was sold to foreign investors. In May 2018 the pilot program was upgraded by removing the one year restriction and changing "pre-approval" to "pre-filing" process. Currently, this pilot program is applicable to banks in Shenzhen only. It is expected that it will be extended to commercial banks nationwide if the pilot program is proved to be successful.

Purchasing NPLs-backed securities issued in China bond market

Loan-backed securities was introduced in China in 2005 but was suspended due to the global financial crisis in 2008 and was resumed in the year of 2015. In 2016, the People's Bank of China ("**PBOC**") and other seven ministries jointly promulgated *Several Opinions on Leveraging Financial Services to Support the Industrial Sector to Stabilize Growth, Adjust Structure and Raise Efficiency (《关于金融支持工业稳增长调结构增效益的若干意见》)*, allowing a small number of financial institutions that satisfy relevant conditions to explore pilot securitization of NPLs under the premise of prudence and stability.

Foreign investors may purchase NPLs-backed securities issued in China inter-bank bond market in accordance with *Announcement on Relevant Matters concerning Further Improvement in the Investment in the Interbank Bond Market by Foreign Institutional Investors (《进一步做好境外机构投资者投资银行间债券市场有关事宜公告》)*. Currently, only qualified foreign institutional investors can invest in the China inter-bank bond market,

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[1] See *Reply of SAFE on Matters Concerning a Pilot Program for the Cross-border Transfer of Non-performing Assets of Banks by the Shenzhen Branch In its Jurisdiction (《国家外汇管理局关于深圳市分局开展辖区内银行不良资产跨境转让试点业务有关事项的批复》)*.

such as:

- commercial banks, insurance companies, securities companies, fund management companies and other asset management institutions;
- pension funds, charitable funds, donation funds and other mid-to-long-term institutional investors recognized by PBOC;
- institutional investors from the Hong Kong Special Administrative Region, the Macao Special Administrative Region and the Taiwan region.

Foreign investors may also invest in China bond market through the "Bond Connect Program" under the *Provisional Measures for the Collaboration in the Mutual Bond Market Access between Mainland China and Hong Kong (《内地与香港债券市场互联互通合作管理暂行办法》)*. In addition to the foreign institutional investors, foreign central banks, international financial organizations and sovereign wealth funds are also allowed. No prior approval is required for market access but the institution entrusted by the foreign investor shall apply for record-filing to the Shanghai Head Office of PBOC.

Incorporating an investment entity in China

A foreign investor may also set up corporate entity in China to invest in NPLs. Establishment of a foreign-invested enterprise engaging NPLs is subject to approval from the Ministry of Commerce ("**MOC**") or its local counterpart. The foreign investor may set up a joint venture with AMCs, or set up a fund management company in the form of wholly owned foreign enterprise ("**WOFE**").

Joint venture

AMCs could use NPLs as its capital contribution and the foreign investors contribute cash. Alternatively, AMC may transfer part of its interests of the NPLs to the foreign investors while holding the remaining NPLs, and then both parties contribute their interests of the NPLs to the joint venture. Up to now, only a few foreign investors have successfully obtained the approval from MOC to set up such joint ventures.

WOFE

More than 40 foreign asset management companies including BlackRock, Vanguard Group and UBS have set up WOFEs in Shanghai Pilot Free Trade Zone alone. WOFEs may conduct NPL-related business as private equity fund managers in accordance with applicable regulations and rules. Despite lack of clear regulations on requirements for setting up such WOFEs, practice in Shanghai indicate a positive attitude of relevant regulatory authorities towards foreign investment in China's NPL.

OUTLOOK

With Chinese government's request to improve the efficiency of disposal of NPLs, foreign investors will be more encouraged to invest in China's NPL. As introduced above, it is now feasible for foreign investors to purchase NPLs from AMCs and Chinese banks located in Shenzhen, to Purchase NPLs-backed securities issued in China bond market and to incorporate a Chinese investment entity carrying out business in relation to NPLs. In addition, more indirect transaction structures are being designed in order to assist foreign investors in sharing with the Chinese NPL market. We will continue to pay close attention to the market development and be delighted to render professional service for foreign clients to invest in China’s NPL.

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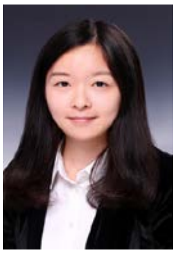

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