

Pandemic Brings More Business Opportunities, More Asset Quality Pressure for DAMCs

A Credit Study on the Distressed Asset Management Sector in China

August 3, 2020

Key Takeaways

- COVID-19 has put pressure on the asset quality and earnings of distressed asset management companies (“DAMCs”) but has also increased their business opportunities as systemwide bad debts build up.
- We expect DAMCs to maintain stable leverage level amid COVID-19, while earnings are set to come under pressure as credit costs increase.
- We anticipate stable government support for DAMCs as they remain a major channel for cleaning up financial institution non-performing assets (“NPAs”) in China.

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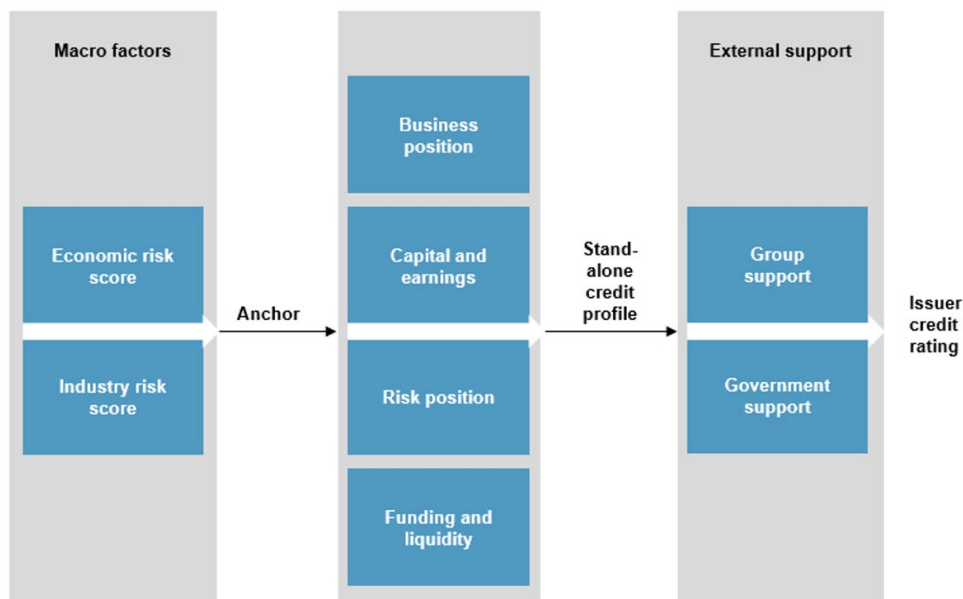
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Overview

This desktop analysis is based on S&P Global (China) Ratings Financial Institutions Methodology. We typically determine the stand-alone credit quality based on our assessment of an institution's anchor, a starting point, and then incorporate its own characteristics compared with the anchor. S&P Global (China) Ratings typically applies an anchor of 'bb+' for non-bank financial institutions ("NBFIs"). For NBFIs licensed and regulated by China Banking and Insurance Regulatory Commission ("CBIRC"), we typically adjust their anchor from 'bb+' to 'bbb-' to reflect their robust regulatory environment and access to the inter-bank market. The entity-specific factors that we may use to adjust from the anchor include business position, capital and earnings, risk position, and funding and liquidity. We then determine the issuer credit quality based on the stand-alone credit quality and our assessment of potential group and government influence.

Chart 1

Financial Institution Methodology Framework of S&P Global (China) Ratings



We typically apply an anchor of 'bb+' to NBFIs and adjust the anchor to 'bbb-' for NBFIs licensed and regulated by CBIRC.

Note: After assessing the issuer's entity-specific factors, a holistic assessment may be applied to evaluate its credit characteristics in aggregate and versus peers before arriving at SACP.

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The distressed asset management sector was established as part of efforts by the central government to ensure the commercial viability of the mega banks after they suffered unsustainably high levels of non-performing assets in the 1990s. The first four DAMCs, namely China Huarong Asset Management Co. Ltd. ("Huarong"), China Cinda Asset Management Co. Ltd. ("Cinda"), China Orient Asset Management Co. Ltd. ("Orient"), and China Great Wall Asset Management Co. Ltd. ("Great Wall", collectively referred to as "Four DAMCs"), were set up in 1999 to take over the mega banks' legacy bad debts.

Distressed asset management has since evolved into a niche sector licensed and regulated by CBIRC. After the Four DAMCs completed their policy mandate of recovering legacy bad debts from the mega banks in 2006, they began their new journey of commercialized distressed asset management.

The number of players in the distressed asset management market has increased dramatically over the past decade. CBIRC began to issue distressed asset management licenses to provinces as regional banks' bad debts increased in the 2010s. So far about 56 regional DAMC licenses have been issued. The fifth national AMC, China Galaxy Asset Management Co. Ltd., was set up in 2020. In addition, we also anticipate the entry of more foreign players in this market in the future.

CBIRC has strengthened its regulation of this niche sector after it released new regulations on DAMCs in 2014. The regulations intend to encourage DAMCs to focus on their core business of distressed asset management.

Because DAMCs are regulated by CBIRC and have access to the inter-bank market for funding, we typically view their average stand-alone credit profiles as better than unregulated financial companies (“fincos”). Therefore, based on the anchor of “bb+” for unregulated fincos, we typically adjust the anchor for DAMCs to “bbb-“. We expect DAMCs’ asset quality and earnings to come under pressure due to economic disruption caused by the COVID-19 pandemic. Such risk may however be mitigated by the counter-cyclical nature of the distress asset management business and strong government support.

Credit Outlook of Distressed Asset Management Companies for the Next 12 Months

Rating Factor	Outlook for the Next 12 Months	Key Views
Business Position	Stable	Typically, we view the Four DAMCs’ business position as strong since distressed asset management is a niche regulated market with high entry barriers. More players have entered the sector, but we believe the expanding market is big enough to accommodate new players. COVID-19 may increase market demand for distressed asset management as systemwide bad debts build up.
Capital & Earnings	Stable with downward pressure	Typically, we view the Four DAMCs’ leverage level as high. We expect their leverage to remain stable due to regulatory capital requirements. Profitability may feel downward pressure amid the COVID-19 pandemic due to higher credit costs and weaker earnings of major subsidiaries.
Risk Position	Stable with downward pressure	Typically, we view DAMCs’ risk profiles as weaker than the banking sector and average regulated fincos, due to the nature of the distressed asset management sector. COVID-19 has put pressure on DAMCs’ asset quality. The real estate sector, to which the Four DAMCs have large exposure, is expected to remain relatively stable amid COVID-19.
Funding & Liquidity	Stable	We typically view the Four DAMCs’ funding and liquidity profiles as being consistent with average regulated fincos. We expect the Four DAMCs to maintain stable funding and liquidity profiles amid COVID-19 as systemwide liquidity remains abundant.
Standalone Credit Quality	Stable with downward pressure	COVID-19 puts pressure on the DAMCs’ asset quality but also increases their business opportunities as systemwide bad debts build up.
Government Support	Stable	We view the government has strong willingness to maintain financial stability during the recovery phase of the pandemic. Although the government now has more entities and tools at its disposal to mitigate banks’ bad debt pressure, DAMCs remain a major channel for cleaning up NPAs.
Issuer Credit Quality	Stable	The Four DAMCs’ indicative issuer credit quality is stable thanks to strong government support.

Business Position

Typically, we assess the business position of a finco by comparing the strength of its business operations relative to peers with similar anchors. The assessment is based on three subfactors: business stability, business diversity and management and governance.

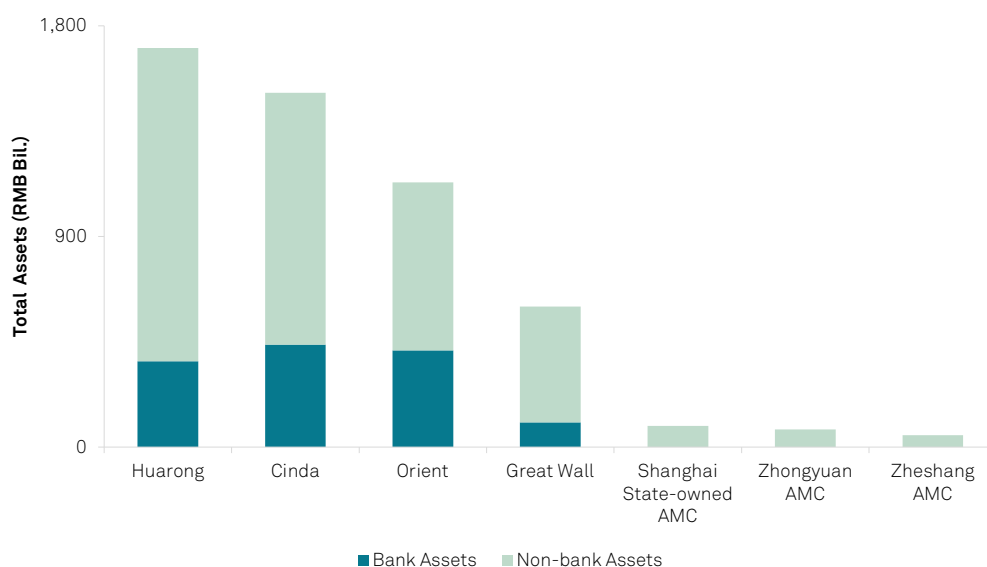
With a strong niche market position in the regulated distressed asset management sector as well as a diversified business structure, the Four DAMCs' business position is much stronger than that of average fincos in China.

COVID-19 may increase market demand for distressed asset management services. As of the end of March 2020, China's banking sector had 2.61 trillion non-performing loans, up by 8.23% compared to the end of 2019. We expect a further increase in non-performing assets in the next two years as bad debts are gradually exposed in the wake of the COVID-19 pandemic. Therefore, although more players have entered the business, we believe the Four DAMCs will continue to enjoy stable business growth opportunities.

The Four DAMCs are among the biggest fincos in China. Their large sizes can be partially attributed to their previous efforts to develop and acquire subsidiaries. We anticipate less focus on business line diversification in the future as the regulator wants the DAMCs to prioritize their core business of distressed asset management.

Chart 2

Asset Size as of End of 2019



The Four DAMCs are much larger than their regional counterparts thanks to their large distressed asset management business and ownership of financial institution subsidiaries.

Note: The Four AMCs all have commercial bank subsidiaries.
Source: Public information of companies, collected and adjusted by S&P Global (China) Ratings.
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Major Subsidiaries of the Four DAMCs

Huarong	Bank, leasing company, trust company, broker, futures company, fund management company, property development company, etc.
Cinda	Bank, leasing company, trust company, broker, futures company, property development company, etc.
Orient	Bank, insurance company, trust company, broker, credit rating agency, etc.
Great Wall	Bank, insurance company, leasing company, trust company, broker, etc.

Source: Public information of companies, collected and adjusted by S&P Global (China) Ratings.

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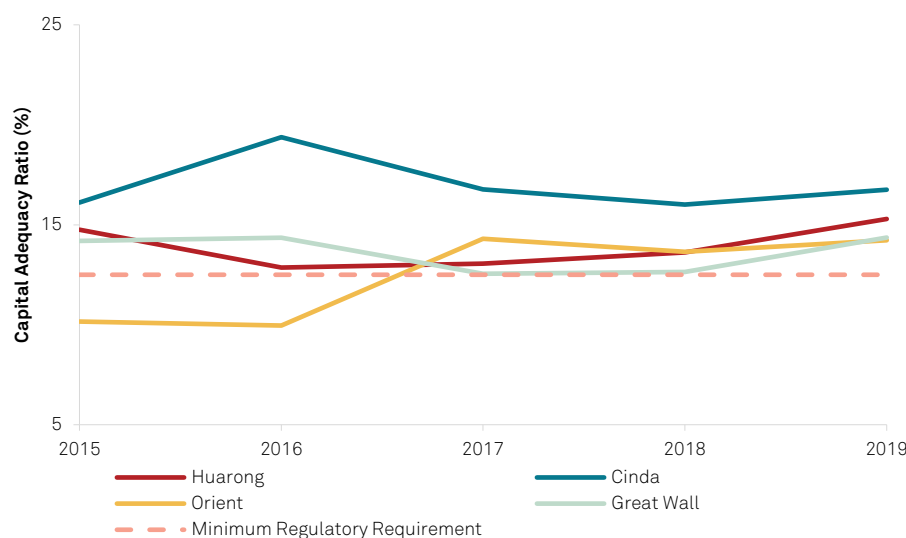
Capital & Earnings

Our analysis of capital and earnings looks at a finco's ability to absorb losses, which provides protection to senior creditors while the firm remains a going concern. In addition to any assessments of regulatory capital, the focus of our analysis for fincos addresses the presence of high absolute leverage (debt to equity), the quality of capital, and the ability of earnings to offset losses.

The regulator established specific capital adequacy requirements for DAMCs in 2017 with CBIRC's publishing of the Interim DAMC Capital Management Method. The minimum regulatory capital adequacy ratio requirement for DAMCs is 12.5% and the minimum requirement on tier-1 capital is 10%. The deadline to meet new capital adequacy ratio requirements is the end of 2020. We expect the Four DAMCs to maintain adequate capital ratios as required by CBIRC.

Chart 3

Reported Regulatory Capital Adequacy Ratios (Unconsolidated)



Regulatory capital adequacy ratio requirements put a limit on the overall leverage level of DAMCs.

Note: The deadline to meet the regulatory capital adequacy ratio requirement of 12.50% is the end of 2020.

Source: Public information of companies, collected and adjusted by S&P Global (China) Ratings.

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We believe the regulatory capital framework serves two purposes. One is to put a limit on the overall leverage level of the DAMCs and the other is to encourage DAMCs to focus on their core business. The risk weights of NPAs in the regulatory capital framework for DAMCs is much lower than that of average corporate loans (100%) in the regulatory capital framework for banks under

the standard approach. The low risk weights of NPAs in the framework are designed to incentivize DAMCs to acquire more NPAs.

Risk Weights of NPAs and other major assets in DAMC Regulatory Capital Framework

Asset Type	Risk Weight
Credit exposure caused by NPA acquisition from financial institutions by batch	50%
Other credit exposure created by NPA acquisition	75%
Other credit exposure to corporates and individuals	150%
Equity exposure to corporates created by policy reasons	100%
Additional equity investment related to NPA collection	150%
Equity exposure due to debt-to-equity swaps	150%

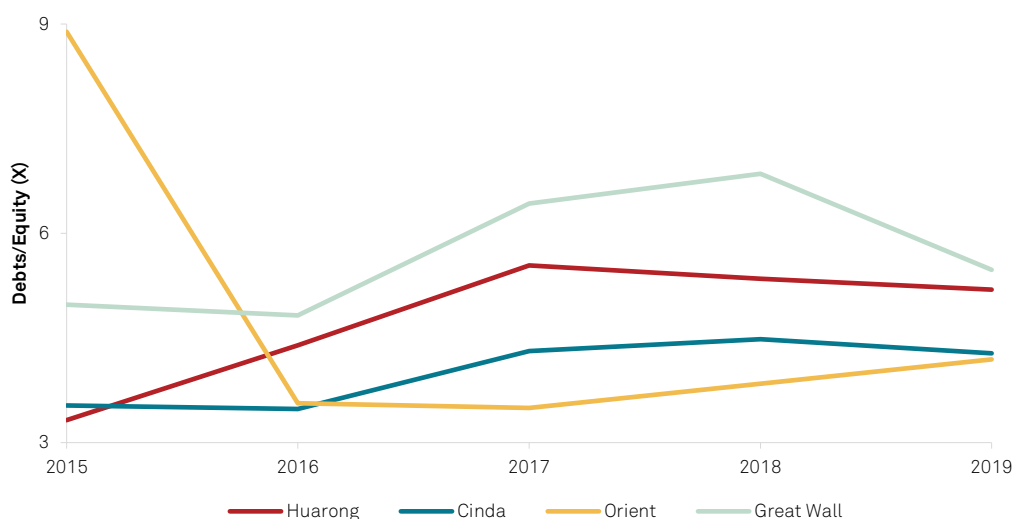
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Due to the high-risk nontraditional nature of distressed assets, we typically assess DAMCs' loss-absorbing capacity by their leverage ratio, rather than risk-adjusted capital adequacy ratio. We believe the leverage level of the Four DAMCs puts them in a relatively vulnerable position in terms of their loss-absorbing capacity under a stress scenario. We expect their leverage to remain stable due to regulatory capital restrictions.

Chart 4

Debts/Equity (Unconsolidated)



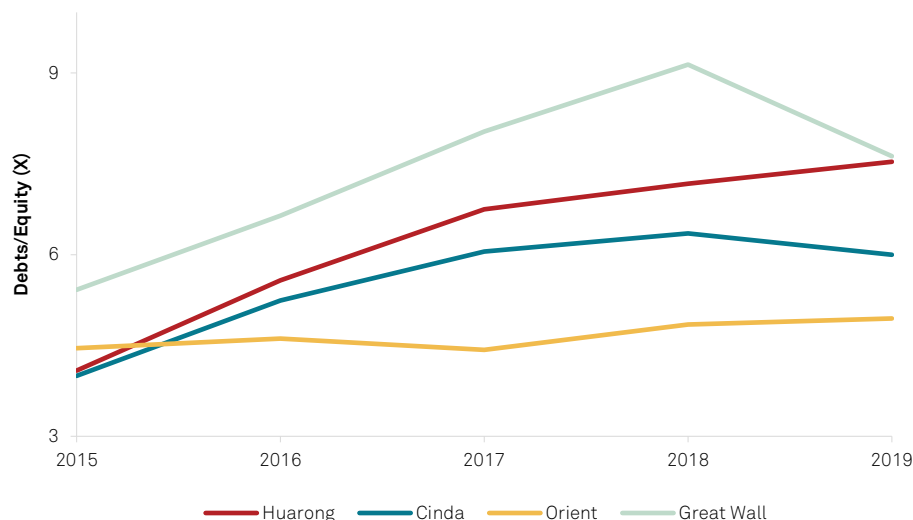
We expect the Four DAMC's leverage levels to remain relatively stable.

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Chart 5

Debts/Equity (Consolidated, excluding the banking subsidiaries)



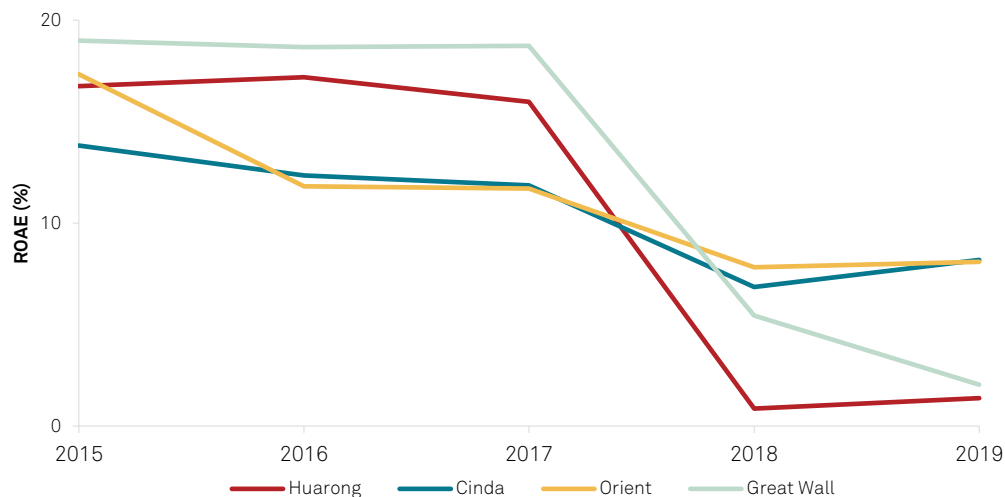
Other non-core businesses of the Four DAMCs have higher leverage levels than distressed asset management business.

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Profitability of the some DAMCs has suffered in recent years mainly due to mounting credit costs, and we expect earnings to remain under pressure amid COVID-19, leading to weakened internal capital generation capacity. In addition to internal capital generation capacity, capital injection is another important way to enhance capitalization for the Four AMCs in recent years.

Chart 6

Return on Average Equity

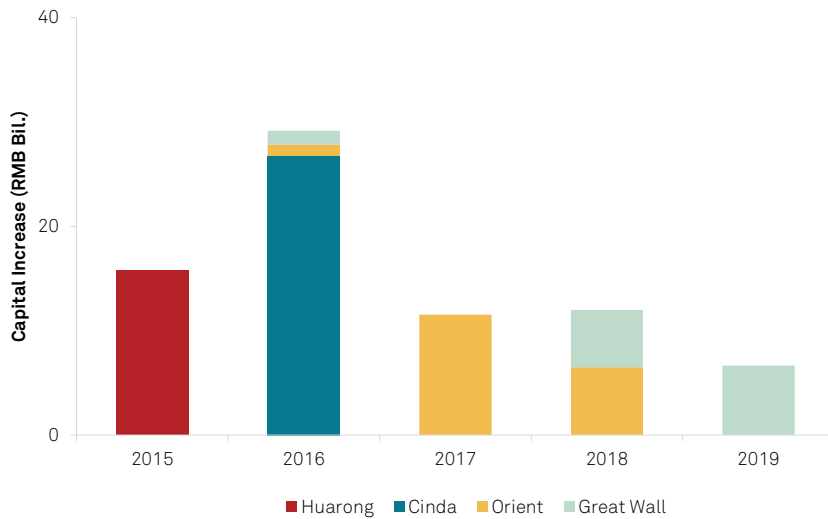


Credit costs have weighed heavily on DAMCs' profitability since 2018.

Note: Return on average equity = net income / [(total equity at the beginning of the year + total equity at the end of the year) / 2]
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Chart 7

Capital Injection



Slowing capital injection in recent years may restrict the DAMCs' ability to expand their business.

Note: Capital injection includes equity raised from HK Stock Market (in the case of Cinda and Huarong), and equity investment from controlling shareholders and other strategic investors (in the case of Orient and Great Wall).

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The regulator encourages regional DAMCs to reduce their leverage. In July 2019, CBIRC issued a notice on strengthening regulation of regional DAMCs. This regulatory document required the DAMCs to reduce their leverage ratio, choose funding sources in a prudent manner, and not to raise money from the public without getting proper approval.

Risk Position

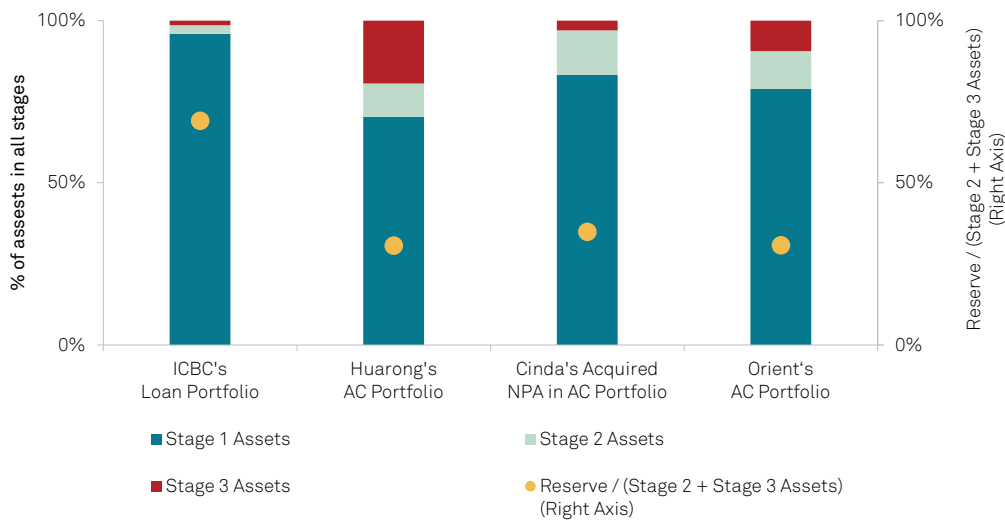
Risk position is a relative assessment that refines our view of a finco's actual and specific risks beyond the standard assumptions made in the capital and earnings analysis. We first analyze a finco's lending and underwriting standards relative to the standards for banks in China to arrive at the preliminary risk position assessment. We then adjust the preliminary risk position for each of the five other subfactors, including (1) loss experience, (2) risks not covered in capital/ leverage analysis, (3) risk appetite, (4) complexity, and (5) diversity analysis.

We believe the risk position of DAMCs is typically weaker than that of average banks and other average regulated fincos due to the inherent high risk of distressed assets. The customer base of DAMCs is mainly composed of weak borrowers with payment difficulties.

The high risk associated with distressed asset management has led to higher credit costs in recent years, and we anticipate higher impairment charges in 2020 as COVID-19 puts more pressure on weak borrowers. In addition, part of the deterioration of the Four AMC's asset quality may be reflected in fair value changes rather than provisioning, making it difficult for outsiders to assess the full picture of changes in asset quality.

Chart 8

Asset Stage Classification and Reserve Coverage as of End of 2019



The risk position of DAMCs is typically weaker than average banks due to the inherent high risk of distressed assets.

Note 1: Under IFRS 9, stage 1 assets are performing assets, stage 2 assets show significant credit deterioration, and stage 3 are non-performing.

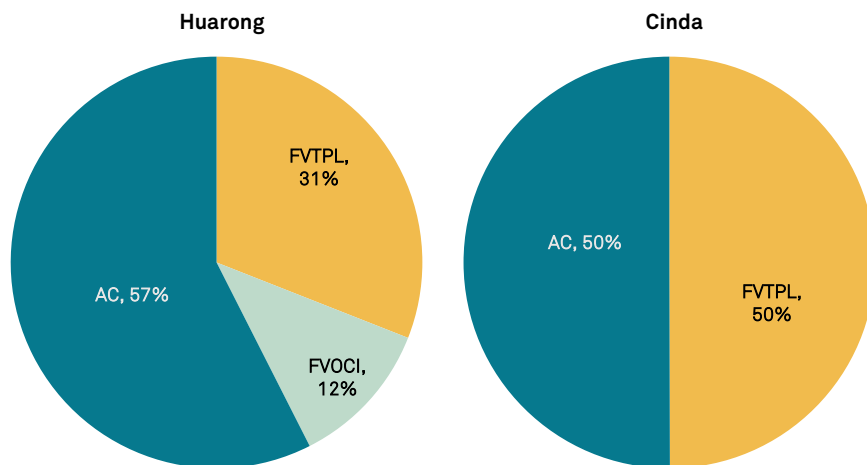
Note 2: NPA – non-performing assets, AC – amortized cost.

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Chart 9

Accounting Classification of Acquired NPA Assets as of End of 2019



Part of the change of the DAMCs' asset quality may be reflected in fair value changes rather than provisioning, making it difficult for outsiders to assess the full picture of the changes.

Note: AC – amortized cost, FVOCI – fair value through other comprehensive income, FVTPL – fair value through profit and Loss.

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While average regulated fincos in China tend to be small or niche and less complex companies, the Four DAMCs are more complex due to their diversified business lines through different subsidiaries. This add further complexity to their risk profile.

The regulator has enhanced its regulation over regional DAMCs since 2019. According to the notice on strengthening regulation of regional DAMCs issued by CBIRC, regional DAMCs shall not help banks hide away NPAs through any bank repurchase agreement, and the NPA purchase transactions must be real. In addition, regional DAMCs shall not disguise their lending activities as NPA acquisition.

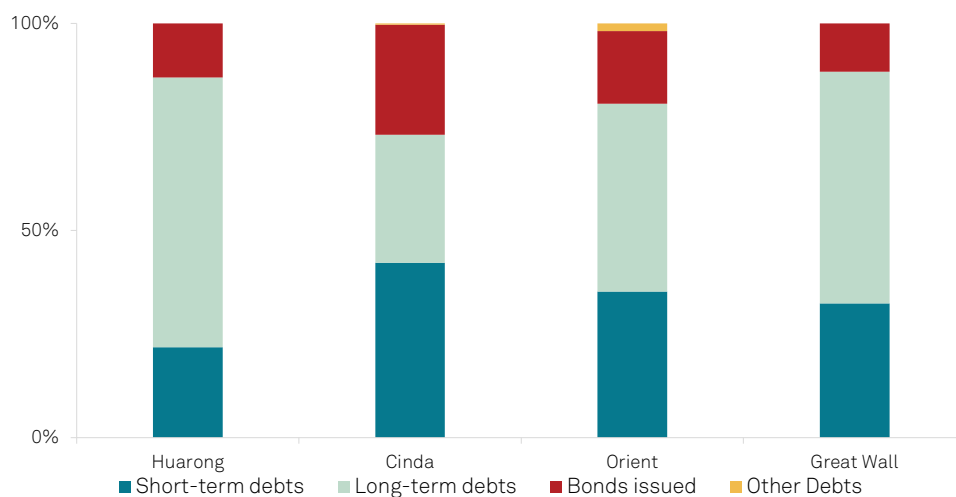
Funding & Liquidity

In our analysis we look at a finco's capacity to support business performance through effective funding, while managing liquidity requirements both on an ongoing basis and under stress conditions.

Typically, we view DAMCs' funding and liquidity profiles as consistent with other regulated fincos. Although the Four DAMCs own banking subsidiaries, their distressed asset management business is mainly funded by wholesale funding rather than bank deposits. This is because of tight regulation over banks' related-party transactions.

Chart 10

Debt Structure as of End of 2019 (Unconsolidated)



The Four DAMCs' distressed asset management business is mainly funded by wholesale funding rather than bank deposits.

Note: Other debts include borrowings from the central bank, placements from banks and financial institutions, and financial liabilities at fair value through profit or loss.

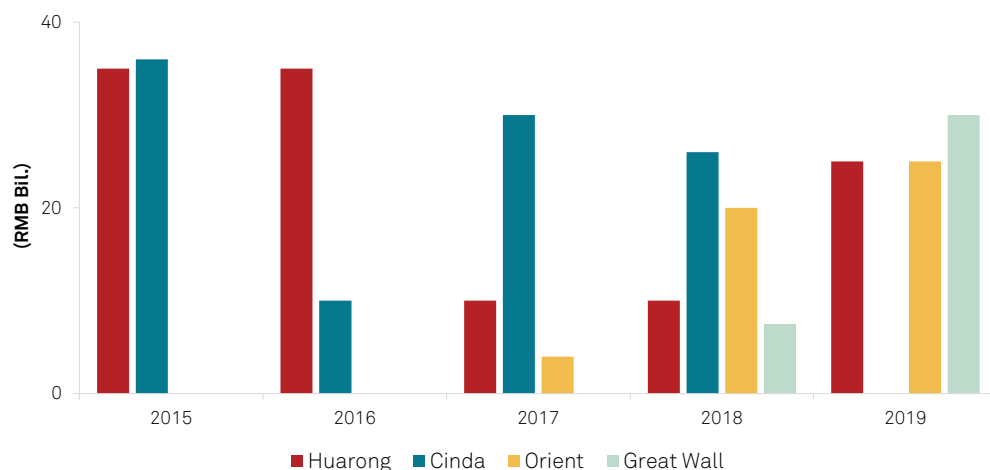
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Given their status as government-owned entities with a special mandate, DAMCs under government control typically have stable access to bank credit lines and the capital market in normal market circumstances. But we anticipate liquidity pressure when systemwide liquidity is tight, given the illiquid nature of DAMCs' distressed assets and their high leverage. However, thanks to ample systemwide liquidity during the COVID-19 outbreak, we expect the Four DAMCs to maintain stable liquidity in 2020.

Chart 11

Domestic Bonds Issued



The bond market is an important funding source for the Four DAMCs.

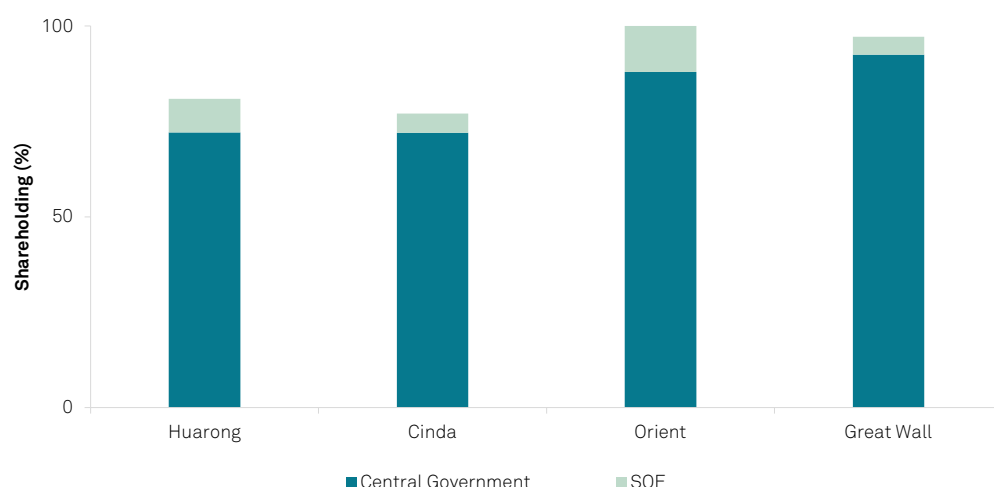
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Government Support

We believe DAMCs under government control have a high likelihood of receiving extraordinary government support thanks to their ownership structure and policy roles. Therefore, we typically view the Four DAMCs' importance level to the central government as high.

Chart 12

Shareholding Structure as of End of 2019



Despite efforts to diversify their investor base in the past decade, the controlling shareholder of the Four DAMCs is still the Ministry of Finance.

Note: SOE - State-owned enterprises.

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The DAMCs have been given a clear mandate to acquire NPAs from Chinese financial institutions. DAMCs also help stabilize financial institutions through bank equity investment. For example, in 2019, Cinda and Great Wall both injected capital into Jinzhou Bank, a city bank with serious undercapitalization due to bad debts. In addition, DAMCs have occasionally assumed the role of receiver/liquidator on behalf of the government to manage troubled institutions.

Although the government now has more entities and tools at its disposal to reduce banks' bad debt pressure, DAMCs remain an important channel for cleaning up NPAs. Bank-affiliated asset investment companies have been set up in recent years, specializing in debt-to-equity swaps of banks. These institutions are playing an important role in the government's efforts to reduce banks' bad debts and deleverage overleveraged corporates. At the same time, the securitization of non-performing assets offers another way to reduce banks' non-performing loans. Despite the emergence of these alternative entities and tools, we don't anticipate a significant reduction in the role played by DAMCs for the government in the foreseeable future. The mounting asset quality pressure caused by COVID-19 highlights a need for multiple solutions to address the problems surrounding NPAs.

This report does not constitute a rating action.

Appendix: Related Methodologies & Research

Methodology Applied:

S&P Global (China) Ratings Financial Institutions Methodology.

This document is prepared in both English and Chinese. The English translation is for reference only, and the Chinese version will prevail in the event of any inconsistency between the English version and the Chinese version.

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