Back to Basics of Banking

Banks have no simple and painless method to resolve non-performing loans.

Two recent news stories report the strong possibility that China's government will permit and encourage its banks to exchange non-performing loans (NPLs) for equity of their distressed corporate borrowers. This move "would help authorities clean up the nation's highest levels of soured credit in a decade," in *Bloomberg*'s words. *Reuters* adds that the reduction in NPLs would "free up cash for fresh lending" to borrowers including to those which had just eliminated their debt since such borrowers would become "more worthy of fresh credit." Quoting *Bloomberg* again, current law already stipulates that "debt can be swapped for equity if shares were used as collateral for the loan."

As a writer, one often pauses to search for the best word or phrase or metaphor. What are the choices here? "Delusional?" "Reality distortion?" "Orwell meets the banking world?"

Equity is not collateral

Years ago as a racquetball player I received some advice from a professional player. She told me what she does when she is losing a match and unhappy with her quality of play. I've never forgotten the advice: "I go back to basics. I think only of hitting the ball low, hitting the ball hard, and hitting the ball away from my opponent."

Let's try that here, let's go back to basics. First, the equity of a borrower is *terrible* collateral for any loan. In fact, the value of equity as collateral is essentially zero. One would not be mistaken to say that it is fraudulent to describe a loan as "collateralized" if the only collateral is borrower equity.

We give two primary reasons for this statement that equity is worthless as collateral. One goal of the lender in taking collateral is to sell such collateral when the borrower fails to repay the loan. But equity of a company must fall tremendously in value when the company cannot repay its loans. More bluntly, the equity will be worthless when the lender needs it. The second reason for equity inadequacy is that, for pledging of collateral, the borrower's equity is simply worthless currency that it can print without limit. It costs a borrower nothing to pledge literally any amount of private equity to a lender.

Debt-to-equity is not a painless solution

There is no magic risk management or risk mitigation technique to resolve NPLs without loss of some magnitude. The standard options for the bank are: (i) sell the NPL at a market price below par; (ii) restructure the loan in exchange for better security and more control in a manner that *may* reduce the ultimate NPL loss; (iii) seize assets of the borrower and sell them for highest possible recovery; and (iv) seize ownership of the borrower from the prior equity investors and, in most cases, replace the executives. It is this last option that one might call the debt-to-equity resolution of NPLs.

All four options are painful and, except in rare circumstances, will produce losses for the bank. Yet the news articles breezily imply that swapping debt for equity fixes a bank's NPL problem. This implicit and optimistic summary is wrong if one focuses on the bank's own shareholder value and insolvency risk. Further, the swap of NPL for borrower equity certainly does not "free up cash for fresh lending."

Markets are different in China

Yes, China is different. One might argue that we need not fret over "shareholder value" or "insolvency risk" for Chinese banks. The government owns the banks. The government even owns most of the corporate borrowers as state-owned enterprises (SOEs). Thus, finding fault with a concept that does not properly describe losses on this or that balance sheet misses the point. It's the government's account one way or another.

Yet the language of the news articles and the quotes of Asia-based experts embody the same accidental or deliberate naïveté. For example, the experts describe this debt-to-equity proposal as based on “market principles” and part of “supply-side reforms” to “reduce the risk of moral hazard.”

Let’s go with “delusional” as the shortest summary.

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