AN EXAMINATION OF CHINA’S NON-PERFORMING LOAN ISSUE

By
Xiaojun Allan Wu

B.A. English and Diplomacy
Foreign Affairs College, China, 1996

Master in Professional Accounting
University of Texas at Austin, 1999

Submitted to the Department of Architecture
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Signature of Author: ____________________________

Department of Architecture
August 2, 2002

Certified by: ____________________________
Edward S. Steinfeld
Assistant Professor, Political Science
Thesis Advisor

Accepted by: ____________________________
William C. Wheaton
Chairman
Interdepartmental Program in Real Estate Development
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Abstract
Non-performing loans (NPLs) are essentially a product of the irrational allocation of resources. Different from other Asian countries, China’s NPL issue resulted primarily from a transitioning economy dominated by the triangular relations of state-owned enterprises (SOEs), state-owned commercial banks (SOBs) and the fiscal system. Even though the total amount of NPLs in 1999 was estimated to be around 30% of the total outstanding loans of SOBs, the NPL problem in China would not lead to an immediate financial crisis as the NPL problem is more a stock problem than a flow one. However, the huge amount of overhanging bad debts has become one of the bottlenecks for China’s further reform, particularly, in the banking sector.

The establishment of four Asset Management Companies (AMCs) was an innovative approach to provide an instant relief of the bad debt burden of SOBs, to recover distressed assets and to restructure SOEs. Despite facing many challenges, the AMCs have been continuously seeking new NPL workout approaches and made substantial progress. A series of workout approaches have been introduced including debt-equity swap, discounted payoff, loan pool sale and property auction, etc. The process, however, will become increasingly difficult because the high quality assets have been disposed of first and the more troubled ones still remain in the portfolio. Furthermore, if the government cannot make a creditable commitment that the current NPL transfer and debt-equity swap is a once-off policy, new NPLs will be encouraged through soft lending by the SOBs and strategic default by the SOEs. There are also several obstacles ahead to the AMCs including China’s immature capital market, the AMCs’ internal structural problems as well as China’s weak legal enforcement mechanism. Fortunately, the Chinese government has made a great commitment to tackle the NPL issue not only from the surface but also from the fundamental structure, evidenced by the Chinese government’s efforts to improve the corporate governance of SOEs and institutional infrastructures. China’s accession to the WTO in 2001 will further force the government to seriously reform the banking sector in order to build up the competitive advantage to face the imminent competition from foreign banks. With more international practices introduced and corporate governance improved, China’s banking system could be more resilient and healthier in the near future. The AMC scheme would hopefully be a once-off prescription.

Thesis Supervisor: Edward S. Steinfeld
Title: Assistant Professor, Political Science
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Banking systems play a central role in mobilizing and allocating resources in a market economy. This stands in fundamental contrast to a planned economy, where financial institutions play a largely incidental role in resource allocation. China is in the process of transitioning from a centrally planned to a market economy, with its banking system gradually evolving from a conduit of budgetary capital supply to a market-oriented modern banking system. During this process, non-performing loans accumulated rapidly in state-owned commercial banks (SOBs) as a result of policy lending, real estate bubbles as well as underdeveloped credit culture and business infrastructures. China’s imminent accession to World Trade Organization (WTO) in addition to the 1997 Asian financial crisis called for an immediate reform of the deteriorating banking system. Four asset management companies (AMCs) were established to take on and dispose of a significant portion of NPLs from the four SOBs as well as to act as the turnaround managers for the loss-making state-owned enterprises (SOEs). A series of workout approaches have been introduced including debt-equity swap, discounted payoff, loan pool sale, property auction and securitization.

The purpose of this paper is to provide a comprehensive and current analysis of the causes, amount, and solutions as well as unsolved problems of the NPL issue in China. The first part of this paper focuses on the background issues including the evolution of the banking system and the causes, amount and special characters of China’s NPL issue, while the second part focuses on the solutions taken and their effectiveness as well as obstacles ahead.
CHAPTER TWO: EVOLUTION OF CHINA’S BANKING SYSTEM

Pre-Reform Period

Before 1978, China had a centrally planned economy with a monobank system. The People’s Bank of China simultaneously served as the central bank and the sole commercial bank. As China heavily relied on budgetary financing during that period, the Ministry of Finance was responsible for allocating investment and operating capital to SOEs. The People’s Bank was mostly an intermediary for passing government budgetary funds to SOEs.

Reform Period: 1978 to 1996 – Transition of China’s Banking System

From 1978 to 1996, China’s economic reform gradually gained momentum. The nation has started to embrace the market economy, utilizing the demand and supply relationship to allocate resources among various economic sectors. During this period, the banking system also experienced tremendous changes. A specialized commercial banking system was set up. The Agricultural Bank of China (ABC), which focuses on deposit and lending activities in rural areas, was reestablished in February 1979 as a separate bank. A month later, the Bank of China (BOC) was separated from the People’s Bank as an independent new bank, in charge of foreign exchange related business. In October 1979, the China Construction Bank (CCB) was restructured to finance large projects, such as infrastructure, transportation, energy, etc. The People’s Bank of China was redefined in 1983 as the central bank, responsible for issuing currency, managing credit, setting interest rates and supervising financial institutions and foreign exchange business. The vast branch network of the People’s Bank was reorganized to form the
Industrial and Commercial Bank of China (ICBC) to support state-owned commercial and industrial enterprises.

From 1983 to 1993, China had established a quasi-monobank system with the two-tier lending structure in which the central bank tightly controlled credit allocation of the four specialized state-owned banks (SOBs) through the credit plan. The credit plan was formulated annually through repeated negotiations between the central bank and various ministries as well as different levels of government. A relending scheme was also set up between the central bank and the four SOBs to facilitate the implementation of credit plan through redistribution of funds between banks and regions. The SOBs were required to support government objectives such as funding priority sectors and underwriting loss-making state-owned enterprises (SOEs). Banks also extended loans at the “request” of local government officials to fund their favorite projects. In many cases, these projects were not approved by the central government and thus no central bank funds had been provided for these lending. Banks had to finance these loans from deposits taken from the public. Because the policy lending is not a result of normal commercial bank decision-making, there are always higher default risks associated with these loans. Through 1991, about 42% of the SOBs’ lending was policy lending. About four-fifths of this lending was financed by borrowing from the central bank and the remaining fifth was financed from the deposits.¹

“Loan for Grant” (Bo Gai Dai) is a new financial reform policy issued in 1984. The new policy was to use interest-bearing loans to replace direct grants to SOEs, thereby shifting the financing responsibility for SOEs from the fiscal budget to SOBs. The impact of the new policy was

reflected in the dramatic lending growth of SOBs. Total loans outstanding by all types of financial institutions grew from RMB 190 billion in 1978 to RMB 6.1 trillion in 1996 as a result.²

Due to the lack of other investment options, most households put their savings into banks. The household savings in China have risen significantly since 1978, increasing from 2% of gross domestic product (GDP) in 1978 to 22% in 1994.³ The financial system, the big four SOBs in particular, heavily relied on household deposits as a source of funds for lending to enterprises. The SOBs, therefore, built up enormous liabilities to households. Currently, the big four SOBs account for about 70% of domestic credit and hold over 70% of household deposits.⁴

Since 1993, the quasi-monobank system has been gradually transformed into a quasi-market system. The People’s Bank of China and the four SOBs were reorganized to reduce local governments’ intervention. The Central Bank Law and Commercial Bank Law were enacted to provide a legal and regulatory framework for the operation of the banking system. The relending policy was abolished in 1993. In 1995, three policy banks, the Import and Export Bank of China, the Development Bank and the Agriculture Development Bank, were set up to take over the policy lending. Despite the establishment of three policy banks, the SOBs were still carrying a heavy percentage of risky loans from the policy lending.

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⁴ John P Bonin, Dealing with the Bad Loans of the Chinese Banks, p. 701/2001, Department of Economics, Wesleyan University
CHAPTER THREE: CAUSES OF CHINA’S NON-PERFORMING LOANS

**Triangular Relations among SOEs, SOBs and the Fiscal System**

During the pre-reform period, China’s SOEs had little economic independence. Accounting for 80% of the gross industrial output, they received production quotas, guaranteed outlets for products and were allocated the necessary resources from the budget. They were also social welfare providers to workers and communities. In the early 1980s, SOEs were first given some autonomy in production, distribution and investment decisions. They were still receivers of state subsidies on input materials under the two-tier price system. Since late 1980s, however, overall SOEs performance has deteriorated due to the following factors. First, starting from 1984, the price reform gradually abolished the two-tier price system and thereby increased the production costs of SOEs. Second, the debt-equity ratio of the SOEs rose dramatically from 23% in 1980 to 440% in 1998, following the “Loan for Grant” reform. The rapid accumulation of debt resulted in a heavy interest payment burden on SOEs. Third, poor corporate governance in Chinese SOEs, resulting from weak incentives for managers to maximize value and protectionist practices of government agencies, led to SOEs’ overcapacity and low efficiency. Fourth, the growth of collective and private firms in addition to joint ventures with foreign investors utterly altered the of SOEs’ dominant status in China’s economy. By 1996, SOEs accounted for only 28% of gross industrial output. Collectively owned, individually owned and other types of enterprises accounted for 39%, 16% and 17% respectively. The increased competition from the market further impaired the financial strength of debt-ridden SOEs. From 1996, the SOEs as a

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5 John P. Bonin, Dealing with the Bad Loans of the Chinese Banks, p. 9, 01/2001, Department of Economics, Wesleyan University
6 Gregory C. Chow, China’s Economy: Reform and Perspectives, p. 3, 02/1999, University of Pennsylvania
whole became a loss-making sector. The IMF estimated that 37% of industrial SOEs were suffering losses at the end of 1997. The amount of operating loss reached RMB 130-140 billion during the same year.

The deteriorating performance of SOEs had a direct impact on the fiscal income of the central government. The share of fiscal revenue to GDP declined substantially from 1980 to 2000 (Table 1), thus dragging down fiscal expenditures of the government and increasing the significance of bank lending in the economy. In 1979 government budgetary expenditures of RMB 127 billion were almost seven times of the increase in loans. Only thirteen years later in 1992, the increase in loans of RMB 498 billion surpassed for the first time annual government expenditures of RMB 439 billion. By 1996 the RMB 1.1 trillion increase in loan outstanding was more than a third larger than total government fiscal expenditures of RMB 791 billion.

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<tbody>
<tr>
<td>Fiscal Rev/GDP</td>
<td>25.7</td>
<td>22.4</td>
<td>15.9</td>
<td>14.6</td>
<td>13.1</td>
<td>12.5</td>
<td>11.2</td>
<td>10.7</td>
<td>10.9</td>
<td>11.6</td>
<td>12.6</td>
<td>13.9</td>
<td>15.0</td>
</tr>
</tbody>
</table>

Source: Statistical Yearbook China 2001

While the state-owned banks (SOB) became the major financial vehicle of the national economy, they became increasingly involved with SOEs. To subsidize the loss-making SOEs, the government sought financial resources from both the People’s Bank and the commercial banks in the form of policy loans. Such high default risk policy loans had adverse impact on the health of

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7 IMF Article IV Consultation, 1998
8 He Qinglian, China's Latent Economic Crisis and Potential Risks, p.2, 11/1999, University of Chicago
the banking system. The profitability of the commercial banks declined consistently in the 1990s (Table 2). If uncollected interest payments were excluded from the revenue side of the financial accounts, most state-owned commercial banks, except the Bank of China, would have reported financial losses in 1996 and the following years\textsuperscript{12}. Meanwhile, the average capital-adequacy ratio was only 4.4%, lower than the 8% required by the China’s Commercial Bank Law. In 1998, the central government had to issued a special treasury bond amounting to RMB 270 billion to re-capitalize the bank to raise their capital-adequacy ratio to be above 8%.

\textbf{Table 2: State-owned Banks’ Performance in the 1990s}

<table>
<thead>
<tr>
<th>Year</th>
<th>Pre-tax Profit (RMB billion)</th>
<th>Capital (RMB billion)</th>
<th>Assets (RMB Billion)</th>
<th>ROE (%)</th>
<th>ROA(%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>24.23</td>
<td>131.6</td>
<td>11,683.8</td>
<td>18.4</td>
<td>1.44</td>
</tr>
<tr>
<td>1991</td>
<td>29.93</td>
<td>148.2</td>
<td>2,061.4</td>
<td>20.2</td>
<td>1.45</td>
</tr>
<tr>
<td>1992</td>
<td>32.47</td>
<td>182.2</td>
<td>2,426.9</td>
<td>17.8</td>
<td>1.34</td>
</tr>
<tr>
<td>1993</td>
<td>27.34</td>
<td>220.7</td>
<td>2,987.2</td>
<td>10.5</td>
<td>0.91</td>
</tr>
<tr>
<td>1994</td>
<td>16.96</td>
<td>217.3</td>
<td>4,084.1</td>
<td>7.8</td>
<td>0.42</td>
</tr>
<tr>
<td>1995</td>
<td>22.21</td>
<td>181.9</td>
<td>5,138.2</td>
<td>12.2</td>
<td>0.43</td>
</tr>
<tr>
<td>1996</td>
<td>23.38</td>
<td>192.7</td>
<td>6,324.7</td>
<td>12.1</td>
<td>0.37</td>
</tr>
<tr>
<td>1997</td>
<td>11.97</td>
<td>210.6</td>
<td>7,783.2</td>
<td>5.7</td>
<td>0.15</td>
</tr>
<tr>
<td>1998</td>
<td>13.91</td>
<td>484.6</td>
<td>9,086.6</td>
<td>2.9</td>
<td>0.15</td>
</tr>
</tbody>
</table>

Source: Almanac of China’s Finance and Banking

\textit{Real Estate Bubbles in 1990s}

After Deng Xiaoping’s southern expedition in 1992, China declared a “socialist market economy”, which inaugurated a new economic boom. Like Thailand, China’s economic boom in the 1990s was largely led by the real estate and construction sector. The SOBs in addition to other financial institutions imprudently funded massive property developments throughout China. First class office buildings, luxurious hotels and lavish residential housing sprang up.

\textsuperscript{12} John P Bonin, Dealing with the Bad Loans of the Chinese Banks, p.10, 01/2001, Department of Economics, Wesleyan University
across the nation. Shanghai with the full support from the new pro-Shanghai leadership of the central government created the "Pudong Miracle". In five years, Shanghai transformed itself into one of the world’s most glamorous metropolis. By the end of 1997, Shanghai boasted over more than one thousand skyscrapers, about one hundred five-star hotels and 13.5 million square feet of office space – five times the 2.7 million square feet in 1994. By late 1996, the bubble started to burst due to the over-supply. When the construction peaked in 1998, the vacancy rate of class A offices had reached almost 50%. Real estate prices slid to below 50% of their peak level. For commercial banks and other financial institutions with heavy exposure to real-estate construction and speculation, the bursting of the asset bubble further deteriorated their balance sheets.

Underdeveloped Credit Culture

As Mr. E Gerard Corrigan, a Managing Director of Goldman Sachs, defined in his speech sponsored by the Bank of China on March 1, 2001, credit culture is a broad and multi-faceted concept related to socially transmitted behavior patterns that define the relationship between lenders and borrowers. The core of the credit culture is that a creditor should not lend money unless the lender is highly certain that the resulting debt can be serviced and repaid in a timely fashion. Correspondingly, debtor should not assume the obligation to take on debt unless the debtor is reasonably certain that the debt can be serviced and repaid on a timely basis.

In China’s transitioning economy, credit culture is far from being perfect. On the creditor side, the SOBs are not used to their new, and vastly more important role. Lending was grounded more

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13 Shalendra D. Sharma, Stability amidst Turmoil: China and the Asian Financial Crisis, 03/01, p. 6, Harvard Asia Quarterly
14 Shanghai Property Market Review, 05/02, Slide 8,
15 Shalendra D. Sharma, Stability amidst Turmoil: China and the Asian Financial Crisis, 03/01, p. 6, Harvard Asia Quarterly
in relationship (Guan Xi) rather than in the capacity of the borrower to repay, the objective review of cash-flow projections and the fundamental understanding of clients’ business and their risks. Without adequate due diligence, bank officials often extended risky lending either under pressure from higher authorities or in pursuit of personal gains. On the debtor side, many Chinese enterprises still have not developed the habit of paying back loans promptly. Some of them even use loopholes in regulations and bank management systems to dodge their debts. According to a Xinhua News Agency’s article “Credit System Emphasized” dated September 20, 2001, credit crisis has become part of social life and economic activities in recent years. The manufacturing and selling of fake goods, swindling contract and dodging of loans remain incessant after repeated prohibition. Cash transaction remains dominant in commercial and trade activities. The ratio of the Chinese enterprises that had bad loans is up to 30%\(^\text{16}\).

China has not established a credit rating system, which is a tool to price risk and thereby increase the transparency of the borrower. A credit rating system is especially crucial for financial institutions, as they need to assess the records of enterprises that have shown a tendency to default. “Some of the bad loans Chinese banks are burdened with are incurred by a lack of credit information about borrowers,” according to China Daily’s article “Credit Culture Comes to China” published in April 28, 2001\(^\text{17}\). Chinese banks did not realized the importance of a credit rating system until recently. “China desperately needs a credit culture,” Wang Xuebing, former

\(^{16}\) Credit Risk Emphasized, 09/01, Xinhua News Agency
\(^{17}\) Credit Culture Comes to China, 04/01, China Daily
President of the BOC, said in early 2001 at a business forum, “the government needs to make special efforts to educate society about the credit culture.”

Underdeveloped Institutional Infrastructure

A financial system can only function efficiently in a clear framework of contract law and predictable law enforcement. Bankruptcy provisions are particularly important. Also vital are appropriate and transparent accounting conventions; adequate transparency and disclosure; strong payment and settlement systems; and appraisal techniques. The legal and business infrastructure is still under development in China. Before a sound institutional infrastructure is available in China, many problems including loan default are inevitable.

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18 Credit Culture Comes to China, 04/01, China Daily
Definition of NPLs in China’s Banking System

Due to the ambiguous definition of non-performing loan and the lack of transparency in China’s banking system, the total amount of NPL has always been a doubtful number. Before 1994, the People’s Bank had an informal loan classification system, that is, the SOBs could classify no more than 2% of all their loans as “bad debt”, meaning the volume of loans not recoverable from the proceeds from bankruptcy and liquidation; no more than 5% as “problem loans,” meaning loans more than three years past due with interests still being paid; and a maximum of 8% as “of concern,” meaning borrowers were more than one year behind on principal repayments\(^\text{19}\). The lenient definition and artificially fixed bad loan quota buried the true picture of the NPL problem in China’s banking system.

In 1995, the People’s Bank formally set forth a new loan classification system. The new system is a three-tier scheme. The first tier is the “past due loans”, which includes loans not repaid when due or not repaid after the due date has been extended. The next tier is the “doubtful loans”, which are loans that have been past due two years or more or loans that have been extended to borrowers who have suspended production or whose projects are no longer being developed. The third tier is the “bad debts”, which are loans that have not been repaid after borrowers have been declared bankrupt and gone through liquidations\(^\text{20}\).

\(^{19}\) Moody’s Investors Service, Effects of Recent Reforms on Credit Quality of China’s Specialized Banks, p.9
\(^{20}\) People’s bank of China, General Rules on Loans, Chapter 7, article 33-37
Even though the new definition is much stricter than the old one, it is still too lenient comparing to the standard international practice, in which commercial loans 90 days past due and consumer loans 180 days past due are generally classified as non-performing. Current international standards divide NPLs in commercial banks into four categories: special mention, substandard, doubtful and loss.

Amount of NPLs in China’s Banking System

The exact amount of non-performing loans in China is not clear at this moment. There is a large discrepancy between the official numbers and the estimate of the foreign organizations largely due to different definitions used. In the press release of the Chinese State Council in January 2000, Dai Xiangrong, the governor of the People’s Bank revealed that there are about 2.7% of “bad debt” and about 8% to 9% of “past due loans” and “doubtful loan” combined. Since the loan outstanding of all state-owned commercial banks in mid 1999 were RMB 9,062 billion, NPLs could be estimated at less than RMB 1,062 billion. This number obviously underestimated the total NPL amount because the total amount of NPLs transferred from the big four SOBs to the asset management companies (AMCs) in 1999 was about RMB 1.3 trillion. Some foreign experts estimated a total of 40% of the banks’ outstanding loans were non-performing in accordance with international standards. Some domestic scholars indicate about 30% of the total outstanding loans of big four SOBs were non-performing\(^\text{21}\) (Table 3). Using the 30% estimate, the balance of outstanding loan at the end of second quarter of 1999 of RMB 9,062 billion would result in an estimated total NPL of RMB 2,719 billion. This estimated NPL is also about twice of the total NPLs the AMCs received in 1999, as confirmed by Dr. Chunlin Zhang, a senior

restructuring specialist from World Bank Beijing Office. Therefore, the tentative conclusion is that 30% of the total outstanding loans of big four SOBs or RMB 2,719 billion could be the estimate of total Chinese NPLs at the end of 1999.

Table 3: Estimate of Total Loan Outstanding vs. Non-performing Loan (RMB Billion)

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</thead>
<tbody>
<tr>
<td>Outstanding Loan</td>
<td>2,108</td>
<td>2,578</td>
<td>2,731</td>
<td>3,228</td>
<td>4,757</td>
<td>5,238</td>
</tr>
<tr>
<td>NPL</td>
<td>422</td>
<td>516</td>
<td>819</td>
<td>968</td>
<td>1,427</td>
<td>1,571</td>
</tr>
<tr>
<td>Percentage</td>
<td>20%</td>
<td>20%</td>
<td>30%</td>
<td>30%</td>
<td>30%</td>
<td>30%</td>
</tr>
</tbody>
</table>

Source: Theory and Practice of AMC Operation

Special Character of China’s NPL Issue - A Stock Problem

The NPL problem in China is more a stock problem than a flow one. The stock problem arises from the bad loans undertaken in the past and the flow problem refers to future loans to enterprises which will not be able to serve such loans and thus become classified. Almost no NPLs had ever been written off from the balance sheets of SOBs before 1991 when SOBs were required to set up reserves for NPLs in their accounting books. The quantity of the reserve provision for NPLs are, however, linked to the volume of total loan outstanding but not to the magnitude of classified loans. In 1991, the Ministry of Finance dictated banks to set aside reserves for NPLs equal to 0.6% of their loan outstanding. In 1997 the reserve ratio increased to 1%22. However the reserves are inadequate compared to the magnitude of NPLs of major banks. Without a cash flow impact, the reserve could be used to write off NPLs gradually and thus smooth the bottom line of the bank and avoid the accumulation of NPLs in the balance sheet.

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The reserve, however, would make the bank look less profitable. The reluctance to impose a higher NPL reserve provision was a result of the tax concern. The SOBs, paying income tax at 33% and business tax at 6% and other taxes such as real estate tax and stamp duty, have been one of the major contributors to the country’s fiscal revenue. The Ministry of Finance is concerned that a lenient NPL reserve provision could possibly be used by the banks as an accounting mechanism to pay less taxes, resulting in the reduction of fiscal revenue. However, if the SOBs had set up the NPL reserve earlier, the NPL magnitude would not have been so significant today. Even though making reserve is only an accounting issue, it helps to explain the a large amount of NPLs in the balance sheets of SOBs.

**Fundamental Issue – Irrational Allocation of Resources**

The fundamental issue of China’s NPL problem is the irrational allocation of resources in the economy. The government has kept pouring capital into these loss-making SOEs because they have been regarded as “the political, economic and social pillars” of China. China’s “socialist market economy” is a compromise between the communist ideology and the economic reality. Without the existence of SOEs, China’s economy would be dominated by collective and private enterprises. From the political standpoint, SOEs are still one of the corner stones of the communist ruling in China. SOEs also take the lion’s share in key industrial sectors. Even though the slow growth of SOEs led to a reduction in their share of industrial output from 80% in 1978 to 28% in 1996, the decline is more in the service sector than in the manufacturing. In construction, for example, SOEs by value in 1995 continued to account for more than 60% of all building projects in urban areas; Telecommunications and long-distance transportation remain
almost entirely within the domain of state ownership\(^{23}\). Meanwhile, SOEs are also key to maintain social stability in China. Chinese people always say “Qiye ban shehui”, meaning that each SOE hosts a small society. As the major sources of employment, SOEs had always been the major social welfare provider for the large number of urban residents until the initiation of SOEs reform several years ago. SOEs’ political, economical and social importance forced the government to provide the with constant and enormous financial support. The protectionist behavior eventually resulted in a misallocation of the resources and put the Chinese banking system in danger.

**Potential Impact**

Why should any increase in NPLs be a matter of concern? First, banks are involved in the money generation process, where a change in base money supply is magnified in the effective money supply through fractional reserve system. Banks with overhanging NPLs may become less responsive to carry out desirable changes in monetary policy during different phases of a business cycle.

Second, banks’ illiquidity caused by loss of capital and inability to use the lending income to serve the deposit interest as a result of the large amount in NPLs is likely to prevent them from executing their critical role to boost the economic growth through supporting and nurturing creditworthy enterprises. Since the banking system reform in 1998, the enormous amount of overhanging NPLs have forced the People’s Bank to tighten its control over SOBs’ risk

management. For example, bank officials would be accountable for their bad lending decisions.
The extra precautions when extending credit slowed down the SOBs’ lending activities substantially, causing inadequate funding to enterprises. In the past four years, the government had to use active fiscal policies to stimulate the economy by issuing government bonds. Ironically, 45% of these issued government bonds were purchased by financial institutions\textsuperscript{24}. The logic is that the SOBs reduced their lending activities so they had to invest a significant portion of the capital in the government bonds in order to serve the interest payment,

Third, if a bank is unable to improve its liquidity through asset sales, it may encounter a premature deposit liquidation which could force the bank into default. Due to interconnections among banks, scared depositors may rush to withdraw their deposits from banks not in default. The resulting bank run could trigger a full-scale financial crisis.

Finally, a sound banking industry is essential for the development of efficient financial markets. In turn, efficient markets are crucial for ensuring effectiveness of the market-oriented economy. Excessive bad debts reflecting inefficient bank management are therefore antithetical to the goal of building a market oriented Chinese economy.

\textsuperscript{24} Takeshi Jingu, Moving Forward in Reforming China’s Capital Market, 01/2002, Nomura Research Institute
Formation of Four AMCs

Between April and October in 1999, four asset management companies (AMCs), Huarong, Cinda, Orient and Great Wall were set up to resolve China’s NPL problems. The AMCs were designed to take over bad loan assets from the four state-owned commercial banks, the Industrial & Commercial Bank of China (ICBC), China Construction Bank (CCB), Bank of China (BOC) and Agricultural Bank of China (ABC) respectively (Table 4). Each of the AMCs with a ten-year duration was capitalized by the Ministry of Finance at RMB 10 billion from the state budget to cover current operating expenses. The NPLs were acquired from the banks at face value.

Purchase considerations included: 1) loans from the People’s Bank of China (PBOC) carrying a fixed interest rate of 2.25%; 2) financial bonds issued by AMCs to the selling banks. The first approach accounts for 40% of the value of the transferred NPLs and the second for 60%.

Table 4: Transfer of NPLs to AMCs

<table>
<thead>
<tr>
<th>AMC</th>
<th>NPL Acquired from</th>
<th>Amount of NPL Acquired (RMB bn)</th>
<th>Total Assets of Selling Banks (RMB bn)</th>
<th>NPL Acquired As % of Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Huarong</td>
<td>ICBC</td>
<td>408</td>
<td>3,540</td>
<td>11.5</td>
</tr>
<tr>
<td>Cinda</td>
<td>CCB</td>
<td>350</td>
<td>2,201</td>
<td>15.9</td>
</tr>
<tr>
<td>Orient</td>
<td>BOC</td>
<td>267</td>
<td>2,904</td>
<td>9.2</td>
</tr>
<tr>
<td>Great Wall</td>
<td>ABC</td>
<td>346</td>
<td>2,276</td>
<td>15.2</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>1,371</td>
<td>10,921</td>
<td>12.6</td>
</tr>
</tbody>
</table>

Source: Deutsche Bank Research

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25 Deutsche Bank Asia Equity Research, Asset Management Companies, A Tough Job Ahead, Feb 12, 2001
26 John P. Bonin, Dealing with the Bad Loans of the Chinese Banks, p.21, Wesleyan University
The AMCs are under the governance of three government agencies. First, the Ministry of Finance is responsible for administration. It provided AMCs with their initial capital and will bear the consequences of their operation. Second, the supervision of AMCs is the responsibility of the People’s Bank of China. Finally, the State Economic and Trade Commission (SETC) is in charge of selecting SOEs for debt-equity swap.

In November 20, 2000, the Regulations on Financial Asset Management Companies were passed. It provided a legal framework for the AMCs’ status and business scope, operation and management as well as AMCs’ termination and liquidation (Appendix I).

**AMCs’ Multiple Roles**

The Asian financial crisis called for China’s immediate banking system reform. However, the enormous amount of NPLs could not be resolved or written off overnight. As one of the most critical components of China’s banking system reform, the AMCs were set up to play multiple roles: 1) as a temporary warehouse of NPLs to relieve burdens from the SOBs; 2) as debt workout agents to dispose of NPLs; and 3) as asset managers to restructure SOEs.

As the temporary NPLs warehouse, the AMCs took over about half of the NPLs from SOBs, thereby helping SOBs to clean their balance sheets. With healthier balance sheets, SOBs can move toward further reforms in order to prepare for a new challenge – China’s accession to the WTO. China made significant concession in the banking sector for the WTO entry, including: 1) foreign banks will be able to conduct local currency business with Chinese enterprises starting
two years after accession; 2) foreign banks will be able to conduct local currency business with Chinese individuals from five years after accession; 3) foreign banks will have the same rights (national treatment) as Chinese banks within designated geographic areas; 4) both geographic and customer restrictions will be removed in five years. To solve their under-capitalization problem and to prepare for the fierce competition with foreign banks, all four SOBs have been seeking to go public. However, their weak financial health has been the main obstacle. The immediate task of setting up the AMCs was to relieve the NPLs burden from the SOBs.

The four AMCs' core business is to dispose of NPLs through different approaches to minimize the loss. The enormous scale and the complication as well as the extensive geographic distribution of NPLs make the workout process an arduous task for AMCs. In addition, NPLs have to be disposed of quickly in light of the ice cream theory, i.e., the longer the NPLs in the book, the less value could be recovered.

The AMCs also play the role of a turnover manager for the financial and operational restructure of SOEs. Due to the lack of investment banks and venture capitalists in China, the AMCs have to perform a host of tasks required to restructure SOEs and promote their eventual financial viability.

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27 Yi-feng Tao, The Impact of WTO Accession on China's Financial System, 11/01, National Chengchi University
28 John P. Bonin, Dealing with the Bad Loans of the Chinese Banks, p.22, Wesleyan University
The Kinds of Assets in the Non-performing Loan Pool

The NPLs at the SOBs can be classified into four major categories by source: 1) NPLs from policy lending to loss-making SOEs; 2) NPLs from real estate and stock market bubbles; 3) NPLs from loss-making enterprises due to banks’ poor lending decisions; 4) NPLs from intentional default due to bad credit culture (Table 5).

<table>
<thead>
<tr>
<th>NPL Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Policy Lending</td>
<td>40%</td>
</tr>
<tr>
<td>Real Estate and Stock Market Bubbles</td>
<td>30%</td>
</tr>
<tr>
<td>Loss-making Enterprises</td>
<td>15%</td>
</tr>
<tr>
<td>Intentional default</td>
<td>15%</td>
</tr>
</tbody>
</table>

Source: Estimate from Theory and Practice of AMC Operation

Depending on the parent bank’s specialization, each AMC has a different combination of assets. For example, 40% of NPLs assumed by Cinda from China Construction Bank are real estate and construction related NPLs (Chart 1). Great Wall, the AMC for Agricultural Bank of China, has a high concentration of NPLs in agriculture related industries. Huarong, the AMC for Industrial & Commercial Bank of China, has a high concentration (about 68%) of NPLs from SOEs (Chart 2). Broken down by collateralized status, 42% of Huarong’s NPLs are unsecured, 36% guaranteed and 21% collateralized (Chart 3).

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Chart 1

NPLs of Major Industrial Sectors

Source: http://www.cinda.com.cn/assets_profile. 07/2002

Chart 2

Huarong - Breakdown By Type of Borrower

Source: Deutsche Bank Research
Chart 3

Huarong - Breakdown by Collaterized Status

- Mortgaged Loans: 21.88%
- Pledged Loans: 0.10%
- Guaranteed Loans: 36.06%
- Unsecured Loans: 41.96%

Deutsche Bank Research
**Major Workout Approaches**

**Debt-Equity Swap**

The AMCs' first and most essential task is to complete debt-equity swap for SOEs selected by the State Economic and Trade Commission (SETC). In August 1999, the SETC came up with five criteria for selecting debt-equity swap candidates: 1) products must have acceptable quality with certain market shares domestic or abroad; 2) the SOE owns state-of-the-art technology and equipments for the production as well as conforms to the environmental regulations; 3) the SOE has sound governance with complete debtor-creditor documentation and appropriate accounting practice; 4) the SOE has strong management team; and 5) the SOE has a feasible restructuring proposal and effectively implementation of all the necessary measures including downsizing, improving profit and diverting the laid-off workers, which must be acknowledged by the local government. The selected SOE would have all or part of its default debt converted to equity held by an AMC.

The debt-equity swap policy drew immediate debates. Some experts in the field support for this policy while others have opposite views. For example, Dr. Zhang from the World Bank, said in an interview, “there are three goals the Chinese government is trying to accomplish by using the debt-equity swap: 1) to help clean up banks’ non-performing loans; 2) to diversify the ownership of SOEs and thus to establish modern corporate structures; and 3) to relieve the debt burden of SOEs in order to help them turn around in three years. It is again a government behavior, which is somehow justified because a lot of the selected SOEs were set up from some zero-equity

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projects by the government.” As Professor Steinfeld from MIT discussed in his paper titled “Free Lunch or Last Supper? – China’s Debt-Equity Swaps in Context”, “the debt-equity swaps are an immediate policy responding to these problems, an effort to kill several birds with one stone…. The swap should certainly not be a free lunch for the firm, and it may not even be a last supper. Indeed, depending on the decision of the new owner, it may be an acknowledgment that the borrowing entity has already consumed its last meal, it no longer worthy of financial nourishment, and instead must be dissolved. Debt-equity swap is a reward to SOEs for their prior financial irresponsibility and another way for SETC to protect those loss-making SOEs.”

After the announcement of the debt-equity swap policy, a lot of SOE managers with their local government officials rushed to Beijing to lobby SETC in anticipation of being selected. Ironically, one of the rules of thumb in corporate finance is that equity financing is supposed to be more expensive than debt financing because equity holder bears the higher risk with a junior claim status to the debtor in the bankruptcy liquidation. However, Chinese SOE managers and their local supporters still queue to participate in debt-equity conversion. According to Professor Steinfeld, “they do so, however, because they understand something implicitly: in China, equity financing is cheaper than debt financing. Indeed, with debt-equity swaps, equity seems to demand no returns whatsoever.”

A total of 601 SOEs were selected by the SETC (Table 6). As the end of 2000, 580 selected SOEs completed the conversion via the AMCs, involving a total of RMB 405 billion, or 30% of

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the total NPLs transferred from the SOBs. According to the official publication, after the conversion, the overall debt/asset ratio of these SOEs was lowered to 45.6%. Their total annual interest payments were reduced by RMB 45 billion. 439 SOEs turned around and became profitable in 2000.

Table 6: Progress of Debt-equity Swap in 2000

<table>
<thead>
<tr>
<th>AMC</th>
<th>SOEs Selected</th>
<th>D/E Swap Completed</th>
<th>Completion %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Huarong</td>
<td>333</td>
<td>161</td>
<td>48%</td>
</tr>
<tr>
<td>Cinda</td>
<td>190</td>
<td>96</td>
<td>51%</td>
</tr>
<tr>
<td>Orient</td>
<td>63</td>
<td>26</td>
<td>41%</td>
</tr>
<tr>
<td>Great Wall</td>
<td>24</td>
<td>12</td>
<td>50%</td>
</tr>
<tr>
<td>Total</td>
<td>601</td>
<td>306</td>
<td>49%</td>
</tr>
</tbody>
</table>


As the new equity holders of these SOEs, the AMCs are expected to act as turnaround managers. Dr. Yang Kai-sheng, President of Huarong, said in a public speech: “our market priority is to work closely with original contributors to promote merges and restructuring between those enterprises while alleviate their debt burden and transform their mechanism, so as to exit smoothly.” However, the interviews with AMC personnel, reveals a different perspective towards this issue. They called the debt-equity swap “an imposed and unwanted obligation to the AMCs from the government”. They asserted that the AMCs were stuck in an awkward situation. First, it is hard to manage these SOEs owing to the shortage of human resources and necessary skills at the AMCs and the extensive geographic distribution of these SOEs. Second, the chances of receiving dividend distributions from these SOEs are remote. Third, since the capital market is

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32 “Asset Management Companies, A Tough Job Ahead”, p.2, Deutsche Bank Asia Equity Research
34 Yang Kai-seng, Economic Environment and Strategic Preference of China’s NPL Disposition, China Huarong Asset Management Corporation
under-developed, it will be difficult for the AMCs to sell their equity holdings in the private placement market. The two exit strategies for the AMCs are either to sell the equities back to the SOEs or to help these SOEs go public and then unload these equities in the stock market in the future.

Mr. Guo, a restructuring specialist from Cinda, revealed that the Ministry of Finance recently announced a new policy that the AMCs would be allowed to sell the equities acquired through the debt-equity swap transactions to the public at a discount. The discount sale might be subject to approval from the State Council. However, the new policy would be a scheme to make it easier for the AMCs to sell the equities back to the SOEs. Since the AMCs have no intention to keep the equities, the discount sale will be a convenient short cut for them to exit. If this is the case, one of the goals of using debt-equity swap, to diversify the ownerships of SOEs and establish the modern corporate structures could never be accomplished.

The Article 10 of the Regulations on Financial Asset Management Companies specifies that the AMCs can undertake the function of “listing sponsorship and bond/stock underwriting for companies within the scope of asset management” (Appendix I). As Dr. Yang Kai-seng put in a presentation: “We have got the approval from the China Regulatory Commission to undertake securities business. This provides us with a better standing to promote state-owned enterprises’ reform and realize the exit of our equity holding rights.” In December 2000, Jiugang Hongxin went public with Cinda as the listing sponsor and associate stock underwriter. In November 2001, Great Wall sponsored Yu Taibai to be re-listed in the Shenzhen Stock Exchange.
The AMCs’ roles as listing sponsor and securities underwriter are controversial. If the policy could be applied properly, it would speed up the asset recovering process and revitalize the SOEs through market forces. However, there is also conflict of interest for an AMC to act as the equity holder and the listing sponsors or securities underwriter for the same SOE. Using the stock market listing as an exit strategy, the AMCs could possibly transfer their holding risks to the public investors. In the case of Yu Taibai, Great Wall AMC acquired 57.36% of the equity of the company through debt-equity swap in 2000. The company had been de-listed in Shenzhen Stock Exchange for two years due to successive losses in the prior three years. After the debt-equity swap, the company went through a series of restructuring. In 2000, the company started to turnaround and even realized net earning of RMB 0.027 per share. In March 2001, the Great Wall AMC recommended Yu Taibai to be re-listed in the Shenzhen Stock Exchange and was approved by the CSRC. The extraordinary turnaround was accomplished through downsizing, asset restructuring, debt restructuring and tax refund. It is hard to tell now how sustainable these restructuring methods can be in keeping the company profitable in the following year. For Great Wall, however, the re-listing could be a very successful exit from this engagement if its holding shares could also be traded in the Stock Exchange.
Discounted Payoff

The SOBs are prohibited by law from accepting discounted payoff, but the AMCs are exempt from such restriction. Therefore discounted payoff has been one of the major NPL workout approaches for the AMCs. The AMCs have utilized all different means to force debtors to pay back at least part of the debt. For example, the debtor could be forced to dispose of some of its assets and use sale proceeds to pay back its loans; the AMCs could bring lawsuit against the debtor’s defaulted borrowers or customers with deeper pockets and use their payments to pay back the debtor’s loans; the AMCs could just waive the accrued interest and force the debtor to pay back the principal (Table 7).

Table 7: Discounted Payoff Case Study - Huarong AMC

<table>
<thead>
<tr>
<th>Company</th>
<th>Beijing Insulation Material Factory</th>
<th>Beijing Light Automobile Company</th>
<th>Shandong Lukang Pharmacy Group</th>
</tr>
</thead>
<tbody>
<tr>
<td>Location</td>
<td>Beijing</td>
<td>Beijing</td>
<td>Jinan</td>
</tr>
<tr>
<td>Outstanding Principal</td>
<td>RMB 17.8 million</td>
<td>RMB 30 million</td>
<td>RMB 30.9 million</td>
</tr>
<tr>
<td>Accrued Interests</td>
<td>RMB 137.4 million</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Collateralized OPB</td>
<td>RMB 0 million</td>
<td>RMB 0 million</td>
<td>RMB 0 million</td>
</tr>
<tr>
<td>Guaranteed OPB</td>
<td>RMB 17.08 million</td>
<td>RMB 30 million</td>
<td>RMB 30.9 million</td>
</tr>
<tr>
<td>Industry</td>
<td>Light Industry</td>
<td>Manufacturing</td>
<td>Pharmaceutical</td>
</tr>
<tr>
<td>Entity</td>
<td>SOE</td>
<td>SOE</td>
<td>JV</td>
</tr>
<tr>
<td>Agreed Recovery</td>
<td>RMB 13 million</td>
<td>RMB 36.87 million</td>
<td>RMB 25 million</td>
</tr>
<tr>
<td>Cash Received</td>
<td>RMB 13 million</td>
<td>RMB 6 million</td>
<td>RMB 15 million</td>
</tr>
<tr>
<td>Agreed Recovery %</td>
<td>76%</td>
<td>122%</td>
<td>80%</td>
</tr>
<tr>
<td>Cash Recovery %</td>
<td>76%</td>
<td>20%</td>
<td>48%</td>
</tr>
<tr>
<td>Resolution Method</td>
<td>Sued debtor’s defaulted borrowers and got payment to pay back debtor’s loan.</td>
<td>Waived accrued interest and got back principal.</td>
<td>Disposed of debtor’s assets and used proceeds to pay back loan.</td>
</tr>
</tbody>
</table>

The process, however, has been slow, with only 6.5% of NPLs foreclosed by the end of 2000 (Table 8). The NPLs disposition speeded up in 2001, with a total of 9.1% of assets disposed of in
the year. The average recovery rate of disposal for all four AMCs in 2001 was around 29%, which is in line with the AMCs’ earlier estimate (Table 8). It is worth noting that the nature of NPL workouts is such that the initial stages of the process are usually easier and become progressively more difficult because the best assets have been disposed of first and the more troubled remain in the portfolio. An interesting finding in 2001 is that the AMCs’ asset recovery rates were in reverse relationship to their disposing speed. For example, Huarong had the highest asset recovery rate of 53.9% but only disposed of 5.7% of total distressed assets. While Great Wall disposed of its asset at the fastest speed, 15.4% of the total, but it had the lowest asset recovery rate of 11.9%. It appears that Cinda achieved the best balance between the speed and the recovery rate because both its speed and recovery rate were around the average of the four AMCs (Table 9).

Table 8: Proportion of Acquired Assets Sold by Four AMCs by 2000

<table>
<thead>
<tr>
<th>RMB billion</th>
<th>Amount of NPL Acquired</th>
<th>Amount of Disposed</th>
<th>Proportion Disposed %</th>
<th>Recovery Rate of Disposal %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Huarong</td>
<td>407.7</td>
<td>7.9</td>
<td>1.9</td>
<td>42</td>
</tr>
<tr>
<td>Orient</td>
<td>267.4</td>
<td>18.8</td>
<td>7.0</td>
<td>NA</td>
</tr>
<tr>
<td>Great Wall</td>
<td>345.8</td>
<td>24.8</td>
<td>7.2</td>
<td>NA</td>
</tr>
<tr>
<td>Cinda</td>
<td>350.0</td>
<td>38</td>
<td>10.9</td>
<td>33</td>
</tr>
<tr>
<td>Total</td>
<td>1,370.9</td>
<td>89.5</td>
<td>6.5</td>
<td>NA</td>
</tr>
</tbody>
</table>

Source: Deutsche Bank Research Estimates

Table 9: Proportion of Acquired Assets Sold by Four AMCs in 2001

<table>
<thead>
<tr>
<th>RMBbn</th>
<th>Amount of NPL Acquired</th>
<th>Amount of Disposed</th>
<th>Proportion Disposed %</th>
<th>Recovery Rate of Disposal %</th>
<th>Cash Recovery Rate %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Huarong</td>
<td>407.7</td>
<td>23.2</td>
<td>5.7</td>
<td>53.9</td>
<td>32.5</td>
</tr>
<tr>
<td>Orient</td>
<td>267.4</td>
<td>18.2</td>
<td>6.8</td>
<td>46.5</td>
<td>24.2</td>
</tr>
<tr>
<td>Great Wall</td>
<td>345.8</td>
<td>53.1</td>
<td>15.4</td>
<td>11.9</td>
<td>7.0</td>
</tr>
<tr>
<td>Cinda</td>
<td>350.0</td>
<td>29.9</td>
<td>8.5</td>
<td>28.0</td>
<td>35.1</td>
</tr>
<tr>
<td>Total</td>
<td>1,370.9</td>
<td>124.4</td>
<td>9.1</td>
<td>28.7</td>
<td>21.0</td>
</tr>
</tbody>
</table>

Loan Pool Sale

In November 2001, Huarong held its first NPL portfolio auction in Beijing. The World Bank’s International Finance Corporation (IFC) pledged to provide a financing package of up to US$ 50 million but no more than 40% of the total project cost to the winning bidder to purchase the NPL portfolio. An international consortium led by Morgan Stanley purchased four out of five pools of assets offered for sale, with a total outstanding principal balance of RMB 10.8 billion. The portfolio comprised loans to 254 borrowers from 18 cities and provinces throughout China. This was the first NPL portfolio sale from a Chinese AMC to foreign investors.

According to Mr. Wang, a senior executive from Huarong, the deal structure includes following components (Figure 1): (a) Morgan Stanley purchased 65% of the total loan portfolio from Huarong at 10% of the face value, i.e. Morgan Stanley’s up-front payment to Huarong amounting to RMB 702 million. (b) The net recovery proceeds from the remaining 35% of the loan portfolio would be shared by Morgan Stanley and Huarong at a split of 65%:35%.
Through the sensitivity analysis, it is evident that the deal structure provided Huarong with a downward protection while allowing it to participate marginally in the upward potential (Table 10). “The deal is structured in a way that allows Huarong to participate in the value we create as partners,” said Mr. Dave Bednar, Managing Director of Morgan Stanley’s Real Estate Investment Fund.

**Table 10: Return Sensitivity Analysis**

<table>
<thead>
<tr>
<th>Total Recovery Rate</th>
<th>Huarong Guaranteed Return</th>
<th>Huarong Un-guaranteed Return</th>
<th>Huarong Total Return</th>
<th>Morgan Stanley Return before Workout Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>6.5%</td>
<td>1.23%</td>
<td>7.73%</td>
<td>2.28%</td>
</tr>
<tr>
<td>20%</td>
<td>6.5%</td>
<td>2.45%</td>
<td>8.95%</td>
<td>11.05%</td>
</tr>
<tr>
<td>30%</td>
<td>6.5%</td>
<td>3.68%</td>
<td>10.18%</td>
<td>19.83%</td>
</tr>
<tr>
<td>32%</td>
<td>6.5%</td>
<td>3.98%</td>
<td>10.48%</td>
<td>22.02%</td>
</tr>
<tr>
<td>40%</td>
<td>6.5%</td>
<td>4.90%</td>
<td>11.40%</td>
<td>28.60%</td>
</tr>
<tr>
<td>50%</td>
<td>6.5%</td>
<td>6.13%</td>
<td>12.63%</td>
<td>37.38%</td>
</tr>
<tr>
<td>54%</td>
<td>6.5%</td>
<td>6.62%</td>
<td>13.12%</td>
<td>40.88%</td>
</tr>
<tr>
<td>60%</td>
<td>6.5%</td>
<td>7.35%</td>
<td>13.85%</td>
<td>46.15%</td>
</tr>
<tr>
<td>70%</td>
<td>6.5%</td>
<td>8.58%</td>
<td>15.08%</td>
<td>54.93%</td>
</tr>
</tbody>
</table>

From the return sensitivity analysis, it is also obvious that Morgan Stanley is bearing a much higher downward risk than Huarong because it has a much larger spread of total return based on a recovery range from 10% to 70%. The international consortium led by Morgan Stanley also includes Lehman Brothers, Salomon Smith Barney, and KTH Capital Management, Ltd., with Morgan Stanley as the general partner and the rest as limited partners. The partnership helped Morgan Stanley to share risks with other firms in the first ever NPL deal in China. As the first mover, Morgan Stanley was not motivated to make easy profit from this deal. The more important strategic consideration was to understand China’s NPL market.

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35 Quoted from Finance Asia.com, Morgan Stanley in Biggest Yet International NPL deal with China Huarong, 12/02
The IFC’s financing package not only allowed Morgan Stanley to mitigate some risks but also served a much broader purpose. According to Ms. Reng from the IFC Beijing Office, the purpose of IFC’s support to this auction is to encourage a transaction that is fair, transparent, and follows international best practices. It would set a precedent for future sales and help provide much needed momentum to the development of the NPL market in China. IFC’s role would contribute to encourage foreign participation, increase competition, restructure assets and help develop a local NPL market.

Prior to this NPL portfolio auction, Huarong’s average asset recovery rate was 54% in 2001 according to the International Finance Report 2001-2002. Assuming the same 54% recovery rate to be realized in this case, Huarong’s willingness to accept a 13.12% return and forego 40.88% to foreign investors may seem surprising at first glance (Table 10). However, such willingness may be attributable to several factors.

First, the published recovery rate could be overstated. The reported asset recovery rate sometimes is an accrued number with a significant portion of total recovered amount paid in the following years or promised to be paid later. The longer the lead time is, the more uncertain the realization of these payments. The reported asset recovery is also the sum of the realty and other goods recovered and the total cash recovered. The recovered properties have to be converted to cash through auctions, mostly at deep discount. To be conservative, the cash recovery rate might be a more realistic number for comparison in this case. In 2001, Huarong’s reported cash recovery rate was 32.5% before deducting workout expenses. If we apply this rate in the

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sensitivity analysis and assume 2% workout expenses, Huarong actually would give up only 20% potential return to foreign investors (Table 10). Second, loan portfolio sales to foreign investors could speed up the disposing speed and thus avoid the evaporation of asset value. It is, in fact, a price issue between wholesale and retail. Huarong already received the up-front payment which could potentially be used to boost its overall return if invested prudently. Third, by selling the NPL portfolio, Huarong could share the risk with foreign investors and save substantial workout expenses from the deal. Finally, without giving up a lion’s share of return to the foreign investors, it would be very hard to attract foreign capitals to China’s much riskier NPL market as compared to other Asian countries.

Chart 4:

![Return Distribution Between Huarong and Morgan Stanley](chart)

The 32% cash recovery rate, however, is a benchmark for Huarong’s return in this deal. It may not apply to Morgan Stanley because a 20% of return could not justify the opportunity cost of Morgan Stanley’s real estate investment fund given the fact that it had to bear very high risks in
an uncertain market such as China. However, if Morgan Stanley were to achieve a recovery rate above 50%, its return would be three times that of Huarong. At such rate the risk is justified (Chart 4). In this case, a higher recovery rate than Huarong’s average cash recovery rate of 32.5% is feasible. First, the quality in the sold loan portfolios was higher than that of Huarong’s overall NPL pool. Even though it was denied by Huarong personnel, some resources still showed that about 40%–60% of the NPL portfolios sold in this deal were collateralized. Collateralized NPLs tend to have a higher recovery rate (Chart 5). If we arbitrarily assign the uncollateralized NPLs half and half to the credit and guaranteed loan, we get recovery rate ranging from 33.7% to 55.1% (Table 11, 12). Following such scenario, Morgan Stanley’s expected return from this deal will range from 20% to 40% (Table 10 and Chart 4). Second, the personnel at Morgan Stanley are more motivated and experienced in loan workout. The KTH Capital Management, one of the partners of the consortium, is in charge of loan workout. Mr. Wang, the head of KTH, is an experienced NPL workout expert. Dr. Li, a Managing Director of KTH, said in an interview: “We put in our own capital, so we have to do it right.”

Chart 5:

![Chart 5: Asset & Cash Recovery Rate](chart5.png)

Source: Huarong Analysis of Asset Resolution & Case Studies
Despite the uncertainty in the actual return of the NPL portfolio investment in China, more foreign investors have followed Morgan Stanley’s lead in similar investments. In December 2001, a Goldman Sachs sponsored investment fund agreed to purchase from Huarong a NPL portfolio with a total face value of approximately RMB 2 billion. Morgan Stanley has negotiated to purchase another NPL portfolio from Cinda.

**Individual Asset Auction**

Auction is another major NPL disposal approach, especially for individual real estate properties and other assets such as vehicles and equipments. These properties are collaterals for loans or recovered assets from the loan workout. During a ten-day auction in May 2002, Cinda offered 304 individual items with a total book value of RMB 2.4 billion to the public investors. 160 items with a face value of RMB 1 billion were actually sold for RMB 400 million[^37]. Started from

[^37]: Wall Street Journal, May 28, 2002
July 2002, Huarong also invited bids for its distressed real estate assets located in Beijing, Shanghai, Shenzhen, Chengdu and Baotou.

Auction could be an effective way to dispose of distressed assets because it fully utilizes the supply and demand relationship and creates competition among buyers. The sale price could mostly reflect the market value of the property. But if there is an oversupply of the distressed assets in the market with limited investors, the price could be devastating. The AMCs have realized this problem and are trying to control the flow of the properties to the market in order to maximize the recovery rate. The buyers, however, could still deflate significantly the real value of assets currently offered in the market because they anticipate more inventories to come to the market and would rather wait for bargains.

**Securitization**

In February 2001, Huarong invited the Korea Asset Management Corporation (KAMCO) to act as the special advisor on a proposed asset-backed securities deal. Not many details of this deal are available for analysis at this stage. However, some securitization deals accomplished by Huarong’s counterparts in Asia can help us understand the transaction and the difficulties facing China’s NPL securitization.

The RTC case proved that securitization could be a useful tool in dissolving NPLs (Appendix II: RTC Case Study). However, it was not until late 1999 that securitization of NPLs became a reality in Asia. In November 1999, Morgan Stanley launched and priced a JPY 21 billion issue of floating rate structured notes for a special purpose vehicle (SPV) called International Credit
Recovery – Japan One Ltd., a Cayman Islands-domiciled company. This was the first time a capital markets solution had been applied to the NPL problem. The deal was backed by NPLs, relating to a total of 700 real estate assets of various types located throughout Japan purchased by Morgan Stanley over time. The real miracle that securitization did to NPLs is not to turn bad apple into good apple but to slice the good portion of the bad apple to sell to outsiders and retain the bad part for the originators. Most NPLs securitization has been supported by substantial over-collateralized or subordinated interests retained by the originators. In June 2001, KAMCO launched a securitization of NPLs with a total value of US$367 million in international market. The deal is supported by portfolios incorporating recourse provisions to each of the originating Korean banks in the form of series of put options, that is, the options of buying back NPL when it defaults.

A successful securitization structure requires the establishment of SPCs (the Special Purpose Corporations – the actual issuers of the securitization products), the “true-sale” of the underlying assets from the originator to the SPC, tax exemption for the asset transfer to the SPC and most important, the support from a well-established market infrastructure in terms of legal, tax and accounting systems. However, China’s legislation does not have securitization guidelines and it is not clear whether the special purpose corporations would be subject to corporate and withholding tax. The possible outcome of China’s securitization deal would be quasi-securitization that is designed to circumvent these hurdles.
CHAPTER SIX: UNSOLVED PROBLEMS

Who Is Going To Bear All the Losses Eventually?

A crucial feature of the purchase of NPLs by the AMCs is that the NPLs were transferred at face value. As a result, assets have been transferred at valuations not set by reference to any market. The truth is no matter which workout approach is used and how effective it is, there is always a big gap between the face value and the recovered value. When the AMCs were formed, it was an unsettled issue as to who is eventually going to bear the losses. Certainly, it will not be the SOBs. They unloaded a large portion of their NPLs by converting the distressed assets into bonds to AMCs implicitly guaranteed by the government. Furthermore, the SOBs also received interest payments from the AMCs based on the face value of transferred NPLs. The SOBs are very much bailed out by the government in the whole AMC scheme. It will not be the AMCs to bear the losses either because they only have ten-year duration. The AMCs’ supervising structure suggests that the Ministry of Finance would possibly bear the losses at the end. The Ministry of Finance is responsible for the AMCs’ administration. If the AMCs are ultimately liquidated, the Ministry of Finance, which is supposed to bear the consequences of their operation, has to take over the AMCs’ bond liabilities to the SOBs. Then the loss resulted from the gap between the face and the recovered value of transferred NPLs would eventually be borne by the government from the fiscal budget. Then the whole scheme would be essentially equivalent to another recapitalization of the SOBs.
Moral Hazards

The one-to-one relationship between a parent SOB and an AMC might be helpful for the collaboration. However, it is likely that the parent SOB would perceive the AMC to be an outlet to which it can transfer more NPLs in the future. If the government could not make a commitment that the current NPL transfer is a once-off policy, the SOB would treat its AMC as a government agency that implicitly insures its lending activities. As a result, the SOB would be lenient both in managing the risk of commercial portfolio and in making new loans on a commercial basis. As a result, new NPLs could again mount up in the SOBs’ balance sheets.

If the government could not commit definitely that the debt-equity swap is a once-off policy, more SOEs may strategically default. Although the objective of this reform was to improve the capital structure of debt-burdened SOEs, the new instrument may actually encourage even profitable SOEs to stop paying interests on the bank loans so that they, too, qualify for debt relief.

If these problems are not resolved, the existing NPL issue will not be dealt with effectively but more frequently, new NPLs will be encouraged through soft lending by the SOBs and strategic default by SOEs. The AMCs will be forced to take on more NPLs over time as the government will re-capitalise the SOBs again and again. Such a vicious cycle will entrench moral hazard problems and guarantee continuing deterioration of the Chinese banking assets38.

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38 John P. Bonin and Yiping Huang, Dealing with the Bad Loans of the Chinese Banks, Working Paper Number 357, 01/2001, Wesleyan University and Australian National University
China’s Immature Capital Market

A well-functioning capital market that includes the mechanisms for efficient capital allocation as well as good corporate governance may strengthen industries and individual companies by weeding out the under-performers. A mature capital market may also be conducive to solving problems such as the NPL issue. Even though China’s capital market has experienced enormous growth since 1980s, it has not been mature enough to accomplish all these goals. There are four major problems facing China’s capital markets. First, the capital market is still too small to absorb the large amount of household and institutional capitals. The numbers from the Flows of Funds Accounts in 1999 (Table 12) provides us with a general picture of the fund flow in China. In 1999, about 75% of household savings in addition to corporation funds were deposited in banks with 70% of these capitals were lent to corporations, 10% to household and another 10% being invested in government bonds. The other 25% of household savings have been invested in government bonds (16%) and stock market (9%). Even though only about 9% of household savings are put in the stock market, many stocks are still over-priced partially due to the relatively large amount of capital chasing the small amount of stocks. There were only 1,116 companies listed in A-share market and 113 in B-share market in 2001.
Table 12: Flow of Funds Accounts in China, 1999 (unit: RMB billion)

<table>
<thead>
<tr>
<th></th>
<th>Households</th>
<th>Corporations</th>
<th>Government</th>
<th>Financial Institutions</th>
<th>Foreign Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Dr.</td>
<td>Cr.</td>
<td>Dr.</td>
<td>Cr.</td>
<td>Dr.</td>
</tr>
<tr>
<td>Deposits</td>
<td>728</td>
<td>505</td>
<td>92</td>
<td>-79</td>
<td>1,340</td>
</tr>
<tr>
<td>Loans</td>
<td>132</td>
<td>914</td>
<td>27</td>
<td>293</td>
<td>1,102</td>
</tr>
<tr>
<td>Bonds</td>
<td>162</td>
<td>10</td>
<td>1</td>
<td>124</td>
<td>278</td>
</tr>
<tr>
<td>Government Bonds</td>
<td>153</td>
<td>93</td>
<td>1</td>
<td>124</td>
<td>278</td>
</tr>
<tr>
<td>Stock</td>
<td>88</td>
<td>15</td>
<td>321</td>
<td>321</td>
<td>321</td>
</tr>
</tbody>
</table>

Source: The People’s Bank of China Quarterly Statistical Bulletin, (As only major items are included, total per department and item may not correspond.

Second, the stock market also suffers from the low liquidity due to the distinction between tradable and non-tradable shares. Stocks in China can be classified into four categories by the type of shareholder: state shares (government-owned), corporate entity shares, employee-owned shares, and general public shares. Among them, only general public shares, accounting for 40% of the total, are listed and traded. State shareholdings accounts for nearly 40% of the total number of shares. The government has introduced a plan to release such state-owned shares for open trading in order to enhance market liquidity. Since June 2002, the plan has been suspended in response to complaints from various market participants that the scheme had caused a sharp decline in stock prices.

Third, the whole capital market is fragmented artificially. In the stock market, the listed shares are divided into A, B and H shares. A shares are denominated in RMB yuan and issued in China, with a market capitalization of about RMB 4.5 trillion. B Shares are denominated in foreign currencies and issued in China with a market capitalization of RMB 121.3 billion. B shares were originally sold exclusively to foreign investors and were made available to domestic individual investors in February 2001. H shares are denominated in Hong Kong dollars and issued in Hong Kong. Company traded in more than one market could have very different stock prices in each
market. For example, the stock price of A share of Jiangling Motors is almost four times of that of B shares in early February 2001. The market fragmentation contributes to the price distortion and speculative tenor of the market.

Fourth, the stock market is lack of adequate supervision and control. The Chinese stock market has serious problems such as inadequate disclosure of corporate information and existence of a host of illegal practices. Since the beginning of 2001, the CSRC has started to go after illegal activities and promote transparency. But it will take a long time for the CSRC to establish a sophisticated supervisory system and for the market to foster a culture of ethics.

Given the fact that the capital market in China is not mature enough, it would be difficult for the AMCs to utilize the capital market to solve the NPL problem, either through IPOs of SOEs or through securitization of NPLs. The AMCs have been granted the right of listing sponsorship and bond/stock underwriting for companies within the scope of asset management. However, even if the AMCs could successfully list SOE in the stock market, it would be difficult for them to unload the shares because most of these shares would be state-owned shares which are not tradable in the stock market at present. In terms of securitization, unless the government cleans up all the legal obstacles and establishes a modern accounting system quickly, the securitization as an effective tool for dissolving NPL will not be realized soon.

**AMCs’ Structural Problems - Competitions, Incentives and Skills**

The AMCs are temporary financial institutions with multiple roles to play during their ten-year duration. The inherent structural problem of the AMCs can significantly hamper their efficiency
and effectiveness. First, competitions among AMCs could be destructive in the workout process. Each AMC has been established to take on NPLs from one parent bank. In many cases, a debtor defaulted to more than one bank and thus is liable to more than one AMC. Each AMC has the same goal in the workout process, that is, to maximize the recovery rate. Their strategies and means, however, could be very different, thereby bringing conflicts and causing delays in the workout process.

Second, the AMCs are structured as SOEs with most employees transferred from the parent banks. Working for a SOB has been the most desirable profession in China’s job market because of the high job security and excellent benefits. Being transferred from a bank to a company with only ten-year lifetime is equivalent to a pending unemployment for a lot of transferees. The unsecured job prospect could considerably dampen down the AMC employee incentive to divest the distressed assets quickly. Although some AMCs have developed incentive schemes to stimulate employees’ efforts, it is unclear how these will be sufficient to overcome the problem of employment insecurity.

Third, although the AMCs are expected to engage in a broad range of financial activities, e.g., loan recovery, venture capital activities, strategic consulting and investment banking, their employees lack the necessary skills to fulfill these tasks. John Bonin, a professor from Wesleyan University, said in his working paper “Dealing with the Bad Loans of the Chinese Banks”, “after five months of operation, Cinda already suffers from two labor problems, redundant workers and the lack of necessary skills in its labor force”39. A staff member from one of the AMCs said in an

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39 John P. Bonin and Yiping Huang, Dealing with the Bad Loans of the Chinese Banks, Working Paper Number 357, 01/2001, Wesleyan University and Australian National University
interview: “the kind of work we are doing requires high quality and committed professionals. But we do not feel secured in our positions”.

Legal Enforcement of Rights

The lack of an effective insolvency system will be a major issue for NPL investors who have to deal with SOEs in China. First, the government administrative department with responsibility for the SOE has the power to veto the bankruptcy, thereby depriving creditors of their rights or at least indefinitely delaying enforcement. Even if an SOE is successfully declared bankrupt and placed in the hands of a court-appointed liquidation committee, that committee will mainly comprise government staff, who lack the incentive and knowledge to deal effectively with the liquidation of an SOE’s assets. The bankruptcy system places creditors at a further disadvantage by requiring that an SOE’s legal obligations to its employees be placed before obligations to creditors. Moreover, at all stages of the bankruptcy process, there is tendency for local protectionism to prevail, especially in the context of an SOE, making results highly unpredictable.

In theory, recourse to China’s courts is available. Under the Chinese law, a creditor can generally request the court to enforce its rights within two years of the date when a debt falls due and is unpaid. If the debt remains unpaid and creditor takes the matter to court, it will generally take

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40 The Bankruptcy Law, Art. 34.
41 David Pierce and Lawrence Yee, China’s Bank Asset Management Companies, p.11, O’Melveneny & Myers LLP
about nine months for the Chinese court to reach a decision and hand down a judgment. Once a judgment is obtained, difficulties may arise with regard to enforcement of such judgment.\footnote{David Pierce and Lawrence Yee, China’s Bank Asset Management Companies, p.11, O’Melveneny & Myers LLP}

Although on an application for enforcement against a debtor, a Chinese court has a number of sanctions available, such as ordering the freezing and transfer of the debtor’s assets, attachment of the debtor’s income, delivery to the court of certificates of title and forced sale or auction of a debtor’s property, the enforcement process tends to be protracted and depends heavily on the proper exercise of judicial discretion. The present bankruptcy system, which has rarely been invoked in practice, is subject to administrative interference and large amount of discretion is vested in judges who may be subject to local influences.\footnote{David Pierce and Lawrence Yee, China’s Bank Asset Management Companies, p.11, O’Melveneny & Myers LLP}
CHAPTER EIGHT: CONCLUSION

NPLs are the cancer in the banking system. Initially, NPLs may not seem to have serious negative effects. Banks remain liquid, and depositors retain their confidence in the system. Over time, however, the size of the problem grows. Eventually, the efficiency of the banking system is comprehensively undermined, as the task of making new loans to productive enterprise takes second place to juggling a portfolio of bad loans with low collectibility. The fiscal cost of cleaning up the banking system can become so large as to be itself an obstacle to needed action.

NPLs are essentially a product of the irrational allocation of resources. China has a NPL issue primarily resulting from a transitioning economy dominated by the triangular relations of state-owned enterprises (SOEs), state-owned commercial banks (SOBs) and the fiscal policy. Other causes include real estate bubbles in 1990s, underdeveloped credit culture and institutional infrastructure. It is not clear what the exact amount of China's NPLs is due to the lack of transparency in the banking sector. The estimated number is around 30% of total outstanding loans of SOBs in 1999. The number looks intimidating at the first glance, however, it is certain that the NPL problem in China will not lead to an immediate financial crisis as it is more a stock problem than a flow one. However, the huge amount of overhanging bad debts has become one of the bottlenecks for China's further reform, particularly, in the banking sector.

The establishment of four Asset Management Companies (AMCs) was an innovative approach to provide an instant relief of the bad debt burden of SOBs, to recover distressed assets as well as to restructure SOEs. The AMCs have been continuously seeking new NPL workout approaches and
made substantial progress. A series of workout approaches have been introduced including debt-equity swap, discount payoff, loan pool sale and property auction. By 2001, including debt-equity swap transactions, the AMCs have finished the workout of about 46% of the total NPLs they took on from SOBs. The process, however, will become increasingly difficult because the high quality assets have been disposed of first and the more troubled ones still remain in the portfolio. Furthermore, if the government cannot make a creditable commitment that the current NPL transfer and debt-equity swap is a once-off policy, new NPLs will be encouraged through soft lending by the SOBs and strategic default by the SOEs. There are also several obstacles ahead to the AMCs including China’s immature capital market, AMCs’ internal structural problems as well as China’s weak legal enforcement mechanism.

The AMCs would be able to accomplish their goal eventually with more workout approaches introduced and much improved skills. More important is that the Chinese government has learned lessons from its neighboring countries and made a great commitment to tackle the NPL problem not only from the surface but also from the fundamental structure, evidenced by its efforts to improve the corporate governance of SOEs and business infrastructure. China’s accession to the WTO in 2001 will further force the government to seriously reform the banking sector in order to build up the competitive advantage to face the imminent competition from foreign banks. With more international practices introduced and corporate governance improved, China’s banking system should be more resilient and healthier in the near future. The AMC scheme would hopefully be a once-off prescription.
Appendix I: Regulations on Financial Asset Management Companies (November 20, 2000)

Chapter I: General Provisions

Article 1: The formulation of these regulations aims to standardize the behavior of financial asset management companies, handle bad loans by state-owned banks according to law, and promote the reform and development of state-owned banks and state-owned enterprises.

Article 2: A financial asset management company refers to a solely state-owned non-bank financial institution, which, established at the approval of the State Council, purchases bad loans of state-owned banks, manage and handles assets formed through the purchase of bad loans from state-owned banks.

Article 3: The principal operational goal of financial assets management companies, which independently bear civil responsibility according to law, is to maximally preserve assets and reduce losses.

Article 4: The People’s Bank of China (PBOC), the Ministry of Finance and China Securities Regulatory Commission (CSRC) execute supervision and administration of financial asset management companies, each within the scope of its official duty.

Chapter II: Company Establishment and Business Scope

Article 5: The registered capital of a financial asset management company is 10 billion renminbi (US$1.2 billion), which shall be approved and allotted by the Ministry of Finance.
Article 6: A financial asset management company must obtain the legal person license for a financial institution from the PBOC and must register at the administration of industry and commerce according to law.

Article 7: A financial asset management company must obtain the approval of the Ministry of Finance to set up branches. Meanwhile, it must apply to the PBOC for the operation license for a financial institute, and register at an administration of industry and commerce according to laws.

Article 8: A financial asset management company shall have one president and several vice presidents, all of whom shall be appointed by the State Council. The president exercises his or her power on behalf of the financial asset management company and takes charge of the company’s operation and management. The qualifications of the high-ranking officer of a financial asset management company must be examined by the PBOC.

Article 9: The composition, duties and work procedures of the board of supervisors and a financial asset management company must conform with the “Interim Provisions on the Board of Supervisors in Key State-owned Financial Institutions.

Article 10: While managing and handling assets formed by bad loans purchased from state-owned banks, a financial asset management company may undertake the following functions:

1. Recovery of debt;
2. Leasing or transferring and reorganizing the assets formed with purchased bad loans in other forms;
3. Debt-equity swap, and holding enterprise equity for a certain period of time.
4. Listing sponsorship and bond/stock underwriting or companies within the scope of asset management;
5. Issuing financial bonds and asking for loans for financial institutions;
6. Financial and legal consulting, and assets and project appraisal, and
7. Other businesses approved by the PBOC and CSRC;
8. A financial asset management company may apply to the PBOC for a new loan.

Chapter III: Scope, Amount and Capital Source for Purchasing Bad Loans

Article 11: A financial asset management company purchases bad loans of state-owned banks according to the scope and amount stipulated by the State Council. Purchase beyond the stipulated scope and amount shall be submitted to the State Council for special examination and approval.

Article 12: Within the amount stipulated by the State Council, a financial asset management company purchases at book value related loan principal and corresponding interest claims receivable charged to profit and loss. Interest claims receivable not charged to profit and loss shall be transferred without compensation.

Article 13: Having purchased the bad loans, a financial asset management company acquires all rights of the original creditor over the debtor. The debtor, guarantor and parties concerned in the original loan contract shall continue to fulfill their obligations as stipulated by the contract.

Article 14: Sources of funds for a financial asset management company to purchase bad loans include the following:

1. Transfer of part of the loans issued to solely state-owned commercial banks by the PBOC.
2. Issuance of financial bonds.

The PBOC loans to solely state-owned commercial banks, when being transferred to a financial asset management company, shall have a fixed annual interest rate of 2.25%.
**Article 15:** The issuance of financial bonds by a financial asset management company shall by subject to the examination and approval of the PBOC and the Ministry of Finance.

Chapter IV: Debt-Equity Swap

**Article 16:** A financial asset management company may swap the creditor’s rights obtained from purchasing the bad loans of state-owned banks for equities from the borrowing enterprises. The equity holding of a financial asset-management company is not limited by its net asset value or registered capital.

**Article 17:** The debt-equity swap shall accord with the state’s industrial policies and facilitate the optimization of economic structure and the related enterprise’s technical progress and product upgrading.

**Article 18:** The State Economic and Trade Commission (SETC) shall recommend enterprises to a financial asset management company for debt-equity swaps. The financial asset management company conducts an independent evaluation and examination of the recommended enterprises, drafts a plan for the debt-equity swap and signs the swap agreement with the enterprise. The debt-equity swap plan and agreement shall be subject to the examination of the SETC, the Ministry of Finance and the PBOC, and the implemented at the approval of the State Council.

**Article 19:** Enterprises that practice the debt-equity swap shall transform their operational mechanism, establish a standardized structure featuring the governance by corporate legal person, and enhance enterprise management according to the requirement of the modern enterprise system. Local government shall assist enterprises in cutting payroll, increasing returns, diverting the laid-off workers and freeing the enterprises from extra social functions.
Article 20: Following the debt-equity swap, a financial asset management company, as a shareholder of the enterprise, may dispatch personnel to join the enterprise’s board of directors and board of supervisors to exercise their shareholder rights according to law.

Article 21: Enterprise equity held a financial asset management company may be transferred to domestic and overseas investors according to related regulations or re-purchased by the enterprises involved in the debt-equity swap according to law.

Article 22: After the enterprise implements the debt-equity swap, it shall register the changes in its property rights according to the related regulations.

Article 23: The SETC is responsible for the organization, guidance and coordination of the debt-equity swap.

Chapter V: Company Operation And Management

Article 24: Financial asset management companies shall adopt the responsibility system for operational objectives. The Ministry of Finance Determines the operational objectives for handling bad loans by financial asset-management companies according to the quality of the bad loans, and carries out the evaluation and supervision.

Article 25: Financial asset management companies shall make operational policies and related measures in accordance with the characteristics of the bad loans, improve internal management, and establish internal restriction and motivation mechanisms.

Article 26: Financial asset management companies shall manage and handle assets formed with the bad loans purchased from state-owned banks in accordance with the best principles of openness, competition and selection.
Financial asset management companies shall transfer assets primarily through bidding and auction.

If the financial claims of a financial asset management company cannot be paid off, due to such reasons as the debtor’s bankruptcy, matters shall be handled according to the regulations of the state council.

The Ministry of Finance shall draft procedures concerning the management and handling of assets by finance asset management companies.

**Article 27:** Financial asset management companies may, if necessary, invite qualified intermediary institutions to take part in accounting, assets appraisal and legal services.

**Article 28:** Financial asset management companies are exempt from taxes in their purchase of bad loans from state-owned banks, or in their undertaking and handling of assets formed with the bad loans purchased from state-owned banks. Specific procedures shall be drafted jointly by the Ministry of Finance and the State Administration of Taxation.

Financial asset management companies shall be exempt from administrative charges such registration fees at the administration of industry and commerce.

**Article 29:** Financial asset management companies shall submit financial and statistical reports as well as other related materials in accordance with the requirements of the PBOC, the Ministry of Finance, the CSRC and other related departments.

**Article 30:** Financial asset management companies shall accept the auditing supervision of auditing authorities according to law.

Financial asset management companies shall invite certified public accountants authorized by the Ministry of Finance to conduct annual audits of their financial status, and submit the auditing report to the supervisory and administrative departments.
Chapter VI: Termination and Liquidation

**Article 31:** At the termination of a financial asset management company, the Ministry of Finance shall organize a team to conduct the liquidation.

**Article 32:** For the financial losses incurred during the handling of the bad loans by the financial asset management companies, the Ministry of Finance shall propose a solution to be executed at the approval of the State Council.

Chapter VII: Supplementary Provisions

**Article 33:** Financial asset management companies violating financial laws and administrative regulations shall be penalized by the PBOC in accordance with the “ Procedures on the Punishment of Unlawful Financial Practices” and related laws. Those breaking other laws and administrative regulations shall be penalized by the relevant departments according to law. Those whose activities constitute a crime shall face criminal responsibility.

**Article 34:** The Regulations shall take effect as of the date of promulgation.
Appendix II: Case Study-The Resolution Trust Corporation (RTC) and S&L Crisis in U.S.

In the 80’s U.S. Savings and Loans had been released from the bonds of regulated interest rates, and given new powers to make commercial and consumer loans beyond the boundaries of their traditional mortgage lending functions. These powers gave them the ability to compete with banks and money market funds for deposits, and make higher yielding loans in order to offer higher yields on deposits. The problem was that many of them were small, relatively unsophisticated financial services companies, with little experience in the types of lending they had undertaken. When the market took a dive, the lack of experience, overly aggressive lending policies, and fraudulent use of depositor funds were exposed. The U.S. taxpayers, via the Resolution Trust Corporation (RTC), funded the bailout.

The RTC was created in 1989, through the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), which created the RTC to 1. Manage and resolve the affairs of failed institutions, 2. Maximize the return on the sale or other disposition of institutions, 3. Operate in such a way as to minimize the impact on local real estate and financial markets and 4) minimize the loss to the U.S. government from failed institutions. In addition, it was required to maximize the preservation of the availability and affordability of housing for low and moderate income individuals. It was given a seven year life to accomplish its goals.

The RTC had a number of tools at its disposal – it was authorized, for example to use seller financing, which means the RTC provided the purchase money loans to purchasers of real estate owned by the thrifts as a result of foreclosures. In the case of performing loan portfolios, the
RTC would issue asset-backed securities. They also had the right to auction properties and loans to private investors.

The RTC created a precedent for the sale of non-performing loan assets by banks and thrifts, as well as for the securitization of commercial real estate loans. The non-performing loans were sold on a discounted basis to Wall Street Investors who would hold the assets until they could be sold at profit, or to other companies who specialized in cleaning up the loans and then re-selling or securitizing them at a profit. The primary benefits for the banks were to reduce their ratio of non-performing assets, convert non-earning assets to cash, and eliminate cost for work out the problem loans. This allowed relatively sound thrifts to recover and rebuild.
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Orient AMC: http://www.coamc.com.cn/

Interview:

Dai, Liping          China Construction Bank
Fan, Qiaoling       China State Administration of Taxation
Guo, Jingchun       China Cinda Asset Management Company
Hu, Shuiwen          China State Administration of Foreign Exchanges
Li, Vivian Ding     KTH Capital Management Ltd.
Li, Yameng           Agriculture Bank of China
Liang, Liyang       Xiamen International Bank
Ren, Li              International Financial Corporation
Sheng, Liurong      China Construction Bank
Southergill, Bryan   Morgan Stanley Dean Witter Asia Limited
Wang, Hong,          School of Economics & Management, Tsinghua University
Wang, Wenjie        China Huarong Asset Management Company
Zhang, Chunlin      World Bank, Beijing Office
Zhang, Lu            People’s Bank of China
ABBREVIATION

ABC: Agricultural Bank of China
AMC: Asset Management Company
BOC: Bank of China
CCB: China Construction Bank
CSRC: China Securities Regulatory Commission
GDP: Gross Domestic Product
ICBC: Industrial and Commercial Bank of China
IFC: International Financial Corporation
NPL: Non-performing Loan
POBC: People’s Bank of China
SETC: State Economic and Trade Commission
SOB: State Owned Bank
SOE: State Owned Enterprise
SPV: Special Purpose Vehicle
WTO: World Trade Organization