

A study on Non-performing Loans of China's Major Commercial Banks

—Evolution, Resolution and Control—

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In recent years, along with the rapid development and the reform of state-owned commercial banks (SOCBs), there has been remarkable progress in resolution of Non-performing loans (NPLs) of SOCBs and other commercial banks.

There are very important relations between the reform of SOCBs and the development of NPLs as well as the policy regarding the NPLs. Since 2004, the 3 major SOCBs, i.e. China Construction Bank (CCB), Bank of China (BOC) and Industrial and Commercial Bank of China (ICBC) have restructured into state-controlled share-holding commercial banks and CCB has listed in Hong Kong security market in 27 October, 2005 and BOC has listed in Hong Kong and Shanghai security markets in 1 June, 2006 and 5 July, 2006 respectively. ICBC has listed in Hong Kong and Shanghai security markets in 27 October, 2006 according. According to the financial reports, the share of state owned in the three banks is about 80%, so they are not so-called state-owned commercial banks. They should be called state controlled share-holding commercial banks. So far, only China Agricultural Bank is still SOCB. In order to restructure the SOCBs and meet the requirements for listing in security markets, China government had made great efforts to separate the NPLs from SOCBs before 2006. Compared with the situation before restructure, the ratio of NPLs of SOCBs decreased remarkably. According to the data from the China Banking Regulatory Commission (CBRC), the ratio of SOCBs is 9.47% by the end of June 2006. The ratio of three restructured SOCBs is about 5%. However, if taking account the NPLs that transferred to the four state-owned Asset Management Companies (AMCs), the size of NPLs is still very big and how to deal with the NPLs is still an urgent and hard task facing the government.

This paper is organized as follow: the first part is a review about the course of reform of financial and bank system since 1979 and current structure of financial market; the second part is about the evolution of the NPLs and current size and structure; the last part is about the effectiveness of the disposals of NPLs and the management of AMCs.

1. The reform of financial and bank system since 1979

1.1 Financial system before reform

Under the planed economic system, the financial system was made up entirely of the state-owned and state-run banking system. The banks played a very limited role in the economy and banks provided trade credit to allow transactions to go forward and firms to hold inventories. The economic planning agency (i.e. Planning Commission) made most of decisions about production and investment and made a detailed credit plan also for banks. Bank was only a kind of accounting agency or an accountant, using financial flows to keep books of the planned economy. We also can say that the bank was only an instrument to keep the operation of plans. There were no stock markets and bonds markets at all before the reform.

Before the early of 1980s, there was only one bank, the People's Bank of China, so-called "mono-bank" and there were many rural collective credit corporations also. Generally speaking, there was not any real commercial bank at all. So there was not the concept of NPLs at all.

1.2 The reform of banking system since 1979

The reform of banking system in China has experienced three stages: the first stage is from 1979 to 1993 and the major task is transfer the mono-bank to dual-bank system and development of new share-holding commercial banks; the second stage is from 1993-2003 and the major task is transfer the specialized banks to state-owned commercial banks; the third stage is from 2004 to present and the major task is the financial restructure of SOCBs and transfer them into the state-controlling share-holding commercial banks. It is also very important to point out that the open-up of financial system and banking system to oversea is also the key part of reform.

During the 1980s, China began to reform the bank system. PBC was separated out to serve as the central bank and four state-run "specialized banks" (i.e. specialized in several major industries or sectors assigned by the government) were established in 1983-84, they are as follows:

Bank of China—foreign trade and foreign exchange transactions;

People's Bank of Construction (China Construction Bank) —capital investment; Agricultural Bank of China—agricultural and rural economy;

Industrial and Commercial Bank of China: industrial and commercial activities for state sector.

It is needed to point out, during the period of 1980s, the "specialized banks" were not real commercial banks. The banks made lending according to the state credit plan and the directions of government economic planning agencies. It is needed also to point out that the local government played a very important role to affect the lending of banks, because the top officials

of the banks were decided by the Beijing headquarters and local governments altogether, and the specialized banks set the branches in line with the administrative regions and levels.

After 1992, along with the set of direction and model of economic reform, i.e. socialist market economic system, China begun to build commercial bank system gradually. The Law of PBC and Law of Commercial Bank were adopted respectively in 1994-1995. According to the law, the commercial banks replaced the specialized banks. These have been so-called Big-four state-owned commercial banks (SOCBs) since then. This was a beginning to establish the modern commercial bank system. In 1998, the state credit plan system was abolished finally. The commercial banks have had got the independent decision-making since 1998.

In the course of the reform of state-run banks, several new type commercial banks were established. These banks are not owned by government solely. They are called joint-stock or shareholding commercial banks (JSCBs), such as the Bank of Communication and the China International Trust and Investment Company (CITIC) Industrial Bank. Most of these joint-stock banks are state-controlling banks so far. China Minsheng Bank is only one owned by private shareholders.

Since the reform, the capital market, especially the stock market have emerged and developed gradually and it has become key part of financial system. However, general speaking, although the direct financing market has developed rapidly since 1992, the banks, especially the Big-four state-owned banks have continued to dominate the financial system so far and they account for more than 50% of commercial bank loans in present.

Another key step of reform is the establishment of three policy banks and this is very important to understand the development of NPLs. Three policy banks (development bank) were created in 1994, specializing in financing for policy-oriented projects. They are as follows:

China Development Bank—key public infrastructure projects;

Agricultural Development Bank of China—agricultural price support and government procurement and storage;

The Export-Import Bank of China—foreign trade policy.

These banks are owned solely by the central government. This is most important step to separate the policy lending from commercial lending. Before the establishment of the policy banks, the four specialized banks had to provide the loans to state-owned enterprises and township and villages enterprises according to the industrial policies and the administrative assignments. So, the business of the banks was mixed commercial and policy lending and a lot of NPLs were created before 1995.

In China, there is another kind of financial institutions, i.e. rural credit collectives in the rural area. The reform of rural credit collectives is underway so far.

2. Evolution of the NPLs and current size and structure

2.1 The evolution of classification system

Nicholas Lardy has done an extensive study on the evolution of classification system in China before 1998. According to his study, in the 1980s, there appears to have little or no effort to classify bank loans by their quality, before 1994, each of major banks had its own system and standards for classifying NPLs. People's Bank of China set the loan classification system formally in 1995 and it is so-called Four-category classification system.¹ The loans are classified into 4 categories: normal loan, past due loan, doubtful loan and bad loan. The past due, doubtful and bad loans are NPLs according to this system. This system is based on the payment status rather than on risk assessment and thus it is far lenient than that Five-categories system prevailing in most economies.

Since 1998, the international loan classification system has introduced into the banking system gradually. According to this system, the loans are classified into 5 categories: normal (pass), special mention, substandard, doubtful and loss. However, the new system has been adopted by the commercial banks only since 2002. People's Bank of China issued "Guidelines on Risk-based loan Classification" in December 2001 and this "guidelines" has been implemented since the beginning 2002. "The loan classification system described here follows a risk-based approach, whereby loans are divided into five categories - pass, special-mention, substandard, doubtful and loss - with the last three categories recognized as NPLs." The definitions of the five categories are as follows:

"Pass: borrowers can honor the terms of the contracts, and there is no reason to doubt their ability to repay principal and interest of loans in full and on a timely basis."

"Special-mention: borrowers are still able to service the loans currently, although the repayment of loans might be adversely affected by some factors."

"Substandard: borrowers' ability to service loans is apparently in question, cannot depend on their normal business revenues to pay back the principal and interest of loans and certain losses might incur even when guarantees are executed."

"Doubtful: borrowers cannot pay back principal and interest of loans in full and significant losses will incur even when guarantees are executed."

"Loss: principal and interest of loans cannot be recovered or only a small portion can be

¹ Nicholas Lardy, *China's Unfinished Economic Reform*, Brookings Institution Press, Washington, D.C.1998, pp115-116.

recovered after taking all possible measures and resorting to necessary legal procedures.”

Because of the different classifications about the loans and NPLs, there are two kinds if the volume and ratio of NPLs before 2002. For example, according to the financial report of 2001 released by ICBC, the ratio of NPLs is 25.7% based on four-category system, and the ratio based on five-category system is 29.8%, the difference is 4.1 percentage points. Hence the ratio in the new system is higher 16% than the old system.

2.2 The evolution of size of NPLs

Although NPLs has been an important issue since the mid-1990s, there was not precise and regular information about the total amount and the ratio of NPLs before 2003. We can only get some numbers from the news and speeches by several officials of PBC or major commercial banks, as well as the studies of several scholars. According to Dai Xianglong, former governor of PBC, “the NPLs in the wholly state-owned commercial banks (SOCBs), amounting to 1.8 trillion yuan at the end of September of 2001, or 26.62% of their loans. About 7% of the total loans are bad. These data are broadly in line with the result based on the five-category risk-based loan classification.”²

According to the estimation by Lardy, the ratio of NPLs, based on four-category system, is 25% in the end of 1995.³

According the estimation by other scholars, the ratio of NPLs is about 24% before the Asia crisis and 29% after the crisis.⁴

According to the report of ICBC, the ratio of NPLs in 2001 is 29.8%.

CBRC released its first report about the NPLs in 2003. According to the data, the ratio of NPLs is 19.6% and the total amount is 2537.7 billion yuan in the end of June 2003. This is the first report about the NPLs since the establishment of CBRC in March 2003. According to CBRC, the ratio of the major SOCBs in the end of 2004 is 15.57% and total amount is 1575.1 billion yuan. In the end of June 2006, the ratio of NPLs is 7.8% for major commercial banks and 9.57% for the major SOCBs. Total amount of NPLs is 1177.88 billion yuan for major commercial banks and 1055.76 billion yuan for major SOCBs.

² Governor Dai Xianglong's Speech at “2001 NPL International Forum”, Nov.1, 2001. www.pbc.org.cn

³ Nicholas Lardy, *China's Unfinished Economic Reform*, Brookings Institution Press, Washington, D.C.1998, p119.

⁴ John P. Bonin, Yipping Huang, *Dealing with the bad loans of the Chinese Banks*, *Journal of Asia Economics*, 12(2001)197-214.

Table 1 NPLs in China's banking system, June 31, 2006

	RMB100 million, %	
	Outstanding balance	Share in total loans
Total	12872.2	7.53
SOCBs	11778.8	9.47
JSCBs	1221.2	3.09
City commercial banks	854.4	6.72
Rural commercial banks	166.4	6.64

(Source: www.cbrc.gov.cn)

Table 2 Change trend of share of NPLs in China's banking system

	June 2003—June 2006						
	June 2003	Dec. 2003	June 2004	Dec. 2004	June 2005	Dec. 2005	June 2006
Total	19.6	17.8	13.32	13.21	8.71	8.61	7.53
SOCBs			15.59	15.57	10.12	10.49	9.47
JSCBs			5.16	4.94	4.66	4.22	3.09
City commercial banks					10.43	7.73	6.72
Rural commercial banks					6.38	6.03	6.64

(Source: www.cbrc.gov.cn)

However, it is necessary to point out that the data about NPLs after 2000 is based on the several separations and transfers from SOCBs and policy banks and there are huge amount NPLs in the four AMCs so far. There are two kinds of sizes about the NPLs, one is within the banks and another is the total of current NPLs of banks and the NPLs in AMCs.

3. The effectiveness of the disposals of NPLs and the management of AMCs

3.1 The major actions of separations and transfers

In order to maintain a sound foundation for the state-owned banks, the government had to inject significant capital in the banks and to separate the NPLs from banks by establishing four asset management companies (AMCs), one for each of the four banks: Huarong—ICBC; Cinda—CCB, Orient—BOC; Great Wall—ABC. According to the “Regulation of AMCs” issued by the State Council of China in 2000, the tasks of AMCs are taking over the NPLs from state owned banks and managing and disposing the assets formed from the taking over; the target is to recover the NPLs the took over, maintain the value and decrease the loss to the largest extent possible.

The major actions of separations and transfers according to various news releases are as follows:

1999: The NPLs occurred before 1996 was transferred to AMCs at their book value; the total is 1.39 trillion RMB (US\$170 billion), equals to 17% of GDP of 1999. According to Tang Shuangning, vice chairman of CBRC, the real transfer of NPLs was 1.076 trillion, the other parts of transfer was normal loans for debt-for-equity swap.

2004: Cinda AMC purchased 278.7 billion (US\$34 billion) NPLs from BOC and CCB at 50% of book value by auction.

2004: Cinda AMC purchased 41.4 billion (US\$ 5 billion) NPLs from Bank of Communication at 50% of book value by auction.

2005: Ministry of Finance wrote off 246 billion (US\$ 30 billion) NPLs of ICBC.

2005: 4 AMCs purchased 460.0 billion (US\$55.6 billion) NPLs from ICBC and CCB at 50% of book value by auction.

Total separation and transfer amount to date: RMB 2.416 trillion (US\$290.6 billion).

The effects were immediate: the ratio of NPLs of four SOCBs decreased remarkably after the transfer. For example, the ratio of NPLs of BOC decreased from 39.34% in 1998 to 28.78% in 1999, i.e. the ratio of NPLs decreased 10.56 percent points, according to the financial report released by BOC. The ratio of NPLs for four SOCBs decreased from 32.34% in the end of 1998 to 21.41% in the end of 2001.⁵

3.2 The progress of disposal of NPLs by AMCs

According to CBRC, up to end of March 2006, the four AMCS have accumulated disposal RMB 866.34 billion. The disposal ratio is 68.61% (disposal ratio = accumulated disposal / total NPLs purchased), the assets recovery ratio is 24.20% (assets recovery ratio = total assets recovered / total accumulated disposal) and the cash recovery ratio is 20.84% (cash recovery ratio = cash recovered / total accumulated disposal). Table 3 summarized the progress of disposal of NPLs:

It would be difficult to make evaluation about the performance of disposal of NPLs of AMCs. According to a study conducted by Xie Ping and Li De, the ratio of assets recovery is not too low compared with the performance of other nations AMCs.⁶ However, RTC (Resolution Trust Company) in USA achieved the high recovery rate. According to Bonin and Huang, the recovery

Table 3 Disposals of NPLs of AMCs
(2004- March 2006)

	RMB 100 millions		
	Dec. 2004	Dec. 2005	March 2006
Accumulated Disposal	6750.6	8397.5	8663.4
Cash Recovered	1370.0	1766.0	1805.6
Disposal Ratio	53.96%	66.74%	68.61%
Asset Recovery Ratio	25.48%	24.58%	24.20%
Cash Recovery Ratio	20.29%	21.03%	20.84%

(Source: www.cbrc.gov.cn)

⁵ Wu Jinglian, Comparative Studies, Vol.9, 2003, p171.

⁶ Wu Jinglian, Comparative Studies, Vol.9, 2003, p170.

rate on total assets transfer was 86%.⁷ There have been some criticisms about the performance of AMCs in China, according to a report released by the National Audit Office of China in 2004, there were many problems in AMCs: a number of financial creditor's rights couldn't be realized due to loose control of acquirement of NPLs; Some banks tried to escape responsibilities and cover losses caused by operation that violate regulations through peel-off; the AMCs' dark box operations, falsification and disposal of creditor's rights at low prices had caused loss of state owned assets; some AMCs' loose finance management had given rise to false report of cash recovered, or embezzlement of cash recovered; some even used the cash recovered as high salaries and benefits for employees.⁸

3.3 Difficulties and Problems of AMCs

In general, the disposal of NPLs has not met the requirement set by the State Council. According to the original plan made by the MOF (Ministry of Finance), the 1.4 trillion NPLs should be disposed before 2006. It was impossible to achieve the target so far.

There have been several very crucial difficulties for the operation and management of AMCs since the establishment of AMCs.

(1) The AMCs are wholly state-owned institutions and are not operated on the commercial base and so they have the similar shortcomings of other SOEs under the planned economic system.

(2) There has been not sound legal framework. Before the adoption of new bankruptcy law in August 2006, there had been not a real bankruptcy law in China. The main bankruptcy law was the Enterprise Bankruptcy Law of PRC (Trial Implementation), a law enacted since 1986. It would be easy to understand the difficulties to protect the creditor rights without a real bankruptcy law and it also would be easy to understand why so many enterprises, especially the SOEs have been reluctant to return the loans of banks. Without the bankruptcy law and the real implementation of the law, the disposal of NPLs would be very difficult.

(3) The transfer price for NPLs from SOCBs was above the market price in general. The first time of transfers in 1999 was at the book value. However, the real value would be below 20-30% of book value according to the estimations.⁹ However, the transfers in 2004 were at the market value and it would be helpful to improve the performance of AMCs.

(4) The asset quality was too low. According to Xie and Li, there was a lot of zero value assets in the 1.4 trillion RMB NPLs transferred to AMCs in 1999. for example, the Great Wall AMC

⁷ John P. Bonin, Yipping Huang, Dealing with the bad loans of the Chinese Banks, *Journal of Asia Economics*, 12(2001) 197-214.

⁸ http://english.peopledaily.com.cn/200501/21/eng20050121_171487.html

⁹ Wu Jinglian, *Comparative Studies*, Vol.9, 2003, p164.

purchased 345 billion NPLs in 1999 at the book value. Of which, there was 100 billion NPLs which real value should be zero. According to the five-category classification system, the amount of loss loans was 149.1 RMB billion, accounted for 49% in the total 345 RMB billion NPLs. According to the relevant rules of MOF, the real value of NPLs purchased by Great Wall AMC was only 49.22 RMB billion.¹⁰ This part of NPLs should be written off according to the market value. It is impossible to recovery this kind of poor assets.

3.4 The improvement of management and future of AMCs

(1) It is needed to set up reasonable incentive system for the operation of AMCs in short run. In order to stimulate AMCs, State Council sets up the new policies already: AMCs who recovery more cash than the targets will be rewarded or will have a reduction in their bonuses if they fail to meet them. It will be very important to establish a transparent system of evaluation of performance of AMCs.

(2) It is also needed to adjust the structure the AMCs. According to the international practice, the AMCs would be closed when the NPLs is disposed completely. In China, the AMCs were given a 10-year life span, according to the original plan of MOF. Along with the listing in stock markets of three SOCBs, ABC will be the only SOCB that needs to transfer NPLs to AMCs in the near future. The other three SOCBs will take responsibility for their new NPLs in future as modern public listing commercial banks. The amount of transfer of NPLs from ABC will be predictable and limited. Along with the progress of disposal of NPLs, the business of AMCs will decrease gradually. One of suggestions is to reduce the amount of AMCs, for example, from 4 to 2 in near future.

(3) It is needed to open further the market of NPLs for private and foreign investors. In recent years, there have been some successful cases to sell the NPLs to international investors. The first landmark NPLs transaction in China was an auction held by Huarong AMC in 2001. Huarong sold RMB 10.8 billion of NPLs to a consortium led by Morgan Stanley at only 8.125% of book value. This transaction is expected to yield a cash recovery rate of above 20%.¹¹ Others cases include: Leman Brothers signed at the Dec.2005 with Huarong AMC a transaction, worth US\$240 million at face value; Mellon Financial Group bought RMB 4.2 billion from Orient AMC in Dec.2005; Citybank Group signed in Dec.2005 with Huarong AMC a transaction, worth RMB 36.4 billion. However, the transactions are very limited compared with the huge NPLs market. It is needed to increase the extend of transparency of NPLs market and improve the service of information related with the selling of NPLs for foreign investors as well as domestic private firms.

¹⁰ Wu Jinglian, *Comparative Studies*, Vol.9, 2003, p164.

¹¹ Li Zhenhua, *Are the AMCs Underselling China Assets?* 21 Century Business Herald, Jan. 8, 2005.

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