

Dealing with Bad Loans of the Chinese Banks

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China was the only major economy in East Asia that not only averted a currency crisis but also sustained relatively strong growth. This was largely attributable to its macroeconomic strengths when the crisis began, including sizeable current account surpluses, dominance of foreign direct investment in capital inflows, large foreign exchange reserves and control of the capital account. There are widespread signs, however, indicating that China's banking sector is fragile. Such banks are not sustainable even in an autarchic economy, let alone that opening up of capital market is inevitable in the perceivable future. The first step of building a strong banking system is to deal with the bad loans.

Why growing financial fragility?

Increases in financial vulnerability were closely associated with the evolving triangular relation between the state budget, the state-owned enterprises (SOEs) and the state-owned banks (SOBs) during the reform period. In pre-reform China, SOEs were run as workshops of the state economy — with all the inputs supplied, output took away and financial accounts automatically balanced. The state budget was the major collector and distributor of capital. The monobank system only played a limited role in allocation of a small proportion of working capital.

The objectives of reform were for the state budget to retreat from accounting functions for enterprises and to focus on public good activities, the bank system to become the major allocator of capital according to market rules, and the enterprises to perform efficiently.

The 'loan for grant' and 'tax for profit' reforms caused dramatic rise of the SOEs' debt-to-equity ratio, from 23 per cent in 1980 to 440 per cent in 1998. The enterprise reforms succeeded in expanding autonomy and improving incentives but failed in effectively enforcing market disciplines. The old 'soft-budget' problem evolved into 'autonomy without discipline' phenomenon. Falling efficiency and over-spending behaviour eventually made the state sector a net loss-maker from 1996. This directly resulted in accumulation of bad loans.

The state budget's capacity to raise revenue declined significantly during the reform period, with the share of fiscal revenue in GDP falling from above 30 per cent in the early 1980s to around 12 per cent in the late 1990s. The government, however, could not retreat completely from economic activities, including subsidising the loss-making SOEs. It thus turned to banks for financial resources through policy loans. In the

1990s, the policy loans accounted for 35-40 per cent of total bank loans. Projects financed by the policy loans usually had high default rates.

Finally, the SOBs suffered from the usual problems of the SOEs, such as lack of market disciplines and slack of managers and employees. Bank managers were appointed by local governments and found it impossible to reject state interventions. In 1998, for instance, all the commercial bank managers were called to help achieving the macroeconomic objectives. Banks' lending decisions lacked risk assessment. Recent survey data on SOEs show that there existed no difference in terms of rejection rates and sizes of approved loans by SOEs between the profitable and loss-making firms.

How bad is the bad loan problem?

It is difficult to determine the exact extent of China's financial fragility partly because the authority does not release relevant information and partly because China had a unique classification system. Nonperforming loans (NPLs) were categorised into 'overdue', 'doubtful' and 'bad'. The international standard method ('mention', 'pass', 'special mention', 'substandard', 'doubtful' and 'loss') was only introduced at the beginning of 1999.

Existing estimates, by both scholars and officials, suggest that, before the East Asian crisis, the bank conditions in China were no better than those in the crisis-affected economies. The average capital adequacy ratio of the four pillar SOBs was only 4.4 per cent, lower than 8 per cent required by the Bank of International Settlement and China's own commercial bank law. Most of the banks made losses from 1996 if uncollected receivable interest payments were excluded from their financial accounts. The proportion of NPLs was estimated at 24-26 per cent, higher than that in Thailand, Korea, Indonesia and Malaysia. The proportion of bad debts was at least 6 per cent, indicating that these banks were technically insolvent.

After the crisis began, the Chinese government recapitalised the four major banks, through issuance of treasury bond of RMB270 billion, raising their capital adequacy ratio to 8 per cent. The bad loan problem, however, worsened. According to conservative estimation, the proportion of NPLs is now above 30 per cent. This was, again, supported by recent enterprise survey data on nonperforming debts. Even assuming that China can achieve the highest recovery rate, 25 per cent, among the transitional economies, its unrecoverable bad loan is still significantly higher than 20 per cent. If this problem is not resolved quickly, banking crisis is unavoidable sometime in the future.

The estimated costs to completely restructure China's banking sector range between 18.8 and 25 per cent of GDP, sitting near the upper boundary of the usual range for countries experiencing banking crisis. This is equivalent to the size of China's whole export sector.

The Asset Management Companies

The Asset Management Company (AMC) is China's main approach in dealing with the bad loans. Between April and October in 1999, four AMCs were established for the four pillar state commercial banks: Cinda (Construction Bank of China), Orient (Bank of China), Hualong (Industry and Commerce Bank of China) and Great Wall (Agricultural Bank of China). All the AMCs are designated to exist for ten years. They modelled on the Resolution and Trust Corporation (RTC) for dealing with the bad assets of the failing Saving and Loan Associations in the 1980s in the United States.

The management arrangements for the AMCs are complicated. The AMCs are directly responsible for the Ministry of Finance which not only provided each of them with RMB10 billion initial capital but would also bear the consequences of AMCs' performance. Supervision of the AMCs, however, is the responsibility of the central bank. The actual management is closely associated with their parent banks. For instance, Cinda's employees were mostly transferred from the Construction Bank of China (CBC). The governor of the CBC is Cinda's Party Secretary and a deputy governor is its Chairman. A primary reason for setting up separate AMCs instead of letting banks handle their own NPLs is that the Chinese law does not allow commercial banks to engage in investment banking activities.

The objective of the AMCs is to maximise recovery from the NPLs. To ensure this, a bonus scheme is devised for the employees. The AMCs will transfer, manage and sell nonperforming loans and assets. The first step is to transfer about RMB1000 billion NPLs (about half of the total estimated NPLs) from the banks to AMCs. The parent banks are to be compensated in two ways: (1) transfer of re-lending by the central bank from parent banks to AMCs (about 40 per cent of the total transferred NPLs); and (2) purchase of state-backed AMC bonds by parent banks (about 60 per cent of the total transferred NPLs). The former approach takes both bad assets (NPLs) and liabilities (central bank re-lending) off the parent banks' balance books. And the latter approach converts bad assets (NPLs) into good assets (state-backed bonds). The parent banks' balance sheets are improved after the transfer.

The AMCs will adopt four types of methods to deal with the NPLs. The first is to directly sell the NPLs in the market. The second is to restructure NPLs with other assets trying to make the whole lot financially valuable. The third is to securitise the NPLs using the stock market. And the last is to directly restructure problem enterprises, particularly their management, organisation and strategy, applying 'debt-equity' swap. According to the initial plan, AMCs will operate as loan recovery agencies. But because of the 'debt-equity' swap, they will also act like holding companies. In fact, their activities will be similar to those of the venture capitalists and investment banks.

Can bad loans be resolved?

Establishment of the AMCs is only the first step. Whether or not China can successfully resolve the bad loan problem depends on the specific methods applied by the AMCs in response to their market and institutional environment.

The AMC's face a much more difficult task than the RTC. The bad assets that RTC had were mainly in the form of real estates which were easier to be dealt with than state enterprises' NPLs often without collateral. RTC operated in a well developed capital market with innovative financial techniques. In China, the capital market is still in its primitive state. This implies that AMC's will have to hold the NPLs for a relatively long period. If they cannot get rid of all the NPLs by the end of the ten-year period, the Ministry of Finance has to either take over the nominal equity or write off the NPLs.

AMC's also have their own institutional and skill problems. The AMC's are in essence SOBs, it remains to be seen if they could introduce efficiency to their own firms as well as the enterprises under their administration. It is critical to not only eliminate slack of employees but also prevent corruptive behaviour. Exactly for this reason, RTC's strategy was to get rid of the bad assets as fast as possible. But this would not be possible for AMC's given the state of China's capital market. Poland's experience suggests that organisations with the right information about the enterprises are not necessarily the best candidates to carry out the restructuring task. China's AMC's also lack needed skills. Five months after establishment, Cinda already suffers from two problems: redundant workers and shortage of skills.

A more important challenge is how to stop creation of new bad loans. Czech's experience indicates that it is not enough to just transfer the NPLs while leaving the problem enterprises with the original banks. Hungary's experience also points to the importance of separating the problem enterprises from the banks. RTC did not have this problem because when it came in most Saving and Loan Associations were already bankrupted or about to be bankrupted. But most problem state enterprises in China are likely to continue to exist, at least in the short term. This raises the question about the proper relationship between the parent banks and the AMC's. Most economists worry about the moral hazard problem on the enterprise side following the 'debt-equity' swap, there is actually also a moral hazard problem on the bank side. The current one-to-one relation is helpful for information sharing and collaboration. This approach, however, also fosters collusive behaviour and inhibits competition among AMC's. It is hard to prevent the parent banks from using AMC's as their outlets for dealing with future NPLs. An alternative option is to define a clear-cut date, such as January 1 1999 when the new accounting system was adopted, after that the banks have to take care of their own new bad loans. It is ideal to transfer the problem enterprises' deposits together with their NPLs to the AMC's. Of course, this would upgrade the AMC's into fully operational banks, with major implications for China's future banking structure.

Beyond the AMC's, successful resolution of the bad loan problem is conditional on breaking the vicious cycle among the state budget, the SOEs and the SOBs. The government should stop imposing policy loans on commercial banks, as three policy banks are already in place. Bankruptcy law and other market institutions should be fully enforceable to effectively discipline inefficient SOEs. Within the banking sector, bank institutions must be further improved and financial supervision further strengthened.