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A Study on Prevention of Non-Performing Assets of Chinese State-Owned Commercial Banks

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Abstract

For a long time, Chinese state-owned commercial banks have to face the actualities of large non-performing assets and a high rate of non-performing assets. Based on China's national condition and referring to the US banking industry, this article makes proposals on preventing and controlling non-performing assets from four aspects: state-owned enterprise system, government regulation, credit risk management, and disposal of non-performing assets.

Key words: Chinese state-owned commercial bank; Non-performing asset; Credit risk management; Control approach

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INTRODUCTION

As we all know, NPA of commercial bank is a shackle of bank development, which not only leads to deterioration of the financial condition of a bank, resulting in loss of the bank's assets, but also affects normal flow of the entire capitals. Especially for the state-owned commercial banks which are recognized as the banner of Chinese banking industry, if plagued by the problem of NPA, they may even directly affect the national economy, whose danger is self-evident. In recent years the Chinese government has concerned about this issue. Along with the implementation

of a series of reform measures, the current NPA of state-owned commercial banks in China has been improved, and the overall NPA and NPA ratio have been basically "both decreased". However, it can not be ignored that the realization of "both decrease" mainly relies on the government to carry out financial restructuring and policy peeling off. This approach can temporarily eliminate a lot of NPA, but does not solve the problem at the roots. Since the last two years we have also seen the reemergence of NPA, which is the performance that the NPA problem has not been completely resolved. In the face of NPA of the state-owned commercial banks, we have to consider how to "clear" on the one hand- that is, how to quickly and effectively deal with the accumulated NPA, on the other hand consider how to "block" — that is, how to prevent NPA from the source. At present China mostly focuses on "clear", and ignores the importance of "block" to a large extent. Referring to the relatively more developed US banking industry, they put in considerable efforts to supervise and prevent NPA, particularly in credit risk management, they make use of more advanced warning means to reduce NPA from the source. Therefore, a more in-depth study on NPA control measures is quite necessary.

1. MAKE EFFORTS TO SOLVE THE INTERNAL PROBLEMS OF STATE-OWNED ENTERPRISES

In China, non-performing loan due to the drawbacks of state-owned enterprises are the biggest reason of NPA, and solution of the internal problems of state-owned enterprises will prevent NPA from the roots. The CCP's 18th National Congress report states that

We will unswervingly consolidate and develop the public economy, improve multiple forms of the public ownership, deepen the reform of state-owned enterprises, improve different

types of state-owned asset management systems, promote the national capitals to invest into important industries and key areas related to national security and national economics, and constantly enhance the vitality, dominance and influence of the state-owned economy.¹

At present, China's state-owned enterprise reform will focus on adjusting strategic layout, deepening joint-stock reform, and improving corporate governance structure, etc.. Since the settlement of NPA of state-owned enterprises is actually to resolve the internal management turmoil and a lower level of profitability, China is mainly working on improving the state-owned asset management systems and internal control.

Firstly, we should improve the state-owned asset management system. The core idea of improving the state-owned asset management system is to establish a modern enterprise system. In accordance with the requirement of modern enterprise system which should "clarify property rights, clarify responsibilities, separate government and enterprises, and have scientific management", China issued as early as in 2000 *General Office of the State Council on Forwarding National Economic and Trade Commission's Notice to Improve State-Owned Large and Medium Sized Enterprises to Establish a Modern Enterprise System and Strengthen Basic Management Specification (Trial)*, proposing two points which can well prevent NPA: The first is to separate government and enterprises, requesting the government on behalf of the investor to exercise the owner's functions in state funded and owned enterprises, not intervene in the daily business activities of the enterprises, but strive to create a favorable external environment. After the separation of government and enterprises, the government should give more autonomous decision-making rights to the enterprises. The enterprises no longer rely on the government for protection, which will help enhance their competitiveness, improve their productivity, and create more profits; The second is to implement joint-stock reform. Joint-stock reform can increase financing channels for production cost, expand production scale and structure, and improve operational efficiency. At the same time, supervisory board, director board and managers can mutually check and balance so as to avoid wrong decisions caused by corruption and reduce NPA.

Secondly, we should improve the internal control system of the enterprise. Improving the internal control system is mainly to improve the management and supervision of finance and personnel. On the one hand, enterprise should follow the scientific rule to propose effective and rational development strategies, not in one-sided pursuit of production value, but for the purpose of maximizing benefits to adjust production

scale and production structure. Meanwhile, strengthen corporate audit institution building, pay more attention to supervise the enterprise's financing liquidity condition, decision-making, corruption control and so on. Among them, supervision of NPA is a special part of financial supervision, which is also a quite important part to resolve accumulated NPA. On the other hand, enterprise should reduce bloated management layers, optimize management structure, improve assessment system, promote responsibility system, and improve personnel quality, so that management and staff can be more effective, profitability can be improved, and corruption can be punished.

Government-level policies for state-owned enterprises have been quite comprehensive, and the central government has spent a lot of manpower and resources on it. But in the author's opinion, the problems of state-owned enterprises, on the one hand are due to "unable to do it", namely there is no scientific internal structure and complete institution but operational problems; It's more worthy of reflection is on the other hand "do not do it." When the government's policies have not been implemented, even the best policy is only empty talk. The drawbacks of state-owned enterprises still exist, which can not help solve the problem of NPA. Therefore, policy implementation is the top priority, which is to remind the Chinese legal and regulatory authorities to promulgate appropriate policies and increase supervision.

2. EFFECTIVELY PLAY THE REGULATION ROLE OF GOVERNMENT

To eliminate NPA, the Chinese government has adjusted on administrative measures. In addition to reducing the interventions of governments at different levels to state-owned commercial banks and reducing the proportion of policy loans in the banks, the government tends to resolve NPA by increasing disposal approaches. One example is the establishment of the four largest state-owned financial asset management companies - Cinda, Huarong, Great Wall and the East, to dispose of NPA of the four largest banks. In 2003, for example, "China's four financial asset management companies disposed of a total of 509.37 billion yuan NPA, with a cumulative cash recovery of 99.41 billion yuan, accounting for 19.52% phased disposed NPA."² Meanwhile, the Chinese government has also strengthened supervision means. On April 25, 2003, China Banking Regulatory Commission (CBRC) has been established, which aims to "according to the authorization of the State Council, conduct unified supervision and management of banks, financial asset management

¹ Xinhua Online *CPC's 18th National Congress Report* 2012-11-08. Retrieved from http://www.xj.xinhuanet.com/2012-11/19/c_113722546.htm

² The Four Largest Financial Asset Management Companies Disposed of Non-Performing Assets of 500 Billion Yuan (2004, January 19). *Shenzhen Daily*. Retrieved from <http://finance.sina.com.cn/g/20040119/1004608635.shtml>

companies, trust and investment companies and other deposit financial institutions, safeguard legitimate and sound operation of the banking industry”.³ CBRC will regularly publish the data of banks, approve banks’ actions, implement on-site and off-site supervisions, investigate and punish their illegal behaviors according to law.

In the 1980s the USA financial crisis erupted, resulting in huge NPA and bankruptcy of many banks. The USA government had to step in to take administrative and economic means for intervention. In June 1989, the US government began to implement the low interest rate policy. In August the government invested public funds to rescue desperate financial institutions. In the same month the USA Congress passed *The Financial Institutions Reform, Recovery and Enforcement Act* (FIRREA), and established Resolution Trust Corporation (RTC) to restructure the malfunctioned savings and loan organizations. RTC was given five goals: The first is to restructure the problem saving and loan organizations to maximize net present value return; The second is to minimize the disposal impacts to local real estate market and financial market; The third is to make full use of the raised funds to dispose of bankrupted saving and loan organizations; The fourth is to minimize recombination losses; The fifth is to maximumly protect the housing supply for middle and low-income earners. In the early years of its establishment, RTC invited public departments, private organizations, related industrial companies (e.g. the real estate industry), and community representatives to discuss restructuring policies and programs. In addition to following FDIC’s traditional experience of disposing of bankrupted organizations, a lot of new restructuring methods have been applied. Within 6 years of its establishment in August 1989 to dissolution in December 1995, RTC has successfully restructured 747 poorly run saving and loaning organizations, involving assets of about \$ 420.6 billion, with an estimated restructuring costs of approximately \$ 87.5 billion. Meanwhile, USA attaches great importance to financial regulation. The Federal Reserve Board, Federal Deposit Insurance Corporation, Office of Currency Comptroller and Ministry of Finance are jointly responsible for banking supervision and conduct rating assessment to banks every year.

Hence we can see that in the face of the crisis of high ratio NPA, Chinese and USA governments have both taken protective intervention policies to banking industry, established specialized agencies (China’s four largest asset management companies and the US RTC) to dispose huge NPA, and attached great importance to

banking supervision. The difference lies in the more advanced regulatory means of the USA. The USA federal financial regulatory authorities use the CAMELS system to conduct annual site assessment to banks in six aspects, including capital adequacy ratio, asset quality, management level, earnings, liquidity and market risk sensitivity, so as to warn the banks in a lower assessment level. Further more, the USA regulatory authorities have also developed the systems capable for off-site risk assessment and early warning, such as UBSS system and FIMS system, etc, in comparison to which China’s regulatory approaches are still left behind. It should also be noted that in the premise of ensuring supervision, US government has supplied the banking industry a very free market environment, and seldom directly intervenes with banks’ operations. However, due to the particular regime of China, the state-owned commercial banks must to some extent obey the central government’s arrangements. In fact the central government has made adjustments since 1994, such as giving supports to a number of projects and enterprises, no longer in the form of direct banking loans, but issuing national financial subsidies or favorable policies to reduce NPL. However, governments at different levels, especially local government, still have a certain intervention inertia. The author believes that referring to the success of the USA banking industry, an appropriate and more free market environment for the state-owned commercial banks will be more adaptive to the trend of market economy, contribute to the comprehensive development of banks, reduce credit risks and NPA.

3. IMPROVE BANK’S MANAGEMENT LEVEL

Firstly, enhance credit risk management. To banks, the core of preventing a large number of NPA is actually to control credit risks. Credit quality and size of risk have profound impacts on the effectiveness and safety of bank credit funds, and relate to the development prospects of the banks. The key to solving this problem is to establish rational and stable operating mechanism, advanced management, and scientific system of credit risk management. Among them, the credit risk management system includes these elements: Loan approval and issuance permission, loan condition and standard, loan type and term principle, loan mortgage and guarantee principle, loan pricing principle, loan information management, loan risk dispersal policy, loan quality assessment and rating policy, loan loss cancellation policy, etc.. A sound credit risk management system will directly determine the loan quality. Its building process not only requires advanced theories as a basis, but also needs highly qualified researchers and operational personnel to implement.

³ Office of the State Council. (2003, April 25). *The main responsibilities, internal organizations and staffing of China banking regulatory commission*. Retrieved from http://www.gov.cn/zwqk/2005-08/12/content_22121.htm

In recent years, Chinese state-owned commercial banks have followed the developed Western commercial banks, while reforming banking operational mechanisms (such as joint-stock reform) and restructuring banking organizations, attached great importance to the construction of credit risk management systems, such as strengthening the “three checks” loan system, namely the control of “pre-loan investigation, review during loan and post-loan inspection” to strengthen the training of staff quality and strengthen banks’ internal supervision, but they also need to draw lessons from other countries’ experience.

As one of the world’s most developed financial industries, the USA banking industry is a world leader in the aspects of internal structure and management, and also has strong progressiveness and science in credit risk management. In terms of pre-loan evaluation, USA attaches great importance to the development of credit risk assessment tools. In 1997, J. P. Morgan launched the first credit risk assessment model—CreditMetrics. The core of the model is to calculate the value at risk (Var) of loans and private bonds, etc.. In addition to CreditMetrics model, KMV model and CreditPortfolio View model have also been applied in banking risk assessment. Compared to the traditional qualitative analysis, the advantages of the credit risk models are obvious, which greatly guarantee the accuracy of risk assessment. In the loaning process, the USA banking industry has formulated strict norms of written loaning policies and regulated operators’ permissions. Here we must mention that the USA banking staff’s professional qualities and operating capacities are generally higher than China, so the banks’ NPA caused by operating risks can be greatly reduced. In terms of post-loan management, in order to make credit quality report closer to the actual situation, all loans must be closely monitored and periodically reviewed.

USA banking credit risk management is highly advanced and worth learning. For these advantages, based on the actual circumstances of China’s state-owned banks, we can improve the following aspects:

a) Improve the operational mechanism and management level of organizational structure. The advanced international (USA) credit risk management framework is composed of three levels: decision-making level (responsible for formulating and reviewing risk policies), execution level (responsible for specific credit operations) and supervision level (responsible for monitoring the risk control of execution departments). The three levels are interrelated and mutually balanced. The decision-making level is responsible to make credit risk management strategy, execution level is responsible for marketing and distribution of loans, and supervision level should supervise the entire process and monitor risks. The superiority of this model lies in developing risk management strategy as the core, having clear labor divisions and smooth internal communications, timely and comprehensively inspecting the process and monitoring

loans so as to improve the overall banking efficiency. The Chinese state-owned commercial banks can emulate this mode to reduce the violation of laws, improve banking efficiency and reduce operational risks.

b) Adopt more scientific assessment techniques and methods. Firstly, the Chinese state-owned commercial banks are currently mainly using qualitative risk assessment methods, such as expert 5C evaluation method and loan five classification method, which are in a certain lack of accuracy compared to the quantitative risk assessment models which have been more used in the USA banking industry, such as CreditMetric model and KMV model. These models have been built on the premise of the USA mature market environment, and since China’s market environment is different, the Chinese state-owned commercial banks can not directly copy them. We therefore need to increase efforts on research, learn the advanced USA credit risk management theories, and carry out effective development based on China’s actual conditions.

c) Establish a more comprehensive data system. An important reason of USA credit risk management analysis’s maintenance of the leading position is the advanced data processing system. On the one hand, USA has a large number of data processing organizations and advanced processing tools; on the other hand, its data have a high openness level. Although China’s four largest banks also have their own internal data systems, the standards are different and data are not complete. If we can build a more comprehensive and effective database with a higher degree of openness, it can not only provide more effective supports for the existing risk analysis, but also provides better data supports and testing basis for our own risk management model development.

d) Improve personnel quality. Personnel quality determines the implementation degree of credit risk management policy, and a higher personnel quality can effectively reduce operational risks in the lending process. The higher overall personnel quality in the USA banking industry mainly benefits from two aspects: The first is the effective bank regulatory system and incentive system, under which the employees will be responsible and motivated to work while being constrained; the second is the systematic pre-service training, which ensures the employees’ credit operational level and a clear labor division. In recent years the Chinese state-owned commercial banks have conducted large-scale adjustment on personnel quality and implemented responsibility system. The five largest banks have carried out a certain scale of layoffs and hired experts and technicians with high salaries, showing the made efforts to improve personnel quality. However, due to less senior technical staff in Chinese banks and a certain degree of disorder in the banks’ internal organizational structures, it requires the banks to make more efforts to introduce external talents, and pay more attention to personnel training.

Secondly, strengthen the disposal capacity of NPA within the bank. USA's banking industry and Chinese state-owned commercial banks both have a certain level of capability to dispose NPA, and relatively speaking, the USA banking industry has more abundant methods and means in this regard. In the 1980s USA financial crisis, some large USA banks adopted financial means to digest a huge amount of NPA without recourse to the government forces. It is worth mentioning that, in addition to the traditional method of extracting bad debt reserve the USA banks pioneered to take two approaches: Asset securitization, namely the "good bank + bad bank" model. The so-called securitization simply means "to convert illiquid assets to be securities which can be freely traded in the financial market to recover its liquidity".⁴ Asset securitization can increase asset liquidity, expand funding sources, disperse credit risks, and ease capital pressures. The so-called "good bank + bad bank" model, that is, to separate the NPA from the balance sheet of a problem bank and hand it over for disposal to a management company designed to solve the problem of bank NPA. Now, the Chinese state-owned commercial banks follow the example, and deal with NPA by adjusting bond structures and extracting bad debt reserves. Presently the state-owned commercial banks have mainly recovered bad debts, dealt with the collateral and extracted bad debt reserves for solution, but the author personally believes that the less used asset securitization is a very promising tool. On the one hand, China's macroeconomic situation is stabilizing, bond market trading volume is gradually increasing. The bond market becomes increasingly mature, and its technology is relatively more mature and feasible. On the other hand, asset securitization can enrich financing channels and reduce financing costs, which is very suitable for the current status of Chinese state-owned commercial banks.

CONCLUSION

NPA of state-owned commercial banks appears to be a relatively older problem. As early as in 1998 the Chinese

government began to pay close attention to control it, and has achieved some success in recent years. But as China's financial industry becomes more and more developed, financial channels have been gradually increased. The implementation of a large number of policies and so much favorable conditions do not solve the state-owned commercial banks' NPA ideally. It should be noted that the government, banks and regulators still need to increase efforts in this regard. The state-owned commercial banks are the most important banking sector in China, but NPA will greatly hinder their development. We need to carry out more researches and discussions to improve NPA of state-owned commercial banks in terms of both prevention and management.

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⁴ *Asset Securitization*. (2013, February 28). Chaian. Net.