Chapter 3 Enterprises and Banks- The NPL-Generating Mechanism

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Chapter 3

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Introduction

A number of factors contribute to the generation of non-performing loans in China. These factors can be roughly categorized into four: (1) Social factors: the social environment is such that fraudulent practices — such as soliciting investment under the false name of a big company or setting up an unlicensed bank to illegally collect deposits — can flourish; (2) Problematic management practices, such as the lack of risk management understanding and skills in financial institutions, and excessive inter-bank competition resulting in slim profit margins; (3) Institutional factors: in the transition to a market economy, actions taken by the government, the central bank, and financial institutions often contradict each other; and (4) Economic problems, including the overheating of the economy and generation of a "bubble" during the 1990s commercial bank reform, which seriously hit many financial institutions; slow development of capital markets meaning that banks absorb not only funds but also high risks; "triangular debt" continuing to bottleneck business activity; and the underdevelopment of securities markets as a mechanism for risk diversification.

Of these factors, (3) and (4) are the most problematic, both involving relationships between the SOEs and state-owned banks. In the following, we outline how institutional factors have caused the deterioration of the balance sheets of SOEs and banks. We then examine how far these negative factors have been overcome and how far the effort to resolve the non-performing loan problem has progressed.

Section 1
Where do Non-Performing Loans Exist?

Where are non-performing loans located, and how much are they in China today? **By non-performing loans we mean (1) loans unrecoverable by financial institutions** including banks and non-banks, and **(2) deteriorated enterprise claims to other enterprises**. The amount of the bad loans in category (1) has been estimated by various sources and we examine this question in Section 1 of the next Chapter. Generally, it is considered that non-performing loans in this category amount to approximately 30% of the total outstanding loans, or more than 2 trillion yuan as of the end of 1998. This is a large amount in comparison with other countries (Figure 1, Chapter 4). The amount of non-performing loans in the second category is harder to verify. One survey reports that, according to SOE balance sheets, unrecovered receivables (the popularly-termed "triangular debt") aggregated 648 billion yuan at the end of 1994 (from the Statistical Bureau's press release on January 25, 1995). This was a fragmentary piece of information, however, which was not updated in the following years so no trend can be ascertained. It is estimated that the category (2) bad loans reached 1 trillion yuan in 1996, however. Whether or not this estimate is accurate, it is indisputable that non-performing loans have grown to a considerably large size, looming as a problem that could affect the stability of the Chinese economy.

Of the non-performing loans in the Chinese economy as a whole, those directly involving the financial sector comprise a factor immediately threatening the stability and efficiency of financial systems. What then is the nature of the financial sector's non-performing loans? **It is generally argued that the deterioration of loans held by state-owned commercial banks was brought about by the deterioration of the SOEs' performance**. Tables 2 and 3, based on a survey of the asset situation of the Zhejiang province branch of the ICBC, endorse this general observation. According to the data in these tables, (1) the proportion of SOEs as sources of generation of non-performing loans is high (Table 2); (2) classifying firms by output size, small firms' generation of non-performing loans is high (Table 3). The ICBC is the largest of the four major commercial banks in terms of asset value. Historically it actively lends capital, particularly working capital, to SOEs. Also Zhejiang Province is where non-state-owned firms are highly developed. Considering these biases of the model, it may appear that the high SOE bad loan ratio as compared with the corresponding ratios for other forms of business is higher than the national average. But this effect, we argue,

Table 1 Non-Performing Loans with Financial Institutions

Li Xinxin analysis		Statement by the governor of the People's Bank of China (PBOC)		Statement by the governor of the Bank of China	
End, 1996		End, 1997		End, 1998	
4 major state-owned commercial banks		4 major state-owned commercial banks			
Total assets	9050.8 bil. yuan	Total lending assets	7069.1 bil. yuan	Overdue loans	6.75%
		Ratio of unrecoverable loans			
			6 to 7%	Doubtful loans	5.52%
Lending assets	6859.9 bil. yuan	Amount of unrecoverable loans	490 bil. yuan (if 7%)	Unrecoverable loans	1.02%
Bad loans/total asset ratio	24.4% (29.9% in June 97)			Non-performing loans	10.29%
Total non-performing loans	2 tril. yuan plus				

Notes:
(1) The four major state-owned commercial banks are the Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), the Agricultural Bank of China, and the Bank of China.
(2) Non-performing loans comprise the aggregate of the following three categories (taken from the General Rules on Loans (see "Lending Guidance").
"Overdue": Loans not repaid by the deadline but repayment not delayed beyond a term set by the Department of Finance.
"Doubtful": Principle not repaid or repayment delayed beyond the DOF-set term.
"Bad debts": 1) The debtor went bankrupt with the principal not repaid; 2) The debtor is deceased or personally bankrupt, with the principal not repaid; 3) The debtor has suffered major damages such as in the event of a natural disaster and fails to repay the principal; and 4) Overdue loans have been written off with the approval of the State Council.
Source: Li Xinxin, "China's Financial Difficulties with Reference to the East Asian Crisis – Analysis of the Asset Quality of State-Owned Commercial Banks," *The Reform*, No. 3, 1998. The Governor of the People's Bank of China was cited by the Hong Kong *Mingpao*, December 14, 1998. "Lending assets" here refers to the deposit-taking banks' lending to governmental and non-governmental non-financial institutions. The Bank of China figures are from a report in the *Nihon Keizai Shimbun*, June 8, 1999.

Table 2 Breakdown of Loans and Non-Performing Loans by Borrower (Zhejiang Province Branch of the ICBC; end, 1997)

In 100 mil. yuan	Industrial output		Working capital lending		Non-performing loan	
Total	10,379.96		324.2		59.1	
SOEs	1,236.93	11.9%	207.7	64.1%	35.14	$\boxed{59.5\%}$
Town and Village collective companies	1,255.08	12.1%	72.7	22.4%	20.22	34.2%
Town and village corporations	2,934.44	28.3%	39.6	12.2%	3.54	6.0%
Private companies and collective companies	4,953.51	47.7%	4.2	1.3%	0.2	0.3%

Note: % = shares of the business bodies.
Source: Yang Yin-yuan, "Two Proposals for Credit Assets Quality Improvement," *Shanghai Urban Finance*, No. 7, 1998, p.30

Table 3 Asset Quality by Bank Branch Grade (ICBC, Zhejiang Province Branch; end June, 1996)

	Asset situation by bank branch grade				Borrowers by size of output		
In 100 mil. yuan	Working capital lending (1)	Non-performing loan (2)	Non-performing loan ratio (3)=(2)/(1)	Unrecovered principal and interests (4)	Large enterprises Over 50 mil. yuan	Medium enterprises 10 to 50 mil. yuan	Small enterprises Below 10 mil. yuan
Total	326.58	54.42	17%		100%	100%	100%
Municipal head branches	101.8 31.2%	11.62 21.4%	11%	4.5%	65.2%	26.9%	7.9%
Municipal sub-branches	92.94 28.5%	11.44 21.0%	12%	10.0%	39.0%	31.6%	29.4%
Country branches	131.84 40.4%	31.36 57.6%	24%	14.0%	17.0%	28.7%	$\boxed{54.4\%}$

Source: Yang Yin-yuan, "Two Proposals for Credit Assets Quality Improvement," *Shanghai Urban Finance*, No. 7, 1998, pp.28 to 30 can be canceled considering that private companies are subjected to severer selection processes than SOEs. We can therefore regard the tendencies illustrated by Tables 2 and 3 as showing a universal pattern of the non-performing loan situation of China today.

Section 2
Balance Sheets of SOEs

As the above figures illustrate, China's non-performing loan problem boils down to the deteriorating quality of bank lending to SOEs. Why then has this happened? Factors common to all market economies, such as (1) business strategy failures of individual firms and (2) excessive competition within the same industry, are certainly at work. But in the historical perspective, we should not minimize the fact that the legacy of the institutions of planned economy still works to thwart capital accumulation in general and accumulation of a firm's internal reserve, in particular. In this Section, we examine this aspect of the problem.

1. Poor Capital and Over-Borrowing

Table 4 shows how the capital structure of SOEs has changed since the launch of economic reforms in 1978. With regard to the structure of working capital acquisition, it can be seen that (1) the rate of self-finance has plummeted and, (2) bank borrowing has increased. For investment capital, direct self-financing data are not available, but it is inferred that (3) SOEs depended increasingly on borrowing from banks. From the above it is concluded that **the**

Table 4 Funding Structure of SOEs (%)

	Fixed asset investment					Working capital		
	Public financing	Bank loan	Foreign investment	Self financing*	Other investment	Public finance	Self finance	Bank loan
1978	78	0	0	0	0	49	21	29
1979	76	0	0	0	0	62	21	38
1980	54	0	0	0	0	49	20	32
1981	50	0	0	0	0	48	18	33
1982	42	0	0	0	0	48	17	34
1983	50	0	0	0	0	48	16	36
1984	48	0	0	0	0	45	14	41
1985	24	23	5	5	7	42	12	46
1986	22	23	6	6	7	41	11	48
1987	21	25	7	40	0	40	10	50
1988	15	24	9	41	12	42	9	50
1989	13	21	10	43	13	42	9	49
1990	13	24	9	42	12	40	8	52
1991	10	28	8	43	10	39	8	53
1992	6	30	8	47	9			
1993	6	25	6	48	15			
1994	5	26	7	51	12			
1995	5	26	7	49	16			
1996	5	24	7	51	14			
1997	5	23	5	53	14			

Notes:
(1) Among fixed asset investments, self-financing represents funds the enterprise acquired outside of the government economic plan, and does not necessarily mean the firm's own fund.
(2) The figures are ratios against 100 for the total investment and total working capital. The discrepancies between the total investment and public finance until 1984 are unaccountable.
Source: *China Statistical Yearbook*, relevant issues

Chinese SOEs saw their own capital decrease and became increasingly dependent on bank loans as the economic reform progressed. This phenomenon arose as a result of institutional changes introduced both for enterprises and banks. We will examine first of all the enterprise side.

In concrete terms, the factor on the enterprise side which fostered the generation of non-performing loans was the distribution mechanism for the value added which was skewed by a number of flaws. To substantiate this point, we show in Table 5 how the value added was distributed during the period of 1980 through 1994. It is clear from this table that value added allocations to wages, depreciation costs, and interest payments were systematically increasing throughout that period. Consequently, the share of profit was decreasing. In fact the profit indicated in this table also included enterprises' payments to the government, so the actual profit retained by the enterprises would have been smaller still.

Table 5 Gross Value Added Distribution Structure in Industrial SOEs (prior to the 1994 tax and accounting reform, %)

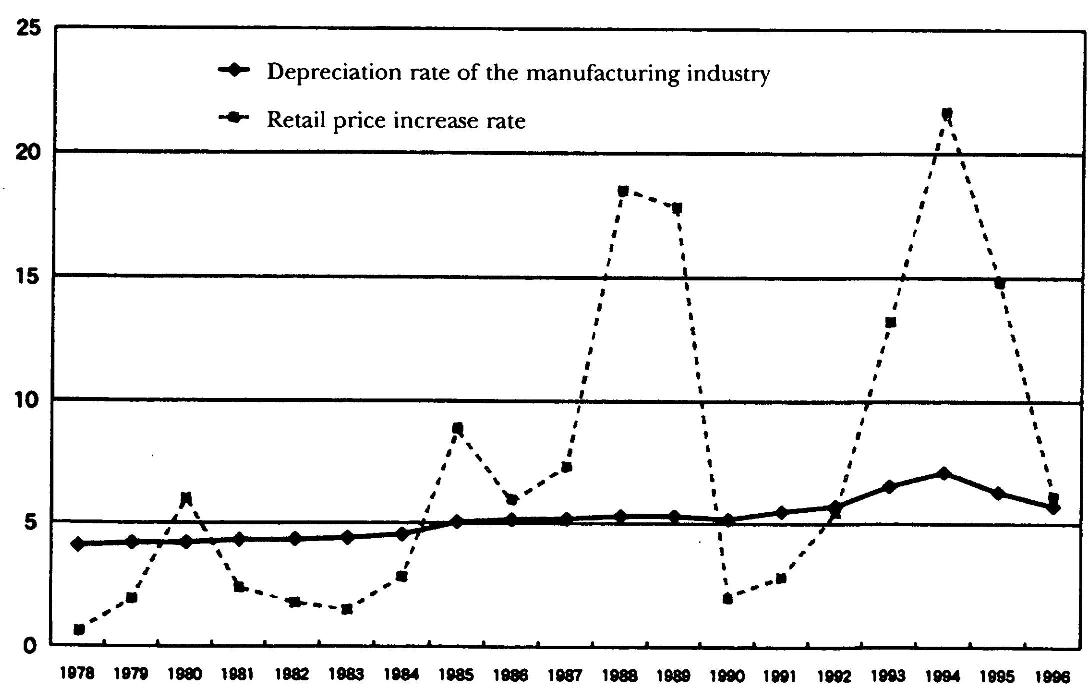
	Taxes (VAT)	Profit(incl. Payment to gov't)	Interest payment	Wages	Depre-ciation costs	Total
1980	25.6	44.5	1.3	19.8	8.8	100
1985	32.1	35.6	3.1	16.7	12.5	100
1990	34.2	9.1	11.1	30.8	14.8	100
1994	29.5	11.5	13.8	28.1	17.1	100

Note: Depreciation costs are partly paid to the government, not fully retained in the firm.
Source: Xiao Yan-shun, "Analysis of factors affecting SOEs' efficiency and policy proposals"

In the following, we discuss internal financing and external financing separately so that we may have a clear idea of the factors that impeded internal accumulation and those that increased borrowing from banks.

Since 1978 when economic reforms were launched, several factors inherent in the SOE system have worked to obstruct SOEs' internal capital accumulation. **Firstly, the depreciation rate was so low that it was impossible for SOEs to maintain**

Figure 1 SOEs' Depreciation Expense Rate and Inflation



Note: The depreciation rate in and after 1994 is the Shandong province figure,which was the closest to the national figure.
Source: *China Fiscal Yearbook*, relevant years

Table 6 Institutional Change in Depreciation Expenses

	Formula of Depreciation	Remarks
1978	Fifty-fifty formula : 50% of depreciation expenses were paid to the government	
1985	Seventy-twenty formula : 20% to the government and the rest retained	
1993	Capital formula introduced : depreciation fully counted as a cost and fully retained	Establishment of new enterprise financing system, centering on introduction of "Financial Guidelines for Business Enterprises" and "Accounting Standards for Business Enterprises."

Source: Ding Xue-dong, Li Guo-Chong, "Reform of Corporate Financial Management in China," *Economic Science Publisher*, April, 1996, pp.52 to 55, pp.147 to 153

capital. Secondly, the profit thus retained was distributed preferentially to workers. Capital accumulation was put under pressure by the political preference for high distribution in terms of wages. **Thirdly, SOEs were heavily burdened with taxes and other payments to the government.** Let us examine these three factors one by one.

(1) Depreciation expenses: Too low to maintain capital

Depreciation expenses are the funds accumulated to maintain the current scale of capital. It is sometimes regarded as one of the main source of internal finance. Without these, (1) a company's assets deteriorate due to depreciation and obsolescence, and (2) the value of retained depreciation expenses itself erodes due to inflation. To be worse, for some years after the reform was put into practice, Chinese SOEs were not allowed to accumulate sufficient depreciation expenses. In addition, the actual depreciation rate was well below the rate of inflation as Figure 1 indicates. To be strictly accurate would require a comparison with the erosion of asset value, but it seems fair to say that, given the high rate of inflation, SOEs would have experienced great difficulties in trying to maintain their capital. Part of the depreciation expenses, moreover, were in the form of payment to the government. Table 5 showed a stable increase of depreciation expenses, but it is not attributed to the enterprises fully. All told, SOEs were left with scant funds to maintain what is usually regarded as their own capital. When they needed funds for replacement investment, the SOEs had to borrow from banks the portion of the depreciation fund that had been paid to the government. Bank loans of course carried interest. The SOEs were in effect quite unable to use their own funds at their own discretion (Table 6).

(2) The over-inflated distribution to labor

The traditional pattern of distribution of value added to workers burdened SOEs in two ways. **First, wages tended to be increased in disregard of the profits earned. Second, as is often pointed out, the SOEs had to shoulder the burden of welfare programs.**

In deciding the wage level, the value added allocation for workers tended to be enlarged for political and economic reasons. For SOEs, the workers' wage belonged in the "hard line" category. The government was constantly urging enterprises to treat workers' employment and income levels as a top priority. This has already been discussed in detail in Chapter 2, Section 2.

The wage decision formula in SOEs passed through several stages after 1978. For some time after the economic reform was launched that year, SOEs were encouraged to raise wages in order to provide work incentives to workers. This policy meant that households, rather than the government, became the main saving body, as we pointed out in Chapter 1. The sharp rise in wages thus engendered obstruction to SOEs' internal accumulation of capital. This led to a policy change in the mid-1980s whereby, in order to restrain undue wage increases, a contract system was introduced that linked total labor costs to an enterprise's profit. But this system had its own shortcomings. For instance, it counted product inventories as part of the profit to which the total wage was linked. Thus, the "profit" used as the basis of wage decisions was actually larger than the real profit and consequently the workers were paid more highly than could be justified by the company's actual performance.[1] The goods still to

Table 7 Institutional Change in Wage Distribution

	Reform content	Contents of changes
1979	Contract production introduced at Capital Steel and some other firms	Enterprises for the first time allowed to pay bonuses and to raise wages if profits exceeded a target level
1985	Tentative introduction of a system linking the wage to the "economic revenue" (profit paid to the government) [Gong-xiao-gua-gou]	Irregular distribution problematized as wage is counted on a cash basis and profit on a work volume basis; enterprises failed to restrain expanding welfare benefits
1987	Gong-xiao-gua-gou spread nationwide	Diversification of the units to which wages are linked, from work volume to foreign exchange earnings; workers begin to calculate for themselves which method is most advantageous
1993	Establishment of a new enterprise financing system; introduction of "Financial Guidelines for Business Enterprises" and "Accounting Standards for Business Enterprises"	Wages incorporated into costs; welfare benefits brought under control

Source: Ding Xue-dong, Li Guo-chong, "*Reform of Corporate Financial Management in China,*" Economic Science Publisher, April 1996, pp.88 to 94, pp.157 to 158

Table 8 Profits and Losses of SOEs

	1994		1995		1996		1997	
1. Number of enterprises	34,273		34,309		32,204		30,926	
With surplus before subsidy	20,759	61%	19,698	57%	20,057	62%	14,574	47%
With deficit before subsidy	12,235	36%	13,324	39%	13,799	43%	14,879	48%
With deficit after subsidy	10,936	32%	11,425	33%	12,097	38%	13,569	44%
2. Sales of goods	18,248		21,246		21,929		22,576	
For enterprises with deficit after subsidy	1,922		2,335		2,921		3,170	
Minus price subsidy for starting new business	110		137		176		221	
Minus costs of goods sold	14,134	77.5%	16,692	78.6%	17,398	79.3%	18,081	80.1%
Minus costs of services sold	266	1.5%	344	1.6%	379	1.7%	446	2 %
Minus taxes and charges	664	3.6%	727	3.4%	803	3.7%	843	3.7%
3. Operating income	3,074	16.8%	3,347	15.8%	3,173	14.5%	2,985	13.2%
Plus other operating income	177	1 %	213	1 %	232	1.1%	222	1 %
Minus general and administrative expenses	1,827	10 %	2,045	9.6%	2,108	9.6%	2,062	9.1%
Minus interest and other financial charges	901	4.9%	1,133	5.3%	1,170	5.3%	1,124	5 %
4. Operating profit	523	2.9%	382	1.8%	127	0.6%	21	0.1%
Plus interest and dividend income	99	0.5%	135	0.6%	162	0.7%	206	0.9%
Plus subsidy income	111	0.6%	143	0.7%	132	0.6%	137	0.6%
Subsidy to enterprises with deficit before subsidy	93		101		79		81	
Plus current income	108		114		117		123	
Minus current expenditure	141	0.8%	162	0.8%	178	0.8%	181	0.8%
Plus profit/loss adjustment from the previous year	6		18		8		9	
5. Pre-tax income	706	3.9%	630	3 %	369	1.7%	296	1.3%
Deficit of enterprises with deficit after subsidy	282	1.5%	365	1.7%	501	2.3%	607	2.7%
Minus income tax	266		269		236		238	
6. Net income	440	2.4%	362	1.7%	133	0.6%	57	0.3%

Note: % figures are the ratios to sales; data only for 1994 and subsequent years as the accounting system was changed in 1994.
Source: *China Fiscal Yearbook*, 1995 to 98

be sold, which were counted as profit, in fact represented the company's implicit deficit in this context, or a reduction from what it could have otherwise retained. (For wage distribution reforms, see Table 7.)

The level of monetary income of the average worker is still low in China. The average monthly income of SOE workers in Beijing, for instance, is 600 to 700 yuan[2] (9,000 to 10,000 yen at the rate of 15 yen to the yuan). This is by far lower than the wages of a comparable Japanese worker. But considering the ample extra-wage welfare benefits Chinese SOE workers receive (the government meets the housing cost and social security premiums), the proportion of enterprise profits distributed to workers is believed to be fairly large. In practice, labor cost expansion was actually greater than wage increase, as can be seen from Table 5.

(3) Heavy "contribution to the state"

In the period of planned economy SOEs existed as "cells" to earn money for the upkeep of the national economy. For the government, SOEs were important primarily because of their capacity to pay taxes and make other monetary contributions to the state. Although, as Table 5 indicates, the volume of profits tended to diminish and the level of enterprises' contributions declined, still the share of value added tax (VAT) remained considerable in the government revenue.

3. Dependence on External Financing due to Internal Fund Shortage and the Resultant High Financial Cost

As the result of the persistence of institutional factors obstructing internal capital accumulation, capital continued to dwindle. SOEs were, so to speak, empty vessels which funds merely passed though, despite the rapid growth of the Chinese economy. **With the erosion of their own funds, SOEs had to procure funds from external sources if only to maintain their current production levels.**

The figures shown in Table 8 testify to such a situation. From the state of SOE business attested to be Table 8, a clear deterioration in business performance can be perceived. Note here that **the increase in the cost of goods sold and in financial costs caused a decrease in operating profit (4.). The increase in return on investment served to squeeze the decrement of the total profit, 5 but net profit dropped as sharply as the operating profits (5.), as the overall deficit enlarged.**

Section 3
Balance Sheets of State-Owned Banks

What then were the conditions for the lending side, the state-owned banks? The banks' own perception notwithstanding, the nature of their assets and liabilities had changed with the progress of marketization. While the debtors' obligation to the lenders was being tightened up, the quality of the banks' assets was deteriorating as the borrowers' financial positions were undermined in the ways already explained. As a result, the profitability of banks declined and their capital shortage became acute, increasing the credit risk of the financial system as a whole. In the following sub-sections, we will trace how this process developed.

1. Banks' Liabilities

(1) Burgeoning individual deposits: "Hard" liability increased

As examined in the preceding sections, SOEs, having little motivation for internal accumulation, continued to increase surplus allocation to workers. This situation affected the liability structure of banks. On the one hand, wage increases contributed to an increase in workers' savings in individual bank accounts. SOEs, suffering from a shortage of internal financing sources, borrowed more from banks, and on the other hand enlarged their workers' share in the value added. Bank loans thus introduced were used for the expansion of production and sales and also for increased payment to workers. This process thus increased individual incomes and led to the expansion of individual deposits. Table 9-1 shows that the share of individual deposits grew from 8% to more than 30% between 1978 and 1993.

Individual deposits comprise hard liability for banks. The lender being a huge mass of people, it is practically impossible for the banks to change their borrowing conditions. **The expansion of individual deposits in this context began a process of rusting of the "great iron bowl" which had long represented the close relations of the enterprise-bank community.** In China people had often claimed that there could be no problems between banks and enterprises because both were merely moving government money back and forth. Such an opinion no longer holds, however, since the money banks are handling is no longer government money but the money of common people.

(2) Dependency on central bank lending: Decrease of "soft" liability

State-owned banks, in the meantime, were spoiled by the system that absolved them of the need to meet for themselves the risks and costs entailed in their expanding lending operations. These banks depended heavily on borrowing from the central bank as their main source of money. Table 9-2 covers only the situation in and after 1993, but shows that in 1993 close to 30% of the banks' borrowing was from the central bank. The central bank effected money supply adjustment by controlling its lending to state-owned banks and their deposits with the central bank. But in practice the central bank had but weak powers of control. Until 1995 when the Central Bank Law was enacted, the central bank had been lending money almost as a matter of course to state-owned banks at the latter's request.

Table 9-1 Changes in the Asset/Liability Structure of State-Owned Banks (1978 to 93) (%)

Liability and equity	1978	1993	Assets	1978	1993
Deposits	60.46	66.45	Loans	98.59	75.65
Fiscal deposits	24.34	3.47	Liquid funds	92.4	53.43
Corporate sector deposits	19.63	21.93	Fixed assets		
Individual deposits	8.25	31.98	Foreign exchange	1.41	2.49
Money in circulation	11.3	16.77	Public sector loans		4.83
Own cash	22.48	4.71	Others		17.03
Others	5.76	12.08			
Total	100	100	Total		100

Source: *China Financial Almanac*, relevant years

Table 9-2 Changes in the Asset/Liability Structure of State-Owned Banks (1993 to 98) (%)

Liability and equity	1993	1998	Assets	1993	1998
Foreign debt	6.5	4.5	Foreign assets	7.2	5.5
Deposits	56.6	72.0	Reserve assets	13.0	10.6
Lending by PBOC	28.8	14.4	Deposits in PBOC	11.9	10.0
Borrowing from non-bank financial institutions	0.0	0.8	PBOC bonds	0.0	0.0
Bonds	0.7	0.6	Claims on the government	0.0	4.0
Owned equity	5.1	5.3	Claims on other sources (non-financial sector)	67.9	67.9
Others	2.4	2.5	Claims on non-bank financial institutions	0.0	2.0
Total	100	100	Total	100	100

Note: Statistical methods changed in 1993. Prior to 1993, depositors were shown identifiably but the assets of the central bank and commercial banks were consolidated. In and after 1993, their assets are shown separately.
Source: *China Financial Almanac*, relevant years

For commercial banks (formerly called specialized banks), central bank money was relatively easy to obtain, and indeed obtain at a low cost. Conversely, their liability to the central bank was a "soft" liability.

Since 1994 the state-owned banks' rate of dependency on the central bank has declined, however. In addition, the risks of lending are to be met by the state-owned banks themselves, by building up a general provision for non-performing loans. Since its introduction in 1988, the general provision rate has been gradually raised, and conditions its application made increasingly strict.

2. Bank Assets: Increased Risks

With regard to assets, banks' risks have consistently increased for the following reasons: (1) financial risks are concentrated on banks as capital markets stay underdeveloped; (2) profits are declining due to excessive lending and increased competition seeking for good lenders which compels banks to offer lower lending interest rates; (3) as mentioned above, bank assets have deteriorated because of credit deterioration as a result of chaotic business management and fund control in SOEs, along with the banks' lack of institutional powers to screen loan applicants.

(1) Policy-induced dependence on bank funds

When an enterprise lacks the capacity to achieve internal capital accumulation, it has to acquire funds from external sources. In the Chinese case, the SOEs could have awakened to the importance of internal accumulation if procurement of external funds had been made more difficult. External funds are obtainable either indirectly from banks and other intermediary financial institutions, or directly from the equity or bond markets. In China, the main supplier of external finance happened to be banks, particularly the state-owned commercial banks.

This channel of money flow was in fact imposed on SOEs by the government. As early as the first half of the 1980s, the government, worried about the poor incentive system and resultant inefficiency of SOEs, switched from fiscal funds to banks as the main source of SOE finances. The source of fixed asset investment was switched from the fiscal fund to banks (The "*Bo Gai Tai*" policy: transformation of the fiscal fund into bank loans) in 1983. The same policy had been adopted for operational funds in 1978.

(2) The emergence of banks as a "generous creditor"

This policy in favor of bank loans caused two problems through its basic lack of understanding about the roles of equity and debt in enterprise operations. The first problem was an acute shortfall of capital. In extreme cases, **some enterprises were set up with no capital of their own, all necessary funds borrowed from banks. Not surprisingly, such enterprises soon fell into crisis.** The other problem concerned the behavior of commercial banks. **They were not as rigorous as a creditor ought to toward the borrower enterprises.** This was because the state-owned banks considered lending money as instructed by the government to be the most rational behavior. In lending money, it was customary that they did not take collateral, nor did they check the borrower's debt equity ratio or liquidity ratio (liquidity assets as a proportion of liquidity debt). The state-owned banks had neither the skill, nor the need, to undertake rational credit control.

Behind this loose credit control were flaws in the banking system itself. The system was constructed so that the more a state-owned bank lent, the larger was the fund it could receive from the central bank. In other words, **the bank did not have to meet the risks and costs involved in lending expansion.** This being the case, state banks extended loans indiscriminately to SOEs. The banks were very generous creditors.

3. Banks Suffer from Capital Inadequacy

Shortages of state-owned bank capital eventually emerged in 1995. With their receivable interests amounting to 220 billion yuan at the end of 1995, all state-owned commercial banks except for the Bank of China had chalked up deficits. By that time 25 to 35% of their loans had turned non-performing while the total value of bad loans was increasing at an annual pace of 6%.[3] The deteriorating performance of SOEs had finally begun to affect the assets of state-owned banks, resulting in their fund shortfall. Table 10 shows that banks' internal asset rates had fallen to 3 to 4% — far below the capital adequacy requirement (8%) set by the Bank of International Settlement.

Table 10 Asset Quality at the Four State-Owned Commercial Banks (as of end 1996)

	Capital adequacy rate	Interest recovering rate	Net profit – asset ratio	Non-performing loans as % of total loans
Total	4.37%	60%	5.55%	24.4% (29.9%: 1997.6)
Industrial and Commercial Bank of China	4.35%		6.17%	
Agricultural Bank of China	3.49%		1.44%	
Bank of China	4.84%		10.29%	10.29% (1998)
China Construction Bank	4.81%		5.70%	

Source: Li Xinxin, "China's Financial Difficulties with Reference to the East Asian Crisis – Analysis of Asset Quality of State-Owned Commercial Banks," *The Reform*, No. 3, 1998.

4. Emergence of Non-Performing Loan Problems and Increased Risks

(1) Deterioration in SOEs' business performance invited by capital shortfall

The mechanism that generated non-performing loans can be explained with reference to the factors that contributed to the deterioration of the balance sheets of both the SOEs and banks. The debt-asset ratio went up under the intersecting influences of the factors that thwarted internal capital accumulation by SOEs and the soft budget constraints applied by state-owned banks. A rise in the debt-asset ratio could have positively contributed toward increasing corporate assets, but that would only occur if the firm's return on investment stayed above the interest rate of its debt (the so-called leverage effect). But in the case of Chinese SOEs, their return on investment stayed far below their debt interest rate, partly because they were operating under a system that worked to erode their own capital. Their asset value was exposed to constant attrition and their balance sheets deteriorated. **Since the cash and assets which they owned were too small for the size of their production, they suffered from declining debt repayment capacity (rendering banks' credit non-performing), which in turn gave rise to the "triangular debt" situation (rendering the enterprises' credit non-performing). This led to a vicious circle with further deterioration in the quality of assets.**

(2) SOEs' capital inadequacy caused banks' capital inadequacy

As described above, the banking sector began to suffer from fund shortages in 1995. On the liability side, although banks are subject to the hard constraint of being loyal to their depositor claimants, they have begun to fail to manage their own assets to meet this obligation. For state enterprises, the interest payable on past loans has snowballed, further undermining their business positions. Under such circumstances, it is increasingly unclear whether the banking system as a whole could remain solvent in the event of a run on banks. In such an eventuality, the financial system as a whole may well face a systemic risk. China now finds itself in a situation where the enterprise insolvency could trigger a general capital shortage throughout the banking sector, thus destabilizing the whole financial system.

Section 4
Coping with Non-Performing Loans

1. Preventive Measures

To avert the possibility of this danger turning into a reality, it is necessary for China first to take measures preventing more loans from becoming non-performing and second to dispose of the existing non-performing loans at an early date. For this, the enterprise side and the banking side have their respective tasks cut out for them, as shown in Table 11.

From among the measures suggested above, let us examine what kind of preventive measures ((1) for the enterprises and (3) and (4) for the banks) are being implemented. To cope with the critical situation, the Chinese government is carrying out economic reform measures while SOEs are working out their own countermeasures.

Table 11 Measures Necessary to Cope with Non-Performing Loans (NPLs)

1. Enterprises	Preventive measures	(1) Building up a mechanism to improve internal financing
	Settlement of past problems	(2) Disposal of existing NPLs
2. Banks	Preventive measures	(3) Improving asset quality
		(4) Enhancing risk-bearing ability
	Settlement of past problems	(5) Early disposal of existing NPLs

Source: present author's formulation

(1) Elimination of institutional flaws

To prevent non-performing loans, more institutional reforms are required. The following measures have been taken within the framework of SOE reform and financial system reform.

(i) SOE reform: Building a system to improve capital accumulation

(a) Provisional revisions have been made to the corporate accounting system and the tax system

In 1993, the "Accounting Standard for Business Enterprises" and the "Financial Guidelines for Business Enterprises" were put into effect, basing Chinese corporate accounting on the same principles followed in the West. This set in place the necessary system for maintenance of capital. Under this system, **(1)** a **corporate capital system** was introduced making it clear that the rights and interests of capital owners should be protected, and **(2) the payment of depreciation expenses to the state was abolished** so that enterprises could retain depreciation expenses. Also, **(3) wages came to be counted as part of costs while profit is defined exclusively as a return on capital.**[4] A unified standard was thus set for surplus distribution between capital and labor. With regard to profit-sharing between the enterprise and the state, two forms of transfer were established: (1) dividends paid to the state as a shareholder and (2) taxes on incomes and business revenues.

(b) Labor-favoring policies are gradually being withdrawn

Securing jobs for workers and stability for local society are still concerns of the highest priority to local governments, particularly municipal governments. But the way in which the concern is handled is changing as local enterprises encounter production difficulties. Local governments nowadays orient their administrative guidance toward minimizing the number of workers laid off and, in the case of bankruptcy, securing the employees' claims first. Section 4 of Chapter 2 dealt with this issue in detail. In addition, the wage determining mechanism was modified by the changes to the accounting system.

(ii) Bank reform: Banks' capitalization is also under way

Efforts to introduce systems for the maintenance of bank capital and for risk management have been made consistently since the mid-1980s. Landmark measures in this direction include (1) the introduction of a legal reserve requirement, (2) mandatory provision against non-performing loans, (3) establishment of loan guidance, and (4) the introduction of an autonomous asset liability management (ALM) system. Table 12 shows when these measures were introduced and what they signify.

(2) Independent initiatives of enterprises

Issues such as how much internal accumulation an enterprise should effect and how much outside funding it should seek are essentially questions to be tackled by the enterprise itself. But in China institutional defects have prevented firms from making their own judgments and from accumulating their own capital. China is now removing these institutional obstacles as we have just seen. **In addition, a number of enterprises are starting to devise their own fund management measures, having become aware of the importance of autonomous control and management of their own funds in the midst of the stormy marketization processes. In some cases, the survival of an enterprise depends largely on its skill in cash management.** Among these enterprises developing their own fund management practices are a number of highly successful firms counted among the best in the country. In China today, the management of receivables and payables

Table 12 The Introduction of Bank Risk Management Systems

Risk management systems	Content
(1) Legal reserve	When the central and specialized banks were separated in1994, the latter were asked to set aside a legal reserve for deposit. But as this reserve was prohibited from being used as a payment reserve, the state-owned commercial banks in 1989 were requested to have a separate reserve for payments. The reserve rate was set at 5 to 7% or more depending on the specific business character of the banks. The two reserves together amounted to close to 20% of the bank's total assets in 1989 to 98. In March 1998 it was decreed that both reserves should be consolidated into a legal reserve and the reserve rate was lowered from 13% to 8%, then to 6% in 1999.
(2) System for a provision for non-performing loans	This system was adopted in 1988 following China's affiliation with the Basel Treaty. The provision is to be counted as an auxiliary part of the bank's capital. In 1992, the method of calculation of the provision rate was revised and greater discretionary powers were conferred upon the banks for the settlement of bad loans to individuals and disposal of unrecoverable claims. In 1994, the Ministry of Finance instructed the state-owned commercial banks to concentrate the power to dispose of unrecoverable claims on their respective head-offices.
(3) Loan guidance	In June 1996, guidelines on loan extension were set out to regulate all money-lending financial institutions. The guidelines provide for supervision of financial institutions, intra-bank managerial control, and loan risk control.
(4) Autonomous asset liability management (ALM)	Autonomous ALM began to be introduced on a tentative basis following the enactment of the Commercial Banking Law in 1994. Later, from January 1 1998, commercial banks moved completely to autonomous asset management under the new asset liability management system.
(5) Deposit insurance system	This system has not yet been introduced, but the possibility of introducing it for local City Commercial Banks is being examined.

Source: Compiled by the present author from *Reference of Recent Loan Disputes*, China Price Publisher, November, 1998 and personal communications

is in fact becoming the crucial factor determining the financial state of enterprises. (See Cases 1 and 2).

Case 1: Group C's establishment of its own sales and settlement contracts

Group C is a township enterprise established through merger of a SOE and two collectively owned firms. Until it issued its first batch of stock shares in 1994, the group met all its investment needs with retained profit. The Group was able to retain profit and secure enough investment funds thanks to its special sales and settlement systems. In its procurement of parts, it followed what is called a quality-check-cum-payment system. This means that the part suppliers are paid the prices of the parts they deliver only after the group has assembled them and verified their quality. The principle of payment is account closure at the end of each month and payment in the following month. This payment practice was far more favorable than that followed by other assemblers, and so the sub-contracting parts suppliers willingly accepted it. For sales, the Group follows a controlled agent contract system. Under this system, the Group offers to conclude exclusive contracts with specific sales agents on a long term basis, and in exchange, asks them to prepay the prices on order placement and to accept all the goods ordered. By following this two-directional formula, Group C is able to obtain inter-firm credit from both the subcontractors and the sales agents, and thus meet its financial needs.

This formula is not perfect, however. It is disadvantageous to the group's partners, especially the parts suppliers. Delayed payment is certainly something the suppliers would like to avoid. In recent years competition is getting sharper within the business area in which Group C operates, and the Group is further delaying payment in order to retain enough money internally. As a result, some of the larger suppliers are said to be reducing their services to Group C.

Case 2: Group B under pressure from sales agents and parts suppliers

Group B is a SOE producing military facilities with a history of 40 years. It moved into the home electrical appliance business in the 1980s and has since been steadily increasing sales as a dependable medium-sized local manufacturer. But its business environment became more difficult in the 1990s due to excessive competition. Difficulties first arose between the group and the retailers with which it had historical ties. Usually, sales contracts designate the date and means of price payment. In concluding a sales contract, the retailer would insert a clause keeping the payment date open for a certain percentage of the sales. If reluctantly, B had to accept it. This is a formula frequently used in the electrical appliance business, and with the onset of overproduction it has become more or less a general practice. It is rumored that even the biggest-selling manufacturer recently lost a contract with a retailer by insisting on the deletion of this clause. In the meantime, today's consumers are increasingly selective about the products they buy, choosing electrical goods based on the quality of the goods' core components. This has reversed the power relationship between Group B and the components suppliers in the lather's favor. Knowing that the Group's products depend on the components supplied, the suppliers have begun to demand settlement in cash. Thus, B is forced to provide credit tô the downstream firms and asked to pay in cash to upstream suppliers. In an effort to meet both requirements, Group B fell short of funds. Its payables outmeasuring its receivables, the firm has become insolvent.

The two contrasting cases illustrate how the pressure of money is exposing enterprises to selection processes.

2. Settlement of Accumulated Problems

As well as preventive measures, processes for settling problems hanging over from the past have been under way during the second half of the 1990s. In accordance with SOE reforms, ill-performing firms are being made bankrupt or are being rehabilitated through mergers and acquisitions. With financial institutions (1) reorganization is taking place, and (2) public funds are being used to dispose of the unrecoverable loans of state-owned commercial banks.

(1) Disposal of corporate debt: the "Capital Structure Optimization" policy

As a measure to dispose of corporate non-performing loans, an asset-restructuring program called "Capital Structure Optimization" is being implemented. This program centers on **(1) capital augmentation, (2) restructuring of enterprises, (3) personnel reduction**, and **(4) bankruptcy. Overall the program is aimed at improving corporate revenue and profit positions.**

Corporate restructuring in accordance with this policy began in the mid-1990s. The first step taken was nationwide reevaluation of state assets as a necessary condition for asset restructuring. In 1994, the government hammered out the so-called "Concentration Policy" (*Zhua Da Fang Xiao*). This policy stipulated that (1) SOEs should limit their activities to the economic areas of "natural monopoly" and exit from competitive industries, and (2) restructuring of medium and small SOEs could include drastic measures such as bankruptcy and mergers and acquisitions. In 1997 the government decided to apply the capital structure optimization policy nationwide. It also set target figures for the disposal of non-performing loans and target increases for the rate of non-performing loan provision by the state-owned commercial banks, to be achieved during the three years from 1997 through 1999. The progress of these reforms is set out in Table 13.

The fact that, in spite of the reforms, the non-performing loans of SOEs are still today being disposed of in a way which favors consideration of workers' jobs above preservation of the banks' claims is serving to enlarge the banks' deficits and credit risks. Consequently, the quality of banks' assets is deteriorating fast. In the meantime, it is frequently reported that enterprises are deliberately delaying interest and loan repayment to banks, risking moral hazards. If a firm goes bankrupt, it is said that the banks can recover less than 10% of their loans.[5] Although the banks are participating in the non-performing loan disposal process together with the government, the banks do not have leadership authority and they are forced to shoulder the cost burdens. The continuation of such a state of affairs has meant a spread of awareness of the growing risks faced by banks. Reflecting this awareness, the People's Congress in March 1999 slightly modified the CSOP, stipulating that bankruptcies should be averted as far as possible so as to preserve banks' assets.

Table 13 Capital Structure Optimization Policy (CSOP): Enterprise Reorganization and Disposal of Non-Performing Loans in State-Owned Commercial Banks

	Enterprise restructuring policy	Content	Amount of settlement of NPLs	Action by State-owned commercial banks
1993	Trial introduction of the modern enterprise system			
	Trial implementation of CSOP	Corporation of SOEs; currently under way.		
1995	*"Zhua Da Fang Xiao"* [Concentration Policy]	State support is concentrated on large SOEs while medium and small SOEs are encouraged to merge or made to go bankrupt.	approx. 8 bil. yuan	Start to dispose of NPLs
1996			23.8 bil. yuan	
1997	15th Congress of CCP		31.6 bil. yuan (30 bil. yuan*)	NPL provision rate raised (0.7%*)
	National application of CSOP			
1998	"Protection from financial risks" policy	Avoidance of easy bankruptcy; preservation of bank loans.	(40 bil. yuan*)	(0.9%*)
1999			(50 bil. yuan*)	(1%*)
2000			(50 bil. yuan*)	(1.5%*)

Note: Figures with asterisks are targets set by the CSOP.
Source: Compiled from Jiang Yao-ying, "On China's non-operating loan and problems" (draft) and personal communications.

Table 14 Chinese Financial Institutions in Crisis and Methods of Their Disposal

	Names of institutions	Reason for crisis	Settlement formula	Features
January 1997	China Rural Development Trust & Investment Co.	Insolvency	Liquidation procedures by China Construction Bank; order for dissolution (Feb.1998)	
	Zhongyin Trust & Investment Co.	Insolvency	Annexation by Guandong Development Bank	
	Everbright Trust & Investment Co.	Insolvency	Dept turned to equity	
June 1998	Hainan Development Bank	Insolvency	Closure	Business deteriorated after annexing poorly performing trust and investment company
	New Technology Creation Corporation	Insolvency	Closure	
July 1998	Enactment of law to regulate illegal financial institutions and activities			
October 1998	Guandong International Trust & Investment Co.	Default on foreign loan repayment Insolvency	Treatment according to bankruptcy law	
	Guanzhou International Trust & Investment Co.	Default on foreign loan repayment	Rescue by Guandong municipal government through asset provision (Jun. 1999)	
	China Investment Bank	Apparent insolvency	Annexed by China Development Bank followed by merger with Everbright Bank (May 1999)	A channel through which the World Bank loans are received
January 1999	Guandong Overseas Chinese Chinese International Trust & Investment Co.	Default on foreign loan repayment	Proposal to set up a new joint firm (Guandong Province Science and Technology Investment Co.)	
	Guandong Financial Trust & Investment Co.	Rumored loan repayment delinquency		
	Guandong Enterprises	Retarded rehabilitation due to difficulty in getting foreign loans	Asset sales under investigation; debt writing-off is proposed and under negotiation with creditors.	
	Dalian International Trust & Investment Co.	Practically delinquent on loans repayment	Not yet defunct	
	Fujian Enterprises	Delayed payment of interest and principle	Not yet defunct	

Source: Compiled by the present author from *Nihon Keizai Shimbun, People's Daily, South China Morning Post* and other sources.

(2) Non-performing loan disposal by the four major commercial banks, and their reorganization

The financial institutions have been in the process of reorganization since 1997. In October 1998 Guandong International Trust and Investment Company (GITIC) was declared bankrupt, sending out warning signals all over the world about the risks Chinese financial institutions faced. **Reorganization of Chinese financial institutions started in January 1997 with a decision to sort out three trust and investment companies (itics).** The three were disposed of in different ways: (1) conversion of debt into equity, (2) absorption by another bank, and (3) liquidation. There is a strong possibility that the decision to liquidate GITIC in October 1998 was also made so as to provide an example of how financial institution reorganizaion could be carried out. Table 14 illustrates the instances of disposal of financial institutions carried out by July 1999.

(3) Capital injection to four state-owned commercial banks

Capital inadequacy in banks can lead to liquidity shortage and eventually trigger a run on banks. To circumvent this danger, the government injected capital amounting to 270 billion yuan into the four major commercial banks.

The details of this capital injection is shown in Table 15. With this infusion of funds the commercial banks are said to have attained the required 8% or higher own-capital ratio.

The major remaining problem is how the four commercial banks' non-performing loans can be settled. A plan to dispose of them through another injection of public money has been under investigation since the end of 1998. The basic concept of this plan and its possible effect on the macro economy will be discussed in the following Chapter.

Conclusion

This Chapter has shown how China has been steadily making efforts to reduce non-performing loans. By way of conclusion, we would like to point to two issues that are likely surface in the future.

The institutional factor responsible for the generation of non-performing loans in China was the presence of systems and policies that ignored the importance of maintenance of capital. This applied to both enterprises and banks. New frameworks are already in place to encourage maintenance of capital: for businesses, the modified accounting system, and the shift away from focusing on worker privileges; and for financial institutions, the institutionalized deposit and bad loan reserves, and the introduction of the concept of lending risk management, among others. The establishment of such an institutional framework is one thing, but whether it can take on a real life is quite another. All depends on whether the staff are motivated to observe the rules and principles set by the new institutions. Thus we see corporate governance, in other word, compromising all the stakeholders' interests, as the first

Table 15 Injection of Public Funds into the Four Major Commercial Banks in March 1998

Content	
Amount of capital injection	270 bil. yuan
Industrial and Commercial Bank of China	74.2 bil. yuan
Agricultural Bank of China	93.3 bil. yuan
Bank of China	42.5 bil. yuan
China Construction Bank	60 bil. yuan
Method of injection	Provision of state bonds using surplus generated by lowering of the legal reserve rate
Term of redemption of special state bond	30 years
Interest rate	7.2% per annum

Source: New China News Agency, *China News*, March 2, 1998.

issue on the horizon.

The second issue involves where the government stands. In most other countries, the government is a third party to inter-enterprise transactions, and it is expected to play a monitoring role or act as a mediator in problem resolution. But in China, past systems mean that the government is one of the parties involved when it comes to the question of banks' unrecoverable claims. **The government is itself a stakeholder in this matter.** For instance, some local governments have in the past forced banks to lend irrationally, so they should be held responsible for the losses the bank incurred. The local government is also the representative of SOE owners, however, so it may well profit from sustaining inefficient firms. The government may also prefer to sustain an inefficient firm rather than risk social unrest due to an influx of unemployed workers if an enterprise is closed. Such biases mean that the settlement of enterprises' non-performing loans is frequently handled in ways unilaterally disadvantageous to the bank side.[6] The withdrawal of government intervention is thus not to be overlooked as a key to the success or failure of China's disposal of non-performing loans.

(Mariko Watanabe)

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Notes:

1. This is one of the factors that explain the differential between average labor productivity and the average wage as indicated in Figure 2, Chapter 2.
2. The wage range at enterprises where this author had hearings in June 1999.
3. Li Bo and Shen Guanchu ed., *Reference of Recent Loan Disputes*, China Price Publisher, p.183.
4. Ding Xue-dong, Li Guo-chong, *Corporate Financial Management Reform in China*, Economic Science Publisher, April 1996, Chapter 4
5. From the 1997 hearings of the State Economic and Trade Committee
6. Wei Jia-ning made the following proposal for overcoming the problems that may be generated by the government as a stakeholder. First, a rating agency of bank loans should be set up as a neutral party. The major problem encountered now in debt settlement is the lack of objective criteria; the selection of the object and method of disposal is entrusted to the government. To resolve problems arising from this, it is essential to establish a third party to evaluate the liabilities. Second, a joint committee encompassing the government agencies involved should be set up to adjust their mutually conflicting interests. Third, a savings insurance scheme should be established for the state-owned commercial banks. With this, these banks could obtain institutionally-endorsed stability, beyond the mere official assurance based on government authority, and they would thus become more independent. (Wei Jia-ning, "How the world is coping with the bankruptcy of financial institutions", *Reform* 1999, No.3)