

# The Way of Dealing with Non-performing Loans and Its Effects on Macro-statistics in China

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## A. Background

1. The non-performing loans (NPLs<sup>1</sup>) of China's banks, in particular state-owned banks and entrust & investment companies mainly accumulated in the period of 1992-1997 during which China experienced first a high inflation and then a contraction. At the end of 1997 NPLs<sup>2</sup> accounted for 35 percent of the total outstanding loans of financial institutions as a whole according to my personal estimation since no official figures are directly available.

2. The rapid accumulation of NPLs during that period was caused by the following factors: (1) the then Agricultural bank of China lent a lot of policy loans to purchase grains at the time grain prices peaked dramatically in 1993-1995 and then could not recover them back in full when grain prices declined in 1996-1997; (2) banks could not recover their loans to small enterprises both because of operational troubles in the contraction period of 1996-1997 and of the cahoot behaviors of local governments, grass-roots branches of banks, and owners or manager of small enterprises; (3) banks could not recover their loans on real estate that were lent in 1992-1994 due to the decline in real estate prices later.

3. The outbreak of the Asian financial crisis in 1997 prompted Chinese leaders to tackle the issue of NPLs of banks. From 1998-2001 up to 1400 billion yuan of NPLs of four major state-owned banks were separated to four corresponding financial asset management corporations. There were two ways of separation. One was that a financial asset management corporation issued full equivalent securities--implicitly guaranteed by the government--to the bank in exchange for its NPLs. The other was that a bank gave up its NPLs to the corporation and was compensated by the write-off of an equivalent amount of central bank lending to the bank.

4. Up to the end of 2002 the four major financial asset management corporations had disposed of 301.4 billion yuan of NPLs excluding the conversion of liabilities to equities, recovering 101.3 billion yuan including 67.5 billion yuan of cash.

5. After the separation and other efforts, the NPLs of the four major state owned banks accounted for on average about 24 percent of the total of their loans according to the latest data in

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<sup>1</sup> As a matter of fact, there were no so-called NPLs in the minds of Chinese bankers until 1996. The *Loan Rule*, formulated by the People's Bank of China in 1996, stipulated that there were three types of NPLs, which were the loans whose principal and interest could not be paid back within 180 days overdue; the loans whose principal and interest could not be paid back after 180 days overdue, and the loans whose principal and interest could not be paid back with certainty. In 1999, the people's bank suggested the commercial banks adopt the five-grade classification of loans.

terms of the five grades of classification suggested by the Institute of International Finance.

6. The other measure taken by the government is to allow the banks to set aside provisions for the loss of NPLs. The provisions are exempt from taxes, but the amount of provisions must be negotiated with the Ministry of Finance every year.

#### **B. The effect of separation of NPLs on financial statistics**

7. At present the financial statistics extensively used in China are those shown in “the Table of outgoing and incoming of credits for financial institutions”, which is in fact a consolidated balance sheet of financial institutions consisting of the central bank, policy banks, commercial banks, credit unions, financial companies, entrust & investment companies, financial leasing companies, post saving agencies, joint venture banks, foreign banks or their branches in China. But the four financial asset management corporations are not covered by the consolidated balance sheet.

8. When the NPLs are separated by exchanging for securities, this has no impact on the total assets of the consolidated balance sheet, but has resulted only in a change in the structure of assets. Nor is there an impact on the each item of liability side that is essential for the calculation of money supply. But it should be noted that the loans could not be compared between different periods due to one-time separation. So it is important for the central bank to provide data on comparable changes in loans for the public.

9. When the NPLs are separated by exchanging for the write-off of the central bank's lending, this influences the balance sheet of both the bank in question and the central bank, and hence the consolidated balance sheet for the financial institutions as a whole. The central bank of China classifies the write-off under the heading of “other liabilities” as negative. So this does not influence money supply or owners equity in the banks.

#### **C. The effect of provisions for NPLs on financial statistics**

10. In the balance sheet of financial institutions the item of “general provisions” under which there is the sub-item of “provisions for bad loans” is set on the liability side according to the requirement of the Ministry of Finance. This arrangement would not influence the equities of banks and other financial institutions except for undistributed profits and the monetary aggregates for the financial institutions as a whole. When NPLs actually cannot be recovered, the corresponding provision will be cancelled out.

#### **D. Interest accrual on impaired loans**

11. The stipulations on the interest accrual on impaired loans change over time. Before 1998, according to the accounting system set by the Ministry of Finance for financial institutions of China, any interest must accrue to loans no matter whether they are sound or impaired ones. The only exception is if the government agrees to suspend the accrual of interest on particular impaired loans, it would not be recorded any more either in the balance sheet of banks and other financial

institutions or in the balance sheet of non-financial enterprises. This symmetric entry would not damage the consistency between sectors in the national accounts. During 1998-2001, the Ministry of Finance stipulated that the interest on the loans with 180 or more overdue days should cease to accrue on the business accounts of financial institutions. This meant that the interest would not be accrued on the loans in the grades of “Doubtful” and “Loss” in the five-grade classification. From 2002 on, the number of overdue days has been reduced to 90 days. This meant that the interest would not be accrued on the loans in the grades of “Substandard”, “Doubtful” and “Loss”.

12. Though the interest ceased to accrue will not appear on the business accounts, it must be shown as off-sheet items. So the extra information can be used for the compilation of national accounts to remove the asymmetry between the sectors.

#### **E. Some suggestions on dealing with NPLs in national accounts**

13. In view of the importance of NPLs to financial institutions, to a supervision authority, and to analysts, it is necessary for international organizations to develop a single definition of NPLs for the world. Now China’s financial institutions all adopt the five-grade classification: standard, watch, substandard, doubtful, and loss, which is suggested by the Institute of International Finance for external reporting.

14. From China’s experience, NPLs can be divided into “recurrent NPLs” and “one-time NPLs” depending on the cause of nonperformance. Those that are caused by external impacts like severe macro-economic problems, relaxed supervision from the authorities, and excessive intervention from government policies could be treated as one-time non-performance loans. Those that are caused by recurrent normal factors and can be reasonably measured from past experience could be treated as recurrent NPLs.

15. The write-off of one-time NPLs can be treated as other changes in the volume of assets, whereas the write-off of recurrent NPLs can be treated like price changes of assets.

16. One-time NPLs can be shown as the memoranda items in national accounts while there is no necessity for recurrent NPLs to be shown.

17. Since financial institutions normally cannot afford to write off NPLs caused by major external impacts, it is reasonable to consider provisions for impaired loans only in the case of recurrent NPLs. The provisions for such impaired loans will constitute a reduction in profit but not in operating profit<sup>3</sup>. The operating profit is more like the operating surplus of the national accounts than the profit. When calculating the value added for banking sector by adding up its four components such as wages and salaries of employees, taxes on production, consumption of fixed capital, and operating surplus, it seems to be better to use the operating profit as operating surplus.

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<sup>3</sup> The concept of operating profit differs from that of profit in China’s business accounting. For example, in the 2002 financial statement of the Industrial and Commercial Bank of China the following relationship between them is shown: profit (62.17) + provisions for bad debt (255.90) + the write-off of accrued interest (82.09) + the write-off of non-credit asset loss (39.03) = operating profit (439.17). The figure in brackets are valued in 100 million yuan.

This implies that the provisions for bad loans or other would-be write-off items are not deducted from output or income. The reason behind the treatment is that any changes in the value of loans after the contract of the lending transaction has been signed have no influence on the production and income in the context of the national accounts.

18. The balance of provisions can be shown as “other receivables”.

19. Thus, for the NPLs that are caused by normal operating factors and can be forecast with reasonable certainty, there is necessity for corresponding changes in the 1993 SNA to take them as changes in the price of financial assets shown in the revaluation account. But for the so-called one-time NPLs that result from severe external factors and cannot be forecast in a relatively precise manner, when they are stripped out from the balance sheet of financial institutions one time for ever, they should be treated as other changes in the volume of assets in SNA. In these two cases, both production account and income account of the SNA would not be affected.

20. The rationale for dealing with recurrent NPLs and one-time NPLs in completely different ways is that the former can be forecast and hence provided for by financial institutions while the latter cannot be forecast and thus cannot be provided for. For the first case, it seems that the treatment suggested above is implicitly contained in 1993 SNA as changes in the price of assets; for the second case, the treatment suggested above is explicitly expressed in 1993 SNA except that a memorandum item for one-time NPLs should be added to financial accounts and balance sheets of national accounts.

21. The recording of interest accrual on NPLs in the national accounts is suggested to follow the rules of business accounting. If the banker or the Ministry of Finance has decided that the interest accrued on NPLs is shown as off-sheet items in the business accounting, they must have strong confidence that this kind of interest accrual is very likely not to be collected. One point that should be noted here is that on debtor side similar recording should be made to keep the national accounts consistent.

#### **F. Further thinking over the treatment of NPLs**

22. In the section E it is suggested that the provisions set aside for NPLs should not affect the production account and the income account. However, we can argue about this issue from an opposite angle. Assuming that there are two types of loans, one with no risks, the other with risks, for the first type of loans, we think that the lender will charge the borrower with a normal interest rate. Since the lending is risk free, the lender will not set aside provisions for it. For the second type of loans, we think that the lender will charge the borrower with a interest higher than normal. Since the lending is risk-related, the lender has to set aside provisions for it. If no risk premium is considered, the higher interest rate will be equal to the normal interest rate after the provisions are deducted. To illustrate the two types of loans more clearly, the following table is used:

Table: Types of loans and their characteristics

	Type A	Type B
Characteristics	Risk free	Risk-related
Charges (interest rate)	Normal	Higher than normal
Provisions for recurrent losses	0	Some amount
Provisions for catastrophic losses	0	0
Charges after deducting provisions	Normal	Normal

19. When the lender charges the borrower with a higher interest rate on risk-related loans, it can be assumed that they could not recover all the lending including the interest promised by the borrower. So they make some provisions for the possible losses before the transaction is completely finished. In this case, we have reasons to take the provisions as negative income when calculating the output of the banking sector. Thus the influence of provisions will be reflected in the production and income accounts rather than in the revaluation account.

20. Thinking more deeply on this issue, the treatment of NPLs and corresponding provisions seems to involve the temporal symmetry of recording transactions. If it is sure that the occurrence of NPLs will sooner or later result in a certain amount of loss so that provision will be charged on the loss, and if the provisions can be set aside just equal to the loss, we can deduct the provision from operating surplus in a rational anticipation as companies treat them as a negative contribution to profits even when the loss has not yet happened. But after all the anticipation is only a forward guess for the future. The loss and hence provision could not be precisely estimated especially for assets like NPLs, so the deduction in advance is quite arbitrary.

21. If the treatment above is not acceptable, we have the second choice. We can assume NPLs are incurred to financial enterprises in a stable way or at random so that the loss of NPLs depends on the time span not on the time point. In this case, we can still deduct the provision that has been used up for the loss from operating surplus in the national accounts, even it cannot keep the temporal symmetry between the occurrence of NPLs and the write-off of them, yet the amount is stable from period to period.

22. If the second treatment is not acceptable, we have the third choice. That is the treatment recommended by 1993 SNA, which treats the write-off of financial assets including NPLs as other changes in the volume of assets. This treatment completely disrupts the symmetric entry required for SNA because the loss of NPLs that take place later on has no impact on the operating surplus generated before.

23. The third treatment can be alternated by a backward adjustment to the operating surplus of financial institutions in accordance with the occurrence of NPLs. The adjustment may more realistically reflect the value added of financial institutions and thus provide more analytical value. Furthermore, it reduces the puzzle on the changes in wealth due to “unexplainable” other changes of and increases the persuasion of SNA since more changes in wealth can be explained by saving. But all these rely on the information on the distribution and severity of NPLs over time.

24. Theoretically, the first treatment is the best acceptable and the third one is the least acceptable whereas the second one is in the midst, but in practice, the third treatment is the soundest by placing the entry on the actual transactions in the context of SNA. What I suggest in the paper is a compromise between these treatments. For recurrent NPLs, the second treatment could be applied. For one-time NPLs, the third one could be used. Considering that NPLs may not be so important in volume in the future as before as supervision authorities now place more stress on them, the SNA treatment, with some modification, could possibly stand there for a long time.