

Using asset management companies to resolve non-performing loans in China¹

Guonan Ma

Senior Economist, the Bank for International Settlements



Ben S. C. Fung

Assistant Chief, Bank of Canada

Abstract

To address the banking system's non-performing loan (NPL) problem, the Chinese government set up four asset management corporations (AMCs). They were to buy bad debts from mainly the big four state-owned commercial banks and dispose of them over 10 years, taking a large step towards NPL resolution. So far, these AMCs have made a limited contribution to the resolution of the NPL problem. They have taken over well over half of the NPLs of the big four banks and probably resolved more than half of those acquired. However,

under plausible recovery scenarios, the AMC losses would surpass the current financial contributions to the AMCs from both the Ministry of Finance (MoF) and the People's Bank of China (PBC). This raises the question of who will pay for the AMC losses. Since their cash recoveries have lagged their interest obligations, they also face cash flow pressures. In response, the Chinese government has offered investment banking business licenses as incentives for the AMCs to meet the deadlines and recovery targets of their NPL resolution.

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The actual scale of the non-performing loan (NPL) problem in China's banking system is still attracting much attention. A few years back, most estimates put the NPL level within the Chinese system, both carved out and remaining, at around 40% of the total loans outstanding in the late 1990s [Lardy (1998), S&P (2001a), Dai (2001), Ma (2006)]. The most recent statistics from the China Banking Regulatory Commission (CBRC) reported the NPLs of the four major state-owned banks (the big four banks) at just below 10% in the first quarter of 2006. That appears to be a significant improvement in less than ten years. However, a report by Ernst & Young in May 2006, withdrawn shortly after drawing fierce criticism from the PBC, suggested that the NPL at the big four banks could still be as high as 30%.

Historically, there are many factors shaping China's NPL levels, including policy lendings during the 40 years of the command economy regime, weak financial performance of the state-owned enterprises (SOEs), poor creditor rights protection, and lax internal credit risk controls of the state-owned banks. To put the Chinese banking system on the proper track so that they can compete with international banks and support the fast growing economy, the Chinese authorities need to address the 'stock' problem and stem the flow of new NPLs.

In this paper, we discuss the use of asset management corporations (AMCs) to resolve China's existing NPL problems and to restore the health of bank balance sheets. In 1999, the Chinese government set up four state-owned AMCs to buy the bad debts of the big four banks (as well as some other banks) and to dispose of them over 10 years. This was a major step forward, underscoring the Chinese government's determination to restructure the banks. Since the big four banks hold half of the Chinese banking sector's assets, they are naturally the prime focus of the government's bank restructuring efforts.

The Chinese approach broadly resembles the Swedish model of separate and decentralized NPL management. Basically, each of the four AMCs pairs up with one of these big four banks in China (Figure 1). The MoF provides each AMC with an

initial equity capital injection of RMB 10 billion (U.S.\$1.2 billion). In theory, the MoF is the sole owner of the four AMCs; the big four banks do not formally have any direct equity stakes in the AMCs. These big four banks have transferred their NPLs to their respective linked but independent AMC. The four Chinese AMCs initially have the overriding mandate to maximize asset recovery over 10 years. Their primary roles include acquiring, managing, and disposing of NPLs.

| Asset management corp | Matched bank | Assets transferred (RMB billions) | Share of bank loans outstanding (% at end-1998) |
|-----------------------------|--------------|-----------------------------------|---|
| Orient Asset Management | BoC | 267.4 | 20.4% |
| Great Wall Asset Management | ABC | 345.8 | 24.6% |
| Cinda Asset Management | CCB | 373.0 | 21.7% |
| Huarong Asset Management | ICBC | 407.7 | 17.9% |
| Total | | 1,393.9 | 20.7% |

Note: BoC = Bank of China, ABC = Agriculture Bank of China, CCB = China Construction Bank, and ICBC = Industrial and Commercial Bank of China. In calculating the CCB loan shares, the figure takes into account that the RMB 100 billion of assets transferred to Cinda are from China Development Bank and not from any of the big four banks.

Figure 1 - The first batch of policy-based NPL transfers in 1999-2000
Source: Zhu et al. (2001a).

More generally, many Asian economies have set up resolution agencies as the preferred tool for handling distressed debts in their financial systems, especially after the Asian financial crisis. China appears to have taken a similar broad strategy in dealing with the NPLs in its system. While there has been a large body of literature on emerging Asia's experiences of using asset management companies to resolve bad debts [Lindgren et al. (1999), Claessens et al. (2001), Fung et al. (2004)], this paper differs from the others in providing an in-depth study of the Chinese AMCs.

NPL transfers from banks to AMCs

Setting up the AMCs to take over and dispose of NPLs from the big four banks was one of a series of ambitious banking reforms in China. The Chinese government set up three principal policy banks during 1994-95, with the stated intention of taking over most of the policy lending responsibilities of the big four banks. The People's Congress, China's legislature,

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passed the Commercial Banking Law in May 1995, for the first time providing the legal basis for commercial banking. Moreover, during 1997-98, the government undertook bank reforms to abolish bank credit quotas and to encourage banks to make their lending decisions on a commercial basis [Lardy (1998), Mo (1999)]. In 1998, the Chinese government injected equity to partially recapitalize the big four banks [Mo (1999)]. Following that, the establishment of the four AMC in 1999, and their subsequent carving out of NPLs at the big four banks, represented a major step towards resolving China's NPL problem².

The first round of NPL transfers totaling RMB 1.4 trillion in 1999

The first round of transfers of the bad loans from the big four banks to the four AMCs took place between 1999 and 2000. Assets transferred amounted to RMB 1.4 trillion (U.S.\$169 billion), more than 20% of the big four banks' combined loan books and equivalent to 18% of China's GDP in 1998 (Figure 1). However, there has been a lot of confusion regarding the actual scope of the NPL transfer, which complicates our efforts to understand the task facing the AMCs.

Firstly, not all NPLs at the big four banks were transferred to the AMCs during 1999-2000. In Ma and Fung (2002), we estimated that the total NPLs of the big four banks – including those already transferred, disposed of, or remaining – could have amounted to RMB 3.4 trillion (U.S.\$410 billion) or around 42% of the big four banks' loans outstanding at the end of 2001. This is similar to the peak levels of 40% to 60% for Korea and Indonesia after the Asian crisis [Claessens et al. (2001); Fung et al. (2004)]. The NPLs transferred to the Chinese AMCs during 1999-2000 represent less than half of the total estimated NPLs at the big four banks at the time. Secondly, the asset transfers during 1999-2000 are mainly policy-based. The AMC purchases of the NPLs were executed uniformly at book value and the government explicitly authorized the related AMC financing that covers such transfers. These NPL transfers were mostly restricted to those loans made before the end of 1995 and identified as 'substandard' or 'doubtful' under the old

Chinese loan classification system before the end of 1998. In addition, some of the bank assets transferred were selected to serve certain specific government goals, such as debt-for-equity swaps [Tang (2001a, 2001b)].

How have the Chinese AMCs been financed? International experience suggests that well funded AMCs are a key ingredient for efficient NPL resolution [Crockett (1998), Lindgren et al. (1999), Claessens et al. (2001)]. Government regulations [State Council (2000)] stipulate that the four permitted sources of AMC financing are MoF equity, borrowing from the PBC, commercial borrowing from other financial institutions, and AMC bonds. When the AMCs were first established, the MoF injected RMB 10 billion in equity capital into each of the four AMCs. These funds were certainly inadequate, funding less than 3% of the 1999-2000 policy purchase of NPLs. We estimate [Ma and Fung (2002); Fung et al. (2004)] that for this first round of big policy NPL transfers, the required financing was predominantly provided by the MoF, roughly 60%, and the PBC, up to 40%. There was no competition in the allocation of the NPL purchase, and the transfer price was uniformly set at book value.

Additional NPL transfers totaling RMB 780 billion since 2004

Since 2004, there have been a number of transfers of both the loan losses and doubtful loans at the recapitalized CCB, BoC, and ICBC onto the books of the AMCs, funded by the PBC and sizable equity write-off by the MoF [Ma (2006)]. First, in 2004, the PBC bought RMB 320 billion of doubtful loans from CCB and BoC (as well as the Bank of Communications, the fifth largest bank in China) for half their book value and then auctioned them to the AMCs for 30 to 40 cents on the dollar. Then in 2005, the PBC bought another RMB 460 billion of doubtful loans from ICBC at par value and auctioned them to the AMCs for an average of 26 cents on the dollar. The total book value of loans transferred was around RMB 780 billion (U.S.\$96 billion)³. One improvement this time, though, was that these NPL transfers were mostly carried out through a competitive auction process, with the

² Since 1999, the Chinese government authorities have taken other measures to deal with the NPL problem. For a more detailed discussion of these measures see Ma (2006).

³ These recapitalized banks also transferred sizable loan losses exceeding RMB 1 trillion at the zero price to their respective AMCs during 2004-2005.

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winning AMC(s) either taking over the entire auction lot for its own recovery business or enjoying the first cut in actual NPL resolution. Hence the more recent NPL transfers were somewhat more market-based than entirely by fiat.

In this case, the PBC appears to have made an outright loss – based on the differences between the acquisition and auction prices of the doubtful loans involved – of nearly RMB 400 billion (U.S.\$50 billion) – or some 20 times the PBC's own reported capital. Furthermore, the PBC balance sheet has an additional exposure to the AMCs because it provided the credit of RMB 216 billion to finance their acquisitions of two NPLs⁴. In essence, the PBC has been decapitalized to finance bank recapitalization, all without a government guarantee, at least on the public record.

The balance sheets of the big four banks and AMCs

As a result of the NPL transfer in 1999, it appears that the asset composition of the big four banks may have improved, since some of their NPLs are replaced at par with AMC bonds and cash. However, the actual improvement hinges on two crucial assumptions. Firstly, the 'performing loan' transfers of around RMB 200 billion noted earlier would not exceed the total cash payments that the big four banks received from the AMCs. This assumption is largely met by our estimated AMC cash payments. Secondly, the AMC bonds are implicitly backed by the state. While most market analysts believe that there is no explicit guarantee from the government [S&P (2001b)], one of the big four banks has remarked that the AMC bonds are state-backed [CCB (1999)]. In China, the general belief is that there is an implicit guarantee by the government, since it could ill afford to let the AMCs default on their bonds. Since 2005, the Chinese government has become more forthcoming in offering clarification to such AMC bonds [Ma (2006)].

Even if the AMC bonds are not guaranteed by the government, a case can still be made that this transfer improved the risk-based capital ratio of the big four banks, given that 'agency' bonds attract a lower risk weighting according to the

current Basel rules. Government regulations stipulate that the AMCs are 'state-owned non-bank financial institutions set up by the State Council' and that 'at the closure of the AMCs, the MoF will propose solutions to final AMC loss' [State Council (2000)]. Therefore, the Chinese AMCs can be viewed as government-sponsored agencies. In this case, a risk rating of 20% on the AMC bonds (compared to 100% on the NPLs) could potentially reduce the big four banks' required core capital by almost RMB 40 billion after the 1999-2000 NPL carving-out⁵.

For the four AMCs, their combined balance sheet is highly leveraged after purchasing the NPLs from banks, with a debt-to-equity ratio of easily exceeding 40 times. Thus, the AMCs are financially vulnerable to the cash recovery of their NPL disposal. Since both PBC credit and the MoF equity capital are considered as the founding capital, PBC credit is being effectively subordinated to the AMC bonds. In the event of debt servicing difficulties, the state would service the AMC bonds before the PBC credit. Thus the PBC may lose all of its funds.

Who actually pays for the AMC losses?

The AMCs' liabilities are expected to exceed their assets and their resulting losses can be substantial, since a mere 18% write-off of the 1999-2000 policy transfers alone will erase the entire AMC founding capital. Thus, under all plausible recovery scenarios, the substantial AMC losses ultimately represent a part of China's quasi-fiscal deficits. This raises the question as to who will pay for the AMC losses. Obviously, for the NPL transfers in 2004 and 2005 the PBC has absorbed a loss of around RMB 400 billion, with a further exposure to the AMCs in terms of RMB 216 billion credit. Under the current AMC financing arrangement, however, the PBC could lose even more as the ultimate sharing of the expected total AMC losses between the PBC and the MoF remains uncertain⁶.

Figure 2 illustrates the sharing of AMC losses under different plausible scenarios of recovery, taking the first policy NPL transfer in 1999-2000 as an example. The solid line indicates

4 The credit risk to the PBC loans in this case would be marginally smaller than in the 1999-2000 case, given that this time the AMCs purchased the NPLs at auctioned prices rather than book value.

5 Based on the current Basel Accord (Basel Committee (1988)), the minimum standard of core capital is 4%. If the AMCs are considered as domestic public sector entities, claims on them could carry a risk rating of 0, 10, 20 or 50%, at national discretion. Assuming a risk rating of 20%, the AMC bonds will require the big four banks to hold RMB 9 billion of core capital. This is much lower than the RMB 46 billion required for the RMB 1,168 billion of loans carved out to the AMCs, which

carry a risk rating of 100%. Note that the potential saving of nearly RMB 40 billion core capital for the big four banks happens to equal the MoF equity capital injection into the four AMCs.

6 The PBoC is not an independent central bank by international standards, since key PBoC appointments and major monetary policies (such as interest rate decisions) are decided at the level of the State Council, China's cabinet. However, the PBoC does not report to the MoF. In the case at hand, the State Council decided how to distribute risks across the MoF and the PBoC.

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that as the recovery rate rises, the total AMC loss declines. Absent the PBC financing, the total AMC loss and the MoF loss would be identical, under the assumption of implicit state backing for the AMC bonds. With the PBC credit effectively subordinated, the MoF loss is represented by the downward-sloping dotted line, which is below and parallel to the AMC loss line. The vertical distance between the total AMC loss line and the MoF loss line is the extremely conservative estimate of RMB 192 billion PBC financing to the four AMCs by Ma and Fung (2002). The PBC will lose all its AMC loans in all plausible recovery scenarios of Figure 2, under the assumption of effective subordination.

Yet the story may not end here. Firstly, the RMB 192 billion is only a lower-bound estimate of the PBC financing, and our updated estimate put the PBC financing of the first batch of NPL transfers at RMB 560 billion. In terms of Figure 2, additional PBC loans to the four AMCs would be represented by further downward shifts of the dotted MoF loss line. In other words, greater PBC financing to the AMCs would result in an

even greater PBC loss and a smaller MoF loss for any given total AMC loss. Thus, the ultimate sharing of the expected total AMC loss between the MoF and the PBC remains uncertain. Secondly, the PBC may not be able to recover the additional RMB 216 billion credit to the AMCs in 2004 and 2005.

The motive for the government to involve the PBC in the AMC financing and to retain its 'constructive ambiguity' stance towards state support for the AMC bonds might have been twofold, in our view. One was to window-dress the fiscal position for as long as possible. Otherwise, the government debt would have risen substantially, as international experience has shown [Sheng (1996)]. Another might have been to direct the PBC capital towards financing the expected AMC loss. In any event, the current Chinese AMC financing arrangement tends to understate the true fiscal costs of using AMCs to resolve the NPL problem.

Cash flow dynamics and asset disposition

What are the main factors affecting the asset recovery of the Chinese AMCs? How likely is it that the AMCs will meet their interest payments? The financial sustainability of the AMCs, in cash flow terms, depends on the dynamics of both cash inflows and outflows. Again, we focus on the first batch of policy transfers in our analysis. Subsequent NPL purchases and PBC financing can be similarly analyzed.

The major cash outflows of the AMCs come from their interest payment obligations and essential AMC overhead expenses. The government has apparently set an annual interest rate of 2.25% on both the AMC bonds and the PBC credit to the AMCs, which was the same as the official one-year bank deposit rate in 2001 [State Council (2000)]⁷. Given the four AMCs' borrowing of RMB 1.36 trillion in the forms of AMC bonds and PBC loans, their combined annual interest obligation alone exceeds RMB 30 billion per year. With several thousands of staff, legal fees, travels and administration costs, it is reasonable to assume that the overheads can cost at least 1% of the value of the NPLs resolved.

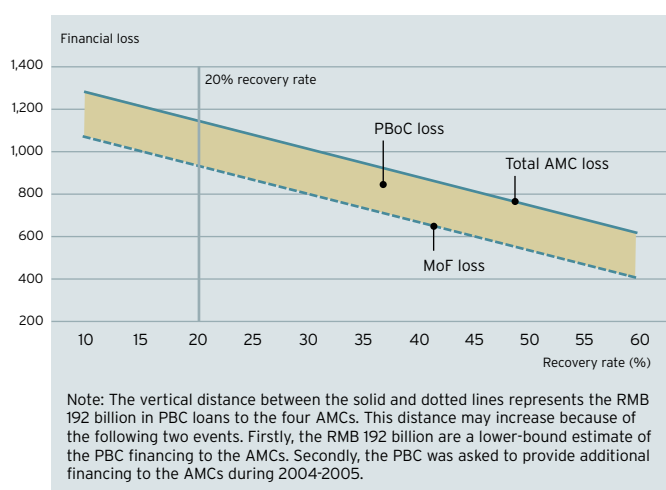


Figure 2 - AMC loss-sharing (assuming effective subordination and implicit MoF backing)

Sources: See Figure 3.

⁷ It is not clear what the rate for the PBC credit to the AMCs is in 2004 and 2005.

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The cash inflows of the AMCs mostly depend on the speed of NPL disposition and the cash recovery rate. It appears that asset liquidation has not kept pace with accruing interest. Since 1999, the four AMCs have cumulatively disposed of RMB 866 billion (62%) of their acquired NPLs during the first policy carving-out, realizing a cash recovery of RMB 180 billion or an implied cash recovery ratio of 20% (Figure 3)⁸. This would barely cover the cumulative interest costs of RMB 183 billion for the four AMCs (on the assumption of six years with an annual interest payment of RMB 30.5 billion), let alone the estimated cumulative overheads of RMB 9 billion. Apparently, such AMC cash flows would render timely servicing of the collective AMC debts impossible. In addition, the AMC bonds will need to be repaid when they mature in 2009.

In response to the rising cash flow pressure, the government is pressing for faster NPL disposals. The MoF has established AMC performance indicators, such as cash recovery ratios, and unveiled an incentive scheme to encourage higher and faster cash recoveries⁹. The AMCs have been more actively pursuing loan sales, auctions, debt restructuring, foreclosures, litigation, and liquidations. In addition, several international NPL auctions have also taken place in China. The government has also set a deadline for the AMCs to dispose of all the NPLs acquired through the 1999 policy carving-out.

| AMC | Face value of transferred NPLs | Face value of disposed assets | Total cash recovery | Annual interest payments | Cash recovery rate (%) |
|--------------|--------------------------------|-------------------------------|---------------------|--------------------------|------------------------|
| Orient | 267.4 | 142.0 | 32.8 | 5.8 | 23.1 |
| Great Wall | 345.8 | 270.8 | 27.8 | 7.6 | 10.3 |
| Cinda | 373.0 | 206.7 | 65.3 | 8.2 | 31.6 |
| Huarong | 407.7 | 246.8 | 54.7 | 8.9 | 22.2 |
| Total | 1,393.9 | 866.3 | 180.6 | 30.5 | 20.5 |

Note: The transfer, disposal, and recovery in this figure all refer to the first batch of large-scale NPL carving-out in 1999-2000. NPL transfers and disposition are both measured in book values. Cash recovery rate is cash recovered as a percentage of book value of disposed assets.

Figure 3 - NPL disposition and asset recovery, as of March 2006 (RMB billions)
Sources: Table 1; Zhu et al. (2001a), Owen Brown of Dow Jones (9 January 2002), and China Banking Regulatory Commission website.

More generally, the quality of the underlying assets held by the Chinese AMCs will be a major factor influencing the recovery performance. Considering the low coverage of collateral within the AMCs' portfolio and given that most of these NPLs have been confirmed as problem loans for more than four years, one cannot expect a higher recovery rate for the 1999-2000 batch of NPL transfers going forward. Moreover, real estate, which tends to be more collectable, accounts for only 7% of policy-based NPL carve-outs, while manufacturing, which is typically more difficult to recover, represents 46%. By contrast, 47% of the assets managed by the U.S. Resolution Trust Corporation were real estate [Lou (2001), Klingebiel (2000)]. If international experience is any guide, the likely asset recovery of the Chinese AMCs may underperform their Asian counterparts, given the aforementioned unfavorable initial conditions [S&P (2002)].

Consistent with the importance of real estate collateral, the four AMCs differ noticeably in terms of recovery performance (Figure 3). Cinda alone accounts for nearly 40% of all the cash recovery by the four AMCs to date. One reason is that assets associated with Cinda's NPL portfolio are apparently better than those of the other three AMCs, in part because of the higher real estate share in Cinda's portfolio [Lou (2001), Zhu et al. (2001a)]. Moreover, Cinda's NPL portfolio is closely tied to large-scale infrastructure projects.

Thus, some AMCs may face more severe cash flow problems than others (Figure 3). If some AMCs are not able to meet their interest obligations on their own, their corresponding banks could end up having swapped NPLs for AMC bonds that may not provide the expected cash streams. For instance, the cash recovery of the Great Wall Asset Management Corporation is so far not enough to meet half of its own annual interest obligations.

Debt-for-equity swaps and AMC governance

This section examines the two other major issues related to Chinese AMCs: debt-for-equity swaps and their governance. We argue that Chinese AMCs are being asked to play distinct

8 As will be discussed below, if we include 30% of the policy transfers intended for debt-for-equity swaps, the AMCs to date could have disposed of some 90% of the policy-based NPL purchases.

9 The MoF's incentive scheme specifies 1% bonus of realized cash recovery for

Cinda and Huarong and 1.2% for Great Wall and Orient [MoF (2001)]. That would translate to an impressive RMB 10,000 cash bonus per AMC staffer a year on the assumptions of RMB 1.4 trillion NPLs, a 15% cash recovery and 20,000 staffers of the four AMCs over a 10-year period.

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and even conflicting roles, and that the supervisory environment is not conducive to the governance of AMCs.

Debt-for-equity swaps and AMC governance

Despite the stated objective of maximizing asset recovery, the AMCs are burdened with a trio of mandates – maximizing asset recovery, lessening the financial risks facing the big four banks, and restructuring the Chinese SOEs [State Council (2000)]. The first two assignments are mostly consistent with each other. More controversy, however, centers on the mandate of restructuring the SOEs through debt-for-equity swaps.

The swap scheme involves converting selected debt claims into AMC-held equity stakes in chosen corporate borrowers, mostly big and cash-strapped SOEs¹⁰. The government and the AMCs jointly chose 580 SOE debtors for the scheme, converting RMB 405 billion of bank loans into equity. In other words, 30% of the policy transfers in 1999 were involved in the debt-for-equity swaps. The scheme was intended to boost SOE profits within a short period by deleveraging the heavily indebted SOEs. As a result, the average debt/asset ratio of the restructured SOEs dropped from 73% to below 50% [Dai (2001)]¹¹. The AMCs are supposed to receive dividends for their equity stakes in these restructured SOEs.

Our view is that restructuring SOEs over the medium-term requires very different skills, political bases, monitoring criteria, and incentive structures from rapid disposal of assets. The AMCs, therefore, may be burdened with multiple and even conflicting tasks, which might have impeded their speedy asset liquidation in their first two years.

AMC governance and supervisory environment

AMC governance and their regulatory and supervisory environment could potentially affect their performance. Here we focus on three specific issues: the regulatory environment, AMC/bank relationships, and incentive structures of the AMCs.

Firstly, the four AMCs are operating under the auspices of multiple government agencies, which may have conflicting agen-

das. The three most important government agencies for the AMCs are the MoF, the PBC, and the China Securities Regulatory Commission (CSRC). They all have their representatives sitting on all the AMC supervisory boards, which are chaired by MoF officials. The PBC issues licenses defining their business scope and supervises their corresponding banks. The CSRC issues securities-related business permits and regulates such business activities of the AMCs. Since 2003, when the CBRC was officially set up, however, it has taken over the responsibility of banking as well as AMC supervision¹².

Secondly, the relationship between each AMC and its respective big four bank is far from clear-cut. Despite the absence of formal equity links between them, most AMC staff members come from the banks that produced the bad loans to begin with. Moreover, the president of each bank is also the party chief of its corresponding AMC. The rules governing loss- and profit-sharing of the 'non-policy' NPL transfers are not clear. And finally, loans to the same obligor are often artificially carved up into policy NPL purchase, non-policy transfers, remaining NPLs, and performing loans [Liu (2001)]. This less than clear-cut AMC/bank relationship seemed to aim for enhanced cooperation in asset recovery between each AMC and its respective big four bank. Nevertheless, it may not contribute to transparency.

Thirdly, the AMCs' involvement in market-based commercial activities could also prove a mixed blessing, potentially distorting their incentives. For example, the AMCs are empowered to broker securities, in order to facilitate sales of equity holdings through stock listing. Nevertheless, several complications could arise, such as the fact that these AMCs will compete directly with the private sector and that the AMCs could evolve into the government agencies, mixing policy mandates (NPL disposition) with commercial drives.

In the end, since 85% of the policy transfers of NPLs involve SOEs, all the above issues underscore the potentially conflicting roles assigned to the Chinese AMCs. As the owner of the state-owned banks, the government could behave as a

¹⁰ Institutional constraints required that the AMCs to oversee the swaps. Chinese law prohibits commercial banks from owning equities of non-bank business entities, while the four AMCs are empowered to hold controlling equity stakes [State Council (2000)].

¹¹ The restructured debtors stopped paying interest on their converted debts as of April 2000. The interest savings for these SOEs are estimated to be as high as RMB 25 billion per annum, equivalent to 15% of the reported impressive jump in

the 2000 book profits of the large SOEs.

¹² In addition, the AMCs have to deal with other government departments, such as the State Economic and Trade Commission, now the Commission of Economic Reform and Development (for implementing debt-for-equity swaps), and the Ministry of Foreign Trade and Economic Cooperation (for paving the way for foreign participation), as well as local governments (for foreclosures and litigation).

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creditor, requiring the AMCs to maximize asset recoveries. But as the owner of the SOEs, the government could act like a debtor, pleading for generous debt restructuring terms. Given this interlocking relationship among the state-owned AMCs, the SOEs, and the state-owned banks, a meaningful resolution of the Chinese NPL problem might be helped by substantial participation from foreign and domestic private sector investors.

Another important factor influencing the corporate governance of the four AMCs is their sunset date [Fung, et al. (2004)]. Initially, the four AMCs had a maximum tenure of ten years as special NPL disposal vehicles. However, to encourage the AMCs to accelerate their policy-based NPL resolution and to help the AMC retain their staff, the government has dangled with the prospects of investment banking licenses for those AMCs that can meet the disposal deadline and recovery ratio targets. Thus, the hope is that these AMC would become more commercially oriented distressed-debt specialists and investment banking business entities.

Conclusion

In this paper, we analyze the four Chinese AMCs that were established to transfer a large portion of the NPLs at the big four banks and to dispose of them in order to maximize recovery. The RMB 1.4 trillion of NPLs carved out in 1999-2000 by the AMCs represent some 40% of the estimated total NPLs of the big four banks. Most NPL transfers in this period are 'policy-based,' as the government took responsibility for bank losses related to policy lending prior to 1996. The AMCs financed the policy-based NPL transfer with 3% MoF equity, 40% PBC credit, and 57% AMC bonds. Since 2004, the PBC and MoF have helped fund two additional transfers of NPLs from banks to AMCs. So far, evidence suggests that the cash recovery rate may not exceed 20%, raising questions about who will ultimately pay for the AMC losses. One impediment to asset recovery is the multiple roles imposed on the AMCs and the overlapping supervisory environment.

Going forward, the main challenge for the Chinese AMCs is to increase the pace of asset recovery. Firstly, international experience shows that speedy and effective asset recoveries are key to managing the fiscal costs of bank restructuring. Secondly, through market-based disposals involving foreign and domestic private sector investors, SOE reform can be pushed forward. This in turn will help contain flows of new NPLs in the Chinese banking system. Thirdly, the government could request the AMCs to shoulder additional responsibilities for NPL disposition in the future, given that the Chinese banking sector beyond the big four banks may also carry a heavy NPL burden.

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