Causes and solutions of non-performing loan in Chinese commercial banks

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Abstract: Non-Performing Loan (NPL) is one of the concrete embodiments of credit risk which banks take. NPL is a huge puzzle for Chinese commercial banks, so how to enhance risk management to improve assets quality and lower down NPL are of great importance to those banks.

Key words: NPL; Chinese commercial banks; causes; solutions

1. Analysis on causes of NPL in commercial banks

There is so-called “4-3-3” distribution for the causes of formation of corporate customers’ NPL from actual practice, i.e. non-standardized outside circumstance factors account for 40%, enterprises’ undeveloped inside operation management factors account for 30%, and banks’ extensive inside operation management factors, which are the emphasis of analysis in this paper, account for 30%.

1.1 Non-standardized outside circumstance is the primary factor of formation of NPL

During the shift from planned economy to market economy, Chinese banks are affected badly by outside circumstance, for example, national policies, behavior of local governments and social credit environment, and they commit great cost for social development, economic mechanism reform and economic structure adjustment. A great deal of enterprises take the advantage of the shift to escape or abolish the bank debts, especially at the end of 1990s, through bankrupting, spinning off, merging and other various methods.

1.2 Enterprises’ undeveloped inside operation management is the main factor of formation of NPL

Ever since a long time ago, many Chinese enterprises have been troubled by inflexible operation mechanism and management confusion. Some enterprises lack accurate judgment for the trend of market and enlarge production scale in hot industries without any consideration, which lead to serious imbalance in supply and demand; some projects even go out of production during construction. And some enterprises enter funding circulation outside the bank system to escape monitoring, through measures of opening many accounts in different banks, paying cash just after received without booking. The above factors make it difficult to reclaim loans for banks and evolve into NPL.

1.3 Banks’ extensive inside operation management is the important factor of formation of NPL

In practice, the operation mechanism, credit culture and management skills are much more influential than operational performance level, so it is important to analyze carefully on banks’ internal operation management to improve credit risk management and assure sustainable healthy development.

1.3.1 Unsound operation mechanism

1.3.1.1 Inaccurate market orientation

There is a long history for inaccurate market orientation in China. During the planned economy period, banks

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only followed national plans and didn't need any own development strategy and market orientation, so they lacked market orientation capability, had vague business development ideas, and often operated following the others. For instance, during the real estate industry fever in 1990s and steel industry fever in the late of 2003, many banks fanatically stepped into these industries and incurred huge loss later.

1.3.1.2 Weak internal control, lack effective control on moral hazard

Banks with no sound internal control system are facing great moral hazard risk, because of the imperfect social credit environment and law environment.

1.3.1.3 Too much emphasis on market share and asset scale, no strict admittance and no active exit

Under the influence of ideas of pursuing market share excessively, banks do not establish detailed and strict market admittance policies, which undermine the first risk to prevent gate and weaken the orientation effect of admittance policies to the market. And the customers' exit policies are not detailed too, which do not lead to enough exit management for customers.

1.3.1.4 Unsound assessment mechanism, no well-suited accountability system

In the past, the setting of performance assessment indicators was heavily equalitarian and didn't consider risk adjusted revenue, so there was little emphasis on risk control and exit management. In addition, there were many behaviors which violated rules or policies, for instance, splitting one big number into several small pieces to avoid authority authorization, exceeding one's authority to approve, etc., in the process of credit management, since the accountability system was not fully established.

1.3.2 Haven't formed active and healthy credit culture

The credit culture, which is the convention and method developed in credit policies. Business process and risk control are important parts of banks' enterprise culture. The insufficiency of credit culture lies in two aspects: weak risk consciousness and misunderstanding in credit conception.

1.3.2.1 Weak risk consciousness

Firstly, no established scientific development ideas, and lack notion of balance among risk, revenue and capital. No full consideration on possible loss of potential risk and having not realized business expansion, which are constrained by capital. Focusing on the possible revenue from business growth will lead to issue loans based on savings only and develop business blindly. Secondly, some relationship managers ignore the review on fundamental information, admittance conditions and collateral revaluation of customers, which impair the authenticity and reliability of pre-loan investigation information. Finally, some risks managers unduly rely on the materials provided by relationship managers and only review the written reports and financial reports, don't make risk review from the second angle objectively so as to damage the independence of review conclusions.

1.3.2.2 Misunderstanding in credit conception

a. The market share is the most important;

b. Loaning is the method to strive for other business;

c. It's safe to rely on the government;

d. The customers approached by other banks are good customers;

e. Foreign enterprises are good customers;

f. The first repayment sources of enterprises with high revenue or operation income are better;

g. The secured loans are loans with low risk;

h. The loans with normal interest paying out are good loans;

i. It's none of our business if the borrowers have NPL in other financial institutions;

j. It’s forced to revolve loans which can’t be reclaimed in time.

1.3.3 Immature management skills

Banks lack effective measures to identify, quantify and control the regional and industrial risk, constrained by obtaining historical data, decentralized information systems, and immature portfolio management skills. So they have to make judgment mainly based on personal experience and consequently have weak management measures on concentrated and systematic risk.

Furthermore, banks are short of quantitative measures on specific customers’ risk, the underlying reasons are: firstly, an insufficiency of fundamental information system support. Secondly, the accumulation of historical information on risk revaluation is not enough, quality of data needs to be enhanced, quantitative modeling technology in risk revaluation standard needs to be improved, and relationship between customers rating and five degrees classification results should be established. Thirdly, it is short of effective measures to calibrate the matching between risk and revenue.

1.3.4 Implementation is faulty, and risk management is not throughout the whole process

1.3.4.1 Pre-loan investigation and review are not thorough and strict

During pre-loan investigation, some relationship managers put little emphasis on authenticity and integrality review on related materials; they haven’t clarified the true intended usage of the loan (especially when extending short-termed credit); the review is too optimistic, which does not have analyzed the potential influence of changes in related factors, no deep review on the market, no enough understanding on enterprises’ operation management situation and future, and no thorough risk revaluation; assessment is inaccurate and the risk of loans is not fully covered; the risk on group customers and affiliated enterprises are not identified effectively. The factors above damage the following loans at the early stage.

Furthermore, some banks neglect the fact that the loan procedures are not completed and the review materials are not enough; some operate anti-procedure, for instance, extending credit before enterprises’ application, signing loan contract before approval of the loan, issuing letter of credit or bank acceptance before approval; consolidated credit is not fully realized, and credit to some group members is not included in the consolidated credit management; extending credit against the rules, i.e. exceeding authority to offer loans, splitting one big number into several small pieces to avoid the authority constraint, issuing bank acceptance to fund enterprises on a rolling basis, or issuing acceptance, discount without actual trade background.

1.3.4.2 Requirements are not strictly implemented during the loan

Deficiency in guaranty is the major concern during the loan. Typical problems are as follows: accepting guaranty from unqualified institutions such as governments and agencies, collateral review are not thorough, loan-to-value ratio is too high, providing loans without property registration and transfer of collateral, guaranty for each other between enterprises, legally flawed credit procedures lead the guarantor is immune from obligation, etc. And there are also problems that the conditions of the loans are not satisfied and the contracts of loans are not completed.

1.3.4.3 Weakness in post-loan management

There are three aspects about weakness in the post-loan management: Firstly, it can’t recognize credit risk in time; secondly, it can’t reclaim or exit in time after awareness of risk; thirdly, it loses rights and interests in litigation.

There are long-standing problems, so-called “emphasize loan, despise management”, in Chinese banks: few follow-up review on customers who have already got the loans, loose monitor on usage of the loans, oversight on operation situation of enterprises, even knowing nothing after the enterprises moving to a new place or even not existing anymore! So the timely and accurate judgments are needed to make on risk profile of loans, because of low frequency of updating management information.

For the sake of seemingly nice business development indicators, business units hesitate to exit from customers with high potential risk, and renew or extend the loans again and again for the enterprises hoping they will not default. The exit methods are simplified and passive, only using cash reclaim, canceling after verification, and paying-a-debt-in-kind assets. And rights and interests in litigation are easy to lose by ineffective loan contracts or collateral contracts with enterprises, poor management on loan archives, or neglect on the timeliness of litigation.

The sequence of influence of the above factors is as follows: post-loan management, operation mechanism, credit culture, pre-loan investigation and review, management skills and extending credit.

2. Systematic root of NPL in Chinese commercial banks

There is systematic root beyond the above various reasons of formation of NPL in Chinese commercial banks. From a long time, operating in half-planned, half-market economic environment, Chinese commercial banks still followed typical government methods just like SOEs (State Owned Enterprises) under planned economy mechanism, such as:

2.1 Lack of balance mechanism for power, weak monitoring system, and incomplete decision making process

There was no balance mechanism for power in banks, whose governance structures were similar to the SOEs before the recent transformation of commercial banks in China. There is no difference between Board of Director and Senior Management, so the internal monitor systems on decision making do no exist. The obvious shortcomings of the arrangement are: firstly, the quality of important decision making such as strategy planning is not high; secondly, the moral hazard risk of senior management is easy to appear.

Frankly speaking, there is strong and direct relationship between deficiency in monitoring system, which should be the powerful method to enhance the control power inside the banks, and reduce many serious problems that have appeared. The fundamental reasons are: independent audit and monitor are no strong; monitor, review and post-assessment on subsidiaries are not well-located; risks are not identified timely; qualities of asset are not authentic; provisions are not enough, etc..

In addition, there are also evident flaws, which are important reasons for formation of NPL, in specialization of decision and control on moral hazard risk of decision making process, although most banks have experienced the shift from simple “Three Level Approval” to “Separation between the checking process and the actual lending” in decision making mechanism.

2.2 Extensive strategic management mechanism, decentralized operation management mode, and missing capital restriction mechanism

Past extensive strategic management mechanism leads to over-extending credit in some regions and industries and exacerbating risk for banks. Firstly, strategic management focuses only on the analysis of market opportunity and neglects huge potential risk, so the business development strategy and risk management strategy are disconnected seriously. Secondly, having strong bureaucratic thinking, internal resource distribution and power allocation are entirely based on bureaucratic levels of institutions, not on the real demand and contribution. Some institutions with low growth potential, poor credit environment, and weak management capability, can have large business scale and high credit approval authority, for the sake of their high bureaucratic level.

There are separate plans for operation, decentralized information systems, and no uniform management on industries and regional risk, so the capability to resist systematic risk in industries and regions is weak. And there is no integration of marketing resources and weak interaction between marketing and business growth among institutions, so it is hard to unify all the resources to marketing the strategic valuable customers for banks. Meanwhile, different institutions in one bank may even have contrary admittance and exit strategies for the same customers.

Capital resource, which is limited and costly, is the constraint to expand the scale. Without capital constraint mechanism, the management will measure the performance only based on scale growth, and even behave irrationally such as attracting savings with interest, and extending credit with high risk and cost. Subsequently, the accumulated risk exceeds the expected loss because of over expanded asset scale and large ratio of high-risk asset, so the banks have to use capital to cover risk and face hot water of insolvency.

2.3 Incomplete internal revenue distribution process, performance assessment mechanism and accountability system

It’s hard to inspire the initiative of institutions at the aspects of different territory loans and group and affiliated enterprises’ loans, and post-loan management and monitoring, since the internal revenue distribution process is not perfect.

Performance assessment mechanism has obvious orientation effect. Incomplete assessment may lead institutions to deal with operation management mistakenly, wrongly grasp the key points of the task, breed plenty of moral hazard risk, and impair the security of credit assets.

The main disadvantages of past assessment mechanism are as follows: firstly, no deep analysis on macro economy trend, characters of regional economy, structure of customers groups, and extent of competition in the same business, and no combination between the above factors and banks’ strategic plan when decomposing assessment tasks. Secondly, no risk-adjusted revenue is assessed. Thirdly, institutions prefer growth to risk in order to perform well in assessment, since there is strong relationship between business growth indicators and short-term financial indicators. Fourthly, people tend to pursue short-term performance through expanding market share at the cost of banks’ security of credit asset, since there is no assessment on medium and long term benefit and credit business is risk lagged in nature. Fifth, there is much emphasis on pre-loan during the loan period in assessment indicators, but no enough emphasis placed on post-loan the management, so huge amount of NPL appears as the result of incomplete post-loan management.

The major shortcomings of current accountability system are: firstly, some managers are not fearless and determined to take responsibilities. Secondly, sometime it is difficult to apply accountability because there are no clearly-defined descriptions of relevant departments and processes in credit business. Thirdly, based on the above analysis of NPL, there are various reasons concerning pre-, during and post-loan management, but the current accountability measures mainly focus on approval process since the measures are not comprehensive, clear and scientific. Fourthly, there is no integration between accountability and quality of loans and no dynamic accountability system, so the accountability is often applied late after the actual loss.

2.4 Rigid human resource management system

Human resource management in banks is still planned economy pattern: Firstly, the quality of personnel in the credit business is not guaranteed, since there is no admittance and exit management of qualification of those people. Secondly, lack of effective motivation, can't fully inspire employer's enthusiasm and responsibility. Thirdly, it is difficult to allocate a suitable person to a suitable position because of the so-called "only promotion, no demotion" management system of leaders. Forth, the human resource deployment is often behind the actual demand of business development and management function reform, so there are not enough people in credit business, which directly affects the quality and effect of the tasks, relative to supporting functions.

3. Suggestions on how to solve the NPL problems in Chinese commercial banks

We here bring forward the five basic principles to solve the NPL problems in Chinese commercial banks, based on the above in-depth analysis on the reasons and systematic root of formation of NPL.

3.1 Transforming the operation mechanism comprehensively is the key measure

The starting point of transforming the operation mechanism is to enhance the corporate governance structure, so as to push banks to become international active commercial banks with abundant market value and great influence.

(1) Improving governance structure and construct a healthy and responsible Board of Directors, which is the core part of western corporate governance. Set up Audit Committee, Risk Management Committee, Remuneration Committee, and Nomination Committee to make sure all things are carried forward.

(2) Establish scientific and clear business development strategy and risk management strategy, adjust and improve the strategies according to the changing situation to make sure the implementation of strategies and plans.

(3) Found capital constraint mechanism, dual mechanism of constraint on risk asset scale and orientation of value-added of economic capital to improve the efficient allocation of credit resource and financial resource, and to optimize the asset structure and profit mode.

(4) Finalize a whole set of complete motivation and constraint mechanism, through enhancing monitoring, assessment, accountability and remuneration mechanism.

(5) Improve credit decision mechanism to control the quality of newly issued credit asset under reasonable level.

3.2 A centralized, specialized and scientific management is the inevitable trend

Decentralized management is one of the major reasons of formation of NPL according to the above analysis. So it is necessary to change the decentralized management to the centralized one controlled by the head office of banks.

The sophisticated, specialized and scientific management is the basis of high level centralized management. So it should integrate and unify the business process, bring forward capital constrained risk asset management, improve limited management on industrial and regional risk, enhance quantitative management skills, based on deep data mining & analysis and advanced risk management instruments. And it introduces systems of relationship managers, product managers, risk managers, specialized credit committee members and specialized approvers so as to guarantee the centralized and scientific management.

In the coming few years, it is the inevitable choice to move towards the centralized, specialized and scientific management for banks facing rapid developing, high risk and non-standard outside environment, in order to achieve sustainable healthy development.

3.3 Independent credit review is the foundation

Banks have to deepen the independent credit review process and avoid following blindly. On one hand, banks should have correct and clear understanding on national policies and local governments' behaviors to grasp the true commercial opportunities and avoid the risk. On the other hand, banks should assign high quality person with excellent capability of independent review to the credit review positions.

However, there are still many difficulties ahead. For example, in the near future, the Chinese economy will still be government-dominated, and some local governments will continue to intervene into banks' credit extending process, especially on municipal and below level. So it urges banks to enhance the independent review as soon as possible.

3.4 Construction of good credit culture is the important condition

It is a hard and long-term task to construct healthy credit culture, and the process of construction should be throughout the whole process of management systems. During the process, banks should enhance motivation and constraint mechanism, infuse new ideas and instruments of credit operation management into pre-, during and post-loan processes, make sure every people incorporate the good risk, cost and revenue awareness into operation and management of every credit business self-consciously, combined with implementation of strategic objectives, adjustment of organization structure, integration of business process, transformation of information system, and team construction.

3.5 Establishment of professional teams is the essential guarantee

The management and credit personnel should have not only the favorable moral ethics, but also enough professional knowledge, skills and experience to solve problems to analyze and judge the strategic location and credit business correctly, and solve the existing problems suitably.

(1) To enhance capability of management. Good management should have profound strategic eyesight, powerful marketing ability, excellent risk management skills, and correct conception of revenue, personal value and power. And good managers should enhance the unification and effectiveness of banks based on the organic combination of personal authority and post authority.

(2) To enhance construction of employee teams. Provide training to improve the business knowledge grasped by employees, train and attract persons with compound abilities to enhance the capability to prevent and mitigate the financial risk, strengthen the admittance and exit management of qualification of credit business people, and establish capable and self-disciplined teams based on the combination of employee team building and construction of credit culture and motivation mechanism.

The essence of the above five principles are concerning leadership, controlling and implementation. Banks have to apply the five principles into daily operation management to realize the implementation of strategic plans. And the most important principle is to transform the operation mechanism comprehensively, and the core is to construct healthy interest driven and long term effective risk management mechanism, and apply the ideas throughout all levels and all parts of operation management.

References (omitted)

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