

The Main Problems of China's financial Industry and Asset Management Companies

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Abstract

China's banking sector, particularly the four wholly state-owned commercial banks (SOCBs), suffer from substantial numbers of non-performing loans (NPLs) and low levels of capital adequacy. To resolve these problems, the government adopted measures, including in 1998 a capital injection of RMB 270 billion and in 1999 the establishment of the four asset management companies (AMCs) to transfer NPLs amounting to RMB 1.4 trillion (\$169 billion). Despite these efforts, SOCBs have not succeeded in containing either the growth of NPLs or the deterioration of capital adequacy. In response, the government used RMB 372.5 billion (\$45 billion) of foreign reserves to inject cash into the Bank of China and the China Construction Bank (two better-performing SOCBs) at the end of 2003. Meanwhile, the capability of the AMCs to recover NPLs has been increasingly questioned. While the AMCs made some initial progress, coping with the remaining (poorer-quality) NPLs is an extremely difficult task. Thus, the government not only wrote off some of those remaining NPLs, but also began to stress that the SOCBs should resolve the NPL problems by themselves. In the near future, the four AMCs are expected to be joined into one comprehensive AMC that will focus on resolving on a commercial basis of not only the NPLs of SOCBs but also those of other financial institutions, extending the scope of business to areas of asset management and investment banking.

Introduction

In November 2003, Standard & Poors rated China's four wholly state-owned commercial banks (SOCBs) and eight joint-stock commercial Banks at levels below A. Among these banks, the highest rating of BB+ was given to the Bank of China (BOC). Given that the banking sector is the principal part of China's financial industry, tackling problems in the financial industry must begin with the banking sector's problems. One of the most important issues faced by the banking sector is the presence of a large number of non-performing loans (NPLs) and the resultant capital inadequacy of SOCBs.

To resolve the problems faced by SOCBs, the government has instituted some measures. To increase the level of capital adequacy, in 1998 the government issued RMB 270 billion of special bonds and injected this sum into the SOCBs. To dispose of NPLs, in 1999 the government established 4 asset management companies (AMCs), capitalized at RMB 10 billion each, to acquire SOCBs' NPLs. About RMB 1.4 trillion of NPLs (about 15.6% of the combined total of outstanding loans) have been transferred from the SOCBs to the AMCs. Since their inception, AMCs have made some progress in terms of reducing the NPLs. Nevertheless, the NPLs of the SOCBs have continued to grow sharply. Also, it has become clear to the public that other financial institutions' NPL problems have also worsened and their capital adequacy ratios too have steadily declined. The most important challenge facing China's financial reform is how to resolve the NPL problems and how to increase capital adequacy ratios.

Various public opinions have emerged since 2003. It has been argued that NPLs should be transferred from SOCBs to AMCs one more time, so that all SOCBs' NPLs are removed from their balance sheets. Another argument is that capital should once again be injected to raise SOCBs' capital adequacy ratios. Reflecting the latter view, the government decided to use \$45 billion (RMB 372.5 billion) worth foreign exchange to increase the capital adequacy ratios of the BOC and China Construction Bank (CCB). The government picked up these two SOCBs over the other two SOCBs because their superior performance would make it possible for earlier public listings. The BOC has the smallest asset size with the highest capital adequacy ratio, more than 8%, while the CCB has the best management skills and the smallest NPL ratio of 11.84%. This injection enabled these two SOCBs to have capital adequacy ratios above the internationally recognized standards. In return, these banks were required to lower their NPL ratios below 15% before 2006. The government's decision to inject money also reflected its determination that there would be no more cash injections, and that the SOCBs should resolve their NPL problems themselves.

Regarding the operations of AMCs, public confidence their capacity to resolve NPL problems has gradually been lost. In view of the AMCs' purchase of NPLs at book values, there is clearly no objective criteria that can be applied for assessing the progress made by AMCs. The ratio of disposing of NPLs also remains low. However, in four years of operation the AMCs have gained experience in terms of disposing of NPLs and have trained many expert staff. Thus, this paper views that despite that the government now encourages SOCBs to dispose of NPLs themselves, the role of AMCs to dispose of NPLs should not be underestimated. It is possible that in the near future the AMCs could be developed into one comprehensive AMC, which would be in charge of NPL resolution through various methods; covering not only SOCBs but also the remaining financial institutions, and in essence function as investment banks.

This paper consists of four sections. Section I provides an overview of the features with respect to China's financial industry. Section II discusses the main problems faced by SOCBs. Section III analyzes areas where there has been some achievement, seen as well as discussing existing problems with respect to AMCs. Section IV is a brief conclusion.

I. Features of China's Financial Industry

1.1. Overview of China's financial industry

Prior to 1979, China's banking system was not modern and played only a limited role in promoting economic growth; reflecting the limited role of banks in a highly centralized planning system whose primary functions were collecting revenue from State-owned enterprises (SOEs) and allocating investment through budgetary grants (Ma, 1997). In these circumstances, banks simply provided credit needed by SOEs for their production plans and provided/monitored cash used principally to cover labor costs and purchases of agricultural products. During this period, the People's Bank of China (PBC), as the sole bank, played a double role of being the central bank and the financier of enterprises

In the process of establishing a modern banking system, the government in 1979 first removed the monopolistic position of the PBC by establishing the Agricultural Bank of China (ABC), the afore-mentioned BOC, and the CCB. The ABC was established to take over the PBC's rural banking business and supervisory authority of a network of 60,000 rural credit cooperatives (RCCs) that had been providing small-scale rural banking. The BOC was delegated to take over foreign currency transactions, while the CCB focused on the construction sector. The government completed a two-tier banking system by removing commercial banking activities from the PBC and transferring them to the Industrial and Commercial Bank of China (ICBC), the fourth specialized bank, established in 1984. These financial institutions were called "specialized banks".

In 1983, the State Council promulgated *The Decision of the PBC Become Central Bank* and removed ordinal banking businesses from the PBC. However, it was not until 1986 that the PBC was explicitly made responsible for monetary policy and the supervision of the financial system, including money and capital markets under relevant law and with legal provisions. It was decided that when the presidents of the local branches of the PBC were appointed or removed, that the bank must consult with the local government, which had the right to veto appointments. In 1995, the *Law of the People's Republic of China on the People's Bank of China* was promulgated to define the functions and duties of the PBC as a central bank. To further strengthen its authority as a central bank and reduce outside influence, the PBC significantly reformed its branch networks in 1998—namely, closing some of its provincial branches and establishing new branches which would be able to supervise across provinces.

In 1987, the Bank of Communications, which was set up in 1908 in Shanghai and whose operations were merged to the PBC in 1958, again became independent as a joint-stock bank. In the 1980s, other banks were also established, including the state-owned China Investment Bank (established in 1981), and the CITIC Industrial Bank (1987) owned by the China International Investment Trust Corporation (CITIC). The China Investment Bank was merged into the CITIC bank in 1999. In the 1990s, the government allowed the entry of more banks. The China Merchant Bank, the Hua Xia Bank, and the Everbright Bank were set up in the first half of the 1990s. In 1995, the Minsheng Bank was established by a tycoon, Mr. Yonghao Liu, and other wealthy business people as the first

domestic private bank. Other banks established include the Guangdong Development Bank, the Shanghai Development Bank, the Shenzhen Development Bank, the Fujian Industrial Bank, the Yantai Housing Saving Bank, and the Bengbu Housing Saving Bank. As at end-2003, there were 11 joint-stock commercial banks.

In order to promote liquidity management by the PBC at the banking system level, rather than at the level of individual banks, the government in 1994 decided to separate commercial and lending policy activities (IMF 1996). It, therefore, established three policy banks—the Export and Import Bank of China, the State Development Bank, and the Agricultural Development Bank of China—which would be responsible for providing policy financing in the areas of foreign trade, national infrastructure development and agricultural development, respectively. In 1995, the *Law of the People's Republic of China on the People's Bank of China* and the *Law of the People's Republic of China on Commercial Banks* were introduced so that the afore-mentioned 4 specialized banks were transformed into wholly state-owned commercial banks (hereafter, these banks are called SOCBs.) These Laws gave rise to a de facto two-tier banking system that consists of (1) commercial banks that are subject to prudential regulations and are supervised by the PBC, and (2) three policy lending banks, which are not subject to this law and whose operations are guided by their individual charters (IMF 1996).

From 2001, some of Urban Credit Cooperatives (UCCs) were merged and transformed into “City United Commercial Banks” (CUCBs). CUCBs are small- and medium-size banks financing mainly small and medium enterprises (SMEs) and individuals, whereas the SOCBs mainly finance large enterprises. At the end of 2002, there were 111 CUCBs; their deposits accounting for 5.3% of the total outstanding deposits, and their loans for 4.34% of the total outstanding loans. At the end of June 2003, there remained just 34,909 RCCs, which still provide 80% of all rural finance; their deposits account for 20.7% of the total outstanding deposits and their loans account for 8.7% of the total outstanding loans. Foreign banks were allowed to set up branch institutions in Shenzhen in 1981. Since then, their number has increased: as at the end of 2001, there were 159 overseas branch banks and branch institutions. In addition, the number of Investment Trust Companies rose in the 1990s. However, after the collapse of the Guangdong International Investment Trust Company in 1998, the government launched a restructuring program for these companies. Thus, their number declined from 240 in 1997 to 60 at the end of 2002.

Table 1: China's Financial Industry

<p><u>Central Bank:</u> the People's Bank of China (9): Tianjin Branch, Nanjing Branch, Chengdu Branch, Shenyang Branch, Jinan Branch, Guangzhou Branch, Shanghai Branch, Wuhan Branch, Xian Branch</p> <p><u>Policy Banks:</u> State Development Bank, Export and Import Bank of China, Agricultural Development Bank of China</p> <p><u>Wholly State-Owned Commercial Banks:</u> Bank of China, Industrial and Commercial Bank of China, Agricultural Bank of China, China Construction Bank</p> <p><u>Joint Stock Commercial Banks:</u> Bank of Communications, CITIC Industrial Bank, Everbright Bank of China, Hua-Xia Bank, China Minsheng Banking Corporation, Guangdong Development Bank, Shenzhen Development Bank, China Merchants Bank, Fujian Industrial Bank, Shanghai Pu Dong Development Bank, Yantai Housing Savings Bank</p> <p><u>Other Financial Institutions:</u> City United Commercial Banks (111), Foreign Banks (159), Rural Credit Cooperatives (34909), Urban Credit Cooperatives (1049) , as well as Securities Companies, Insurance Companies, and Trust and Invest Corporations</p>
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1.2. Features of China's Financial Industry

In the 1990's, China's financial structure underwent great change. While indirect financing (i.e. bank loans) remained a leading part of the financial structure, direct financing grew rapidly especially after the Shanghai Stock Exchange was established in December 1990 and the Shenzhen Stock Exchange in July 1991. The share of government bonds accounts for about 15% of the total domestic financial market size (the sum of the total bonds, loans and stocks). However, the proportion of corporate bonds remains small, with the amount of funds raised through the stock market being bigger than that raised through the corporate bond market. The share of former reached its highest level in 2000—12.2% of the domestic financial market, as compared with only 0.4% in the case of corporate bond finance. Nevertheless, loans remain the major channel of financing, though their share reached the lowest level of 72.8% in 2000, rising again to 80% in 2002 (see Table 2).

Table 2 Structure of China's Domestic market

	2000		2001		2002	
	Financing (billion RMB)	Share (%)	Financing (billion RMB)	Share (%)	Financing (billion RMB)	Share (%)
Total	1,716.3	100.0	1, 655.5	100.0	2, 423.3	100.0
Bank Loans	1,249.9	72.8	1, 255.8	75.8	1, 928.8	79.5
Government Bonds	247.8	14.4	259.8	15.7	371.8	15.3
Corporate Bonds	8.3	0.5	14.7	0.9	32.5	1.2
Stocks	210.3	12.3	125.3	7.6	96.2	4.0

Source : *Contemporary Bankers*, page 10, April 2003.

In the banking sector, the four SOCBs remain dominant despite that joint-stock commercial banks and CUCBs were established in the 1990s. The market shares of

SOCBs in terms of loans, deposits, and assets are reported in Table 3. With respect to these three indicators, the market shares of SOCBs exceed 60%. In particular, in terms of total assets, their market shares remained at more than 80% in 2001. According to Anti-Trust Laws, as practiced in some other countries, the largest four enterprises are not supposed to occupy more than 50% of the market share in order not to be regarded as “oligopolistic”. It is clear from the table that the four SOCBs enjoy an oligopolistic position in China’s banking sector. This means that a large part of China’s banking sector problems naturally arise from these four banks.

Table 3 Market Shares of the Four SOCBs

Item	1999	2000	2001	2002
Balance of Deposits (%)	63.7	70.7	67.8	59.6
Balance of Loans (%)	61.3	64.8	62.8	56.6
Total Assets (%)	88.7	84.0	82.6	62

Source : *Almanac of China’s Finance and Banking, 2000,2001,2002,2003.*

II. China’s SOCBs’ Main Problems

2.1. NPLs of SOCBs

2.1.1. NPLs classifications

A four-category classification was used for a long time, in accordance with the *Financial System of Finance and Insurance Company*, promulgated by the Ministry of Finance in 1988. The four-category classification consisted of *normal*, *past-due*, *idle* and *bad* with the last three categories being recognized as NPLs. The classification is made based on whether the repayment of the principal and interest has been delayed. For example, those loans with repayments that have been delayed for more than one year would be classified as *idle* and those delayed for a lesser time would be put into *past-due*.

In 1999, the international five-category classification system was adopted by the PBC. The five-category system classifies bank loans according to their inherent risks—*pass*, *special-mention*, *substandard*, *doubtful* and *loss*—with the last three categories being recognized as NPLs. There are some differences between two classifications. Under the new classification, for example, a *substandard* class refers to assets in which the “borrower may be able to cover the principal and interest in full from their normal operation income, and some losses may be incurred”. Therefore, even loans for a borrower with financial difficulties might have been recognized as *normal* under the old system as long as banks continued to provide loans. The old classification, thus, enabled banks to report an underestimated amount of NPLs by lending to insolvent firms and allowing them to repay using the proceeds of those new loans, thereby postponing the timing of the resolution of the problem.

2.1.2. The magnitude of NPLs

Since the middle of the 1990’s, the Chinese government has paid increased attention to the problem of NPLs of banks. In 1995, the annual meeting of the National Banking Operation and Management explicitly pointed out the NPL problems of SOCBs. At the

annual meeting of the National Financial Work Conference of 1997, the problems were again referred to. In January 1998, the Governor of the PBC, for the first time, disclosed data regarding NPLs at a press conference. According to the report, the NPL ratio reached 25-26% at end-1997, of which past-due loans constituted 15%, past-due beyond 2 years 8%, and bad loans 2%. The 1997-2003 data of NPLs, reported by the Governor of the PBC, are shown in Table 4. It should be noted that all the data are classified based on the four-category classification, except those for 2002 and 2003.

Table 4 Formally Released Ratios of NPLs in SOCBs

	1997	1998	1999	2000	2001	2002	2003
Ratio of NPLs (%)	25	10	25	25	25.3	25.3	22.2
Total Loans(100 million)	--	62476.8	65819.6	65207.8	70577.8	80361.2	--
Amount of NPLs(100 Million)	12864.5	6247.7	16454.9	16301.9	17644.4	20331.4	20000
NPLs/GDP (%)	17.2	7.9	20	18.2	18.4	19.8	17.1

Note:

Speech of the PBC's Governor in January 1998, (*International Financial News*, January 19,1998).

Speech of the PBC's Governor in March 1999, the ratio of past-due loans beyond one year was 7.2%, bad loans 2.9%.

The Governor of PBC answered questions at a press conference of the Information Office of the State Council, January 20 ,2000. The ratio of past-due loans beyond one year was 5.3-6.3%, bad loans 2.7%.

Speech of the PBC's Governor in January 2001, after removing RMB 1.4 trillion NPLs to the 4 AMCs, the ratio of NPLs was 25%.

Speech of the PBC's Governor, Dai Xianglong, at *the Senior Forum of Development of China*, March2002.

Speech of the China Banking Regulatory Commission's Governor, Liu Mingkang, at a press conference, May2003.

At the end of September 2003, NPLs data from the Daily Time of Economy on China, November13, 2003.

According to the *Almanac of China's Finance and Banking*, adding data of the 4 SOCBs.

According to the NPLs ratio and loans sum announced by the Chinese government.

The data released on NPLs are likely to be underestimated for several reasons. First, the 1998's figure of 10% appears puzzling given that the NPL ratio of SOCBs reached more than 25% in other years. Some have pointed out that 10% was meant to refer to the ratio of bad loans, thus it is likely that the NPL ratio reached about 25% in 1998 as well. Second, the NPL data of 1999 is also somewhat doubtful. After the SOCBs transferred RMB 1.4 trillion of NPLs to the four AMCs, the PBC unambiguously stated that this enabled the NPL ratio of the SOCBs to be reduced to 10 percent. However, this adjustment appears not to be reflected in the official data. Shi Huaqiang (2003) estimated that the NPL ratio of SOCBs reached 39% in 1999 and 29.2% in 2000.

Based on NPL data released by the government, foreign research institutions and credit rating agencies also carried out several estimates. For example, Moody's Investors

Service estimated that the NPL ratio of SOCBs was in the range of 35%-70% in 1996, while Morgan Stanley Dean Witter estimated that the ratio was 36% in 1998(Li Hongjiang 2002).

Regardless of which data or estimates are correct, the fact is that the sheer amount of China's banking sector NPLs is immense, and the problems it presents are serious. For example, at the end of July 2001, in ChaoYang City, the balance of loans issued by all financial institution was RMB 6.76 billion, of which NPLs were RMB 4.9 billion. This means that the NPL ratio was 72.4% (Wu Liang 2002) . Given that the accounting and auditing systems were opaque before 2002, collecting reliable data is an extremely difficult task. Furthermore, as pointed out earlier, the four-category classification basis allows some banks to falsify reports by adopting the practice of *making new loans to pay back old loans* so that on the balance sheet some NPLs can be concealed.

From 2000, the ABC excepted, the SOCBs have begun to disclose NPL data under the four-category classification in the respective Annual Reports. The data of NPLs under the five-category classification were also reported simultaneously in comparison with the four-category classification. The PBC required that the SOCBs should disclose NPL data based on the five-category classification from 2002 onward. So far, the ABC has not followed this requirement and has just reported that it reduced the NPL ratio by 4.99% compared with the ratio of 2002. The China Banking Regulatory Commission (CBRC) stipulates that China's SOCBs and joint-stock commercial banks should adopt the five-category classification system as of 2004. It is not yet clear whether these banks will follow the new regulation. The NPL ratios reported in Table 5 are based on the annual reports of the three SOCBs, as well as other information sources.

Table 5. Trends of SOCBs' NPLs
(Based on the Five-Category Classification)

	2000	2001	2002	Sep.2003
The Industrial and Commercial Bank of China	34.43	29.78	25.69	21
Bank of China	27.2	27.51	22.49	17
China Construction Bank	20.27	19.21	15.17	11
the Agricultural Bank of China	--	34.99	30.0	--

Note: *Financial News* July 11,2003 (the Agricultural Bank of China issued its Annual Report 2002, which reported that the NPL ratio was 30.07%, lower than last year in the order of 4.99% based on the four-category classification. If the figure had been based on the five-category classification, the ratio would be expected to be higher than 38%.)

Source : Annual Reports of The Industrial and Commercial Bank of China; Annual Reports of Bank of China; Annual Reports of China Construction Bank; Daily Time of Economy.

According to figures provided by the CBRC, the amount of NPLs totaled RMB 2.54 trillion at end-June 2003. The amount includes NPLs of major financial institutions (such as the four SOCBs, three policy banks and 11 joint-stock commercial banks), whose aggregate loans accounted for 82 % of the total loans. The amount of NPLs of SOCBs

reached about RMB 2 trillion. At the end of September 2003, NPL ratios of various financial institutions under the five-category classification were 21.4% for SOCBs, 18.1% for policy banks, and 8.4% for joint-stock commercial banks.

NPL problems of CUCBs and RCCs appear more serious than those of SOCBs and other banks. Based on the four-category classification, the NPL ratio of CUCBs are estimated to have reached more than 30%--much greater than the national average (Economic Daily, December 3, 2002). The ratios of RCCs are likely to be even greater than those of the CUCBs, although relevant data are not available.

2-2. Low Levels of Capital Adequacy of SOCBs

The amount of SOCBs' capital has been small. Given that they could not find ways to increase capital, the Ministry of Finance issued RMB 270 billion of 30-year special government bonds in August 1998. As a result of this capital injection, SOCBs capital adequacy ratios reached 8%, respectively. But since then, the capital adequacy ratios of the SOCBs have dropped (see Table 6).

Table 6 The Capital Adequacy Ratio of the SOCBs

	1997	1999	2002
Industrial and Commercial Bank of China	2.55	5.7	5.54
Bank of China	4.70	3.0	8.15
China Construction Bank	2.73	2.5	6.91
Agricultural Bank of China	2.14	5.1	1.44

Source: Annual Reports of The Industrial and Commercial Bank of China, Bank of China, China Construction Bank and Agricultural Bank of China

One of the problems faced by the SOCBs is that the speed of asset increases is higher than that of capital increases. In fact, the decline in the capital adequacy ratio results from the rapid extension of credit. Another factor is that a decline in profits from lending activities has added to the lowering of the capital adequacy ratio. Based on the recent editions of the *Almanac of China's Finance and Banking*, the profits on assets of the banking sector have been calculated and are reported in Table 7. The profits on the assets of the SOCBs have been lower than those of policy banks as well as those of joint-stock commercial banks. While profits of all these Chinese banks are much lower than those of foreign banks.

Table 7 Profits on Asset of China's Banking Sector

Year	SOCBs	Policy banks	Shareholding Commercial Banks	Foreign banks
1998	0.10%	0.11%	0.97%	
1999	0.17%	0.15%	0.64%	2.69
2000	0.25%	0.51%	0.49%	1.92

2001	0.20%	0.49%	0.49%	2.26
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Source: *Almanac of China's Finance and Banking* 1999-2002

In early 2004, the government launched a program of comprehensive banking sector reform. The program includes the disposal of the NPLs of SOCBs through various measures: recapitalization, reform of the capital market, improvement of corporate governance, and preparing SOCBs for public listing. The government injected foreign exchange of \$45 billion (RMB 372 billion) to two of the SOCBs (BOC and CCB) as at the end of 2003. Total owners' equity of the two SOCBs amounted to about RMB 300 billion. The State Council as a shareholder of these two firms has established another firm, China HUIJIN, under its jurisdiction to assist the BOC and CCB to become public listed banks. As a result of the cash injection, the two bank's capital adequacy ratios exceeded 15% each. Given that China has ample foreign reserves, utilizing foreign exchange reserves to inject capital to banks is one measure to resolve the problems of capital inadequacy and could be regarded as a reasonable way of utilizing foreign exchange reserves. It is widely viewed that the injection to the two SOCBs is just a first step in China's banking restructuring strategy; the remaining two SOCBs (ABC and ICBC) are expected to follow along the same path in the near future. However, the government has not decided whether cash injections should be made to them given that their performance is poorer, so that it will take a longer time for them to be eligible for public listing. The ABC has the largest NPL ratio while the size of of ICBC's assets is the largest.

III. Establishment and Operation of AMCs in China

3.1. The Establishment of AMC

To acquire NPLs from SOCBs, in 1999 the government established four AMCs, capitalized at RMB 10 billion each: Cinda associated with the CCB, Great Wall with the ABC, Oriental with the BOC, and Huarong with the ICBC. Information summarizing these AMCs is reported in Table 8. As wholly state-owned financial institutions, the AMCs remain under the supervision of the PBC, with guidance from the State Securities Supervisory Committee of China and the Ministry of Finance. The general mandate of the AMCs is to collect debt, restructure, or assign NPLs; convert NPLs into equity; issue financial bonds and borrow from financial institutions; and, recommend companies for listing.

According to practices in other countries, one AMC is established to play a role of disposing of NPLs of all financial institutions. Contrary to this practice, however, China took a different approach, for two reasons. First, the size of loans is, on average, small and the clients are widely dispersed. For example, China and Great Wall took over about 2 million enterprises/natural debtors, totaling about 4 million contracts, averaging \$ 20,000 for each debtor and \$10,000 for each contract. Thus, it is difficult to have one AMC to deal with all these firms' NPLs. Second, given that every loan emerges from relationship lending, it is crucial to have informal information about those loans. For this reason, the main staff members of AMCs are generally seconded from the relevant SOCB. Thus, to fully exploit information related to each SOCB, having a separate AMC for each is important.

At the AMC management level, the State Council of the government appoints a Managing Director and several vice- Managing Directors for each AMC. The Managing Director exercises authority on behalf the AMC and takes charge of operating and

managing the AMC. The PBC, the State Council and Chinese Securities Regulatory Commission jointly supervise AMC operations. In May 2003, the newly established China Banking Regulatory Commission took over the AMCs supervisory role the PBC. An AMC is comprised of a headquarters and agencies, which are established based on the amount of NPLs, so the numbers of each AMC's agencies differ. The number of agencies for Cinda, Greatwall, and Huarong is 30, while that for Orient is 29. The total number of employees in the four AMCs is more than 11,000.

Table 8 Details of AMCs
(Hundred Million RMB)

AMC	Cinda	Huarong	Greatwall	Orient	Total
Time of establishment	1999.4	1999.10	1999.10	1999.10	
Related SOCBs	China Construction Bank	Industrial and Commercial Bank of China	Agricultural Bank of China	Bank of China	
	22,011	35,399	22,759	9,103	89,277
NPLs removed	3,730	4,077	3,458	2,674	13,939
Capital	100	100	100	100	400
Central Bank Lending	0	947	3,450	1,074	5,479
Financial Bonds	3,730	3,130	0	1,600	8,460

Source: Websites of AMCs

Note: RMB 80 billion of the NPLs received by Cinda were removed from the State Development Bank.

3-2. Purchasing Assets and Contents of The Assets

AMCs took over SOCBs' NPLs, which had been contracted before 1996. In principal, the past-due and idle loans classified under the four-category loan classification were purchased at their book value. This indicates that the government took over the NPLs produced in the era of planning economy. The total NPLs received by the four AMCs were RMB 1.4 trillion, which accounted for 15.6% of the total assets of the four SOCBs.

The four AMCs financed this transfer by issuing bonds of RMB850 billion and borrowing RMB55 billion from the PBC. This operation, however, did not increase reserves, since the SOCBs' total borrowings of RMB55 billion from the PBC were deducted from their liability (and the total amount of RMB85 billion in bonds issued by AMCs appeared on the asset side of SOCBs in exchange for a reduction of transferred NPLs of RMB 1.4 trillion.) The interest rate for the PBC lending was 2.25%. The purchase of RMB 1.4 trillion NPLS was completed by end-2000.

In fact, the quality of the transferred NPLs was extremely poor. More than 70% of the debt assets are credit loans, which are largely loans made by the state-owned enterprises for investing in equipment and production capacity. Quite a few of the loans include those guaranteed by the government. It has been pointed out that 40% of SOCBs' assets are NPLs and should be written off (Economic Daily, Nov. 14, 2001).

As for measures to cope with the RMB 1.4 trillion worth of NPLs transferred, the AMCs have used two approaches. One is to conduct a debt-equity swap for firms (largely, state-owned enterprises) that are relatively better performing and thus can be regarded as candidates for becoming public companies. The other is to directly deal with transferred

NPLs to firms that are unlikely to survive.

3.3 . Debt-equity Swaps and Problems

The debt-equity swaps scheme involves the following measure: Initially, the State Economic and Trade Commission investigates insolvent enterprises and makes recommendations to the relevant AMCs. The conditions for such a recommendation are stringent for several reasons. First, the enterprise debtor must have the necessary management skills, employ competent managers, maintain good accounting standards, have an element of competitiveness, etc. The enterprises whose debts were transferred to the AMCs were mostly state-owned, and only a few were foreign trading enterprises. The companies had been established without any equity and their liabilities consisted totally of loans.

Second, based on the enterprises book value, the AMCs are supposed to pay principal and interest to the SOCBs that own the debt of the particular enterprise.

Third, the AMCs are in charge of arranging debt-equity swaps and signing contracts with enterprises after their own investigation. Such contracts become effective after being examined and confirmed by the State Economic and Trade Commission, the Ministry of Finance and the PBC, and are then followed by the issuance of the certification of the State Council.

Fourth, the AMCs as shareholders are supposed to encourage the enterprises to improve their management in order to realize a public listing, and thereby recover the costs of their acquisition by selling stocks on the stock market, or by facilitating the enterprises ability to buy back their stocks.

By the end of 2000, the AMCs had performed debt-equity swaps of RMB 341 billion in respect of 587 enterprises. But the impact of the debt-equity swaps was not as successful as expected. This was because those enterprises made little progress in terms of reforming their management. By the end of 2002, AMCs have gotten the shares of only 10 enterprises. (China Business Post, March 31, 2003).

The debt-equity swaps enabled firms to lower the ratio of their liabilities, on average, from 73% to 50%. In 2000, the balances of 80% of firms performing debt-equity swaps shifted from deficit to surplus. The main reason for such an improvement came from a reduction in the cost of funding. According to the available statistics, from April 2000 when firms were allowed to escape paying any interest for up to April 2003, enterprises could lower their interest payment burden to a significant degree. For example, in the case of 5-year loans with an interest rate of 5.76%, enterprises could save RMB 69 billion worth interest, which accounted for one third of their total profit.

On the other hand, the debt-equity swaps also had problems: First, the operation of the debt-equity swaps was de facto equivalent to debt relief for both the insolvent firms and banks. The original scheme of debt-equity swaps didn't work out, so that the swaps gave rise to moral hazards for both banks and enterprises alike.

Second, the State Economic and Trade Commission limited the authority of the AMCs in respect to the supervision of enterprises; so that the AMCs could not fully monitor those enterprises. One of the reasons for limiting the authority was because the AMCs' involvement in firms met with strong resistance from local governments and individuals with vested interests in the effected enterprises. Furthermore, in the early days of the debt-equity swaps operation, the programs also included a stock repurchasing plan, such

that firms conducting debt-equity swaps would be able to repurchase those stocks held by the AMC's within the specified period without them being publicly listed. This plan was supposed to guarantee asset recovery for the AMC's and thus protect them. However, the government canceled the plan because firms, being unsatisfied with the purchase prices and the costs needed, were not willing to do so.

3.4 Asset Disposition Methods

The direct measures to cope with the NPLs include bidding, auctions, restructuring of debt, liquidation and bankruptcy, contracting agreements, ¥ Asset Backed Securities (ABS) and so on. The most widely used methods have been bidding and auction. The AMC's held various auction fairs and exhibitions of the assets they had for sale (including land, buildings and tangible assets such as vehicles). They also used package selling for disposing debts by category. The assets were packaged on the basis of the characteristic of the areas or industries. Generally used practices are (1) packaging debts and establishing an AMC with foreign investors; (2) directly selling the package to domestic or foreign investors, and entrusting the asset package to foreign investors; (3) setting up a securitization fund for each package. In November 2001, Huarong established a first Joint AMC with Morgan Stanley and Rongsheng with Goldman Sachs.

As of June 2003, the data on the amount of NPLs recovered by the AMC's is shown in Table 9. The AMC's have made some progress in cash recovery; not only in terms of the cash recovery but also the recovery rate.

Table 9 Balance of AMC's Retrieving NPLs (June 2003)

	Cinda	Orient	Greatwall	Huarong	Total
Purchased Sum	3,730	2,674	3,458	4,077	13,939
Settled Asset Sum	941.28	536.8	1204.69	935.67	3014.42
Recovery of Cash Sum	296.25	136.33	129.75	229.96	792.29
Rate of Recovery of Cash	31.47	25.4	10.77	24.58	21.9

Source : Newspapers.

In China, it is hard to implement ABSs, which are instruments that are widely used in other countries. In the beginning, the AMC's believed that they would be able to do so, but it gradually became clear that that this would not be possible because of the policy limits. In the beginning, the ABS program was attempted by making the Trust and Invest Corporations undertake the functions of special purpose vehicles (SPVs). However, the *Administrative Rules on Trust and Investment Companies* and the *Provisional Rules on Entrusted Funds Management of Trust and Investment Companies* promulgated in June 2002 prohibits these Corporations from issuing securities. In order to circumvent this

regulation, Cinda AMC made an ABS contract with Deutsche Bank, which in turn then issued bonds abroad.

Generally, the process of disposing of NPLs started with those that were easiest achieved; meaning that the remaining NPLs are those that are much harder to tackle.

IV. The Future of The AMCs

4.1. NPLs Disposed of by the SOCBs Themselves and the Challenge to the AMCs

The total amount of SOCBs' NPLs reached RMB 2 trillions at the end of June 2003. It thus became necessary for SOCBs to dispose of NPLs before making any restructuring reforms. Thus, how to dispose of a large amount of NPLs is one of the most important issues. For a long time, there have been regulations that discourage banks conducting direct disposals of NPLs. For example, a regulation prohibits a bank from disposing of its NPLs at a discount. The four SOCBs are also prohibited from performing informal negotiations with a debtor or canceling part of the debt (without court approval). The basis on *the Law on Commercial Banks*, is that these SOCBs are not allowed to carry out investment banking businesses. Given that the number of measures to deal with NPLs by the SOCBs is limited, the government hopes were that the AMCs could successfully dispose of the NPLs.

However, the pace of NPL restructuring through the AMCs is not as rapidly as envisaged. The , since NPLs increased rapidly in the meantime, the government from 2003 began to encourage SOCBs to directly dispose of NPLs and welcomed foreign investors to join in the market for NPLs. Currently, foreign investors are not allowed to directly acquire NPLs from SOCBs, so that they must do so through establishing joint venture entities. These transactions are structured through forming a strategic relationship between SOCBs and foreign investors. For example, the ICB and the CCB established venture entities with Morgan Stanley and Goldman Sachs, respectively, to dispose of their NPLs. These banks have begun to deal directly with foreign investors regarding their NPL portfolios and are considering auctions, as well as private placements, despite the current regulatory restrictions. The regulatory hurdle facing China's domestic banks in doing private deals with foreign investors is found in Article 43 of the *Commercial Banking Law*, which prohibits commercial banks from investing in non-banking financial institutions; but the article may be overlooked in the near future.

As the government's stance against disposing NPLs has changed and the SOCBs have begun to dispose of NPLs on their own account, rather than depending on the AMCs, the public view now is that the government is disappointed at the work done by the AMCs. The public also has the view that the government will not transfer NPLs from SOCBs to the AMCs for a second time, so the SOCBs must resolve their NPL problems themselves. This has presented an opportunity for lowering the dominance of AMCs in terms of disposing of NPLs and intensifying competition with the SOCBs.

4.2. The Future of the AMCs

Since they began to operate four years ago, the AMCs have acquired experience and skills in how to resolve NPLs. Thus, the role of the AMCs should not be ignored when the government designs an institutional mechanism aimed at disposing of NPLs. Currently, the

SOCBs are likely to dispose of those NPLs remaining on their balance sheets, while the AMCAs will continue to dispose of those already transferred NPLs.

The China Banking Regulatory Commission (CBRC) has emphasized the role of the AMCAs in its campaign to reduce bad loans. CBRC Chairman Liu Mingkang recently told the China Daily that “although asset management companies have some inherent problems in their system and operational mechanism, we need to note that... their level of professionalism has been continuously improving, and their disposal work has been fairly smooth”. He also added that “the government is considering new AMC policies in the areas of operational mechanisms, performance evaluation and incentive measures as well as the external environment to further improve their efficiency.”

The AMC staff and scholars are hoping that the government would allow the AMCAs to expand their businesses to become more commercially-oriented. In the future, they believe that AMCAs should develop into a comprehensive AMC that will focus on NPL resolution as its main business; meanwhile, maintaining the function of asset management and an investment bank. The scope of the business area to be granted to the AMCAs will include the following aspects: First, AMCAs will be authorized to use their capital to invest in some NPLs that have the potential to increase their value. This approach differs from the existing debt-equity swaps, since the former is related to investment decisions made in the discretion of the AMCAs, whereas the latter is an investment determined by the State Economic and Trade Commission. In general, the profits for the former are greater than those arising from the latter, since some firms not selected for debt-equity swaps by the Commission are viable, so that their swaps could generate higher returns. Second, AMCAs will be allowed to dispose of NPLs of the SOCBs and other financial institutions as well as dispose of their assets on a commercial basis. Third, AMCAs will be allowed to operate as investment banks, performing such functions such as underwriting, giving financial advice, and NPL securitization. The AMCAs were established originally as institutions that would only be operational for up to 10 years. Given that there are no investment banks in China, the government now envisages that the AMCAs can be transformed into investment banks after their completion of NPL disposal, and that the transformation can take place within 10 years. Fourth, AMCAs are expected to be able to participate in the inter-bank repurchase asset market. The government has not yet expressed its view with respect to the AMCAs’ future. While it is still possible that the government dissolve them after 10 years, this possibility is getting lower given that the total employment has already reached 11 million.

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