

# NON-PERFORMING LOAN RESOLUTION IN CHINA

By Richard Peiser\* and Bing Wang\*\*

*Executive Summary.* China, like with other Asian countries, is closely following the approach used by the United States through the formation of the Resolution Trust Corporation (RTC) to resolve its non-performing loan problem. The purpose of this article is to review China's progress in attracting foreign investors to purchase the NPLs, and to evaluate a long list of factors that affect investor perceptions of uncertainty. These factors must be addressed before investors are likely to enter the Chinese market in force—a necessary requirement for the government to see higher NPL recovery rates and lower losses on loans made by the state-owned banks.

The article discusses three broad categories of uncertainty that affect investor perceptions about China's NPL market. Of these, it is in the area of execution that foreign investors face the greatest uncertainty. The government has been moving forward to resolve key issues with respect to repatriation of capital and tax rates for foreign buyers. Other issues depend more on what happens at the local level or on property-level negotiations such as laid-off employee liability. While these areas would benefit from strong national direction, only experience in resolving actual loans is likely to reduce investor uncertainty.

\*Michael D. Spear Professor of Real Estate Development, Harvard Design School or [rpeiser@gsd.harvard.edu](mailto:rpeiser@gsd.harvard.edu).

\*\*Harvard Design School

The success of the RTC in the United States hinged primarily on the speed with which NPL assets were brought to market and securitized. Investors responded creatively to the opportunity, and prices, which were initially low, rose quickly, thereby reducing the losses to the government. The Chinese government has

---

*attempted to apply the lessons of the RTC by creating four Asset Management Corporations (AMCs) to speed the loan resolution process, and by encouraging foreign investors to buy the NPL portfolios. Whether or not prices in China will rise rapidly as they did in the United States depends on whether foreign investors are able to get control of NPL assets quickly and to realize higher recovery values than they currently project, especially from loans originally made to the state-owned enterprises.*

China, like every other Asian economy, is dealing with a mountain of bad loans. The total clean-up cost is estimated by Standard & Poor's to be some \$518 billion, or 43% of this year's gross domestic product (*Business Week*, 2002, p. 18). China has begun the long process of resolving its non-performing loan (NPL) problem by establishing four Asset Management Corporations (AMCs) to resolve some \$169 billion of non-performing loans (NPLs) made to the four major state-owned policy banks. Resolution of the NPLs and recapitalization of its banks are of fundamental importance to China as it enters the World Trade Organization, and prepares its banks to compete head-on with Western banks. Toward this end, China is attempting to attract foreign investors to purchase the NPL portfolios.

The purpose of this article is to review China's progress in attracting capital to invest in its budding NPL market, and to evaluate a long list of factors that affect investor perceptions of uncertainty. These factors must be addressed before investors are likely to enter the Chinese market in force—a necessary requirement for the government to see higher NPL recovery rates and lower losses on loans made by the state-owned banks.

In establishing the four AMCs to work out the bad loans of the four major state-owned banks, China has closely followed the United States' experience with the Resolution Trust Corporation (RTC). The RTC's aggressive sales of NPLs has become a model for the rest of the world. Despite predictions of loan losses in excess of \$400 billion, the final cost to the United States government was under \$100 billion—one of the most successful government interventions into the U.S. financial markets.

To be sure, China has its own unique set of problems in dealing with its NPL situation. Unlike the United States, many of the loans are not real estate backed. Furthermore, many of the loans were made to state-owned enterprises (SOEs) that have assets of questionable value. Great uncertainty surrounds the ability of foreign investors to foreclose on delinquent loans and to collect much money from the sale of collateral. However, like the United States, China is using the NPL resolution process to introduce a new set of institutions into the market place. The success of the RTC depended on opportunity investors' bringing massive amounts of capital into the real estate markets and led to the first securitization of non-performing loans. Similarly, China is looking to Wall Street and other global capital markets to resolve the NPL crisis through the first major foreign direct investments into Chinese financial markets.

The article has three main parts. It begins with a discussion of the RTC's experience in resolving the United States' NPL problem and a review of the literature on NPLs in Asia. The second part presents the NPL resolution process in China. This section begins with a brief discussion of China's banking system. It proceeds with a discussion of the classification and magnitude of China's NPLs, and ends with the government's approach to loan resolution by establishing the four AMCs. The third part evaluates fifteen factors that affect foreign investor perceptions about risk and uncertainty for investing in China's NPL market. The article concludes by highlighting the changes that must occur in order for prices on China's NPLs to rise—key to the government's objective for bringing in foreign investors to help reduce the ultimate cost of NPL resolution. The article's main contribution is to add to the literature about non-performing loan resolution—one of the most important financial restructuring issues throughout the world over the last decade—and to illuminate the challenges facing China as it attempts to resolve its NPL problem.

---

## PART I: BACKGROUND AND LITERATURE REVIEW

There are two strands of literature that are important for understanding China's NPL resolution process. The first strand describes the experience of the Resolution Trust Corporation (RTC) in the United States. The second strand relates to China's NPL problem and the fundamental financial restructuring that China's economy is undergoing. For both strands, the serious academic examination is only just beginning. Journal articles are sparse, so we have had to rely more than we would like on articles in the financial press.

### The FDIC and the RTC Resolution Process

For understanding the RTC, two important compendiums of articles and forum discussions have been assembled by the Federal Deposit Insurance Corporation (FDIC). *History of the Eighties: Lessons for the Future* (FDIC, 1997) examines the formation of the RTC and the U.S. government's response to the banking crisis of the 1980s and early 1990s. A second two-volume publication by the RTC, *Managing the crisis: the FDIC and RTC experience, 1980—1994*, (FDIC, 1998) reviews the resolution methods and techniques used by the RTC during the Savings and Loan banking crisis and the RTC's performance.

The primary success of the U.S. resolution process was that despite the magnitude of the crisis, there were no serious bank runs or credit flow disruptions at federally insured institutions and, more importantly, no evidence of depositors losing their insured deposits (FDIC, 1998, v.1, p.6). In the resolution process, the FDIC performed its essential role as a deposit insurer of banks and savings associations and as a receiver. Its primary objective was to preserve the overall stability of the U.S. financial system and maintain public confidence. The RTC, on the other hand, had a narrower focus; its duty was to maximize net present value returns from the disposition of failed institutions and their assets.

One of the RTC's earliest challenges was to deal with the requirement of selling assets quickly without being accused of "dumping" them for prices that were considered to be too low. Initially, FIRREA (the Financial Institutions Reform, Recovery, and Enforcement Act of 1989) required that the RTC sell real estate for no less than 95% of

its appraised (market) value. In 1991, however, in response to growing criticism of its slow sales and congressional concern over the cost of maintaining a rapidly growing inventory of properties, FIRREA was amended, and the minimum sales price was reduced to a stipulated figure of no less than 70% of the appraised value (FDIC, 1998, v.1, p.9).

Due to its limited life span, the RTC had neither the time nor the resources to develop an experienced staff, but by establishing working relationships and partnerships with large private asset management and disposition firms, it was able to acquire as much expertise in NPL resolution as it needed. It was also able to set up national sales centers and successfully sell assets in bulk.

### Resolution of assets

Methods used by the RTC to dispose of assets previously owned by failed institutions include auctions and sealed bids, securitization, equity partnerships, and the use of asset management contractors. About \$400 billion in assets were handled in one of these ways. Most of the RTC's assets were secured by real estate mortgages, and their disposition was further hampered by a nationwide decline in the real estate market. To meet this challenge, real estate-backed loan portfolios were stratified and placed in pools in accordance with such criteria as geographic area, asset type, asset quality, and asset maturity. In addition, the RTC also adopted the use of seller financing as a convenient tool for portfolio sales (FDIC, 1998, v.1, p.30).

"The FDIC began holding real estate auctions periodically in the late 1980s to dispose of large inventories of smaller, distressed, and labor-intensive real estate properties, such as condominiums and vacant lots. Because of this, real estate auctions connoted the image of 'fire sale' in which the seller was willing to accept heavily discounted prices to liquidate undesirable real estate" (FDIC, 1998, v.1., p.34).

"Consequently, in the early stages of the RTC's existence, real estate auctions were prohibited for fear that they would aggravate already distressed markets and damage the financial standing of banks and thrifts that were heavily invested in the real estate market" (FDIC, 1998, v.2, p.62). This prohibition was later lifted when it became apparent

---

that it was inhibiting the rapid disposition of assets and increasing the cost of resolution.

In fact, the two distinctive asset disposition techniques used by the RTC in its successful handling of NPLs were (1) the creation and sale of large asset pools; and (2) the use of securitization. Nearly 500,000 loans were packaged for securitization. To accomplish this, a variety of collateral types were used: e.g., home mortgages, commercial mortgages, manufactured housing loans, leases and installment contracts on personal property. 71 of these transactions, out of a total of 74, performed extremely well (Glassman, 1998).

The RTC's effectiveness in the crisis can be attributed to the following five principles: (1) Throughout the entire process, the efforts of the RTC were coordinated with those of legislators. (2) Clearly defined roles and objectives for the FDIC and the RTC helped both agencies to remain focused. The RTC's resolution process was based largely upon the prior experience of the FDIC. (3) The RTC gradually adopted an evolutionary approach to resolution methods. (4) By using private-sector resources whenever possible, it saved a lot of time and money in the disposition of the NPLs. (5) By going to the public capital markets through securitization, it was able to achieve unprecedented results.

Over its seven-year life, the RTC succeeded in disposing of more than \$410 billion in NPLs and other assets. While the pricing of early pools was low, prices rose quickly as investors became comfortable with the process of resolution and recovery. In the end, the government's losses on NPL resolution were much lower than originally predicted.

### **China's NPL Problem**

The second relevant strand of literature for this paper is on the subject of Asian NPLs. Most work in this area has focused so far on the macro-economic or political and legal aspects of the debt resolution process [Olson (1999), Dornbusch and Giavazzi (1999), *China Daily* (2001)]. The micro-pricing aspect of the loans has yet to be given serious analysis. This is not surprising since the transactions that by definition would underlie any econometric analysis have occurred only over the last couple of years.

Two systemic studies of Chinese NPLs are worthy of note: 1) a survey report entitled "China's Non-Performing Loan Problems," (Watanabe, 2000); and 2) a working paper entitled "China's Asset Management Corporations," (Ma and Fung, 2002). The first of these fully explains the macro-mechanisms that have generated the bulk of China's NPLs. The second focuses on their scope and offers a theoretical deduction of the actual amount of the loans, as well as an analysis of the financial shortcomings of the resolution process presently being implemented by China's four AMCs.

In addition to the above two academic publications, there have been a number of articles in the financial press that trace the sequence of events in the NPL resolution process. These articles focus on the establishment and development of China's four Asset Management Corporations (AMCs) and the groundbreaking international auction of NPLs carried out by the Huarong AMC (*Dow Jones International News*, 2001; *Financial Times*, 2001).

The cover story of the February 2002 edition of *EuroMoney Magazine* was the first to offer an in-depth report on the auction process and to discuss the opinions of the various foreign investors and government officials regarding the value of the NPLs being auctioned.

### **PART II: NPL RESOLUTION IN CHINA**

The underlying causes of China's NPL situation have to do with the way China has traditionally financed its multitude of state-owned enterprises (SOEs). The trials and errors resulting from the country's efforts to return to a market economy have complicated NPL resolution. The current NPL dilemma is the product of a legacy of central planning, and the main players in the drama are Chinese government officials, particularly members of local governments; in most decisions, third parties are conspicuously absent. The banks involved have acted primarily as government agents, disbursing funds to a variety of pre-determined projects without any preliminary credit analyses. Such analyses were never performed, nor was there thought to be any need for them, since all credit terms—the amount of the loans, loan maturity, interest rates, and so forth—were pre-determined by the government. Such a system could not help but generate irrational investment decisions, and these decisions frequently resulted in non-performing loans.

---

Moreover, in China's transition to a market economy, there remain institutions that inhibit the maintenance of capital and traditions that have long since outlived their usefulness. Of these, the most serious is the lack of attention given to the maintenance of capital. This, more than anything else, can be blamed for the current NPL problem. In essence, State-owned enterprises (SOEs) have treated their share of credit allocations as government grants and used them to finance working capital and fixed investment. In too many cases, these disbursements have not been thought of as debt obligations that had to be repaid. Though state enterprises have been able to shift the consequences of their lack of foresight to Chinese banks, the banks have had no way to pass the burden on.

The overly optimistic expansion of credit that China experienced in the early 1990s was an additional source of NPLs. It overheated the economy and created runaway inflation. Domestic credit grew at the rate of 30% per year between 1991 and 1995, a rate significantly higher than the average growth rate of 21.3% in the 1980s. During that same period of time, real estate lending increased rapidly and fueled property development that was far beyond the limits of the country's demands. Many of the problem loans that now plague China's banks were created by the credit boom in the 1990s and by subsequent asset price bubbles. The majority of the country's NPLs are the survivors of loans to, and assets of, failed SOEs. This is a significantly different NPL scenario from that of the United States.

### **The Banking System in China**

Since the banking reforms of the mid-1980s, the People's Bank of China (PBOC) has been turned step-by-step into a central bank. Three policy banks have been established to take up the job of policy lending, and the four state-owned specialized banks are being gradually transformed into commercial banks. Meanwhile, thirteen shareholding commercial banks and four public-quoted banks have been set up. 75 credit cooperatives were turned into city commercial banks, and 65 foreign banks have set up 155 branches and 248 representative offices.

The three policy banks are:

- The China Development Bank (CDB)
- The Export and Import Bank of China (Chexim)
- The Agricultural Development Bank of China (ADBC)

Policy banks, with mandates from the national government, use their capital to support infrastructure construction, develop basic and mainstay industries, release bottlenecks, and adjust industrial and local economic structures. After the 1994 bank reforms, three policy banks started to issue Policy F-bonds to commercial banks and other non-bank financial institutions.

The "Big Four" dominant state-owned commercial banks are:

- The Industrial and Commercial Bank of China (ICBC)
- The Agricultural Bank of China (ABC)
- The Bank of China (BOC)
- The China Construction Bank (CCB)

Because the "Big Four" hold a crucial position in China's national economy, the central government has required them to sort out their assets and restructure into "true commercial banks" within the next five years. By that time, they will have to compete in a market that will be fully open to foreign financial institutions.

The "Big Four" face disadvantages and advantages for competing against Western banks. Their disadvantages include the current overhang of huge bad loan portfolios; they lack modern banking products; they have many uncreditworthy customers (SOEs); and they are overstaffed and overbranched. Their advantages are that they are too big to fail: they dominate about 80% to 90% of China's banking assets. They retain profitable customer bases, widespread branch networks, and government support for building competitive infrastructures. The government is using AMC's to purchase the banks' bad loans at apparently full-book value with bonds guaranteed by the state.

Over the next five years, the Chinese government wants to transform the "Big Four" into modern strongly competitive commercial banks. Some state-owned commercial banks will be restructured to become state-controlled shareholding commercial banks. Cutting down on the number of NPLs has become a reform priority, with impressive results having been achieved. In April, the ICBC became the first to make public its NPL rate, and it was followed by the CCB and the BOC.

Moreover, commercial banks are now competing for the efficient resolution of NPLs in an effort to prepare themselves for competition with foreign banks and to obtain a better chance to go public through an IPO before their peers do. Chinese central bank chief Dai Xianglong has urged the four big banks to reduce their bad loan ratios from 28% to 13% of their total lending over the next five years.

### Non-state-owned Banks

In addition to the state-owned banks, there are two types of non state-owned banks: One is called a shareholder-owned bank and is actually owned by investors, private citizens, and corporations: the CITIC, the Bank of Communication, and municipal commercial banks, such as the Beijing Commercial Bank and the Bank of Shanghai are all banks of this kind. The other type includes four banks that trade on the stock exchange: they are the Shanghai Pudong Development Bank, the Minsheng Bank, the China Merchants Bank, and the Shenzhen Development Bank, the previous Hainan Development Bank, etc.

In June 1998, the PBOC ordered the Hainan Development Bank (HDB) in Hainan Province to be closed. This was the first bank failure since the establishment of the People's Republic of China (PRC), and it signaled the end of the myth that "China's banks never fail." Immediately before HDB's failure, there was a run on the bank, the first instance of a run on a PRC bank triggered by worries about its credit. This demonstrated that the stability of the credit system, which had been maintained by the commitment of central and local governments, was changing: it indicated that Chinese banks were now exposed to much greater liquidity risks. To avoid a liquidity crisis within the financial system, the government injected 270 million RMB into the "Big Four" in 1998.

### Classification and magnitude of NPLs

The PBOC, the central bank of China, required commercial banks to introduce a newly defined five-category asset classification system in 1998, which is modeled on the United States' system (Figure 1).

Table 1: Loan Classification

	Loan Categories
Performing Loans	normal loan
	watch list loan
Non-Performing Loans (NPLs)	inferior loan
	problem loan
	loss loan

The system is set forth in the Guiding Principles on Lending Risk Classification issued by the PBOC. Although these guiding principles detail the criteria that should be used in loan classification, the system for monitoring loan performance in China remains substandard. Chinese banks do not appear to adequately grade the quality of their loan assets and, when compared to international banks, it can be seen that they understate their NPLs. Although the PBOC announced that 25% of all its loans are NPLs, S&P estimates that the NPLs may account for up to 50% of all lending done by the four big state-owned banks. They claim that even in the Bank of China, the best of the "Big Four," NPLs account for 39% of the bank's loan portfolio.

### Government Approach to NPL resolution and establishment of the AMCs

Government involvement in NPL resolutions in China has taken various forms. From the mid-1990s, the government began to separate commercial lending from policy lending. It established three policy banks to handle all policy-related lending, in the hopes that wasteful lending to failing companies from the four commercial banks would decline and that internal and external competition would intensify within them. Since Prime Minister Zhu Rongji took control of the financial reform, a number of reform measures have been put forward to deal with NPLs and to guard against risks in the banking system. These included (1) injecting equity to recapitalize state-owned banks; (2) compelling banks to adopt international standards when classifying NPLs; (3) requiring banks to make loans on a commercial basis; (4) for-

---

bidding local governments to interfere with the lending decision of banks; (5) creation of four Asset Management Corporations (AMCs) to take over and liquidate the NPLs from the "Big Four" state-owned banks; and (6) debt to equity swaps.

The AMCs in China are largely based on the RTC model successfully used in the U.S.. They are government-sponsored agencies with limited life (10-year). China's four AMCs are responsible for the disposal of approximately 1.3 trillion-RMB (US\$169 billion) in NPLs injected into them from the four State commercial banks. NPLs in the four AMCs consist largely of corporate loans to SOEs. Among these, it is estimated that around 25% to 30% are real estate loans. Outside of the AMCs, another \$220 billion in NPLs are estimated to be held by other banks. This figure excludes bad loan holdings by large SOEs, insurance companies, and non-bank financial institutions.

Cinda, the first AMC in China, was established in April, 1999, after the State Council's decision to experiment with the disposal of NPLs. Cinda received 373 billion-RMB (book value) as a lump sum financial asset transfer from the China Construction Bank and the State Development Bank. Most of these assets were in the form of loans to key capital construction projects and large-scale state-owned enterprises, with 203.8 billion RMB concentrated in 1,050 enterprises. Cinda's assets were also largely concentrated in basic industries, among which 16.1% (61.2 billion RMB) were in the energy industry, 13.1% (50 billion RMB) in real estate, 6.2% (23.5 billion RMB) in the metallurgical industry, and 5.4% (20.5 billion RMB) in the construction material industry. Loans in the amount of some 144 billion RMB (40.8%) were concentrated in the developed Eastern region.

Technically, Cinda assumed only that portion of NPLs which had been incurred prior to 1996. NPLs incurred after 1996 stayed on the China Construction Bank's balance sheet and were categorized as results of the bank's own mismanagement and not the result of government policies. Loans deemed irrecoverable (i.e. recognized loan losses) were also not transferred to Cinda instead, they were written off by the government.

Following Cinda, three other AMCs were established in 1999. These were the Huarong AMC, the Great Wall AMC, and the China Orient AMC. In terms of their legal status, the four AMCs are wholly state-owned, non-bank financial institutions under the supervision of the Ministry of Finance (MOF) and the PBOC. Each of them had/has registered capital of RMB 10 billion (approximately US\$1.2 billion) and was/is directly funded by the MOF. In 2000, to finance the purchase of the commercial banks' assets that had been transferred to them, each AMC issued ten-year bonds, guaranteed by the MOF, to their respective "partner" in the Big Four. Cinda purchased assets valued at RMB 375 billion; the Great Wall purchased RMB 345 billion in assets; China Orient acquired assets valued at RMB 264 billion; and Huarong bought assets valued at RMB 407 billion.

Under applicable law, the four AMCs are authorized to deal with all three types of assets: debt, equity and real property. By far the largest proportion of the AMC assets are comprised of unconverted debt in the form of NPLs. Most of these NPLs are unsecured. A comparatively small proportion of the debt now held by the AMCs is secured by physical collateral or pledges. The equity of SOEs that the AMCs hold is the result of debt-to-equity swaps.

By July 2002, China's four asset-management companies (AMCs) had disposed of 210.36 billion RMB (US\$25.4 billion) in nonperforming loans (NPLs) and recovered 45.45 billion RMB (US\$5.5 billion) in cash. The recovered cash accounted for 21.6 percent of the face value of the NPLs that were disposed. Within slightly more than two years since the four AMCs were established, Huarong has disposed of 38.85 billion RMB (US\$4.7 billion) in NPLs and recovered 12.426 billion RMB (US\$1.5 billion) in cash (31.98%). China Great Wall has disposed of 76.04 billion RMB (US\$9.2 billion) in NPLs and recovered 6.6 billion RMB (US\$793.4 million) in cash (8.64%). China Orient has disposed of 31.96 billion RMB (US\$3.9 billion) in NPLs and recovered 7.41 billion RMB (US\$895.2 million) cash, accounting (23.19%). China Cinda has disposed of 63.5 billion RMB (US\$7.7 billion) in NPLs and recovered 19.04 billion RMB (US\$2.3 billion) in cash (29.98%).

---

Attracting foreign capital to help resolve China's NPLs and raise the recovery rates has become a principle objective of the government. Following the successful experience of the RTC in auctioning off NPL assets in the United States, China Huarong AMC carried out the first auction to foreign investors in November 2001. The cover story of the February 2002 edition of *EuroMoney Magazine* was the first to offer an in-depth report on the auction process and to discuss the opinions of the various foreign investors and government officials regarding the value of the NPLs being auctioned. As the article points out, the pricing of these non-performing assets is extraordinarily difficult. In fact, there are so many unknowns that a number of the parties involved consider the available assets to be worthless: "We used the normal criteria we use elsewhere but we just couldn't compute a value." There are others, however, who still think the assets are investment-worthy.

Among the divergent opinions, there remains a single consensus that the involvement of foreign investors will help China to speed up the disposal process and improve its rate of recovery as measured by the ratio of sales proceeds to outstanding principal balance (OPB). The estimated recovery rate for the Huarong auction was about 22%, according to an insider foreign financial adviser. This figure is much higher than the average existing recovery rate under the present bankruptcy laws (less than 10%). The target recovery rate for the four AMCs has been set at 30% of the total value of all of the outstanding loans that have been taken from China's four major commercial banks.

### **PART III: FACTORS AFFECTING FOREIGN INVESTOR'S PERCEPTIONS OF UNCERTAINTY ABOUT CHINA'S NPL MARKET**

While the bids by foreign investors in the first auction for NPLs by China Huarong AMC were higher than the other current recovery rates, they were still below the target recovery rate set by the government. The low pricing was largely due to the presence of many loans by SOEs. Uncertainty relating to whether foreign investors will be able to get control of the underlying assets of the SOEs, and the value of those assets if and when they do so, have caused the foreign investors to give little value to the SOE assets.

While China has taken a number of critical steps to deal with its NPL problem, many of the rules and regulations necessary to resolve the NPLs are just now being passed. Although the opportunities are enormous, foreign investors have demonstrated considerable reluctance to plunge into China's NPL market. This reluctance reflects the uncertainty that investors have about their ability to resolve NPLs, convert them to cash, and repatriate the proceeds in a timely manner. The speed with which investors can accomplish the various steps necessary to take control of assets used as collateral for NPLs directly affects their willingness to pay more money for the NPLs—a principal objective of the Chinese government, and a necessary condition for reducing the losses associated with NPLs.<sup>1</sup>

There are three broad areas that affect investors' uncertainty and reluctance to plunge in the Chinese NPL market:

A. Political and social will to get the job done

B. Legal environment

C. Execution

Below we assess fifteen different factors that must be in place if China is to succeed in attracting significant foreign investment in NPLs at prices and recovery rates that they hope to achieve.

#### **A. Political and social will to get the job done**

1. *National level.* There is general agreement that China's leaders have been aggressive in tackling the need to perform major financial restructuring. Under Prime Minister Zhu Rong Ji (1992-present), the government recognized the NPL problem before it became a major crisis.<sup>2</sup> The government has demonstrated its commitment to change by establishing the AMCs and by having the four major state-owned banks sell loans to them. They passed rules that tackled fundamental issues such as letting foreigners own leasehold interests and repatriate their capital. So far, the central government's will to get the job done seems to have been strong.

2. *Local Level.* While China has done the structural work to set up the AMCs, it is unclear whether they have the political and social will to push deals through the system. The problem is that



---

politics are very local, and the national government has less authority than most Americans assume to command local politicians to carry out their policies. While the national government has demonstrated its will to get the job done, it has not been proven yet whether they will be able to force local politicians to go along with the hard decisions that must be made. Will local politicians, for example, allow foreigners to take over and close down local factories, putting a lot of people who supported the local party officials out of work?

3. *New leadership.* The other big political unknown is what the new leadership will do. Will they take the same aggressive stance in support of financial reform as the previous leadership did, or will they bow to pressures as in Japan to go more slowly with financial restructuring?
4. *Social security.* Fear of social upheaval make China's national government ambivalent about giving foreign investors full reign to take action against SOEs that may cause people to lose their jobs. SOEs have provided many aspects of social security, including housing, and education for workers and their families. As SOEs are restructured or closed, the social services that they provided must be replaced by a broader social security system that has yet to be fully developed. The absence of a safety net increases investor concerns that the political will to get the job done will fade quickly if foreclosures by foreigners lead to even hints of social unrest.

## **B. Legal environment**

In order for a market in NPLs to flourish, the legal framework must provide for foreclosure, orderly bankruptcy resolution, established creditor rights, and ownership rights for foreign investors.

5. *Foreclosure laws.* The foreclosure laws in China are similar to those in the United States. They give creditors all the powers they need to foreclose on debtors for non-payment of loans and to go after their assets. Creditors are allowed under the law to (i) institute civil proceedings and enforcement against the debtor and/or guarantor and their assets; (ii) realize the value of collateral through sale at auction or agreement or by transfer of the creditors' rights; (iii) realize creditors' rights through negotiation with debtors and guarantors to restructure the enterprise; (iv) to petition for bankruptcy of the debtor or guarantor; and (v) to go to court to foreclose where no agreement is reached between the creditor and debtors. The court will decide whether the mortgaged property will be auctioned or sold.
6. *Bankruptcy laws.* Bankruptcy laws also operate in a similar manner to those in the United States, both for private enterprises and SOEs. Upon petition for bankruptcy, which may be initiated by the creditor, the debtor is required to submit a plan of reorganization after the creditors and the court have approved the plan of reorganization. The SOE has up to two years to complete the reorganization, which can be terminated by court order sooner if the debtor's financial situation deteriorates or if he fails to implement the settlement plan.
7. *Creditor rights.* Priority of creditors-rights are well-established. Protection of secured creditors and payment of liens is enforced in the order in which the loans were registered.<sup>3</sup> Collateral includes land-use rights, buildings, machinery and equipment, and transportation vehicles. Mortgages of all these forms of property are permissible under PRC Security Law. The four state-owned banks have been actively working their NPL portfolios to resolve as many loans as possible. Foreclosure and bankruptcy laws and processes as well as creditor's rights seem to be functioning in a similar manner to those in the United States, although they have not been tested yet by foreign investors.
8. *Foreign investor rights and ownership.* All private property ownership is in the form of leasehold interests ranging from 50 to 70 years depending on the land use. Foreign investors are able to assume the leasehold rights on property. More complicated are restrictions on foreign ownership in certain industries including financial institutions. A complex set of legal entities and special joint ventures has been established to deal with servicing issues on the Morgan Stanley consortium that purchased the first China Huarong portfolio. They have established the first foreign-owned independent company for holding and servicing the NPLs for their disposition (Yang, 2002). Receiving government approvals for these unique arrangements has taken much more time than originally anticipated.

---

ed, but such approvals are now in place, opening the way for similar arrangements by other purchasers in the future.

### C. Execution

The third area, execution, presents the greatest uncertainty for NPL resolution because there simply has not been enough experience yet in China to see if the process of NPL resolution will go smoothly. Some areas are clearer than others in terms of having rules in place or tested. For space reasons, the list below emphasizes only the highlights.

9. *Court enforcement.* Court enforcement is the ultimate weapon that investors have to force borrowers to pay up or hand over collateral quickly. How local courts will treat foreign investors as they attempt to exercise their creditor rights is untested. Will local courts enforce the laws regarding foreclosure and bankruptcy? The vast majority of borrowers are SOEs or joint ventures with SOEs. Will the courts enforce laws that lead to closure of local factories, especially where the general manager of the factory may be related to the judge? Considerable uncertainty surrounds the interpretation of legal processes and how local courts will behave. Although the central government supports enforcement of the laws, political power is more decentralized than westerners expect. Thus, even though strong national pressure for courts to enforce the laws may be present, no one knows how local courts will respond.

10. *Level of fees to transfer assets.* It is unclear whether unpaid taxes follow a property or stick with the individual who sold it. Do unpaid taxes become an obligation of the new buyer? When one buys property, what should bidders assume about these obligations?

11. *Laid-off employee liability.* Is the new owner subject to a company's liability for employees who have been laid off? In principle, the answer is "yes." When SOEs cease operations, they have obligations to compensate laid-off employees. Whether or not NPL buyers who become the leaseholders of property must assume these obligations is a matter of negotiation between the SOE and the creditor (NPL buyer). If the creditor must assume the obligation, it is unlikely that he/she will want to take over the collateral. In many cases, the price to settle

laid-off employee liability claims is determinable in advance and thus becomes a factor in valuing the NPLs.

12. *Repatriation of capital.* Previously, Chinese law required foreign investors to complete a transaction in order to repatriate capital. NPL investors want to repatriate capital as each loan is resolved in order to boost interim cash flows and IRRs on their invested capital. A November 2002 approval by the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) gives investors the right to repatriate capital (net cash flow after profit tax) as loans are resolved rather than waiting until the entire transaction for a given loan portfolio is completed (Yang, 2002).

13. *Favorable tax rates.* The government has established Business Development Areas (BDAs, similar to enterprise zones) such as Pudong in Shanghai that offer foreign companies favorable tax rates. If the companies are set up in BDAs, they are entitled to the tax benefits given to the BDA. In addition, companies set up by foreign investors in China to dispose of NPLs are subject to taxes under the current tax structure. However, it is not known yet whether they will be exempted from the business tax that financial institutions now pay. The combination could reduce taxes from 33% to 15%, significantly boosting returns to foreign investors

14. *Processing time.* Investors price assets based on the time it takes them to get their hands on assets. Buyers of NPLs have yet to go through the process of seizing and getting control of assets. As mentioned above, the processing time depends heavily on the attitudes of local courts. Some cities like Shanghai have more commercially oriented court systems. What will happen in other areas?

15. *Land-use rights.* The option to convert to another land use provides the NPL servicer a "big stick" to get something out of settlement. (Investors in most cases don't want to get a factory back.) In order for investors to do anything other than the current land use with property they acquire through loan resolution, the property must have a *granted land use right*. Many SOEs have *allocated land use rights* which

must be converted to *granted land use right* by payment of a conversion fee to the local authority of approximately 20-40% of the leasehold value (present value of 50-70 year lease).<sup>4</sup> The processing time and actual fee for making this conversion has not been tested and is likely to differ between jurisdictions. The need to pay high conversion fees will leave little loan recovery value to many collateralized properties where the market value of the property with the granted land use right is not much higher than the conversion fee.

The issues listed above must all be resolved if China is going to realize higher prices on the sale of the NPLs to foreign investors. In addition to these issues, bidders must rely on local partners for information. The collection of reliable and detailed information is difficult, because contact with borrowers and guarantors is prohibited and public sources of information are not readily available.

The legislation that will allow the market in China to develop as rapidly as they desire is just now being passed. The State Council is working on a variety of regulations that will encourage foreign investments in China. While bankruptcy and foreclosure laws to enforce creditor rights have been established, Westerners have yet to experience whether or not local courts will enforce the laws. Critical regulations with respect to repatriation of foreign capital and setting up foreign investment enterprises to work on NPLs through joint ventures with the AMC's had just been passed at the end of 2002.

The explanation for the system's slowness to change lies in the fact that the government is both a debtor (in its capacity as the owner of SOEs) and a creditor (in its capacity as the owner of state banks). Its ambiguous financial position has created a plethora of conflicting economic incentives.

Furthermore, because of the social and political disruption that would result from "overly aggressive" restructuring and the liquidation of moribund SOEs, it is hard to get AMC's to accept significant discounts on the book values of their NPLs, although there are signs this is changing.

At the present time, there is active disagreement in the Chinese government and in the academic community over the speed and methods needed to resolve China's NPLs. Some argue that since the resolution of NPLs is associated with the stability of SOEs and employment rates, the government and its regulators should be wary of opening conduits for private sector investors, either domestic or foreign. On the other hand, this apparent failure to address China's NPLs may well result in a financial crisis that could lead even the "big four" to bankruptcy.

**Table 2**  
**Assessment of Investor Uncertainty**

	level of uncertainty		
	little	some	considerable
<b>Political and social will</b>			
1 National Level	■		
2 Local Level			■
3 New Leadership			■
4 Social Security			■
<b>Legal Environment</b>			
5 Foreclosure Laws	■		
6 Bankruptcy Laws	■		
7 Creditor Rights	■		
8 Foreign Investor Rights		■	
<b>Execution</b>			
9 Court Enforcement			■
10 Fees to Transfer Assets			■
11 Laid-off Employee Liability			■
12 Repatriation of Capital	■		
13 Favorable Tax Rates	■		
14 Processing Time			■
15 Land Use Rights			■

---

## SUMMARY AND CONCLUSION

China is pursuing a course to resolve its NPL problem that follows closely out of the United States' experience with the Resolution Trust Corporation. They have established four AMCs, which have similar powers and responsibilities to the RTC. The AMCs are in the midst of overcoming a number of hurdles to bring in foreign investment to purchase some of the NPL portfolios. The auction by China Huarong AMC has brought these efforts to a head, since many of them must be resolved in order to close the first sale to the Morgan Stanley consortium.

Table 2 summarizes the fifteen factors discussed above that affect investors' perceptions about the Chinese NPL market.

Of the three broad areas above, the legal environment is the most developed. Laws with respect to seizing property, getting control of collateral, and realizing value for creditors through foreclosure and bankruptcy appear to be in place to support a favorable resolution of NPLs. On the surface, the system supports orderly transfer of assets and has been used by the four AMCs to resolve a number of NPLs already. The leadership at the national level has demonstrated a strong commitment politically, but there is still considerable uncertainty about reactions at the local level. In addition, the strong commitment of the new national leadership to address with the hard issues surrounding NPL resolution especially with respect to closing down factories and job losses has yet to be confirmed.

It is in the third area, execution, that investors face the greatest uncertainty. The government has been moving forward to resolve key issues with respect to repatriation of capital and tax rates for foreign buyers. Other issues depend more on what happens at the local level or on property-level negotiations such as laid-off employee liability. While these areas would benefit from strong national direction, only experience in resolving actual loans is likely to reduce investor uncertainty.

It is revealing in that more than half of the above factors are a source of considerable uncertainty for investors. If the experience of the early foreign buyers of NPLs is positive, then many of the uncertainties in Table 2 will be quickly reduced. The long list, however, helps to explain why it has taken over one year to close the first auction sale by China Huarong to the Morgan Stanley consortium. As China Huarong's president, Yang Kaisheng has emphasized, however, the situation has not been static. In fact, over the past year they have been extremely active in addressing the fundamental issues that must be resolved before significant foreign investment will occur.

The success of the RTC in the United States hinged primarily on the speed with which NPL assets were brought to market and securitized. Investors responded creatively to the opportunity, and prices, which were initially low, rose quickly, thereby reducing the losses to the government. The Chinese government has attempted to apply the lessons of the RTC by creating the AMCs to speed the loan resolution process, and by encouraging foreign investors to buy the NPL portfolios. Whether or not prices in China will rise rapidly as they did in the United States depends on whether foreign investors are able to get control of NPL assets quickly and to realize higher recovery values than they currently project from the real estate assets and other collateral of the state-owned enterprises.

## Endnotes

1. It should be noted that any losses associated with the NPLs were deferred when the government issued 10-year bonds to enable the AMCs to buy the assets from the Big Four state-owned banks. The losses will be recognized only when the bonds are retired and there is insufficient capital from the NPL resolution to pay off the bonds. Presumably the difference will be made up by the government.
2. William Overholt, speaking at a forum on Asian Financial Restructuring (Harvard Kennedy School of Government, December 13-15, 2002), stated that among Asian countries, only China acted before the crisis hit. "The system had a strong leader who could rally the nation and get acceptance of difficult measures."
3. In cases where loans are not registered, then lien priorities are determined by the order in which loan documents were signed and dated.
4. This conversion fee is in essence the state's payment for selling the leasehold right to develop or use property to the tenant.

---

## Acknowledgements

We would like to acknowledge the significant participation in developing this paper by George von Liphart, Managing Director of Lehman Brothers, Tokyo, Japan in the Global Commercial Real Estate Group. Jack Rodman, Managing Director, and Chris Seyfarth, Partner, of Ernst & Young, and Dr. Yang Kaisheng, President of China Huarong Asset Management Corporation, also provided critical input and advice on many aspects of the transactions described herein.

## BIBLIOGRAPHY

- Business Week*, "China: Caught in Quicksand?" November 25, 2002, p. 18.
- China Daily*, "Reform of SOEs to be Accelerated" (May 10, 2001)
- Dow Jones International News*, "China Watch: Creating Wealth Through Bankruptcy," March 25, 2001.
- Dornbusch, Rudi and Francesco Giavazzi (1999): "Heading off China's financial crisis," in BIS Policy Papers, no. 7, *Strengthening the banking system in China: issues and experience*, October, Basel, pp. 40-58.
- Ernst & Young, *Nonperforming Loan Report: Asia 2002*.
- Euromoney Magazine*, "China puts on a garage sale," February, 2002
- FDIC, *History of the Eighties—Lessons for the Future*, (Vol. 1-2) Washington DC, 1997.
- FDIC, *Managing the Crisis: the FDIC and RTC experience, 1980-1994*, (Vol. 1-2) Washington DC, 1998.
- Financial Times*, "China Set to Sell Bad Loans to Foreigners," May 9, 2001.
- Glassman, Mitchell, (1998) "Lessons learned on NPL Resolutions in the United States," a speech delivered at an FDIC conference.
- Ma, Guonan and Ben S C Fung (2002): "China's asset management corporations," in BIS Policy Papers, no 115, August, 2002
- Olson, Gerry, *Banks in Distress—Non-Performing Loans: Recognition and Response by Debtors and Creditors*, University of London, 2000.
- Yang, Kaisheng, "The CJV Designated for Huarong International NPL Disposition is Approved," announcement issued by China Huarong AMC, Beijing, December 2, 2002.
- Watanabe, Mariko, *China's Non-Performing Loan Problem*, Institute of Developing Economics, Japan, March 2000.