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WTO: Time’s Up for Chinese Banks—China’s Banking Reform and Non-Performing Loan Disposal
Weitseng Chen

This year’s hottest topic in global capital markets will probably be the overseas listings of China’s “big four” state-owned commercial banks. International investment banks and a considerable number of prestigious international law firms are currently joining forces to shape another golden image of China’s economic ascent. Equally striking is the less dazzling side to this tale—that the overseas listings will keep China’s banks from collapsing after December 11, 2006, when China, in order to abide by its pledges in the World Trade Organization ("WTO") accession agreement, will have to open its banking market to foreign competition.

China’s state banking system has been struggling with a staggering amount of bad loans, which are estimated at around 40 percent of total outstanding loans. In theory, if foreign banks will be conducting local currency business in China, the massive deposit base that has been supporting China’s de facto bankrupt banking system will shift elsewhere. In order to prepare its banks for

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2 Martin Wolf, Opening a Three-Part Series, Martin Wolf Looks at Why Beijing has Enjoyed the Greater Success in Stimulating Growth—and What New Delhi Will Have to Do to Catch Up, Fin Times 21 (Feb 23, 2005).
this tough challenge, China has been pushing these banks to seek overseas listings.\textsuperscript{4}

This Article will briefly examine several issues underlying the hottest financial news in this year's global market. In particular, the Article will ask how such large non-performing loans ("NPLs") have come to exist in the Chinese banking system, how the Chinese economy has managed to grow despite its many flawed and vulnerable banks, and how the Chinese have resolved the NPL problem. Finally, the Article will discuss how effectively the NPL disposal scheme has worked thus far, in the period before the upcoming overseas listings.

I. INTRODUCTION

Why was China able to survive the Asian financial crisis that began in 1997? A high-ranking Chinese official has given a concise but clear answer: how could we lose this game if we did not even attend it?\textsuperscript{5} However, the Chinese government was shocked by the pervasive banking failures that occurred in neighboring countries, including Thailand, South Korea, Indonesia, and Malaysia. The reason for China's concern was understandable: the Chinese banking system's ratio of bad loans to total outstanding loans was even higher than that of the aforementioned Asian countries prior to the 1997 financial crisis.\textsuperscript{6} Surprisingly, estimates revealed in 2005 indicate that this is probably still the case.\textsuperscript{7}

Pinpointing the actual amount of China's NPLs is a task that has stymied many top economists and investment analysts. According to the Chinese government, the official number was approximately $240 billion in the middle of 2003,\textsuperscript{8} a total representing less than half of the number estimated by international organizations and economists. The real figure, as estimated by

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\textsuperscript{5} Gong Yi and Kai Guo, \textit{The Rationale of China's Banking Reform}, in Xinqiao Ping, Min Song, and Junxi Zhang, eds, \textit{Corporate Governance, Security Market, and Banking Reform} 268–69 (Peking 2003).

\textsuperscript{6} The pre-crisis proportions of NPLs in these countries were: Thailand, 15 percent; South Korea, 16 percent; Indonesia, 12 percent; and Malaysia, 6.4 percent. Indeed, China's proportion of NPLs is similar to or exceeds that of these countries in the post-crisis period (for instance, Thailand, 27 percent; Indonesia, 33 percent; and South Korea, 25 percent). Justin Yi-fu Lin and Tzu-bing Lee, \textit{State-Owned Enterprises and Financial Institutions Reform in China} 23–42 (Peking 2003), available online at <http://jlin.ccer.edu.cn/article/article.asp?id=246> (visited Apr 22, 2006); Yiping Huang, \textit{China's Last Steps Across the River} 112–13 (Asia Pacific 2001).

\textsuperscript{7} Martin Wolf, \textit{Why is China Growing So Slowly?: For All its Success, China is Still Not Living Up to Its Potential}, 146 Foreign Poly 50, 50–51 (2005).

\textsuperscript{8} Roubini and Setser, \textit{China Trip Report} at 11 (cited in note 3).
recent studies, ranges widely from $410 to $815 billion due to the lack of complete, reliable official statistics. Studies also show that NPLs have been increasing at the rate of $150 billion per year since 2000.

Furthermore, the high concentration of financial assets in China’s economy fosters a lack of diversification and competition, thereby increasing financial risks. Without a modern capital market, most Chinese households save their money in banks. The savings rate in China is around 40 percent, the world’s highest. Eighty-five percent of total household financial assets were in the form of bank deposits in the 1990s, accounting for at least 70 percent of total domestic savings as of 1997.

If the huge amount of NPLs eventually causes a financial meltdown, it will also undoubtedly trigger a political crisis in China. China’s state banking system has amassed 70 percent of total household savings and provided around a million job opportunities. Meanwhile, the weak financial market has resulted in bank loans accounting for more than 80 percent of total corporate financing, with state-owned enterprises ("SOEs") supplying nearly 80 percent of these loans. SOEs essentially borrow money from people through state banks to maintain their inefficient businesses while thrifty Chinese people live by working

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9 The quoted amount of bad loans includes both bad loans removed from the banks' balance sheets to the Asset Management Companies ("AMCs") and bad loans that remain in the Chinese banking system. Due to the Chinese bureaucracy's lack of transparency, the amounts estimated by different researchers are not identical. However, even the most conservative estimate is much higher than the official number. See, for example, Roubini and Setser, China Trip Report at 10-11 (cited in note 3); Wolf, 146 Foreign Pol'y at 51 (cited in note 7); Pieter Bottelier, Implications of WTO Membership for China's State-Owned Banks and the Management of Public Finances: Issues and Strategies, 11 J Contemp China 397, 401–02 (2002); Yiping Huang, Is Meltdown of the Chinese Banks Inevitable? 13 China Econ Rev 382, 382–83 (2002); Guonan Ma and Ben S.C. Fung, China's Asset Management Corporations, 115 BIS Working Paper 1–2 (Bank for Int'l Settlements 2002), available online at <http://www.bis.org/publ/work115.htm> (visited Apr 22, 2006); Nicholas R. Lardy, China's Unfinished Economic Revolution 115–24 (Brookings 1998).


11 Huang, China's Last Steps at 100–01 (cited in note 6).

12 A Taiwanese entrepreneur has relayed an astonishing story about the fragility of the Chinese banking system. His business was based in a city with an energetic new mayor who swore to shut down the prostitution industry. However, the mayor's policy was terminated merely one week after taking effect because the city's banks did not have enough cash for those prostitutes who wanted to move out and withdraw their deposits. The anti-prostitute policy unexpectedly triggered a run on banks and a liquidity crisis. Interview with J.R. Chen, CEO of a technology company, in Taipei, Taiwan (May 30, 2003).


14 Huang, China's Last Steps at 101–02 (cited in note 6).
for SOEs. During the past two decades, this model, by which the government could efficiently collect capital from ordinary people for injection into various strategic industries, has contributed to China’s continuing economic growth. It is also one of the means through which the Chinese Communist Party has secured its legitimacy. The model will invariably be destroyed if its key mechanism, the state banking system, collapses.

II. CHINA’S ECONOMIC TRANSITION AND THE CAUSES OF BAD LOANS

The causes of China’s NPLs can be clarified only in the context of China’s economic development strategy. Prior to the start of banking reform in the 1990s, China’s banks maintained close connections with state-owned enterprises, including both large SOEs and their smaller local counterparts, town and village enterprises ("TVEs").15 Because SOEs play a crucial role in linking Chinese banks to the market and generating employment opportunities, state banks are cash cows for SOEs. Indeed, SOEs and TVEs received almost all of the credits allocated by state banks in the period preceding the banking reform movement, and they continue to dominate in this respect, despite producing only one-third of the country’s industrial output. Studies examining the period from 1993 to 2000 show that more than 60 percent of bank loans were earmarked for SOEs.16 In short, the banks are one integral part of the governmental mechanism for allocating community capital, which is merely viewed as a component of the government’s budget.17

As a consequence, SOEs and TVEs, the Chinese banks’ two major clients, are responsible for a considerable amount of NPLs held by the banks.18 During the first fifty years after the establishment of the People’s Republic of China, SOEs and TVEs played distinct, strategic roles in the nation’s development. SOEs were responsible for developing technology and products that allowed China to become independent of the international market during the Cold War.

15 For a general discussion, see Jean C. Oi and Andrew Walder, eds, Property Rights and Economic Reform in China (Stanford 1999); Jean C. Oi, Rural China Takes Off: Institutional Foundations of Economic Reform (Berkeley 1999).

16 Huang, China’s Last Steps at 100–18 (cited in note 6).


era while the less controlled TVEs experimented with capitalism at the local level.

The quantity of NPLs increased markedly when SOEs failed to carry out strategic missions that far exceeded their capacity. By implementing these costly policies, the SOEs would have collapsed without the banks’ fiscal support. To maintain such financially precarious SOEs, the Chinese government was forced to allocate credits in state banks to the SOEs, attaching loose conditions to the extension of credit. According to a survey conducted in 1999, loans to SOEs have accounted for about 75 percent of all bank loans.19 To buttress the SOEs, the government has implemented a so-called “unified system of deposits and loans” that collects and centralizes all private sector credits and savings by restricting the incorporation of new banks.20 These constraints have led to an uncompetitive and inefficient financial market that hides NPLs.

Local TVEs, which have fewer policy burdens than SOEs, have received correspondingly less credits from the government. Because of their limited formal access to state banks, TVEs have either approached banks informally or established their own underground banking networks.21 Insufficient monitoring mechanisms and flawed accounting systems in state banks have enabled local officials and party cadres, who also have positions in TVEs, to readily access credit by informal means, such as guanxi (connections) and bribery.22

Furthermore, the Chinese Communist Party has adopted a performance-oriented evaluation system that promotes local cadres on the sole basis of their economic achievement for state-owned enterprises and local governments. This evaluation mechanism, which ties performance to the amount of capital accumulated, provides further incentives for local officials and cadres to bribe bank staff members to access credits. Such behavior jeopardizes the banking system and results in increased NPLs.

20 Huang, China’s Last Steps at 48 (cited in note 6).
21 See, for example, Peter S. Goodman, Financial Enterprise in China at Odds with Party Politics, Wash Post A01 (Jan 2, 2004). For a general discussion, see Kellee S. Tsai, Back-Alley Banking: Private Entrepreneurs in China (Cornell 2002).
The dynamics of China's banking reform can be divided into three phases. Interestingly, while China initiated economic reform in 1979, it did not launch the banking reform movement until the mid-1990s. Indeed, for at least a decade, China's successful economic reform was not based on an efficient banking system.

A. WHY A LATE BANKING REFORM?

Three hypotheses help to explain why Chinese banking reform began more than a decade after the country's economic reform. First, China did not have a banking system that needed reformation because the Chinese government viewed its banks as branches of the Ministry of Finance rather than as a contemporary banking system. While Chinese banks operate as mechanisms used by authorities to manipulate the private sector and to allocate credits to SOEs, they also resemble tax agencies in that they take savings from thrifty people, which thereafter sustain the state apparatus, at a minimal cost to themselves. These people, who rarely withdraw their money, believe that saving is a traditional moral virtue and doubt that Chinese banks will suffer a meltdown. Without liquidity pressure, Chinese banks are not run like typical banks.

Second, China did not demand a modern banking system whose characteristic autonomy may have reduced the flexibility needed by authorities to conduct other economic reforms. For instance, since 1979, the Chinese banking system has been both a tool to support economic growth and an instrument to facilitate other reforms, such as those of SOEs. Asset Management Companies ("AMCs"), which are major institutions that were established in 2000 to dispose of China's NPLs, have similar multiple functions.

Third, China did not have the capacity, political or economic, to reform its banking system amidst a highly decentralized transition process. Its central bank serves as a notable example of this hypothesis. In September 1983, the State Council of the People's Republic of China ("State Council") decided in principle to have People's Bank of China ("People's Bank") function as the central bank. However, the State Council waited until 1986 to promulgate the "People's Republic of China Provisional Regulations Related to Bank Management" that

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gave People's Bank the legal basis to operate as China's de facto central bank. However, the central government failed to enforce this ordinance, which required placing the state banks' local branches under the supervision of People's Bank. Powerful local governments vetoed the personnel policy of People's Bank's local branches, fearing that this policy might endanger the substantial funds that the local governments had set aside for various regional businesses, including some illegitimate ones. It was not until 1993 that People's Bank was able to enforce its financial supervision authority.

Since 1979, China's decentralization policy has been regarded as a major incentive for local governments to achieve economic growth. This policy, a quick fix to China's pressing problems after the Cultural Revolution (1966–1976), aims to relieve the central government's financial burdens by delegating the decision-making power over economic policies to local governments in return for tax revenues. However, local governments that have captured institutions to achieve their short term economic goals have fewer incentives to promote institutional reforms.

B. BEFORE 1993: BANKING REFORM AS PART OF STATE-OWNED ENTERPRISE REFORM

Banking reform measures, including the push to dispose of NPLs, were triggered by two major financial crises in the 1990s. The first was the domestic inflation crisis from 1993 to 1994 and the second was the Asian financial crisis in 1997.


26 Jinglian Wu, Economic Reform in Contemporary China 212–13 (Shanghai Far East 2004); Lardy, China's Unfinished Economic Revolution at 173 (cited in note 9).


Prior to the 1993 inflation crisis, China's banking reform played only a supplemental role in SOE reform. For instance, the Chinese government stopped subsidizing SOEs through the banking system in 1986 and began to require that they borrow money from banks. Nevertheless, these measures were intended to enhance the SOEs' incentive to use capital more efficiently by raising capital costs; they did not endeavor to relieve the banks' policy burdens. Because banks were still essentially governmental agencies supporting the SOEs, they were not allowed to reject loan applications. In addition, they lacked the bargaining power to require enterprises to repay loans. SOEs dominated the planned economy, and officials and party cadres retained a deep involvement in the SOE loaning process.

In this regard, the court system has played an insignificant role in loan disputes between banks and SOEs. Studies show that Chinese courts have only administrative and record-production functions in cases involving competing loan claims between banks and SOEs. They follow orders from the SOEs and banks, which both intend to manipulate their balance sheets and internal accounts by collecting judicial documents. For example, banks may write off bad loans and stop providing loss reserves if they obtain a court order announcing the financial inabilities of defaulting SOE borrowers. Meanwhile, SOE borrowers will exist and operate without repaying their loans. This state of affairs has persisted in recent years even as AMCs have become very active in bringing lawsuits against defaulting borrowers.

C. AFTER THE 1993 INFLATION CRISIS: BAD LOAN DISPOSAL INITIATIVES

1. The 1993 Inflation Crisis and Banking Reform

China's 1993–1994 inflation crisis resulted from an expansionary monetary policy that sought to achieve rapid growth by bidding down interest rates to

34 Id at 75–86.
35 Id at 58–62.
stimulate spending and, in turn, raise output and inflation.\footnote{Wu, \textit{Economic Reform} at 212–13 (cited in note 26).} When Chinese banks were required to maintain low interest rates, they became unprofitable since the real interest rate at the time was actually negative and loans were rarely fully repaid.\footnote{See Lardy, \textit{China’s Unfinished Economic Revolution} at 126–27 (cited in note 9).} High inflation, further lowering the real interest rate, worsened the banks’ financial status.

This crisis underscored the fragility of China’s financial system, which lacked mechanisms to monitor and stabilize the increasing inflation rate.\footnote{Charles Wolf, Jr., et al., eds, \textit{Fault Lines in China’s Economic Terrain} 121–23 (RAND 2003).} Since then, the Chinese government has been determined to transform the state banks from mere cashiers for the state sector into a modern banking system. The movement to rectify the NPL problem has also gained serious momentum.

2. Legal Initiatives for Banking Reform

Chinese banking authorities initially focused on restructuring the banking system since this was the easiest, most familiar method for China to conduct reform. The method did not require making more difficult decisions involving fundamental policy or personnel changes.


The Commercial Bank Law was a significant milestone demonstrating that the Chinese government sought to resolve the NPL crisis through institutional reforms. Since the banks’ inefficient investments had been a fundamental cause of NPLs, the government adopted the US banking model established by the
Glass-Steagall Act,\textsuperscript{42} which restricted commercial banks' involvement in investment business.\textsuperscript{43} The Chinese government also centralized power over credit allocation by prohibiting local branches of state banks from loaning money without obtaining consent from headquarters.\textsuperscript{44}

However, the NPL crisis continued and in fact escalated after SOEs demanded more loans to survive in China's increasingly open and competitive market. In China, whenever a major state firm has been threatened with financial collapse, central authorities have traditionally provided bailout subsidies in the form of “policy loans” from commercial banks. As long as SOEs remain inefficient and unprofitable, state banks are required to sustain them. Meanwhile, existing regulations and governance reforms are ignored and bypassed.

Because the banks have no chance of becoming profitable, banking officials experience distorted incentives. Even though the Commercial Bank Law authorizes them to make their own lending decisions,\textsuperscript{45} bank officials are never actually held accountable for bad loans, which mainly result from policy loans. After making the policy loans directed from above, bank officials have nothing to lose by simply loaning the remainder of their available capital to the highest bidder in rent-seeking games, regardless of the bidder's creditworthiness.\textsuperscript{46}

Pervasive corruption thus reigns and bank officials can easily cover illegal payoffs under the guise of bad loans. The uncompetitive nature of the banking market has further decreased the incentive for banks to conquer inefficiency and capital misallocation. While private enterprises and TVEs are becoming more prominent and eagerly seeking capital, they have either approached illegal banks or obtained loans through bribes and guanxi.\textsuperscript{47} Rent-seeking behaviors have been penetrating the weak risk evaluation and supervision mechanisms and the NPL problem has, in turn, become more pressing.


\textsuperscript{43} Wu, \textit{Economic Reform} at 220–21 (cited in note 26).

\textsuperscript{44} Id at 215. See also Lin and Lee, \textit{State-Owned Enterprises} at 28 (cited in note 6); Lin, \textit{China's Financial System Reform} at 9 (cited in note 27).


\textsuperscript{46} See Steinfeld, \textit{Forging Reform} at 68–73 (cited in note 31).

The booming Chinese real estate market since the early 1990s is another major factor that has counterbalanced the effect of NPL reform. In 1990, the Chinese government liberalized state-owned land and allowed individuals renting the land to develop it. Countless speculative land developers—local officials, party cadres, and their relatives—rushed to borrow money from state banks for leveraging their investment in this capital-oriented land market, leading to a flood of NPLs.

While loans to SOEs account for 75 percent of all bank loans, the average proportion of NPLs in SOEs increased from 25 percent in 1991 to 31 percent in 1995. In fact, most of the bad loans existed in the four major state-owned commercial banks, which had recently been restructured under the framework of the 1995 Commercial Bank Law.

Although its piecemeal banking reforms failed to alleviate the bad loan crisis, the Chinese government refused to take further steps to restructure either the state banking system or the monopolized banking market. By contrast, the experiences of Eastern European countries, such as Poland and Hungary, suggest that competition from foreign banks provides the most effective stimulus for the transformation of domestic banking systems in transitional economies.

Why did China remain reluctant to open its market to foreign banks? It is not hard to understand the rationale behind the Chinese government’s hesitance. First, if banking reform occurs before successful SOE reform, it must be gradual and conservative. Otherwise it might endanger SOEs and trigger financial and political crises. Second, unless banking reform succeeds, it is in China’s interest that the banking market remains a monopoly. Otherwise, foreign banks will dominate the Chinese capital market, grasp a significant share of domestic

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48 Chinese bank senior staff members use the term “golden age” to describe the widespread corruption of officials and land developers in the early 1990s. Interview with anonymous Chinese AMC employee (May 2, 2005) (hereinafter AMC Employee Interview). See also Lardy, China’s Unfinished Economic Revolution at 172–76 (cited in note 9); Lin, China’s Financial System Reform at 9–10 (cited in note 27).

49 Provisional Regulations of the People’s Republic of China regarding the Grant and Assignment of State-owned Land-use Rights in Urban Area (1990), arts 8, 19, 48. This ordinance is available in English in Isabelle I.H. Wan, et al, A Professional’s Guide to PRC Land Legislation 2097–2107 (Sweet & Maxwell Asia 1999).

50 See, for example, Shu Song Ba, Good Money vs. Bad Money 100–01 (Tsinghua 2004); Qing-Lian He, China’s Descent into a Quagmire 43–44 (Broad 2003); Lin, China’s Financial System Reform at 21 (cited in note 27).

51 Huang, China’s Last Steps at 113–15 (cited in note 6).

52 Lin, China’s Financial System Reform at 11 (cited in note 27).

53 Lardy, China’s Unfinished Economic Revolution at 125–26 (cited in note 9).
savings, and then fail to support inefficient SOEs after applying international loan standards.\footnote{In April 2005, Chinese banking authorities announced that they are considering restricting the expansion of foreign banks in spite of China’s commitment to the WTO that it should fully open its market to foreign banks. One can readily trace the reasoning behind this potential restriction by evaluating China’s SOE reform strategy, though how such restrictions can be reconciled with the terms of China’s membership in the WTO is unclear. Richard McGregor, *Beijing May Look to Protect Local Banks from Competition*, Fin Times 13 (Apr 28, 2005).}

D. AFTER THE 1997 ASIAN FINANCIAL CRISIS: AMCs AND BANK RECAPITALIZATION

1. A Mixed Approach to NPL Disposal

The 1997 Asian financial crisis has prompted the Chinese government to finally take decisive measures to cope with NPLs. The fundamental challenge is how to soften the bad loan problems generated by SOEs before taking major strides toward SOE reform. SOE reforms are unlikely to succeed in the short term since the nature of SOE reform resembles that of a complicated social welfare reform program. While SOEs maintain urban employment, they also provide social services, including social insurance, welfare, pensions, medical care, housing, and education.\footnote{Daochi Tong, *The Heart of Economic Reform: China’s Banking Reform and State Enterprise Restructuring* 100–07 (RAND 1999).} Thus, it is implausible that state banks can obtain swift relief from the policy burdens of supporting SOEs that have been generating NPLs.

Ultimately, banking authorities must make state banks learn how to run as commercial banks—namely by establishing the necessary conditions for this initial reform. To do this, authorities must strengthen the financial capacity of state banks, both as an incentive for banks to implement effective risk-management measures and for the benefit of international investors, who can then participate in the banks’ potential schemes for overseas listings. The most efficient way to attain these goals is to write off bad loans by recapitalizing state banks.

However, one confronts a paradox when considering the extent to which state banks should be recapitalized. If the government injects too much capital into the banks, it will reduce the incentive for banks to undertake further bad loan disposal. If the amount is too small, the government will create the expectation that additional recapitalization funds will be available perpetually.
The pitfall of governmental recapitalization itself will foster the expectation that, having bailed out the troubled banks once, the government will do so again.\textsuperscript{56}

The Chinese government finally selected a strategy representing a hybrid of financial recapitalization and institutional reform. The central government began by committing substantial funds to finance bad loan write-offs for state banks and SOEs.\textsuperscript{57} With respect to institutional reform, the government undertook two initiatives. First, banking authorities conferred more autonomy upon commercial banks. For instance, controls over credit quotas were abolished. The central bank, People's Bank of China, also established its headquarters, replacing the local branches in order to reduce interference from local officials.\textsuperscript{58} Second, in 2000, banking authorities started to employ a progressive institutional initiative—asset management companies—as a foundational method to curb NPLs.

2. Asset Management Companies

AMCs are modeled after the US Resolution Trust Company ("RTC").\textsuperscript{59} They are firms that invest pooled funds from retail investors in securities or equities, and their returns mainly derive from NPL disposal, such as through sales of discounted bad assets purchased from Chinese bank creditors. One way AMCs can package these assets is by securitizing mortgaged real estate, which will then be sold in a secondary market at a higher price. However, Chinese AMCs have a unique feature—the retail investors are the banks themselves. This in turn means that AMCs are not subject to market forces, and the parent banks set the amount and price of NPLs purchased by AMCs.

Four AMCs have been established by the four pillar state-owned commercial banks, and these AMCs, which deal with the four parent banks' pre-1996 NPLs, are designed to operate for ten years.\textsuperscript{60} Parent banks can select and


\textsuperscript{57} In 1998, the government raised $32.5 billion through the issuance of treasury bonds. These bonds sought to increase the capital-adequacy ratio of the four major state banks to 8 percent. At the same time, the government financed SOEs to decrease their debts. Subsidies to SOEs increased from $2.4 billion in 1996 to $3.6 billion in 1997 to $4.8 billion in 1998. This amount rose further in 1999 and 2000. Huang, \textit{China's Last Steps} at 130–31 (cited in note 6); Lin and Lee, \textit{State-Owned Enterprises} at 23–42 (cited in note 6).

\textsuperscript{58} Huang, \textit{China's Last Steps} at 129 (cited in note 6).

\textsuperscript{59} Zhao-Sheng Zhou, \textit{Experience and Reference from RTC For China AMCs to Dispose NPLs under The Goal and Responsibility Assessment System for NPLs Disposal}, \textit{25 J Theory & Prac of Fin & Econ} 25, 28–29 (2004); Huang, \textit{China's Last Steps} at 134 (cited in note 6).

\textsuperscript{60} The four AMCs are Cinda, Huarong, Orient, and Great Wall. Each AMC received $1.2 billion in the form of registration capital. Ma and Fung, \textit{China's Asset Management Corporations} at 1 (cited in
then transfer NPLs predating 1996 to their respective AMCs. Banks are supposed to dispose of NPLs dating from 1996 onward by themselves since the government has restructured the banking system and financed banks to write off their NPLs as of 1996.

AMCs have been viewed not only as the main strategy for the disposal of bad loans, but also as a solution that takes into account the close ties between state banks and SOEs. The remainder of this Article will explore the rationale behind the AMC strategy, the effectiveness of AMCs, and recent challenges to the use of AMCs.

IV. AMCs: TURNING RISK INTO OPPORTUNITY?

A. INTERNAL OR EXTERNAL DISPOSAL?

The first question that Chinese banking authorities need to consider is whether NPLs should be disposed of within or outside the banks. While disposal within the banks represents the regular institutional arrangement, the outside model represented by AMCs entails that the banks sell NPLs to an external entity (here, an AMC) at a discounted rate in order to redeem cash to write them off. AMCs that buy discounted NPLs subsequently package and sell them to make returns.

Banks should generally be in a better position to resolve NPLs as compared to centralized AMCs. AMCs may have to cope with information asymmetry while banks have loan files and long-term relationships with their borrowers. Leaving the problematic assets on banks' balance sheets has additional advantages—encouraging banks to review and improve their flawed loan procedures by providing incentives to both maximize the recovery value of bad debts and avoid future losses.62

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61 In 1998, China's banking authority adopted the international standard loan classification, which consists of five categories: normal, special mention, substandard, doubtful, and loss (unrecoverable). Loans selected to be transferred to AMCs must be classified in the “doubtful” category and must satisfy various technical requirements, such as adequate documentation. Huang, China’s Last Steps at 130 (cited in note 6).

B. STRATEGY CHOSEN: THE AMC MODEL

In spite of the above-mentioned disadvantages, Chinese banking authorities have chosen to dispose of NPLs through AMCs outside of the four commercial banks. A legal reason underpinning their decision is the Commercial Bank Law provision barring commercial banks from engaging in investment banking activities.\(^6^3\) If authorities had entrusted banks, and not AMCs, with the responsibility to carry out the debt-for-equity plan, the Commercial Bank Law would have proscribed the arrangement.\(^6^4\) By swapping the debts of a troubled SOE for equities, an AMC can become a new shareholder with representation on the SOE’s board of directors, which helps structure a viable SOE. Meanwhile, the bad debts of that SOE can be written off.

This legal issue seems relatively minor because the NPL disposal scheme in China, where the legal system lacks autonomy, is not decided by statutes but by economic policies. The following reason thus appears more convincing: by selling debts to AMCs in exchange for AMCs’ outstanding shares, banks can write off their bad loans immediately. This approach exchanges banks’ bad assets (NPLs) for good assets (AMC bonds) and hence attracts foreign investors willing to help recapitalize the banking system by investing in the pillar banks.

It is important to underscore another major reason behind the establishment of AMCs: assistance in the restructuring of SOEs. After becoming the SOEs’ biggest creditors, AMCs have started to convert their credit to outstanding shares in these troubled companies. By doing so, AMCs have taken control of the board of directors and have been able to engage in corporate reforms.

C. WORRISOME OUTCOMES OF AMC OPERATION BY 2005

From 1999 to 2000, the four major banks initially transferred approximately $168.2 billion to Chinese AMCs.\(^6^5\) This considerable quantity indicated that the Chinese government, by financing AMCs to purchase NPLs at book value,\(^6^6\) was taking responsibility for bank losses from policy lending that predated 1996. Given the potential moral hazard resulting from the banks’ expectation that the government will bail them out again, the State Council, the

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\(^{6^3}\) Shuxian Wu, *The Opportunity to Establish Modern Corporate Institutions: Effective Operation of AMC*, 10 China Econ 17, 17 (2000).


\(^{6^5}\) Roubini and Setser, *China Trip Report* at 10–11 (cited in note 3).

highest Chinese banking authority, has stated that there will be no policy-driven NPL transfers from the big four banks to AMCs in the future; AMCs will have to survive in the market by themselves.

Therefore, AMCs’ future viability will depend on maintaining a balance between high leverage and capital costs. They must make returns that can cover operation costs. While AMCs will generate revenues through the recovery of NPLs by workout or sales on secondary markets, they may also make returns by selling SOE equities that they hold through debt-for-equity swaps. On the cost side, AMCs must pay to purchase NPLs and fulfill interest obligations resulting from People’s Bank and parent banks’ financing. AMCs’ capital costs primarily arise from their interest obligations, which are linked to the amount of financing AMCs have been given to buy and swap NPLs. With the high leverage that Chinese AMCs are using, their combined annual interest obligations are estimated to exceed $3.63 billion.

Hence, the AMCs’ basic goal is to come up with a like amount of cash recovery, and the success of this objective depends on the speed of NPL disposal and the cash recovery rate. Unfortunately, as discussed below, both the speed of NPL disposition and the cash recovery rate have lagged. In response, the president of China’s central bank surprisingly broke his no-bailout pledge, announcing in late 2003 that the banking authority had decided to restart the policy of subsidizing state banks to curb bad loans.

V. FUTURE CHALLENGES FOR CHINESE AMCs

A. THE LACK OF INSTITUTIONAL TOOLS

China’s AMCs lack one major tool—asset securitization—commonly adopted by other AMCs. International experience demonstrates that a necessary condition for successful AMC operation is a type of asset that is easy to restructure and liquidate by securitization, such as real estate loans or secured loans. Two highly successful examples of AMCs are found in Sweden and the US. Real estate assets account for 80 percent of the transferred bad assets in Sweden’s AMC and 49 percent of the transferred bad assets in the US RTC.

However, most of China’s NPLs are not secured loans, but consumptive loans resulting from policy loans for SOEs and banking corruption. Real estate

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67 Ma and Fung, *China’s Asset Management Corporations* at 2–3 (cited in note 9). See also Bartel and Huang, *Dealing with the Bad Loans* at 16 (cited in note 19).

68 Ma and Fung, *China’s Asset Management Corporations* at 11 (cited in note 9).


70 Klingebiel, *The Use of Asset Management Companies* at 21–22 (cited in note 62).
accounts for only 7 percent of transferred NPLs in Chinese AMCs while consumptive manufacturing NPLs represent 46 percent of transferred NPLs.\textsuperscript{71} Thus, Chinese AMCs have struggled to follow in the tread of earlier, successful AMCs.

China’s lack of legal institutions, such as property laws, also hinders its securitization efforts. For instance, owners of mortgaged real estate in cities only possess usage rights in their land, not full ownership, which vests in the state under the General Principles of the Civil Law of the People’s Republic of China (1987)\textsuperscript{72} and the Law of the People’s Republic of China on Land Administration (1986).\textsuperscript{73} The complicity behind such property rights allocation adds to the challenge of securitization.

B. BUREAUCRACY AS AN OBSTACLE

As semi-official departments of their parent banks, AMCs fail to cut through red tape and cannot operate as efficiently as private financial institutions should. Foreign investors, such as Goldman Sachs, Morgan Stanley, and Citigroup, which have made enormous returns in Asian NPL disposal markets, have expressed impatience with the Chinese bureaucracy.\textsuperscript{74} For instance, by 2004, five years after the initial surge of excitement from foreign investment banks, only one deal with foreign buyers was closed.\textsuperscript{75} In September 2004, Lone Star Funds, a US private equity group, closed its office in Beijing and reduced its activity in China because of a shortage of deals.\textsuperscript{76}

On October 29, 2004, China’s National Development and Reform Commission (“NDRC”) promulgated new rules for approvals and pledged to issue approvals for purchases by foreign investors within twenty days of application.\textsuperscript{77} However, given that the NPL disposal process has been delayed

\footnotesize{71} Ma and Fung, China’s Asset Management Corporations at 12 (cited in note 9).
74 Foreign bankers have been wondering whether China’s real aim in opening this market is to tap expertise from abroad to modernize its financial system or to offload the cost of propping it up. Guy De Jonquieres, China’s Banking System Needs a Cultural Revolution, Fin Times 19 (Apr 5, 2005).
75 NPLs with a face value of $2.67 billion were sold by Huarong AMC in an auction won by two consortia led by Morgan Stanley and Goldman Sachs. Huarong AMC achieved a return of only 8 percent of the face value of those NPLs. Francesco Guerrera and David Wells, Asia’s Bad Debts Have Been Wall Street’s Good Fortune, Now Deals are Dying Up, Fin Times 13 (Sept 30, 2004).
77 Francesco Guerrera and Mure Dickie, Citigroup Close to NPLs Deal, Fin Times 29 (Nov 9, 2004).}
for the multiple reasons discussed in this section, the NDRC’s new rule, which focuses on removing bureaucratic shackles, can only have a limited effect in accelerating NPL disposal.

C. Low Cash Recovery Rate

The cash recovery rate represents the most important index for evaluating AMC performance. By 2004, the average cash recovery rate of the four Chinese AMCs was around 21 percent. Although that rate sounds respectable, cash inflow actually covers less than half of the AMCs’ interest burden. By failing to meet their interest obligations, AMCs face cash-flow pressure and liquidity problems, which have already materialized. The recovery performance of AMCs is largely related to the type of NPLs they are disposing. The AMC with the best recovery performance is Cinda AMC, whose NPL portfolio is closely tied to large-scale infrastructure projects that are easily liquidated. Take away Cinda, which by 2002 accounted for nearly 40 percent of the total cash recovery by the four AMCs, and the cash recovery rate of the remaining three AMCs drops to only 17 percent.

D. Failure to Lead State-Owned Enterprise Reform

It is important to mention that the four Chinese AMCs also emphasize restructuring problematic SOEs by engaging in the debt-for-equity swap, thereby advancing the Chinese government’s policy of concurrently pursuing NPL and SOE reform. To promote this scheme in 1999, government authorities and the four AMCs jointly selected 580 SOEs, most of which were large and cash-strapped, from the group of debtors. AMCs converted the credit of these problematic SOEs to equity, thereby allowing these SOEs to rapidly write off debts from their balance sheets. Since then, AMCs have acted as asset-holding

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78 Guerrera and Wells, Asia's Bad Debts Have Been Wall Street's Good Fortune, Fin Times at 13 (cited in note 75); Mure Dickie, Chinese AMCs: Look for Permanent Role: Asset Management Companies Dealing with Non-Performing Loans See a Future in Competing with Investment Banks, Fin Times 18 (Nov 22, 2004); Ma and Fung, China's Asset Management Corporations at 11–12 (cited in note 9).

79 See, for example, Ma and Fung, China’s Asset Management Corporations at 12 (cited in note 9).


81 The reason is that Cinda AMC’s parent bank, China Construction Bank, specializes in construction-related loan business.

82 Ma and Fung, China’s Asset Management Corporations at 12 (cited in note 9).

83 Id at 13.
companies and have participated in the daily operation of these SOEs through AMC representatives on the SOEs’ board of directors. AMCs are required to help restructure these SOEs and enhance their commercial viability.

The debt-for-equity swap has become one of the most important business ventures for Chinese AMCs. On average, debt-for-equity swaps involve 30 percent of total transferred NPLs, amounting to $48.97 billion. AMCs are supposed to receive dividends for their equity stakes in these SOEs, and these equity stakes can become another source of cash inflow if the problematic SOEs yield returns after being restructured.

However, this model has, to date, proven to be a failure. In 2004, banking authorities ordered four AMCs to sell their equities and exit SOEs as soon as possible. Information asymmetry has hindered AMCs from efficiently restructuring SOEs. Without capable personnel and professional knowledge about SOEs’ various businesses in mining, textile, and handicraft manufacturing, AMCs were unable to adequately monitor SOE operations. Furthermore, the government’s scheme forced AMCs to become political reformers, for SOE restructuring is inherently political. Due to the elaborate guanxi network and structural corruption within SOEs, any economic reform of SOEs faces strong political resistance from vested interests. Unfortunately, AMCs are incapable of making and enforcing such political decisions.

E. GOVERNANCE

Chinese AMCs’ complicated management arrangements also hinder the development of an efficient monitoring mechanism. AMCs are primarily accountable to the Ministry of Finance, which not only provides them with initial capital, but also bears the fiscal consequences of their operations. However, supervision of AMCs as banking institutions is the responsibility of other institutions as well. Before February 2004, the central bank, People’s Bank of China, shared the responsibility. After that date, responsibility was transferred to the Banking Supervision Commission under State Council.

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84 Id at 13-14. The figure cited by Ma and Fung is RMB 405 billion, which has been converted into dollars using the then-existing exchange rate of $1 per RMB 8.27.

85 AMC Employee Interview (cited in note 48).

86 At the end of the designated ten-year period, if AMCs retain some NPLs, the Ministry of Finance must either take over the nominal equity or write off the bad debts. Huang, China’s Last Steps at 131 (cited in note 6); Watanabe, ed, China’s Non-Performing Loan Problem at 43 (cited in note 18).

87 In early 2004, the Banking Supervision Commission was established under State Council to succeed People’s Bank as the major banking supervision institution. It endeavors to allow People’s Bank to focus on macroeconomic matters such as monetary policy and interest rate regulation. Law of the People’s Republic of China on Banking Regulation and Supervision, art 2
However, AMCs still maintain close ties with their parent banks. Consider the example of Cinda AMC. Most of Cinda's four hundred current employees are transfers from its parent bank, China Construction Bank ("CCB"). A CCB deputy governor is the chairman of Cinda and CCB and Cinda AMC share the same Chinese Communist Party secretary.  

This complicated governance structure is likely to lead to moral hazards. First, the strong links between parent banks and AMCs create an incentive for parent banks to treat AMCs as an outlet for transferring NPLs, particularly by exchanging bad assets for good assets (AMC bonds) without serious evaluation of the quality of the NPLs. Second, since AMCs are backed by the Ministry of Finance, which will assume responsibility for their fiscal problems after ten years, AMCs may lack the incentive to maximize benefits from the disposal of NPLs. They may sell NPLs at an unreasonably low price to improve their short-term performance in a system that gauges performance mainly by the speed and quantity of NPL disposal, rather than by the actual returns from NPL disposal.

F. MARKET DISTORTION

Since early 2005, banking authorities have contemplated prolonging the AMCs' ten-year lifetime, namely because the current outcome of NPL disposal lags far behind expectations. However, given the AMCs' special relationship with their parent banks and with banking authorities, this extension may give rise to market distortion in the long run. For precisely this reason, the US RTC seeks to dispose of bad assets in the shortest time possible.

At least two market distortions may occur if the Chinese government increases the ten-year life of AMCs. First, to the extent that the government cannot make a credible commitment that NPL transfer is a once-off policy, state-owned banks will treat their AMCs as a kind of insurance for their lending activities. Second, SOEs have taken advantage of debt-for-equity swapping to relieve themselves of debt burdens. In the worst-case scenario, even profitable SOEs would stop paying interest on loans in order to qualify for involvement in the debt-for-equity swap selection list. For example, in the case of Cinda AMC, the State Economic and Trade Commission, the agency in charge of recommending SOEs for debt-for-equity swaps, was swamped by requests from local officials and enterprise directors who wanted their SOEs included on

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88 In China, the Chinese Communist Party leads the Chinese government. Every branch of the government has a party secretary, who is superior to the head of the bureaucratic branch.

89 See Mure Dickie, Support for China Move on Share Issues, Fin Times 7 (Nov 22, 2004); Dickie, Chinese AMCs Look for Permanent Role, Fin Times at 18 (cited in note 78).
Cinda’s selection list. Governmental accession to such requests may generate more institutional incentives for corruption and exacerbate the moral hazard problem.\(^9\)

VI. CONCLUSION

The fundamental problem with China’s banking system stems from the banks’ complicated relationship with SOEs. The close nexus between banks and SOEs has created large NPLs as well as influenced the dynamics of banking reform, the rationale of the reform strategy chosen, and the constraints faced by policymakers.

The success of China’s banking reform will largely depend on the success of its SOE reform. If banks evaluate borrowers’ credit purely on a business basis before successful SOE reform, most SOEs will collapse from a loss of financial support, immediately triggering political and social crises. Banking reform in China accordingly began more than a decade after economic reform, and even then, banking reform initiatives were not autonomous of SOE reform.

The most challenging aspect of China’s banking reform is the NPL problem, which illustrates Chinese banks’ irrational lending behaviors, poor governance structures, rent-seeking inclinations, and overall corruption. In the early stage of the economic reform movement, the Chinese government had considered NPLs as a necessary evil. Only since the 1997 Asian financial crisis have banking authorities squarely confronted the NPL problem that has placed nearly all domestic banks in a de facto state of bankruptcy. Beginning in 1997, the problem has increasingly been treated as an issue independent of SOE reform although the AMC solution is partially designed to curb the SOEs’ problems.

Chinese AMCs are facing identical problems caused by policy burdens and state-ownership since they are in reality merely another type of state-owned banking institution. The multiple roles AMCs are supposed to play have constrained their capacity to defuse the bad loan problem. In addition to being financial institutions, AMCs have assumed the role of venture capitalists or incubators in SOE operations through debt-for-equity swaps. Given the corruption and governance problems within SOEs, AMCs have also been forced to act as social and political reformers. But AMCs cannot fulfill any of these roles effectively if they lack the power to choose their clients and to set the price.

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90 Huang, China’s Last Steps at 134–35 (cited in note 6).
for bad loan sales. AMCs’ operations are presently not subject to market forces and their officers do not have a requisite incentive to carry out responsibilities.

The success of AMCs can be assessed along two dimensions. The narrower success is measured by the speed of bad asset disposition and corporate restructuring. The broader success is evaluated by whether or not the banking system experiences repeated financial distress and whether or not credit is efficiently allocated.

In terms of the speed of bad asset disposition, studies show that although the speed has been improved to an annual recovery rate of around 21 percent, the amount of annual returns accounts for less than half of the yearly AMC interest burden. As for the effect of corporate restructuring, anecdotal evidence suggests that Chinese banking authorities have required AMCs to retreat from SOEs due to the AMCs’ limited ability to conduct SOE reform.\(^9\)

In terms of the broader evaluation of the improvement in China’s banking system, although no detailed information has been revealed, a general assessment indicates that the growth rate of NPLs has actually been accelerating since the 1997 Asian financial crisis.\(^9\) It is important to re-emphasize that those post-1996 NPLs are not even included in the AMCs’ disposal responsibility.\(^9\) In 2005, the Standard & Poor’s rating agency estimated that China’s banks still had about $650 billion in NPLs, accounting for about 40 percent of outstanding loans.\(^9\) This proportion is similar to the figure in the pre-AMC period,\(^9\) which is not surprising given that a significant fraction of new lending after the establishment of AMCs is thus far failing to perform. Not only is the underlying health of the banking system not improving, but the speed at which old NPLs loans are being disposed is not exceeding that at which new NPLs are being created.

It clearly appears that AMCs have not fundamentally fixed the faulty mechanism that has produced NPLs. Recent research even shows that the huge

\(^9\) Scant research has addressed this issue because it is hard to distinguish the impact of AMCs from the impact of other reform initiatives on SOEs. Ministry of Finance Announced: Tax Exemption for Enterprises Conducting Debt-for-Equity, China Anhui Internet News (Feb 23, 2005), available online at <http://finance.anhuinews.com/system/2005/02/23/001139712.shtml> (Chinese) (visited Apr 22, 2006); AMC Employee Interview (cited in note 48).

\(^9\) Feng, Bank of China, Epoch Times (cited in note 10); Huang, China’s Last Steps at 133 (cited in note 6).

\(^9\) However, according to my interview, the Cinda AMC has started to receive post-1997 NPLs from its parent bank. AMC Employee Interview (cited in note 48).

\(^9\) Wolf, 146 Foreign Poly at 51 (cited in note 7).

\(^9\) Several studies estimate that the NPL proportion of total outstanding loans has remained around 40 percent since the late 1990s. See Roubini and Setser, China Trip Report at 12–13 (cited in note 3); Ma and Fung, China’s Asset Management Corporations at 1 (cited in note 9).
amount of bad loans, supposedly intended to make bank loan behavior conservative, have instead made China’s banks expand their lending under the pressure to decrease their bad loan ratio. Banks can trim this ratio by increasing the amount of outstanding loans instead of reducing NPLs, and they have readily done so. This tricky behavior shows one distorted effect of banking reform under the state ownership structure in China.

With its approaching accession to the WTO, China has promised to open its financial market to foreign banks by December 11, 2006. The Chinese government has viewed this date as the deadline for banking reform. However, it seems that China’s NPL disposal program has not substantially reduced the problem. The proposals for a ten-year AMC lifetime, the SOE restructuring plan via a debt-for-equity swap, and the vow of no bailout for post-1996 NPLs have all yielded to reality.

What lies ahead for Chinese banking reform? After this Article’s analysis of Chinese AMCs, the answer remains uncertain. On one hand, some scholars are optimistic given China’s lofty savings rate (the world’s highest), its soaring economic growth, and the strong confidence of its general public in the state banking system. On the other hand, the Chinese people have not experienced market or banking failures during these past two decades in the reform era, and their confidence and expectations may thus not reflect actual risks. Although Chinese AMCs have helped state-owned banks write off their non-performing loans in order to list overseas, the bad loans problem has not been fundamentally resolved; instead, it has been shifted from one state institution to another. The Chinese government maintains its tight grip on the banking system, and state-owned AMCs represent one example of this domination. While the international capital market may, in the short run, be able to intervene in this turmoil-laden situation through timely injections of cash, such a delicate banking reform scheme cannot afford any unexpected risk in the long run.

97 Roubini and Setser, China Trip Report at 11–12 (cited in note 3); Yi-fu Lin, Is It Useful for Beijing to Raise the Interest Rate? Bus Wk (Taiwan) 125, 126–27 (July 12, 2004); AMCs to Play Bigger Role in Reducing NPLs, People’s Daily (Jan 7, 2004), available online at <http://english.peopledaily.com.cn/200401/07/eng20040107_132018.shtml> (visited Apr 22, 2006).

98 See, for example, Huang, China’s Last Steps at 382–87 (cited in note 6); Watanabe, ed, China’s Non-Performing Loan Problem at 43–48 (cited in note 18); Ba, Good Money vs. Bad Money at 23–24 (cited in note 50).