Resolution of Non-Performing Loans in China

Min Xu

The Leonard N. Stern School of Business
Glucksman Institute for Research in Securities Markets
Faculty Advisor: Paul Wachtel
April 1, 2005

Tables of Contents

I. Introduction[1]

Despite its impressive economic growth, China also has one of the largest non-performing loan (NPL) portfolios in the world. According to the China Banking Regulatory Commission (CBRC), major commercial banks[2] carried NPLs of RMB 1.7 trillion on their balance sheets as of December 31, 2004, representing 13 percent of total loans. This NPL figure does not include the RMB 1.05 trillion[3] of NPLs remaining on the balance sheet of four asset management corporations (AMCs), which were established in 1999 as decentralized vehicles to manage and dispose of NPLs they had purchased from the four state-owned commercial banks (SOCBs). These official figures reveal NPLs of about RMB 2.8 trillion or $340 billion in the financial system. However, various sources estimate that the total amount of non-performing assets (NPAs) in the system, which includes not only NPLs, but also debt-equity swaps and repossessed collateral, is even higher. PricewaterhouseCooper's' *China NPL Investor Survey 2004*, for example, estimates this figure to be about $500 billion. Standard & Poor's is more pessimistic, estimating that it would cost $656 billion to resolve bad loans at all of China's banks (Cheng and Miller 2004).

This paper is organized as follows. The first section provides an overview of China's financial sector and post-1998 measures initiated by the government to relieve the NPL burden. The second section examines the root causes of the NPL problem and alerts to

---

[1] I would like to acknowledge my gratitude to David Bednar, former head of Morgan Stanley's bad loan business in China, and Kevin Young of Citigroup, who provided valuable information about their NPL investing experience in China.

[2] The major commercial banks include the four state-owned commercial banks (SOCBs) and the joint stock commercial banks (JSCBs).

[3] Based on my calculation, the four AMCs purchased RMB 1.72 trillion of NPLs in total from the four SOCBs, China Development Bank, and Bank of Communications between 1999 and 2004. CRBC reports that the AMCs have disposed RMB 675.06 billion of the assets through December 31, 2004.

the buildup of new NPLs in the system. The third section compares China's NPL resolution efforts against East Asian economies that faced the same problem, analyzes the reasons for China's shortfalls, and presents recent policy measures that are narrowing the gap. The fourth section studies each of the main NPL resolution methods that China undertakes, evaluates their effectiveness and challenges, and highlights measures that could increase the likelihood of their success.

II. Financial Sector Overview and Developments

With a thinly traded stock market and an almost non-existent corporate bond market, banks in China play a major role in intermediating private savings, which comprises approximately 40 percent of GDP (Rolnick 2003).

The major players in China's financial system include state-owned commercial banks, joint stock banks, as well as urban and rural cooperatives. The four SOCBs dominate the nation's banking sector, collectively accounting for 54 percent of total assets and liabilities[4]. The four SOCBs are the Industrial and Commercial Bank of China (ICBC), the Agricultural Bank of China (ABC), the Bank of China (BOC) and the China Construction Bank (CCB). All the SOCBs were spun off from internal divisions within the PBOC, China's central bank, in the late 1970's. Even after NPL transfers of RMB 1.6 trillion to the AMCs between 1999 and 2004, the SOCBs collectively still carry RMB 1.7 trillion of NPLs on their books, representing 15.6 percent of total loans. Table 1 summarizes the composition of China's financial sector and the reported distribution of NPLs across different types of institutions.

[4] China Banking Regulatory Commission, December 31, 2004.

Table 1

Financial Institutions in China, December 31, 2004

	% of Total Assets & Liabilities	NPLs	NPL % of Total Loans
State-owned Commercial Banks	54%	RMB 1.58 trillion	15.6%
Joint Stock Banks	15%	RMB 143 billion	5.0%
City Commercial Banks	5%	N/A	N/A
Other Financial Institutions[a]	26%	N/A	N/A

(a) Other financial institutions include policy banks, rural commercial banks, foreign banks, urban credit cooperatives, rural credit cooperatives, finance companies, trust and investment companies, financial leasing companies and postal savings.

Source: China Banking Regulatory Commission Website, http://www.cbrc.gov.cn.

Since China's entry into the World Trade Organization in 2001, the Chinese government has stepped up the country's transition from a centrally planned economy to a market-oriented one. At the heart of this migration, China committed to open up its domestic banking sector to full-fledged competition from foreign banks by 2007. This planned transition heightened the need for a speedy resolution of the pervasive NPL problem in the financial sector.

Since 1998, the Chinese government has carried out a variety of measures to reduce the NPL burden. These included the direct recapitalization of the SOCBs as well as the transfer of NPLs from the banks to AMCs that focus exclusively on the collection and resolution of the NPLs. Table 2 summarizes these major actions.

Table 2

Recapitalization/NPL Transfer Measures Undertaken by the Chinese Government

Year	Action
1998	The government injected RMB 270 billion ($33 billion) of capital into the four SOCBs.
1999	The government established four AMCs: Cinda, Huarong, Orient, and Great Wall. Each of the four AMCs was originally matched up against each of the four SOCBs: Cinda with CCB, Huarong with ICBC, Orient with BOC, and Great Wall with ABC.
	The AMCs purchased RMB 1.4 trillion ($170 billion) of NPLs from the four SOCBs and the China Development Bank. Transferred loans were primarily "substandard" or "doubtful" loans (under the old four-tier classification mechanism) made prior to 1996 and overdue for more than one year by the end of 1998. The AMCs purchased the NPLs at book value.
2003	The government injected RMB 370 billion ($45 billion) of capital into CCB and BOC, both slated for public offerings in 2005.
2004	Cinda AMC won the auction to purchase RMB 278.7 billion ($34 billion) in NPLs from BOC and CCB, at 50% of book value. The ultimate recovery rate of 33 cents on the dollar for the loans is required by year-end 2005.
2004	Cinda AMC bought RMB 41.4 billion ($5 billion) of NPLs from Bank of Communications at a 50% discount, funded entirely by a loan from PBOC. Cinda has promised ultimate recovery of 30% to 40% of face value.

Total bailout/transfer amount to date: RMB 2.36 trillion ($287 billion).

Sources: Various News Releases.

Of note, for the 1999 NPL transfer, the recovery value of the NPLs will surely be below the full book value that the AMCs paid for the assets. As a result, the AMCs will be unable to repay the ten-year bonds they issued to the banks, which accounted for RMB 1.2 trillion, or approximately 84 percent of the AMC's purchase price (Fung and Ma 2002)[5]. While China's Ministry of Finance did not explicitly guarantee these bonds, it is widely anticipated that the government would not allow the AMCs to default on their bonds. Hence, any ultimate loss is likely to be absorbed by the government.

The speed of recovery at the AMCs, as indicated in Table 3 below, has been somewhat

[5] The remaining RMB232 billion was provided by the PBOC and the Ministry of Finance (MoF) (RMB 40 billion of paid-in-capital from the MoF and RMB 192 billion of loans from the PBOC).

disappointing to date. Through year-end 2004, they collectively disposed of only RMB 675 billion, or about 39 percent of the total NPLs they acquired. This presents challenges for the government's original mandate that the AMCs complete their missions by 2009. Further, the AMCs' cash recovery rate of only 20.3 percent, or recovery of RMB 137 billion to date, was insufficient to service the interest on the bonds they had issued and the loans they had acquired from PBOC in 1999 to fund the initial transfer of NPLs. The AMC's total interest obligation is estimated to be about RMB 30 billion annually for five years, or a total of RMB 150 billion[6]. Should NPL resolution continue at the current speed, the AMC could face considerable cash flow pressure.

Table 3

Disposal of Non-Performing Assets at China's AMCs, December 31, 2004

(RMB in Billions)

	Total	Huarong	Great Wall	Orient	Cinda
Accumulated Disposal	**675.06**	209.54	209.91	104.55	151.06
Asset Recovery Ratio	**25.5%**	25.3%	14.4%	29.5%	38.3%
Cash Recovery	**137.00**	41.34	21.57	23.29	50.81
Cash Recovery Ratio	**20.3%**	19.7%	10.3%	22.3%	33.6%

Source: China Banking Regulatory Commission.

As evidenced in Table 3, Great Wall AMC's cash recovery ratio of 10.3 percent was among the lowest of the group. This was due to the low quality loans it took over from the ABC, which historically financed a large number of rural enterprises. On the other hand, Cinda AMC has the highest cash recovery ratio among the group. Cinda was originally matched up with the CCB in 1999, which historically provided financings for capital construction projects and urban housing development. These real estate assets are

[6] Both the AMC bonds and the loan from PBOC carry an annual interest rate of 2.25%, which translates into RMB 30.6 billion of interest per annum.

substantially more liquid than other collaterals, thus maximizing the recovery value. According to Cinda's website, more than 26 percent of the NPLs it purchased in 1999 were collateralized by real estate assets. For the four AMCs in aggregate, this ratio was only 7 percent.

III. Main Causes of China's NPL Problem

Unlike many other Eastern Asian countries, whose large NPL portfolios stemmed from the 1997 Asian financial crisis, China's closed capital market shielded it to a large extent from the crisis. Instead, China's huge NPL burden was largely a result of two functions: (a) sustained losses at state-owned enterprises (SOEs) and (b) the lack of a commercial credit culture at major financial institutions.

The first side of the story is the SOEs, which represent over 40 percent of China's manufacturing output, employing more than half of the industrial workforce (Norton and Chao 2003). Having long suffered from technological obsolescence and excess capacity, the SOEs were squeezed by intensified competition as China gradually opened its doors to foreign capital in most industries. In 1998, over two-thirds of all SOEs generated a loss for the year[7]. The SOEs obtained the majority of their funding from the banks, in particular the four large SOCBs. These bank lenders often continued to extend loans to the same debtor with little regard to the latter's ability to repay its loans, under the perception that the ultimate loss will be borne by the government. At the end of 2001, the total liabilities to equity ratio

[7] *Financial Yearbook of China*, 2002.

for China's SOEs stood at 158 percent[8]. SOEs in the construction, real estate, food, and textiles industries were among the most highly leveraged, with total liabilities to equity ratio in excess of 350 percent. When adjusted for unhealthy assets, the total leverage ratio of locally-administered SOEs[9] escalated even further, from 252 percent to 632 percent[10]. The continuous losses of the SOEs and the unremitting credit support that they received from banks resulted in mounting bad loans in China's banking system.

The other side of the coin is the lack of a commercially-oriented credit culture at major financial institutions, in particular the four SOCBs. This mentality originated from the pre-1994 period, when the Chinese government routinely mandated that the SOCBs lend to SOEs for key infrastructure projects and social welfare subsidies, regardless of profitability. Under the "policy lending" guidance, poor documentation for loan collateral was common, and credit risk management skills were far from meeting international standards.

In 1994, the Chinese government established three development banks that took over the policy lending tasks from the SOCBs, leaving the latter with more healthy capital to develop a commercial lending orientation. The administration also established a legal basis for commercial banking with the promulgation of the *Commercial Banking Law* in 1995. However, the intended market-oriented reform was hampered by a legacy loan classification system and the lack of a free-market interest rate regime.

Until 2002, loan performance had been classified mechanically based on the length of the past due period rather than based on the assessment of loan quality. Under the legacy

---

8 See supra note 7.
9 Locally-administered SOEs are owned, and often to some extent, managed by the local governments.
10 See supra note 7.

four-category classification system, only loans overdue by more than one year were considered non-performing, and only the overdue portion counted as an NPL[11]. Thus, even if a company is deemed incapable of repaying its debt or has ceased operations completely, it may still be considered performing should the loan be overdue by less than one year. Furthermore, in certain instances, banks simply extended new loans to insolvent SOEs, so that they could use the new funds to fulfill existing debt obligations.

Secondly, instead of letting supply and demand determine interest rates, the central bank, People's Bank of China (PBOC) has traditionally set an arbitrary interest rate collar for both loans and deposits; this measure prevents the banks from effectively linking risks and returns. They are unable to charge a lending rate above the interest rate cap on loans to high-risk clients in order to compensate for the risks. Nor can they reward the low-risk clients with a lending rate below the interest rate floor. As a result, the least creditworthy companies routinely resorted to bribing bank officials or furnishing fraudulent information to lenders in order to obtain a loan.

On January 1, 2004, the PBOC announced its decision to expand the collar of lending rate charged by financial institutions. The lending ceiling charged by commercial banks and urban credit cooperatives was raised to 170 percent of the benchmark rate, although the floor remained at 90 percent of the benchmark rate[12]. On October 28, 2004, along with its interest rate increase decision (see below), the PBOC removed the lending ceiling on RMB

---

[11] In 2004, the CBRC required that all SOCBs and joint-stock commercial banks to start adopting the five-tier loan classification system, which classifies loans as "Pass," "Special Mention," "Substandard," "Doubtful," or "Loss." The latter three loan categories – including loans overdue by more than 90 days and those likely to be impaired – are considered NPLs. The new classification system was fully adopted in 2004.

[12] Previously, the ceiling had been 130 percent of the benchmark rate.

loans completely for all financial institutions except for urban and rural credit cooperatives[13]. This action demonstrated the central bank's willingness to relax its control over interest rates and will allow banks to better price their loans by matching risks with returns.

While the government's main focus is on addressing the existing "stock" problem of NPLs in the financial system, the creation of new bad loans, i.e. the NPL "flow" problem, should not be neglected. The explosive loan growth in China over the last two years, especially to certain over-invested sectors – such as the iron and steel, aluminum, cement, and real estate development industries – has created piles of new NPLs in the system. According to the PBOC, fixed asset investment grew by 28% from 2002 to 2003 and 38% year-over-year in the first half of 2004, much of which was financed by banks. Total bank lending of RMB 18.5 trillion at the end of June 2004 was more than double the figure at the end of 2001 (Wilson 2004).

In order to prevent a hard landing for the economy, the PBOC has instated a series of measures since the second half of 2003 to reduce credit expansion. The central bank raised the deposit reserves requirement twice, initiated a tired reserve requirement system tied to each bank's capital adequacy ratio, and imposed credit controls on certain overheated sectors[14]. On October 28, 2004, the PBOC raised the benchmark rate for one-year RMB loans by 0.27% from 5.31% to 5.58%, and the benchmark one-year RMB deposit rate by 0.27% from 1.98% to 2.25% - its first interest rate increase in nine years[15]. While these measures have managed to curb over-investment and slow year-over-year GDP growth from

---

13 "China's First Interest Rate Hikes in Nine Years," Hong Kong Trade Development Council, November 11, 2004.
14 See supra note 13.
15 See supra note 13.

a peak of 9.9% in the fourth quarter of 2003[16] to an expected 8.8% in the first quarter of 2005[17], the excessive credit expansion has resulted in an increase in NPLs at major banks during the second half of 2004, as evidenced in Table 4.

Table 4

NPLs at Major Financial Institutions [(a)], 2003 – 2004

(RMB in Billions)

	1st Half 2003	Full Year 2003	1st Quarter 2004	2nd Quarter 2004	3rd Quarter 2004	4th Quarter 2004
NPLs	2,538	2,441	2,078	1,663	1,700	1,718
NPL % of Total Loans	19.6%	17.8%	16.6%	13.3%	13.4%	13.2%

(a) Major financial institutions include the four SOCBs and the twelve JSCBs.

IV. NPL Resolution: China versus other East Asian Economies

Many East Asian countries have been burdened with monstrous NPL portfolios since the 1997 Asian financial crisis. Among the countries that emerged with successful NPL recovery stories are Korea, Japan, and Thailand. Similar to China, all of these countries created public AMCs as a primary vehicle to acquire distressed assets and focus on NPL resolution. However, the asset recovery rate of these AMCs has generally outperformed that of China's AMCs. The Chinese authorities are aware that they have a lot to learn from other economies, and specifically retained Korea Asset Management Corporation as advisor to the four Chinese AMCs. In this section, I would like to first study three countries' NPL recovery experience, then move on to analyze the reasons for China's underperformance compared to these countries, and finally discuss measures that are narrowing the gap.

While public AMCs are not the only type of NPL resolution vehicle in the countries

[16] "Table - China's economic indicators - March 16," *Reuters News*, March 15, 2005.
[17] "China's GDP Forecast to Grow 8.8 Percent in First Quarter," *Asia Pulse*, March 29, 2005.

mentioned above, they play a leading role in NPL recovery efforts and the results of their actions are highly publicized. I have thus chosen to focus on studying the activities of the public AMCs. Another caveat to keep in mind is that, due to the differences in accounting rules and NPL definition, the NPL figures are not necessarily comparable across countries.

IV.a. Cross-Country Experience

IV.a.i. Korea

Korea's NPL problem originated from the excessive leverage at domestic companies and the ineffective credit risk management of domestic financial institutions. The contagion effect of the Asian Financial Crisis in October 1997 triggered a wave of corporate bankruptcies and accumulation of NPLs in the financial sector. The Korean government acted quickly, giving Korea Asset Management Corporation (KAMCO) the mandate of recovering NPLs in November 1997. Between November 1997 and December 2003, KAMCO purchased Won 110.5 trillion worth of NPLs from the financial sector, including Won 33.2 billion from the *chaebol* Daewoo Capital in 2002 (KAMCO 2003)[18]. KAMCO paid an aggregate amount of Won 39.7 trillion for the NPLs, or only 36 percent of face value. All of the NPLs were formed in the second half of the 1990's.

By the end of 2004, KAMCO had resolved Won 71.8 trillion ($68.4 billion) of NPLs, representing 62.1 percent of the acquired loans. Both the rate of recovery and the ultimate recovery price are very impressive. The total sale price for the NPLs amounted to $32.7 billion, equal to 117 percent of the original $27.9 billion that KAMCO had paid for these

[18] KAMCO 2003 Annual Report.

NPLs, for a profit of $4.8 billion[19]. Strong legal and political backing, diverse recovery approaches, and KAMCO staff's prior involvement with restructuring were among the factors that accounted for KAMCO's success.

KAMCO's major NPL disposition methods include bulk/individual sales to domestic and international investors, Asset-Backed Securities (ABS) issuance, bankruptcy auctions, debt collection, and workouts. Additionally, KAMCO conducted massive debt-for-equity swaps, mergers and acquisitions, and spinoffs in order to rescue subsidiaries of Daewoo Capital. Recently, KAMCO has moved its focus from NPL sale to managed workouts, as approximately three-quarters of the remaining unresolved NPLs are related to Daewoo loans[20]. Table 5 shows KAMCO's initial purchase price and sale price achieved through various NPL resolution methods. It is evident that KAMCO has managed to generate a profit using almost every resolution method.

Table 5

KAMCO NPL Resolution by Method[(a)]
December 31, 2004 (Figures in U.S. Dollars)

Method	Face Value	Purchase Price	Sale Price	Purchase Price/FV	Sale Price/FV	FV % of Total
International Bidding	$5.79	$1.25	$1.53	21.6%	26.4%	8.5%
ABS Issuance	8.31	4.42	4.60	53.2%	55.4%	12.2%
Sale to AMC	2.46	0.63	0.88	25.6%	35.8%	3.6%
Sale to CRC	2.08	0.38	0.75	18.3%	36.1%	3.0%
Individual Loan Sale	3.23	0.75	1.23	23.2%	38.1%	4.7%
Court Auction, Public Sales	8.15	2.69	3.32	33.0%	40.7%	11.9%
Collection	14.40	4.54	6.46	31.5%	44.9%	21.1%
Daewoo Loan Repayment	4.45	3.05	3.70	68.5%	83.1%	6.5%
Workout Loan Repayment	0.69	0.38	0.46	55.1%	66.7%	1.0%
Repurchase Cancellations[(b)]	18.79	9.81	9.81	52.2%	52.2%	28.7%
Total	$68.35	$27.90	$32.74	40.8%	47.9%	100.0%

(a) Does not include debt-for-equity swap of $9.95 billion.
(b) KAMCO negotiated put options that allowed it to put back certain portion of an NPL back to the original financial institution, should the returns not meet certain thresholds.

Source: KAMCO's website, www.kamco.or.kr/eng/.

19 KAMCO website, http://www.kamco.or.kr/eng/.
20 See supra note 18.

Korea's relatively mature legal framework and further reforms to its bankruptcy legislations are major factors that contributed to KAMCO's accomplishments. Although corporate liquidation and reorganization procedures have been in place in Korea since 1962, both the *Bankruptcy Act* and the *Composition Act* were amended soon after the Asian financial crisis, in 1998 and 1999, respectively (Zafft and Vassiliou 2002). Finally, the *1998 Agreement for the Promotion of Corporate Workouts* and the 2001 *Corporate Restructuring Promotion Law* provided a standardized framework for out-of-court workouts for creditors (Zafft and Vassiliou 2002). All of these measures improved the legal enforcement mechanism for creditors and helped KAMCO achieve a NPL recovery rate of almost 48 percent.

One of the most noteworthy methods that secured KAMCO's success was securitization. Securitization is the act of transferring assets to a special-purpose vehicle (SPV) and issuing securities to investors with the backing of the stream of cash flows generated by the assets. KAMCO's use of securitization was supported by the promulgation of the *Asset-Backed Securitization Act* in 1998, followed by the *Mortgage-Backed Securitization Company Act* in 1999. The regulations stipulated that (a) SPVs may purchase or issue securities using any receivables, real estate and other property rights, and (b) all rights to the securitized assets are directed to the transferee without retention by the transferor (EIU *Country Finance South Korea* 2004). This latter provision set the foundation for a true sale of the securitized asset – an important prerequisite for securitization. Foreign investors facilitated securitization efforts by contributing both their funds and expertise in securitization, which had been a relatively novel concept in Asia before 2000.

IV.a.ii. Japan

The major cause for Japan's NPL problem was the banking system's concentrated lending to the property sector through the 1980's. The subsequent explosion of the real estate bubble lowered the value of loan collaterals dramatically, affecting virtually all types of financial institutions. Bank failures, occurring sporadically since 1991, escalated between 1994 and 1998.

After an initial delay in responding to the NPL problem, the Japanese government created the Resolution and Collection Corp. (RCC) in 1998 to take over NPLs from 90 failed financial institutions at only 7.1 cents on the dollar (Fung et.al. 2004) – a substantial discount from book value. This price approximated the true value of the real estate backing the acquired NPLs, given the distressed state of the property market in the late 1990's. RCC's cash recovery rate is reported to be between 20 and 30 percent[21], far exceeding its purchase price for the NPLs.

The RCC has historically resorted to straight loan collection, while turning only recently to restructuring. Although securitization has so far represented only 1 percent of RCC's total NPL recovery (Fung et.al. 2004), Japan has successfully completed two NPL securitizations, facilitated by important amendments to its legal framework. The *MITI Law of 1993* allowed SPVs to issue Asset Backed Securities using leases, credit card, auto, and installment sales contract receivables (Chen 2004). The *SPC Law of 1998* lowered the capital requirement for SPVs and reduced taxes by 50 percent (Chen 2004). Finally, an

[21] "China Suffers Losses from Undervalued Bad Loans," *SinoCast China Financial Watch*, October 28, 2004.

amendment to the *SPC Law* in 2000 expanded the range of assets that could be securitized and allowed the usage of a trust structure (EIU *Country Finance Japan* 2004).

Reorganization of companies has been a recent initiative facilitated by the *Corporate Reorganization Law*, effective as of April 2003. This legislation was accompanied by the establishment of the Industrial Revitalization Corporation of Japan (IRCJ), a joint-stock company with government-guaranteed loans to focus on reorganizations. The IRCJ reviews reorganization plans and purchases loans from “non-main banks” – secondary or tertiary creditors – at the request of debtor corporations with excessive debts and their “main banks” (primary creditors). Ten trillion yen of funds have been made available to the IRCJ to purchase NPLs, which has received requests from six companies as of September 2003 (Takagi 2003).

IV.a.iii. Thailand

Thailand’s NPL problem was triggered by the 1997 Asian Financial Crisis, which affected many banks that issued foreign currency loans to debtors with local currency income streams. Thailand accepted a rescue package from the International Monetary Fund valued at $3.9 billion, in exchange for agreeing to certain economic reforms. The country’s NPL ratio, in excess of 45 percent of total loans in 1998, was successfully reduced to just about 12 percent by March 2004 (Vongvipanond 2004).

The first reaction of the Thai government to the NPL problem was to create the Financial Sector Restructuring Authority (FRA), an agency that rapidly divested the assets of 58 suspended finance companies through a series of bulk sales, 56 of which were subsequently shut down (Zafft and Vassiliou 2002). These NPL sales stimulated activities in the real estate sector and resulted in new legal procedures for the disposal of foreclosed assets.

Following FRA's bulk NPL sales, Thailand focused on using restructuring as the main approach in resolving NPLs. Two state agencies were founded to restructure NPLs: the Thai Asset Management Corp. (TAMC) and the Corporate Debt Restructuring Advisory Committee (CDRAC). Each organization adopted a different approach in pursuing the restructuring, generating substantially different results.

The TAMC, established in 2001 under the sanction of *TAMC Decree*, was given extraordinary legal powers to unilaterally amend loan terms, conduct debt-for-equity swap, and foreclose on debtors' assets – all without the debtor's consent or court approval (EIU *Country Finance Thailand* 2004). The TAMC was also given superpowers for reorganization and its workout officers were granted immunity from prosecution. The TAMC acquired primarily substandard NPLs from state-owned institutions, in addition to secured NPLs from private financial institutions (Kosolkitiwang 2001).

By the end of November 2004, the TAMC had resolved Baht 767 billion of NPLs, over 98% of the total amount of loans it had acquired from state-owned and private financial institutions over the past three years[22]. The expected recovery rate of 49 percent of the restructured loans far exceeds the 34 percent of book value that the TAMC had paid to financial institutions on average in exchange for the assets[23]. A profit-sharing scheme[24]

[22] "TAMC Reports on Debt Restructuring Progress," *Thai News Service*, December 23, 2004.
[23] See supra note 22.
[24] If the ultimate recovery yields a profit, the first 20% of the profit is shared equally by the TAMC and the financial institution; additional profit not exceeding the difference between the recovery value and the transfer price is absorbed by the financial institution; whereas any profits remaining is absorbed by the TAMC. If the ultimate recovery yields a loss, the first 20% of the loss is absorbed by the financial institution; the second 20% is shared by the TAMC and the financial institution; whereas any loss remaining is absorbed by the TAMC (Pornavalai 2002).

between the TAMC and the financial institution further increased the incentive for the TAMC to maximize the realization value of the NPLs.

In contrast, the CDRAC was established as a committee to focus on out-of-court workouts. It adopted the more traditional approach of encouraging private negotiations between creditors and debtors, with the objective of allowing enterprises to survive whenever possible. The CDRAC took over Baht 2.84 trillion of NPLs between mid-1998 and September 2003, and has moved much more slowly than the TAMC. By the end of 2004, the CDRAC has successfully restructured cases worth Baht 1.40 trillion, yet failed restructuring in cases worth Baht 413 billion (EIU *Country Finance Thailand* 2004).

The contrasting results of the TAMC and the CDRAC indicate a likely link between the success rate of recovery and the resolution approach undertaken. Drawing from the TAMC's success, China should benefit from awarding special legal powers to its AMCs, giving them the latitude to exercise more aggressive collection methods against the debtors.

On the legal front, Thailand introduced major reforms to its insolvency laws following the Asian financial crisis. In 1998, the government amended its *Bankruptcy Act* to include a new reorganization procedure in addition to the existing liquidation provisions. In 1999, the *Bankruptcy Act* was amended again to eliminate the immunity of debt guarantors from bankruptcy cases, to establish a formal mechanism in determining classes of creditors, and to extend the definition of applications where "avoidance power" can be exercised[25] (Dasri 2003). During the same year, a specialized bankruptcy court was formed to expedite

[25] The court can void payments that debtors made up to three months before the bankruptcy application, and for "advantaged creditors," up to one year before the application.

the legal hearing process, followed by the creation of new foreclosure laws that allowed most foreclosure cases to be completed within 12 to 18 months (Dasri 2003).

Thailand also adopted securitization methods in its NPL disposal, facilitated by, notably, the *1997 Securitization Act*, which permitted the creation of SPVs and the transfer of assets from issuers to investors without giving notice to debtors (EIU *Country Finance Thailand* 2004). The investors of the securitized assets are further insulated from future problems of the issuer.

IV.b. Challenges to China's NPL Resolution

Both Korea and Thailand have worked through NPA resolution in a speedy and efficient manner, although the approaches they emphasized have varied. Korea focused on securitization, direct asset sales, and debt collection, in order to maximize upfront cash recovery in a short period of time. Thailand, on the other hand, chose to carry out debt restructuring and workouts almost exclusively, recovering little cash upfront yet expecting to maximize asset value in the future. Compared to Korea, Thailand faces a higher residual risk of restructured loans, i.e., the restructured loans might not ultimately be repaid, especially if macroeconomic conditions suffer a downturn. Disadvantaged by its huge NPL portfolio, low quality of assets, and limited expertise in restructuring, China should preferably adopt primarily Korea's approach of emphasizing speedy resolution.

To date, China has largely followed KAMCO' model, utilizing a variety of NPL resolution methods, including debt-for-equity swap, restructuring, liquidation, direct sales to investors, and securitization, to be discussed in detail in section V. However, the speed of recovery in China has trailed the performance of both Korea's KAMCO and Thailand's

TAMC. Through the end of 2004, the four AMCs collectively recovered only RMB 675 billion of NPLs, or less than 40 percent of the NPLs transferred to them since 1999. The banks have been even slower in their resolution, given regulations that prohibit them from selling NPLs at below book value (with the exception of settled assets). In contrast, as of December 2004, Korea's KAMCO resolved over 62 percent of loans it acquired since November 1997. The cash recovery rate of the Chinese AMCs approximated 20 percent as of December 2004. This performance was also substantially behind KAMCO's actual cash recovery rate of 48 percent and TAMC's expected recovery rate of 49%[26], although closer to RCC's estimated cash recovery of 20 percent to 30 percent. Both the resolution speed and cash recovery rate of Chinese AMCs have lagged those of their counterparts, primarily as a result of (a) lower asset quality, (b) weak legal framework, (c) book value NPL transfer to AMCs, and (d) poor corporate governance and transparency at the AMCs.

IV.b.i. Low Asset Quality

Except for the healthiest bad loans, the quality of most NPLs declines in proportion to the amount of time they stay in the system. Out of the 1.7 trillion of NPLs transferred to the Chinese AMCs to date, 1.4 trillion were policy loans from the pre-1995 years. This implies that the AMCs face the arduous task of recovering value from operations that had been suspended for as long as ten years. Furthermore, investments into "redundant projects" – those that were halted due to the violation of land, environmental and other regulations – amounted to about RMB 800 billion, some RMB 300 billion of which originated from bank lending (Kynge 2004). There is arguably little value to be extracted from such projects,

[26] Thailand has focused on debt restructuring instead of disposal, hence the realized cash recovery rate is very low.

where plants and equipment have stayed idle at length. In comparison, KAMCO purchased most of its NPLs between the years 1998 and 2002. All of these NPLs were formed during the second half of the 1990's, suggesting a higher quality of the loans and thereby increasing the recovery potential.

Another problem with China's NPL portfolio is the lack of physical collateral backing many of the NPLs, which automatically decreases the potential sale price of the loans. In 2001, the AMCs estimated that only about 22 percent of the RMB 1.4 trillion NPL portfolio they had taken over were secured by real estate, intellectual property rights, or other tangible securities (Pierce and Yee 2001). Furthermore, the true value of the security backing the loans accounted for only about 42 percent of the amount of the total amount of secured debt. The substantial valuation differential between secured and unsecured loans can be demonstrated through KAMCO's acquisition price of NPLs. KAMCO offered only three cents on the dollar for unsecured NPLs, whereas secured NPLs were purchased at 45 percent of the senior lien on the appraised value of the collateral[27] (Mulye et.al. 2002).

Among the types of collateral backing the NPLs, investors have an overwhelming preference for real estate due to its liquidity. This was substantiated by my interviews with David Bednar, former executive at Morgan Stanley and Kevin Young, Citigroup executive, as well as PwC's *China NPL Investor Survey 2004*. According to Bednar, Morgan Stanley focused on being a real estate play in its NPL purchase from Huarong AMC, and exercised far more caution with loans backed by machinery, accounts receivable, and inventories. The

[27] Except for initial purchases which were adjusted for the present value of projected cash flows multiplied by the discount rate.

valuation of the latter is more difficult to determine due to the deterioration of these assets over time and the insufficiency of loan documentation. Unfortunately, real estate collateralized loans accounted for only seven percent of the NPL portfolio transferred to the Chinese AMCs in 1999, much lower in comparison to Thailand's TAMC as shown in Table 6.

Table 6

Sectoral Distribution of Assets Transferred to AMCs (Book Value)

	Real Estate	Manufacturing	Commerce	Import/Export	Others
China	7%	42%	18%	8%	22%
Thailand	24%	28%	11%	10%	27%

(a) Represents only the non-performing loans transferred to the AMCs in 1999.

Source: Fung, et.al. 2004; based on central banks, AMC publications, official estimates, and authors' own estimates.

IV.b.ii. Weak Legal Framework

Korea, Thailand, and Japan's experiences demonstrate that a key factor to succeeding in NPL recovery is a transparent and user-friendly insolvency law framework that gives creditors adequate protection. All of these countries have made significant improvements and/or additions to their bankruptcy and securitization legislations over the last six years. In contrast, the main governing bankruptcy law in China, remains the *Enterprise Bankruptcy Law of the PRC (Trial Implementation)*, a legislation enacted almost 20 years ago and exclusively tailored to SOEs. Although a series of legislations containing articles regulating non-SOEs' bankruptcies had been issued since then, including the 1991 *Civil Procedure Law*, the 1993 *Company Law*, and the 1996 *Measures on Liquidation Procedures for Foreign Invested Enterprises*, none of the legislations went into much details about the subject (PwC December 2004). Until now, there have not yet been unified bankruptcy legislations applicable to both private and state-owned enterprises.

My interviews with Bednar and Young revealed that legal impediments are among the top obstacles for NPL investors. In reality, bankruptcy procedures are carried out on an ad hoc basis, and are heavily influenced by local political powers. Many of the bankruptcies are "policy-directed," or directly enforced by the government with little consultation of the 1986 *Enterprise Bankruptcy Law*. There are also restrictions by region on the number of entities eligible for bankruptcy (Jones and Culler 2005). Even when a company goes through the bankruptcy process, the court-appointed liquidation committee typically consists of governmental staff with limited expertise in the bankruptcy process and little regard for creditor rights (see the GITIC case study in Section V.b.iii.).

Unlike the other aforementioned East Asian economies, China does not have provisions regulating the reorganization process in the current bankruptcy legislations. Nor are there real repossession or foreclosure laws, so that investors have generally been hesitant in acquiring NPLs when the foreclosure of assets is required in order to realize the value of the investment.

IV.b.iii.Book Value NPL Transfers to AMCs

In 1999, the Chinese government mandated that the four AMCs complete their first NPL purchase at the full book value of RMB 1.4 trillion. The transfer price of the NPLs was far from their true value, widely anticipated to be below 20 percent of book value. This requirement prevented the four SOCBs from having to take immediate, large write-downs of their loan portfolios. However, it also created an inevitable loss for the AMCs, hence providing disincentives for them to maximize the recovery price. In comparison, Korea's KAMCO, Japan's RCC, and Thailand's TAMC have, on average, acquired their NPL portfolios at 36 percent, 7 percent, and 35 percent of face value, respectively – all based on formalized valuation methods. The actual or expected recovery price exceeds the transfer price in each of these countries, thus establishing the public AMCs as profit-making entities and incentivizing them to maximize resolution potential. Moreover, KAMCO's put provision to financial institutions and the TAMC's profit/loss-sharing arrangement with financial institutions (see footnote 24) allowed them to transfer some of the loss burden back to the banks, should the NPLs be lower in quality than envisioned. Such mechanisms are unprecedented in China.

IV.b.iv. Poor Corporate Governance and Transparency at the AMCs

As state-owned non-banking financial institutions, China's AMCs answer to a multitude of political agencies whilst attempting simultaneously to act as commercial entities. Members from the CBRC, the Ministry of Finance, and the China Securities Regulatory Commission sit on the Supervisory Board of the AMCs, all with separate agendas. Perhaps the most controversial matter regarding corporate governance at the AMCs is the fact that the President of the four SOCBs also serve as the Party Secretary – a key position – at each of the four corresponding AMCs (Fung and Ma 2002). This intertwining relationship between the banks and the AMCs points to the lack of independence of the AMCs, and may have attributed to the slow pace of NPL recovery.

The degree of information transparency among the AMCs is also deficient, especially compared to the Korean and Thai AMCs. While two of the larger AMCs, Cinda and Huarong, regularly publish press releases and disclose some information on NPLs available for sale on their websites, the other two AMCs' English websites are loaded with missing or outdated information. In contrast, KAMCO and TAMC publish annual reports in addition to providing regular updates on their websites (Fung et.al. 2004).

Unlike KAMCO and TAMC, the Chinese AMCs are exempt from external audits by independent parties. Thus, corruption and inadequate controls are a widespread problem at the AMCs, similar to their banking counterparts. According to a recent press release by IFR Asia (2005), the Chinese National Audit Office has uncovered 38 cases of illegal practices at each of the four AMCs – involving assets totaling approximately RMB 6.7 billion. Industry insiders believe that such practices included "collusion, insider trading, connected transactions, improper appraisal processes, fraudulent bidding and auction processes, lack of internal controls, embezzlement and mismanagement of assets."[28] The AMCs are currently under investigation from the National Audit Office, the CBRC, and the PBOC.

IV.c. Measures to Narrow the Gap

While there is little that can be done to upgrade the quality of its NPLs, the government has realized that it could undertake other proactive measures to improve the recovery speed and rate of its NPLs. Over the last two years, China has started making progress towards reforming its legal framework, rationalizing NPL transfer pricing to AMCs, and revamping the cultures at its AMC.

IV.c.i. Legislative Reform

A redraft of the *Enterprise Bankruptcy Law* has been in the works, on and off for the last ten years. In October 2004, a second version of the law was submitted to the Standing Committee of the National People's Congress, and is expected to be passed in 2005 after a third reading. The new law represents the Chinese authorities' willingness to move towards

---

[28] "China's AMCs at the Crossroads," *IFR Asia*, February 16, 2005.

international standards and cast some transparency on the worst-case scenario for NPL investors. In fact, many of the provisions are similar to those found in the United States' Bankruptcy Code (Jones and Culler 2005). PwC's report *China's Proposed New Bankruptcy Law: The Practical Implications* (2004) outlined the following categories where the proposed bankruptcy law breaks new grounds:

- *Scope of Application:* The law applies to all types of legal enterprises, including private, state-owned, and foreign investment enterprises. This was a significant improvement from the 1986 *Enterprise Bankruptcy Law*, which applied exclusively to SOEs.
- *Nature of Bankruptcy Test:* While the new law recommends both the cash flow insolvency test and balance sheet insolvency test to support a bankruptcy petition, it also proposes that a creditor could file for involuntary bankruptcy on behalf of the debtor if the debtor fails to repay its debt obligations. This implies that a cash flow test – typically more indicative of the debtor's true solvency – could suffice for the creditor to file a petition.
- *Determination of Administrator:* The law tightened the qualifications for the administrator, a trustee assigned to manage the debtor's assets and oversee the liquidation/reorganization process. Although the People's Court makes the initial appointment, the administrator will report to a creditors' commission, which has the power to remove the trustee or withhold fees from the administrator, if unsatisfied with the trustee's actions (Jones and Culler 2005). This contrasts with the current process, whereby bankruptcy procedures are administered strictly by government

officials. The creditors' rights to oversee and if necessary, to replace the administrator will clearly give them more confidence in the bankruptcy process.

- *Penalties for Foul Play:* The law provides for the application of "avoidance powers," i.e. the administrator can revoke payments made by the debtor within six months prior to the commencement of the bankruptcy case, if the debtor entered into the transactions with the knowledge that it might damage other creditors' rights. Debtors, administrators, or members of the creditors' committees can also be subject to fines and criminal prosecution for negligence or deliberate offense.
- *Priority of Payments*: The new law clarified the priority of payments in the following order: bankruptcy estate expense, secured property claims (up to the value of the collateral, with the remainder being treated as a common claim), labor claims (including salaries, social insurance and other fees), taxes, and common claims (Jones and Culler 2005).
- *Provisions on Reorganization*: The new law established a new chapter on reorganization procedures, covering the application process, examination and approval of the application, business operations during the interim period, and reorganization plans. The administrator has the exclusive right to propose a reorganization plan within six months after the commencement of the bankruptcy case. All creditors who declare a claim are entitled to vote on a proposed plan, the approval of which requires the vote of at least two-thirds of the dollar claims in each class, and more than half of the creditors in each class – similar to the U.S. bankruptcy code stipulations.

While the proposed bankruptcy law has taken huge strides on a variety of issues including reorganization and administrator designation, it is not without its problems. First, given the untested nature of many provisions, it is yet to be seen whether the law could be successfully implemented in a society where local political forces have overwhelmingly impacted the bankruptcy process in the past. Second, as PwC's December 2004 report pointed out, the People's Court is burdened with too many roles that will test its technical expertise and human resource capacity, especially when numerous clauses are still subject to interpretation. Third, the new *Enterprise Bankruptcy Law* does not apply to all companies. It excludes about 1,800 of the nation's largest SOEs in select sectors, which will continue to undergo "policy-oriented bankruptcy" within the next three to five years, according to PwC's report *China's New Bankruptcy Law: The Start of Something Big?* (2004).

IV.c.ii.Fair-Value NPL Transfer to AMCs

The requirement for AMCs to purchase NPLs at book value underwent alteration for the first time in 2004. In July 2004, Cinda AMC beat out the other AMCs in winning an auction to purchase RMB 278.7 billion of NPLs from CCB and BOC, paying 50 cents on the dollar and promising to recover 33 to 34 cents on the dollar by the end of 2005, according to PwC's *NPL Asia* report (2004). Cinda also won an auction to buy RMB 41.4 billion of NPLs from Bank of Communications, the fifth largest bank in China, at 50 percent of book value[29]. The promised recovery value for that deal was 30 percent to 40 percent. While the transfer pricing remains high and will likely exceed the ultimate recovery value – as indicated by Cinda's promised recovery prices – this migration away from mechanical book

[29] "Cinda to Buy Bank of Communications' Bad Loans at 50% Discount," *Business Daily Update*, July 12, 2004.

value pricing implies the government's willingness to draw the line between pure recapitalization and NPL carve-out, and is a right step towards providing the proper incentives to AMCs. The Chinese government is also providing cash incentives to AMCs for maximizing returns and accelerating recovery rate, which should further help increase the commercial orientation of these entities.

IV.c.iii.Revamping of AMC Cultures

The Chinese government encourages AMCs to partner with foreign investors and advisors with substantial expertise in management of distressed assets. Through its first large-scale NPL auction, Huarong AMC formed two separate joint ventures with Morgan Stanley and Goldman Sachs, respectively, to collect, manage and dispose of NPLs. The investors paid an initial price of about 10 percent of book value for the assets, and the joint ventures agreed to share the remaining proceeds from the sale of loans. The joint ventures gave Huarong the valuable opportunity to learn from distressed asset specialists, while enabling the AMC to ultimately recover over 20 percent of book value on the NPLs. Cinda AMC formed similar joint ventures with Deutsche Bank and Lone Star, a U.S.-based distressed asset fund. The two AMCs also engaged international advisors Ernst & Young and Deloitte & Touche to assist in its activities, while all four AMCs retained KAMCO to explore asset-backed securitization opportunities.

The TAMC's ability to restructure over Baht 700 billion of NPLs in just two years was largely attributable to its superior legal power in amending debt terms, foreclosing on assets, and reorganizing. Since it will take some time for the new bankruptcy law to be in place and fully functional, the Chinese government should create a special decree for the four

AMCs to override the current legislations. The new decree should award the AMCs with special legal powers, similar to those given to the TAMC, to enforce their creditor rights in a speedy manner.

V. NPL Resolution Methods

The Chinese AMCs have primarily adopted the following recovery methods: debt-for-equity swap, restructuring of debt terms, debt collection, sale or lease of real property, direct sales of packaged or individual NPLs, and securitizations. The banks themselves have also applied some of these measures in resolving their NPL portfolios, although they face much tougher regulatory restrictions, such as prohibition from selling loans at below book value.

V.a. Debt-for-Equity Swap

V.a.i. Background

In 1999, the Chinese government decided to implement a debt-for-equity swap program for large and medium-sized SOEs where it deemed that growth opportunities existed. This action wiped out the debt obligation of a SOE to its bank and substituted it with the equity ownership of the AMC(s) that took over the NPL in question from the bank. AMCs would then be entitled to dividends and subsequent share repurchase from the SOEs at agreed-upon prices within ten years (Fung and Ma 2002), should the latter ever become profitable. Furthermore, local governments were often required to guarantee that the AMCs get first priority in exiting their equity stake through public listings or a change of control event. In addition to the AMCs, the banks themselves have also converted some of the

NPLs into equity, although the exact amount is unclear.

To date, around 580 SOEs converted more than RMB 400 billion of debt into equity rights held by the AMCs. The short-term result of the program appears impressive. The SOEs' average indebtedness decreased from 73 percent in 1999 to 50 percent of total capital in 2000, and 80 percent of the companies turned a profit during the year (Ye and Zhai 2001). However, these figures were largely a result of the pure conversion of debt to equity and the termination of interest payments. The new equity stakes that the AMC inherited could remain worthless under a new capital structure, if it is not accompanied by an improvement in the fundamentals of the SOEs.

V.a.ii. Effectiveness

One major debate with the debt-for-equity swap scheme is whether it would ultimately improve the financial health of the SOEs over the long term. The 580 SOEs that underwent the financial restructuring were handpicked by the State Economic & Trade Commission and subsequently approved by the State Council, the Ministry of Finance, and the central bank (Pierce and Yee 2001). Given the lack of transparency in the qualification process, many question whether political influences may have outweighed commercial judgments in certain instances.

One of the measuring sticks of the debt-for-equity swap program is the level of improvement to corporate governance standards at the SOEs. Historically, high-level decisions at such companies have typically been handed down by an individual or a bureaucratic entity. Some SOEs established a Board of Directors to govern the decision-making process after undergoing the debt-for-equity swap. As members of the

Board, AMCs were then able to exert real influence over the company's operations and potentially manage to turn the company around over the long term. One of the SOEs that made such progress was Xingang Steel, a subsidiary of the Capital Iron and Steel Company, which reincorporated as a limited liability company after the debt-for-equity swap. Three AMCs, Huarong, Cinda, and Orient received nearly RMB 3.6 billion of debt-equity stock rights, controlling approximately 47 percent of the company together. Xingang earned a profit of RMB 10.1 million in 2000, and Huarong, a 39 percent shareholder, was able to retrieve equity of RMB 44.5 million and receive a dividend totaling RMB 1.5 million during the year[30].

While corporate governance standards have improved at some of the SOEs, most experienced limited changes of substance following the debt-for-equity-swap, especially when the AMC became the minority instead of the controlling shareholder at the restructured SOEs. An example was Fu Shun Special Iron (Group) LLC which, despite its reincorporation and a 26.2 percent equity transfer to three AMCs, continued to operate without a Board of Directors and under the sole discretion of the Company's President (Ye and Zhai 2001). Fu Shun's restructuring appears to be a mere formality, and the debt-for-equity swap did not improve the chance of ultimate cash realization for the AMCs through dividends and/or equity repurchase. Thus, unless the debt-for-equity swap program fundamentally improves the operation of a SOE, this measure is merely a mechanical fix to the capital structure, and will have little impact on cash recovery over the long-term.

---

[30] "Debt-to-equity Swap Brings Economic Results to Steel Firm," *People's Daily*, June 7, 2001.

V.a.iii. Exit Options

For the Chinese AMCs and banks, there are three exit options for debt-for-equity shares: direct sale to investors, IPO listing, and equity buyback by SOEs. The timing and likelihood of the latter two options are highly uncertain, while a direct sale to investors is the fastest way for the AMCs and banks to convert their equity rights into cash. Based on public news releases and my discussions with various parties, however, there have been relatively few transactions of direct sales of debt-for-equity shares to investors[31]. Conceivably, this is because investors typically aim to realize their investments within a short period of time, an unlikely scenario for completely uncollateralized equity shares. Purchasing equity rights will also require the investor to take on the active day-to-day management of the company, given the limited protection for passive investors (Lawrence and Yee 2001). Lastly, the dearth of equity rights transaction to date may point to the likelihood that investors have little conviction in the quality of the companies approved to undergo the debt-for-equity swap. According to PwC's *NPL Asia* report (2004), China Construction Bank is planning to hold an auction of debt-for-equity interests, with an estimated book value of RMB 46 billion ($5.6 billion). The success of this auction may provide further insight into the likely value that investors place on debt-for-equity shares.

[31] One of the exceptions was Cinda AMC, which sold a majority debt-for-equity stake in a power plant in Anhui province to American Alliant Energy International Ltd. in 2001 ("Alliant Energy Takes Over Debt-Ridden China Power Plant," *Dow Jones International News*, April 20, 2001). In 2002, China Development Bank, one of China's three policy banks, worked with UBS Warburg to manage and dispose of RMB 40 billion of debt-for-equity shares ("Banks Cooperate to Swap Debt Into Equity," *China Daily*, April 6, 2002). However, an inside source revealed that only 30 percent of the equity was transformed from NPLs, while the remainder consisted of secured and profit-making assets.

V.b. Other Restructuring/Liquidation Methods

V.b.i. Background

Aside from direct sales and securitizations – to be analyzed next – the main NPL disposition methods adopted by the AMCs include debt collection, sale or lease of real property, restructuring of debt terms, and bankruptcy settlement.

Despite antiquated bankruptcy legislations dating back to the 1980s, approximately 70,000 enterprises have gone bankrupt by the end of 2004 (PwC December 2004). So far in China, bankruptcy usually means liquidation, and was mostly "policy-directed." Through April 2004, the Chinese government has closed approximately 3,500 insolvent SOEs, allocating about $6 billion to SOE bankruptcy subsidiaries, financing the settlement of laid-off liability relating to 6.2 million workers, and writing off about $27 billion of bad loans (PwC December 2004). Small and medium-sized enterprises (SMEs) have taken the full brunt of these ownership transformations, in accordance with China's 1999 4th Plenum Decision to "let go" small SOEs and "grasp" large SOEs (Mako and Zhang 2003).

V.b.ii. Major Issues

One of the main obstacles that AMCs encountered in their debt collection efforts is created by their own status as SOEs. A manager at Orient AMC was quoted as saying: "We go to a SOE and they say: 'I am state owned, you are state owned. I don't have to pay you back because we are brothers.' They always try their best to dodge the affair. With foreign investors, although it will still be difficult, it will be different." (Cockerill 2002) Another impediment is the AMCs' inability to seek remedy when companies reneged on the debt restructuring contracts they entered into – a recurrent phenomenon. According to Zhang

(2004), as many as thirty percent of total contracts were breached for Huarong, and about 50 percent of total contracts were breached for Orient and Great Wall. This problem can be alleviated if the Chinese government awards the AMCs special legal powers to foreclose on assets immediately, as soon as a SOE reneges on a restructuring contract.

When it comes to bankruptcy, the proceedings in China have often been subject to political manipulation. In order to evade their debt obligations, solvent companies were able to set up new entities, transfer all of their assets into the new company, and then declare bankruptcy on the original shell, which has been stripped free of any assets. Companies have also misappropriated assets in other types of fraudulent insider transactions prior to declaring bankruptcy. Orient AMC, for example, reported in April 2001 that SOEs had evaded about RMB 12 billion worth of debts through such methods (Lawrence and Yee 2001). Frequently, local governments were in collusion with such firms, and creditor rights have too often been set aside in the bankruptcy process, manipulated by liquidation committees usually consisting solely of governmental officials. This was evidenced in the largest bankruptcy in China since 1949 – that of Guangdong International Trust and Investment Corp. (GITIC) in 1999.

V.b.iii. Case Study – GITIC

Until its bankruptcy, GITIC was the second largest investment trust corporation in China, with assets exceeding RMB 20 billion at the end of 1996 (Shih 2003). It was also one of the first major financial institutions to issue bonds overseas. The company's loans and investments were extremely diverse, ranging from MacDonald's restaurants in Guangdong to stock brokerages to the Guangdong Exhibition Center, with projects extending to other countries including the U.S. and Australia. GITIC was headquartered in the tallest building in China at the time – the 63-story Guangzhou International Building, a five-star hotel, office and residential complex also owned and operated by the company.

Due to overextended real estate investments and misappropriation of funds, GITIC became insolvent. When the company filed for bankruptcy in January 1999, it owed RMB 46.7 billion ($5.6 billion) of debt to 494 domestic and international creditors. Eighty percent of this amount was owed to international creditors (Shih 2003). However, the bankruptcy court recognized only about $2.4 billion of the claims against the company (Mitchell 2003). As of 2003 – following four years of bankruptcy proceedings – the creditors received only about $300 million, or 12.5 percent of the $2.4 billion.

Bottini's 2003 article revealed a few controversial issues emerging from the bankruptcy process that undermined creditors' – in particular foreign creditors' – confidence in the Chinese bankruptcy system. First, creditors, even the largest ones, were unable to obtain a list of the parties with claims against the bankrupt estate. Many of these creditors on the list were other SOEs. GITIC's liquidation committee argued that such SOEs would experience difficulties in borrowing from state banks, should the list be made public. Ironically, this argument was directly opposed to the commercial orientation that the banks are supposed to adopt. Ultimately, the creditor list was released, yet only after the bankruptcy court had already confirmed the list of claimants. At that time, none of the creditors had the opportunity to challenge any of the claims. To date, the identity of Guangzhou International Building's buyer still remains a secret to many overseas creditors.

Second, GITIC's liquidation committee refused to disclose the details of specific assets, including assets that other companies owed to GITIC. Many of these debtors were also other SOEs. The confidential arrangement effectively prevented creditors from challenging any special status for specific assets.

Lastly, even though many of GITIC's loans and investments were guaranteed by local governments, the Bankruptcy Court voided all of these guarantees on the basis of illegality. The court did order the governmental entities to pay 50 percent of total liability based on a "reliance type theory." (Mitchell 2003) However, most of these organizations declared inability to fulfill these obligations, which remain unpaid to date. The total unpaid government compensation fees amounted to $360 million, which if paid, could have brought the recovery rate to 30 percent for creditors (Mitchell 2003).

The lack of transparency in the GITIC bankruptcy case revealed the urgency for the enactment of the new bankruptcy law and the involvement of qualified trustees untainted by political agendas to oversee the liquidation process. Hopefully, under the new law, creditors' rights could be strengthened by their ability to oversee and if necessary, reappoint the administrator.

V.c. Direct Sales to Investors

V.c.i. Background

The direct sales of NPLs to investors generally take two forms: sales of individual assets and bulk sales, including negotiated sales and auctions. Assets available for sale include debt, equity (converted from debt), and real property, i.e. assets that banks seized from debtors as settlement. Sales of debt rights are the most frequent type of transaction, followed by settled assets and to a lesser extent, equity rights. Investors profit from the difference between the purchase price and their ultimate recovery price, typically through either negotiated settlements with the debtor or sales/transfers to a third party. Some investors manage to foreclose on assets backing the loans, although this is much more difficult due to legal and bureaucratic restrictions.

The primary benefit of the direct sales method is immediate liquidity to the bank or the AMC, somewhat at the expense of lower recovery value – a phenomenon demonstrated in other countries such as Korea. Investors, in particular international ones, are showing strong interest in China's distressed assets, as other Asian NPL markets (such as Korea and Japan) have matured and the Chinese government opened up its huge NPL market. However, to date only about US$6.6 billion of NPLs were sold to foreign investors, representing a tiny fraction of the US$500 - US$650 billion in total NPAs. Table 7 provides a summary of direct NPL sales to foreign investors. Sales to domestic investors, in comparison, are not well publicized. Upfront recovery value typically ranged between 7 and 15 percent, or about 10 percent on average for reported transactions, although the AMCs may be able to recover additional value through JV arrangements. The two transactions with the highest recovery rates (around 34%) are both collateralized by real estate assets.

Table 7

Direct NPL Sales to Foreign Investors

AMC/ Bank	Year	Asset Nature	Geography	Book Value	Sale Value	Recovery/BV for the Seller	Sale Type	Investor(s)
Cinda	2001			$145MM (RMB 1.2 Bn)			Negotiated	Chenery Associates
Orient	2001		Harbin	$217MM (RMB 1.8 Bn)	$21MM upfront	10% upfront (50% JV after)	Negotiated	Chenery Associates
Orient	2002		Yanjiang	$210MM (RMB 1.7 Bn)			Negotiated	Chenery Associates
Huarong	2002	Debt rights, 60% secured /guaranteed		$1.3 Bn (RMB 10.8 Bn)	RMB 877.5 MM upfront	8.125% upfront (exp. 21% recovery)	Open Auction	Consortium led by Morgan Stanley
Huarong	2002	Debt rights, 60% secured /guaranteed		$240MM (RMB 1.97Bn)	RMB 197 MM upfront	10% upfront (exp. 21% recovery)	Open Auction	Goldman Sachs
BOC (Cayman)	2003			$1.8 Bn (RMB 14.9 Bn)			Open Auction	Citigroup
Huarong	2004	Debt rights, 40% secured /guaranteed		$2.2Bn (RMB 18.4 Bn)		7 – 15% upfront (Huarong retained some interest through JVs)	Open Auction	Morgan Stanley, Citigroup, UBS, Goldman Sachs, JP Morgan, Lehman, Ao Yi Er (domestic)
CCB	2004	Settled Assets (Real Estate)	160 assets over 18 provinces	$513MM (RMB 4.2 Bn)	$178MM (RMB 1.5 Bn)	34.75%	Open Auction	Morgan Stanley, Deutsche Bank
Total Closed				**$6.6 Bn**				
CCB	Signed 2003	Debt Rights		$524MM (RMB 4.3 Bn)		70% sold to MS, 30% JV	Closed Auction	Morgan Stanley
Huarong	Signed 2004		Wuhan	$215MM (RMB 1.8 Bn)			Closed Auction	Morgan Stanley, GE
Great Wall	Signed 2004		Guangdong	$281MM (RMB 2.3 Bn)			Negotiated	Citigroup
Great Wall	Signed 2004			$1 Bn (RMB 8.3 Bn)				Goldman Sachs
Great Wall	Signed 2004	Unsecured Debt Rights	Guangdong	About $140MM	About $14 – 15MM	10 – 11% (unofficial)	Auction	1 Domestic, 1+ Intl. Buyer(s)
Orient	Signed 2004		180 firms in Harbin	$290MM (RMB 2.4 Bn)			Open Auction	CSFB
Cinda	Signed 2004	Debt rights Backed by Real Estate	Tianjin	$29.7MM (RMB 246MM)	$10.2MM (RMB 85.1MM)	34.6%	Open Auction	1 Domestic, 1 Intl. Buyer
Total Closed/Signed				**$9.1 Bn**				

Sources: PwC China NPL Investor Survey 2004, PwC NPL Asia Report 2004, EIU Country Finance China (2004), and AMC website releases.

A spur of NPL transactions were closed or signed in 2004, pointing to an acceleration in activity on the supply side. During the year, Cinda AMC acquired RMB 278.7 billion ($34 billion) of Category IV or "doubtful" NPLs from BOC and CCB, as well as RMB 41.4 billion ($5 billion) of NPLs from Bank of Communications. These NPLs, unlike the policy-oriented bad loans transferred to the four AMCs in 1999, are from the post-1995 years and are likely to be more attractive to investors in terms of quality. Cinda has already announced plans to market RMB 21.5 billion ($2.6 billion) of NPLs from its newly acquired portfolio. As many as 46 per cent of the tranche carries guarantees, and another 40 per cent is secured[32]. This total proportion of guaranteed or secured loans is much higher than that the proportion in either of the Huarong auctions (40 to 60 percent of total loans).

The demand for NPL transactions from foreign investors also held its ground. The early movers, Morgan Stanley and Goldman Sachs, closed or signed several NPL transactions in 2004 following their participation in the two Huarong auctions. Deutsche Bank management announced that the bank expects to spend about US$1 billion on NPL purchases over the next three to five years[33]. In addition to direct loan purchases, foreign investors adopted other creative measures to penetrate the Chinese NPL market. Citigroup, for example, paid HK$845 million in 2004 to take a 16.4 percent equity stake in Silver Grant International Industries – an active, Hong-Kong based buyer of China's distressed debt with close connections to Cinda AMC[34] (Cheng and Miller 2004). The U.S. bank became the

---

[32] "Cinda Pondering Massive NPL Sales," *Business Daily Update*, February 1, 2005.
[33] "Deutsche Bank Plans NPL Outlay," *South China Morning Post*, September 1, 2004.
[34] In September 2004, Silver Grant set the record of purchasing RMB 56.9 billion of "Category V" (lowest quality) NPLs from Cinda at only 1.5 cents on the dollar, with more than half of the purchase funded through a convertible note and the remainder in cash (Elliot Wilson, "Silver Grant Sees Gold in Bad Loans," *The Standard*, November 9, 2004). Silver Grant acts as a NPL middleman, purchasing NPLs from banks and AMCs, packaging them and reselling them to third-party investors.

second largest stakeholder in Silver Grant, behind Cinda which still owns 18.8 percent of the company. According to a managing director at Citigroup, this joint venture with Silver Grant will provide Citigroup with "a platform to better understand underwriting, modeling and acquiring nonperforming loans in China." (Cheng and Miller 2004)

V.c.ii. Attractiveness to Investors

China's NPLs can be extremely attractive to investors, despite their lower quality compared to assets in Korea and Thailand. First, given the newness of the market, analyses of the true value of NPLs are scarce. Investors willing to spend the effort and funds on due diligence have the prospect of purchasing the loans cheaply, sometimes at even pennies on the dollar, while gaining valuable understandings of China's NPL market. The first landmark NPL transaction in China was an auction held by Huarong AMC in 2001. Huarong sold RMB 10.8 billion of NPLs to a consortium led by Morgan Stanley at only 8.125 percent of face value. This transaction is expected to yield a cash recovery rate of above 20 percent[35], which would imply a gross return in excess of 100 percent for Morgan Stanley (Li 2005). Even taking into account the considerable due diligence, asset appraisal, legal, loan monitoring, office rental, and other fees, investors are still able to yield healthy post-tax returns. Additionally, Morgan Stanley was able to obtain lending of about 30 percent from International Finance Corporation (Li 2005), thereby defraying its upfront cost and further maximizing the returns on its own capital. According to a banker at Goldman Sachs, Goldman also generated a venerable profit of $50 million on a $16 million investment

[35] As of year-end 2004, about 75 percent of the NPLs in the portfolio have been resolved, yielding a cash recovery rate of 19%.

over a two-year period from the same Huarong auction (Slater 2005).

The purchase of NPLs creates special attraction to foreign investors, who still face substantial regulatory limitations in direct lending to Chinese companies. Both analyst reports and my conversation with Bednar confirm that foreign investors see an important first-mover advantage in entering China's NPL market ahead of competitors, both in terms of understanding the financial and legal aspects of a distressed asset purchase and gaining favorable access to future transactions. This is a replay of Goldman Sachs' story in Korea. Goldman made substantial returns on its investments by entering the Korean NPL market early – at a time when other investors hesitated due to the untested nature of corporate guarantees. When its competitors finally decided to test the market themselves, Goldman relied on its advantage of a steeper learning curve to win four auctions in a row (Cockerill 2002). There are further investors that hope to capitalize on a potential revaluation of the RMB to higher levels, which may lead to an appreciation in the NPLs.

Second, certain non-performing loans originated from suspended projects after they ran out of funding. When these projects are secured by real estate collateral, NPL investors may benefit from property price increases, especially in coastal areas such as Shanghai, where real estate prices have escalated in recent years. For example, through the Huarong auction in 2001, Goldman Sachs acquired a loan collateralized by a piece of land in Pudong, Shanghai – a project that had been suspended since 1995. The value of the land soared in 2002, enabling Goldman Sachs to recoup its entire investment in the Huarong transaction through the sale of the land (Li 2005).

Third, certain NPLs are guaranteed by related corporate entities and local governments, providing the potential for investors to negotiate a settlement price with the borrower and their guarantor that is below their acquisition price. Both Bednar and Young noted that their firms had considered guaranteed loans on a case-by-case basis, requesting in each transaction a thorough understanding of the relationship of the parties involved as well as the strength of the guarantee. According to Bednar, Morgan Stanley valued cases where important corporate relationships existed and preferred to invest in subsidiaries whose existence is of vital importance to their parent companies. Danny Bao, a partner of a small NPL fund, Shanghai Global Partners Fund, also expressed great interest in a loan 70 percent guaranteed by a local government. However, thorough due diligence of such relationships is crucial, since guarantees by local government are not always honored, as demonstrated in the case of GITIC.

Fourth, profit sharing arrangements and JV structures between the foreign investors and the AMCs create a "win-win" situation for both parties. On the one hand, the AMCs are able to learn from foreign investors with distressed asset management expertise in the Asian region, while retaining some economic interest in the NPL transaction. On the other, foreign investors gain assurance that their JV partners would help them with the debt collection process in a market where legal enforcement of creditor rights remains largely undefined.

V.c.iii. Main Obstacles to Foreign Investors

Both Bednar and Young noted that the lengthy regulatory approval process, the nebulous legal protection for investors, and the poor transparency of loans are among the biggest challenges to NPL investors. Various press releases and papers confirmed these claims.

V.c.iii.1.Protracted Regulatory Approval Process

At the very beginning, the cumbersome, multi-tiered government approval process has hindered transactions from closing quickly. As a result, the first landmark NPL auction held by Huarong AMC in 2001 did not close until 16 months after its signing. However, NPL investors are hopeful that the approval process is accelerating as the government remains committed to opening up the market. For instance, Huarong's second auction of an even larger scale was approved within 11 months to slightly over a year after signing for various parties. CCB's JV transaction with Morgan Stanley[36], on the other hand, was signed in July 2003, yet still has not been approved. A potential reason is that current regulations expressly prohibit state banks from selling NPLs directly to investors below their book values. As regulatory policies are silent on settled assets, CCB was able to complete a sale of RMB 4.2 billion of settled assets to Morgan Stanley and Deutsche Bank in 2004.

V.c.iii.2.Legal Barriers

Due to the lack of foreclosure and repossession laws, foreign investors typically choose to bid on deals whereby they are able to negotiate with the borrower to settle the NPLs at a reasonable price. According to Bednar and Young, both Morgan Stanley and Citigroup have also accomplished exits by transferring assets backing the NPLs to interested third parties. Foreign investors usually avoid the need to foreclose on assets due to the untested nature of the legal system. Similarly due to weak bankruptcy legislations, foreign

[36] In July 2003, CCB agreed to sell RMB 4.3 billion of debt rights to Morgan Stanley. Seventy percent of the book value was an outright sale, whereas both parties will resolve the remaining 30 percent of assets together in a joint venture (Sun 2004).

investors have rarely been involved in any restructuring of debtor companies, although Young noted that restructuring might be the "next step" as the legal environment improves and the AMCs start to auction off NPLs from higher quality companies. Foreclosure and restructuring efforts should be aided by the promulgation of the new bankruptcy law expected in 2005, although enforcement of the law in practice will be the real key to stimulating new interest in the NPL portfolios.

V.c.iii.4.Asset Transparency

According to Bednar, information on NPL obligors' loan documents and payment history are obtainable from the AMCs. However, the information is more limited compared to those seen in developed economies, and even though they might be from official sources, extensive due diligence is necessary to gauge the true value of the loans. The collateral nature and location of the debtors are crucial to getting the investors comfortable with a transaction. For example, compared to small towns in inland areas, the information provided for debtors in coastal, economically developed cities such as Shanghai and Guangzhou tend to be significantly more transparent. Court systems are also substantially more advanced in coastal areas and creditor rights are easier to enforce.

China's current bankruptcy law places employee liability as top priority, ahead of creditor rights. Hence, NPL investors are liable for laid-off employee liability for up to three years. Bednar and Young both confirmed that they always factored the calculation of expected laid-off employee liability into their NPL valuation. Another factor that could lower the NPL values is the conversion of allocated land-use rights. Historically, the Chinese government has awarded certain SOEs with land-use rights to carry out specific infrastructure projects. An NPL investor wishing to convert the land for other commercial purposes would have to pay a fee of 20 to 40 percent of leasehold value to the government (Peiser and Wang 2002). This fee will again be incorporated into the NPL valuation, further lowering the pricing that an investor could offer.

V.c.iii.5.Hefty Fees

Li (2005) illustrated the hefty fees in NPL transactions through an example of Goldman Sachs' purchase of approximately $240 million in NPLs from Huarong's second auction in 2003. The purchase price of the assets is estimated at roughly 10 cents on the dollar, or about $24 million. The expected recovery price for the NPLs of 20% implies a gross return of about 100%, or $24 million for Goldman. However, miscellaneous fees, expenses and taxes (Table 8) reduced the value of the net profits to about $13 million, implying a 56% return. This rate of return is no doubt still an admirable accomplishment for Goldman Sachs. However, this example is sufficient to illustrate that the hefty pre- and at-purchase expenses for NPL auctions are sufficient to scare away any investors without deep financial pockets.

Table 8

Breakdown of Fees and Expenses for Goldman's Huarong II NPL Purchase

	Estimate
Gross Profits	**$24,000,000**
Legal Fees for Loan Document Inspection (on 50% of Huarong II's NPL Portfolios) [a]	500,000
Asset Appraisal Fees (on Secured and Guaranteed NPLs)	250,000
Travel Expenses for Due Diligence	250,000
Total Pre-purchase Expenses	**1,000,000**
Legal Expenses for Drafting of Documents	400,000
Office Rental Expenses	120,000
Loan Monitoring Expenses	200,000
Total Expenses During Purchase	**720,000**
Servicing Fees to Huarong (5% of NPL Book Value)	**120,000**
Total Fees and Expenses	**1,840,000**
Profits Net of Fees and Expenses	**22,160,000**
Distribution of Huarong's Share of Profits Net of Fees and Expenses (Est. 10%)	2,216,000
Goldman's Profits Net of Fees and Expenses	**19,944,000**
Taxes (33%)	6,581,520
Net Profits for Goldman	**$13,362,480**
Implied Net Returns	**56%**

(a) Legal fees for document inspection amounted to about $1,000 for each company. Goldman inspected about 50% of the 1,000 companies in the Huarong II portfolio.

Source: Zhenhua Li. "Are the AMCs Underselling China's Assets?" 21 Century Business Herald, January 10, 2005.

V.c.iv. Importance of Attracting Foreign Investors

PwC's *China NPL Investor Survey 2004* estimates that foreign investors have roughly $10 to $15 billion earmarked for investment in the Chinese NPL market over the next three years. While this figure is significant, I believe that in terms of the pure dollar amount, the contribution from overseas investors is not imperative to China's NPL recovery effort. In fact, the domestic investor base is more familiar with the Chinese market and often does not demand a risk premium for investing in China. As a result, while few press releases cover domestic deals, it is conceivable that such investors are likely to bid a higher price for the assets, especially when they are confident that they could restructure instead of selling/foreclosing on assets to realize value (Slater 2005).

However, foreign financial institutions are the dominant players in auctions, given their deep financial resources and strong expertise in distressed asset management. They tend to be more efficient in the collection process than the AMCs and domestic investors, who are likely to be state-owned and more politically motivated. More importantly, foreign investors' involvement increases the transparency of the NPL sale process and stimulates liquidity in the market. Korea's story testifies to this latter hypothesis. In late 1998, KAMCO first started marketing NPLs to investors. Domestic demand was non-existent then, and only American distressed debt investors participated in the sales (KAMCO 2003). Between 1999 and 2001, KAMCO and the domestic banks created bulk sales transactions targeting foreign investors, and domestic investors finally followed suit in 2002 (KAMCO 2003). Korea's case demonstrates that the early involvement of foreign investors is essential in attracting domestic interest throughout the NPL resolution process. Thus, the Chinese government should continue to reform regulatory processes to facilitate the participation of foreign investments.

V.d. Securitization

V.d.i. Background

Securitization is the creation of securities that are "primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders."

(U.S. Securities and Exchange Commission) In the case of NPL securitization, the securitized receivables are the expected stream of cash flows to be generated from the NPLs. Disparate recovery methods – such as debt collection, liquidation of property, corporate restructuring, and negotiated settlements – still have to be utilized to produce the cash flows in order to service the interest and principal owed to security holders. However, the originators of the NPLs – in this case the banks or the AMCs – are able to recover a portion of the cash recovery value upfront, and may outsource the NPL recovery task to third party servicers.

Since the first securitization of NPLs by Resolution Trust Corporation (RTC) in the United States, this disposition method has played a growing importance in many countries' NPL disposal programs. KAMCO experienced the greatest success among Asian economies, securitizing one-third of its cumulative NPL disposal through the end of 2000[37]. China is increasingly looking to securitization as the next innovative solution to bulk NPL resolution, with various CBRC and AMC executives voicing strong support for the development of this financial instrument.

In the absence of a specific securitization law, securitization projects in China to date have been facilitated by the *2001 Trust Law*, which allows securitization to be completed via a trust structure and enables sellers to retain upside residual benefits. Table 8 summarizes securitization and "quasi-securitization" projects to date.

[37] "Asset Securitization: What did Cinda's Experience Tell Us?" *Finance Daily*, April 20, 2004, from Huarong AMC's website, http://www.chamc.com.cn.

Table 9

Primary Securitization / Quasi-Securitization Projects Overview

Year	AMC/Bank	Securitized Assets	Details
2003	Huarong	RMB 13.3 Bn ($1.6 Bn)	• Repackaged 256 NPLs • Sold only to domestic investors • Two classes of trust certificates: RMB 1.0 trillion of senior trust certificates were issued to investors → recovery rate of about 10%; the subordinated tranche was retained by Huarong • Interest rate on the senior trust certificates: 4.17% • 80% of senior trust certificates have changed hands • Used the Trust Law • Three-year maturity
2004	Cinda	RMB 2 Bn ($240 MM)	• Assets dispersed in ten regions • Engaged Deutsche Bank as servicer • Established offshore SPV to bypass Chinese legal restrictions • Sold to international investors (U.S. and Southeast Asia) • Promised term: three to five years
2004	ICBC	RMB 2.6 Bn ($314 MM)	• Assets in Ningbo • Securitized portfolio included non-performing and sub-performing loans • First securitization project by a commercial bank • Partnered with CSFB • Three classes of trust certificates: Class A Senior, Class B Junior, and residual equity position retained by ICBC • Class A and Class B, both rated AAA per 2 domestic rating agencies and guaranteed by ICBC • 820MM RMB ($99MM) in certificates issued to investors → recovery rate of 31.5% • Marketed only to domestic investors • Used the Trust Law

Sources: Various news releases.

In addition to these completed projects, Cinda is planning to launch a securitized product for its RMB 20 billion worth of bad assets in Guangdong, targeting domestic investors, although its planned first-quarter launch has been delayed due to legal obstacles (LeeMaster 2005). PwC's *NPL Asia* report (2004) also reported that one of the four SOCBs will conduct one to two securitizations totaling RMB 5 to 9 billion ($600 million to $1.1

billion) in the next few months. These transaction(s) are likely to carry a similar trust structure and target domestic investors.

V.d.ii. Advantages

Asset securitization repackages cash flows generated by a diversified loan pool into tradable securities and can target a broader investor base with different risk characteristics. In the early 1990's, the RTC packaged roughly 500,000 loans for securitization, including home mortgages, commercial mortgages, manufactured housing loans, leases and installment contracts on personal property; 71 out of 74 transactions performed well (Peiser and Wang 2002). Given the large size of China's NPL pool and the slow recovery rate to date, securitization could be a great solution, as it allows the pooling of a large number of assets and results in immediate cash recovery for the seller.

Securitization also enables the creation of security classes with different yields and maturity dates. Each tranche has different levels of loss protection and could attract investors with varying risk appetite. Usually, the issued securities are substantially overcollateralized. For example, in the ICBC securitization (Table 9), only RMB 820 million of AAA-rated securities were issued to investors, with the backing of RMB 2.6 billion of assets. The originating AMC or bank typically retains a residual equity position – in ICBC's case over 68% of the securitized assets. Furthermore, the low rate of 3.24% for three-year RMB deposits and the choppy performance of the stock market in China are likely to make this financial instrument extremely attractive to domestic investors. Lastly, as PwC's *NPL Asia* report (2004) points out, securitization allows the seller to retain the residual upside, which may help the AMCs or the banks defend themselves against accusations that they are selling the state's assets too cheaply, a recurring theme during NPL direct sales.

V.d.iii. Challenges

V.d.iii.1.Legal Constraints

The most significant challenge to securitization is the lack of a specialized legal framework in China for the financial instrument. Normally, a securitization has to satisfy all of the following requirements: (a) legal true sale of assets to a SPV with narrowly defined purposes and activities; (b) reliance on the performance of the securitized assets instead of the seller's credit for repayment; and (c) insulation of the SPV's assets from the obligor's potential bankruptcy (Henderson 1997).

Notably, current Chinese laws prohibit the use of a SPV as the securitization vehicle, a restriction that has already delayed Cinda's planned RMB 20 billion securitization project. The *1993 Company Law* requires that net assets of a bond issuer must exceed RMB 30 million ($3.6 million), while the total bond issuance must be limited to 40 per cent of the issuer's net assets. The latter restriction makes the establishment of a SPV virtually impossible, as the only purpose of the SPV is to receive assets and facilitate their securitization.

Instead of using a SPV, two of the three securitization/quasi-securitization projects completed to date (Table 9) used a trust structure facilitated by China's *2001 Trust Law*, which allows the creation of a grantor trust instead of a SPV to hold assets. For example, in the Huarong quasi-securitization (Table 9), Huarong transferred RMB 13.2 billion of NPLs into a grantor trust governed by CITIC; and the trust assigned the entire senior and subordinated beneficiary interests in the assets to Huarong[38]. Huarong then requested the CITIC trust to transfer the senior beneficiary interests in the assets (RMB 1.0 billion) to investors in exchange for cash. Huarong and the CITIC trust issued joint notices to debtors that all the debt rights originally held by Huarong have been transferred to the trust[39]. On an ongoing basis in the future, Huarong will service the NPLs and transfer recovered cash into the trust, which will then pay interest and principals to investors. By retaining the subordinated beneficiary interest, Huarong will keep any cash remaining after the investors are paid in full. The trust structure effectively isolated the securitized NPLs from Huarong's other assets.

A major shortcoming of the trust structure is that the transfer of senior beneficiary interests to investors constitutes a transfer of rights to receivables. It does not guarantee a legal "true sale" of the assets, whereby the investors in the trust are the only ones that hold legal ownership in the securitized receivables, unlike secured lenders to a company that could be challenged in a bankruptcy proceeding. This provision is particularly important because unless the trust holds a perfected debt claim to the assets, a bankruptcy court could decide to prevent the obligor – the original SOE that owned the assets – from paying the trust. The uncertainty of tax and accounting treatment for trusts further complicates asset transfers to securitization vehicles.

V.d.iii.2.Capital Markets and Investor Characteristics

China's debt market is underdeveloped and largely dominated by government bonds

---

[38] "Huarong Net – Huarong's Bold Experimentation in NPL securitization," Huarong website, September 12, 2003.
[39] See supra note 38.

that account for 95 percent of all traded debt (Bottelier 2003). The corporate bond market is extremely small and has historically been reserved for large SOEs. Coupon rates have ranged between 150 and 250 basis points above the 1-year RMB deposit rate (Bottelier 2003). This state of the bond market can be favorable for NPL securitization, as the securities can pay yields comparable to corporate bonds while carrying lower credit risks, if they are properly collateralized by diversified assets and overcollateralized. However, domestic investors are still relatively unfamiliar with the concept of securitization, and further education is important to stimulate sufficient demand for the securitized products.

To complicate matters, Chinese financial institutions and insurance companies require special approval from the government to invest in securitized products, often constituting a *de facto* prohibition from their participation. For example, in the 2004 ICBC transaction (see Table 9), only corporate buyers and high net-worth individuals were able to purchase trust certificates from the bank (Davies 2005).

V.d.iii.3.Credit Enhancement

If the cash flows generated from the NPLs fail to meet the interest or principal obligations on the securities, investors could face a loss. In order to protect investors again such risks, external credit enhancement is necessary in addition to internal collateralization. While third-party bond insurers such as MBIA and Ambac are active in the U.S. and other countries with mature securitization laws, they have not yet gained enough comfort with China’s legal system to provide credit enhancement for securitizations of Chinese NPLs. A possible solution for China is to have the government use its huge foreign exchange reserves

– in excess of $600 billion at the end of 2004[40] – as credit enhancement for the senior tranche(s) of the securities issued by AMCs or banks (Chen 2004).

V.d.iii.4.Lack of Asset Transparency

The value of traditional securitized products, such as credit card and auto loans, can be estimated by statistically extrapolating the historical loss data to forecast the expected probability of default and severity of loss for each loan pool. The cash flows of the NPLs can be extremely difficult to estimate, due to a lack of transparency on historical loss data and the short credit history for consumer loans still in their infancy in China, such as mortgage and auto loans. This substantially increases the difficulty of valuation for investors. Encouragingly, AMCs and banks are gaining proficiency in identifying and collating the historical cash flow data, which will become a vital part of the disclosure in securitization documents. The establishment of consumer credit information services in China will also ease the securitization of non-performing consumer loans.

In his 2004 paper, Chen suggested using the "Changchun approach," the separation of low quality assets from profitable assets, as a precursor to securitization. The Changchun approach originated from a field study by Wang (2000). After negotiations with its major creditor(s), a financially distressed SOE transfers its healthy assets to a new legal entity, also a SOE. The main creditor(s) secure a claim on the assets transferred to the new enterprise, which then utilizes the cash flow stream generated by these assets to repay the original debts owed by the old SOE. When applied prior to securitization, this method has the benefit of isolating the most profitable assets from the distressed assets, which substantially increases

---

[40] "FDI, Foreign Reserves See Huge Balance in China," *Sinocast China Financial Watch*, March 18, 2005.

the transparency of the securitization to investors.

VI. Summary

In this paper I explored China's NPL resolution effort, both from a macro-level in comparison to other East Asian economies and from a micro-level in terms of specific resolution methods. I found that while the resolution progress has been somewhat disappointing to date, the government's commitment to maximizing and accelerating NPL recovery is strong, and bulk disposal activities, which require regulatory approval, have picked up considerably since 2004. In order to overcome the inherent weaknesses of its lower-quality NPLs, China should continue to strengthen its regulatory and legal framework. If the government enacts the following actions, the likelihood of success in NPL resolution would increase significantly:

1. Accelerate the NPL transfer process from banks to AMCs and continue the competitive bidding process among AMCs
2. Allow state banks to sell NPLs below book value to third-party investors
3. Award AMCs with immediate, special legal power for collection, foreclosure, and restructuring
4. Improve the legal framework for foreclosure, liquidation, and reorganization
5. Streamline the regulatory approval process for bulk sales/securitizations and limit the approving party to no more than one or two organizations
6. Create a securitization law to enable the creation of SPVs and true sale of assets; clarify tax and accounting treatment for SPVs/trusts

Among the various disposition methods, debt-for-equity swap appears to have only temporarily solved a capital structure problem for the restructured SOEs. As few market purchases of debt-for equity shares have occurred, it is hard to gauge the ultimate value of the converted equity shares. In order to maximize the speed of asset recovery, China has followed KAMCO's model of adopting a wide variety of resolution methods, with a focus on structuring bulk sales and securitization transactions. Such deals have yielded reported upfront recovery rates ranging from 7% to 35%, largely dependent on the asset nature (real estate vs. less liquid assets) and quality (geographic location, aging, etc.). Various banks and AMCs have successfully accomplished direct NPL sales to domestic and foreign investors, although many transactions were slowed by the protracted regulatory approval process and legal impediments, among other obstacles. Securitization, on the other hand, is being heavily researched and has already experienced successful experimentations despite the lack of a perfected legal structure. Foreign investors have played an irreplaceable role in China's NPL resolution program, both by providing the financial resources and, even more importantly, by contributing their intellectual capital and stimulating liquidity in the domestic market. Given the large NPL portfolio remaining in China's financial system and the inevitable creation of new NPLs from the recent surge in bank loans, it is essential for the government to continue improving the regulatory and legal process to retain foreign participation in the market.

A recurring theme in the resolution process is the difficult situation of the Chinese AMCs, who act as the intermediary between the government, ultimate owners of the NPLs, and investors. Their status as state-owned enterprises obliges them to answer to a multitude of political authorities and promise not to sell the country's assets too cheaply, especially to foreign investors. On the other hand, negotiating prices incessantly with investors slows down the disposition process and gives the AMCs the reputation of holding unrealistic expectations, with the consequence of eventually discouraging investor interest in the NPLs. This problem can be alleviated by the following actions: (a) increase transparency in the NPL sales process to defend against criticisms that the AMCs are under-selling assets; (b) introduce private sector involvement on the Board of the AMCs; and (c) clearly prioritize the objective of maximizing asset recovery value over maximizing the speed of asset resolution, or vice versa.

To the credit of the Chinese government, China is dealing with its NPL problem before a financial crisis hits, unlike the other Asian economies mentioned in this paper. I believe that the country's colossal NPL portfolio is largely a result of historical reasons, and that the governmental authorities are moving in the right directions to conform its financial system to international standards. While the recent buildup of new NPLs due to rapid credit expansion is concerning, the government has again proven its determination to avoid a hard landing. The country's sustainable economic growth, its immense foreign exchange reserves, a closed capital market, and the healthy margin between lending and deposit rates at banks all point to the likelihood that China will be able to circumvent a financial crisis.

REFERENCES

Bottelier, Pieter, "China's Emerging Domestic Debt Markets: Facts and Issues," Discussion Paper for a Conference on Chinese Economic Policy Reform organized by Stanford Center for International Development, Stanford University, September 2003.

Bottini, Thomas, "Bankruptcy Perils in China: The GITIC Tale," Multinational Business Review 115, Volume 1, Issue 1, April 1, 2003.

Chen, Johnny, "Non-Performing Loan Securitization in the People's Republic of China," Department of Economics, Stanford University, May 2004.

Cheng, Patricia, and Matthew Miller, "Deal Propels Citigroup in China Bad-Loan Market," *Bloomberg News*, November 9, 2004.

Cockerill, Chris, "China Puts On a Garage Sale," *Euromoney* February 2002: P. 42 – 49.

Dasri, Tumnong, "Informal Workouts and Insolvency Reform Initiatives to Address Non-Performing Loan Problems in Thailand," The Third Forum for Asian Insolvency Reform, Seoul, Korea, November 2003.

Davies, Rob, "China MBS Becoming a Reality," Asset Securitization Report, Thomson Media, March 7, 2005.

Economist Intelligence Unit, *Country Finance China*, 2004.

Economist Intelligence Unit, *Country Finance Korea*, 2004.

Economist Intelligence Unit, *Country Finance Japan*, 2004.

Economist Intelligence Unit, *Country Finance Thailand*, 2004.

Fung, Ben, and Guonan Ma, "China's Asset Management Corporations," Bank of International Settlement, Working Papers No. 115, August 2002.

Fung, Ben, Jason George, Stefan Hohl, and Guonan Ma, "Public Asset Management Companies in East Asia, a Comparative Study," Bank of International Settlement, Financial Stability Institute, Occasional Paper No. 3, February 2004.

Gao, Peiji, and Paul Kruger, "China Faces Up to the New Challenges of Securitization," International Financial Law Review 19 (2000): P. 29 – 34.

Henderson, John, Asset Securitization: Current Techniques and Emerging Market Applications, London: Euromoney Publication, 1993.

Korea Asset Management Corporation, *Annual Report*, 2003.

Korea Asset Management Corporation, "Korean Experience of Securitization and NPL Disposition," 2003.

Kosolkitiwong, Punjaporn, "The Establishment of the Thai Asset Management Corporation," Dej-Udom & Associates, International Lawyers Network, 2001.

Kynge, James, "Banking Sees Transformation from Chinese Economy's Weakest Link to Tower of Strength," *Financial Times*, November 18, 2004.

Jones, Evan, and Emily Culler, “China’s Draft Bankruptcy Law,” O’Melveny & Myers LLP, February 2005.

LeeMaster, Tim, “Cinda’s Plan to Sell off NPLs Run into Trouble,” *The Standard*, January 13, 2005.

Li, Zhenhua, “Are the AMCs Underselling China’s Assets?” *21 Century Business Herald*, January 10, 2005.

Mako, William, and Chunlin Zhang, “Management of China’s State-Owned Enterprises Portfolio: Lessons from International Experience,” World Bank Office, Beijing, September 2003.

Mitchell, Tom, “GITIC Creditors Left Chasing Millions,” *South China Morning Post*, March 5, 2003.

Mulye, Vishakha, et al, “Valuation of NPLs,” March 2002.

Norton, Patrick, and Howard Chao, “Mergers and Acquisitions in China,” O’Melveny & Myers LLP, April 2003.

Peiser, Richard, and Wang Bing, “Non-performing Loan Resolution in China,” Real Estate Issues 27 (2002): P. 115.

Pierce, David and Lawrence Yee, “China’s Bank Asset Management Companies: Gold in Them Thar Hills?” Topics in Chinese Law, O’Melveny & Myers LLP, July 2001.

Pornavalai, Cynthia, “Thai Asset Management Corporation (TAMC),” Tilleke & Gibbins International Ltd., March 2002.

PricewaterhouseCoopers, *China NPL Investor Survey 2004*, Hong Kong, November 2004.

PricewaterhouseCoopers, *China’s New Bankruptcy Law: The Start of Something Big?* Hong Kong, 2004.

PricewaterhouseCoopers, *China’s Proposed New Bankruptcy Law: The Practical Implications*, Hong Kong, December 2004.

PricewaterhouseCoopers, *NPL Asia*, Issue 4, Hong Kong, September 2004.

Rolnick, Arthur, “Interview with Ping Xie, Director General of the Research Bureau, People’s Bank of China,” Federal Reserve Bank of Minneapolis: The Region 32, Volume 17, Issue 4, December 1, 2003.

Shih, Toh Han, “My Say – GITIC’s Fall – A Cautionary Tale,” *The Singapore Edge*, June 9, 2003.

Slater, Dan, “China’s NPLs Show Rich Pickings,” *Finance Asia*, February 28, 2005.

Sun, Ming, “China Construction Bank Reveals NPA Auction of RMB Four Billion,” *21 Century Business Herald*, June 3, 2004.

Takagi, Shinjiro, “Inauguration and First Stage of the Industrial Revitalization Corporation of Japan,” The Third OECD Forum for Asian Insolvency Reform, Seoul, Korea, November 2003.

Wang, Weiguo, “Changchun Approach: A New Scheme for Debt Restructuring in China,” China University of Politics and Law, 2000.

Wilson, Elliot, “Credit Squeeze Risks Triggering Loans Crisis,” *The Standard*, August 30, 2004.

Vongvipanond, Pairoj, “Thailand’s Post Crisis’s Institutional Change: Corporate Restructuring and Financial Institution Risk Management,” Forum on Asian Insolvency Reform 2004, November 2004.

Ye, Chen, and Qingguo Zhai, “Effect of Debt-Equity Swap on Reform of State-Owned Enterprises from the Angle of Company Management,” School of Business Management, Liaoning University of Petroleum and Chemical Technology, November 30, 2001.

Zafft, Robert, and Lampros Vassiliou, “Policy Implications from the Second Forum on Asian Insolvency Reform,” Informal Workouts, Restructuring and the Future of Asian Insolvency Forum: Proceedings from the Second OECD Forum for Asian Insolvency Reform, December 2002.

Zhang, Peijuan, “Unsatisfactory Recovery Results, Four AMCs in Five Dilemmas,” Huarong AMC website, November 26, 2004.