



FUND OF PROBLEM LOANS
ACQUISITION. MANAGEMENT. SALE.

China's Experience in Resolving Non- Performing Loans

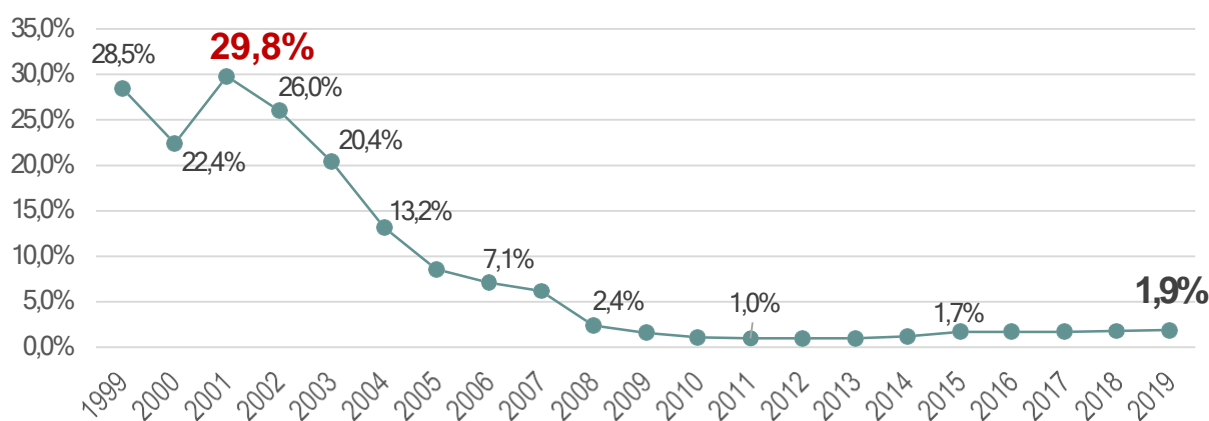
Activities of State-Owned Asset
Management Companies

Prerequisites for the Creation of the Four State-Owned AMCs

Forty years of a planned economy, weak financial performance of state-owned enterprises, and insufficient internal credit risk control in state-owned banks led to an **unprecedented rise in non-performing loans (NPLs) in China's banking sector.**

According to various sources (Lardy, Dai, BBC), by the **late 1990s and early 2000s**, the real NPL ratio in the Chinese banking system **reached 40%**, while other estimates (ADB) put it at **around 30% of total loans.**

Dynamics of the NPL ratio in the total loan portfolio of China's banking system



Source: Asian Development Bank

As a response, in **1999**, the Chinese government decided to establish **four state-owned asset management companies (AMCs)** to acquire and manage **distressed loans** from the **four largest state-owned commercial banks (the “Big Four”)**:

- **China Great Wall Asset Management Co.** – to acquire and manage assets from the **Agricultural Bank of China (ABC).**
- **China Orient Asset Management Co.** – to acquire and manage assets from the **Bank of China (BOC).**

I. Banking Sector Crisis in China

Prerequisites for the Creation of the Four State-Owned AMCs

3) **China Huarong Asset Management Co.** – to acquire and manage assets from the **Industrial and Commercial Bank of China (ICBC)**.

4) **China Cinda Asset Management Co.** – to acquire and manage assets from the **China Construction Bank (CCB)**.

These banks were selected because they accounted for **65% of the total loan portfolio** of the banking system.

It is also important to note that the newly created AMCs were directly **owned by the government, not by the state-owned banks**.

The establishment of AMCs was just **one of a series of ambitious banking reforms** in China. For instance, in **1994–1995**, the Chinese government created **three “policy banks”** to implement government economic policies by **taking over non-commercial lending** from the Big Four banks and financing **government projects**.

In **May 1995**, the **National People’s Congress** passed the **Commercial Bank Law**, providing the **first legal framework** for commercial banking in China.

Moreover, in **1997–1998**, the government **required banks to make lending decisions based on commercial principles** and **partially recapitalized the Big Four banks**.

When established, the state-owned AMCs were **capitalized through the issuance of 10-year bonds** and loans from the **National Bank**.

It was initially assumed that their operations would also be **limited to 10 years**.

However, in **2009**, the bonds were **extended**, and the AMCs’ **mandates were prolonged indefinitely**.

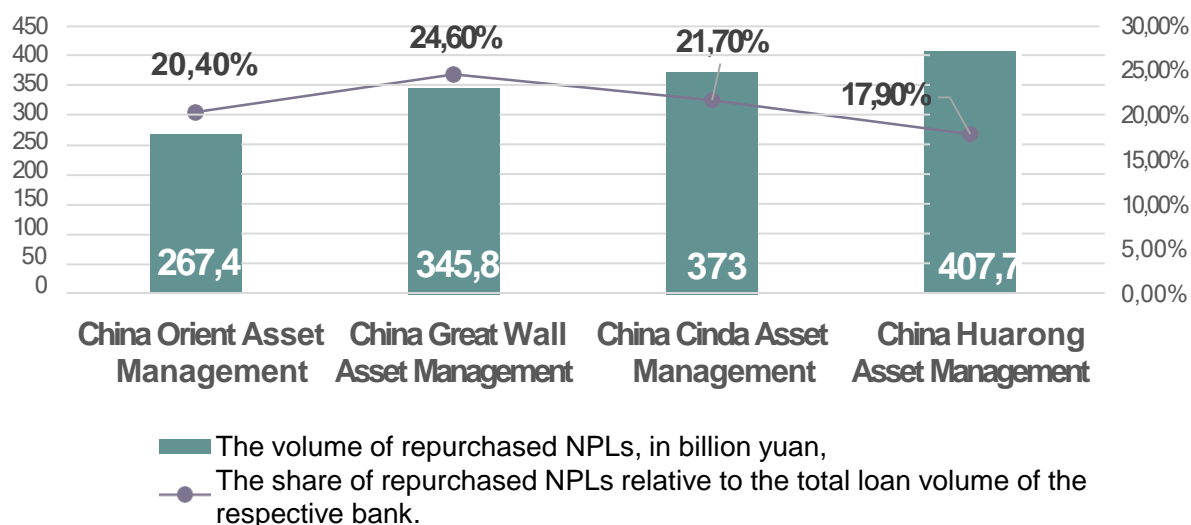
Additionally, AMCs were no longer **restricted to acquiring distressed assets only from the Big Four banks**—they were now **authorized to purchase NPLs from any financial institution**

II. Purchase and Resolution of Distressed Assets from State-Owned Banks

The first transactions for the transfer of troubled loans to state Asset Management Companies (AMCs) began in 1999-2000. The total amount of transferred assets was 1.4 trillion yuan, or 169 billion US dollars, which accounted for more than 20% of the total loan portfolio of banks and 18% of China's GDP in 1998. At the same time, the volume of assets transferred to state AMCs was less than half of the total amount of non-performing loans of the "Big Four" banks.

The repurchase of assets from the "Big Four" state-owned banks was carried out using AMC bonds at face value.

The first AMC transactions for the repurchase of NPLs



The majority of transactions for the disposal of assets repurchased during this period took place in 2001.

The methods used by the four companies to resolve non-performing loans included: • debt-for-equity swaps, • debt restructuring, • loan recovery procedures, • sale or lease of real estate, • direct sale of non-performing loans (in pools or individually), • securitization.

II. Purchase and Resolution of Distressed Assets from State-Owned Banks

One of the debt resolution methods used by AMC's was the Debt-to-Equity Swap Program, which was implemented in 1999 for large and medium-sized state-owned enterprises with growth potential. The program involved the cancellation of the debt obligations of these enterprises in exchange for granting equity stakes in their capital to their creditors – the four state-owned AMC's. As a result, the average debt of state-owned enterprises decreased from 73% in 1999 to 50% of total equity in 2000, and 80% of companies became profitable within the year. The total amount of converted debt for the 580 state-owned enterprises selected for this program amounted to approximately 405 billion yuan, or 30% of the total volume of non-performing loans transferred to AMC's.

The resolution of non-performing loans through other methods began in 2001. For example, at the end of 2001, China held its first international auctions for the sale of NPL's, during which Huarong sold loans worth 13 billion yuan to two international consortia.

In total, in 2001, the four AMC's resolved non-performing loans (NPL's) amounting to 124.5 billion yuan; in 2002, the amount was 141.7 billion yuan; and by 2006, the companies had resolved assets worth 866.34 billion yuan, or about 70% of the total volume of the repurchased portfolio (excluding loans exchanged for equity stakes in state-owned enterprises). At the same time, the average recovery rate of the four AMC's remained relatively low, at around 21-22%.

In 2006, an additional volume of non-performing loans (NPL's) amounting to 320 billion yuan from two state-owned banks (BC and ICBC) was transferred to their AMC's at a price approximately 35% of their nominal value, due to these banks' initial public offering (IPO) on the Hong Kong Stock Exchange.

Although the share of non-performing loans in the total loan portfolio of Chinese banks eventually decreased to 2.4% in 2008, experts attribute this reduction to the sharp growth in GDP rather than the transfer of distressed assets to AMC's.

III. Commercialization and Expansion of the Powers of State Asset Management Companies (AMCs)

With China's accession to the WTO, the country undertook the commitment to open its borders to foreign capital by December 2006. In this regard, starting in 2004, the Ministry of Finance took on the leadership of China's financial transformation aimed at commercialization (i.e., focusing on and maximizing profits). This policy also affected the state-owned Asset Management Companies (AMCs), which were granted new powers aimed at transforming them into fully-fledged, market-oriented financial institutions.

To achieve commercial goals, AMCs were now able to independently make decisions on asset investments, conduct commercial transactions, and establish platform companies (such as financial leasing companies, trusts, etc.).

The onset of the Global Financial Crisis marked a new phase in the fight against toxic loans within the system. To attract capital to the AMCs (whose activities were no longer limited to resolving troubled loans and had expanded to a wide range of financial services), the government decided to list the companies on the Hong Kong Stock Exchange.

Cinda was selected as the "pioneer" in the listing process due to its highest recovery rate among the four AMCs (at around 30%). The government transformed the company into a joint-stock company and restructured its bond obligations, which allowed it to attract strategic investors in 2012 and go public in 2013. As a result of the initial public offering on the Hong Kong Stock Exchange, Cinda raised 2.5 billion USD, the company's assets increased more than fourfold, and its net profit doubled from 2012 to 2016.

The next AMC to go public was Huarong, which underwent the listing process in 2015 and raised 2.3 billion USD. Its commercialization yielded even more impressive results – the asset volume increased by four and a half times, while net profit more than tripled.

IV. Current State of the Non Performing Loan Market in the People's Republic of China (PRC)

As of 2019, the volume of non-performing assets in the People's Republic of China (PRC) was estimated by PwC to be around 10.5 trillion yuan, or 1.5 trillion US dollars, and it continues to grow.

Despite the creation of 53 local (municipal and regional) AMCs between 2015 and 2017, the "Big Four" state-owned AMCs remain the largest buyers in the market, investing around 100 billion USD annually. This is partly due to regulatory requirements, which state that Chinese banks can only sell asset pools to AMCs (which then resell most of these assets), while selling individual assets directly to investors is only permitted for specific assets.

The "equilibrium point" for the "Big Four" AMCs was reached only in the first half of 2019, when the volume of recoveries approached the volume of purchases.

One of the ongoing issues in the stressed asset market in the PRC remains the pricing of assets. There is no consensus between AMCs and potential investors on the price of assets that were previously acquired by AMCs from banks at inflated values. This practice leads to the "settling" of assets in the AMCs' portfolios. However, in 2020, AMCs expressed their willingness to sell assets at market value and absorb the corresponding losses.

Due to the expected increase in non-performing loans (NPLs) from the COVID-19 pandemic, in December 2020, China's financial regulator announced the establishment of a fifth state AMC – China Galaxy Asset Management Co., with a registered capital of 1.5 billion USD. The newly established AMC is authorized to acquire non-performing loans from financial institutions and invest in them, as well as conduct restructuring procedures and debt recovery on repurchased loans.

The material was prepared by the Corporate Development Department of JSC "FPK." Materials used in the preparation include:

China's Asset Management Corporations by Guonan Ma and Ben S. C. Fung, BIS
China's Asset Management Companies as State Spatial–Temporal Strategy by Sarah Ho and Thomas Marois
Non-Performing Loan of China's Banking System by Huang Bihong
The Chinese NPL Market in 2020, PWC

Nonperforming Loans in Asia and Europe - Causes, Impacts, and Resolution Strategies, ADB
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