KDI Conference on the Current Financial Issues in China

Study on Non-performing Assets of China's Commercial Banks

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Study on Non-performing Assets of China’s Commercial Banks

I. Non-performing Loans—the Main Form of Non-performing Assets in China’s Banking System
II. Evolution of the Definition and Classification of Non-performing Loans in China
III. The Formation and Changes of NPLs under China's Financial System Reform
IV. Disposition of Banks’ NPLs and the Four Financial Assets Management Companies
V. Future Risk Management on Non-performing Assets of Commercial Banks in China

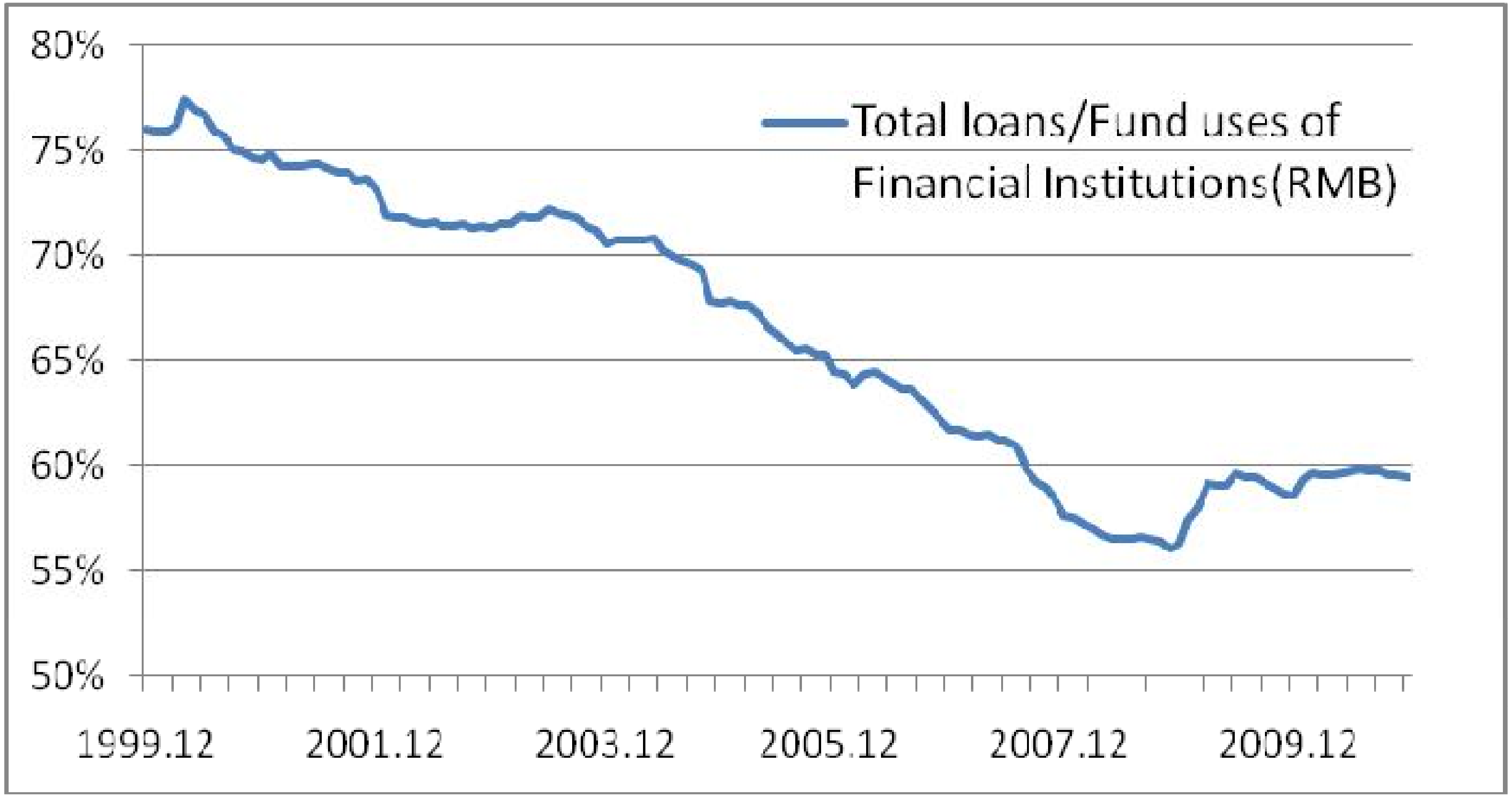
I. Non-performing Loans—the Main Form of Non-performing Assets in China's Banking System

- In 2004, China Banking Regulatory Commission issued "Provisional Measures of Monitoring and Assessment of Non-performing Assets of Commercial Banks", stipulating non-performing loans, non-credit assets and off-balance sheet business are all under risk monitoring and assessing of the non-performing assets in commercial banks.

- But non-performing loans are the most important part of non-performing assets and could reflect the rough operating situation of Chinese commercial banks.

I. Non-performing Loans—the Main Form of Non-performing Assets in China's Banking System

a. Loans are the main fund uses of Chinese financial institutions.



I. Non-performing Loans—the Main Form of Non-performing Assets in China’s Banking System

b. Banks’ investment activities are limited. Based on the newly issued “Commercial Banking Act of People’s Republic of China", China's commercial banks must not invest in physical assets except for self-using fixed assets, not in the stock market, and not in business equity.

c. Statistics caliber deletions make it difficult to count the generalized non-performing assets.

II. Evolution of the Definition and Classification of Non-performing Loans in China

- In 1988, the Ministry of Finance issued the “Financial System of Financial and Insurance Enterprise", dividing the loans into four categories, namely normal, overdue, dull, and bad debts, with the last three collectively falling into non-performing loans.

- In 1996, "General Rules on Loans" promulgated by the People's Bank of China took effect, in which the definition of overdue and dull loans were adjusted to be more specific.

II. Evolution of the Definition and Classification of Non-performing Loans in China

- In 1998(After Asian financial crisis), the People's Bank of China decided to adopt internationally accepted five-category classification method to stress banks' risk management.

- After the pilot in Guangdong in1998, the five-category classification became popular in 1999 and was fully implemented throughout banking system in 2002.

III. The Formation and Changes of NPLs under China's Financial System Reform

- We couldn’t talk about NPLs without exploring China's Financial System Reform.

a. From 1979 to 1983, the recovery and reconstruction of China's commercial banking system progressed along with the China's overall economic reform, and no large NPLs formed during this period yet.

- ➢ Four state-owned commercial banks established.
- ➢ But scale of bank credit was quite small since state-owned enterprises’ working funds and fixed investment were all appropriated by government.

III. The Formation and Changes of NPLs under China's Financial System Reform

b. From 1984 to 1993, the emergence of joint-stock commercial banks started to promote some competition in China's banking sector, but still the banking system was an oligarchy of the four large state-owned specialized banks, which led NPLs to emerge and grow rapidly.

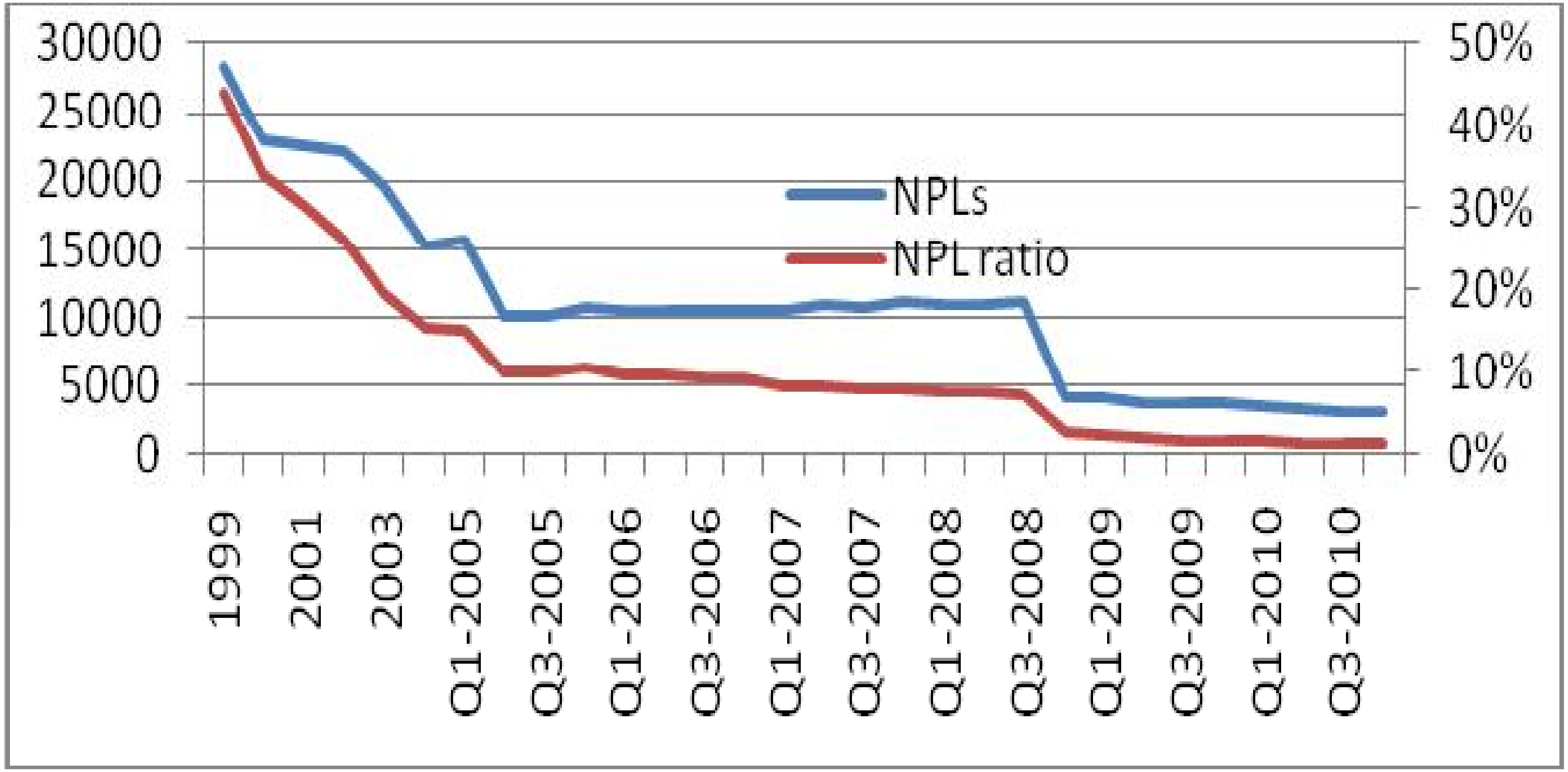
c. From 1994 to 1998, the state-owned banks' commercialized status had been clear (Policy-related business was formally stripped away), but banks' management and internal control mechanism was insufficient, causing accelerated growth of their non-performing loans. Statistics showed that in 1996 the NPL ratio for four state-owned banks was 20.4%, 5 times that of 1991. The ratio climbed to 44% by the end of 1999 even after some stripping.

III. The Formation and Changes of NPLs under China's Financial System Reform

d. From 1998 to 2003, the banking industry carried out market reform with experiencing rapid expansion of loan size but the "double down" of NPLs and NPL ratio. Reform measures include:

- Financial restructuring: capital supplement through the Ministry of Finance issuing special treasury bonds of 270 billion Yuan; establishment of four financial asset management companies to acquire 1.3939 trillion Yuan NPLs.
- Improve internal management: Economic evaluation on banks' performance instead of the previous executive judges.
- Strengthening external supervision: China Banking Regulatory Commission formally established on April 28, 2003, directly responsible for the State Council.

III. The Formation and Changes of NPLs under China's Financial System Reform



III. The Formation and Changes of NPLs under China's Financial System Reform

e. From the end of 2003 to 2008, the joint-stock reform of state-owned banks proceeds, with NPLs and NPL ratio continued to "double down" to meet the needs of going public.

Finally, after a series of NPLs' stripping, the overall NPL ratio for five top commercial banks (China Bank of Communications included) falls to 2.81% at the end of 2008.

IV. Disposition of Banks' NPLs and the Four Financial Assets Management Companies

- Corresponding to the market reform of state-owned banks, the disposition of four state-owned banks' NPLs experienced the policy spin-off to more market-oriented approach as well.

a. Policy stripping of NPLs:

1) In 1999, four financial asset management companies (AMC)—China Cinda, China Orient, China Great Wall, and China Huarong respectively acquired NPLs of 407.7 billion Yuan of CCB, 345.8 billion Yuan of BOC, 267.4 billion Yuan of ABC, 373 billion Yuan of ICBC, totaled 1393.9 billion Yuan according to the book value.

Funds for AMCs' acquisition were from the PBC's loans and financial bonds issue to commercial banks.

IV. Disposition of Banks’ NPLs and the Four Financial Assets Management Companies

2) The special policy stripping of ABC’s non-performing assets of 815.695 billion Yuan at the book value by Ministry of Finance in 2008.

For:

- ABC’ non-performing assets constituted of large amount of assets widely distributed around the country, but with small amount of money for each single asset.
- The quality of a large part of ABC's non-performing assets was very awful and its NPL ratio was 23.50% since most of the NPLs were transferred to ABC from Agricultural Development Bank, People's Bank of China, BOC, and CCB.

IV. Disposition of Banks' NPLs and the Four Financial Assets Management Companies

b. Commercialized acquisitions of NPLs:

1) BOC and CCB NPLs' disposal of 278.7 billion Yuan (Principal) in 2004 – selected an AMC as the wholesale AMC of NPLs through Tender, then divided the whole asset package into several asset packages and passed them on to other AMCs though Tender as well.

Flaws:

- AMC's due diligence investigation was inadequate as bidder.
- The asset package was too large to unpack and repack in a short time which affect transactions on secondary markets.
- Distribution of package to other AMCs lengthened the package residence time in the primary market, affecting the development of NPLs' second market.

IV. Disposition of Banks' NPLs and the Four Financial Assets Management Companies

2) ICBC NPLs' disposal of 456 billion Yuan (Principal) in 2005– built 35 doubtful loans packages in accordance with the distribution of loans and the regional distribution of 35 immediate branches of ICBC, and each package was tendered by all AMCs through market-oriented approach.

IV. Disposition of Banks' NPLs and the Four Financial Assets Management Companies

- AMCs themselves also underwent Commercial transformation – whose operating targets are to build an integrated international modern financial group with non-performing assets disposal to be current core business, financial services and asset management to be future focus of the development.

a. On July 16, 2010, China Cinda Asset Management Co., Ltd. was established, marking the launch of Chinese AMCs transformation.

IV. Disposition of Banks' NPLs and the Four Financial Assets Management Companies

b. The other three asset management companies are also being actively arranged in various ways.

1) Great Wall Asset Management Corporation, with Tianjin municipal government, jointly initiated the establishment of the first domestic financial asset exchange In May 2010 – Tianjin Financial asset exchange, accelerating the progress of their preparations for transition.
2) China Orient Asset Management Corporation also increased training and financial support for financial companies, by building the financial services industry chain with securities as its key points and credit rating as its highlight.
3) The financial leasing companies owned by Huarong Asset Management Corporation already entered into the financial bonds distribution market, creating an approach to marketized direct financing for financial leasing companies by issuing financial bonds. And Huarong Asset Management Corporation will the next to be turned into Joint Stock Corporation.

V. Future Risk Management on Non-performing Assets of Commercial Banks in China

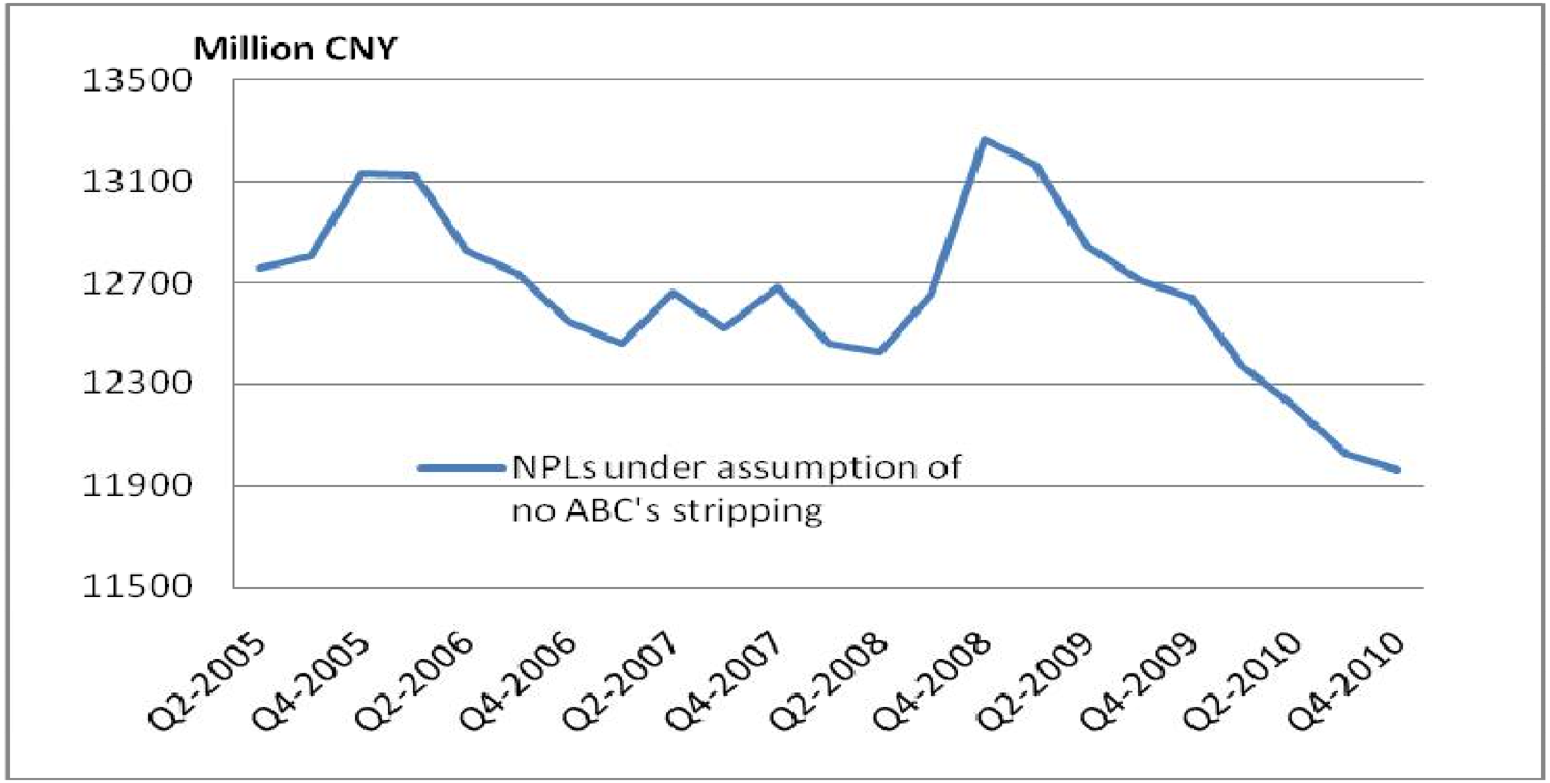
- There still exists risk of non-performing assets' expansion and NPL ratio's increase in Chinese commercial banking system.

a. The decline of NPL ratio in recent years was not mainly because of banks bringing down their non-performing loans through good management.

1) Most NPLs were stripped away.

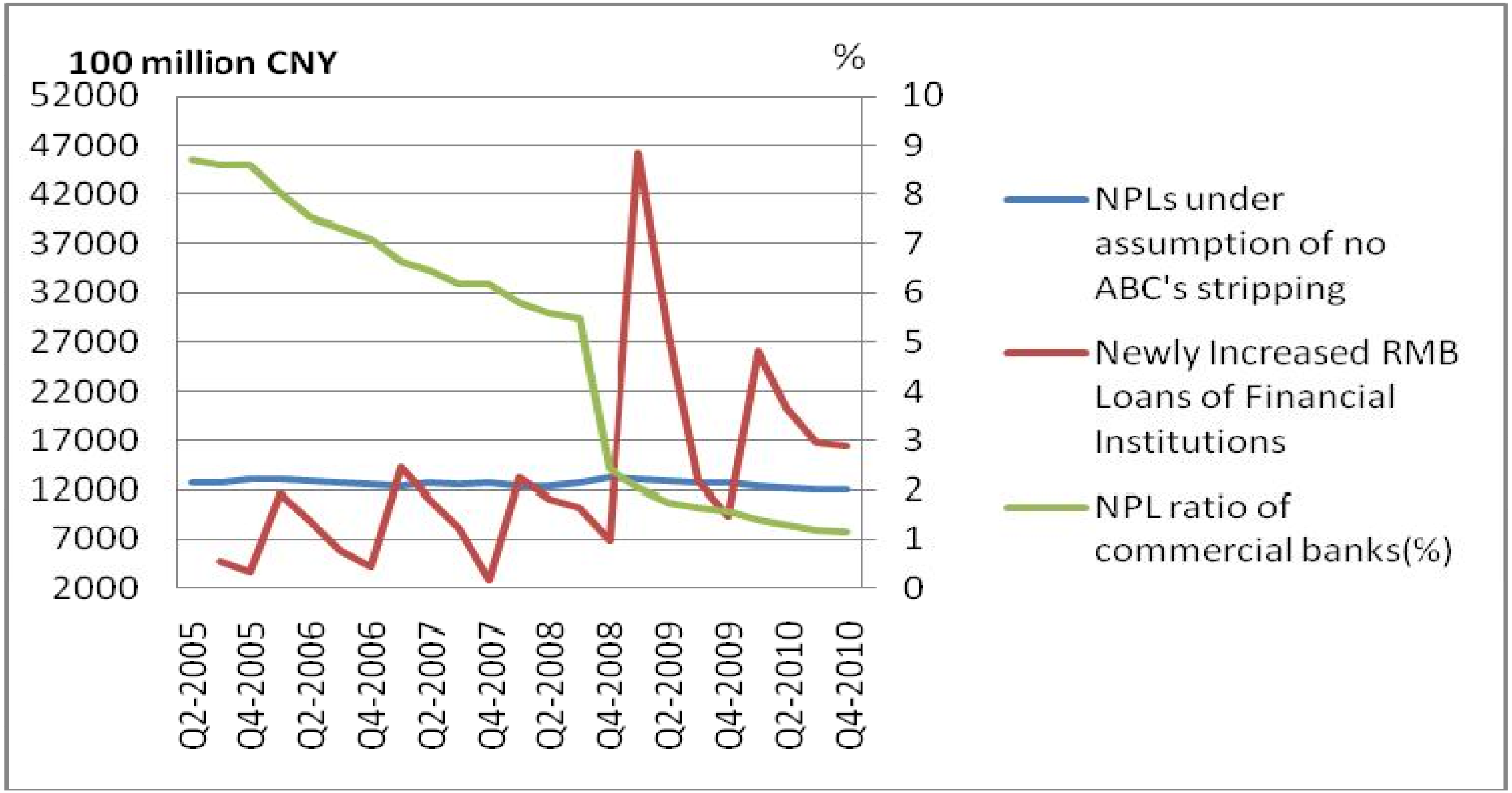
V. Future Risk Management on Non-performing Assets of Commercial Banks in China

2) NPLs of state-owned banks climbed high for twice since the second quarter of 2005 without considering ABC's stripping, showing commercial banks' weak capacity to control risks and the real economy's excessive reliance on indirect financing.



V. Future Risk Management on Non-performing Assets of Commercial Banks in China

3) Gradual decline of NPL ratio was largely due to increasing size of loans in the denominator, called dilution effect.



V. Future Risk Management on Non-performing Assets of Commercial Banks in China

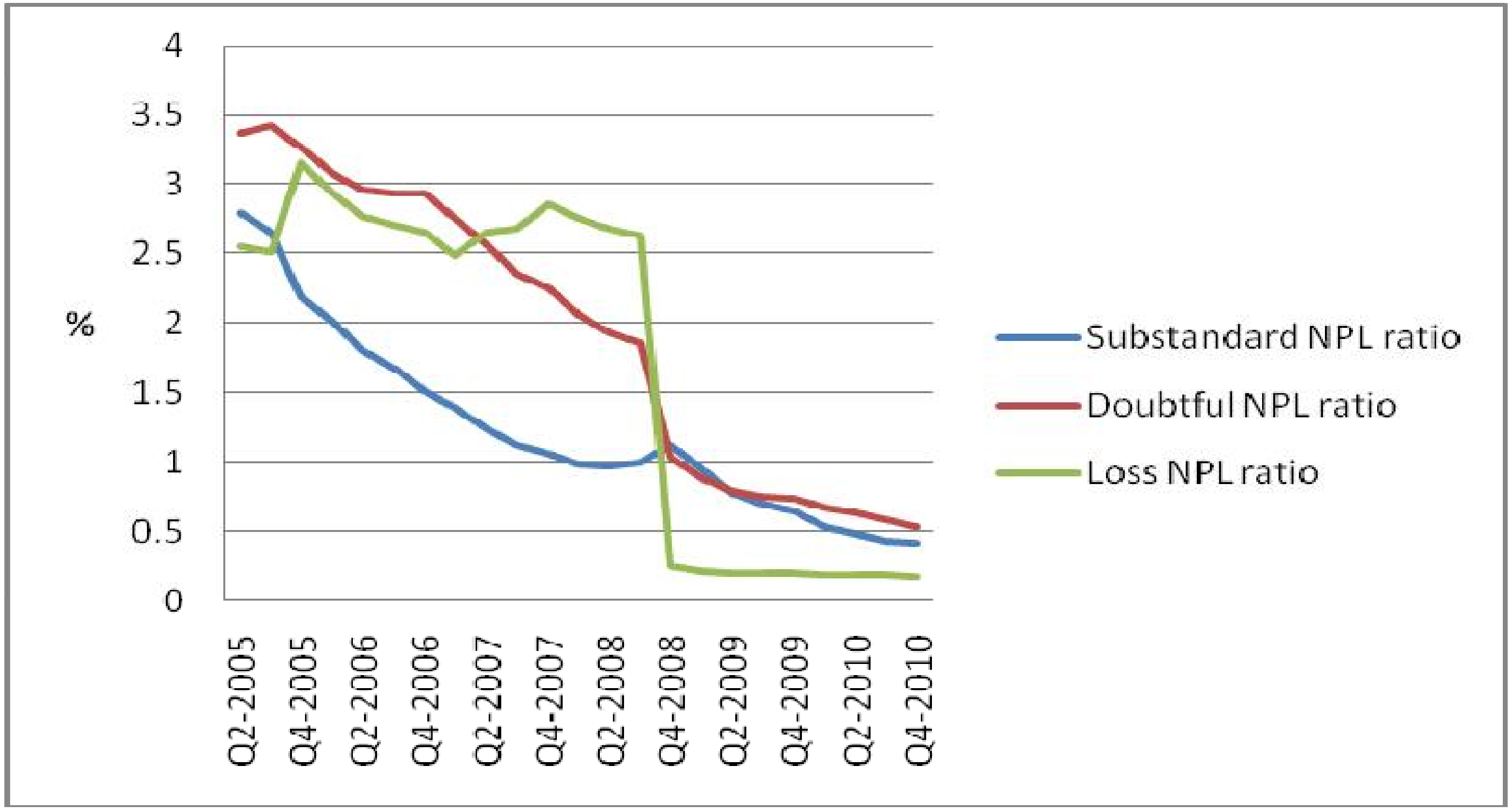
b. Under the economic stimulus policy after global financial crisis started from 2008, rapid expansion of credit had resulted in decline of NPL in short-term, but the risk of NPL ratio climbing high in next few years rose at the same time.

1) In the first quarter of 2009, the amount of new loans reached record high of 4.6 trillion Yuan, of which loans made by state-owned commercial banks accounted for 50.5%.
2) High risk in real estate loans and local financing platform loans in the following years.

- 54% of the loans have terms over 5 years.
- These loans will be unsustainable, and the denominator effect will be weakened, which might result in an increase in bad loan ratio.

V. Future Risk Management on Non-performing Assets of Commercial Banks in China

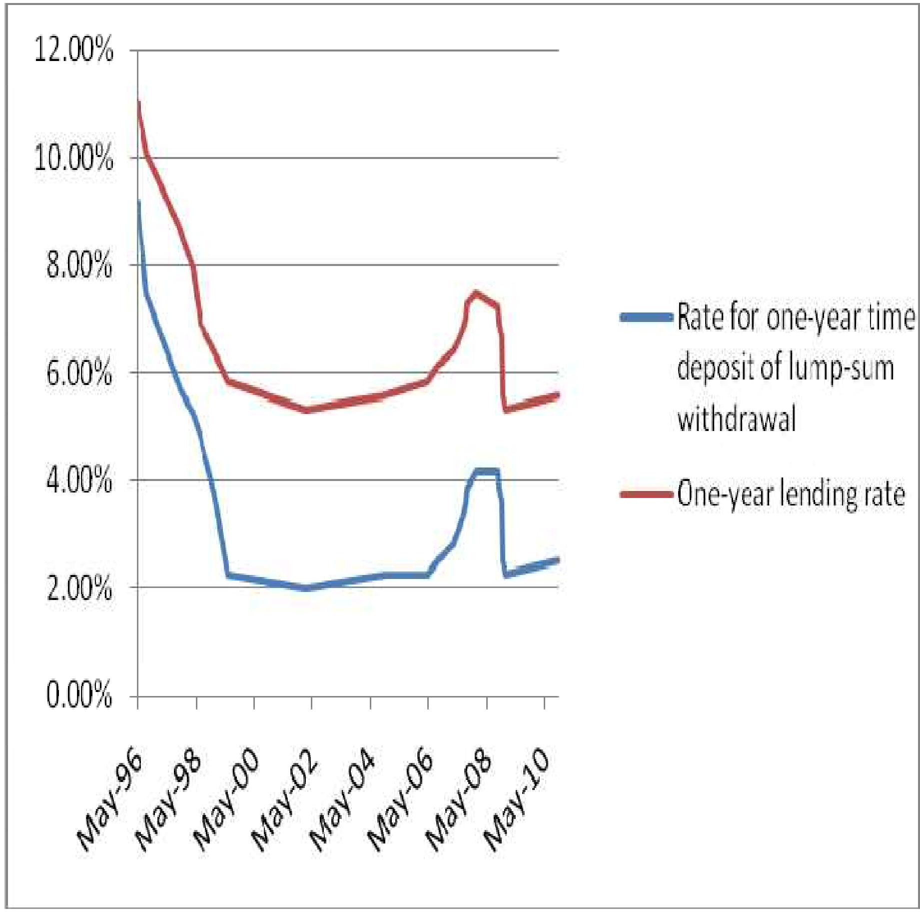
c. Thirdly, sub-standard and doubtful loans are easy to turn into loss loans.



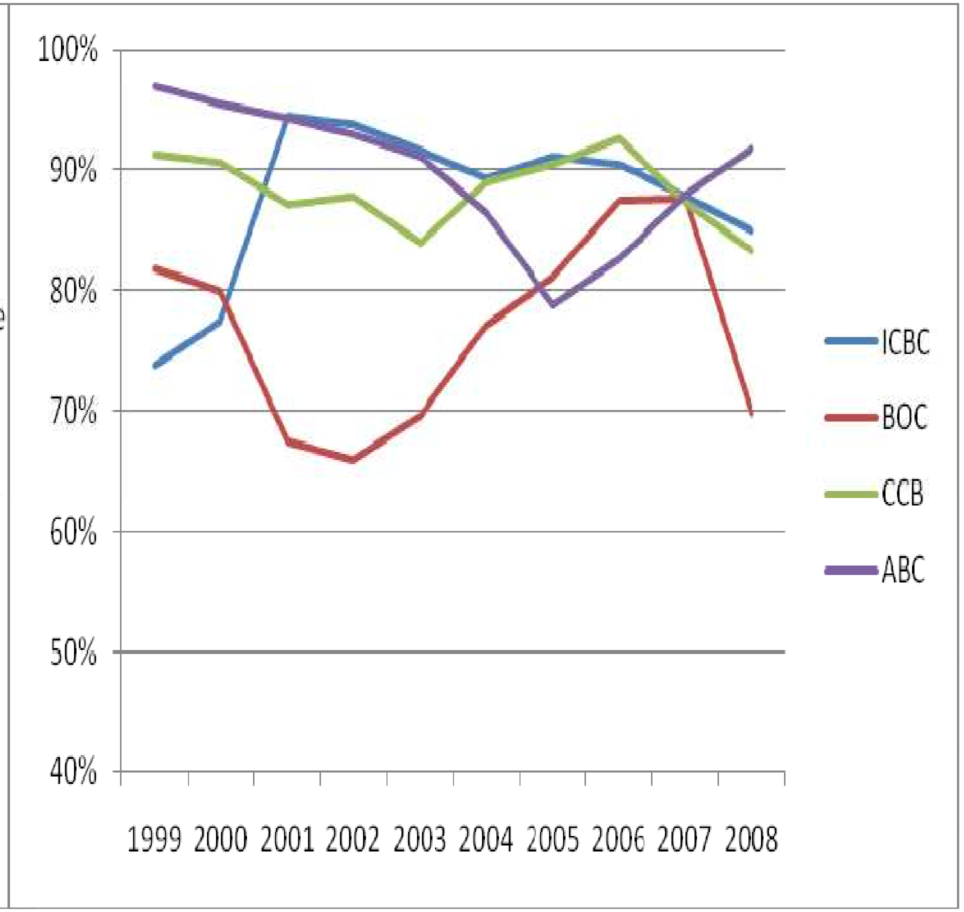
V. Future Risk Management on Non-performing Assets of Commercial Banks in China

- The main factors causing these potential risks to rise still are:

a. Commercial banks’ operation severely relies on savings and loans, and their profitability severely relies on the difference between deposit and lending interest rate.



Interest Rate Difference



Proportion of Banks' Income from Interest Rate Difference

V. Future Risk Management on Non-performing Assets of Commercial Banks in China

b. The lack of bankruptcy system results in weak sense of risk among large commercial banks.

c. Enterprise operation mechanism and system reform still do not reach the designated position. Enterprises still lack financing channels except borrowing from banks, resulting in a serious situation of "high proportion of indirect financing" and "high liability ratio".

V. Future Risk Management on Non-performing Assets of Commercial Banks in China

- Regarding these problems, China should continue to push forward the reforms of commercial banks from the following aspects:

a. Accelerate interest rate liberalization which shall include: 1)the marketization of deposit and lending interest rate of commercial bank; 2)the indirect regulation and control should be adopted by central bank to affect the market interest rates.

The breakthrough point of marketization of interest rates is to change banks' profit making model since the obstacle of marketization comes from banks whose profits always rely on high interest difference.

V. Future Risk Management on Non-performing Assets of Commercial Banks in China

b. Strengthen prudential supervision over banks.

Plans and efforts for risk prevention and control have been made: at the end of the third quarter of 2010, the capital adequacy ratio of ICBC, ABC, BOC, CCB and Bank of Communications reached respectively 11.57%, 11.38%, 11.73%, 11.64% and 12.53%, listed small and medium banks have capital adequacy ratio of more than 10%, which makes China's banking system could easily meet the high requirements of Basel III.

V. Future Risk Management on Non-performing Assets of Commercial Banks in China

c. Accelerate the diversification of banking business model and improve banks' management capabilities.

1) The decline in loan demand of real estate and local government investment and financing platform will put pressure on banks' operation. ("Twelfth Five-Year Plan" stated specifically that government will strictly implement differentiated housing Credit, effectively curb the purchase of homes for speculation or investment purposes)
2) As the construction and development of China's capital market, the bank's credit investment is bound to be shocked, and high interest rates of credit will be unsustainable.
3) China's economic transformation will inevitably slow down economic growth target to reduce the demand for credit.

V. Future Risk Management on Non-performing Assets of Commercial Banks in China

d. Accelerate the establishment and development of deposit insurance system and the Bankruptcy Ordinance of financial institutions.

e. Improve the legislation on financial activities.

Thank you !