

On Disposal of Non-Performing Assets of the Banking Industry

Li Fu-an

Rules and Regulations Department
China Banking Regulatory Commission

In disposing of non-performing assets of the banking industry, which areas deserve our attention as the industry watchdog? In this article I would like to offer some personal views, procedure wise, on how to effectively enhance and best exercise supervision of the banking industry, particularly from the moment non-performing loans occur to the ultimate recovery of the value of non-performing loans.

First, I would like to offer my observations on the measures, approaches, and environment for the handling of non-performing loans. In my opinion, compared to 1997, 1998, 1999, and even earlier years a lot had changed by 2004. In fact, there are remarkable changes even compared to 2 or 3 years ago. A great number of barriers and bottlenecks in place then have been eliminated and the development of the market, improvement of the internal governance of the banking industry, and enhanced profitability of the banking industry present an excellent opportunity for us to reflect upon how non-performing loans were handled in the past and to put forward new ideas in this regard.

In the past, the non-performing loans of the four major state-owned commercial banks were transferred to the four asset management companies. Despite the difficulties encountered and whatever the cash recovery rate, in any account, the four asset management companies disposed of the bulk of these non-performing loans. It seems that in terms of banking industry regulation, it is no longer the primary or a challenging task to supervise the four asset management companies. However, it is important for us to reflect upon the past, draw lessons from the experiences to improve our understanding, institutional framework and methods in relation to handling non-performing loans, and to accumulate experiences to provide a better mechanism and platform for future use, as new non-performing loans are unavoidable in the long-term development of the banking industry. That is the significance of our discussion on non-performing loans.

I will elaborate my views in 7 aspects.

1. Due diligence on banks.

It would not do just to separate non-performing assets from banks and deliver them to asset management agencies. We need to investigate how the non-performing loans occurred. Many people have indicated that in the very beginning, we did not investigate the causes of non-performing loans or their timing.

Here, in-depth analysis is necessary. We should bear in mind that many years ago, when central government and State Council leaders were deliberating on project financing, they invited representatives from many departments including credit officers from banks to participate in the discussion on the feasibility, risks, and necessity of projects. The representatives offered their views and everybody supported the projects. For instance, many people supported projects when there were plans to bring in a new set of equipment from overseas or when some state officials were planning an overseas tour or negotiating a project. However, once the equipment is handed over to the factory, all the people involved feel it is a feasible project, even before relevant questions, such as how to organize production, how to obtain raw materials, etc., are answered. The bank representatives were seated at the back or did not offer any comments. Finally, when the question on financing was raised, they would stand up and say, "We will provide financing for this project and we will provide loans to support the country to develop". In the end, the juicer is brought in from Europe, but it is

not suitable for Chinese oranges and the project is dropped.

It is not that banks should bear no responsibility for such projects. During our investigation, we should find out to what extent banks should be held responsible. Once non-performing loans are identified, the first question is who should handle the non-performing loan? For each non-performing loan, the bank should bear the redoubled costs, not the doubled costs or even half of the costs. The causes of non-performing loans should be investigated, and responsible personnel should be prosecuted or handled according to law. If the problem lies with the system, appropriate changes should be made and if necessary, experts should be consulted to improve the system and prevent further occurrence.

The above is the first step in supervising non-performing loans. If no effort is made in this regard, it means the environment encourages banks to come up with non-performing loans and they could even profit from such practices. Consequently, banks will produce more non-performing loans and even produce fresh non-performing loans, doubling the current amount of non-performing loans over night. If the objective of handling non-performing loans were not to prevent banks from incurring fresh non-performing loans, we would be better left without such a mechanism. The key issue is in the disposition of non-performing loans; we must bear in mind that the disposal of non-performing loans itself represents a positive incentive to the business operations of banks. We need to encourage banks to minimize non-performing loans and let them practically feel that there are costs to pay for each non-performing loan. One issue has often been discussed—who should pay for the non-performing loans and who should be held responsible. This is absolutely necessary and we should carry out due diligence and exercise supervision on the accountability system.

When the four asset management companies started to transfer non-performing loans from banks, many banks verified the value of each loan strictly in accordance with the 5-category system and made a determination. As a result, the amount of non-performing loans of those banks is very small, the disposal process has been accelerated, and the number of non-performing loans is dropping rapidly. However, some other banks did not know which were good loans and which were bad loans. In the end, they just transferred a great deal to the asset management company. Later, they found that they had not transferred some of their non-performing loans and it was difficult for the asset management companies to do a proper job. If our mechanism fails to constrain bad banks and to encourage good ones, how could banks recognize their responsibility to carefully identify and manage bad loans, and what good is it for us to establish a mechanism to dispose of bad loans?

Therefore, in my opinion, we should conduct stringent investigation of those banks that produce non-performing loans. The Banking Regulatory Commission will issue a guideline on credit authorization this year, which will serve as a regulation to conduct audit and investigation on who is responsible for non-performing loans and find out who causes the problems, who could be waived, and who should be held accountable.

Of course, there will be normally non-performing loans even if all necessary precautions have been taken, which is a common understanding of many experts. The issue of a reasonable level of non-performing loans should be considered as a reasonable operational cost of the banking industry. In such cases, once a loan is identified as non-performing, provisions must be allocated immediately and the banking accounts should be settled in a timely fashion to keep the bookkeeping clean. At the same time, responsible persons should be investigated and handled so that responsibilities and obligations are clearly divided and appropriate procedures are taken—either by dealing with the responsible personnel, by amending the system or regulations, by reviewing the mechanism, or by adjusting the credit mechanism—and only then is the whole process of non-performing loan disposal completed. The disposal of non-performing loans is not simply selling off the non-performing loans and settling the accounts. Banks must deal with the non-performing loans in relation both to their accounts and to the responsible persons; only in this way could the system be regarded as a scientific and rational mechanism.

2. Once a loan becomes non-performing, the earlier the bleeding is stopped, the less the losses will be, which is an internationally accepted principle.

I have always supported authorizing banks to dispose of the non-performing loans they have identified, including reducing and waiving the principal and interest charges and taking measures to help borrowers to repay the loans as soon as possible. If necessary, banks should take all possible measures to solve the issue to their best capacity. If the issue is beyond the banks themselves and if it will involve great costs to the bank or to third parties, banks should transfer the non-performing loans by settling the accounts. That is the professional management of non-performing loans.

Professional management of non-performing loans is similar to a hospital's emergency service, requiring a team of experts and professional measures that are better able than credit officers to deal with non-performing loans, and it will help a bank to better conduct its normal business operations. Just as looking at the rearview mirror every one or two minutes allows a driver to focus on driving, instead of always worrying that there is an injured tiger in the trunk, such a management system is beneficial to banks and it could also prevent banks from delaying the disposal of non-performing loans. In society, once a person is found to be ill, it is better to send that person to hospital for emergency treatment immediately, because delaying might reduce the patient's chance of survival; this principle should also apply to the disposal of non-performing loans.

It is well known that banks took many years to dispose of their non-performing loans and only in 2004 did they start to deal with the non-performing loans related to some enterprises that had disappeared a long time ago. If the same thing had happened to a patient, the patient would have died many times over.

3. There should be a variety of ways to deal the non-performing loans.

In the early stage, banks had little experience and it was thought to be a good idea to let asset management companies deal with non-performing loans. Now, different measures should be allowed to address non-performing loans. First of all, commercial banks should be allowed to come up with their own measures, starting with reducing and waiving the principal and interest on such loans, or extending the loans, or settling the loan accounts. Commercial banks should be fully authorized and they should be able to apply all the preferential policies granted to the asset management companies. It does not matter whether commercial banks or asset management companies deal with those non-performing loans that occurred despite due diligence and precautionary measures.

Necessary preferential policies related to the disposal of non-performing loans should be granted to both asset management companies and commercial banks. Joint branch agencies and project teams could be established and joint project companies could also deal with non-performing loans.

Some approaches are better than others. For instance, many of the non-performing loans were related to ports and docks, and dealing with such port-related non-performing loans requires the same professional expertise no matter which bank was involved and no matter whether the port was located in Dalian, Tianjin, or in a small city. A special team to handle port-related non-performing loans would be more effective than any comprehensive joint agency consisting of several asset management companies. The best international experts on ports as well as the best port investment experts could be hired. Together the team could find the best transport routes, optimize port resource allocation, and optimize the value of troubled ports. A single bank or asset management company might not be able to organize such a professional project company. In my opinion, such companies should be encouraged. Last year many overseas investors and technical experts met with us and expressed their hope to develop this market and I think we should encourage them to do so.

4. The disposal of non-performing loans should be more market-oriented.

A market mechanism should be established in the first place and to the extent possible existing non-performing loans should be disposed of according to market rules. In the first place, whichever entity is responsible for the disposal of non-performing loans—a bank, a professional asset

management company, or any other agency—should conduct road shows and standard enquiries so that both domestic and foreign investors can compete on an equal footing.

Each new participant, including the intermediaries, must answer one question: how do you plan to help increase the value of the non-performing assets? We have to see how the new participant, be it a professional technical company, a professional human resources company, a CPA firm, or a law firm, could help to increase the value of the non-performing assets. Any agency that could increase value, not just powerful banks or investors, should be welcome, since power does not represent the full extent of participants' potential to add value. Financial strength is just one aspect; fairness, impartiality, and transparency could also help to increase the value of non-performing assets in China.

As a market regulator and competent administrative agency, we need to lay the foundation necessary for the establishment of market principles. As many experts have commented, relevant agencies should provide historic data on the disposal of non-performing loans and on how much was listed as losses in the transactions. Such data should be disclosed in full periodically, and more information should be provided on such loans. I know that for a great number of non-performing loans, including those sold recently, few agencies and personnel interested in participating in their disposal had much idea about them, such as what types of loan were involved, for how much such loans had been sold, and what kinds of companies were involved. Minimum information, in some cases no information, is provided. Nobody knows what is happening. People only know there was a transaction yesterday, but no readers or outsiders could get information about it. Where is the information? Who has demanded to keep it secret? Why does it need to be kept secret? I am afraid there is no good reason to explain the situation.

5. In disposing of non-performing loans, market rules should be adopted.

We believe that little could be hidden if the general public, the media, and journalists were allowed to see each transaction. Now we can see the role played in many cases by media and general public supervision in the evolution of the capital market. Even the internet discloses more information than what is known to regulators. We need to conduct transactions following market rules and to expose them to sunlight to make them open to the general public. Who could hide anything if that is the case?

Furthermore, there should be third-party investigation, grading, and auditing. Some rating agencies could issue an AAA rating to a commercial bank in exchange for 100,000 RMB or 200,000 RMB. Could we allow such agencies to grade non-performing loans? Is there any sense for them to issue a rating without reviewing the financial accounts and studying individual transactions? Therefore, we should emphasize the importance of professional, legitimate rating agencies that could add more value. Only with such agencies could the market be properly regulated and could the accountants serving buyers and sellers identify the true market value of non-performing loans, and only thus could the market be fair.

The core function of auditing agencies is to make market transactions open and fair. In my opinion, we should completely ban the practice of inviting a few agencies to stage a show of competition. Public bidding with little strings attached should be implemented and the participants should not be restricted to a few sectors. In such cases, we also need to enhance regulation of illegitimate transactions and to prevent agencies from conspiring to force prices down or from negotiating a price the previous night and just going through the formalities the next day. In an extreme case, someone might sell RMB 5 million-worth of assets for RMB 4 million to get a rebate of RMB 700,000 afterwards. We should expand the involvement of the public security department and disciplinary departments and initiate criminal procedures where necessary. I believe that all these issues could be resolved through public supervision.

6. The ultimate disposal of non-performing loans.

The core is not only to sell non-performing loans and settle accounts, the critical issue is to salvage the maximum value of the non-performing assets and let them play their role in economic

development. We should encourage professional agencies to genuinely manage and inactivate those non-performing assets to explore and bring about their value.

7. On regulating the non-performing loan disposal market.

Most importantly, we need to set up a market platform, that is to say, we need to establish a market platform and the rules for buyers and sellers to do deals. We should clarify what should be regulated, the transaction methods, and transaction prices. Irregular transactions should be regulated and there should be power to nullify irregular transactions within a certain period of time. The ultimate goal is that the prices of all transactions should be open and kept on file to be viewed by any interested party. I believe that such a regulatory mechanism for market transactions would be conducive for the market to play its role.

In summary, in disposing of non-performing loans we should have more confidence in the market and market-oriented approaches. We should expose transaction methods and activities to sunlight and let the market help us enhance supervision. The regulator and the market need to join forces to exercise regulation and supervision of the banking industry.