CHINA

Non-performing loans in China: a potential win-win opportunity for foreign investors and China's economy

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China's economy is facing a potential economic crisis. Estimates of China's nonperforming loans ("NPLs") range from almost 18 percent to about 40 percent of total loans outstanding at the end of 2003.[1] Standard & Poor's estimates that a full and immediate bailout of China's NPL-laden banks would cost approximately US$656bn, which is the equivalent of over 40 percent of China's forecast 2004 GDP.[2] The vast majority of the NPLs were extended by China's four state-owned commercial banks[3] to state-owned enterprises ("SOEs"), which are a mainstay of the Chinese economy.[4] As a result, if the insolvent SOEs went bankrupt and liquidated, they likely would bring down China's entire banking system.

NPLs have caused sleepless nights for Chinese economists and financial leaders due to the potential for a sudden economic collapse. However, China is not necessarily destined for a financial crash. By allowing foreign investors to purchase NPL portfolios, China is moving in the right direction to stabilise and revitalise its economy.

NPLs in China

Large quantities of NPLs on banks' balance sheets distort the incentives for both banks and SOEs.[5] High NPL ratios cause bank managers to "bet the bank" in reliance on an SOE's ability to pay its debts. In its most extreme form, if a bank is so heavily exposed to an SOE that the bank would fail if the workout loan were not made, the bank will be willing to make the loan if there is some chance, no matter how remote, that the workout loan will succeed.[6] Compounding the problem, SOE managers have little pressure to scrutinise their projects knowing that banks must keep on lending. Moreover, many of the SOEs' projects come at the direction of the government. Due to the banks' passivity in enforcing loans and their willingness to grant new loans to troubled SOEs, the SOEs have come to rely on the four state-owned commercial banks and have become unable or unwilling to adjust their production to respond to market signals.

SOEs have limited ability to restructure and reduce their NPLs through the current bankruptcy system. Under the Enterprise Bankruptcy Law of 1986, which only applies to SOEs, an SOE may reorganise only where the governmental authority in charge of the SOE (and not the SOE itself) requests a reorganisation, and the SOE's creditors and the court agree.[7] The absence of a well-developed reorganisation framework exacerbates the NPL problem by causing banks to continue lending to insolvent debtors (or face the consequences described above), thereby increasing the banks' exposure. In addition, ambiguities in China's current bankruptcy law regime have hindered the development of the restructuring market in China. China is in the process of adopting a new bankruptcy law which includes a focus on corporate reorganisation.[8]

Asset management companies

As a result of the deficiencies under the current bankruptcy regime, the Chinese government has been working to reduce the quantity of NPLs through other means. The most effective method has been through the creation and utilisation of four asset management companies ("AMCs") to purchase, manage and dispose of NPLs.[9] In 1999, the Chinese government provided each AMC with paid-in capital totaling US$1.2bn and China's four state-owned commercial banks transferred US$170bn in NPLs to the AMCs.[10] By the close of 2003, the AMCs had resolved over 41 percent of their NPLs by recovering on-average almost 20 percent of their cash book value.[11] By shifting NPLs to the AMCs, the commercial banks are freed from the burden of the debt, allowing the banks to be more selective in making workout loans.

The AMCs' main goal is to maximise recovery on the NPLs through asset resolution and collections. The AMCs have special legal powers to forgive partial debts and dispose of assets at less than their book value.[12]

Bulk sales of NPLs

In 2001, the AMCs began focusing on bulk sale transactions with international investors to speed up asset resolution. In these transactions, the AMCs sell their NPL portfolios at less than face value but retain some "upside" interest in the collections in exchange for assisting the purchaser with the administration and collection of the NPLs.

In 2001, Huarong AMC conducted the first auction of NPL assets. Goldman Sachs and a Morgan Stanley-led consortium paid nine cents on the dollar for controlling stakes in an NPL portfolio of US$1.5bn.[15] According to the profit sharing plan, the investors receive varying levels of income from the disposal of the NPLs. If recovery on the NPLs goes well, Huarong could receive as much as 21 percent of the portfo-

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lio's face value.[16]

In December 2003, Huarong AMC launched a second international auction of an NPL portfolio totaling US$3bn.[17] More recently, in May 2004, China Construction Bank launched a tender of a US$507.5m pool of distressed assets, mostly consisting of real estate properties in China.[18] Investors in Chinese NPL markets have been quite successful, with annual returns generally exceeding 25 percent.[19]

Asset-backed securitisations for NPL assets

The AMCs also have worked to implement a variation on asset-backed securitisations for NPL assets. In 2003, the Huarong AMC piloted an NPL securitisation program for an NPL portfolio with a face value of US$1.3bn.[20] Under this structure, the AMC works with a trust company using an "Asset Trust" relationship. A third-party appraiser and a rating firm evaluate the assets, which are then placed into one of two classes, "preferred" or "subordinated," based on the expected level of future cash flows. The trust company then transfers the interest in the preferred class to investors.

Several factors limit the feasibility of securitising NPLs.[21] First, the nature of the Chinese obligors reduces the pool of NPLs available for securitisation. Ideally, the portfolio should have a large number of debtors, low loan concentration ratios, and similar loan terms. In China, as noted above, the vast majority of the NPLs were extended by the state-owned commercial banks to SOEs, particularly favouring the largest SOEs, which the government viewed as pillars of the state sector. In addition, the underlying loan agreements vary, depending upon the borrowers' financial condition. Second, the AMCs need enforceable creditors' rights and a functioning liquidation market. Both of these elements need to be improved in China. Third, the repayment stream under debt restructurings must be fairly predictable. The AMCs will have to rely on non-judicial methods to enforce their restructured payment plans; such methods have not been very effective to date. Fourth, the domestic demand for NPL-backed securities has been limited, due to the novelty and complexity of such transactions. Fifth, China's legal system does not explicitly provide for asset securitisation as a financial technique. Finally, foreign investors face additional hurdles due to the multi-departmental regulatory regime, the opaque approval procedure, restrictions on the type of special purpose vehicle that a foreign investor may create to take over NPLs, and China's foreign exchange controls imposed on profit repatriation.

NPL investment opportunities

In sum, China created the AMCs to reduce the overwhelming quantity of outstanding NPLs through asset resolution and collections. The AMCs have been actively marketing their NPL portfolios to international investors, who have traditionally received a high rate of return. In addition, the AMCs have been experimenting with securitising NPLs. Both of these options present potentially lucrative opportunities for investors, while aiding China's efforts to stabilise its economy. ■

1 In contrast, other developed nations have NPL ratios of 2%-3%. See "China Banks Face Challenges from Economic Slowdown," China Economic Net, http://en.ce.cn/Business/Macro-economic/t20040525_924886.shtml (May 25, 2004).
2 Id.
3 These banks are Bank of China (BOC), Industrial and Commercial Bank of China (ICBC), Agricultural Bank of China (ABC) and China's Construction Bank (CCB).
4 China's private sector receives less than 5% of the banking sector's lending. See Hui (Hannah) Cao, Asset Securitization: Is It a Resolution Option for China's Non-Performing Loans?, 28 Brook. J. Int'l L. 565, 570 (2003).
5 For an in-depth examination of China's NPLs, see Jianbo Lou, China's Bank Non-Performing Loan Problem: Seriousness and Causes, 34 Int'l Law. 1147 (2000).
6 Id.
7 See Shirley S. Cho, Note, Continuing Economic Reform in the People's Republic of China: Bankruptcy Legislation Leads the Way, 19 Hastings Int'l & Comp. L. Rev. 739, 747 (1996).
8 The proposed new bankruptcy law may be adopted as early as the end of 2005.
9 The AMCs are: Cinda Asset Management Company (for the debts of CCB), Orient Asset Management Company (for the debts of BOC), Great Wall Asset Management Company (for the debts of ABC), and Huarong Asset Management Company (for the debts of ICBC). See Cao, supra n.4 at n.65.
10 See Yang Kaiseng, World Bank Conference on Corporate Restructuring: International Best Practices (March 22-24, 2004).
11 Id.
12 The state-owned commercial banks are not authorised to forgive debt.
13 See Corporate/Debt Restructuring: Japan, the Hong Kong SAR & the People's Republic of China, A Roundtable Discussion, 10 Am. Bankr. Inst. L. Rev., 1, 25 (2002).
14 Id.
15 See Cao, supra n.4 at 578.
16 Id.
17 See Kaiseng, supra n.10.
18 See "China Bank Launches Long-Awaited Asset Tender," www.forbes.com/reuters/newswire/2004/05/27/rtr1386301.html (May 27, 2004).
19 See Dale Anne Reiss, "Nonperforming Loan Issues Reach Watershed," http://www.globest.com/viewpoints/bigpicture/121064-1.html (Apr. 7, 2004).
20 However, these financings structures are not "true" securitisations due to various legal, accounting and supervisory obstacles in China. For a discussion of the Huarong AMC pilot NPL securitization program, see Kaiseng, supra n.10.
21 For an in-depth discussion on asset-backed securitisations for NPLs, see Cao, supra n.4.

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