

## China's Non-Performing Loans: History, Current Infrastructure, and the Future of Bad Debt in China

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### Abstract

The People's Republic of China is the world's second largest economy. Beginning in the 1980s, substantial economic growth combined with political and regulatory changes led to a dramatic increase in non-performing loans. By the turn of the century, 1/4 of loans held by Chinese banks were overdue. This article examines how China managed its non-performing loans, discusses bad debt in China today, and provides suggestions for how it should tailor its non-performing loan strategy as its economy continues to slow.

### INTRODUCTION

The amount of non-performing loans ("NPLs") held by a nation's financial institutions is a strong indicator of its economic stability and the risks associated with the infrastructure of its banking industry. Although Chinese NPLs only constitute approximately one percent of the People's Republic of China's ("China" or "PRC") total gross loans,<sup>1</sup> this one percent of the world's second largest economy constitutes more than 96 billion USD.<sup>2</sup> The manner in which China addresses NPLs held by PRC banks will have significant effects on its financial services industry.

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<sup>1</sup>See *Bank nonperforming loans to total gross loans*, THE WORLD BANK GROUP (last visited Aug. 25, 2014), available at <http://data.worldbank.org/indicator/FB.AST.NPER.ZS> (showing that China's NPLs constitute one percent of its total gross loans, which is much lower than the global average of approximately four percent).

<sup>2</sup>*China Banks Bad-Debt Ratio Seen Rising to Most Since 2009*, BLOOMBERG (last visited Aug. 25, 2014), available at <http://www.bloomberg.com/news/2014-05-28/china-banks-bad-debt-ratio-seen-rising-to-most-since-2009.html> (reporting that China's ten largest lenders had overdue loans amounting 588 billion RMB by the end of 2013).

This article begins with a global history of NPLs. As this article considers the implementation of the United States' ("US") and Japan's NPL models in the PRC, the background section also discusses the history of these countries' NPLs. It then provides an in-depth discussion of Chinese NPLs. Afterwards, it analyzes Chinese NPLs and considers implementing an NPL strategy based on the models utilized by the US or Japan. Lastly, this article proposes how China should tailor its own NPL strategy.

## I. BACKGROUND

This section begins by defining NPLs and their history. It reviews the structure of China's banking industry, introduces US and Japanese NPL strategies, discusses the major holders of NPLs, and examines the laws and regulations that affect bad debt in China.

### 1. Overview of Non-Performing Loans

#### A. Determining When a Loan is "Non-Performing"

There is no universal definition of "nonperforming loan."<sup>3</sup> Countries and financial institutions may have relatively diverse standards for determining whether a loan is non-performing. Additionally, they may also distinguish between types of NPLs and create their own definitions to define these distinctions.

##### i. Standard Definitions

The most commonly used definition for an NPL is (1) when a bank believes an

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<sup>3</sup>*The Treatment of Nonperforming Loans: Clarification and Elaboration of Issues Raised by the December 2004 Meeting of the Advisory Expert Group of the Intersecretariat Working Group on National Accounts*, INTERNATIONAL MONETARY FUND (June 2005), available at <http://www.imf.org/external/pubs/ft/bop/2005/05-29.pdf>.

obligor is unlikely to pay its obligations in full or (2) a material credit obligation is more than 90 days due.<sup>4</sup> In comparison, the International Monetary Fund (“IMF”) asserted that the most widely used definition is a loan that either has (1) payments of principal and interest that are due by at least 90 days or (2) been “capitalized (reinvested into the principle amount), refinanced, or rolled over ([...] payment has been delayed by agreement)[.]”<sup>5</sup> According to the IMF, this is a broad definition – NPLs may also include loans with past payments that have not reached 90 days if there is evidence that the borrower will not make payment (such as filing for bankruptcy).<sup>6</sup>

Some countries define NPLs much more stringently. For example, they may consider loans that are only 31 or 61 days overdue to be non-performing.<sup>7</sup> Additionally, they may distinguish between types of NPLs. Common categories include “substandard,” “doubtful,” and “loss loans.”<sup>8</sup> NPLs thus occur when borrowers do not make payments as provided in their promissory notes or credit agreements. The next section discusses Chinese definitions for NPLs – in addition to understanding the differences between countries’ definitions, note the difficulties that these differences create for comparing NPLs in China with those held by another country’s financial institutions.

## ii. Defining Chinese Non-Performing Loans

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<sup>4</sup>See Beck, Roland et al., *Non-Performing Loans: What Matters in Addition to the Economic Cycle?*, pg. 10, EUROPEAN CENTRAL BANK (Feb. 2013), available at <http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1515.pdf>.

<sup>5</sup>*Compilation Guide on Financial Soundness Indicators*, pg. 57, INTERNATIONAL MONETARY FUND (July 2004), available at <https://www.imf.org/external/np/sta/fsi/eng/2004/guide/chap4.pdf>.

<sup>6</sup>See *id.*

<sup>7</sup>Beck, Roland et al., fn. 4 at 10.

<sup>8</sup>See *id.*

China does not have a comprehensive definition for NPLs.<sup>9</sup> Instead of creating an overall definition for “non-performing loan,” Chinese regulations categorize NPLs into three separate types of loans: overdue loans (逾期贷款), idle loans (呆滞贷款), and bad loans (呆帐贷款).<sup>10</sup> These three types of NPLs are referred to jointly as “One Overdue, Two Bad” (一逾两呆).<sup>11</sup>

#### a. Overdue Loans

A loan becomes an overdue loan if both its principal and interest have not been paid in full by the date provided in the loan agreement.<sup>12</sup> As China categorizes loans as NPLs as soon as this date passes, these loans are considered as non-performing before their counterparts in the US and many other countries. Financial institutions place higher values on these loans than the other two types of NPLs because they are more likely to be repaid. Banks will increase interest rates by approximately 30-50 percent after a loan becomes overdue.<sup>13</sup>

#### b. Idle Loans

“Idle loan” refers to an overdue loan upon which interest payments have been

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<sup>9</sup>See Yang Chengchang, *Shangye Yinhang Buliang Daikuan de Jieding yu Shibie* (商业银行不良贷款的界定与识别) [Defining and Distinguishing Commercial Banks' Non-Performing Loans], 2011.1 *Caihui Yuekan* 41, available at <http://doc.mbalib.com/view/043511a8521c31af782faa44e4b34c9b.html> (writing that “不良贷款的界定是建立在贷款分类基础之上的，但迄今为止，国际上还没有形成一套被各国普遍接受的贷款分类办法。” (The foundation for defining “non-performing loan” is the establishment of loan categories. However, there still does not exist a universally accepted method of classifying NPLs.”)).

<sup>10</sup>See *Daikuan Tongze* (贷款通则) [General Principles of Loans] (promulgated by the People's Bank of China, effective Aug. 1, 1996.), art. 34, available at <http://www.pbc.gov.cn/rhwg/19961202f.htm>.

<sup>11</sup>See *Buliang Daikuan Rending Zanxing Banfa* (不良贷款认定暂行办法) [Interim Measures for Determination of Non-Performing Loans] (promulgated by the People's Bank of China, effective Sept. 25, 2000), art. 3, available at [http://www.pbc.gov.cn:8080/image\\_public/rhwg/001604f.html](http://www.pbc.gov.cn:8080/image_public/rhwg/001604f.html).

<sup>12</sup>See, e.g., *Yinhang Yuqi Daikuan Lilv Shi Duoshao?* (银行逾期贷款利率是多少?) [How Much Are Overdue Bank Loan Interest Rates?], ROADDOOR.COM (Feb. 20, 2014), available at <http://finance.roaddoor.com/32314.html>.

<sup>13</sup>*Id.*

outstanding for a long time.<sup>14</sup> From a legal perspective, loans that are over three years overdue are automatically categorized under Chinese law as idle loans.<sup>15</sup> From an institutional point of view, a loan is idle when the institution will be unable to fully recover before three years have passed from when it became overdue.<sup>16</sup>

These two perspectives are almost identical. The only significant difference is that a financial institution may record a loan as idle before three years have passed. However, as there is generally little to no overlap between when the institution has to declare its NPLs and when the three year date accrues, this difference does not have a significant impact on Chinese NPL practices. Additionally, the practical effects are minimal because (1) this is merely changing the category of NPL, as opposed to determining whether a loan is non-performing, and (2) as discussed below, the majority of China's NPLs are held by a select few financial institutions that are regulated by the same agencies.

It is important to remember that this three year period does not determine when a loan becomes non-performing. As discussed above, Chinese loans are categorized as NPLs once the date in the loan agreement passes and there are outstanding payments. If three years pass, then the loan's categorization changes from overdue to idle.<sup>17</sup>

### c. Bad Loans

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<sup>14</sup>*Shenme Shi Daizhi Daikuan, yu Daizhang Daikuan You Shenme Qubie?* (什么是呆滞贷款，与呆账贷款有什么区别?) [What Are Idle Loans, and How Do They Differ from Bad Loans?], EDAL.COM (Jan. 25, 2013), available at [http://www.edai.com/news/article\\_1459.html](http://www.edai.com/news/article_1459.html).

<sup>15</sup>*Daizhi Daikuan* (呆滞贷款) [Idle Loan], 360DOC (May 29, 2014), available at [http://www.360doc.com/content/14/0529/11/8064468\\_381965689.shtml](http://www.360doc.com/content/14/0529/11/8064468_381965689.shtml).

<sup>16</sup>*Daizhi Daikuan* (呆滞贷款) [Idle Loan], MBA LIBRARY (last visited Aug. 28, 2014), available at <http://wiki.mbalib.com/wiki/%E5%91%86%E6%BB%9E%E8%B4%B7%E6%AC%BE#>.

<sup>17</sup>*See id.*

Both overdue loans and idle loans are narrowly defined by Chinese regulations. In comparison, there are many circumstances that may cause a loan to fall under the “bad loans” category in China’s NPL scheme.<sup>18</sup>

A loan may be categorized as a bad loan if a debtor and guarantor declare bankruptcy, and the bankruptcy settlement does not satisfy the loan.<sup>19</sup> A loan could also be a bad loan if a debtor dies or is declared presumed dead according to the General Principles of the Civil Law of the People’s Republic of China (“Civil Law General Principles”), and the distribution of the estate does not satisfy the loan.<sup>20</sup> A loan would also fall under this category if a debtor suffers substantial losses from a natural disaster or accident, and does not receive adequate compensation or insurance proceeds to allow the debtor to repay his or her loan.<sup>21</sup> Also, a loan would be a bad loan if the lender successfully recovers from the collateral in the loan agreement, but it is still not enough to satisfy the full principal amount of the loan.<sup>22</sup>

There are also several situations wherein bad loans may result from judicial proceedings or government regulations. Chinese lenders often file lawsuits against debtors in the local people’s court with jurisdiction over either where the loan agreement was formed or where the debtor resides to receive a judgment for the principal and overdue interest on a loan. If a lender sues a debtor after the statutory

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<sup>18</sup>*Daizhang Daikuan* (呆账贷款) [Bad Loan], MBA LIBRARY (last visited Aug. 27, 2014), available at <http://wiki.mbalib.com/wiki/%E5%91%86%E8%B4%A6%E8%B4%B7%E6%AC%BE#> (providing a comprehensive list of the situations that may result in a loan being classified as a “bad loan”); *Shilun Shangye Yinhang Bimian Buliang Zhaiquan de Falv Jizhi* (试论商业银行避免不良债权的法律机制) [Discussing Commercial Banks’ Avoidance of Legal Mechanisms Associated with Non-Performing Loans], 110.COM (July 24, 2009), available at <http://www.110.com/ziliao/article-142097.html>.

<sup>19</sup>*Daizhang Daikuan*, fn. 18.

<sup>20</sup>*Id.*

<sup>21</sup>*Id.*

<sup>22</sup>*Id.*

period for a cause of action to accrue for lack of payment, which is currently two years, then a loan may be deemed as a bad loan if the court determines that the lender will not be able to recover due to lack of funds or bankruptcy.<sup>23</sup> Additionally, a loan will be considered a bad loan if a debtor is subject to criminal proceedings that strip him or her of assets, resulting in the inability to pay off the loan.<sup>24</sup> Finally, the State Administration of Taxation of the People's Republic of China ("Tax Bureau") may instruct a bank to write off bad debt.<sup>25</sup>

### B. Select Countries' Histories of Non-Performing Loans

Lenders have encountered difficulties collecting loans since the first loans were made over two millennia ago, and countries have been attempting to regulate loans for hundreds of years. As this article is concerned with contemporary Chinese NPL practices, this section discusses China's history as well as the histories of the US and Japan, as their NPL models provide essential lessons for tailoring a Chinese NPL strategy.

#### i. United States History

The US's history, especially from the 1930s to the present, reflects upon the effects of the economy on the percentage of NPLs held by financial institutions.<sup>26</sup> For example, the Great Depression in the 1930s resulted in a large number of borrowers being unable

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<sup>23</sup>*Id.*

<sup>24</sup>*Id.*

<sup>25</sup>*Id.*

<sup>26</sup>See, e.g., Saba, Irum et al., *Determinants of Non-Performing Loans: Case of US Banking Sector*, 44 Rom. Econ. J. 141, 150 (June 2012), available at <http://www.rejournal.eu/sites/rejournal.versatech.ro/files/issues/2012-06-02/556/15-determinantsofnon-performingloanscaseofusbankingsector.pdf> (providing data and a corresponding graph showing the effect of the 2007-2008 US economy on the percentage of US NPLs).

to pay off their loans and resultant bank failures. Various programs were put in place to manage the financial services crisis, including the creation of the Federal Deposit Insurance Corporation (“FDIC”), which not only serves as the principal provider of deposit insurance but also acts as receiver for failed and failing banks and the Reconstruction Finance Corporation, an early forerunner of today’s asset management corporations. The US did not encounter substantial NPL problems until the 1980s.

Large US banks such as Bank America and Chase Manhattan Bank experienced substantial increases in the volume of NPLs during the late 1970s and early 1980s.<sup>27</sup> More stringent banking regulations helped reduce the amount of NPLs held by US banks, and this trend continued into the 1990s until NPLs were approximately only one percent of the US’s total loans in 2000.<sup>28</sup>

The financial crisis of 2007-08 caused the percentage of NPLs held by US banks to jump to over five percent in 2010.<sup>29</sup> The overall percentage of US NPLs has reduced slightly as the domestic economy recovers.<sup>30</sup>

## ii. Japanese History

The foundation for the rise of Japan’s NPLs was set in the late 1980s.<sup>31</sup> Rising

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<sup>27</sup>See Markham, Jerry W., *A Financial History of the United States*, M.E. SHARPE, INC. (2002), Vol. III, pg. 128 (writing that “Bank America’s nonperforming loans increased from about \$400 million to \$1.2 billion between 1980 and 1981 and climbed to \$3.1 billion in 1982.”); *see also id.* at pg. 67 (stating that “[i]n 1975, nonperforming loans at Chase Manhattan Bank were over \$1.8 billion. That amount increased by another \$400 million in 1976.”).

<sup>28</sup>See Stiroh, Kevin J. & Metli, Christopher, *Now and Then: The Evolution of Loan Quality for U.S. Banks*, FEDERAL RESERVE BANK OF NEW YORK, 9.4 CURRENT ISSUES IN ECONOMICS AND FINANCE 2 (Apr. 2003), available at [http://www.newyorkfed.org/research/current\\_issues/ci9-4.pdf](http://www.newyorkfed.org/research/current_issues/ci9-4.pdf).

<sup>29</sup> Bangalore, Asha & Pressler, James, *Ten Questions: USA v. Japan*, SAFEHAVEN (Sep. 15, 2010), available at <http://www.safehaven.com/article/18191/ten-questions-usa-vs-japan>.

<sup>30</sup>*See id.*

<sup>31</sup>See Bloch, Jonathan Adam, *Interests Great and Petty: Japan’s Nonperforming Loans Debates, 1991-1998*, PROQUEST (2008), pg. 2, available at <http://books.google.com.hk/books?id=QUOQSQE6qjkC&printsec=frontcover&hl=zh-CN#v=onepage&q&f=false>.



real estate values prompted Japanese banks to increase lending.<sup>32</sup> The amount of lending was much higher than what was permitted before the 1980s due to financial liberalization and the removal of banking regulations.<sup>33</sup>

In the early 1990s, sharply increased interest rates caused a collapse which resulted in hundreds of billions of Japanese yen in NPLs.<sup>34</sup> By 1998, over 13 percent of Japan's loans were nonperforming.<sup>35</sup> That year, the Japanese government began purchasing bad debt from banks.<sup>36</sup> Financial institutions also began to merge, allowing them to process NPLs more efficiently.<sup>37</sup> These practices resulted in a dramatic decrease in Japanese NPLs to approximately two percent by 2005.<sup>38</sup>

Although US financial institutions held a relatively high percentage of NPLs after the financial crisis of 2007–08, the lessons learned by Japan made it nearly impervious to the financial crisis. In fact, Japanese NPLs only rose a few tenths of a percent after 2007.<sup>39</sup>

### iii. Chinese History

#### a. Structure of China's Banking Industry

In 1949, the PRC created a centrally planned economy that only had one bank – the

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<sup>32</sup>*Id.*

<sup>33</sup>See Kawai, Masahiro, *Japan's Banking System: From the Bubble and Crisis to Reconstruction*, UNIVERSITY OF TOKYO INSTITUTE OF SOCIAL SCIENCE, 03A-28 PRI DISCUSSION PAPER SERIES 5 (Dec. 2003), available at [https://www.mof.go.jp/pri/research/discussion\\_paper/ron080.pdf](https://www.mof.go.jp/pri/research/discussion_paper/ron080.pdf).

<sup>34</sup> Bloch, Jonathan Adam, fn. 31 at 2.

<sup>35</sup>*Id.*

<sup>36</sup>*Id.* at 5.

<sup>37</sup>*Id.* at 6.

<sup>38</sup>See *Burying China's Bad Loans*, MACRO BUSINESS (Nov. 16, 2012), available at <http://www.macrobusiness.com.au/2012/11/burying-chinas-bad-loans/> (providing, in Chart 12, Japanese NPL trends from 1992 to 2010).

<sup>39</sup>See *id.*

People's Bank of China ("PBOC").<sup>40</sup> Its existing banks, including what had been and would become the "Big Four" (四大商业银行): the Bank of China ("BOC"), the Agricultural Bank of China ("ABC"), China Construction Bank ("CCB"), and the Industrial and Commercial Bank of China ("ICBC"), each split in two – their domestic operations were subsumed under the PBOC, and their Taiwan and foreign operations were structured abroad.<sup>41</sup>

In 1978, China underwent major financial reforms. These reforms included separating the Big Four from the PBOC.<sup>42</sup> The Big Four, which would operate as state-owned banks under the PBOC's regulations,<sup>43</sup> made most of their loans to state-owned enterprises ("SOEs").<sup>44</sup>

China utilizes a bank-centered financial structure.<sup>45</sup> In comparison to the US, which had 18 percent of its financial stock in the banking system in 2006, China had 55 percent in its banking system.<sup>46</sup> This allowed China to partially insulate itself from the impact of the financial crisis of 2007-08.<sup>47</sup> However, this bank-centered system also detracts from investment efficiency.<sup>48</sup>

By the end of 2011, the PRC had over 3,800 financial institutions.<sup>49</sup> Of these

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<sup>40</sup> Scott, Hal S. & Gelper, Anna, *International Finance: Transactions, Policy, and Regulation*, FOUNDATION PRESS (2012, 19<sup>th</sup> ed.), pg. 1286.

<sup>41</sup> See Turner, Grant et al., *The Chinese Banking System*, RESERVE BANK OF AUSTRALIA (Sept. 2012), available at <http://www.rba.gov.au/publications/bulletin/2012/sep/7.html>.

<sup>42</sup> Allen, Franklin et al., *China's Financial System: Past, Present, and Future*, BOSTON COLLEGE (July 21, 2005), pg. 6, available at <https://www2.bc.edu/~qianju/China-finsystem-book-072105-ALL.pdf>.

<sup>43</sup> See Allen, Franklin et al., fn. 42 at 17.

<sup>44</sup> Turner, Grant et al., fn. 41.

<sup>45</sup> Scott, Hal S. & Gelper, Anna, fn. 40 at 1285.

<sup>46</sup> *Id.*

<sup>47</sup> See *id.* at 1286.

<sup>48</sup> *Id.* at 1285.

<sup>49</sup> *Id.* at 1294–95.

financial institutions, only 164 of them were municipal, regional, and national banks.<sup>50</sup>

China's commercial banking system can be divided into three tiers: the large commercial banks, national banks (there are approximately 12 national banks that are significantly smaller than the Big Four), and municipal/regional banks.<sup>51</sup> Although there is not sufficient publicly available data on the NPLs currently on the books of Chinese banks, it is commonly understood that most of the NPLs in the banking industry are held by the Big Four.

#### b. History of Chinese Non-Performing Loans

Many of the NPLs held by PRC banks were originally created in the 1980s and 1990s.<sup>52</sup> Constant and accelerated economic growth incited substantial investments in infrastructure and housing.<sup>53</sup> However, the slowing down of the domestic economy resulted in the inability of many debtors to repay their loans.<sup>54</sup> Unlike in Japan, the PRC did not have adequate risk-control procedures or regulations to counteract the accumulation of NPLs.<sup>55</sup> Also, China did not have a credit-rating system, which would have been invaluable to banks at the time of their lending decisions.<sup>56</sup> This led to very high NPL v. total loan percentages, topping out at over 25 percent around

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<sup>50</sup>*Id.* at 1295.

<sup>51</sup>*See id.*

<sup>52</sup> Dai, Xianglong, *A Short History of China's Banking Sector, 1978-2003*, in *China's Emerging Financial Markets: Challenges and Opportunities*, MILKEN INSTITUTE (Barth, James R. eds. et al, 2009), pg. 406, available at [http://books.google.com.hk/books?id=ik1ugTMcltMC&pg=PA404&lpg=PA404&dq=history+of+chinese+nonperforming+loans&source=bl&ots=nsW\\_-jJ8b4&sig=wIJ7GYcvR5wHbg85LZmtcJ3VdYY&hl=zh-CN&sa=X&ei=qYYAVPqlA4bEggTdx4GABg&ved=0CGsQ6AEwCA#v=onepage&q=history%20of%20chinese%20nonperforming%20loans&f=false](http://books.google.com.hk/books?id=ik1ugTMcltMC&pg=PA404&lpg=PA404&dq=history+of+chinese+nonperforming+loans&source=bl&ots=nsW_-jJ8b4&sig=wIJ7GYcvR5wHbg85LZmtcJ3VdYY&hl=zh-CN&sa=X&ei=qYYAVPqlA4bEggTdx4GABg&ved=0CGsQ6AEwCA#v=onepage&q=history%20of%20chinese%20nonperforming%20loans&f=false).

<sup>53</sup>*See id.*

<sup>54</sup>*Id.*

<sup>55</sup>*See id.*

<sup>56</sup>*Id.*

1999-2000.<sup>57</sup>

In 1999, China established four asset management companies (“AMCs”) to manage its NPLs: Changcheng (“Great Wall”), Dongfang (“Orient”), Huarong, and Xinda (“Cinda”).<sup>58</sup> Various government ministries and other financial institutions funded China’s AMCs, which then purchased NPLs from its banks.<sup>59</sup> These four AMCs primarily manage NPLs through debt equity swaps, auctions, and bids.<sup>60</sup>

Chinese NPLs have dropped from 25 percent to one percent since the establishment of the AMCs.<sup>61</sup> China has steadily maintained this low rate of NPLs since 2010.<sup>62</sup> Nonetheless, considering the massive size of the PRC’s economy, even a one percent NPL v. total loan rate is still almost 100 billion USD.<sup>63</sup> As the rate of growth of China’s economy abates, there is a high probability that more of its debtors will be unable to satisfy their loans.<sup>64</sup>

## 2. Non-Performing Loan Strategies

Financial institutions handle their NPLs in different ways. Generally speaking, NPL strategies can be classified by country. There were many differences for the causes of US and Japanese NPLs. Likewise, the US and Japan have used different

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<sup>57</sup>See Holmes, Frank, *Heart of China Bull Beats Strong*, SAFEHAVEN (Jan. 30, 2012), available at <http://www.safehaven.com/article/24195/heart-of-china-bull-beats-strong> (providing a graph of China’s NPL ratio for 1999-2011).

<sup>58</sup> Dai, Xianglong, fn. 52 at 408; see also Kuang, Haibo et al., *AMC Non-Performing Assets Disposal with CDO in China*, 5.7 JOURNAL OF CONVERGENCE INFORMATION TECHNOLOGY 197, 198 (Sept. 2010), available at [http://www.aicit.org/jcit/ppl/JCIT\\_09-26\\_640091JE.pdf](http://www.aicit.org/jcit/ppl/JCIT_09-26_640091JE.pdf).

<sup>59</sup> Dai, Xianglong, fn. 52 at 408.

<sup>60</sup> Kuang, Haibo et al., fn. 58 at 198.

<sup>61</sup>See Holmes, Frank, fn. 57 (showing in the graph labelled “China’s Non Performing Loans Ratio Remains Near Historic Low” that the PRC’s NPL v. total loans percentage (1) was around 25 percent from 1999-2002, (2) steadily decreased from 2002 to 2008, and (3) have remained around one percent since 2010).

<sup>62</sup>See *id.*

<sup>63</sup>See *China Banks Bad-Debt Ratio Seen Rising to Most Since 2009*, fn. 2.

<sup>64</sup>See *id.*

methods for resolving their NPL issues.

This section describes how the US and Japan addressed their financial institutions' NPLs. I have chosen these two countries because there are varying underlying causes for their accumulation of NPLs, they exhibited disparate methods for dealing with NPLs, and there is more data on their NPLs than many other countries.

#### A. United States

The US government generally has not acquired NPLs from financial institutions unless they have failed.<sup>65</sup> Not many banks failed before 1980 and, as most of the failed banks were small banks, NPLs did not make up a substantial portion of their portfolios.<sup>66</sup> The assets of failed banks were retained by the FDIC, which would first attempt to sell the NPLs to the acquiring bank.<sup>67</sup> If the acquiring bank did not acquire the NPLs, then the FDIC would attempt to recover payment.<sup>68</sup> Although the FDIC typically sought the full balance of the loan, it would sometimes allow the loan to be reevaluated according to the market value at the time.<sup>69</sup>

The percentage of NPLs in the US gradually increased in the 1980s, causing the FDIC to open regional offices to handle the liquidation of failing banks.<sup>70</sup> In response to the savings and loan crisis, Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA"), which created the Resolution Trust

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<sup>65</sup>See, e.g., Curry, Timothy & Shibut, Lynn, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, 13.2 FDIC BANKING REVIEW 26, 29 (2000), available at [https://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2\\_2.pdf](https://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf).

<sup>66</sup>See *Managing the Crisis: The FDIC and RTC*, THE FEDERAL DEPOSIT INSURANCE CORPORATION (Oct. 4, 2013), pg. 292, available at <https://www.fdic.gov/bank/historical/managing/>.

<sup>67</sup>*Id.*

<sup>68</sup>*Id.*

<sup>69</sup>*Id.*

<sup>70</sup>See *id.* at 294.

Corporation (“RTC”) in 1989.<sup>71</sup> The US government entrusted the RTC to place all savings and loans that were insolvent on Jan. 1, 1989 into conservatorships except for select banks that were already in receivership by the Federal Savings & Loan Insurance Corporation (“FSLIC”).<sup>72</sup> Former savings and loan regulators were also subsumed by the FDIC as “parent” of the RTC.

The RTC curtailed the lending practices of its conservatorships, and also focused on selling their assets.<sup>73</sup> Not only did Congress mandate that the RTC would pursue the largest possible return on its NPLs, but it was expected to sell the assets quickly and “preserv[e] . . . the availability and affordability of residential real property for low- and moderate-income individuals.”<sup>74</sup>

Unlike in the PRC, the RTC only managed NPLs held by its conservatorships.<sup>75</sup> In total, the RTC managed over 300 billion USD in assets.<sup>76</sup> Unlike the FDIC, the RTC usually lowered the price of its assets, which allowed it to dispose of NPLs more quickly.<sup>77</sup> The RTC merged with the FDIC in 1995,<sup>78</sup> and the FDIC is still the receiver for many US failing banks.<sup>79</sup>

## B. Japan

The Japanese government exhibited a delayed response to the rapid accrual of

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<sup>71</sup>*Id.* at 297.

<sup>72</sup>Kettl, Donald F., *Accountability Issues of the Resolution Trust Corporation*, 2.1 HOUSING POLICY DEBATE 93, 96 (1991), available at <http://content.knowledgeplex.org/kp2/img/cache/sem/39932.pdf>.

<sup>73</sup>Curry, Timothy & Shibut, Lynn, fn. 65 at 297.

<sup>74</sup>See Kettl, Donald F., fn. 72 at 97.

<sup>75</sup>See Curry, Timothy & Shibut, Lynn, fn. 65 at 297.

<sup>76</sup>See *id.*

<sup>77</sup>See *id.* at 300.

<sup>78</sup>*Id.* at 295.

<sup>79</sup>See Failed Banks, THE FEDERAL DEPOSIT INSURANCE CORPORATION (last visited Aug. 29, 2014), available at <https://www.fdic.gov/bank/individual/failed/>.

NPLs in the 1980s.<sup>80</sup> However, the widespread systemic crisis of Japan's banking system in 1997 prompted the government to take drastic steps.<sup>81</sup> First, the government made more than 300 billion USD available to Japan's equivalent of the FDIC, the Deposit Insurance Corporation ("DIC"), and nationalized the Long-Term Credit Bank of Japan and Nippon Credit Bank.<sup>82</sup>

Japan's first step to managing the high percentage of its NPLs was to determine the amount of NPLs that it had. It established the Financial Reconstruction Commission ("FRC"), which, in collaboration with the Bank of Japan ("BOJ"), calculated that Japanese financial institutions held approximately 375 billion USD in NPLs.<sup>83</sup> The government also created an agency called the Financial Services Agency ("FSA") to audit banks' NPLs.<sup>84</sup>

Much like the US, which created the RTC to purchase and collect on NPLs, Japan established the Resolution and Collection Corporation ("RCC") and Industrial Revitalization Corporation of Japan ("IRCJ").<sup>85</sup> For the NPLs that these agencies did not acquire, the Japanese government set standards and goals for NPL management.<sup>86</sup> These efforts reduced the percentage of NPLs to total loans from around 10 percent to two percent in roughly five years.<sup>87</sup>

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<sup>80</sup>See Kawai, Masahiro, fn. 33 at 11; *see also* Xu, Min, *Resolution of Non-Performing Loans in China*, THE LEONARD N. STERN SCHOOL OF BUSINESS, GLUCKSMAN INSTITUTE FOR RESEARCH IN SECURITIES MARKETS (Apr. 1, 2005), pg. 16, *available at* [https://www.stern.nyu.edu/sites/default/files/assets/documents/uat\\_024327.pdf](https://www.stern.nyu.edu/sites/default/files/assets/documents/uat_024327.pdf).

<sup>81</sup> Kawai, Masahiro, fn. 33 at 11.

<sup>82</sup>*See id.*

<sup>83</sup>*See id.* 13–14.

<sup>84</sup>*See id.* at 14.

<sup>85</sup>*See id.* at 18.

<sup>86</sup>*See id.* at 14.

<sup>87</sup>*See Burying China's Bad Loans*, fn. 38.

### 3. Chinese Non-Performing Loans

As with its counterparts discussed in the previous section, China also previously held a high percentage of NPLs. This section begins by discussing how China accumulated its NPLs, introduces the current holders of bad debt in China and Chinese bankruptcy proceedings, and concludes by providing an in-depth review of Chinese laws and regulations associated with NPLs.

#### A. Major Holders

The major holders of Chinese NPLs are large Chinese commercial banks and China's four AMCs.

##### i. Banks

The US began to encounter NPL issues in the 1970s, and Japan's NPLs rose in the 1980s. In comparison, China did not experience problems with bad debt until the 1990s.

Many of China's SOEs not only made profits, but relied heavily on state-owned banks to fund their operations.<sup>88</sup> Since both the banks and SOEs were owned by the government, and the government needed the banks to provide credit in order to allow its companies to run, these banks made loans to SOEs despite their knowledge that the loans would probably not be repaid.<sup>89</sup> As these loans were not repaid, Chinese financial institutions began to classify them as NPLs. By 1998, nearly 1/4 of China's loans were non-performing, causing the central government to inject approximately 33

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<sup>88</sup> Turner, Grant et al., fn. 41.

<sup>89</sup> See *id.*



billion USD into the Big Four.<sup>90</sup> It also restructured these four banks, and created its AMCs to help manage its NPLs.

#### ii. Asset Management Companies

As mentioned above, the PRC created four AMCs in 1999 to manage its NPLs. Cinda was the first AMC, and it received approximately 61 billion USD (book value) of NPLs from the CCB and State Development Bank (“CDB”).<sup>91</sup> The NPL transfer to Cinda did not include NPLs incurred by these banks after 1996, nor did they include loans deemed irrecoverable, which were simply written off by the central government.<sup>92</sup> The other three AMCs purchased NPLs from the other Big Four banks by issuing bonds backed by the Ministry of Finance of the People’s Republic of China (“MOF”).<sup>93</sup> Orient was matched with BOC, Great Wall with ABC, and Huarong with ICBC.<sup>94</sup>

Initially, China’s AMCs marketed their NPLs to foreign buyers.<sup>95</sup> This led to a larger amount of NPLs being purchased at auction than what would have otherwise been possible with only domestic buyers.<sup>96</sup> The first of these auctions was conducted in 2001 by Huarong.<sup>97</sup> Goldman Sachs and a group of investors led by Morgan

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<sup>90</sup>See *id.*

<sup>91</sup> Peisner, Richard & Wang, Bing, *Non-Performing Loan Resolution in China*, 8.4 JOURNAL OF REAL ESTATE PORTFOLIO MANAGEMENT 115, 121 (2002), available at [http://www.cre.org/memberdata/pdfs/27\\_3\\_4\\_china.pdf](http://www.cre.org/memberdata/pdfs/27_3_4_china.pdf).

<sup>92</sup>*Id.*

<sup>93</sup>*Id.*

<sup>94</sup>See Ma, Guonan & Fung, Ben, *China’s asset management corporations*, BANK FOR INTERNATIONAL SETTLEMENTS, BIS WORKING PAPERS No. 115 (Aug. 2002), pg. 1, available at <http://www.bis.org/publ/work115.pdf>.

<sup>95</sup> Peisner, Richard & Wang, Bing, fn. 91 at 122.

<sup>96</sup>See *id.*

<sup>97</sup> Sprayregen, James et al., *Non-performing loans in China: a potential win-win opportunity for foreign investors and China’s economy*, 2004 GLOBAL RESTRUCTURING & INSOLVENCY REVIEW 38, 38, available at [http://www.kirkland.com/siteFiles/kirkexp/publications/2435/Document1/Non-performing\\_Loans\\_In\\_](http://www.kirkland.com/siteFiles/kirkexp/publications/2435/Document1/Non-performing_Loans_In_)

Stanley acquired an NPL portfolio valued at 1.5 billion USD for less than nine cents on the dollar.<sup>98</sup> Huarong and the other AMC's subsequently held other auctions with foreign investors.<sup>99</sup> These auctions were not categorized by industry or any other method – they were merely large sales of miscellaneous distressed debt. For example, Morgan Stanley's purchase of Huarong's NPLs gave it loan rights to various types of manufacturers from bicycles to coal-mining to Maotai liquor.<sup>100</sup>

These large auctions stopped in the mid-2000s after the AMC's had disposed of most of their NPLs.<sup>101</sup> Currently, AMC's only auction smaller portfolios of NPLs, although they may increase the size and frequency of their auctions depending upon the amount of NPLs on their books.<sup>102</sup>

### iii. Bankruptcy Proceedings

Not surprisingly, the amount of bankruptcy cases in other countries, including the US, dwarfs the number of cases filed in China.<sup>103</sup> For example, the US saw over 8000 bankruptcy cases filed in March 2009 alone, while only 2,900 cases were filed in China for the entire year of 2009.<sup>104</sup> This is primarily due to the lack of bankruptcy regulations and specialized bankruptcy courts.<sup>105</sup>

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China.pdf.

<sup>98</sup>*Id.*; Liu, Henry, *China: Banking on bank reform*, ASIA TIMES (Jan. 1, 2002), available at <http://www.atimes.com/china/DF01Ad05.html>.

<sup>99</sup>*See id.* at 39.

<sup>100</sup>*See* Clifford, Mark & Webb, Alysha, *Beijing: Look Out, Deadbeats*, BLOOMBERG BUSINESSWEEK MAGAZINE (Dec. 23, 2001), available at <http://www.businessweek.com/stories/2001-12-23/beijing-look-out-deadbeats>.

<sup>101</sup>*See* Burroughs, Tim, *China tipped to see more NPL deal flow*, Asian Venture Capital Journal (Feb. 10, 2012), available at <http://www.shoreline-capital.com/articles/AVCJ10Feb2012.pdf>.

<sup>102</sup>*See id.*

<sup>103</sup>*See* Pedone, Richard & Liu, Henry, *The Evolution of Chinese Bankruptcy Law: Challenges of a Growing Practice Area*, ASPATORE (last visited Sept. 16, 2014), pg. 1, available at [http://nhdd.com/linked\\_media/publications/China\\_Bankruptcy\\_Law\\_Pedone.pdf](http://nhdd.com/linked_media/publications/China_Bankruptcy_Law_Pedone.pdf).

<sup>104</sup>*See id.*

<sup>105</sup>*See id.* at 1–2 (providing that the PRC did not have a bankruptcy system until 1986, and that the

Between 1987 and 2007, many SOEs declared bankruptcy due to “policy bankruptcies.”<sup>106</sup> In these situations, the government promoted the bankruptcy of SOEs that were losing money, and its main concern was ensuring that employees received compensation for the expectation of life-long employment.<sup>107</sup> This practice ended with the implementation of the Enterprise Bankruptcy Law in 2007.<sup>108</sup>

As the Enterprise Bankruptcy Law only applies to companies, and there currently is no law for individual bankruptcy, China has yet to create a system for individual bankruptcy proceedings.<sup>109</sup> Instead of establishing bankruptcy courts, this law determines that bankruptcy cases should be filed with basic people’s courts.<sup>110</sup> The PRC also provides rescue options wherein companies going through the bankruptcy process can attempt to rehabilitate their business.<sup>111</sup>

#### B. Laws and Regulations

China has implemented dozens of laws and regulations pertaining to its NPLs. On the national level, the State Council has promulgated laws that define the responsibilities of AMCs as well as the agency powers of related administrations. In turn, these administrations have issued regulations that further determine how China manages its NPLs. This section provides these national laws and administrative regulations in chronological order, according to date of last revision, to demonstrate the

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Enterprise Bankruptcy Law was implemented in 2007).

<sup>106</sup>See *id.* at 2.

<sup>107</sup>*Id.*

<sup>108</sup>See *id.*

<sup>109</sup>See Nowina, Michael, *Bankruptcy law comes to China*, LAWYERS WEEKLY (Nov. 19, 2010), available at <http://www.lawyersweekly.ca/index.php?section=article&articleid=1295>.

<sup>110</sup>See *id.*

<sup>111</sup>See *id.*

evolution of the PRC's regulation of NPLs. Due to the large number of administrative regulations, this article does not discuss every law and regulation associated with NPLs such as joint venture requirements and taxation.

#### i. National Laws

##### a. Asset Management Company Regulations

China has enacted four laws that affect NPLs. In 2000, China passed the 金融资产管理公司条例 (“Asset Management Company Regulations”) to promote credit lending to Chinese companies through the management of NPLs.<sup>112</sup> This law provides that the BOC, MOF, and China Securities Regulatory Commission (“CSRC”) have the power to regulate China's AMCs.<sup>113</sup> It allocated 10 billion RMB (app. 1.6 billion USD) to each of the four AMCs for registered capital,<sup>114</sup> states the typical operations that AMCs will conduct in order to manage NPLs,<sup>115</sup> and discusses accounting and record-keeping.<sup>116</sup> It also provides that AMCs should sell NPLs primarily through auctions.<sup>117</sup>

##### b. Regulations on the Main Functions, Interior Institutions, and Staffing of the China Banking Regulatory Commission

In April 2003, nearly three years after the Asset Management Company Regulations, the State Council implemented two additional laws. The first law, 中国

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<sup>112</sup>See *Jinrong Zichan Guanli Gongsi Tiaoli* (金融资产管理公司条例) [Asset Management Company Regulations] (promulgated by the State Council, effective Nov. 1, 2000), art. 1, *available at* [http://www.pbc.gov.cn/publish/tiaofasi/273/1386/13861/13861\\_.html](http://www.pbc.gov.cn/publish/tiaofasi/273/1386/13861/13861_.html).

<sup>113</sup>*See id.* art. 4.

<sup>114</sup>*See id.* art. 5.

<sup>115</sup>*See id.* art. 10.

<sup>116</sup>*See, e.g., id.* art. 27.

<sup>117</sup>*See id.* art. 26.

银行业监督管理委员会主要职责内设机构和人员编制规定 (“Regulations on the Main Functions, Interior Institutions, and Staffing of the China Banking Regulatory Commission”),<sup>118</sup> created the China Banking Regulatory Commission (“CBRC”), allocating it regulatory jurisdiction over all financial institutions including AMCs.<sup>119</sup> It broadly defines the CBRC’s duties such as investigating financial institutions’ potential violations of the law.<sup>120</sup> It also set up the CBRC’s 15 departments,<sup>121</sup> and its initial number of staff.<sup>122</sup>

c. Resolution of the Standing Committee of the State Council on the Assumption of Regulatory Functions of the People’s Bank of China by the China Banking Regulatory Commission

The second law created in 2003 was the 全国人民代表大会常务委员会关于中国银行业监督管理委员会履行原由中国人民银行履行的监督管理职责的决定 (“Resolution of the Standing Committee of the State Council on the Assumption of Regulatory Functions of the People’s Bank of China by the China Banking Regulatory Commission”).<sup>123</sup> This short law authorized the CBRC to regulate and supervise

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<sup>118</sup>See Zhongguo Yinhangye Jiandu Guanli Weiyuanhui Zhuyao Zhize Neishe Jigou he Renyuan Bianzhi Guiding (中国银行业监督管理委员会主要职责内设机构和人员编制规定) [Regulations on the Main Functions, Interior Institutions, and Staffing of the China Banking Regulatory Commission] (promulgated by the State Council, effective Apr. 25, 2003), *available at* [http://www.gov.cn/gongbao/content/2003/content\\_62146.htm](http://www.gov.cn/gongbao/content/2003/content_62146.htm).

<sup>119</sup>See *id.*, preface.

<sup>120</sup>See *id.*, art. 2.3.

<sup>121</sup>See *id.*, art. 3.

<sup>122</sup>See *id.* art. 4.

<sup>123</sup>See Quanguo Renmin Daibiao Dahui Changwu Weiyuanhui Guanyu Zhongguo Yinhangye Jiandu Guanli Weiyuanhui Lvxing Yuanyou Zhongguo Renmin Yinhang Lvxing de Jiandu Guanli Zhize de Jueding (全国人民代表大会常务委员会关于中国银行业监督管理委员会履行原由中国人民银行履行的监督管理职责的决定) [Resolution of the Standing Committee of the State Council on the Assumption of Regulatory Functions of the People’s Bank of China by the China Banking Regulatory

AMCs.<sup>124</sup>

d. Banking Supervision Law of the People's Republic of China

The fourth national law that affects NPL management in China is the 中华人民共和国银行业监督管理法 (“Banking Supervision Law of the People's Republic of China”), which lists the specific duties of the CBRC.<sup>125</sup> The CBRC's responsibilities include creating and implementing regulations on financial institutions,<sup>126</sup> update financial institutions' scope of business,<sup>127</sup> and setting operational standards such as asset quality and acceptable risk.<sup>128</sup>

ii. Administrative Regulations

As described above, the PRC's national laws associated with NPLs do not regulate NPLs directly. Rather, they establish a regulatory environment for NPLs. This same trend appears in China's administrative regulations from the CBRC and MOF.

As there are a large number of administrative regulations, and many of them do not directly affect NPLs, this section briefly examines seven of the most important regulations to provide the reader with an understanding of the way that China addresses issues related to NPL management.

a. Administrative Measures for Investing and Shareholding in China-Funded Financial

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Commission] (promulgated by the State Council, effective Apr. 26, 2003), *available at* [http://www.pbc.gov.cn/publish/tiaofasi/272/1383/13833/13833\\_.html](http://www.pbc.gov.cn/publish/tiaofasi/272/1383/13833/13833_.html).

<sup>124</sup>*See id.* art. 1.

<sup>125</sup>*See* Zhongguo Renmin Gongheguo Yinhangye Jiandu Guanlifa (中华人民共和国银行业监督管理法) [Banking Supervision Law of the People's Republic of China] (promulgated by the State Council, effective Dec. 27, 2003, last revised Oct. 31, 2006), ch. 3, *available at*

[http://www.pbc.gov.cn/publish/zhengwugongkai/501/1810/18100/18100\\_.html](http://www.pbc.gov.cn/publish/zhengwugongkai/501/1810/18100/18100_.html).

<sup>126</sup>*Id.* art. 15.

<sup>127</sup>*Id.* art. 16.

<sup>128</sup>*Id.* art. 21.

### Institutions by Foreign Financial Institutions

Two years after Huarong held the first NPL portfolio auction for foreign investors, the CBRC implemented the 境外金融机构投资入股中资金融机构管理办法 (“Administrative Measures for Investing and Shareholding in China-Funded Financial Institutions by Foreign Financial Institutions”) to set guidelines on foreign investment in Chinese financial institutions.<sup>129</sup> It creates minimum requirements for foreign investors including having made a profit for the last two years, good credit standing, and strong internal controls.<sup>130</sup> This regulation also limits foreign participation in Chinese financial institutions. For example, a single foreign financial institution cannot own 25 percent or more of a Chinese financial institution’s shares.<sup>131</sup>

#### b. Administrative Measures Concerning Asset Management Company Risk Management

In 2004, the MOF issued a regulation to the four AMCs that expanded on the Asset Management Company Regulations. The purpose of this regulation, the 金融资产管理公司有关业务风险管理办法 (“Administrative Measures Concerning Asset Management Company Risk Management”), is to increase efficiency and control the risks taken by AMCs.<sup>132</sup>

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<sup>129</sup>See Huanwai Jinrong Jigou Touzi Rugu Zhongzi Jinrong Jigou Guanli Banfa(境外金融机构投资入股中资金融机构管理办法) [Administrative Measures for Investing and Shareholding in China-Funded Financial Institutions by Foreign Financial Institutions] (promulgated by the China Banking Regulatory Commission, effective Dec. 31, 2003), art. 1, available at [http://www.cbrc.gov.cn/chinese/home/docDOC\\_ReadView/295.html](http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/295.html).

<sup>130</sup>See *id.* art. 7.

<sup>131</sup>*Id.* art. 8.

<sup>132</sup>See Jinrong Zichan Guanli Gongsu Youguan Yewu Fengxian Guanli Banfa(金融资产管理公司有关业务风险管理办法) [Administrative Measures Concerning Asset Management Company Risk

It sets standards for determining which assets to purchase, such as whether the AMC could obtain property rights associated with a loan,<sup>133</sup> and holds that the investment in an asset cannot exceed 2/3rds of the asset's cash capital.<sup>134</sup> This regulation also states that AMCs must hold shareholder voting for policy changes.<sup>135</sup> A policy will not be changed unless 2/3rds of the shares vote for the change, and the chairman approves the motion.<sup>136</sup>

c. Guide to Performing Due Diligence while Handling Distressed Financial Assets

In 2005, the CBRC and MOF jointly issued one of China's most important regulations on NPLs. The 不良金融资产处置尽职指引 (“Guide to Performing Due Diligence while Handling Distressed Financial Assets”) provides a guide to Chinese financial institutions, including commercial banks and AMCs, on how to manage NPLs.<sup>137</sup> As the guide is much longer than the other regulations on NPLs, the CBRC and MOF divided it into chapters: (1) an overview of the guide, (2) asset transfers, (3) asset management responsibilities, (4) pre-disposal due diligence, (5) methods of disposal and associated responsibilities, (6) price determinations, (7) disposal due diligence, (8) due diligence supervision, (9) identification and disclosure

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Management] (promulgated by the Ministry of Finance, effective Apr. 28, 2004), art. 1, *available at* [http://jrs.mof.gov.cn/zhengwuxinxi/zhengcefabu/200805/t20080522\\_33543.html](http://jrs.mof.gov.cn/zhengwuxinxi/zhengcefabu/200805/t20080522_33543.html).

<sup>133</sup>*See id.* art. 6.1.

<sup>134</sup>*See id.* art. 11.

<sup>135</sup>*See id.* art. 9.

<sup>136</sup>*Id.*

<sup>137</sup>*See generally* Buliang Jinrong Zichan Chuzhi Jinzhi Zhiyin (不良金融资产处置尽职指引) [Guide to Performing Due Diligence while Handling Distressed Financial Assets] (promulgated by the China Banking Regulatory Commission and Ministry of Finance, effective Nov. 18, 2005), *available at* <http://www.cbrc.gov.cn/upload/zwgk/ml3/2/5-2-15.doc>.



responsibilities, and (10) a short supplementary section.<sup>138</sup>

This regulation sets guidelines for the entire NPL management process. It states that if loans are non-performing, then they should be classified and publicized as such, and should be disposed of efficiently and in a manner that maximizes return.<sup>139</sup> It discusses how to evaluate a borrower's and guarantor's ability to repay a loan,<sup>140</sup> evaluating and reevaluating the potential value of an NPL,<sup>141</sup> and emphasizes the importance of due diligence.<sup>142</sup>

The guide reads somewhat like a national law, wherein it contains a heavy amount of idealistic language seeking to promote legal behavior and harmony.<sup>143</sup> It does not state that financial institutions must follow its suggestions. Rather, this guide functions as a framework for how the CBRC and MOF would prefer due diligence to be performed.

#### d. Administrative Measures for Financial Licenses

The CBRC revised the 金融许可证管理办法 (“Administrative Measures for Financial Licenses”) in 2007.<sup>144</sup> This regulation controls the CBRC's licensing procedures for financial institutions.<sup>145</sup>

#### e. Administrative Measures for Financial Asset Companies' Disposal of Assets

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<sup>138</sup>See generally *id.*

<sup>139</sup>See *id.* art. 4.

<sup>140</sup>See *id.* art. 15.

<sup>141</sup>See *id.* art. 36.

<sup>142</sup>See *id.* art. 55.

<sup>143</sup>See generally *id.*

<sup>144</sup>Jinrong Xukezheng Guali Banfa (金融许可证管理办法) [Administrative Measures for Financial Licenses] (promulgated by the China Banking Regulatory Commission, effective July 1, 2003, last revised Dec. 28, 2006), available at [www.cbrc.gov.cn/upload/zwgk/ml3/2/1-1-2.doc](http://www.cbrc.gov.cn/upload/zwgk/ml3/2/1-1-2.doc).

<sup>145</sup>See generally *id.*

The MOF revised the 金融资产管理公司资产处置管理办法 (“Administrative Measures for Financial Asset Companies’ Disposal of Assets”) in 2008.<sup>146</sup> The purpose of this regulation is to standardize how AMC’s dispose of NPLs.<sup>147</sup> It sets standards for how NPL disposal meetings are held, such as that they must consist of at least seven members, and at least 2/3rds of the members must agree on a disposal plan.<sup>148</sup> This regulation also sets guidelines for bidding,<sup>149</sup> additional regulations for selling assets to companies not listed on a stock market,<sup>150</sup> and confidentiality requirements.<sup>151</sup>

f. Regulatory Guide to Consolidated Supervision of Financial Asset Management Companies (Provisional)

In 2011, the CBRC implemented the 金融资产管理公司并表监管指引 (试行) (“Regulatory Guide to Consolidated Supervision of Financial Asset Management Companies (Provisional)”).<sup>152</sup> This guide is the CBRC’s first attempt to codify how

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<sup>146</sup>See Jinrong Zichan Guanli Gongs Zichan Chuzhi Guanli Banfa (金融资产管理公司资产处置管理办法) [Administrative Measures for Financial Asset Companies’ Disposal of Assets] (promulgated by the Ministry of Finance, effective Apr. 30, 2004, last revised June 9, 2008), available at [http://www.mof.gov.cn/zhengwuxinxi/caizhengwengao/caizhengbuwengao2008/caizhengbuwengao2008/200810/t20081030\\_86341.html](http://www.mof.gov.cn/zhengwuxinxi/caizhengwengao/caizhengbuwengao2008/caizhengbuwengao2008/200810/t20081030_86341.html).

<sup>147</sup>See *id.* art. 1.

<sup>148</sup>See *id.* art. 9.3.

<sup>149</sup>See *id.* art. 19.

<sup>150</sup>See *id.* art. 23.

<sup>151</sup>See *id.* art. 36.

<sup>152</sup>See Jinrong Zichan Guanli Gongs Bingbiao Jianguan Zhiyin (Shixing) (金融资产管理公司并表监管指引 (试行)) [Regulatory Guide to Consolidated Supervision of Financial Asset Management Companies (Provisional)] (promulgated by the China Banking Regulatory Commission, effective Mar. 8, 2011), available at [http://www.cbrc.gov.cn/chinese/home/docDOC\\_ReadView/201103253AD00ED0392AFC6DFF72607D72848700.html](http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/201103253AD00ED0392AFC6DFF72607D72848700.html).

AMCs supervise their subsidiaries.<sup>153</sup> According to the guide, an AMC should manage a subsidiary if it (1) owns over 50 percent of the subsidiary, (2) has contractually acquired representative rights from other investors that total over 50 percent of the subsidiary, (3) is given the power to supervise by the subsidiary's articles of association or by agreement, (4), can make decisions through majority presence on the subsidiary's board, or has the majority representative presence on the subsidiary's board.<sup>154</sup>

g. Administrative Measures on Financial Institutions' Transfers of Distressed Assets

The last regulation discussed in this article was recently implemented by the MOF, and is titled the 金融企业准备金计提管理办法 (“Administrative Measures on Financial Institutions' Transfers of Distressed Assets”).<sup>155</sup> This is the only regulation written directly to China's commercial banks, and informs them how to transfer their NPLs to other financial institutions.<sup>156</sup> It sets the standard formula for assessing the risk associated with an NPL<sup>157</sup> and reporting requirements.<sup>158</sup>

## II. ANALYSIS

Having developed the foundation for a discussion of Chinese NPLs, this article

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<sup>153</sup>See *id.* art. 2.

<sup>154</sup>*Id.* art. 8.1–2.

<sup>155</sup>See Jinrong Qiye Zhunbei Jin Jiti Guanli Banfa (金融企业准备金计提管理办法) [Administrative Measures on Financial Institutions' Transfers of Distressed Assets] (promulgated by the Ministry of Finance, effective Mar. 30, 2012), available at [http://jrs.mof.gov.cn/zhengwuxinxi/zhengcefabu/201204/t20120411\\_642214.html](http://jrs.mof.gov.cn/zhengwuxinxi/zhengcefabu/201204/t20120411_642214.html).

<sup>156</sup>See *id.* art. 4.

<sup>157</sup>See *id.* art. 10. (potential risk = normal risk for asset class \* 1.5% + concerned class's asset risk \* 3% + secondary risk for asset \* 30% + doubtful class's asset risk \* 60% + losing class's asset risk \* 100%) (“潜在风险估计值=正常类风险资产 × 1.5%+关注类风险资产 × 3%+次级类风险资产 × 30%+可疑类风险资产 × 60%+损失类风险资产 × 100%”).

<sup>158</sup>See *id.* art. 12.

continues by analyzing the causes of NPLs in the PRC. It then discusses China's current potential NPL problems, and provides a brief hypothetical implementation of the US's and Japan's NPL strategies in China.

## 1. Analyzing Chinese Non-Performing Loans

### A. Causes

China accumulated a massive amount of NPLs by the beginning of the 21<sup>st</sup> century. The causes of this rise in NPLs are not solely connected to its loan industry. Rather, they demonstrate many of the economic, legal, and political issues that were especially prevalent in China during the 1990s.

Although "China" has existed for thousands of years, the PRC was established in 1949, and the Cultural Revolution ended in 1976. These periods of political upheaval made it impossible for the country to establish even a basic legal foundation. For example, the PRC did not have a constitution until 1954. By 1990, China had begun to establish what would evolve into its current corpus of national laws and regulations.

However, China's economy was already developing at a massive rate by the 1990s. Its laws and regulations were not sufficient to properly manage its booming economy, which led to problems including inadequate loan practices. Additionally, the PRC focused its efforts on promoting SOEs. This caused its financial institutions to make loans to these SOEs, regardless of whether they would be able to pay those loans. After a few years, these loans were classified as non-performing, leading China to address the problem after realizing that over 25 percent of its loans were not being paid.

### B. Current Issues

There are two current issues that take center-stage in China's NPL market: (1) how to resolve its remaining outstanding NPLs and (2) the potential increase in NPLs as China's economy slows.

i. Outstanding Non-Performing Loans

Although only one percent of the PRC's loans are non-performing, China holds approximately 96 billion USD in outstanding debt. This remaining one percent is mostly composed of older NPLs that China's financial institutions, including its AMCs, were unable to resolve. This signifies that there is a very low possibility that China's financial institutions will receive any meaningful return on these loans.

It is probable that a small fraction of these NPLs will be resolved. However, it is unlikely that most of their value will be recovered. In consideration of China's history of bailing out companies, especially SOEs, the PRC may simply write off the remaining NPLs. On the other hand, the government's perceived willingness to write off bad debt is one of the main reasons that some debtors are holding off repaying their loans.

ii. Potential Increase in Non-Performing Loans as Economic Growth Slows

Both the US and Japan experienced the greatest increase in NPLs when their economies slowed after a period of substantial growth. Japan resorted to more drastic measures because (1) it had more liberal regulations during its growth and (2) its economy slowed at a faster rate. Generally speaking, China's accumulation and management of its NPLs was a combination of the trends seen in the US and Japan. Although China's loan market was even less regulated than Japan's loan market, it addressed its NPL issues earlier. Also, China's economy continued to exhibit strong

growth despite substantial changes.

China may be facing a second wave of NPLs as its economy continues to slow down and stabilize. Unlike its first encounter with a rapid increase in NPLs, where China's economy continued to grow at over 10 percent per year, the slowing economy will contribute to the number of NPLs as debtors' profits are reduced. Nonetheless, it is unlikely that the percentage of NPLs will increase too much due to the current NPL management system and potential aid from the central government.

## 2. Implementation of United States Strategy

Although China's AMCs and the US's RTC may appear very different, China based its AMCs partially on the US's method for resolving its NPL problems. The RTC was formed to take over failing banks – managing their NPLs was one of its functions. However, a Chinese bank does not need to be failing to transfer NPLs to an AMC.

The main difference between these institutions is size. The US was able to manage its NPLs by creating the RTC, and it later merged the RTC into the FDIC. In comparison, each of China's Big Four had a large amount of NPLs on its books. As a result, the PRC formed an AMC for each bank.

If China were to reduce the size and/or number of its AMCs, then it would be unequipped to manage the potential rise in NPLs as its economy slows. Additionally, it does not have an equivalent of the FDIC for the AMCs to be subsumed under (the People's Bank of China typically interacts with the FDIC and other countries'

equivalents).<sup>159</sup>

### 3. Implementation of Japanese Strategy

The rise in Japan's NPLs was due to its real estate bubble, coupled with a slowed economy. Also, its government waited too long to address the country's NPL issues, which led the government to ultimately resort to drastic measures. Japan's method for resolving its NPLs, which was primarily nationalizing large banks and changing the regulatory environment, is not feasible in the PRC. China's laws and regulations concerning NPLs have helped it reduce NPLs from 25 percent to only one percent of its total loan industry. Additionally, China couldn't "nationalize" its banks and AMCs because they are already state-owned institutions.

### III. PROPOSAL

China has continuously and effectively reduced its NPLs since the foundation of the four AMCs. Although there is still around 96 billion USD in NPLs in China, which has resulted in widespread attention, this value only constitutes one percent of its loan industry.

Considering China's success in managing its NPLs, this article provides three suggestions for modifying its NPL strategy to better fit its current situation. These suggestions are listed from least to most effect on Chinese NPLs. Ultimately, the determination of which type of actions to implement depends on the national government's anticipation of the amount and type of NPLs in the future and the

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<sup>159</sup>See, e.g., *The People's Bank of China Signs the Memorandum of Understanding with the Federal Deposit Insurance Corporation*, People's Bank of China (Oct. 28, 2013), available at [http://www.pbc.gov.cn/publish/english/955/2013/20131028182243486169847/20131028182243486169847\\_.html](http://www.pbc.gov.cn/publish/english/955/2013/20131028182243486169847/20131028182243486169847_.html).

importance it places on reducing debtor expectations of debt forgiveness.

### 1. Reduce Debtor Expectations of Government Write-Offs

Some of China's debtors will hide their assets in order to complicate loan collection, and pretend that they do not have enough assets to ever fully repay the loan. Unfortunately, they will do so after weighing the risks of not paying their loans with the possibility that the government will forgive their debt. China's government has a reputation of funding SOEs regardless of whether they turn a profit. It has also forgiven large debts in the past, which adds to debtor confidence that it will eventually write off their debt.

The percentage of NPLs connected to debtors that purposely avoid loan repayment is rising. This is due to the simple fact that the loans which are easier to collect have already been settled. It is essential that the PRC reduce debtors' expectations that the government will reduce their debt. As the heightened interest rates for bad debt continues to accrue, debtors become increasingly unwilling to repay their loans. Therefore, time is also an important factor. If the PRC does not reduce debtors' expectations, then writing off their debt may be the only way to remove it from the loan industry.

It would be very difficult for the PRC to reduce debtor expectations of debt forgiveness unless it substantially changes its current system (e.g. downsize AMCs). However, there are less effective methods that could be used that would not affect its NPL management system. For example, the CBRC and MOF could jointly issue a statement to financial institutions that they will not ask the national government to



forgive debtors. Financial institutions could send this statement to debtors, promulgate the statement via brochures and loan documents, and attach a personalized statement for debtors with outstanding loans.

The benefit of this method is that it would have no effect on how China manages its NPLs. At the same time, it would decrease debtor expectations of loan forgiveness. However, it is unlikely that it would significantly change debtor views of government debt forgiveness because there would be no real change in China's NPL system.

## 2. Reduce Preferential Treatment for State-Owned Companies

The PRC has exhibited a strong intermingling between the government and select companies (and families) since 1949. This still exists today in China's banking industry wherein SOEs often receive better treatment than their private counterparts. Financial institutions have consistently demonstrated more lax lending practices to SOEs. Also, the AMCs were primarily developed to handle NPLs from the Big Four, which are state-owned banks, and most of the debtors for those NPLs were SOEs.

As a substantial portion of China's NPLs come from SOEs, partially because SOEs function in necessary or important but often unsustainable sectors and also due to the practices stated immediately above, the PRC should shift away from distinguishing between private and state-owned companies. A potential way to begin this process in the NPL industry would be for the CBRC to issue a regulation to all financial institutions.

This regulation should begin by stating whether a company is owned by the government or privately owned will not be a factor in how the financial institution

interacts with the company. The author only has two recommendations for specific clauses in this regulation. First, it should state that loan practices will be the same for private and state-owned companies. The regulation should also reiterate that a bank may not give a loan to an SOE that it would not give to a private company. Second, the regulation should provide that the management of NPLs will not differ depending on the type of debtor.

### 3. Downsize Asset Management Companies

China's AMCs are currently functioning according to the standards set when 25 percent of China's loans were non-performing. As this article mentions, it is likely that the percentage of NPLs in China will rise as its rate of growth slows. However, the amount of China's NPLs probably will not increase more than a few percent. Foreign purchasers of NPLs in China have already substantially reduced their employees or even closed down. On the other hand, the national government may be hesitant to downsize its NPL management infrastructure because of uncertainties surrounding its economy in the near future and local government debt.

First, China's investment strategy is rapidly changing from heavy high-risk investment to promote growth to a secure robust investment strategy with a moderate regulatory atmosphere. This means that reduced investment may cause companies that cannot operate without third party funds to fail. However, it will also promote long-term NPL prevention through regulations that foster reliable business practices. Second, China's local governments (especially municipal and county) are indebted to the national government. Although the national government will most likely forgive

their debt, the close relationship between these governments and local SOEs promotes unsustainable business practices. As a result, this increases the potential for outstanding loans from local companies accustomed to relying on the local government for funding and incentives.

Despite high uncertainty regarding the future of China's NPL market, it is very unlikely that Chinese NPLs will substantially increase. As such, it is the author's opinion is that AMCs should downsize their infrastructure in accordance with their projections of the NPL industry.

#### CONCLUSION

Despite foreign investors' continued interest in Chinese NPLs due to the high number of outstanding loans, China has successfully mitigated the NPL issues that it experienced in the early 2000s. Currently, NPLs constitute an acceptable amount of China's loan industry. However, the PRC will have to change its NPL strategy to resolve its remaining NPLs. Additionally, it may be beneficial to consider restructuring AMCs pursuant to expectations of the future NPL market.

As China's economy slows down, it is likely that it will experience an increased amount of NPLs. This provides opportunities for foreign investors because AMCs will create new NPL portfolios. At the same time, investors should temper their expectations because these portfolios will be substantially smaller than their predecessors.