China's experience in small and medium financial institution resolution

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China has been constantly deepening its financial system reform as it endeavours to construct a socialist market economy. A financial system serving the need of a market economy and characterised by a multi-layer and multi-category structure has taken shape in China. Depository institutions such as regional commercial banks, city commercial banks, urban credit unions and rural credit unions have grown to become an important part of the country's financial system. At the end of 1998, there were 10 regional commercial banks, 88 city commercial banks, 3,200 urban credit unions and 44,000 rural credit unions countrywide. The assets of these institutions totalled RMB 2.9 trillion, representing 28% of the total assets of all depository institutions (see Table 1). Small and medium financial institutions have been playing an important role in supporting the development of small and medium businesses and the expansion of employment. However, due to lack of managerial skills, negligence of the basic principles of asset-liability management and even

Table 1

Balance sheets of small and medium financial institutions in China

Types of institution	Number of institutions	Total assets	Loans	Total liabilities	Deposits
		in billions of RMB			
Regional commercial banks	10	877.6	521.6	822.7	764.5
City commercial banks	88	494.2	230.8	470.9	382.2
Urban credit cooperatives	3,200	267.3	168.9	265.1	246.2
Rural credit cooperatives	44,000	1,261.1	834.0	1,246.0	1,219.1
Total		2,900.2	1,755.3	2,604.7	2,612.0

defiance of relevant laws and regulations, a small number of small and medium financial institutions incurred severe losses and turned out to be insolvent. The People's Bank of China has taken a variety of legal measures such as closure, assistance and management takeover to tackle the problem institutions.

Summary of closure activities concerning small and medium financial institutions and a case study

The PBC closed 42 problem depository institutions: one commercial bank (Hainan Development Bank), 23 urban credit cooperatives and 18 rural credit cooperatives in the course of 1997 and 1998. In addition, The PBC closed three trust and investment companies (China Agricultural Trust and Investment Corporation, China Venture Investment Corporation and Guangdong International Trust and Investment Corporation). The face value of assets of the closed institutions totalled RMB 108.8 billion (see Table 2).

Over the two years, the PBC acquired some operational experience in closing problem financial institutions. Trust liquidation was imposed on the majority of closed institutions. The PBC established a set of standard

Table 2

Summary of closure of financial institutions in China

Closed institutions	Closing date	Face value on closing date (in billions of RMB)	
		Assets	Liabilities
5 urban credit cooperatives in Hainan	16/12/97	5.4	5.9
Hainan Development Bank	21/6/98	16.9	16.6
Urban Credit Cooperative in Luchuan, Guangxi	16/6/98	0.2	0.2
Hongye Urban Credit Cooperative in Qinghai	12/7/98	0	0
12 urban credit cooperatives in Beihai, Guangxi	26/10/98	1.5	1.8
20 urban credit cooperatives in Pingen, Guangdong	7/12/98	8.5	8.3
CATIC	4/1/97	30.1	31.4
CVIC	6/98	10.3	10.4
GITIC	6/10/98	35.9	34.1
Total		108.8	108.8

procedures for closure, liquidation and management takeover. While liquidation of CATIC has been completed, other closed institutions are still in the liquidation process. GITIC has entered the bankruptcy process. Hainan Development Bank is very close to the completion of payment on its deposits. Liability registration of credit cooperatives has been progressing smoothly. In the liquidation process, household savings deposits were paid in batches based on the asset quality of the closed institutions. As priority is given to small and medium depositors, the majority of the creditors remained calm. There was no sign of social instability.

Case study

For a more detailed introduction to the closure of small and medium financial institutions in China, the case of 14 urban credit cooperatives in Beihai, Guangxi Zhuang Autonomous Region will be taken as an example.

A common feature of the 14 institutions was the large proportion (over 50% at the end of 1997) of loans to the real estate sector. As the bubble burst, the bulk of such assets turned into losses of varying degree. Moreover, long-standing chaotic management and moral hazard problems had led to poor asset quality and severe losses in these institutions. On 14 March 1998, the 14 institutions had total assets of RMB 1.75 billion and total liabilities of RMB 1.87 billion. Their accumulated losses over the years reached RMB 180 million.

In September 1997, a sudden run on deposits took place at Dayecheng Urban Credit Cooperative in Beihai and rapidly spread to other urban credit cooperatives. By the end of March 1998, 11 urban credit cooperatives were unable to repay matured deposits. The default on matured deposits reached RMB 560 million. By June 1998, all 14 local urban credit cooperatives had fallen into an overall payments crisis. Upon finding that the 14 institutions could not be bailed out, the PBC decided, after consultation with the Guangxi Zhuang Autonomous Region Government, to close them on 26 October 1998 by revoking their *financial institution legal person licence* and the *financial institution operation licence*. The PBC set up liquidation teams consisting of relevant agencies of the local government and professionals. Twelve of the institutions were entrusted to the Construction Bank of China. It took the liquidation teams and trust teams two months to complete the

clearing of assets and registration of debts. Based on the result of asset clearing and evaluation, it was decided that the first payment on savings deposits was to be made on 28 December 1998. Two payment principles were set: (1) the maximum payment per account was RMB 10,000; (2) the remaining debts were to be paid in instalments and in proportion depending on the proceeds from the sale of assets. By now, small savings depositors (accounting for roughly 60% of all depositors) will have been paid in full.

So far, administrative closure of problem financial institutions that cannot be bailed out has proved to be effective in locking in the levels of losses and liabilities, reducing cost in risk management, protecting small and medium depositors and averting systemic risks. In addition, the closure is conducive to alerting the public consciousness to financial risks and containing moral hazard behaviours. However, the process of liquidation and management takeover took a significant amount of financial and labour resources on the part of the PBC and entrusted banks. Meanwhile, the resolution of non-performing assets proved to be very difficult. It remains to be discussed how to accelerate the resolution process.

Assistance of problem small and medium financial institutions: a case study

Weihai City Commercial Bank basically arose from a merger of five urban credit cooperatives. Due to problems inherited from the former credit cooperatives, mismanagement and deteriorating creditworthiness, the bank had serious liquidity problems and great difficulties meeting its obligations.

In September 1997, the PBC, together with the local government, implemented priority supervision on the bank. The PBC also provided some loans to alleviate the bank's liquidity pressure. Meanwhile, the PBC gave consent to the bank's proposal to increase capital by RMB 250 million to obtain a paid-in capital of RMB 350 million and a nominal capital adequacy of 9.09%. This measure strengthened the bank's capacity to shield against risks. The management was dealt with according to the relevant legal procedures. The bank's operation was gradually put back on track.

As a next step, the PBC will guide the bank's restructuring through conversion of debt into equity. The move is expected to improve the bank's asset-liability ratios and to further strengthen its resilience to risks.

Management takeover as a resolution of problem financial institutions: case study

Hongfeng Urban Credit Cooperative in Guiyang City started to show a high risk of insolvency in 1996. The credit cooperative had deteriorating creditworthiness and repeated payments crises. At the end of 1996, the credit cooperative's assets totalled RMB 14.32 million, liabilities totalled RMB 12.89 million, net worth totalled RMB 1.42 million (paid-in capital RMB 1.44 million) and accumulated loss over time totalled RMB 390,000. The credit cooperative's deposit-loan ratio was 70% and non-performing loan ratio 100%. Its poor asset quality and severe losses mainly resulted from chaotic family-style management. In April 1997, there was a run on the credit cooperative. After a series of measures by the PBC and local government aimed at resolving risks, the PBC took over the management of the credit cooperative on 1 November 1997. After practising strict internal control, clearing assets, recalling overdue loans and developing new business, the credit cooperative's overall asset-liability ratios were significantly improved. Public confidence was restored. The credit cooperative has now normalised its operation.

Some thoughts on closure of small and medium financial institutions

How to protect more fairly the interests of different categories of depositors to avoid systemic risks?

Deposit insurance systems have been set up in many countries to protect small investors, maintain the stability of the financial industry and, in particular, enhance the confidence of medium and low-income groups in the financial system. Deposit insurance funds are established to support necessary takeovers and transfers. As reform in the financial

sector deepens in China, financial risks accumulated from, and dormant in, the past will gradually materialise. Measures need to be taken as early as possible to prevent, mitigate and resolve financial risks. To draw on other countries' experiences and to establish a deposit insurance system with Chinese characteristics is therefore a very urgent task. The principles concerning the protection of small depositors and debt repayment observed in problem financial institution resolution in China have been implicitly a kind of deposit insurance system.

How to handle the assets of closed institutions?

The most difficult aspect of the liquidation of closed institutions is the management of their assets. If discounted immediately, the assets would lose their value more severely. If the assets were not sold at a discount for a long period of time, the administrative and liquidation costs would increase. How to manage the assets of closed financial institutions is therefore a great challenge.