

# Bank restructuring in China

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## Introduction

Since 1997, it has been an important task for financial reform in China to restructure financial institutions that are having difficulties making payments, are making losses or are even insolvent, so as to mitigate financial risks and find ways for the weakest financial institutions to exit the market. In China, bank restructuring includes not only the restructuring of commercial banks, but also restructuring of those non-bank financial institutions, such as trust and investment companies and urban/ rural credit cooperatives, which also receive deposits. There are several ways of restructuring banks in China, including recapitalisation, conversion of debt into equity, merger, disposal of non-performing loans (NPLs), and closure and bankruptcy of some insolvent financial institutions.

## Recapitalisation

In March 1998, a special Treasury bond amounting to 270 billion yuan was issued. The purpose was to strengthen the capital bases of the four wholly state-owned commercial banks and to increase their capital ratio to 8%. The bonds were purchased by the four state banks, with funds freed up by a lowering of the required reserve ratio from 13% to 8%. However, joint-stock commercial banks and rural credit cooperatives are ineligible for such funding from the central government. Their capital increases mainly come from capital injections from shareholders or

\* This paper represents the views of the author, not necessarily those of the People's Bank of China.

accumulated profits; however, their capital is unlikely to be built up quickly in this way. Especially for some trust and investment companies, their capital has not been increased for a long time, while losses and NPLs accumulated. Other than the four wholly state-owned banks, financial institutions are mainly owned or controlled by local governments and state-owned enterprises, and their shareholders were unwilling to inject fresh funds unless they were under great pressure.

## Conversion of debt into equity

In October 1996, the Everbright Trust and Investment Company, whose biggest creditors included a state oil firm and two state-owned commercial banks, could not meet its maturing debts. To avoid its bankruptcy, the central bank decided to convert its debts, of about 5 billion yuan, into equity. However, the company hardly earned any profits during the next three years, and creditors suffered great losses from this kind of conversion. Conversion of debt into equity should be the last resort in bank restructuring, because it is at the expense of creditors' interests, and its final effect is not very good.

## Mergers

From 1995 to 1998, more than 2,000 urban credit cooperatives were merged into 88 city commercial banks according to the following principles: assessing assets and capital, writing off some bad debts, estimating net worth of equity and encouraging new shareholders.

Even though these measures have been adopted, there are still unsuccessful cases. In August 1995, Hainan Development Bank was formally established after the merger of five trust and investment companies based in Hainan Province and the introduction of new shareholders. However, the asset quality of those trust and investment companies was very low and led the newly formed bank to perform poorly. In December 1997, Hainan Development Bank took over another 28 local urban credit cooperatives that were suffering liquidity problems, resulting in a further deterioration of its situation. Although the central bank provided more than 3 billion yuan in liquidity assistance to it, runs

on deposits still occurred. In January 1998, Hainan Development Bank was finally closed by the central bank.

Furthermore, since the performance of the former urban credit cooperatives was poor, the new 88 city commercial banks suffered high NPLs and heavy losses; several city commercial banks even experienced payment crises.

To mitigate the risks of trust and investment companies, the Chinese authorities are planning to reduce their number from the existing 239 to around 60 through merger.

### **Closure, liquidation and bankruptcy**

During 1997 and 1998, one insolvent commercial bank and three trust and investment companies have been closed in China. Their total liabilities reached about 120 billion yuan.

In China, closure of a financial institution is different from bankruptcy. Closure of a financial institution follows these procedures:

- Firstly, the central bank announces the closure of a financial institution and designates a commercial bank to take care of its claims and debts.
- Secondly, the commercial bank or an external accounting firm liquidates the assets of the closed institution, calculates its losses and realisable net assets as well as registers and confirms debts.
- Thirdly, the principles for the repayment of debts are decided. In general, the principal and legal interests of foreign debtors and individual depositors will be repaid in priority. How much of the deposits of domestic legal entities can be repaid depends on the net assets after liquidation, and usually, it is not enough to repay even the principal of deposits.
- Fourthly, if an institution incurs an especially heavy loss, it can also apply for bankruptcy to the court. Once the bankruptcy procedure begins, the procedure of closure and liquidation terminates.

In October 1998, Guangdong International Trust and Investment Company (GITIC) incurred heavy losses and could not meet maturing debts. The central bank announced the closure of this financial institution. However, the liquidation led by a well known international accounting firm found that GITIC was seriously insolvent. In January

1999, GITIC applied for bankruptcy. This is the first case of bankruptcy of a financial institution in China.

### **Disposal of NPLs of state commercial banks**

In China, NPLs of state commercial banks are relatively high; bad loans account for about 6–7% of total loans, and there are further amounts of overdue loans. Up to now, according to the regulations set by the Ministry of Finance, only 1% of outstanding loans of the previous year should be reserved as loan loss provisions against which bad loans can be written off in the current year. As a result, the loan loss provisions are far from adequate.

The first Asset Management Company responsible for dealing with NPLs of state banks was established in April 1999. Another three are planned to be set up. They will separate NPLs from the four state banks, and use various methods to dispose of them.

### **Some difficult issues regarding bank restructuring**

The issue of bank restructuring in China only emerged within the past three years. While financial risks in China were gradually exposed, the Chinese authorities have fully recognised its urgency, and do not wish the situation in Japan to recur in China. However, under the existing social environment and within the existing legal framework, the restructuring of financial institutions in China faces some difficult problems.

- Guarantee of repayment of individual deposits (since China has not established a deposit insurance scheme). Net realisable assets of some closed financial institutions are not enough to repay the principal of saving deposits of individuals. Under this circumstance, shareholders, local governments, central government or the central bank usually have to provide funds to subsidise the repayment.
- Different orders of repayment among individual deposits, foreign debts and domestic legal entity debts. When dealing with some insolvent financial institutions, different orders were applied to different creditors. This practice did not have a sufficient legal basis, especially for the different treatment of foreign debts and domestic

legal entity debts. Furthermore, it is at the expense of the central government or the central bank: because most of the domestic legal entity creditors are state-owned enterprises or state-owned financial institutions, the government or the central bank has to rescue them.

- Absence of a specific closure and bankruptcy law for financial institutions makes it very difficult for them to go bankrupt. The treatment of GITIC's bankruptcy was based on the bankruptcy law for general enterprises.
- Even though asset management companies are being established to cope with NPLs of state commercial banks, the question of who will compensate for the final losses is yet to be resolved. Under some specific circumstances, it may be necessary for the central government to use public funds to make some compensation; while at present, the central government budget does not have such arrangements. Therefore, some of the losses are compensated by the central bank in terms of central bank loans.
- Considerations of applying deposit insurance scheme to rural credit cooperatives. The four biggest banks have about 63% of the deposit and loan market, which means that if they do not join the deposit insurance scheme, the contributions will not be enough, and this is not fair to medium- and small-sized financial institutions. However, if the authorities request the biggest four to join the scheme, because of their huge deposits, they would have to make very large contributions, for possible rescues of medium- and small-sized institutions, and they will be reluctant to do this.
- The existing financial accounting principles can not meet the needs of developing financial business, nor embody the prudential accounting principles, such as the calculation of maturities of interest receivable and the principle of provisioning for bad debts. Especially in the process of bank restructuring, there is not a criterion for the evaluation and calculation of net assets.
- The inadequate integrity and reliability of business records of financial institutions in China and the low transparency of information make it more difficult for merger, restructuring or closure of financial institutions.
- Some financial institutions needing to be restructured are either solely owned by local governments or largely controlled by them. Local governments usually appoint senior management of financial

institutions and intervene heavily in their business. While local governments assume limited responsibility for providing funds for the merger, restructuring, closure, and even bankruptcy of financial institutions; they often intervene in all the restructuring on behalf of their own interests. Furthermore, the restructuring of financial institutions can not be implemented justly, because judiciary departments also obey instructions from local governments.

- When NPLs of banks are disposed and financial institutions closed or bankrupted, there exist several obstacles to transfer, sale or securitisation of the valid assets. The first is the absence of a secondary market for credit in China, second is that most credits do not have explicit collateral; and the third is that there are a lot of legal difficulties and other problems in the auction of any collateral. Thus, the market price for the net assets of financial institutions can hardly be realised, and the ratio of realised asset values to book values is relatively low.