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MAXIMISING VALUE OF NON- PERFORMING ASSETS

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**Recent Development in Maximizing Value of
Distressed Assets in China**

by

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Since the FAIR II held in Bangkok last December, China has gained remarkable development in dealing with distressed assets. Firstly, the institutional framework for administration on banking industry is improved. Secondly, AMCs become more and more active and creative in managing and disposing distressed assets. Thirdly, the reform of bankruptcy law keeps going. Let me give a brief introduction as the following.

I. Improving Institutional Framework for Administration of Banking Industry

In this spring the new government decided to separate the function of supervising the banking industry from the central bank, the People's Bank, and established the Banking Supervisory Commission. Then a draft Law on Banking Supervision and Management was submitted to the National People's Congress. Even though the draft law is still on the process of legislation, the commission has been operating and issued a number of orders.

It is believed that the separation of the central bank is a significant step aiming at gradual transformation from separate business system to multiple business system. Now China has got supervision commissions for banking, insurance and securities industries separately. It is expected that these three commissions will join together someday when the financial sectors become allowed to run business multiply. Under such circumstances, it is said, the financial economy will be stronger in coping with risks.

Now both the central bank and the Banking Supervisory Commission have paid attention to the problem of distressed assets of the commercial banks. Some proposed measures for that purpose are under discussion. For instance, some of the State-owned commercial banks are preparing to be listed in the stock market. They are requested to reduce their bad assets to below 15%. Therefore they are trying to quicken up disposition of distressed assets in more flexible ways. If this is achieved, while more fresh capitals fill in, the quality of assets of these banks will improved to a large extent.

II. Active Role of AMCs in Assets Management and Disposition

The 4 Assets Management Companies (AMCs), as counterparts of the 4 major State-owned commercial banks, have been operating for 4 years. Today we can say that they have become mature in dealing with distressed assets. This can be shown in three aspects.

1. Understanding and accept the concept of "maximizing value of distressed assets"

First, they understand that assets should be evaluated by market value and that so-called "distressed assets" means the book value is lower than market value. When talking about the assets management and disposition, the wording "maximizing" means the marginal cost thereof equals the marginal gain. Therefore the way to achieve that objective may be summarized in two aims: taking every effort to maximize the rate of assets return and minimize the cost of management and disposition.

Second, they understand that market value of distressed assets should be maximized by improving management and disposition. The basic strategy is, first, to dispose "worse" assets as early and quickly as possible, and then, to manage and cure the "better" assets and dispose then in right occasion or lately.

2. Special legal measures and policy supports for maintaining value and reducing cost

The basic model of taking distressed assets by AMC is “purchase on book value, and peel off from bank in a lump”. The characteristic of this model is that it is supported by several legal and policy measures. For instance, the central government provides AMCs some favorable treatment in taxation, interest rate and administrative fees, and additionally provides favorable taxation to foreign investors who make assets transactions with AMCs. Meanwhile the people’s courts provide support to AMCs in collecting claims by some favorable treatments, e.g. half legal cost, strict punishment on the debtors who are illegally escaping from the debts.

3. Maximizing the assets value by comprehensive measures

(1) Day-to-day management

First, they categorize the distressed assets in 4 sorts:

1. debt/equity swap assets (held as shares);
2. assets valuable in debt restructuring (large amount owed by enterprises with positive future via corporate rescue);
3. ropy assets (small, dispersive and limited gainable value);
4. bad assets (much worse than ropy ones).

Second, they make dynamic analysis on repayment ability of debtors, with reference to the following elements:

1. book value of the assets;
2. purchase value or take-over value;
3. loss rate anticipated by the original creditor bank);
4. current value calculated in light of the standard made by the Ministry of Finance;
5. evaluation after inner investigation;
6. external evaluation in considering the situation of project or need of disposition.

Third, they take into account the scheme of legal actions and possible risks.

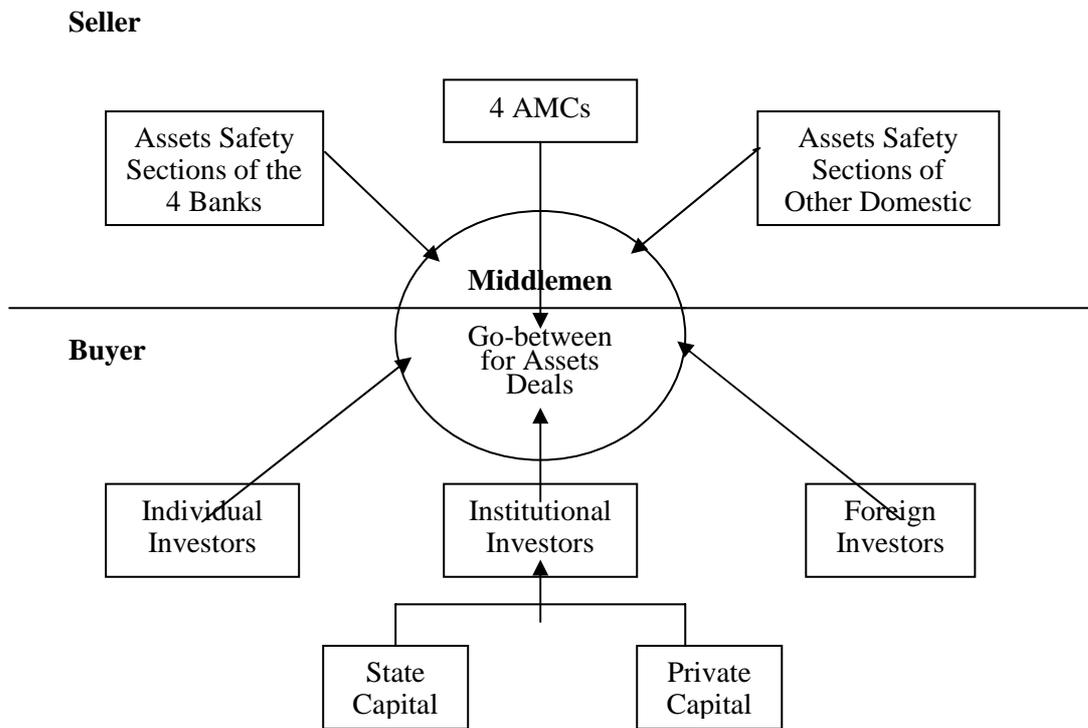
Fourth, they stress on the management when a project is under disposition in order to keep its going concern value as much as possible.

Fifth, they take various methods to cope with the debt escapees, e.g. lawsuits, proclaiming the list of repudiators.

Sixth, they have established computer network to manage the data of assets disposition.

(2) Strategy of disposition

First, they are exploring market vigorously, following the principle of transparency and fairness in assets transactions. The existing market for transactions of distressed assets is composed of various parties as shown on the chart below.



Second, they sell scattered material assets by way of auction and public bidding. When there are large scale assets that have long expectation in good value, they choose lease until there is a good deal.

Third, they dispose the assets of sorts 3 and 4 quickly, e.g. sale, entrustment, or collection by lawsuit.

Fourth, they increase the value of the assets of sort 1 and 2 by using the measures that investment banks usually use comprehensively. When managing their shares, the general route map is “to improve corporate management → to deepen restructuring → to dispose in combination or large bulk”.

- *Improving corporate management.* Since AMCs are not allowed to participate the day-to-day management of debt/equity-swap enterprises, they exercise their managing powers on the macroscopical level, including management on development strategy, important matters, and mechanism of promoting and restricting high-ranking officers.
- *Deepening restructuring.* It should include a comprehensive scheme, for instance restructuring inner components, restructuring within a industry breadthwise into a large combination or lengthways into a business chain

- *Disposing in combination.* Up to now AMC's have not met the right season to disposing their shares in large scale, though there are some fragmentary sales in dealing with devaluated assets. During this period the major task seems to be the former two, improving and deepening.

Up to the end of June 2003, the 4 AMC's disposed distressed assets RMB 361.841 billion (not including that by debt/equity swap) in total, with RMB 79.229 billion return totally, as 21.90% of the disposed. The result by each of them is shown in the following chart.

AMCs	Total Assets Disposed (RMB Billion)	Total Cash Return (RMB Billion)	Return Rate (%)
Xinda	94.125	29.625	31.47
Huarong	93.567	22.996	24.58
Great Wall	120.469	12.975	10.77
Orient	53.680	13.633	25.40

Generally speaking, AMC's are going well in their business, especially in the season when Chinese economy is very strong, expected more than 8.5% in GDP growth this year, and the central and local government become more and more positive to encourage workout and corporate rehabilitation. However, they have still some challenges and difficulties, for example, limited authorization in financing and investment, some obstacles from the foreign debt supervision system, overloaded procedure of examination and approval on assets disposition, etc.

III. Keep Driving the Reform of Bankruptcy Law

In August this year the new National Congress established the drafting team for the new bankruptcy law, remaining almost all the old members and add some new ones. The new parliament attaches importance on this law. Last month the drafting team discussed the existing draft and made some consensus in perfecting it. One of the major modifications is to establish creditors committee instead of supervisor and shift most of the functions of creditors' meeting to the committee. This change may give commercial banks as major creditors an opportunity to keep strong voice in the proceeding. Another change is to give the existing managers of a reorganizing company more powers in business operation, quite similar to the concept of "debtor in possession" in US Bankruptcy Law. This would be helpful to advance the efficiency of business rehabilitation.

What is worthy to be mentioned here is that this year both the central bank and the Banking Supervisory Commission are very active in discussing the possible scheme of legislation on banking insolvency. As the draft bankruptcy law decides to exclude commercial banks from the common proceedings, it is needed to draft a special law on some legal proceedings for rescue or liquidation of an insolvent commercial bank.

Summary

As a short summary I would like to say that even though there are remarkable achievements China still has a long way to go to cure the illness of distressed assets in commercial banks. However we believe the future will be positive on the basis of four conditions, the development of market economy that provides more flexible solutions to debts-assets problems, the entry into WTO that

provides more opportunities for Chinese banks and companies to get foreign investment, the establishment of the legal system equipped with modern institutions and technology that may provide means to safeguard the progress, and the growth of Chinese economy that may provide financial resources to energize the progress.

At FAIR II last year I presented a report on debt restructuring of distressed enterprises in China, focusing on the practice as “Changchun approach”. In this presentation I focus on the distress assets of banks. Actually the distressed enterprises and distressed assets are the two sides of a coin. We should bear in mind that the value of banking assets depends to a large extent on the future of repayment in whatever ways. Of course this amounts to, basically, a matter of corporate rehabilitation. Therefore the essential notion is not simply a creditor-debtor relationship but a community of all relative parties: commercial banks, companies, AMCs, the central bank, the Banking Supervisory Commission, the central and local governments, old and new investors, workers and other persons or entities involved. That is the reason why we need new legal system and new culture to integrate the interests and adjust the behaviors.