

Status quo and disposal of non-performing assets of commercial banks

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Abstract: As China's economic structure undergoes continuous adjustment and economic growth slows, the issue of non-performing assets of commercial banks is becoming increasingly evident. The scale of domestic non-performing assets is expanding on an annual basis. The article commences with an examination of the extant situation of non-performing assets of Chinese commercial banks, before proceeding to an investigation of the innovative disposal methods of non-performing assets of domestic commercial banks in recent years. Finally, it identifies the difficulties in the disposal of non-performing assets of Chinese commercial banks and suggests potential solutions.

1. Introduction

China's economic structure is currently undergoing a period of continuous adjustment, particularly in the wake of the epidemic. Domestic economic growth has slowed, while the relative strength of economic supervision has increased. The number of non-performing assets held by commercial banks has been increasing. The formation of non-performing assets of commercial banks is the result of a complex interplay of factors. In the case of Chinese commercial banks, the primary drivers of non-performing assets are changes in the economy, shifts in government macro-policy, deficiencies in the legal environment, the unsoundness of the domestic credit system, and the absence of an effective control mechanism within the bank. As the field of finance continues to evolve, the expansion of banking business will inevitably seek a balance between profitability and safety, given the inevitable connection with the Internet. In light of the ongoing fluctuations in the macroeconomic environment and the relentless advancement of financial digitalisation[1], the disposal and avoidance of non-performing assets of commercial banks has become a paramount concern. The potential risk of non-performing assets has the capacity to destabilise and impede the performance of commercial banks, with the possibility of transmission to the entire banking system via the interbank market, which in turn affects the overall stability of the financial system[2]. It is therefore of the utmost importance to gain an understanding of the current state of non-performing assets held by commercial banks and to implement effective strategies for their disposal in order to mitigate the risk of non-performing assets. This is a pivotal aspect for the sound development of the banking industry[3].

2. Status quo of non-performing assets of commercial banks

In order to facilitate a discussion on the disposal of non-performing assets held by commercial banks, it is essential to gain an understanding of the general status of non-performing assets held by domestic commercial banks. This necessitates an appreciation of the operational and potential risks associated with non-performing assets, as well as a confirmation of the necessity for commercial banks to dispose of such assets.

2.1 Current situation of non-performing assets

The term "non-performing assets" as used in the context of commercial banks primarily encompasses non-performing loans, loans designated as sub-prime or in the loss category, and interest. Of these, non-performing loans represent the principal component of banks' non-performing assets. In the 21st century, China's commercial banks have demonstrated effective governance of their non-performing assets. The non-performing loan rate has declined gradually since 2001, reaching a low of 0.95% in the calendar year 2012. However, in recent years, the non-performing loan rate and the tendency to rise have become a concern. Given that the supply of non-performing assets is not expanding and the requirements for the disposal of non-performing assets are accelerating, it is important to be vigilant about the potential for a "second boom" in non-performing assets[4].

The CBRC has released data indicating that at the conclusion of 2023, China's commercial banks had a balance of non-performing loans amounting to 3,225.6 billion yuan, with a non-performing loan ratio of 1.59%. This represents a medium level of non-performing loans in recent years. However, the total amount of non-performing loans has been expanding, with an increase of 242. At the conclusion of 2018, the balance of non-performing loans stood at 202.54 billion yuan, with a non-performing loan ratio of 1.83%. Despite this seemingly normal level of non-performing loans among commercial banks, the total amount of non-performing loans has increased by 120.2 billion yuan over the span of just five years. In the current year, banking institutions have been reducing deposit rates. Following the decline in profits, the non-performing assets of commercial banks will be exposed with greater rapidity, and the disposal of non-performing assets of commercial banks will become a more active process.

2.2 Risk of non-performing assets

At present, commercial banks encounter a number of common issues when attempting to dispose of non-performing assets. These include a lengthy asset disposal cycle, high disposal costs and a high risk of failure. Concurrently, commercial banks confront a multitude of risk-related challenges throughout the non-performing asset disposal process. These challenges encompass a range of factors, including legal and regulatory constraints, market dynamics, and other pertinent considerations.

2.2.1 Capital liquidity risk

The liquidity of a banking institution may be significantly impaired if it holds a considerable quantity of non-performing assets. In particular, during periods of monetary tightening or a slump in deposits, it is challenging for banks to increase their positions by recovering loans. This may lead to payment difficulties, which in turn could affect the banks' reputation and normal operations.

2.2.2 Risk of asset loss

The existence of non-performing assets can result in direct losses for banks in terms of their assets. Even in the event of the existence of collateral, there may be a loss of funds in the process of realisation. Furthermore, in the event of default on such non-performing assets, the bank will have to bear the loss of these funds as well as pay interest on these borrowed funds. As a result, this stock of assets can constrain the liquidity of banks, preventing them from investing their funds in projects with higher returns and further aggravating their capital losses.

2.2.3 Resource allocation risk

The accumulation of non-performing assets in banks will result in the failure to realise the benefits of resource allocation. For banks with poorer operating efficiency, a large backlog of non-performing assets will lead to the inefficient use of their own resources, thereby further deteriorating their operating and financial conditions. Furthermore, a significant accumulation of non-performing assets will also impede the realization of benefits for the national economy as a whole and will exert a constraining influence on the rational allocation of social resources.

2.2.4 Risk of deterioration of the financial condition

The effect of non-performing assets on the financial position of banks can be considered to have two aspects. From the perspective of the bank, the loss of interest revenue resulting from non-performing loans represents a significant challenge. Despite this, the bank is still required to pay the relevant interest and expenses, which can lead to the phenomenon of false profit and loss. Conversely, according to the national financial system, even if the interest is not actually recovered, it is still required to be included in the operating income, which further deteriorates the bank's financial position[5].

3. Disposal method of non-performing assets of commercial banks

After years of exploration and innovation, commercial banks have developed a variety of methods for the disposal of non-performing assets. Traditional methods include the collection of debts, the legal collection of loans, mergers and acquisitions, restructuring, write-offs, and the transfer of assets in bulk. More innovative methods include the securitisation of assets, the conversion of debt to equity, and the transfer of non-performing income rights. The article primarily presents an overview of the novel non-performing asset disposal methods, with the objective of providing a comprehensive understanding of the non-performing asset disposal strategies employed by commercial banks in the contemporary context.

3.1 Securitization of non-performing assets

Non-performing asset securitisation (NPAS) encompasses the securitisation of a range of financial instruments, including non-performing loans, quasi-performing loans, restructured loans, non-performing bonds and offset assets. The securitisation of non-performing assets (NPAs) in China has undergone three principal phases. The initial exploration phase, which commenced in 2005 and concluded in 2008, was succeeded by an adjustment and stagnation phase that extended from 2008 to 2016. This was followed by a period of standardised development, which has continued up to the present day[6]. After years of development, a number of financial institutions are involved in the issuance of non-performing asset securitisation. The main body of issuance includes commercial banks, policy banks, some urban commercial banks, agricultural and

commercial banks, foreign banks, and the type of the main body is more diversified. According to the data of the securitisation analysis network (CNABA), as of May 2024, 19 commercial banks in China have participated in the issuance of non-performing asset securitisation, with an issuance size of RMB 193.137 billion.

The fundamental steps in the securitisation of non-performing assets are as follows. Firstly, a bank or an AMC institution, acting as an originator, selects a portfolio of non-performing assets, forms a pool of these assets, packages and sells this pool to a special purpose vehicle (SPV). The SPV then credit enhances and rates the pool of assets. Finally, the securities are sold to the investor in the form of a public or private placement.

In summary, NPA securitisation offers the following advantages: Firstly, it accelerates the speed of asset turnover. In general, NPA recovery is high-risk, uncertain and unstable cash flow. Through asset securitisation, however, it is possible to achieve the rapid return of funds, accelerate the speed of capital turnover and realise the reinvestment of funds. Secondly, NPA securitisation enables the realisation of NPA business from the table. The premise of NPA securitisation is that banks or AMC institutions will package and sell non-performing assets to SPV institutions, with the ultimate goal of recovering cash flow in advance. Therefore, non-performing asset securitisation is conducive to optimising commercial banks' balance sheets and relieving financial pressure. Thirdly, NPL securitisation achieves risk diversification. The transfer and dispersion of the bank's NPL risk to the investor effectively achieves the bank's risk diversification.

Nevertheless, the securitisation of non-performing assets is not without risk. The most significant risks are the concentration risk of the underlying asset pool, credit risk, liquidity risk, interest rate risk and operational risk. The concentration risk of the underlying asset pool is primarily attributable to the geographical and industrial distribution of the assets. A concentration of assets in a specific geographical area or industry can potentially lead to an increased concentration risk of the underlying asset pool. Furthermore, given the inherent uncertainty associated with asset recovery, the dynamic evolution of the asset portfolio in the future may further accentuate the concentration of the asset pool. The probability of default of non-performing assets is higher than that of ordinary asset securitisation products. Therefore, it is necessary to prevent credit defaults. Liquidity risk is mainly manifested in the loss faced by investors who are unable to sell the assets at fair value within a reasonable period of time. This is mainly due to the fact that China's non-performing asset securitisation is still in its infancy, and the development of the market and the valuation system is not mature enough. Therefore, investors may face liquidity risk when they sell the securities. The potential for liquidity risk when investors sell the securities is a further consideration.

3.2 Debt-to-equity swap

Debt-to-equity conversion is the process of changing from a creditor to a shareholder status in order to achieve a transformation of debt to equity. It is not feasible for a company to repay the principal and interest of debt into equity. Therefore, the "creditor-debtor relationship" is transformed into a "shareholding and shareholding relationship". Furthermore, the "repayment of principal and interest" debt servicing method is replaced by the "dividends or selling in the market to get the income" repayment method[7]. The repayment method previously employed, which entailed the repayment of principal and interest, is now replaced with a new method, namely the repayment of dividends according to the number of shares held or the sale of shares on the market to generate income[7]. In general, commercial banks are not permitted to directly convert debt into equity. Rather, the conversion of non-performing assets into equity should be achieved through the transfer of claims to an implementing agency, which will then convert them into the object of the company's equity. The application of debt-to-equity conversion can assist commercial banks in reducing the

total amount of non-performing assets, promoting improvement in the provisioning coverage rate, and effectively relieving the pressure on the collection and write-off of commercial banks.

The principal types of debt-to-equity conversion include debt-to-equity, equity-to-equity, debt-to-equity combination, restructuring combination and debt-to-preferred stock conversion. The primary process of converting non-performing assets into equity shares for commercial banks involves the sale of these assets to third-party organisations. Once the receivables have been acquired by the third party, they are converted into equity shares of the debtors. Subsequently, the commercial banks transfer the equity shares to the asset management company, which oversees their management on their behalf. In return, the commercial banks receive dividends and bonuses from the asset management company, thereby completing the process of converting the non-performing assets into equity shares.

The conversion of debt to equity in the context of commercial bank non-performing assets has a certain practical significance. This process can benefit three main parties: For the debtor, this process effectively alleviates financial difficulties, increases the probability of survival and development of the enterprise, and effectively alleviates the pressure of financing. For the creditor, the commercial bank effectively resolves this part of the non-performing assets, recovers this part of the non-performing assets in advance, and avoids the impact of capital allocation due to the long time it cannot recover this part of the funds. For the asset management company, the acquisition of the debtor company's equity through debt-to-equity conversion at a low price represents a potential avenue for achieving the maximum change in equity value, contingent upon the successful revitalisation of the company. From the perspective of creditors, commercial banks play a pivotal role in resolving non-performing assets, recovering them in advance, and circumventing the impact of prolonged fund unavailability. For asset management companies, the debt-to-equity conversion offers a strategic avenue to procure debtor equity at a competitive price. When the enterprise is successfully revitalised, this strategy can potentially yield the maximum transformation in equity value.

3.3 Transfer of non-performing usufruct

The transfer of non-performing rights of commercial banks is also referred to as the transfer of credit assets. The underlying principle is to realise the transfer of the right to claim income. In contrast to the transfer of claims, the creditors under the transfer of non-performing rights of creditors remain unaltered. In comparison to the transfer of claims, the creditors under the transfer of non-performing rights of creditors remain unaltered. In this process, the commercial bank merely transfers the proceeds of the non-performing assets to the transferee, while the debtor continues to make the payments to the original creditor. Furthermore, the transferee may request the opening of a supervision account through a "funds supervision agreement" in order to oversee the funds under the right to proceeds.

The current non-performing asset transfer model has been developed to a greater degree of maturity. The transfer of non-performing credit asset income rights offers numerous advantages. Primarily, it reduces operational risk. Through the transfer of non-performing asset income rights, banks can effectively resolve the risks caused by non-performing loans, thereby reducing the loss rate after the occurrence of risk[9]. Furthermore, the transfer of non-performing asset income rights enables banks to rid themselves of some of the more risky assets, thus improving the quality of the bank's credit assets and increasing the safety of the overall assets. Secondly, non-standardised debt assets are not included in the statistics, and the CBRC has a clear limit on the size of banks' non-standardised debt assets. However, when a commercial bank successfully transfers the income rights of non-performing credit assets through the BRC model, such assets will no longer be

included in the statistics of non-standardised debt assets and will be listed independently in the National Banking Industry Wealth Management Information Registration System. This initiative will permit banks to adapt their asset allocation in a flexible manner, while maintaining the limits for non-standard assets. This will enable them to earn higher profits by investing in non-standard assets, thereby maintaining and enhancing the overall level of returns. Thirdly, the depth of social capital participation in the transfer of non-performing assets from banks is oriented primarily towards social capital, with the transfer of non-performing credit asset income rights forming a significant aspect of this process[10]. In practice, the group packaging of underlying credit assets typically involves multiple debts, and the trend of bulk packaging provides social investors with the opportunity to engage extensively in the credit market of the banking system. In this manner, banking institutions may facilitate the transfer of credit risk beyond the confines of the system, thereby drawing in the involvement of social capital and fostering the sound advancement of the credit market.

4. Difficulties in disposing of non-performing assets of commercial banks

The disposal of non-performing assets by commercial banks has been a topic of discussion for several years, yet the results have not been satisfactory. The issue of non-performing asset disposal remains a significant challenge that impedes the growth and development of banks. The difficulties encountered in the disposal of non-performing assets by commercial banks can be attributed to a complex interplay of external and internal factors. External factors include the absence of a robust non-performing asset valuation system, inadequate legal protection, and significant information asymmetry concerning non-performing assets. Internal factors pertain to shortcomings in the internal control system of commercial banks, the absence of effective risk management, and the scarcity of qualified professionals.

4.1 External factors that restrict the disposal and development of non-performing assets of commercial banks

4.1.1 Lack of a perfect non-performing asset valuation system

The complexity and specificity of distressed assets presents numerous challenges in their valuation. The absence of uniform valuation standards in the market gives rise to considerable discrepancies in the valuation of the same asset by different parties. This not only increases transaction costs but also facilitates the emergence of unnecessary disputes[11]. In the context of the sale of bank assets, the valuation of non-performing assets is of particular importance, as the valuation results directly determine the sale price of the assets.

The valuation of distressed assets is primarily concerned with the distressed claims they hold, which are frequently debtors of companies that have ceased to exist or have failed. Furthermore, these companies frequently lack comprehensive financial and operational data, which further complicates the valuation process. Furthermore, the absence of legally sound investment agreements for long-term equity investments of certain enterprises and the fact that enterprises owning real estate, such as property or land, may not have obtained valid title deeds, further complicates the valuation process.

4.1.2 The construction of laws and regulations related to the disposal of non-performing assets is incomplete

The current challenge is the lack of a comprehensive legal and regulatory framework governing the disposal of non-performing assets[12]. Non-performing assets are frequently associated with

intricate legal relationships, including those pertaining to credit and debt, security, and other related matters. In the absence of effective management of these relationships, there is a risk of legal complications and impediments to the orderly disposal of assets. The completeness of the national legal system represents a fundamental pillar of the disposal of distressed assets, and its role in facilitating the orderly development of business activities cannot be overstated. The advent of commercialised banking in China has been relatively recent, and as a consequence, the field of asset disposal in China still lags behind that of developed countries in terms of conceptualisation, mode, method and technology. Consequently, the legal framework in this area is also relatively underdeveloped, which constrains the effective promotion of non-performing asset disposal.

4.1.3 The information asymmetry in the non-performing asset market is prominent

In the context of distressed assets, information asymmetry represents a particularly salient issue, frequently impeding investors' ability to ascertain the true condition of the assets in question. This, in turn, increases the difficulty and risk associated with investment decisions. Such information asymmetry may not only mislead investors' judgement, but may even threaten the healthy functioning of the market as a whole, leading to market failure. In the absence of a scientifically sound historical database of non-performing assets, banks and financial institutions are unable to make informed decisions regarding the disposal of such assets. A database of this nature should contain information pertaining to a range of non-performing assets, including the activity of the debtor, historical records of defaults, asset valuations, and other pertinent data. Nevertheless, the establishment or improvement of such a database is frequently impeded by the challenges associated with data collection and organisation. This renders the process of valuing and disposing of non-performing assets more complex and increases the risk of disposal.

4.2 Internal factors that hinder the development of non-performing assets disposal of commercial banks

4.2.1 The internal control system is imperfect

The main manifestation is that some commercial banks have not established a perfect internal control mechanism within the satellite city bank unified non-performing assets identification and disposal mechanism. At the same time, the credit process also lacks effective control, and does not strictly implement the requirements of the loan pre-credit, credit and post-credit review process, and these shortcomings directly lead to the non-performing assets management and disposal process there are obvious loopholes and risks.

4.2.2 Risk management is not being implemented in place

In their dealings with loans to government projects, monopolistic industries, and "high-quality clients," financial institutions frequently prioritize superficial appeal over thorough pre-credit investigations and risk assessments. In pursuit of business scale and speed, financial institutions tend to lower entry thresholds and relax risk limits, which can lead to excessive credit expansion. With regard to post-credit management, there is a clear lack of attention to the tracking and monitoring of corporate credit funds, as well as an overreliance on repayment sources and guarantee measures provided by enterprises. This is coupled with a failure to assess the actual quality and capacity of the guarantees in place.

4.2.3 Lack of professional talents

The talent structure of commercial banks is characterised by a preponderance of financial and accounting talents, with a relative paucity of professionals in legal, valuation and other specialised fields. This imbalance in talent distribution directly constrains the degree of specialisation and the overall effectiveness of the disposal of non-performing assets. In light of the current challenges posed by the rapid expansion of non-performing assets, domestic commercial banks are experiencing a notable lag in team-building capabilities.

The aforementioned lag is evidenced by several factors. Primarily, the internal organisational structure is not fully adapted to the complexity of non-performing asset disposal, and the division of authority is not sufficiently delineated. Secondly, the mechanism for cultivating and introducing high-level talents is not yet robust, which impedes the effective support of the business's accelerated growth. Furthermore, the performance evaluation mechanism is deficient in scientific rigour and completeness, which hinders the accurate assessment of employee contributions and value in non-performing asset disposal.

5. Suggestions for countermeasures

5.1 Improvement of the external environment

The improvement of the external environment is primarily concerned with the establishment of a standardised system for the valuation of non-performing assets and the formulation of disclosure standards, as well as the enhancement of the legal system pertaining to non-performing assets. In terms of establishing a standardised non-performing asset valuation system and disclosure norms, the initial step is to establish a relatively standardised non-performing asset valuation system and non-performing asset disclosure standards. This is to effectively deal with differences in value determination in the process of non-performing asset valuation and avoid legal risks. Furthermore, it is to comprehensively disclose the actual information of non-performing asset-related debtors and non-performing assets with the help of standardised platforms and contracts. This is to address the information asymmetry problem of the non-performing asset market. The distressed asset market is characterised by information asymmetry.

Furthermore, it is imperative to advocate for the sound legalisation of non-performing asset disposal. This entails elucidating the rights and obligations of all parties involved, including creditors and debtors, and ensuring that their interests are equitably safeguarded. Additionally, it is crucial to standardise the code of conduct and delineate the conduct requirements of creditors, particularly with regard to information disclosure, due diligence, and other pertinent aspects. This will guarantee transparency and fairness in the operational process. It is recommended that the fight against debt evasion be intensified, with particular focus on malicious debt evasion. In addition, it is proposed that the legal responsibility for debt evasion be clarified, with the establishment of a corresponding penalty mechanism.

5.2 Internal environment optimization

The optimisation of the internal environment of commercial banks is primarily concerned with enhancing the awareness and system of non-performing asset disposal, as well as strengthening the construction of non-performing asset human resources. The concept of disposal serves as the internal driving force to enhance the level and efficiency of disposal, to further develop the concept of non-performing asset disposal among personnel, to instill a sense of consciousness regarding this matter, to prioritize it from top to bottom, to alter the concept, and to take the initiative to learn.

This represents the initial step to improving the disposal of non-performing assets in commercial banks. Furthermore, it is necessary to innovate the concept of bad asset disposal. In order to do so, it is essential to accurately grasp the macroeconomic situation, to clarify the development trend of various industries, to make targeted investments and to reduce risky behaviour. In addition, it is important to try to avoid losses. Secondly, the non-performing asset disposal system of commercial banks requires improvement. Staff training in the non-performing asset management process should be a priority, as should the strengthening of pre-lending, lending and post-lending management of loans. The management of non-performing assets pre-proposal, the implementation of the division of responsibilities, the establishment of a non-performing assets early warning mechanism and the strict division of responsibilities of staff in each process should also be given greater attention, with particular emphasis on the implementation of the layers. The establishment of a dedicated team for the management of non-performing assets represents a crucial organisational measure for the effective disposal of such assets. The composition of this team, and in particular the quality of its members, is of paramount importance in addressing the deficiencies in the disposal of non-performing assets observed in commercial banks. The objective is to enhance the quality and efficiency of non-performing asset disposal.

Concurrently, in accordance with the actual requirements of the management of non-performing assets, the deployment of personnel with diverse professional backgrounds should be undertaken in a rational manner. For example, for positions requiring a high level of legal knowledge, personnel with a legal background or legal experience should be employed. Finally, the non-performing asset management team should engage in echelon construction and cultivate a group of reserve talents with potential through internal selection and external recruitment. Concurrently, it is essential to provide sufficient training and development opportunities for the reserve talents, thus ensuring the continued vitality and competitiveness of the team and the enrichment of the commercial banks' NPL management team.

6. Conclusions

As China undergoes a transformation in its economic structure and experiences a gradual deceleration in economic growth, the necessity for the disposal of commercial banks' non-performing assets will continue to intensify. An understanding of the current situation of non-performing assets and disposal methods of Chinese commercial banks is beneficial for the improvement of non-performing asset disposal systems, the adjustment of asset investment directions and the assurance of commercial banks' healthy development.

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