

## CHINA'S BANKING SYSTEM

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This paper examines the Banking System of China and explores in detail the policy reforms and restructuring of its banks to create a market based economy. We evaluate the history of the China Banking system, the restructuring and financial liberalization that has occurred over the last 11 years. The inception of the reform policies started in 1995 with the first set of laws introducing commercial banks and new governance of the Peoples Bank of China (PBC). We examine the impact and implications of the numerous policy reforms and milestones that are shaping the financial and monetary sectors in China today.

This paper further examines the implications of the WTO agreements and Basel accords on the Chinese Banking System. The WTO agreements signed by China in 2001 will open up the China banking system to foreign investors and allow them to operate in the retail markets in domestic currency without any business or geographical limitations. The impact of this agreement is significant as it will broaden the reach of all banking services— even to Chinese households and allow foreign affiliates to enter with fewer restrictions. Even though these agreements are effective this year, the expected systemic benefits are several years away; however this is a critical milestone that will help achieve solvency, promote competition and hopefully create sustainability.

We conclude the paper with the future actions needed to further strengthen the Chinese Banking System that include more aggressive actions as well as faster execution of banking reform policies that will accelerate China's financial success.

### **Introduction**

The China Banking System has been analogized to a “ticking time bomb”.<sup>1</sup> While substantial progress has been made in reform of the banking sector of the People's Republic of China in the last several years, it is widely acknowledged that additional changes are still needed. The extent to which these adjustments can be made will have a direct impact on the continued viability and growth of the Chinese economy.

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<sup>1</sup> Ong, Lynette, “China's Banking System a Ticking Time Bomb”, 2004, [www.atimes.com](http://www.atimes.com).

The root cause of many of the challenges faced in the Chinese Banking System can be found in the legacy of State utilization of banks for financing the operations of State-owned enterprises (SOEs), regardless of their profitability or risk.<sup>2</sup> The institutions most profoundly affected by this practice have been four large State banks, often referred to as the Big Four: the Industrial and Commercial Bank of China (ICBC), Construction Bank of China (CBC), Bank of China (BOC) and Agriculture Bank of China (ABC). These banks, anchors of the Chinese Banking System., have been saddled with an unhealthy level of non-performing loans (NPLs) from the SOEs.<sup>3</sup>

By 2003, the Big Four employed more than 1.4 million workers in 116,000 branches across China. While their market share has decreased with the introduction of other banking institutions, the Big Four still accounted for approximately 75 percent of the assets of the banking sector.<sup>4</sup> At the close of 2001, NPLs were \$213 billion or about 25 percent of total loans. By any external accounting standards, these banks would be deemed insolvent.

Reform of the banking sector is the key to China's ability to sustain success in economic transformation. Reform initiatives among the Big Four such as re-capitalization through China's foreign exchange reserves and the creation of asset-management entities to remove a sizeable amount (US \$170 billion) of bad assets have had some success. However, transformation of these large banks into sustainable commercial entities with external shareholders, modernized governance structures and public stock listings will require serious, additional efforts.

As a further step in the reform process, through its World Trade Organization (WTO) agreement, China has committed to gradual opening of specific bank markets to foreign banks culminating in the opening of dispersed retail banking services. However, the changes mandated by the WTO have been characterized as "slow in coming", if they have happened at all.<sup>5</sup> Other regulatory changes such as the introduction of the Chinese Bank Regulatory Commission (CBRC) are also underway.

While the Chinese Government has undertaken significant reforms that have liberalized agricultural production, grown its private sector, and initiated the opening of its doors to international trade and foreign direct investment, China's future economic growth is constrained by its financial sector, which continues to function below its potential. In order to overcome this obstacle, China must demonstrate the capacity and resolve to implement a comprehensive reform agenda that will promote the continued evolution of its banking system.

### **History of Chinese Banking**

The history of the Chinese Banking System has been checkered.<sup>6</sup> It has had ebbs and flows, but is now on a qualified upswing. The modern Chinese banking system was created in

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<sup>2</sup> FRBSF Economic Letter, "Reforming China's Banking System, Number 2002-17, May 31, 2002.

<sup>3</sup> McGeehan, Kevin, "China's Banking System and How Citibank Can Capitalize on Its Liberalization", Master's Thesis, The Fletcher School, Tufts University, April 29, 2005. p. 3.

<sup>4</sup> Ibid, p.1.

<sup>5</sup> Op. cit., McGeehan, p. 5.

<sup>6</sup> U.S. Library of Congress, "Country Studies", [www.countrystudies.us/china](http://www.countrystudies.us/china), p.1.

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the 1950s with the People's Bank of China (PBC). It was an all inclusive mono-bank, system<sup>7</sup> which halted inflation and brought the nation's finances under central control at the conclusion of the Chinese civil war (1949-52). By the 1970s the scope of PBC's powers included: issuing currency, controlling the money supply, and serving as the government treasury. "It was the main conduit through which all banking activities traveled".<sup>8</sup>

Beginning in 1979, China's banking system was expanded and diversified in support of the government's reform program. The changes began with the separation of individual banks from the PBC, signaling the Government's recognition of the need to "modernize its banking system due to significant inefficiencies in the allocation of capital"<sup>9</sup> and China's increasing interaction with the outside world. This was coupled with institutional diversification, which was characterized by a rapid growth in the number and size of non-banking financial institutions.

By 1987, the China banking sector included: the People's Bank of China, Agricultural Bank, Bank of China, China Investment Bank, China Industrial and Commercial Bank, People's Construction Bank, Communications Bank, People's Insurance Company of China, rural credit cooperatives, and urban credit cooperatives.<sup>10</sup>

Between 1979 and 1985, the volume of banking activity in China increased significantly. Deposits nearly tripled with the value of bank loans increasing by 260 percent.<sup>11</sup> By 1985 rural credit cooperatives held total deposits of 72.5 billion RMB. In 1986 there were more than 1,100 urban credit cooperatives, holding total deposits of 37 billion RMB and making loans worth 1.9 billion RMB.<sup>12</sup>

A brief overview of the reforms that took place with respect to key institutions comprising the Chinese banking sector sheds further light on the direction in which the State government was seeking to move and challenges that remained. The Agricultural Bank was created in the 1950s to support financial activities in China's rural areas. Its duties included: issuing loans, funneling state appropriations for agriculture, directing rural credit cooperatives and generally supervising rural financial affairs. Headquartered in Beijing, the Bank's network extended throughout the countryside. While initially successful, bank performance lapsed in the mid-1960s. The Bank was revitalized when its functions and authority were increased, and it was separated from the PBC in order to spur agricultural production in 1979.

During this same time period, the Bank of China which was responsible for all foreign exchange matters, including the allocation of foreign exchange reserves, foreign loans, letters of credit, and setting the exchange rates for China's currency was re-launched and made directly subordinate to the State Council. Similarly, the People's Construction Bank, which was responsible for state appropriations and loans for capital construction, was removed from the administrative control of the Ministry of Finance. It began to accept deposits in 1980.

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<sup>7</sup> Op. cit., McGeehan, p. 5.

<sup>8</sup> Ibid, p. 5.

<sup>9</sup> Ibid, p. 7.

<sup>10</sup> Ibid, p.2

<sup>11</sup> Ibid, p.1

<sup>12</sup> Op. cit, U.S. Library of Congress, p. 2.

Another significant reform to the Chinese banking sector occurred with the creation of a true central bank by the State Council in 1983.<sup>13</sup> The duties of the PBC which had previously been in charge of all banking functions in China -- including both lending and central bank functions, were fully re-defined by 1985 to be more in line with the tasks that a central bank fulfills. These duties included: issuing currency, managing credit, setting interest rates, and oversight of China's foreign exchange business.<sup>14</sup> While this transformation brought improved functional alignment to the banking sector, it also served as an important indicator to the world that China was committed to modernizing its banking system.

By the 1990s, authorities mandated that the Big Four be transformed from their role at State fiscal agencies into commercial bank organizations, and under the Commercial Banking Law of 1995, they were reclassified as commercial entities. During this same period, three new policy banks—the State Development Bank of China (SDBC), the Agricultural Development Bank of China (ADBC), and the Export-Import Bank of China (EIBC) were established and designated to perform policy loan functions.<sup>15</sup>

The Big Four has continued along the path of transformation. In 2000, four asset/liability management companies (AMC) were created to take ownership of the NPLs in each of the banks. These banks have shifted focus and are increasingly requiring lending based on generally accepted commercial banking techniques, closing loss-incurring branches, and investing in decision support tools such as information technology which link systems and offices.

Concomitant with improvements in the banking system reforms, other key related policy initiatives have been undertaken. The Chinese government is working to restructure SOEs—the source of NPLs which continue to pose significant threats to the stability of the economy. Limitations are being placed on spending, and creditworthiness as a condition for loans is being emphasized. Chinese businesses are increasingly recognizing the importance of corporate governance, both from the perspective of efficiency and the ability to attract outside investment.<sup>16</sup> However, while changes continue to be instituted, and the economy continues to grow, the legacy of banking in China coupled with the concerns about the stability and viability of the Communist regime has created an economic/investment environment that remains uncertain and speculative.

### **Current Status**

China's GDP is growing at a torrid pace of 10.3 percent during the first quarter and 11.3 percent during the second quarter of 2006. The rapid growth in GDP is partially attributed to the excess liquidity, large foreign capital inflows and currency manipulation by PBC. The rapid growth in GDP has several consequences including growth in investment partially contributing to the NPLs, faster growth in money supply resulting in inflation, imbalance in foreign trade, increased interest rates, increased pressure for a faster appreciation of currency, etc.

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<sup>13</sup> Ibid., p. 8

<sup>14</sup> Ibid, p.8.

<sup>15</sup> Cho, Yoon Je, "The Banking System of the People's Republic of China, Sogang University, Seoul, Korea, p.5.

<sup>16</sup> Op. cit, McGeehan, pp. 9-10.

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In order to accommodate the growing needs of the financial sector and to stabilize the financial system in the light of the country's rapid growth, several banking sector reforms were introduced with an intention to create a world class banking system. The East Asian financial crisis along with the Japanese banking sector problems due to high NPLs further emphasized the need to reform China's banking system to avoid similar repetitions.

The financial reforms were designed to address several key problem areas such as vast number of NPLs, government influence and interference in the daily operations, WTO commitments, Basel accords, Non Banking Financial Institutions (NBFI), etc. These reforms in the banking sectors are broadly classified into three categories, restructuring, financial liberalization, and regulation and supervision. However, before these reforms are analyzed, it is important to review the risk factors at play in the Chinese economy.

### a. Risk Factors

The Chinese economy has rapidly been growing, but there are questions about the long-term stability and viability. Before the economic reform was launched and opening-up in 1978, the banking system in China was known as the mono-banking system with the PBC being the only bank serving both government and business customers. Starting in the late 1970s, four state-owned specialized banks were established successively, which were named as ICBC, ABC, BOC and CCB.

In 1984 a reshaping of a two-tier banking system in China began when the PBC began to function as the central bank. Later on transforming four specialized banks into state-owned commercial banks, three policy banks, namely China Development Bank, Export-import Bank of China and Agricultural Development Bank of China, were then created in 1994 to take over the policy-natured businesses from the four specialized banks. There have been two decades of reforms and evolution, a comprehensive and multi-layered banking system has developed in China, in which the State-owned commercial banks play a dominant role, and, together with other banking institutions of various types, provide a full range of products and services to the economy. While the economy is still evolving, lack of accountability in various areas of the banking environment is creating risk in the banking and overall financial system.

### *Non-Performing Loans Accumulated*

NPLs are contingent debts, that are not backed by sufficient funds or assets. Since there is no implicit government guarantee of State-Owned Commercial Banks (SOCB) deposits with a large proportion of which has been used to finance NPLs poses a threat to China's financial system. The implicit guarantee represents the State's contingent NPL debt. Reform appears to require complex and time consuming process involving change in many areas of government policy. "The four state banks are allowed to transfer to the four Asset Management Company's (AMCs) any loans that were non-performing before the end of 1995. The central government contributed RMB 10 billions toward the paid in capital of each of the four AMCs, which raised capital by borrowing from the central bank and issuing bonds."<sup>17</sup>

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<sup>17</sup><http://64.233.167.104/search?q=cache:zonDZGcZePMJ:www.iadi.org/html/App/SiteContent/Introducing%2520DIS%2520in%2520China.pdf+china+NPLs+accumulated&hl=en&gl=us&ct=clnk&cd=21>

NPLs Transferred as of June 2000			
	NPLs Transferred (Rmb b)	To Total Transferred (%)	Related Bank
Total NPLs transferred	1,363.5	100.1	Four state banks
Huarong AMC	407.7	29.9	Industrial and Commercial Bank
Greg Wall AMC	345.8	25.4	Agricultural Bank
Oriental AMC	260.0	19.1	Bank of China
Cinda AMC	350.0	25.7	Construction Bank
Sources: Various sources: BNP Prime Peregrine (Table 1)			

AMCs acquired the state banks' NPLs for the face value plus accumulated interest. In June 2000, all pre-1996 NPLs had been transferred. This amounted to be more than 1,300 billion RMB, equivalent to 13.6% of the country's outstanding loans, or 18.1% of the four state banks' outstanding loans.

Although the Bank of China's ratio of nonperforming loans to total lending was reported at 4.4 percent in mid-2005—down from more than 33 percent in 2003, the China Banking Regulatory Commission and other industry experts have warned repeatedly that all lenders risk a rebound in bad debt if they don't improve controls over branch management -- where most of the problems occur.<sup>18</sup>

### New weak regulatory regime

The PBC as the central bank continues to suffer a lack of sufficient independence. It is not an independent body, but a ministry under the State Council of China. It is responsible for making the country's monetary policy; however the policy remains largely subject to the macroeconomic policies formulated by other ministries such as the State Development and Planning Commission, the State Economic and Trade Commission and the Ministry of Finance.

The effectiveness is constrained due to the lack of comprehensive and clearly defined regulations and laws, independent institutional framework, qualified staff and policy enforcement efficiency.

### Banks Weak Corporate Governance

China's banking system has a poor system of governance and risk control. The current reforms established asset management companies, debt for equity swaps and recapitalization of banks. The primary problems are largely the politics of the banking system, as banks are still expected to support a wide range of political and social activities, thus giving managers a high

<sup>18</sup> [http://www.boston.com/business/articles/2006/05/26/bank\\_of\\_china\\_97b\\_ipo\\_lures\\_investors/](http://www.boston.com/business/articles/2006/05/26/bank_of_china_97b_ipo_lures_investors/)

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degree of discretion in allocating funds that may lead to decisions of lending based relationships versus creditworthiness.

### *Deposit Insurance Scheme*

The deposit insurance system refers to a mechanism of establishing insurance institutions within the financial system absorbing the insurance premium paid by banks or other financial institutions and setting up the deposit insurance reserve. Under the system, once the insured is found to be suffering risks, the insurer will provide financing or directly pay off a part or whole of the deposits of the insured.

The Chinese government introduced a Deposit Insurance Scheme (DIS) that has not been embraced by the National Banks. The four big state-owned commercial banks - the BOC, CCB, ICBC and ABC have all along been unwilling to implement the deposit insurance system, due to the perception that their credit ratings are equal to state credit ratings. Furthermore, these banks will have to pay premiums based on the deposits they hold resulting in substantial amount of insurance premiums due to the large deposits held by these banks

### *Accounting Practices Still Inadequate*

The State banks are audited by internal personnel, while the shareholding banks mainly use local auditors. Even for those using a local auditor and an international auditor, their released financial statements are still audited by the local auditors.

While accounting principles are already fairly consistent with the International Accounting Standards, accounting practices in China remain inadequate. China's practices lack sufficient transparency, prudent concept, and consistency in the application of standard, timely public disclosure and accuracy of basic data in disclosing the exact information on NPLs and loss reserves.

### *Credit Rating*

A credit rating assesses the credit worthiness of an individual, corporation, or even a country. Credit ratings are calculated from financial history, current assets and liabilities, and indicate to a lender or investor the ability to pay back a loan. A poor credit rating indicates a high risk of defaulting on a loan, and thus leads to higher interest rates. A sovereign credit rating is the credit rating of a sovereign entity, i.e., a country. The sovereign credit rating indicates the risk level of the investing environment of a country and is used by investors looking to invest abroad. The movements of capital are affected to a considerable extent by the credit ratings assigned to individual countries. The credit rating at times may suffer from some inherent weaknesses in the country's economy.

S&P started covering the four Chinese banks in 1999 and rated as following: Bank of China (BB+), China Construction Bank (BB+), the Industrial and Commercial Bank of China (BB+), and China Bank of Communications (BB). This means 12 mainland banks, including four state-owned commercial banks and eight joint-stock commercial banks, were rated by the S&P. According to S&P's rating standards, any bank rated BB and below is not safe for investment. Therefore, the day after S&P released its information on the rating of the eight

Chinese banks, the Wall Street Journal published an article on S&P's categorical rating of Chinese banks as junk, causing a public outcry.<sup>19</sup>

With the main four banks having a rating grade in the B category, it demonstrated a degree of risk, to investors, no guarantee of investment security, and unreliable capability of repaying capital with interest. As of September 2005, the Bank of China has been rated as BBB+/stable demonstrating improvement in their fiscal health.

### Profitability of Banks

The profitability of banks determines whether a bank can generate sufficient income to cover possible losses and provide shareholders with a positive return. Factors that have attributed to the low and deteriorating profitability in Chinese banks are believed to be many such as overburden from taxation and quasi-tax charges, inadequate ability to control costs and cost growth, and deficiencies in internal management.<sup>20</sup> If the banks do not generate enough profitability or improvement, the viability of these banks become questionable in the long-run.

### China's Economic Bubble

Economic bubbles are caused by excessive credit creation. In China, the loan growth of the commercial banks has amounted to approximately 15% per annum for almost 15 years. To extend loans, banks must have deposits. The deposits the Chinese banks extended as loans were earned as exports of goods to the United States. Without its trade surplus with the US, China's economy would have grown at a much slower pace—if at all—both because the exporter's profits would have been much worse and also because the banks would not have had enough deposits to allow them to expand lending so rapidly. “There are a number of problems with this economic model. First, a very large percentage of the credit extended by the Chinese banks cannot be repaid: estimates of non-performing loans in the banking system range from 25% to 50% of all loans. Next, credit expansion in China has already been so excessive that the supply of goods exceeds the purchasing power of the public by a considerable margin. Consequently, prices are falling and China is experiencing deflation despite its rapid economic growth. Finally, China cannot depend on maintaining such large trade surpluses with the US for very many more years. The origins of China's rapid growth—credit creation and trade surpluses—are both unhealthy and unsustainable.”<sup>21</sup> This may lead to the economy taking a downturn impacting the banking environment.

## **b. Policy Reforms and Impacts**

### **i. Restructuring**

As has been discussed, China's financial system, which is one of the largest in the world, is heavily reliant on its banking system. Bank loans represent a higher allocation of funds raised by non-financial institutions than stocks or bonds, and the banking system is the main financier of non-profitable SOEs. As China continues to deal with many challenges that face a developing

<sup>19</sup> [http://www.bjreview.com.cn/200402/Business-200402\(C\).htm](http://www.bjreview.com.cn/200402/Business-200402(C).htm)

<sup>20</sup> <http://www.macrochina.com.cn/english/analysis/outlook/20010724001708.shtml>

<sup>21</sup> [http://www.business-in-asia.com/dollar\\_crisis.html](http://www.business-in-asia.com/dollar_crisis.html)



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and rapidly growing country, the restructuring of its banks is a critical factor to the country's financial success and viability as well as its strategy to become a dominant global force. As China moves toward a market based economy, it must focus on the restructuring of the monetary and financial sectors. Yet progress has been slow and reform has been deliberate in an effort to ensure control and thwart failure. Systemic consequences such as a banking crisis slow down of capital export to finance the US account deficit or fear of foreign investors controlling Chinese banks are among the many worst case outcomes that face the banking reform. However, sluggishness of the reform has hurt the financial system and has prevented the economic and financial evolution needed to become a market based economy. More aggressive action as well as faster execution of banking reform policies are the remedy that many believe will accelerate China's financial success.

Over the past 11 years, there have been numerous milestones in China's banking reform efforts. China's banking reform started in 1995 with the first set of laws introducing commercial banks and new governance of the PBC. During this time, the newly instituted Commercial Bank Law introduced capital requirements to all commercial banks and assigned new responsibilities to the PBC that included: monetary stability, banking supervision and management of the payment system. This was the first step toward gradual removal of government ownership of the banking system and the foundation for a checks and balance system in its financial sector to create profitability.

The biggest steps in China's bank restructuring efforts are its attention toward equity management, capitalization, and profitability. The four SOCBs are among the biggest banks in the world, and along with the credit cooperatives carry over half of all the outstanding NPLs in China. Historically, the SOCBs were the sole financial source for large SOEs and their close relations with these state owned enterprises has made it difficult for the SOCBs to manage their assets and maximize profitability, especially considering that profitability was never a core objective among these banking institutions from inception. Clean up of NPLs is critical to the stability of the banking system. China's efforts to recover these loans are primarily held by the AMCs. These recovery efforts have been difficult given the logistics, quantity and lack of relationship needed to recover these loans.

Equity management in Chinese banks is slowly growing and has been helped by the infusion of new investments resulting from its explosive economy and export growth in the last 10 years. Additionally, the government has infused the largest banks with capital in an effort to build assets; yet these banks continue to run very low capital adequacy ratios which could threaten the sustainability and security of the financial sector. Much of this is a result of NPLs, and key initiatives have been taken to prevent accumulation of additional NPLs including:

“closure of branches and reduction of staff, strengthening bank governance and internal controls, the establishment of a board of directors, and the development of credit risk management techniques, including internal rating systems in the largest banks.”<sup>22</sup>

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<sup>22</sup> Where is the Chinese Banking System Going With the Reform? Alicia Herrero, Diniel Santabarbara and Banco de Espana, <http://129.3.20.41/eps/mac/papers/0408/04080001.pdf>, p.16

The government's infusion of capital or substitution of NPLs into the SOCB was an effort to help reduce the shares of outstanding NPLs and help increase asset management. This primarily took place over 7 years, from 1998 to 2005 and was estimated to be 20% to 24% of the GDP in 2004 and 110% of SOCB capital.<sup>23</sup> To ensure continued sustainability and to open the banks up to better management and more capital, listings of these banks will allow foreign investors to acquire ownership as we have seen by Bank of America's 9% stake in CCB in 2004 and UBS's investment of half a billion dollars in Bank of China in 2005. Recently, UBS purchased a 20% stake in Beijing Securities in June of 2006. UBS will be the first foreign-run brokerage in China after the country's Securities Regulatory Commission gave the bank approval to invest \$200 million in state-owned Beijing Securities, which will change its name to UBS Securities.<sup>24</sup> This is a big milestone for the China government and its economy.

The growing Chinese economy is also having a significant impact on rural areas and consequently banking sector services. Rural Credit Cooperatives (RCC) and Urban Credit Cooperatives (UCC) have been consolidated and reformed to better support the growing needs of the agricultural community especially as the government tries to ensure stability among industries as well as new WTO requirements.

## ii. Financial Liberalization

Financial liberalization focuses on several areas that have a significant impact on China's economic vitality and growth. Reforms have centered on opening up the banking system to foreign competition, establishment of better market practices, and liberalizing interest rates and exchange rate controls.

Liberalization of the banking system started in 1997 with the introduction of market practices, the removal of a number of credit quotas in SOCB and more autonomy in their lending decisions. A landmark occurred in 1999 when the government was forbidden to interfere with commercial lending and the lending rate ceilings were lifted to encourage loans to small and medium sized enterprises (SMEs). Additionally, private capital was authorized to enter joint stock commercial banks (JSCBs) and city commercial banks (CCBSs). At the same time, the reserve requirements were lowered to encourage banks to practice better asset management.

Another crucial milestone occurred in late 2001 when China agreed to fully open the banking system to foreign institutions under WTO agreements. Prior to this, foreign currency transactions were the only approved transactions and were controlled by restrictions on geographic limits. The WTO agreements opened up the banking system to foreign investors and allowed them to operate in the retail markets in domestic currency without any business or geographical limitations.<sup>25</sup> It opens up all banking services even to Chinese households. Additionally it allows foreign affiliates to enter with fewer restrictions. These agreements were effective in 2005, but took place toward the end of 2006. The systemic benefits are several years

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<sup>23</sup> China's Banking Reform: an Assessment of its Evolution and Possible Impact pg 17 Alicia Garcia Herrero and Daniel Santabarbara

<sup>24</sup> Banking Business Review Online. June 2006 [http://www.banking-business-review.com/article\\_news.asp?guid=315C467D-454C-4DB8-BF8E-5A41703AC5AD&z=](http://www.banking-business-review.com/article_news.asp?guid=315C467D-454C-4DB8-BF8E-5A41703AC5AD&z=)

<sup>25</sup> Where is the Chinese Banking System Going With the Reform? Herrero and Santabarbara, *op. cit.* pp 18-22.

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away; however this is a critical milestone that will accomplish solvency, competition and hopefully sustainability.

Foreign acquisitions of Chinese banks have the global financial market scurrying to enter the Chinese economy. Chinese authorities still like to limit ownership to roughly 20% for a single investor and 25% for a joint investment, yet these thresholds have become flexible as China seeks capital infusions and better management. Bank of America was the first bank to spend nearly \$3 billion on a stake in China Construction Bank in 2004, followed by The Royal Bank of Scotland, Singapore's state investment agency Temasek Holdings, UBS and the Asian Development Bank, purchasing a 25% stake in the Bank of China in 2005, and DBS & Deutsche Bank's stake in the Guangdong Development Bank in Guangzhou in late 2005 represent a new era toward a global financial market.<sup>26</sup> Most significant is UBS's 20% stake in Beijing Securities in June of 2006. This will result in UBS being the first foreign-run brokerage in China after the country's Securities Regulatory Commission.

Interest rate liberalization has been slow yet plays a dominant role in the banking reform efforts. Liberalization efforts have introduced market based monetary instruments, improved monetary transaction and increased competitiveness among financial institutions. Loans, deposits and bonds are currently controlled by market forces. Foreign currency lending and large value deposits have all recently had limits removed in the past 5 years. The government anticipates in the near future, the liberalization of rates on foreign currency deposits of small value with less than a year maturity, which will be significant for Foreign Institutional Investors (FIIs), especially given that capital inflows are more liberalized than outflows and need to be authorized by SAFE (State Administration of Foreign Exchange). Currently, the lending spread has widened and the rates have dropped which has reduced exposure for the banks and have helped them more toward profitability.

### iii. Regulation and Supervision

Since the beginning of the reforms in the regulation and supervision of the banking sector in the mid 1990s, China has introduced several prudential regulations to meet the international banking standards. In 1995, the Commercial Banking Law was introduced stipulating the loan capital adequacy requirements to all commercial banks among several other measures.<sup>27</sup>

Since 1996, supervision of rural credit cooperatives has become the direct responsibility of PBC. PBC conducts off-site monitoring by collecting and analyzing 16 prescribed asset-liability ratios, based on monthly and quarterly reporting by the banks on some 850 items, including both prudential indicators as well as other statically information.<sup>28</sup>

In June 1997, PBC created a nation-wide interbank market and interbank bond market to trade bonds alongside of equities on an exchange mainly serving the institutional investors. Over

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<sup>26</sup> Foreign Bank Acquisitions: Goin' South August 2005

[http://survivedsars.typepad.com/survivedsars/2005/08/foreign\\_bank\\_ac.html](http://survivedsars.typepad.com/survivedsars/2005/08/foreign_bank_ac.html)

<sup>27</sup> Where is the Chinese Banking System Going With the Reform?, Alicia Herrero, Diniel Santabarbara and Banco de Espana, [op.cit](#)

<sup>28</sup> The Banking System of the People's Republic of China, Yoon Je Cho,

[http://www.adb.org/Documents/Books/Rising\\_to\\_the\\_Challenge/Republic\\_of\\_China/2-bank.pdf](http://www.adb.org/Documents/Books/Rising_to_the_Challenge/Republic_of_China/2-bank.pdf)

the 10 year period after the creation of interbank markets, the bond market has increased leaps and bounds in terms of bond issues, market capitalization, turnover of the secondary market, and number of participants. The interbank market has promoted the development of direct financing reducing financial risk of over-reliance on the banking system for credit while enhancing the market efficiency, introduced the market based interest rate reform, effective application and transmission of monetary policy by the central bank in its open market operations, and provided a way for the financial institutions to better manage their liquidity.<sup>29</sup>

In 1997, PBC also issued provisional rules establishing board of supervisors that includes representatives from the PBC, the Ministry of Finance, and the State Economic and Trade Commission, the State Auditing Administration of State Property, and commercial banks, as well as economic and legal experts to oversee the bank operations.<sup>30</sup> In 1998, PBC announced that the central banking system would be transformed into a system similar to the Federal Reserve System of the US to further strengthen its supervisory power. As part of this transformation, regional headquarters were formed by combining the PBC provincial branches to reduce the influence of local governments on PBC in regulating the local banks.

Historically China's bank loan portfolios contained a very high level of non-performing loans (NPL) due to the focus of banking supervision on meeting the key goals and targets set by the government in accordance with its policy. In 2001, PBC introduced several regulatory and supervision measures including tougher provisioning rules to increase loan loss reserves to total loans, loan classification, increased off-site and on-site inspection by PBC, internal audit controls, etc., to reduce the NPLs. Even though stricter regulations were adopted to reduce the NPLs, increased substandard lending, loan concentration, and assumptions of optimistic economic conditions may have further increase the NPLs that are already at high levels.

In 1988, the Basel Committee introduced the Basel I framework for the capital adequacy. The Basel I framework was designed to establish minimum levels for capital for internationally active banks. Until China adopted the Basel I accord in 2002, the NPLs were classified using a four-category classification - normal, past due, idle and bad.<sup>31</sup> In 2002, PBC introduced the NPL classification system in accordance with Basel I accord that classifies the loans into five categories, normal, special attention, substandard, doubtful and loss.<sup>32</sup> However, this classification involves a subjective judgment by the bank staff and requires substantial training for the staff to properly classify the loans.

In 2003, CBRC was created to take over regulatory and supervisory functions from PBC to enforce stricter regulatory and prudential enforcement, accounting, internal reporting and disclosure requirements in accordance with the international accounting standards, and to reduce the high levels of NPL.

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<sup>29</sup> The development of China's bond market, Mu Huaipeng, People's Bank of China, <http://www.bis.org/publ/bppdf/bispap26j.pdf>

<sup>30</sup> The Banking System of the People's Republic of China, Yoon Je Cho, [http://www.adb.org/Documents/Books/Rising\\_to\\_the\\_Challenge/Republic\\_of\\_China/2-bank.pdf](http://www.adb.org/Documents/Books/Rising_to_the_Challenge/Republic_of_China/2-bank.pdf)

<sup>31</sup> The Main Problems of China's Financial Industry and AMCs, Feb 13, 2004, Guifen Pei and Sayuri Shirai, Heibei University and Keio University, [http://coe21-policy.sfc.keio.ac.jp/ja/event/files/s1-7\\_presentation.pdf](http://coe21-policy.sfc.keio.ac.jp/ja/event/files/s1-7_presentation.pdf)

<sup>32</sup> BIS Working Papers No. 115, China's asset management corporations, Guonan Ma and Ben S C Fung, August 2002, <http://www.bis.org/publ/work115.pdf>

## China's Banking System

In June 2004, the Basel Committee released the new Basel Capital Accord referred to as Basel II consisting of three pillars: (1) minimum capital requirement, (2) supervisory review of capital adequacy, and (3) public disclosure. Basel II is slated to be implemented globally by the end of 2006.<sup>33</sup> Subsequent to the release of Basel II accord in 2004, CBRC announced that it will issue new regulation on the risk management based on the three-pillar approach of Basel II accord to be implemented soon after it goes into effect at the end of 2006. However, at the annual ADB conference, the Chinese officials have indicated that they will require only the large complex banks to adopt Basel II standards by 2010 and vast majority of locally incorporated banks and foreign bank subsidiaries will continue to function under the capital regulation issued in the early 2004, a combination of Basel I and some elements of Pillar 2 and Pillar 3 of Basel II.<sup>34</sup>

In order to implement the regulations and supervision effectively, China needs to develop know how in terms of implementing the modern accounting and reporting system to meet the international standards. The supervisory staff needs to be trained to effectively implement the loan classification system and enforce the rules and regulations. The introduction of increased on-site inspections from the current interval of 3 years at the local levels will help uncover the disparities in the disclosures made by the banking institutions and educate the bankers with the latest regulations.

Several areas still either lack the regulation and supervision or are antiquated and need reforms. The tax system needs to be revamped to eliminate taxing heavily on estimated profits which are overblown due to the poor classification of loans rather than taxing on the actual profits due to the inadequate accounting standards. Several regulatory and supervisory reforms have focused specifically on the banking institutions and ignored several NBF entity types such as a variety of trust and investment corporations, finance companies, leasing companies, insurance companies, and security dealers. Most of the NBFIs are owned by the state, local and provincial governments or their subsidiaries and the indiscriminate business operations due to the weak regulatory oversight pose potential threat to the banking system.

China's financial system lacks a comprehensive deposit insurance system. The vast number of NBFIs necessitates a deposit insurance system to protect the depositors in the event of their failure and contain the jolt to the financial system. The deposit insurance becomes even more important for NBFIs in the light of low loan provision and loan deposit ratios. The state-owned bank deposits may not need the deposit insurance system as it is implied that these deposits are backed by the government due to the state ownership of these entities.

Since the reforms have started in the mid 1990s, several regulations are in place to manage the China's banking system risk. However, the implementation of these regulations and supervision standards are still lax and vague. When the Commercial Bank Law was introduced in 1995, none of the four state-owned commercial banks met the loan provision and loan to

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<sup>33</sup> Basel Committee on Banking Supervision, *The Overview of The New Basel Accord*, April 2003, Bank for International Settlements.

<sup>34</sup> *Basel II Challenges and Implications for Asia*, ADB Annual Meeting, <http://www.adb.org/AnnualMeeting/2006/seminars/Presentations/Huaqing-Wang-Basel-II.pdf>

deposit ratio criteria.<sup>35</sup> The ownership of the largest banks by the government presents several potential problems even after introduction of several regulations for risk management and supervision due to the conflicting goals. The government's role as owner, regulator, taxing authority and primary borrower for state-owned banks presents the potential of conflict of interest.

The lending by the state-owned banks to the government entities and preferred sectors to meet the government targets and objectives further increases the already worse NPL. These lending practices are further exacerbated due to the lack of enforcement for public disclosure of the loan concentration ratios. Introduction and implementation of several regulations has not curbed in the loan concentration and priority lending. At present, lending to the construction industry is so pervasive that around the middle of June 2006, China's premier, Wen Jiabao ordered banks and local governments to tighten financing for the construction projects in order to curb the speculative investment and contain the exorbitant real estate price increases.<sup>36</sup>

The irrational lending by the banks due to inadequate regulation and supervision resulted in new loans equaling a whopping \$312.5 billion during the first half of 2006 or 85.6 percent of the government's full-year target of \$375 billion for 2006.<sup>37</sup> In order to curb the large GDP growth, PBC has recently raised the key interest rates and is in the process of raising them again along with the credit tightening.

### **Recommendations for Future Steps**

Recommendations for future steps in the Chinese banking system consist of a reduction of NPLs and the success of SOCBs listing on the international stock exchange will provide strategic investors the ability to diversify. The restructuring of the RCCs should include clarification of ownership structure and improvement in management. In parallel, the CBRC announced it would move ahead with the reforms of other types of financial institutions, including policy banks, AMCs. Thus additional improvements in risk management, corporate governance and profitability will be required and elimination of any government interference

With financial liberalization, the PBC intends to continue introducing flexibility in lending rates and to eliminate the rules on credit allocation to reach a more efficient financial model. Additional steps will be introduced to improve the regulation and supervision of risk management policies to support the Basel II accord. This will support large banks in their efforts to build their own internal credit risk rating system. If this reform plan is not clearly defined and executed within aggressive timelines, then the long term view of the banking system may be too slow for the rapid growth of the economy.

An obstacle to a successful bank reform, especially when the liberalization and privatization processes are accelerated, is the lack of a deposit insurance system. While the

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<sup>35</sup> The Banking System of the People's Republic of China, Yoon Je Cho, [http://www.adb.org/Documents/Books/Rising\\_to\\_the\\_Challenge/Republic\\_of\\_China/2-bank.pdf](http://www.adb.org/Documents/Books/Rising_to_the_Challenge/Republic_of_China/2-bank.pdf)

<sup>36</sup> <http://www.washingtonpost.com/wp-dyn/content/article/2006/06/15/AR2006061500824.html>

<sup>37</sup> [http://news.yahoo.com/s/ap/20060710/ap\\_on\\_bi\\_ge/china\\_economy](http://news.yahoo.com/s/ap/20060710/ap_on_bi_ge/china_economy)

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introduction of a limited guarantee is welcome, it is crucial that the scale, scope and duration of the guarantee be defined in advance to determine whether the State will support bank deposits in case of bank failure. Finally, improving China's banking system transparency will be important overtime as the system grows. They key areas of focus are statistics, methodologies and data collection.

PBC has recently raised the key interest rates to curb the lending by the banks and is in the process of increasing further along with the tightening of credit. However, these tightening measures will not have a large and immediate effect unless the interest rates and dividend policies for large state enterprises are changed. In 2005, the state owned enterprises made profits of \$78.6 billion, and the bank deposits by the state enterprises earn a very low interest rate on their deposits with a tax imposed on the interest income.<sup>38</sup> Unless these policies are changed, the state owned enterprises will quickly invest the profits further increasing the liquidity.

Artificially pegging the Chinese currency to the US dollar also reduces the effectiveness in increasing the interest rates to curb the growth as higher interest rates result in more foreign inflows to reap higher interest rates thus increasing the liquidity and investment. The currency pegging also reduces the independence of PBC in determining the interest rates that are suitable to the market conditions. Recently the Chinese government has broken the dependency of RMB on the US dollar and tied to a basket of currencies, and allowed the currency to float within a range. The government must expedite floating the currency while carefully evaluating the implications of such an action to balance the impact on the economy.

## Conclusion

The Chinese economic model is characterized by: a large percentage of NPLs (ranging from 25 -50% of all loans); excessive credit expansion where the supply of goods has significantly exceeded consumer purchasing power, and the consequences— falling prices and deflation in spite of rapid economic growth. This current economic model is viewed as volatile and unsustainable. The Chinese financial market, which is one of the largest in the world, is heavily reliant on its banking system. The reform of its banking system is a critical factor in China's success as it moves toward a market based economy and recognition as a dominant global force. While the State clearly recognizes this fact, a combination of forces: political, cultural, geographic and legacy have slowed the pace of reform.

Numerous milestones in China's banking reform have been realized during the past 11 years with the first set of laws that introduced commercial banking and new governance of the PBC. China continues to struggle with the removal of government ownership of the banking system and the push towards profitability of the financial sector. China has also moved to reform its banking system through opening up its banking system to foreign competition, establishing better market practices and liberalizing interest rates and exchange rate controls. While ownership remains limited to roughly 20% for single investors and 25% for joint investors, a number of prominent foreign companies such as Bank of America, Bank of Scotland and the Deutsche Bank have availed themselves to investment opportunities in China.

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<sup>38</sup> <http://www.ft.com/cms/s/8c7f3cd0-12d4-11db-aecf-0000779e2340.html>

China is also working to implement key reforms in the regulation and supervision of its banking sector; however the pace of reform is slow. Basel II is slated to be implemented globally by the end of 2006. China will require only its largest, complex banks to adopt Basel II standards by 2010. The vast majority of locally incorporated banks and foreign bank subsidiaries will continue to function under a less stringent combination of Basel I and some elements of Basel II.

If China is to demonstrate its commitment to reform and transformation of its economy, it must aggressively pursue and broaden the scope of the policy reforms it is undertaking. Restructuring, financial liberalization, regulation and supervision must remain the key areas of focus. The future stability of the China economy is dependent upon the pace of progress in addressing reform; the alignment of strategic approach both within China and the broader global community; the comprehensiveness of reform; and the openness of the State to divesting itself of long-standing impediments to change.