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Chinese Bank *Report Card*

The reform road is still bumpy, so forget full RMB convertibility anytime soon.

BY CHI LO

China's banking system has gone through some profound changes, though reform is far from complete. Financial liberalization has yet to fully unleash banking's potential to fulfill asset demand, and China's mortgage and personal finance markets remain in infancy.

It will take a few more years than expected for banking reform to be completed, despite the World Trade Organization requirements for China to fully open its banking sector to competition by the end of 2006. The banking system is unlikely to collapse, however, despite the slow pace of reform and the inherent banking woes. But Beijing must take bold steps to push reform forward.

These include making asset management companies more effective by reforming the institutional and legal framework, creating a truly commercial banking culture, and ceding public control of the banking system by allowing eventual full private ownership.

Given China's reform momentum, its banking reform outlook remains benign. But full capital account (and hence RMB) convertibility will be delayed until bank-

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BANKING REFORM PROGRESS

China has made some material progress in reforming its ailing banks. Non-performing loans have fallen steadily, as a share of total assets, GDP, and new loans (see Figures 1 and 2). Private analysts estimated that China's non-performing loans amounted to more than 50 percent of GDP in the early 1990s. But official estimates put them now at less than 10 percent. Even if the true bad debt levels were three times higher, this still represents a sharp improvement. Nevertheless, some are still worried that the bulk of the nonperforming loan decline in recent years resulted from bank loan expansion, especially between 2002 and 2004 when bank lending grew by an average of 18 percent per year.

Fundamentally, China's banking sector has undergone some serious reform since 1998, when financial liberalization and banking clean-up efforts were launched. The process started with fresh capital injections, nonperforming loans carve-outs, and organizational restructuring for the Big Four state banks, which still account for 53 percent of the system's assets and liabilities.

Beijing issued RMB270 billion (US$32.6 billion) of special-purpose bonds to recapitalize the Big Four in 1998, and set up four asset management companies to buy RMB1.4 trillion (US$170 billion) of bad debts from them between 1999 and 2000. Then at the end of 2003, Beijing used the country's huge foreign reserves to inject US$45 billion into the Bank of China and the China Construction Bank. The cash injection allowed the two banks to boost their capital adequacy ratios to over 8 percent and cut nonperforming loans to less than 10 percent.

These efforts cost Beijing US$260 billion since 1998, about twice the amount South Korea spent on restructuring its banks after the Asian crisis and about the same amount the United States spent on cleaning up its savings and loan industry in the 1980s.

Chinese banks have also improved their technical ability since 1998 by raising accounting and regulatory standards. The People's Bank of China's decision in October 2004 to lift the commercial lending rate ceiling has, in principle, allowed banks to price loans according to credit risk. Crucially, the China Banking Regulatory Commission was created in late 2002 as an independent bank regulator,

Political Power Struggles

Thick politics has manifested itself in the struggle between the People's Bank of China and China Banking Regulatory Commission. The tussle has severely limited the ability of the CBRC to be a true independent regulator. The CBRC was born of political battling, when Premier Wen was consolidating his power after taking over from Zhu Rongji in late 2002. The People's Bank of China, which was closely related to Mr. Zhu and had multiple objectives (of which being a bank regulator was only one of them), had strongly resisted separating the regulatory role from its other roles.

When Mr. Wen came to power, he moved to weaken Mr. Zhu's agency and installed his protégé Yan Hai-wang to form a team of experts, excluding anyone from the People's Bank of China, to create an independent bank regulator—the CBRC headed by Liu Ming-kang. But People's Bank of China governor Zhou Xiao-chuan, who is a favorite of Mr. Zhu, has not given up the turf fight. He uses the People's Bank of China's mandate of keeping overall financial stability to continue to supervise and audit banks, overlapping the CBRC's work.

—C. Lo

People's Bank of China Governor **Zhou Xiao-chuan**

focusing on cutting banks' nonperforming loans and improving their operations.

Most of China's 128 local commercial banks have independent directors sitting on their boards now, and have installed better shareholding and incentive structures that involve some market discipline. Management has also invested in new risk management system and tried to eliminate the conflict of interest problem by separating the roles of making and approving loans.

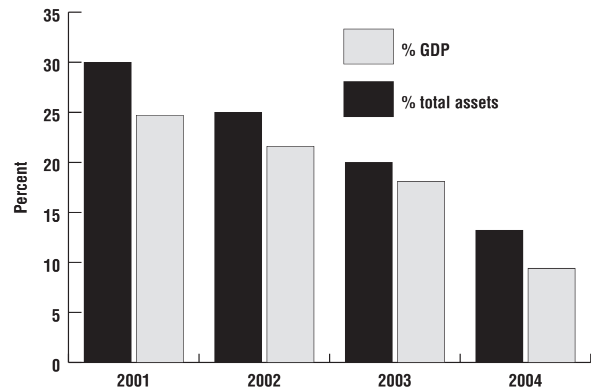
A BETTER REFORM STRATEGIC FOCUS

The government's reform tactics took a sharp turn, arguably for the better, in 2003 when Wen Jiabao took over from Zhu Rongji the premiership. Mr. Zhu's policy focused on recapitalizing the Big Four in return for operational restructuring but no privatization. After recapitalization, the banks were expected to grow their way out of the nonperforming loans problems before opening up to foreign competition.

But such a strategy prompted an extreme pro-growth policy that created economic bubbles in various sectors. The state banks tried to grow out of their problems by lending lavishly between 2002 and 2004, thus feeding speculation in property, auto, steel, and other unprofitable industrial projects.

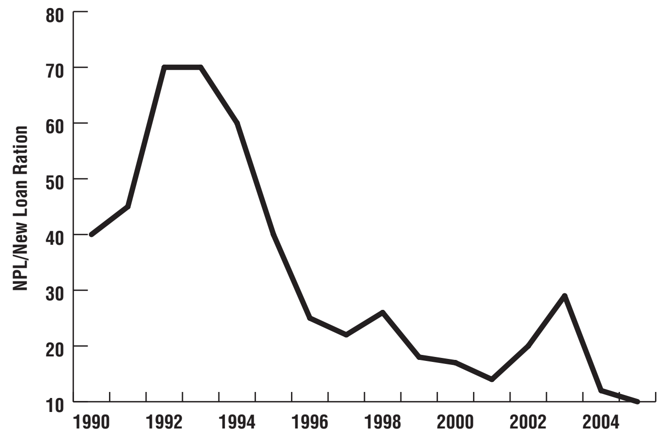
Mr. Wen has taken a different approach since 2003. He has combined recapitalization, with renewed fund injection in the Bank of China and China Construction Bank, with privatization, in particular selling them off to foreign investors. The aim is to use private investors as an external force to push structural changes. The pre-listing cleanup has pushed the amount nonperforming loans down sharply.

1 The Big Four's Non-Performing Loans



Sources: CIEC, Hoover Institution, China Banking Regulatory Commission

2 Non-Performing Loans as a Share of New Loans



Source: UBS

CONFIDENCE RISING

Granted, all this does not mean that Chinese banks are now fully commercialized with sound risk management and lending decision. But it suggests that the bad debt situation is more manageable than before. The Chinese authorities have opened the door to foreign strategic investors, who have responded with a strong vote of confidence.

From a trivial US$500 million cumulative foreign equity stake in Chinese banks in 2003, overseas investors poured US$18 billion into the Chinese banking system between late 2004 and 2005, with the bulk of the investment coming in the second half of 2005 (see table). More funds will flow in, as the 25 percent cumulative foreign ownership ceiling on individual Chinese banks will be lifted soon.

The Chinese banks are also listing overseas, mainly in Hong Kong, with the Bank of Communications and the China Construction Bank already listed in Hong Kong in May and October 2005, respectively. The market is expecting as much as US$20 billion worth of initial public offerings from Chinese banks in the coming year.

NOT SO SMOOTH

However, political, technical, and incentive problems remain in the way of reform. There is a big moral hazard problem with the asset management companies, which are supposed to clean up the banking woes by debt-equity

The aim of the Chinese bank sales has not been to get money for banking reform. In fact, the local banks are flooded with liquidity from both the depositors and the recapitalization funds.

swaps after restructuring the state-owned enterprises. The program has not worked as planned because there is an incentive incompatibility problem between the asset management companies and many officials and state-owned enterprise managers. Many state firm managers still see these as just another way to salvage the crumbling state-owned enterprises. The banks also have no incentive to recover nonperforming loans because they see the asset management companies as public bailout agencies created to absorb their losses. This situation has improved recently, but the pulse of market discipline is still weak.

There is also a worry that the Chinese banks may rely too much on technical solutions, such as credit scoring models, while they do not have enough qualified personnel to spot bad borrowers and price credit properly. Interest rate liberalization and stringent loan classifications have limited help for building a strong credit culture, which is fundamental to commercialization.

Turf fights makes the reform road bumpier. While reform incentive is strong at the head office level, it still has difficulty in filtering down to the branch level. The decentralized structure of the banks only makes matter worse. The head offices, which want to centralize control and push down changes, clash with the branches, which often cave in to local officials and industrialists' demand for preferential lending.

Major foreign investment deals in Chinese banks

Deal date	Foreign buyer	Target bank (% bought)	Amount (US$ mn)
March 2004	ING Group NV	Bank of Beijing (19.9%)	214.8
Late 2004	HSBC	Bank of Communications (19.9%)	2,250.0
April 2005	Commonwealth Bank of Australia	Hangzhou City Commercial Bank (19.9%)	77.6
June 2005	BankAmerica	China Construction Bank (9%)	2,500.0
July 2005	Temasek	China Construction Bank (3.6%)	2,500.0
August 2005	Royal Bank of Scotland consortium	Bank of China (10%)	3,100.0
August 2005	UBS	Bank of China (1.6%)	500.0
August 2005	Temasek	Bank of China (9.9%)	3,000.0
August 2005	Goldman Sachs, Allianz, AMEX group	Industrial and Commercial Bank of China (10%)	3,000.0
September 2005	Deutsche Bank & partner	Hauxia Bank (14%)	330.0

Sources: AWSJ, UBS

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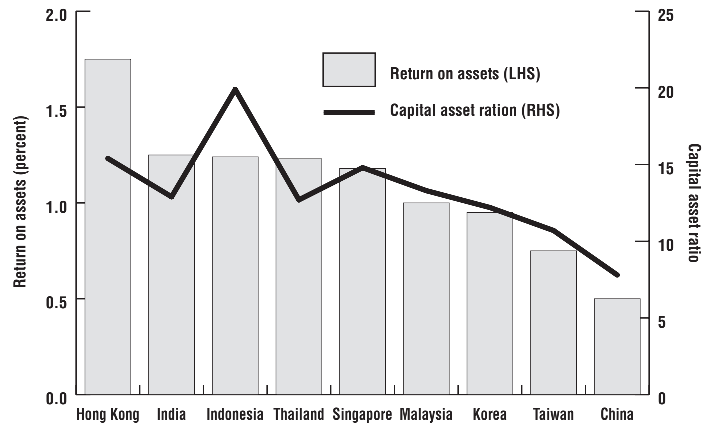
The People's Bank of China-CBRC power struggle has created regulatory inefficiency. It has also dampened the outlook for a truly independent financial regulator. Political intervention in the banking system will remain an issue. These problems are aggravated by serious corruption and reflected in the poor profitability of the Chinese banking industry.

3 Asian Banks' Return on Assets and Capital Ratios



Source: Fitch

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In 2004, Chinese banks managed to generate a return on assets of only 0.5 percent, the worst in Asia, with lowest capital-asset ratio (see Figure 3). Their returns looked better on an equity basis, with an average return on equity of 11 percent. But analysts argue that was because of the Chinese banks' low level of equity (and hence capital).

Arguably, Chinese banks should carry a capital-to-asset ratio above the BIS standard of 8 percent to cover their inherent risks. For example, Indonesian banks have an average capital-to-asset ratio of almost 20 percent to cushion their risks. If the Chinese banks were to do the same, banking analysts estimate that their return on equity would fall below 5 percent.

Meanwhile, the handicap of the asset management companies is seen in the difficulty of asset disposal. They have managed to sell off only about half of the bad debts seven years after inception. The average cash recovery rate is about 20 percent. But this rate is going to fall, as the better quality assets have been sold off.

FORCES TO PUSH AHEAD

Despite the problems, reform momentum is strong. The CBRC has started a clean-up effort on the rural credit co-ops and postal savings since 2003. These institutions account for over 25 percent of total banking assets and liabilities. Their size will grow as financial liberalization spreads to the rural areas. Hence, Beijing is starting to tackle the problems before it is too late.

Financial liberalization has changed the banking landscape drastically. It has boosted competition among local banks. Younger and leaner commercial banks

(accounting for over 20 percent of the banking sector) in the more affluent urban areas are competing fiercely with the Big Four. Free from historic burdens and more flexible in lending to small- to medium-sized firms, these new players are more adaptable to changes.

The development of new funding and saving vehicles are starting to compete for business with the state banks. As China's emerging capital markets mature, there will be large shifts of saving and borrowing from the banking sector to the capital markets. The stock and bond markets will play a bigger role in China's increasingly market-oriented economy for savers and companies to diversify financial risks.

Foreign investors will help push China's bank restructuring by providing the skills in risk management, financial product knowledge, and innovation. The aim of the Chinese bank sales has not been to get money for banking reform. In fact, the local banks are flooded with liquidity from both the depositors and the recapitalization funds. Rather, the purpose is to create a competitive momentum by bringing in foreign players in the Chinese system.

Chinese banks will not be able to handle volatile international capital flows before they are fully reformed. This means no fully opened capital account for a few more years. In other words, there will be no full RMB convertibility until the bank restructuring process is completed.

As the obstacles are eventually dismantled for the foreign banks to take local RMB deposits and make RMB loans, the foreign players will become an immense challenge to the Chinese banks. If Chinese savings shift to the foreign banks in large amounts, the local banks' deposit base, and hence lending ability, will be eroded. Thus, the local banks are racing against time to improve.

POLICY AND MARKET IMPLICATIONS

To take reform further, China must take bold steps to allow take-overs, mergers and acquisitions, and bank failures. Beijing must also make the asset management companies work effectively. Transferring state-owned enterprise bad debts to the asset management companies and recapitalizing the banks are the easy part of reform. The hard part is for the asset management companies to sell these bad assets to debt workout specialists to recoup the losses. This can only be done by thorough financial and institutional reforms to eliminate the incentive problems between the state-owned enterprises and the AMCs and create a liquid market for these special assets.

Eventually, the government must cede control of the banking system and allow full private ownership. In this sense, strategic foreign investors are brought in as a catalyst for this ownership transfer process. But ceding control does not mean the government has no role. It should develop an effective regulatory framework for supervising the system. Strong banks, sound regulations, and minimal government distortion are the necessary and sufficient conditions for China to fully liberalize its financial markets without worrying about the stability of the state banks.

It will take some years for Chinese banks to shed the communist legacy and establish a true commercial culture. To achieve this needs a mindset change from the old socialist mentality to a liberalized and professional attitude. This change will quicken when the older management retires (normally at age sixty)—another five to seven years from now.

In other words, China's banking reform will likely take a few more years than most have expected to be fully completed. This means that the business scope will remain limited in China's banking sector, despite the WTO requirements that China will have to open up banking to full foreign competition by the end of 2006.

Last but not least, Chinese banks will not be able to handle volatile international capital flows before they are fully reformed. This means no fully opened capital account for a few more years. In other words, there will be no full RMB convertibility until the bank restructuring process is completed. ◆