ECON4033 Money and Finance in China

Week 7: Reform of the Banking Sector[1]

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[1] These lecture notes are largely based on the materials prepared by Prof. Siu Kee Wong for the same topic.

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I. First Stage (1979-1993)

- The major objective is to establish a two-tier banking system to replace the mono-bank system: the first tier is the People's Bank of China (serving as the central bank) and the second tier consists of other banks (and non-bank financial institutions).
- The reestablishment of the four specialized banks (四大國有專業銀行的重建).

Table: Major reforms in the first stage

February 1979	Agricultural Bank of China (中國農業銀行) was re-established
March 1979	Bank of China (中國銀行) was detached from People's Bank of China
August 1979	People's Bank of Construction (中國人民建設銀行) was detached from Ministry of Finance (財政部). It was later renamed as Bank of Construction (中國建設銀行)
September 1983	Setting up Industrial and Commercial Bank (中國工商銀行) to perform the commercial functions of the People's Bank of China
September 1983	Assigning People's Bank of China (中國人民銀行) as the central Bank

- **Problems after the initial stage of reforms**

1. Insufficient competition

    - Specialized banks could run business only in specific areas. Although they could run overlapping business, competition was limited.

    - The market share of the four specialized banks is too big. Competitions from other financial institutions (e.g. foreign banks, and non-bank financial institutions) were insufficient.

2. Heavy policy burdens of the specialized banks

    - The specialized banks had to follow government policies to provide loans that might not be profitable. They are often asked to provide low-interest loans to support agriculture and construction of infrastructure and to firms that were not managed well.

    - These "policy-induced losses" could be mixed with "operational losses". The banks had no incentive to improve the management.

    - Large amount of non-performing loans: In the early 1990s, the ratio of non-performing loans was around 30% for the four big banks.

II. Second Stage (1994-1997)

A. The Major Objectives

1. Differentiate the roles of state banks. Policy banks are supposed to be engaged in lending activities with low profits. Specialized banks were commercialized.
2. Strengthen the role of the banking system in screening projects and reduce the intervention of lending activities from the local governments.
3. Improve the regulation of the banking sector and improve the risk management of the banks.
4. Enhance competition in the financial system and encourage the growth of other financial institutions.

B. Major events

1. The establishment of 3 policy banks in 1994:
    - National Development Bank (國家開發銀行)
    - Agricultural Development Bank (農業發展銀行)
    - Import and Export Bank (中國進出口銀行)
2. Commercialization of the specialized banks
    - The four state-owned specialized banks were renamed as state-owned commercial banks, with most of the "policy loans" transferred to the policy banks.
    - Despite the reform, the state-owned banks continued to be perplexed with non-performing loans.

C. New Governance Structure

- Nine regional branches were established to replace the provincial branches of PBOC; regional branches of PBOC are under the leadership of the headquarters (instead of under the "dual leadership" of the headquarters and the local government in the past).

- The internal control mechanism of the central bank was re-centralized. The credit granting power of its branches was abolished.

- The link between fiscal deficit and monetary expansion was severed, as the Ministry of Finance had to issue bonds to cover its revenue shortfall instead of borrowing from the PBOC.

D. Increasing Domestic Competition

- The government started to consolidate the city credit cooperatives (城市信用合作社) and established over 100 city commercial banks (城市商業銀行).
- Many credit cooperatives are poorly managed. Consequently, the government replaced credit cooperatives by city commercial banks with a clear objective of making profit.
- The Chinese government also allowed the private banks to grow (e.g. China Minsheng Banking Corporation Ltd. 中國民生銀行).

E. The Entry of Foreign Banks

- China has gradually allowed the entry of foreign banks into the market:
  - Allow the setting up of representative office of foreign banks in 1979.
  - Business offices of foreign banks were allowed in special economic zones in 1981. More cities were opened up subsequently. However, their scope of business was highly restricted.
  - China allowed foreign banks to operate some RMB business in Pudong (Shanghai) in 1996 and in Shenzhen in 1998. Since then, more and more foreign banks were allowed to do RMB business.
  - Subsequent to the accession to WTO, China has further opened up the banking sector.

F. Problems Remained: What should China do with the large state-owned banks?

- Privatization?
- Breaking each of the big banks into smaller ones (to avoid the problem of "too big to fail")?
- Reforming the governance structure? How?

III. Third Stage (1997 – present)

- The PBOC abolished the credit plan system in 1998 to promote commercial lending by SOCBs (state-owned commercial banks).
- The SOCBs gained more rights to choose independently the projects to which they extended loans.
- However, the PBOC still restricted the total amount of bank credits through the "window guidance". They also persuaded the banks to extend credit to certain sectors they preferred.
- In 2003, China established The China Banking Regulatory Commission (中国银行业监督管理委员会) to take up the responsibility of regulating the banking industry, while the PBOC concentrates on the formulation and implementation of China's monetary policy.
- Reform of the Financial Sector in 2020:

  In 2020, China's cancelled the foreign ownership restrictions for securities, fund, futures and life insurance companies and removed the investment quota restrictions for qualified foreign institutional investors.

A. Basel Accord (巴塞尔协议)

- The Basel Accord is a set of recommendations for banking regulations issued by the Basel Committee on Banking Supervision (BCBS).
- Basel I: Assets of banks were classified and grouped in five categories according to credit risk:
  1. 0% risk weights (for example cash, home country debt like Treasuries),
  2. 20% (securitizations such as mortgage-backed securities (MBS) with AAA rating)
  3. 50% (municipal revenue bonds, residential mortgages),
  4. 100% (most corporate debt),
  5. and some assets given No rating.
- Banks with an international presence are required to hold capital equal to 8% of their risk-weighted assets (RWA).
- The capital to risk-weighted assets ratio, or capital adequacy ratio, of a bank measures its financial stability.

B. Recapitalization

- To ensure that the big four banks fulfilled the capital adequacy ratio requirement under the Basel Accord, the government injected cash to re-capitalize the big four banks. The capital adequacy ratio has been raised to 8%.
- In 1997, the government issued a total of RMB 270 billion of special financial bonds and inject the funds into the big four banks. In 2003, a second injection was given to Bank of China and China Construction Bank using the foreign exchange reserves.
- To reduce the fragility of the banking system, the government set up four asset management companies (AMCs) in 2000 to take over a total of RMB 1400 billion of the non-performing loans (不良貸款).
- However, it was found two years later that the 4 big state banks still had RMB 2000 billion of non-performing loans: potential moral hazard issue.

- **Recapitalization (cont.)**
  - In 2003, the Central Huijin Investment Limited (中央匯金投資有限責任公司) was established by State Administration of Foreign Exchange (SAFE).
  - Huijin used foreign exchange reserves to inject funds to the SOCBs. Why?
    - It could create disputes in People's Congress if fiscal revenues are used for recapitalizing the banks.
    - It could improve the corporate governance of the banks because the mission of SAFE was to raise the value of its assets and would be more concerned with the profitability of the banks.
  - Controversy: Is it legal to use the foreign reserves in this way? Are the shares underpriced?

C. A New Loan Classification Scheme

- In its pursuit of fulfilment of the Basel Accord, the loan classification system was changed to one that are based on riskiness.

- In the past, the Chinese government classified the non-performing loans into three categories: (1) debts of which the debtor has died or the debtor enterprise has been liquidated (呆帳貸款); (2) debts that are overdue for three years or debts for projects have been suspended (呆滯貸款); (3) debts that are overdue for six months (逾期貸款).

- At the end of 1997, the share of these non-performing loans in total loans was 29.2% in the four big banks. The regulation required that the shares of them should be below 2%, 5% and 8% respectively.

- While the old loan classification system is based on ex post repayment difficulties, the new scheme classifies loans into 5 categories according to the levels of risks: five categories: (1)Pass (正常), (2) Special Mention (關注), (3) Substandard (次級), (4) Doubtful (可疑): (5) Loss (損失).

D. Improvement of Corporate Governance

- More and more rural commercial banks are established (following the reform of rural credit cooperatives).
- In recent years, some foreign banks have been allowed to acquire their shares. For instance, the Federal Bank of Australia acquired 11% of Jinan Commercial Bank in 2004.
- Introducing foreign investors could bring in (a) capital, (b) better corporate governance of the banks; (c) management skills and business strategies, and (d) reputations for raising more funds in IPO.
- Encourage the improvement of corporate governance in big banks by listing in the stock markets (E.g. Minsheng Bank and Communication Bank).

E. Opening Up of The Banking Sector

- China’s strategy in reforming the large state-owned banks: “capital injection (注資) ⟶ shedding off bad assets (剥離不良資產) ⟶ introducing (foreign) strategic investors ⟶ Initial public offerings (IPO 上市)”.

- The government wanted the SOCB to be listed in the Hong Kong stock market because the requirements for qualification and disclosure are much stronger there.

- The first two IPOs (for BOCOM 交通银行 and CCB 建设银行) were carried out in Hong Kong. By mid of 2010, all the four major banks have been listed in the stock market.

- All big four banks invited foreign accounting firms to review their accounting records. Disclosure of results are fast and clear.

Table 3: **The Pre-IPO and Post-IPO Ownership Structure of China's Leading Banks (%)**

		Immediately prior to H-share IPO	30 June 2009
Industrial and Commercial Bank of China Ltd.			
• Major Domestic Investor(s):	Ministry of Finance	(43.28)	(35.3)
	China SAFE Investment	(43.28)	(35.4)
	NSSF (1)	(5.00)	(4.2)
• Major Foreign Investor(s):	Goldman Sachs	(5.75)	(3.9)
	Allianz	(2.25)	(1.0)
	American Express	(0.45)	(0.2)
Bank of China Limited			
• Major Domestic Investor(s):	Central SAFE Investment	(79.90)	(67.49)
	NSSF (1)	(3.91)	(4.46)
• Major Foreign Investor(s):	RBS China (8)	(9.61)	———
	Temasek (5)	(4.81)	(4.13)
China Construction Bank			
• Major Domestic Investor(s):	China SAFE Investment (2)	(71.13)	(57.03)
	China Jianyin Investment (3)	(10.65)	———
• Major Foreign Investor(s):	Bank of America (6)	(9.00)	(10.95)
	Temasek (5)	(5.10)	(5.81)

Notes:

(1) NSSF refers to the China National Social Security Fund.

(2) From inspection of various prospectus documents, China SAFE Investment Limited is also referred to as Huijin and also China Central SAFE Investment Limited.

(3) China Jianyin Investment (中国建银投资证券有限责任公司) is wholly-owned by China SAFE Investment Limited [see Anderlini, J. (2006), 'Firm Hand Steers Vehicle of Financial Reform', South China Morning Post, 6 February 2006, p. 2.

(4) For BOCOM there was a further 'unlisted foreign share' investor, holding 0.06 per cent of the issued shares pre-IPO (see BOCOM Prospectus, p. 199).

(5) For CCB and BOC, Temasek's holdings were housed under AFH (see CCB Prospectus, p. 84 and BOC Prospectus, p. 102).

F. China’s WTO Commitments in The Banking Sector

- Upon accession, foreign currency business is allowed without geographic restriction. Within five years, geographical restrictions on local currency business of foreign banks will be phased out.

- Within two years of accession foreign banks will be permitted to provide local currency services to domestic enterprises. Within five years, they will be allowed to provide local currency services to all Chinese customers.

- Within five years, all non-prudential restrictions regarding the ownership, operation, and establishment of foreign banks will be eliminated.

- In 2007, foreign banks will be accorded national treatment 国民待遇 and be able to offer a full range of banking services, including RMB retail business.

- In 2003, the CBRC (China Banking Regulatory Commission, 中国银监会) raised the limit of equity shares held by a foreign investor in a Chinese financial institution to 20% from the previous 15%. Moreover, the combined limit of the shares held by foreign investors is 25%. Exceeding this limit, the bank would be considered as a foreign financial institution.

- The continued existence of various formal and informal barriers to foreign participation in the Chinese banking sector has disadvantaged foreign banks.
- The strict working capital and other requirements made it more difficult for foreign banks to establish their presence in China.
- The sale of equity stakes in existing SOCBs is limited to a single foreign investor to 20%, while the total equity share of all foreign investors is limited to 25%.
- Foreign-funded banks can apply to incorporate in China only if they have representative offices in China for two years and have total assets of $10 billion. After incorporation, they can offer full domestic currency services only if they have operated in China for three years and have had two consecutive years of profits.
- For foreign banks seeking to issue their own domestic currency credit and debit cards, the PBOC insists as a condition of its approval that the banks move the data processing for these credit and debit cards onshore.
- In 2011, China opened up a window for applications for underwriting licenses. However, the application procedures were non-transparent. Initially only one foreign bank was approved to underwrite. In 2017, China issued bond settlement licenses and underwriting licenses to two qualified U.S. financial institutions.

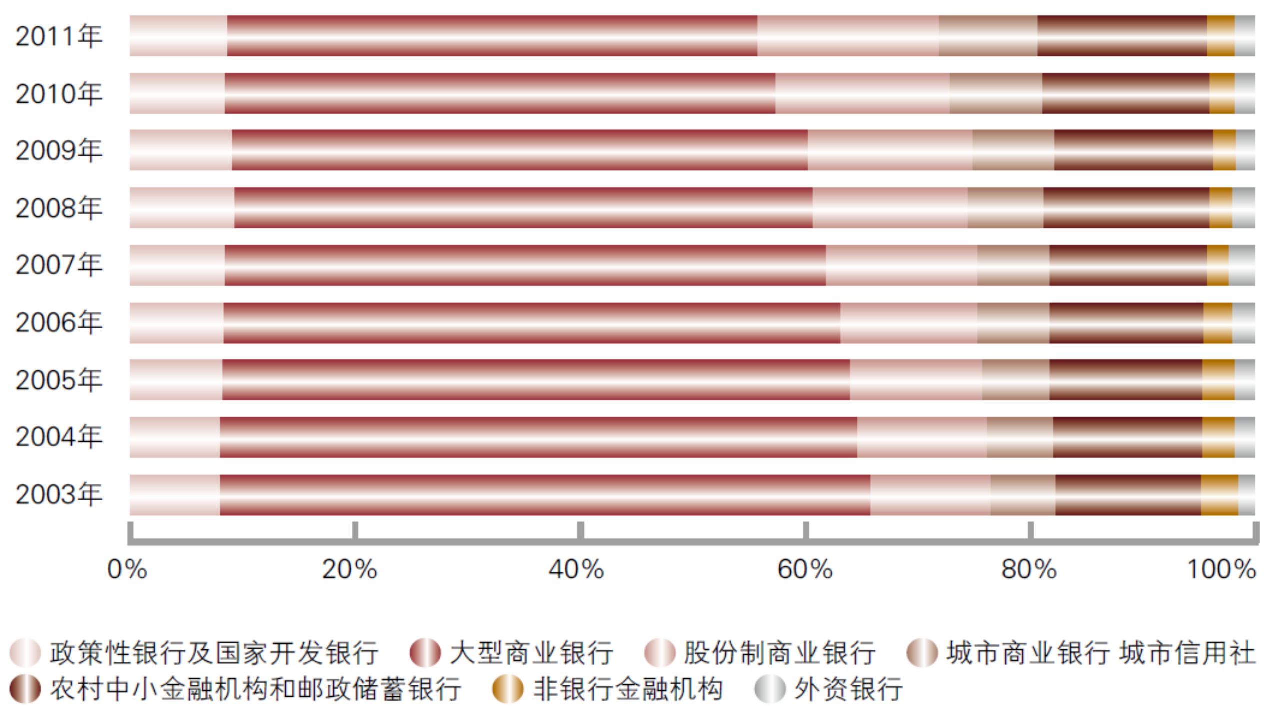
G. Impact of Foreign Banks' Entry

- In theory, the presence of foreign banks can intensify competition and thus forces domestic banks to become more efficient.
- It also improved the access to credit of small and medium-sized companies.
- The impact of the foreign banks' entry has been limited and their market share is rather small. Their business activities are largely restricted for "high-end customers", corporate banking and marketing financial derivatives.

IV. The Effects of The Reforms

1. China now has a more diversified market structure, with much more financial institutions and more competition. The dominance of the large state-owned banks has declined steadily, while the market share of other banks has increased significantly.

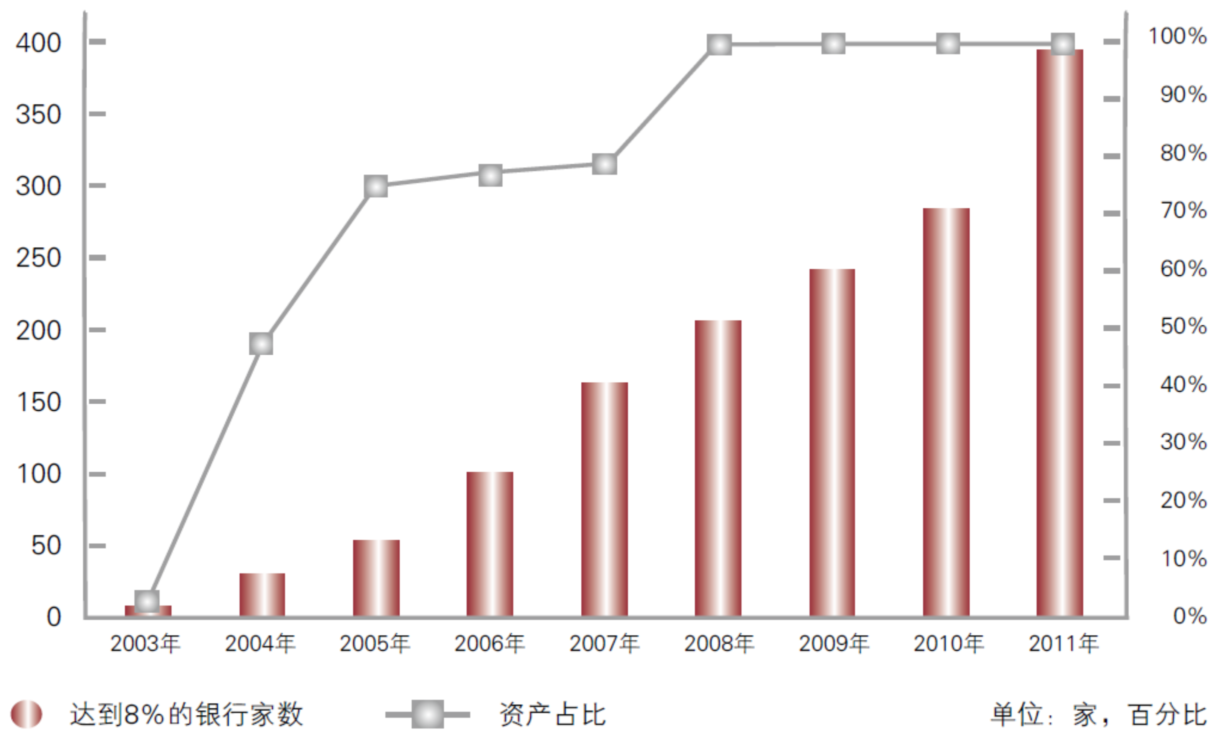
图2：银行业金融机构市场份额（按资产）（2003 – 2011年）



Source: Annual Report of China Banking Regulatory Commission (2011)
http://www.cbrc.gov.cn/chinese/home/docViewPage/110007.html

2. The capital adequacy ratio (CAR) has improved. As of the end of 2011, the weighted average CAR of China's banking industry stood at 12.71 percent, higher than the international minimum requirement (10% under Basel III). In the meantime, all the 390 commercial banks satisfied the minimum CAR requirement.

图4：资本充足率达到8%的银行数量和资产占比（2003－2011年）



Source: Annual Report of China Banking Regulatory Commission (2011)
http://www.cbrc.gov.cn/chinese/home/docViewPage/110007.html

- Indicators of the performance of different banks

	1994 – 1997	1998 – 2001	2002 – 2004
Return on Assets			
SOCB	0.1	0.1	0.3
Other Banks	1.5	0.9	0.3
Return on Equity			
SOCB	3.3	2.2	7.8
Other Banks	20.7	11.0	15.4

3. The asset quality of the banking sector has improved – the amount and the rate of non-performing loans have declined drastically since 2003. The commercial banks have continued their restructuring efforts and increased the asset impairment provisions (for writing off of NPLs).

Source: Annual Report of China Banking Regulatory Commission (2011)
http://www.cbrc.gov.cn/chinese/home/docViewPage/110007.html

表1：在华外资银行业金融机构情况（截至2011年底）

单位：家

	外国银行	独资银行	合资银行	独资财务公司	合计
法人机构总行		37	2	1	40
法人机构分行及附属机构		245	8		253
外国银行分行	94				94
总计	94	282	10	1	387

表2：在华外资银行业营业机构数与总资产情况（2004－2011年）

单位：家，亿元，百分比

项目/年份	2004年	2005年	2006年	2007年	2008年	2009年	2010年	2011年
营业性机构数[1]	188	207	224	274	311	338	360	387
总资产	5,823	7,155	9,279	12,525	13,448	13,492	17,423	21,535
占银行业金融机构总资产比	1.84	1.91	2.11	2.38	2.16	1.71	1.85	1.93

[1] 含法人机构总行、分行和附属机构，外国银行分行。

Source: Annual Report of China Banking Regulatory Commission (2011)
http://www.cbrc.gov.cn/chinese/home/docViewPage/110007.html

V. Future Challenges

- Will the state-owned banks be immune to policy burdens or government intervention?
- The Communist Party Committee in each SOCB has retained critical power over the bank's decision-making process. When conflict arises between commercial interests and the party's goals (such as social stability), very often the latter prevail. This does not change after the bank goes public as the state still holds a majority of shares.
- Is the current financial system satisfying the needs of the economy?
  - State-owned banks tend to extend loans to large state-owned enterprises. Is it necessary to improve the financial system so that small and medium-sized enterprises can also get good financial services?
  - As in 2006, less than 1% of all loans extended by SOCBs were going to private businesses, which account for about 50% of China's GDP.
- The interest rate was strictly controlled by the government.
- The ceiling of lending rates and the floor of deposit rates were abolished in 2004.
- The floor of the lending rates and the interest ceiling on saving deposit were removed in 2013 and 2015, respectively.
- Many believe that interest rate should be further liberalized to have genuine competition in the banking sector.

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