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Mr. Chairman, members of the Commission, good afternoon. My name is Michael Petit. I am Managing Director in charge of Standard & Poor's Corporate and Government Ratings in Asia-Pacific. I welcome this opportunity to appear before this commission to discuss China’s banking sector.

China has made meaningful progress in strengthening its banking system over the past five years, though it remains weak by global standards. The burden of problems loans in the bank sector has been materially reduced through government-owned asset management companies' purchases of non-performing loans (NPLs). The government has also demonstrated an unequivocal commitment to restructuring the financial sector by means of recapitalizing its large banks, improving the regulatory system, introducing better risk management systems and control, and encouraging in a measured way the participation of foreign financial institutions in the ownership and the management of some Chinese banks to bring in new technologies and share best practices.

The Chinese government has recently reconfirmed its commitment to the broad range of structural reforms now underway. For the banking industry, this should mean strengthening of the regulatory and prudential systems to make banks more commercially oriented and transparent, gradually opening the sector to increased foreign competition to help upgrade systems and skills, and also to developing capital markets that can serve as an alternative financing source to the now dominating banking system.

Notwithstanding the great strides realized to date, China’s banking system still significantly lags those of almost all other developed and major developing markets in terms of asset quality, corporate governance, risk management, internal controls, transparency, and financial strength. This is not to say the integrity of China's banking system is in question. It is true that the overly rapid loan growth occurring currently suggests vulnerability to an eventual economic slow-down and to the emergence of a new wave of problem loans. But the Chinese government has the wherewithal to prop-up its banking system through additional capital infusions or purchases of troubled loans if needed, and has done so before. Rather, the more fundamental burdens of a financial system still overwhelmingly dominated by a critically weak banking system are twofold: It places a massive contingent fiscal cost on the government; and it falls short in properly allocating capital towards profitable investments and thus contributing to China's balanced and sustainable economic development.

Role And Structure Of The Banking Industry In China's Financial Markets

Chinese banks, cooperatives, and other deposit-taking financial institutions account for the bulk of the financial system. As such, a review of the banking system serves as a satisfactory proxy for that of China's entire financial system, particularly in identifying critical weaknesses.

A lack of investable products accounts for the disproportionate share of bank deposits—at some 75%—of China's financial stock. The comparable figure for India would be around 45% and for the US 20%. The banking system is the prime source of domestic financing (outside of corporate retained earnings), with new bank loans of Chinese renminbi (RMB) 2.1 trillion (US$262 billion) in the first half of 2006 dwarfing the amount of financing raised through the burgeoning, but still small, short-term bill and corporate bond markets, which are expected to aggregate less than RMB 200 billion (US$25 billion) for the full year.

The amount of bank deposits is not only large in relation to the country's total financial stock, but also in absolute terms, and is growing fast. As of March 2006, bank deposits amounted to RMB 32 trillion (US$4 trillion), up 18% year-on-year, and represented 1.7 times China's 2005 GDP. The increase of liquidity in the banking system has been partly fueled by the increase in high-powered money engendered by international reserves that have not fully been sterilized. This banking liquidity, in turn, has financed a commensurately large and fast-growing loan market and, given still developing credit-lending skills, into the creation of potentially new non-performing loans.

The fragmented Chinese banking industry—notwithstanding being some 30,000 institutions rich—can be divided into two broad groups: Those that have been recapitalized and have relatively acceptable levels of loan loss provisions; and those that are close to insolvency or are already insolvent in economic terms. That first group includes the big four banks (Bank of China, Bank of Communications, China Construction Bank, and Industrial and Commercial Bank of China), which are now among the largest financial institutions in the world. In the past couple of years, some of these banks have raised tens of billions of dollars through IPOs, and global institutions, including Goldman Sachs and Bank of America, have invested substantial sums in their equity. The major commercial banks account for about 50% of all banking assets.

Beyond this group are three policy banks; joint-stock commercial banks, in which equity ownership is distributed among the central government, local governments, and other investors; and numerous other financial institutions, including over 100 city commercial banks and 30,000 rural cooperatives. To this could be added the postal savings system, with some 36,000 branches, which is reportedly establishing a Postal Savings Bank.

The industry is thus ripe for consolidation, and the central and local governments are likely to encourage consolidation of weaker or smaller financial institutions to increase their chances of survival. Foreign banks have taken equity stakes in both the mega-banks and in some of the joint stock commercial banks and city commercial banks, and would be expected to contribute to this consolidation process if allowed to.

Asset Quality: Extent Of Non-Performing Loans

The most visible weakness of China's banking system is the extent of its problem loans, which S&P estimates to represent around 20%-25% of total credit to the private sector and non-financial public enterprises (NFPEs) at year-end 2005, or an amount equivalent to RMB 4-5 trillion (US$500-650 billion). In contrast, the official amount of NPLs was RMB 1.8 trillion (US$225 billion), or 8.9% of loans outstanding at year-end.

The difference between the official figure for NPLs and S&P's estimate of problem assets stems from the inclusion of special mention loans (10%-13% of total loans), rescheduled or restructured loans, repossessed collateral, and other non-performing assets in rural and policy banks that are not included in the official number (1%-3%).

Special mention loans (SMLs) are included in our estimate of problem assets, as these are loans whose performance appears fragile and that are likely to fall into the non-performing category if the business environment were to deteriorate markedly. Given the currently exceptionally supportive business environment, which would be expected to prove highly forgiving even to marginal borrowers, the currently high level of SMLs is of particular concern. Existing loan portfolios have been built up over recent years characterized by persistently strong economic growth and low interest rates, suggesting that any material slowdown is likely to give rise to a new wave of NPLs.

S&P has conducted some stress tests to assess the banking sector's vulnerability to a possible deterioration of external conditions, using interest rates and foreign exchange rates as the exogenous variables. In a moderate case scenario whereby the renminbi were to appreciate by 10% and borrowing rates were to increase by 1% in real terms, S&P estimates that NPLs would increase by an estimated RMB 560 billion (US$ 70 billion). A slightly more stressed scenario, with the renminbi appreciating by 25% and borrowing rates increasing by 2%, would cause an estimated RMB 1.7 trillion (US$212 billion) of incremental NPLs.

Such stress tests are convenient, albeit hypothetical, exercises to reveal system vulnerabilities. In practice, the greatest risk to credit quality in China is a slowdown—or worse, a contraction—in global trade. With the U.S. still China's main trading partner, and given recent trends in U.S. economic performance and external accounts, these developments could come about as a result of a U.S. recession, or, most damaging, from protectionist measures.

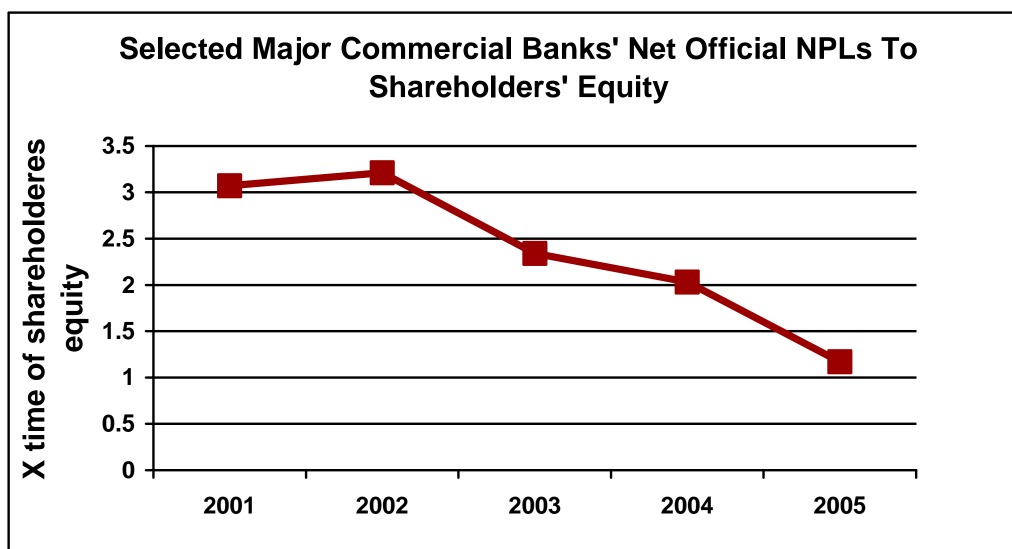
Other Financial Weaknesses: Profitability And Capitalization

Poor asset quality is only the most readily apparent of the weaknesses afflicting the financial profile of most Chinese banks. Weak profitability and capitalization are others.

The profitability of Chinese banks trails global standards, and earnings are essentially dependent on interest income from lending activities, as opposed to fees and commissions. And the vast majority of loans, some 90%, are extended to the corporate—as opposed to the retail—sector. At large U.S. banks, as a comparison, fee income represents about half of total profits, and the retail sector represents over half of total lending. The average ratio of net interest income to assets was a relatively low 2.4% in 2004, particularly in comparison with emerging markets where ratios in excess of 3% are common. The extremely high levels of liquidity in the system are such that ensuing competition for lending will work against any meaningful enhancement in loan pricing.

The profitability of the banking system is also inadequate in regard of the rapid growth in loans, as it does not permit banks to put sufficient provisions aside to cope with the inevitable fraction of loans that eventually go bad. S&P estimated that for a bank growing its loan portfolio by 20% per annum (close to the current pace of loan growth in China's banking system) and paying dividends of 20% on its profits, it would need to generate a return on assets before provisioning for bad loans of 2.6% to cover the credit costs associated with a loan portfolio of average credit quality. The average figure, however, was 1.3% in 2004, meaning that banks will need to eat into their already weak capital bases to cover future credit costs.

The above presumes that banks have enough of a capital cushion to provide against the eventuality of loans that need to be written off, but this is typically not the case. While the four mega-banks have benefited from capital injections, the disposal of NPLs, initial public offerings and strategic investments by foreign institutions, the overall level of capitalization in the banking system remains insufficient. For the 34 large banks tracked by S&P, despite the ratio of net non-performing assets (NPAs—a broader measure of NPLs that also includes special mention loans) steadily trending down, total NPAs continued to exceed shareholders' equity, underlining a still marginal aggregate solvency status.



Corporate Governance, Management, and Control

Meaningful improvement has been brought to the corporate governance standards and management skills of some Chinese banks, but most of the progress has taken place among the larger institutions that have been, or are about to be, listed. And these changes are being introduced at the senior management level of banks that have thousands of employees. The reform process is still in its early stages among other financial institutions.

Critically, the government remains the main shareholder in the banking sector, and the prospect of stricter management practices is dampened by the state's extensive role in the economy. Even though China's financial institutions are becoming banks in nature as well as in name, they may have to balance their own commercial decisions against the government's broader economic and social objectives. The overlap between government, bank, and borrowers, and the frequent rotation of party members through them, is inimical to the creation of arms-length relationships, and accordingly likely to inhibit the creation of effective corporate governance practices alongside a culture of commercial banking. A 2005 survey by the central bank concluded that more than 80% of NPLs could be attributed to such conflicts of interest and directed lending.

The mega-banks and some of the listed national banks have generally made good progress in establishing sound corporate structures, enhancing internal control functions, and installing financial discipline. Controls over the vast branch networks remain less than satisfactory, however. Senior managers of provincial branches no longer treat their branches as personal fiefs, but strong resistance to change from vested interests at different levels within individual banks tends to hinder reform.

Local governments typically maintain an ownership stake in the city commercial banks, mitigating the benefits of a gradually more diverse ownership base. High levels of lending to related parties, including local government shareholders themselves, are a cause of concern at some city commercial banks, where weak awareness of

corporate governance and control functions remains an issue. The central government is currently reforming the city commercial bank sub-sector by reducing conflicts of interests and beefing up on-site control. However, the quality of corporate governance, management and control functions at most of these smaller institutions is likely to continue to lag behind that of their bigger rivals.

A final factor that could reduce the speed of establishing higher standards of corporate governance is moral hazard. Although government bailouts of ailing mega banks are essential to preserving the integrity of the financial system, moral hazard may increase if the government's roles as owner, regulator, and lender of last resort are not clearly defined.

Impact On China's Economy: Contingent Fiscal Costs And Inefficiency of Financial Markets

The chief cost of the poor state of China's banking system is in the form of the contingent fiscal liability it places on the government, as aggressive credit expansion is likely to result in the emergence of more problem loans that the banking system will not be able to absorb without government help. A second critical cost—though not readily obvious when GDP is growing in excess of 10% per annum—is in its failure to allocate capital efficiently and contribute to the balanced development of China's economy.

The government has taken a supportive stance towards the banking system, spending an estimated RMB 3.6 trillion (US$450 billion) recapitalizing or closing ailing financial institutions since 1998, an amount equivalent to around 18% of 2005 GDP. The government has the wherewithal to engage in similarly large—and if needed considerably larger—operations to prop up its banking system. Steadily increasing fiscal revenues, which will exceed 20% of GDP this year from less than 12% a decade ago, and an exceptionally strong external position, provide significant flexibility. Indeed, in S&P's assessment of China's overall creditworthiness, which stands at a relatively strong 'A' rating, substantial contingent fiscal costs related to the need to restore the banking system to health—with direct debt and recapitalization costs potentially increasing government debt to 60%-70% of GDP—have been factored in.

So while the government's supportive stance means that the integrity of the banking system is not under threat, the on-going cost of China's weak banking system is in its misallocation of capital and poor contribution to economic growth. However paradoxical this may sound in an economy that has averaged over 8% growth per annum in the past decade, the reality is that Chinese banks, which account for the bulk of the financial system, have contributed little to the development of the *non-state* sector of the Chinese economy, which has been the main driver of GDP growth.

China's banking system has excelled at mobilizing savings, in large part because of the lack of attractive investment alternatives, but has allocated the majority of these to the state-owned enterprise (SOE) sector whose overall weight in China's economy has been steadily decreasing. While the function of a properly functioning financial market is to allocate savings towards the more profitable investment opportunities,

China's banking system has historically directed the vast majority of lending to the SOE sector, thus serving more as a means to cushion social stability than to support growth. This is not to say that the state sector has received unlimited access to bank credit. To the contrary, credit rationing was used as a tool to force the closure of the smaller and weaker SOEs, causing the share of SOEs in the employment of the urban industrial workforce to plunge from 57% in 1998 to less than 40% today, a drop representing over 30 million workers. Today, SOEs continue to be the recipient of most of bank financing, but only account for an estimated one-quarter of GDP. In contrast, private and foreign firms account for over half of GDP and the bulk of new job creation, but account for less than one-third of outstanding bank loans.

At a macroeconomic level, the misallocation of capital is also visible in the relatively high amount of investment it takes China to produce a unit of output. China posts a savings rate of close to 50% to generate GDP growth of 8%-10%, while India (to cite another country with a large population at a similar stage of development) requires half that savings rate to achieve an only modestly lower GDP growth rate. A study of the National Bureau of Statistics of 160,000 firms between 1998-2003 similarly revealed that private firms used half the capital per unit of output as state firms. The difference stems in part to the larger weight in China's economy of capital-intensive heavy industries, whereas India has a larger and more dynamic services industry. But these differing economic structures can themselves be traced in part to how and where the financial markets have allocated savings in the two countries. Today, rapid growth in corporate loans continues to fund commensurately strong investment growth, creating overcapacity problems in certain industries. The most noticeable capacity buildups are in the mobile phone, metals, steel, automobile, cement, and construction sectors. As a general pattern, bank financing typically backs investment in the tradable sector rather than in the service industry. In that way, the banking system can be faulted for skewing the economy into one that is less resilient to external shocks, such as a slowdown in global trade or a significant change in the value of the renminbi.

A number of other factors interact to distort the structure of the economy. Whereas the banking sector is large compared to the size of the economy for a country at China's stage of development, its capital markets are still small. As a result, entrepreneurs have to rely on internally generated capital or state-owned banks to finance their growth, and households have few investment products other than their homes that offer capital appreciation. Consequently, China has a higher savings rate than it would otherwise, as corporations self finance and households constitute savings out of cash. Households are also prompted to save more than they would otherwise, because real interest rates on deposits are low or even negative and because of the uncertainty generated by the government offering a limited social safety net.

Lastly, the need to contend with a weak banking system also acts to constrain China's monetary flexibility. The poor quality of bank loans, and the fear of the impact of potentially higher real interest rates on some marginal borrowers, deters the Chinese government from aggressively raising rates.

The separate but related issue of opening the capital account is also impractical until the banking sector is clearly put on a path to sustainable profitability.

Measures To Support The Banking System And Control NPLs

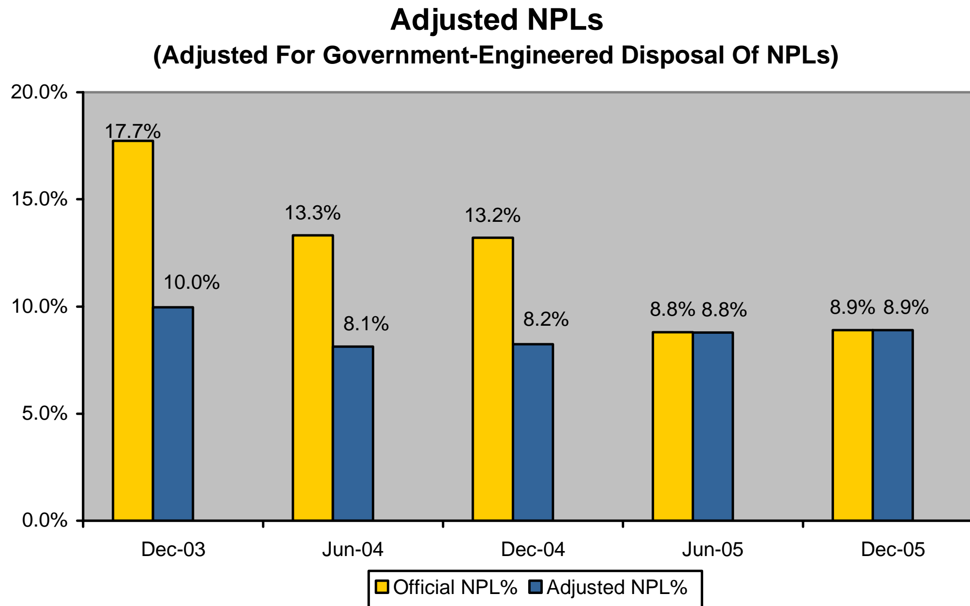
The government is using a combination of direct and indirect tools to tackle the NPL problem, ranging from the purchase of problem loans at face value to the strengthening of regulatory oversight and control. It is also, in a measured way, encouraging foreign banks to invest in local institutions as a means to import international expertise and instill industry best practices. On the monetary policy front, the government is seeking through a mix of conventional monetary tools and blunt administrative measures to prevent excessively rapid credit growth that eventually goes to finance unproductive assets, results in excess capacity and creates future problem loans. But limited monetary flexibility, itself due to the controlled pace of liberalizing trading of the renminbi, accounts for the government's only mediocre success to date in controlling credit growth.

NPL disposals: The marked improvement in cutting the amount of outstanding NPLs—from an official 17.7% of total loans in 2003 to 8.9% in 2005—was the result of the government-orchestrated disposal of bad loans. Between 2004 and 2005, government-owned asset management companies purchased RMB 1 trillion (US$125 billion) worth of NPLs at face value. This followed a similar round of problem loan disposals aggregating RMB 1.4 trillion (US$175 billion) between 1999 and 2000. Another form of direct government support is recapitalization. S&P estimates that the government spent about RMB 3.6 trillion (US$450 billion) recapitalizing or closing ailing financial institutions since 1998, an amount equivalent to around 18% of 2005 GDP. The government has the resources to engage in similarly large—and if needed considerably larger—operations to prop up its banking system, and is likely to do so. Steadily rising fiscal revenues—to exceed 20% of GDP this year—and an exceptionally strong external position, provide significant flexibility. Indeed, S&P's recent upgrade of China's sovereign rating to 'A' factors in substantial contingent liabilities related to the need to restore the banking system to health, with direct debt and bank recapitalization costs increasing government debt to 40% of GDP, and possibly reaching 60%-70% of GDP.

While large-scale asset disposal programs and recapitalization measures are critical to restoring a distressed bank to sound financial footing, they are not sufficient to bring a bank onto the path of sustainable recovery. Indeed, even in this recent environment of exceptionally strong economic growth, NPLs have been trending upward. Adjusted for the government-engineered bad loan disposals, the official NPL ratio would have risen from 8.1% in June 2004 to the current estimate of around 9%.

Regulatory policy and oversight: The government has also been taking measures to improve the regulatory framework and oversight, and has also acted to enhance professional skills and system capabilities in the industry. In 2003, it set up a new bank regulator, the China Bank Regulatory Commission (CBRC), with the mission of protecting the interests of depositors and consumers, maintaining market confidence, increasing public understanding of finance, and reducing financial crime. The CBRC has actively promoted risk control concepts, most importantly through the introduction of a five-category loan classification system (normal, special mention,

substandard, doubtful, and loss loans) based on the risk inherent in the loan, and capital adequacy requirements.



To date, state-owned commercial banks, joint-stock commercial banks, and city commercial banks have implemented the five-category system, but only a small number have disclosed NPL ratios based on it. And while banks had been required to make adequate provisions based on their estimated recovery of NPLs by 2005, few managed to meet that target without central or local government support. Another problem is that banks lack monetary incentives to address NPLs. Provisions are not tax-deductible or must get authorization of the tax authorities; interest rates are relatively low, so it is often more economical to roll-over problem loans than to call them, particularly so since the absence of robust foreclosure laws make it difficult to repossess security interest.

People's Bank of China (PBOC) continues to wield a significant influence on China's banking sector, even after having transferred much of its supervisory power role to the CBRC in 2003. In addition to its high profile mandate to set benchmark rates, it administers China's inter-bank lending market, and is responsible for maintaining stability of the financial system, particularly by means of formulating credit policies that are meant to influence commercial banks' lending decisions to particular sectors. PBOC is also strengthening its infrastructure on several fronts. It is conducting a bank loan assessment pilot to promote more stringent credit risk analysis system-wide, as well as to monitor aggregate credit quality trends. It is also developing a centralized credit data sharing system with credit information on both corporations and individuals. And the central bank is investigating the feasibility of introducing a formal deposit insurance system.

And while keeping a tight control (20% ownership cap) on foreign banks' ability to invest in local firms, regulators have actively looked to foreign financial institutions as a means to instill more professional corporate values, enhance credit underwriting and risk management practices, and import advanced technology and other operational systems expertise into the domestic banking industry.

Regulatory oversight is also being strengthened. In 2005, CBRC unearthed irregularities involving some 1,200 institutions and aggregating RMB 767 billion (US$95 billion), up 31% from 2004. The sharp jump over 2004 is not necessarily reflective of increased fraudulent activity, but more likely of enhanced enforcement efforts. Regulators are thus showing a clear commitment to reform, steadily pushing policy and supervisory approaches toward international norms.

Monetary policy: In recognition that excessive liquidity in the system leads to aggressive credit growth, and helps fuel a correspondingly high level of investments that create pockets of excess capacity and potentially a new round of NPLs, the government has also repeatedly looked to cool off excessively rapid credit growth. Such was the situation in the first half of the year, when new loans extended amounted to over RMB 2.1 trillion (US$262 billion), or about 85% of the full-year target. The central bank recognized the risk of over-heating early and twice lifted the reserve requirement by 0.5% to the current level of 8.5%, raised the benchmark interest rate by 0.27% in late April, and has hinted that it may raise rates again in the near future. But while the central bank over the past decade has shown improved skills in managing economic cycles, its independence to conduct monetary policy is constrained given its decision to allow the renminbi to float only within a narrow band against the U.S. dollar and given its concerns over the impact of higher interest rates on marginal borrowers.

As a result, the government has had to resort to more blunt administrative measures, such as direct caps on new lending in certain sectors where excess capacity is apparent, such as steel or real estate, or the outright cancellation of large-scale projects. Departing from market mechanisms, however, is in the best of cases a sub-optimal way to address misallocation of resources. And in practice, the (central) government has found it difficult to impose its will despite ongoing reinforcement of its regulatory oversight activities, as it has bumped up against vested interests—typically of the local governments backing the underlying investments or associated with the borrowing SOE.

Recognizing the propensity of the banking industry to create bad loans, the government is looking to alternatives to the banking market for sources of financing. The corporate bond market has been slow to develop, with a mere RMB 65 billion (US$8.1 billion) worth of bond issues in 2005 and a 2006 full-year target of RMB 61 billion (US$7.6 billion) for 43 companies. A lack of regulatory clarity and unattractive economics, stemming from the low interest rates available in a bank loan market flush with liquidity, together with a lack of transparency in corporate accounting and of an insolvency regime that allows creditors to enforce their rights, are chiefly to blame for this underdevelopment. Moreover, issuers of corporate bonds to date have typically been restricted to SOEs looking for long-term funds to finance specific projects and all have required bank guarantees, thus making the corporate

bond market little more than an extension of the bank loan market. On its side, the PBOC has taken an active role in seeking to create an alternative to bank loan financing and to a slow-moving corporate bond market by sponsoring a short-term bill market. This effort has been quite successful, but at RMB 284 billion (US$35 billion) raised by mid-year 2006 since its May 2005 inception, it remains a fraction of the bank loan market (with some RMB 2.1 trillion or US$262 billion-equivalent of new loans in the first half of 2006) and is by definition only a source of short-term financing.

Foreign Banks' Beneficial, But Restricted Role

Foreign banks operate in China both directly, through their own branch networks, and indirectly as strategic investors in some of China's commercial banks. Regulators have actively encouraged foreign ownership, within strict bounds, as a means to instill stronger corporate governance, introduce better credit risk assessment and risk management skills, as well as to bring in new capital.

As of the end of 2005, 71 foreign banks from 20 countries were operating in China through a total of 238 branches. Singaporean institutions have the largest presence, ahead of U.S., British, French, and Japanese institutions. Branch operations are typically focused on treasury transactions and trade finance to better serve their international customers that have Chinese operations or are involved in trade with China. At present, foreign banks only command about 2% of total industry assets, and this minor presence is not likely to change significantly in the near future, given their limited branch networks. Foreign banks have a more significant presence in the market for foreign currency-denominated loans, where they account for about 20% of the industry.

WTO Commitments and Implications: China is by and large living by the terms of its December 2001 accession to the WTO, which calls for providing a uniform regulatory environment to all banks by the end of a 5-year transition period. By December 2006, branches of foreign banks should thus be allowed to engage in local currency (deposit-taking and lending) operations on a nationwide basis. This is very unlikely to have any impact on the competitive landscape, however, as foreign banks are already permitted—in line with WTO accession commitments—to engage in local currency operations in 25 of China's larger cities. Some less visible but potentially critical restrictions could remain, however, such as the need for regulatory permits for branch openings or the introduction of new products. For example, approvals to deploy ATM machines—a key tactic to attract a wealthy clientele and expand into the high-growth and profitable retail-banking sector—have been notoriously slow.

At the same time, China's commitment to deliver a uniform regulatory environment post December 2006 in some ways may handicap foreign banks' competitiveness. For example, deposit rate ceilings, which are unlikely to be liberalized in the near future, act to prevent foreign banks from competing—albeit on a limited scale due to small branch networks—in the retail sector with higher-earning deposits, not to mention the deleterious effect an artificially low cost of bank funding has on the development of alternatives forms of financing, such as the corporate bond market. Regulators are reportedly discussing whether to require foreign banks to incorporate their domestic

operations under one local entity, in contrast to the current business model of operating through branches owned by overseas headquarters. Such a change would not only be costly, calling for a minimum capital investment into the new local entity and requiring on-going added administrative expenses, but could also result in a less creditworthy entity—thus removing one of the key perceived competitive advantages of foreign institutions operating in China.

In any case, organic growth is a strategic option that can only take a foreign bank so far into establishing a meaningful presence in China's banking market, mainly due to the high degree of penetration and entrenchment of local players. In response, many foreign banks have also taken minority stakes in domestic banks. Existing regulations restrict foreign ownership of local banks to 20% for a single investor, and cumulative foreign ownership is effectively capped at 25%. Government and regulators do recognize that international strategic investors have been instrumental in bringing clarity around the conflicting roles of the government as both owner and regulator, and are looking to international investors to have an inculcating role in introducing best practices. But they appear to be weighing these benefits against the policy objective of protecting national interests, and have not given any indication that these ownership caps are to be reviewed. There is thus considerable uncertainty as to whether foreign banks will be able to convert their stakes into controlling participations, even in the long term.

Given these limitations, foreign banks' role in upgrading corporate management capabilities and governance practices is restricted. Foreign bank investors should help further discourage politically motivated directed lending, but will probably have a lesser role in strengthening lending skills, not so much because of their limited ownership positions, but because an excess of funds in the banking system would generally make it difficult to be competitive while abiding by disciplined risk-pricing lending practices.

Conclusion

China is keenly aware of the flaws in its existing banking system. The government realizes the importance of developing a more diversified and efficient financial market to better allocate resources if it is going to be successful in realizing its objective of creating a better balanced and resilient economy that is more reliant on domestic spending than investments.

It also has the financial strength to tackle the problems. Strong external liquidity, with foreign exchange reserves expected to top US$1 trillion by year-end, plus controls on capital flows that prevent bank deposits from flowing out of the country, and a high domestic savings rate all combine to give China ample resources necessary to address the problems.

The government has also demonstrated its will to reform. The progress that has been made in placing China's financial system on a commercial footing is material and irreversible: the capital of the large banks is being opened, NPLs have been cut, recapitalizations have been carried out, many SOEs have been reformed or closed, and there is less directed lending in the system.

From an outsider's perspective, the pace of these reforms may seem sluggish and their outcomes uneven. Commercial banks are still likely to remain subject to directions from local—if no longer central—governments. And asset quality trends will remain affected by a monetary policy that fuels rapid credit growth, even as banks reorganize internal procedures and adopt enhanced risk-management techniques, partly under the beneficiary influence of foreign banks and investors. But, given both the dominance and weakness of the banking system, the risks China faces in setting down a liberalizing path are in making a misstep. Its reform program needs to be carefully coordinated and implemented in a sequenced approach to avoid any unwanted disruption to its economic system.