United States-China Economic and Security Review Commission

Hearing on 8.11.05: ***The General Health of China's Banking System***

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Reforms and risks in the banking system:

1. Intermediation through banks remains the dominant form of domestic financial intermediation in China, by far. The local stock exchanges are experiencing serious problems; they accounted for only about 1.3% of domestically intermediated new corporate finance in 2004, even less than in earlier years. Domestic debt markets are dominated by bonds issued by the Ministry of Finance and the China Development Bank. Most bond trading is in the form of repo transactions for liquidity management. The corporate bond market remains very small and under-developed. The interbank market has become very large and important in recent years, especially in light of open market operations by China's Central Bank (PBoC) to sterilize M2 resulting from excess foreign exchange accumulation.

2. Serious banking reform in China did not start until after the Asian financial crisis of 1997/8. Reform intensified significantly in recent years, no doubt inspired, at least partly, by China's commitment to open the sector completely to foreign investment and competition by the end of 2006 under its WTO accession terms. WTO-related pressures are forcefully pushing banking reforms in the right direction. Clarity of ownership and management responsibilities has much improved in recent. This is enhancing corporate governance standards. Regulatory agencies are becoming more effective.

3. Though still weak, the major state-owned commercial banks (SOCBs) and the banking system as a whole are in better shape now than only a few years ago; prospects for further improvement appear good. *Indirect* management of the financial system through monetary policy and regulatory agencies is gradually replacing traditional direct controls. Paradoxically, top managers of China's central bank, the regulatory agencies, and big state banks – all senior Party members and highly trained technocrats – are actively trying to reduce the Party's *political* influence on banking operations and on financial policy making.

4. China's state banks have been gradually shedding their de-facto status as fiscal agents of the state for many years and are slowly becoming real banks, responsible for their own bottom line. It is my impression that subsidized interest rates for favored customers have become rare and that commercial risk management by the four large state-owned commercial banks (controlling about 53% of total bank assets and over 60% of deposits) is rapidly improving. The extent to which de-facto subsidies continue to flow to favored enterprises through the state-controlled financial system (e.g. in the form of NPL accumulation with

local banks) is hard to gauge. Although many improvements have been and are being made, the banking system as whole remains largely state-controlled and needs to undergo significant further reform.

5. Reform progress is uneven across the spectrum of banks and continues to be marred from time to time by policy contradictions and corruption scandals. In spite of the scandals, there are many indications that risk management and corporate governance standards for state banks in general are improving. Many smaller local banks – usually owned by local governments – tend to lag in this regard. The trend toward improving governance standards in the big nationally owned state banks (and undoubtedly also in some of the better managed local banks), is reinforced by strategic foreign minority participation and international IPOs (Table 1). In fact, one of the main motivations of China's state banks in seeking strategic foreign minority partners is to strengthen governance standards. "Corporate governance" has become a buzz word in China. The State-owned Assets Supervision and Administration Commission (SASAC) recently announced that it is recruiting 25 private sector managers for top executive positions in SOEs under its supervision.

6. The massive lending binge that lasted from about the last quarter of 2002 through the first half of 2004, may lead to a new wave of NPLs in coming years, especially if the current gradual economic slowdown accelerates, or in the event of a downturn in housing prices in major cities such as Shanghai where housing bubbles have developed in some segments of the market. On the other hand, if China should succeed in maintaining high growth (8-9%) in spite of a necessary slow down in investment growth[1], NPL portfolios may only level off or even continue to shrink. Since excess capacity was created in many industries during the recent lending binge, it is to be expected that China will seek external markets for surplus output. This may conflict with the need to allow the exchange rate of the RMB to further appreciate.

7. Well over 60% of reported *incremental lending* between Q4 02 and Q2 04 was accounted for by China's smaller banks, most of which are owned by local governments. These include several joint stock banks, city commercial banks, rural commercial banks and others. Loan risk management and corporate governance standards of many small banks is believed to have lagged considerably behind the large nationally owned state banks. Lending by state-owned non-bank financial institutions, a big problem in the early and mid-1990s, has been largely brought under control. In the meantime, however, informal lending in curb markets and through private credit coops is reported to have become important. The government recently initiated measures to try and integrate informal financial markets into the official system.

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[1] China's gross investment/GDP ratio has reached an all time high of about 46% in the first half of 2005. Economic policy makers agree that this unusually high ratio is not sustainable, but there seems to be no consensus on how much and how quickly investment growth should be reduced.

8. The share in total banking system assets of the big four SOCBs fell from 62.2% in 2000 to about 53% in 2004. Most *incremental deposits*, on the other hand continued to flow into the big four SOCBs, which means that some of the smaller banks had to borrow on the interbank market to fund their rapid loan expansion. Hence, there is a strong possibility that potentially dangerous maturity mismatches have developed on the accounts of some smaller banks. In the event of a sharp down turn in the economy and/or a housing price collapse in big cities, this could become a source of instability in the banking system. China's central bank (PBoC) created a Financial Stability Department which is empowered to intervene to protect system stability in the event of local bank runs. A national banking crisis, though technically possible, seems very unlikely under present circumstances.

Selected indicators of change and progress:

1. Much has been done to clarify the ownership of state banks and the responsibilities of their managements and boards. This is making it easier to improve corporate governance standards at the level of individual banks.

2. Two of the four large SOCBs, China Construction Bank (CCB) and Bank of China (BOC) received a major capital injection from forex reserves, ($22.5 bn each) at the end of 2003 and were transformed into limited liability shareholding companies in 2004. CCB announced recently that Bank of America and Temasek of Singapore will purchase strategic minority shareholdings of 9.1% and 5.1% respectively. BofA has an option to increase its share to 19.9%. Many other foreign minority participations in Chinese banks have been negotiated in recent years or are under negotiation. (Annex Table 1)

3. The maximum share of a single foreign shareholder in a Chinese state bank under current Chinese regulations is 20%; the maximum share for all foreign shareholders together is at present 25%. The latter ceiling will have to be lifted when the major state banks go forward with their planned international IPOs.

4. BOC is reported to be negotiating with Royal Bank of Scotland, Morgan Chase, UBS, Temasek and Deutsche Bank for strategic minority participation(s). Both CCB and BOC are preparing international IPOs. CCB is likely to go first, perhaps as early as the fall of 2005. The IPO for CCB may be $ 5 bn or more. For BOC's IPO the amount most recently mentioned is $3-5 bn. CCB is reported to be considering London and Singapore for listing (perhaps to avoid the extra costs for a New York listing associated with Sarbanes Oxley), while BOC is believed to prefer New York. Both will probably also list in Hong Kong and on the domestic stock exchanges. Conditions for listing in the U.S. by Chinese state companies appear unfavorable at the present time.

5. The accounts of BOC and CCB have been audited by international auditing firms since 2003 and 2004 respectively.

6. Industrial and Commercial Bank of China (ICBC), the largest of the four SOCBs was transformed into a limited liability shareholding company during H1 05 after receiving a capital injection of $15 bn in April – also from forex reserves – and disposing of an additional $85.2 bn of NPLs (through AMCs and otherwise). As a result, ICBC lowered its NPL ratio from 19% at the end of 2004 to 4.58%, and increased its CAR to 8.07% by the middle of 2005. ICBC also engaged international auditors and is negotiating strategic minority partnership(s) with several international banks (Table 1 and Chart 4) in preparation for an international IPO at a later date.

7. Agricultural Bank of China (ABC), by far the weakest of the big four SOCBs, remains in very poor financial condition (Chart 4). There appears to be no plan at present for conversion to a limited liability shareholding company, but a number of internal reforms are underway.

8. Many *urban* credit coops (UCCs) have been consolidated and converted into city commercial banks, while many *rural* credit coops (RCCs), traditionally the weakest part of China's financial system, are being consolidated and converted into rural commercial banks, after recapitalization. The financial performance of rural commercial banks so far has been significantly better than that of the RCCs they replaced.

9. The Ministry of Finance stopped using SOCBs as cash cows for fiscal revenue purposes some years ago. Restrictions on provisioning were removed and the onerous Business Tax on state banks is gradually being reduced. Control over the major state banks has shifted from MOF to PBoC (since early 2004 through its newly created holding company for incorporated state banks: Central Huijing Investment Company) and the China Banking Regulatory Commission (CBRC).

10. CBRC, created in 2003 to take over regulatory and bank supervision functions from PBoC, recently introduced minimum provisioning standards for banks, linked to the international loan risk classification system which was adopted by China in 2001. These standards are expected to become effective later this year.

11. The share of non-SOEs in incremental lending in recent years has been over 50%. An important loan-risk-classification bias that used to encourage state banks to lend primarily to SOEs was removed in 2004. Consumer loans to households (mortgages, car loans), together with loans to agricultural households for working capital, have been the most rapidly growing loan categories in recent years. Loans to households accounted for 16% of the aggregate banking sector portfolio at the end of 2004; the number was almost zero in 1997. (Chart 1) As a proportion of total lending, consumer loans are still relatively modest in China. (Chart 2)

12. The shift in lending to non-SOE borrowers was reinforced by the enormous boost to the construction industry (public and private) and to consumer loans for

mortgages and home improvement that resulted from the privatization of almost all urban housing in China between 1997 and 2003. This was probably one of the largest privatization programs in history and also a huge wealth redistribution program, because transfer prices were generally far below market value. The recent introduction of asset-backed securities on China's domestic capital market is an outflow of the rapid development of mortgage lending in recent years.

13. Special windows for lending to private small and medium sized enterprises (SMEs) are under preparation in several state banks. Much training to equip loan officers with skills for new risk assessment and coaching tasks is being provided. To increase SME access to equity capital, a special board for SMEs was opened at the Shenzhen stock exchange recently.

14. Reported NPL *ratios* have fallen sharply since 2001. Among China's state banks, China Development Bank, one of three "policy banks" created in 1994, has the lowest NPL ratio – 1.21% at the end of 2004. CCB and BOC reported to have NPL ratios of 3.7% and 5.1% respectively at that time. (Charts 3 and 4)

15. The four state-owned Asset Management Companies (AMCs) created in 1998 to take over part of the NPL portfolio of SOCBs and recycle these assets through auctions, direct sales, debt/equity conversions and debt restructurings, are reported to have disposed of 57.3% of their assets by the end of June 2005. Their average asset recovery rate since the beginning of their operations was 25.6% and their average cash recovery rate 20.7%. The progress of AMCs has been much slower than was originally projected. Their costs are not reflected in the recovery rates cited. MOF is responsible for their ultimate losses.

16. The remaining amount of reported NPLs on the books of state-owned banks and AMCs is still very large, probably of the order of $350-400 bn (22-25% of GDP). There is no reliable estimate for the amount of unreported NPLs in the system; it could be another $100-150 bn. The amount of reported NPLs will probably increase in the event of an accelerated economic slow down or a housing price collapse in major cities. Ultimate losses associated with absorbing the remaining stock of currently reported NPLs would be of the order of $260-300 bn, which is well within the capacity of the Chinese state to finance, even without additional foreign equity participation in state banks.

17. The capital asset ratios (CAR) of CCB and BOC at the end of 2004 were reported to be 9.4% and 10% respectively, above the minimum international (Basel) standard of 8%. After its reform during H1 05, ICBC also reached a CAR of 8%. (Table 2)

18. The liberalization of domestic interest rates is progressing slowly; it may take many more years before all rates are essentially market-determined. Late 2004, the ceiling on lending rates (except for RCCs, UCCs and mortgage loans) was removed for the first time since the start of China's market reforms in 1978. Since

state banks are highly liquid and compete for market share, average lending rates have increased more slowly in response to this measure than might otherwise have been expected. Deposit rates remain controlled.

19. China has been a member of the Bank for International Settlements (BIS) in Basel since 1996 and is currently working to adopt and implement the "Revised Framework for International Convergence of Capital Measurement and Capital Standards", known as Basel II (2004). China is adopting international standard in many areas, because it believes that this in the nation's best interest.

20. To improve operational efficiency, BOC is aggressively downsizing its staff (over 200,000 at the beginning if this year) and reforming its internal management and information systems. All managers were required to resign their old position and were given the opportunity to apply for new positions in a flatter, streamlined organization. Those who do not find a new position after 3 applications are out. CCB (over 300,000 staff) is following a different plan for its internal reorganization.

21. To reduce costs, all four SOCBs have closed numerous redundant branch offices since the late 1990s. At the end of 2003, together they had about 80,000 domestic branches, about half the peak number of 1995. Earlier, in 1997, PBoC had reduced the number of its branches from 33 (one for each province or autonomous region) to 9 regional offices, essentially on the model of the US Federal Reserve system.

22. To better compete with foreign banks and broaden their earnings base, many domestic banks in China are actively developing financial services for their corporate and household customers, including debit cards, credit cards, investment advice, fund management, etc.

23. The American Bankers Association is about to sign a contract with CBRC for a national training and professional certification program for commercial bank managers and staff in China.

24. Cooperation between East and Southeast Asian central banks in the form of automatic forex swap arrangements and periodic consultations under the "Chiang Mai Initiative" of 2000 (originally a Chinese proposal), is intensifying. The objective is to promote regional economic integration and development of common capital markets.

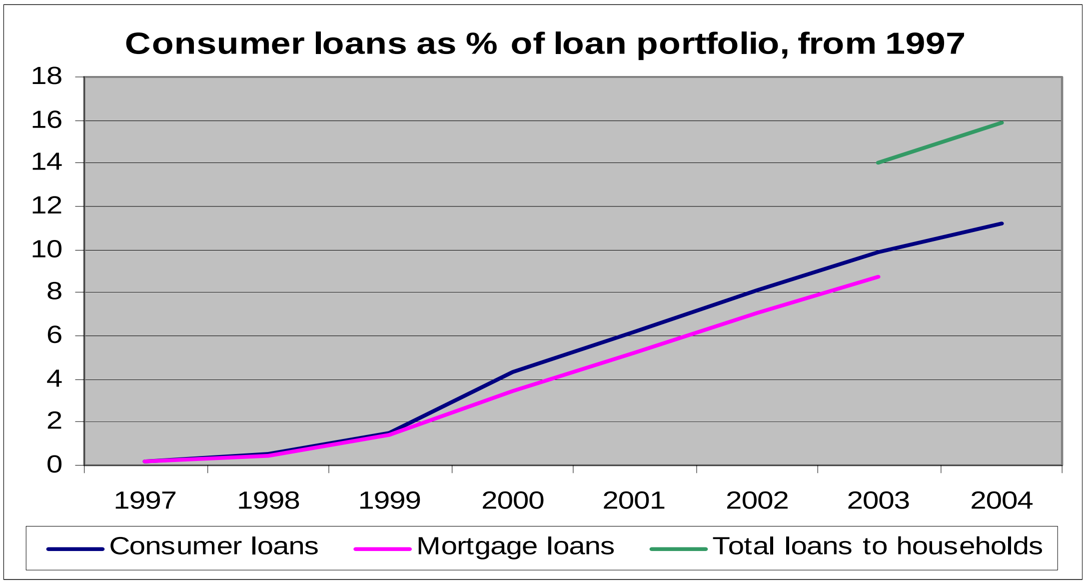
Table 1. Foreign Equity Participation in Chinese Banks **Annex**

Target bank	Acquiring bank	Stake	Investm. in $mn	Year
China Everbright Bank	ADB	3.03%	?	1996
Bank of Shanghai	IFC	7.0%	50.3	1999
Bank of Shanghai	HSBC	8.0%	63	2001
Nanjing City Commercial Bank	IFC	15.0%	27	2002
Shanghai Pudong Dev. Bank	Citigroup	5.0%	73	2003
Industrial Bank	Hang Seng Bank	16.0%	208	2003
Minsheng Bank	IFC	1.2%	23.5	2003
Minsheng Bank	Hang Seng Bank	8.0%	?	2003
Minsheng Bank	Temasek	?	?	2003
X'ian City Commercial Bank	IFC	12.5%	19.9	2003
X'ian City Commercial Bank	Bank of Nova Scotia	2.5%	3	2004
Bank of Communications	HSBC	19.9%	2,225	2004/5
Shenzhen Development Bank	Newbridge Capital	17.9%	149	2004
Jinan City Commercial Bank	Commonwealth Bank of Australia	11.0%	17	2005
Bohai Bank	Standard Chartered	19.9%	120	2005
Hangzhou City Commercial Bank	Commonwealth Bank of Australia	19.9%	76	2005
Bank of Beijing	ING	19.9%	215	2005
Nanchong Commercial Bank	German Investment and Development Bank	13.0%	4.8	2005*
CCB	Bank of America	9.1%	3,000	2005*
CCB	Temasek (S'pore)	5.1%	1,400	2005
BOC	UBS	?	500 ?	#
BOC	Royal Bank of Scotland	10%	2,500	2005*
BOC	Morgan Chase	?	?	#
BOC	Deutsche Bank	?	?	#
BOC	Temasek	?	1,000 ?	#
BOC	ADB	?	?	#
ICBC	Goldman Sachs & Allianz	?	1,000 ?	#

Sources: press announcements; Federal Reserve Bank of San Francisco

* Pending.
# Reported to be under negotiation; no official announcements have been made.

Chart 1. Consumer lending rose from almost zero 8 years ago to 16% of aggregate bank loan portfolio by the end of 2004



Note: the difference between the green line and the blue line is working capital loans to farm households.

Chart 2. Consumer lending in China (as % of GDP) is still modest compared to Asian economies with more advanced financial systems

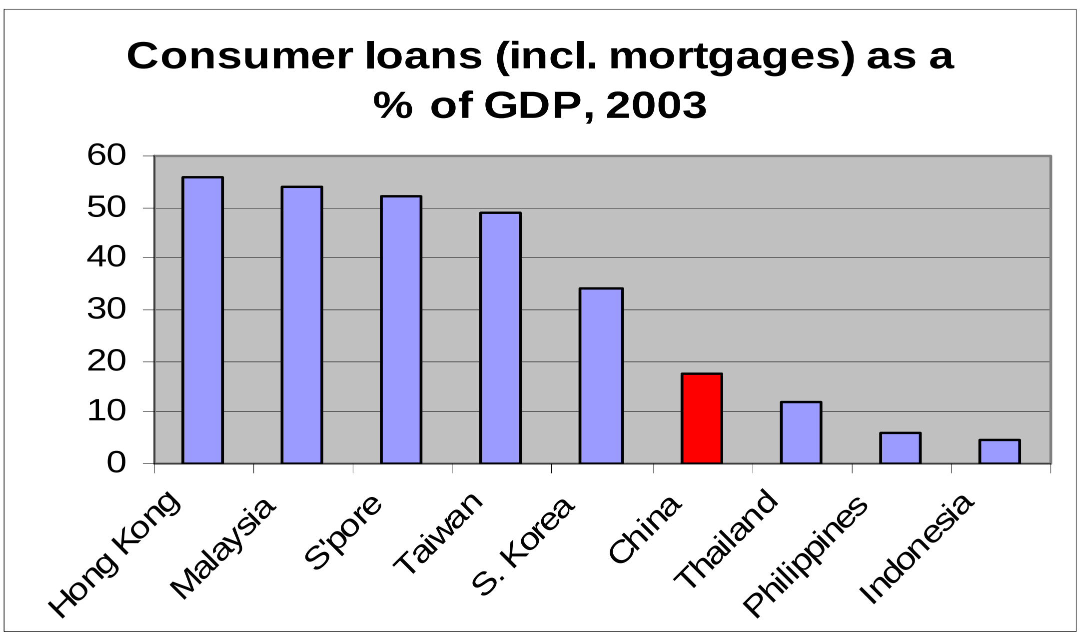
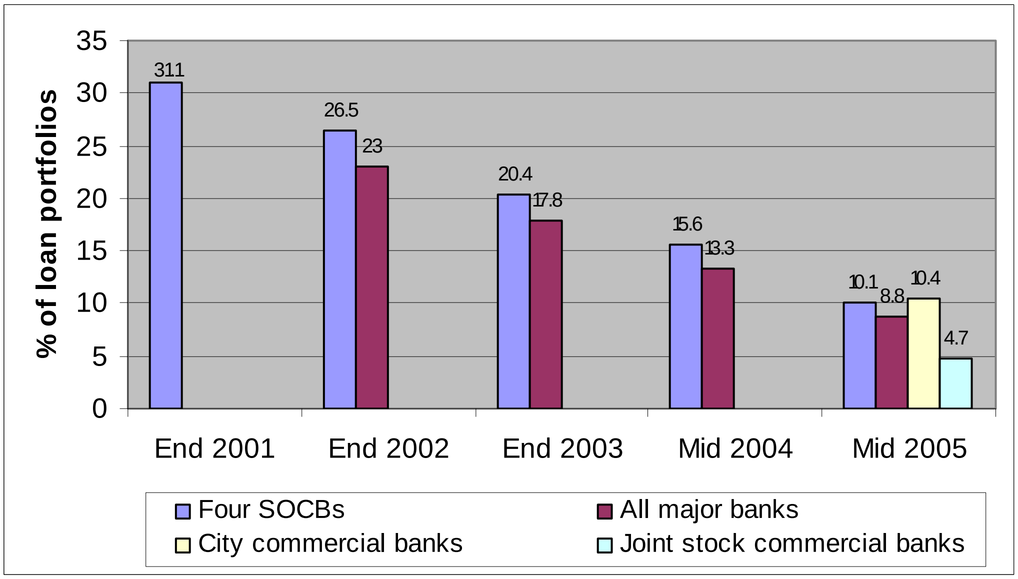
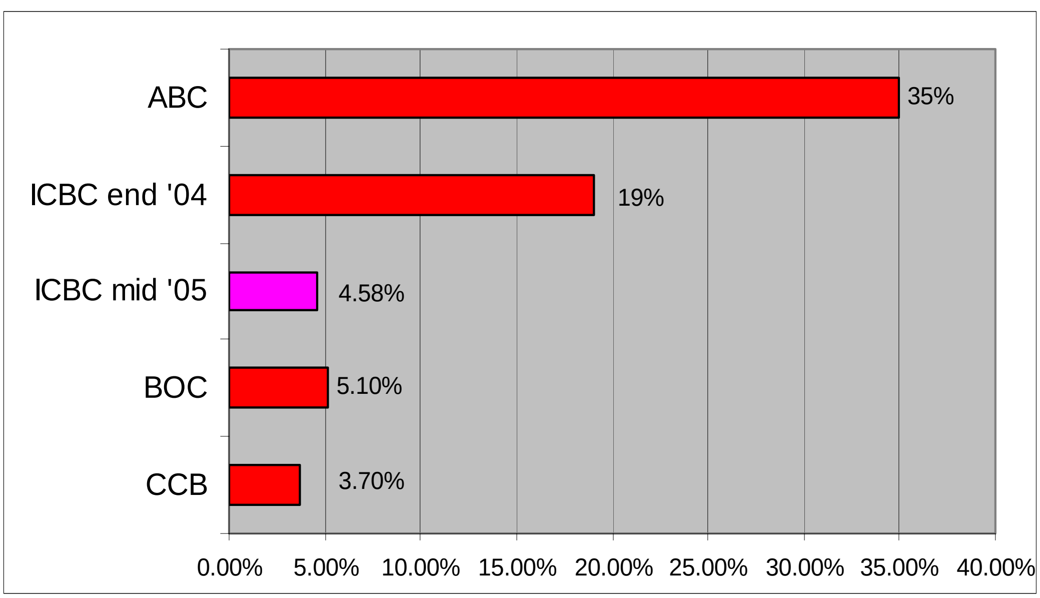


Chart 3. Reported NPL ratios for various groups of banks, end 2001 – June 2005



Source: China Banking Regulatory Commission (CBRC)

Chart 4. Reported NPL ratios for the four main State-owned commercial banks (SOCBc) end 2004 (incl. ICBC for mid-2005)



Sources: China Banking Regulatory Commission (CBRC) and individual bank reports. **ABC**: Agricultural Bank of China. **ICBC**: Industrial and Commercial Bank of China.
BOC: Bank of China. **CCB**: China Construction Bank.

Table 2. Capital adequacy and NPL ratios for the three leading SOCBs

Name of Bank	Date	CAR	NPL ratio	Provisioning ratio
ICBC	June 2005	8.07%	4.58%	
BOC	Dec. 2004	10.04%	5.12%	68.02%
CCB	Dec. 2004	9.4%	3.7%	

Sources: reports of CCB and BOC; press announcements by ICBC and CBRC