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Marshall W. Meyer
Richard A. Sapp Professor of Management and Sociology
The Wharton School of the University of Pennsylvania
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Thank you for the opportunity to appear before the Commission.

China's banking system and banking problem are of immense proportions. China has four large commercial banks (Agricultural Bank of China, Bank of China, China Construction Bank, Industrial and Commercial Bank of China), fourteen national commercial banks (e.g., Everbright, Huaxia, Minsheng), 113 city commercial banks, and about 3500 rural credit cooperatives. The big four commercial banks are huge organizations. The Bank of China, for example, has more than 200,000 employees, 12,000 branches, and 1.5 billion active accounts. Until 2003, the banks were extensions of government—both the central and local government. The banks did not have independent legal status, which state-owned enterprises have enjoyed since 1988. Bank personnel were civil servants and not accountable for performance. Their loyalty, not surprisingly, was as much to government officials as it was to the bank's headquarters in Beijing.

Since 1994 steps to place the banks on a sound commercial basis have been taken. The first step was the creation of three policy banks, the National Development Bank, the Agricultural Development Bank, and Export-Import Bank, in an effort to remove the policy function from the commercial banks. Recently there have been efforts to centralize control of the big four commercial banks. Provincial branch mangers are now appointed by and accountable to headquarters. Local branch offices have become profit-seeking rather than asset-seeking, and non-performing offices in poorer counties have been closed or shifted to the policy banks. Importantly, risk management has been consolidated. Today, in the Bank of China, only 35 provincial-level branches can approve loans or credit facilities. The large commercial banks were also recapitalized in 2003. Huijin, a holding company created by the Peoples Bank of China, borrowed from China's foreign reserves and then injected more than US$20 billion each into the Bank of China and China Construction Bank. Non-performing loans were shifted into asset management companies. Capital ratios improved and NPLs declined as a consequence. At the same time, the large commercial banks were legally separated from the government and reorganized as shareholding companies with boards of directors. Initially, there was a single shareholder, Huijin. Ultimately, shareholding will be diversified as shares are listed and foreign investors are attracted.

Despite these reforms, challenges remain. NPLs are still a problem. How much of a problem is unclear because loans about to be classified as nonperforming are often covered by new loans. The root cause of the persistent NPL problem is also unclear. The simplest and most common explanation is that the commercial banks retain their policy

function: loans are still by command despite improvement in and centralization of risk management. However, research on NPLs by the Development Research Center of the State Council suggests that this is not entirely the case. The DRC's research finds that about 30 per cent of NPLs arise due to government intervention in the banking decisions, 30 per cent are due to corruption, 15 per cent are due to bankruptcies, mainly of state-owned enterprises, and 15 per cent are the result of poor banking judgment. There are other and, perhaps, more fundamental problems as well. The business model of Chinese banks is rudimentary: take deposits, make loans, and live on the spread. There are few if any fee-based financial products and services. The performance of the Chinese banks, thus, is closely tied to the performance of the Chinese economy. The exposure to macroeconomic risk is exacerbated by two additional factors. Since Chinese capital markets are poorly developed, most household savings go into bank accounts; for the same reason, firms, to the extent they can borrow, rely on bank loans rather than equity financing. Moreover, as the banks constrict credit, SOEs and local governments sell off real estate to raise cash, ballooning mortgage lending and contributing to the property bubble.

The solution proffered to these problems is corporate governance: reorganize the banks as shareholding companies, recruit independent directors, seek foreign investors and place board representatives of foreign investors on risk management committees, recruit seasoned managers, and centralize control while introducing innovative and profitable financial products. The mantra of corporate governance, in other words, envisions top-down reform. Whether top-down reform is possible is structures as large and embedded as the big four commercial banks is uncertain. Reforming legacy firms in the U.S. has proved difficult; reforming the Chinese banks may prove more difficult because China though politically centralized has been economically decentralized since the beginning of the reform era. Chinese firms are overwhelmingly local and small by global standards. Large centralized firms, save for state quasi-monopolies in the electricity, petrochemical, and telecom sectors, are unusual. Perhaps of greater concern, a gap between the rhetoric and the reality of corporate governance in China opened last year. In November, 2004 the executives of the top for Chinese telecoms, China Telecom, China Mobile, China Unicom, and China Netcom, all listed companies, were reshuffled by the central government. The reshuffling occurred without consultation with the telecoms' boards of directors. To the best of my knowledge, no independent directors have resigned and none have spoken out publicly.

Despite these problems, the lure for foreign investors is powerful. The size and, more importantly, growth potential of the Chinese market is unmatched elsewhere in the world: where else can 1.3 billion potential customers and 8-10 per cent annual growth be found? There is also a substantial advantage afforded foreign banks investing in the big four and national commercial banks: instant access to markets throughout China. Foreign banks investing in the smaller city banks gain access only to local markets; foreign banks seeking to open de novo branches in China must negotiate tedious licensing procedures city by city and province by province. Still, WTO poses huge risks for Chinese banks with or without foreign investors. Their liquidity could be threatened by relaxation of currency controls and a rapid outflow of deposits from China. Their best and potentially

most profitable customers, customers for fee-based services, could be lost to foreign competitors.

There is also an important mitigating factor. China has no choice but to reform its banks. The alternative is nearly unimaginable. The reform of state-owned enterprises has been more rapid and more successful than most people predicted. It is possible that pragmatism will overcome inertia and that the banks will repeat the performance of the SOEs. As a senior banker put it, “This is a revolution. If everything is normal we can overcome the problems. The way is difficult but the light is ahead.”