# OPTIONS FOR CHINA'S FINANCIAL SYSTEM

A panel discussion chaired by Tommaso Padoa-Schioppa[1]

The first discussant, **Edgar Meister**,[2] stressed the importance of banking supervision in keeping financial systems stable. Only healthy and profitable banks are able to function as financial intermediaries for credit and savings business on a lasting basis. If stable and efficient, the financial sector can support economic growth and contribute to higher employment; but if financial institutions are weak (unprofitable or under-capitalised), the sector may also become the trigger or catalyst of macro-economic disturbances.

As a result of globalisation, crises in one part of the world may spread very rapidly to other countries. Even those countries which have opened their markets only partially to global competition may ultimately be affected through exchange rate movements and changed capital. A strengthened banking system can prove to be a protective wall: by providing the economy with a sufficient volume of loans, it can contain the negative effects on growth and employment.

Although the papers presented at this conference have illustrated the complexity of the situation in China and the features that set China apart from other countries, he nevertheless believed that it was worthwhile to analyse the reasons which have led to the weakening and destabilisation of the banking system in other parts of the world. He said that developments in central and Eastern Europe, which he was particularly familiar with, showed that a large volume of delinquent bank loans narrows everybody's room for manoeuvre and ultimately destabilises the financial system. Mistakes committed in the past may accumulate and develop into a genuine problem: for example, an overheating of the markets ("bubbles") or some other form of resource misallocation.

[1] Member of the Executive Board, European Central Bank and former Chairman of the Basel Committee.

[2] Member of the Board of the Deutsche Bundesbank and Chairman of the ECB Committee on Banking Supervision.

This system has proved to be generally successful in east European countries. The RTC has the task of buying delinquent loans from the banks, recovering valuable asset components wherever possible, and utilising any available collateral. To this end it has to be furnished with budgetary means by the government; however, it could also borrow in the local capital market. Bad loans would be written off using funds made available by the public authorities.

The much needed revamping of supervision of the financial sector needs to be carried out in accordance with international standards: the basis for this should be the Core Principles drawn up by the Basel Committee. Not only were representatives of the People's Bank of China actively involved in formulating those principles, but the PBC is also a member of the Core Principles Liaison Group, which deals with the implementation and refinement of the core principles. As the core principles have been generally accepted, their implementation should be given a high priority in China. He said it is important to identify local risks in the financial sector as quickly as possible, to change the legal framework and, in this way, to extend banking supervision increasingly to risk-prone areas.

He stressed three important requirements. The first was capital. On the basis of the Basle Capital Accord of 1988, capital should be adequate in both quantitative and qualitative terms to take due account of the risks incurred by the banks, thus also stabilising the financial sector. Capital must exist in actual fact and not just on paper. This means above all that the assets and liabilities of the banks must be valued cautiously and must not include undisclosed losses – which is sometimes the case.

The second was that certain types of risk can be minimised by introducing a fit-and-proper test for bank managers as a precondition for their taking up or continuing their activities. The cases of mismanagement that have already come to light recently, and the financing of obscure speculation have shown what the consequences can be if the requirements of professional qualifications and the reliability of bank managers are ignored.

The third requirement is that bank managers are able to make their business policy decisions independently and autonomously. Monitoring business activities requires that banks and other institutions have independently operating internal control systems. The German banking supervisory system attaches great importance to this.

Even after successful restructuring, it is still necessary to manage future risks. This presupposes the existence of an efficient banking supervisory system which is as independent as possible of political influence. Sound supervisory practices, such as rules on risk diversification and limits imposed on the granting of loans, are essential. So too is a reliable accounting system that gives a true and fair view of the bank's economic position. His view was that the accounts of networks of subsidiaries should be consolidated in order to make the risks incurred transparent, both for the institutions and for supervisors, and to disclose the amount of capital actually available. He also noted that several countries in Europe had found that a Central Credit Register helped to create greater transparency. It shows both supervisors and creditors the volume of loans extended per debtor, and thus also any concentrations of risks. If the threshold is sufficiently high (e.g. US$2 million), such a registration and evaluation programme can be established at an acceptable cost and still provide detailed information on major risks. China might consider this system.

**Akira Nagashima**[3] agreed that China's banking system faces very difficult problems related to state-owned enterprises in the transition of its economy: the lack of an effective bankruptcy law limited options for China.

The state-owned commercial banks in China had a high proportion of non-performing loans, and the supervisory authorities should fully recognise this and compile accurate information on the condition of financial institutions and on asset quality. Loan classification and provisioning standards must be up to internationally accepted norms.

He said it was essential for China to avoid repeating the mistakes of Japan, where loan classification standards had been lax by international standards. The definition of the structure of loans had been very vague; the valuation of the quality of the assets of non-bank subsidiaries had not been strict because bank balance sheets were not consolidated. The true size of the bad loans was underestimated so that the scale of the problem was not well recognised by the general public. The financial statements of banks and others in China should be prepared so as to conform to strict international accounting standards. The financial information about the financial condition of individual institutions should be disclosed to the public in a transparent way.

[3] Executive Adviser, The Tokio Marine and Fire Insurance Co. Ltd. Former Executive Director, Bank of Japan.



He recognised that dealing with troubled state banks in China was complicated because the root cause of the problems was the loss-making state-owned enterprises which have to be restructured. The treatment of state-owned enterprises in China raises difficult political problems because some of the firms are big enough to affect entire segments of society. Hence the treatment of state banks will have to co-ordinated with the disposal of state-owned enterprises. Substantial consolidation, rationalisation and recapitilisation will in any case be necessary for state banks. He suggested that although privatisation is at present out of the question for state banks in China, the idea of establishing new banks through the reorganisation of existing institutions, introducing some elements of private commercial banking management, with particular emphasis on risk management, deserves consideration.

Turning to non-bank financial institutions, Nagashima thought that their difficulties came directly from lending for investment in real estate or securities and from loans to local government for infrastructure investment. These difficulties should be dealt with quickly. When deciding how to restructure the state-owned enterprises, the Chinese authorities should also consider how to deal with the relatively large share of losses incurred by foreign international institutions. In the past, foreign banks usually extended credit on the assumption that the Chinese local authorities would compensate them in the event that a non-bank institution fails. However, it is the responsibility of private financial institutions to make allowances for credit risks when there is no explicit state guarantee – they should therefore share the losses. This would mean that risk premia would of course rise. In any case, it is important that the liquidation procedures are made transparent with foreign and domestic institutions receiving equal treatment.

Nagashima concluded by saying that China has three important advantages compared with other countries with severe problems. First, there is a clear and strong political will to solve the problem and China's social and political system can ensure that this political will is realised. It could be quite different from the situation in Japan, where the strong public and media reaction against the use of the public funds led to delays that made banking problems all the more serious.

Secondly, the general public's confidence in the financial system in China remains. He said that the financial system in Russia does not work because people do not believe that the government will honour their deposits. It is important that Chinese authorities proceed expeditiously in this restructuring basis while public confidence in the financial system is maintained.

Thirdly, high saving and low national debt ratios make it easier for China than other countries to absorb the cost of financial restructuring. In Indonesia, the cost of recapitalization of the banking system is estimated at about 30% of GDP. It would be a considerably more difficult task for Indonesia to raise such an amount of funds, where capital flight is worse and interest rates are much higher than in China. In short, he said, China should take advantage of its comparatively favourable environment to implement its reform programme in a decisive manner, and to succeed in solving their problems.

**Roberto Zahler**[4] said he was not an expert on China and that his comments were tentative. He thought that the Chinese situation had two favourable aspects. The first was that China has quite a closed capital account which meant that it had not had a massive inflow of foreign funds intermediated by the banking system. China should therefore act now to rapidly reform its banking system because economic development leads to a more open capital account. In the future, China will face very significant capital inflows, probably largely intermediated by the domestic banking system. This will generate both an appreciation of the domestic currency and a relaxation in bank credit standards.

The second aspect was related to the structure of competition in China. The pattern in other countries had been that troubled banks try to attract deposits by increasing interest rates, forcing other banks to respond. This competition will lead to pressure for higher interest rates on loans. This increases the risk portfolio of banking system, tends to create more distress borrowing and tends to increase moral hazard. Such risky behaviour can be all the more marked when banks are inadequately capitalised. Moreover, there was an agency problem – the lending bank becomes the agent of borrowers who have the right connections. It appears, however, that the Chinese banks do not compete with each other to push up deposit interest rates to unsustainable levels.

[4] President of Zahler & Co. Former President of the Central Bank of Chile.



However, he warned that the fact that the Chinese economy has enjoyed growth of around 8% a year in the recent past had masked some of the problems in the banking system. If the economy were to slow, these problems would become more acute. The competitive situation of banks would change. As earlier speakers had done, he underlined the need for prompt action.

As for policy choices for China, he thought the first priority was to develop proper framework for risk analysis – which could be simpler than in countries with a sophisticated capital market. A key distinction was between the tradable and non-tradable sectors. Lending to state-owned enterprises was in effect related lending: if both borrower and lender belong to the same owner there was a major problem of credit-risk monitoring. He agreed with Nagashima that state-owned enterprises were the main source of banking or loan problems. He said China should impose a capital requirement higher than the 8% in the Basle Accord.

He pointed out that the supervision of the financial system does not depend only on official institutions. "Auto-regulation" was becoming more important, allowing banks to manage their own situation, with the authorities acting in a strategic monitoring mode. The stability of banks depends not only on official supervision but also on market mechanisms, including external auditors, credit-rating agencies and so on. He concluded with a very important question related to political economy: how to allocate the losses of financial system, including the losses of foreign banks in China. The owners and shareholders of problem banks should lose their shares, their capital and assets. But what this meant when the banks were state-owned was unclear.

In any event, countries trying to eliminate or minimise financial crisis should reform the governance of banks so as to minimise future losses and risks. A deep capital market can help. To deal with the huge financial crisis of 1984 (the estimated loss was around 25–30% of GDP), Chile had had the foresight to develop a pension fund scheme to absorb the large issuance of domestic public bonds. This had created a very sophisticated domestic capital market. This has some implications for China.

**John Heimann**[5] explained that the Financial Stability Institute was a joint undertaking between the BIS and the Basel Committee on Banking Supervision. The aim was to assist developing nations in improving their financial sectors – including banking, securities and insurance. He outlined three main functions.

First, the Institute will bring together supervisors from around the globe through a series of symposiums, to discuss problems and to analyse the changes in their systems and their societies. It would provide a venue for them to work together to share their experiences. It is very important that bank supervisors understand not only the principles of supervision and the Core Principles of Banking Supervision published by the Basel Committee, but also techniques for implementation and enforcement that can be applied, partially or wholly, in their own systems. The FSI will help supervisors with this. The focus will be on case studies, which will cover the implementation of the Core Principles in some countries, experiences of financial/banking crises and policies to restructure of banking and financial systems. These case studies will analyse what happened, why it happened, and what could have been done better.

The second function will be to provide continuing support and assistance to supervisors that have participated in the programme. The FSI recognises that there is a need for supervisors to disseminate the correct information as the world changes, as financial intermediation changes, as markets change. But they also need somewhere to ask questions and to seek assistance or help. The FSI will play an important role in this respect. When one country faces a given problem, the Institute might try to identify similar problems in other countries, enabling the supervisor to understand what others did when faced with a similar problem.

The final function will be to take up some special projects for individual countries and coordinate experts from around the world, to help them deal with their problems.

Heimann concluded by saying that the central purpose of the Institute is finally to prevent crises. It will assist countries in improving the quality of supervision in the financial sector, thereby strengthening the financial sector. In addition, he stressed, foreign banks could inject new capital, introduce new techniques into the developing countries and train professional staff for the host country. These functions are clearly critical in all these countries. Foreign banks should be treated equally with domestic banks.

[5] Chairman, BIS Financial Stability Institute.



**Xie Ping**[6] thought China is facing a number of choices in strengthening financial supervision.

The first choice is whether the ownership structure of Chinese financial institutions (especially the state-owned commercial banks) could be diversified. He thought that it is, in essence, a question of privatisation and joint-ownership, as discussed by Nagashima and Zahler. He pointed out that China's banking sector remains one of the few industries where private investments are still considered taboo. While it is generally acknowledged that privatisation goes hand-in-hand with improved efficiency, this might not be the case in China because the very fact that the banks are owned by the state reassures the depositors. None the less, he said, it should be realised that joint-ownership helps commercial banks to strengthen their capital bases and to improve governance.

Second, should China establish a deposit insurance mechanism and, if so, how? At present, the structure of China's bank deposits is unique in that the big four state commercial banks account for 64% of the market. If all banks are involved in deposit insurance scheme, the "big four" will have to bear most of the cost. If the big four opt out, 64% of the deposits will be left uninsured, in which case the premiums of hundreds of small and medium-sized institutions can hardly cover the payment risks of two of them. Another alternative is to establish a deposit insurance system covering rural credit cooperatives, which means treating the 40,000 credit cooperatives as a whole. A few of the institutions might be allowed to go bankrupt in the future.

The third is whether the government should commit itself to fully repaying the household deposits of ailing institutions. Japan and most other major countries do so. Though no legally binding commitment has been made in China yet, such commitments were made on the closure of China Agricultural Trust and Investment Company, Hainan Development Bank and Guangdong International Trust and Investment Company. The moral hazard risk is that, if the government makes such a commitment, the management of individual institutions may become lax. If the government does not commit itself, deposits may rush to the state

[6] Director of Research Bureau of the People's Bank of China.

commercial banks. The consequent crowding-out effect will discourage the development of the financial sector.

The fourth choice is the issue of division of responsibility between the central and local governments. The principle is that "one must take care of one's own children": the owner of a financial institution is responsible for the repayment of its debts in case of liquidation. However, it should be noted that action by financial institutions (especially deposit-taking institutions) always has externalities. When the local government does not take care of its "baby", or even allows the baby to die, negative externalities will probably spill over across the country. For instance, if an ITIC owned by a local government goes bankrupt and the local government does not act responsibly, then its peer groups will be penalised by the public. These negative spillover effects are observable in real life recently.

The fifth choice is relevant to foreign participation in bank restructuring in China. In bank restructuring and auctioning non-performing assets, a commonly used strategy is to introduce the participation of foreign banks or investors. The typical practice of foreign participation in Southeast Asian countries was merger (acquisition), sales of non-performing loans and even some stakes to foreign institutions. This is in essence a strategy of market access for foreign institutions. It should be studied whether it would be available for China and how strong the opposition would be. He thought this is also a question to be faced in China's accession to WTO.

The sixth issue is whether the central bank's liquidity support to problem institutions should become a regular practice. Then the questions are how? And how much? He pointed out that the current practice is to follow a case-by-case approach rather than an institutionalised arrangement. It is known that, as the lender of last resort, the central bank has to provide liquidity support to help ailing institutions. But the cases given by Liu Shiyu showed that more often than not such liquidity support does not work well. At times of payment crisis of financial institutions, the liquidity support is financed by public funds. Here the fundamental question is whether public funds and budget resources should be used to rescue ailing financial institutions.

The seventh issue is the disposal of non-performing loans by the asset management company. The question is how should China proceed. This method presents as a new alternative to resolve non-performing assets by means of a commercial institution. However, some say that an asset management company can only resolve the stock of non-performing assets but not the flow. If poorly managed, it may even exacerbate moral hazard.

Eighth, China now practises both the segregation of financial business for financial institutions and the segregation of supervision by the supervisory authorities. In this way, one institution can get involved in only one kind of banking, insurance, trust and securities business. The People's Bank of China, the Insurance Regulatory Commission and the Securities Regulatory Commission are assigned different jurisdiction competencies. It has not been long since this system was put into practice and how effectively it can run in the long-term remains unanswered. Facing fierce global competition and booming development of information technology, it is not certain how long this approach can last.

Ninth, the governance of Chinese commercial banks (financial institutions) is problematic: what kind of governance should such banks adopt? No optimal approach is in sight yet. The mechanism used at present to improve commercial banks' (financial institutions') governance is to strengthen leadership of the Party through the establishment of the Steering Committee of the Party on the Financial Industry. In fact, what is at work is bureaucratic incentives rather than meritocracy. How well this system will work in the future remains to be seen.

Finally, Xie Ping talked about the issue of transparency and disclosure. He thought there are a lot of problems in this respect in China and discussed the feasibility of the establishment of mandatory requirements on disclosure for financial institutions. One point of view is that such requirements would jeopardise public confidence since all financial institutions have serious problems. He wondered how long it would take to get ready to be able to implement disclosure requirements. He concluded by saying that without the disclosure requirements and transparency standards, financial supervision will be built on sand.

**Dai Genyou**[7] agreed with Lardy's opinion that, at present, the level of bad loans in Chinese commercial banks was high, and reflected loans to state-owned enterprises. To solve this problem, the authorities should

[7] Director of Monetary Policy Department of the People's Bank of China.

focus not only on the stock of non-performing loans, but also on the flow. To do this, the mechanism of competition should be introduced into the financial sector while the tax burden of financial institutions should be reduced. He said that China was fully aware of the challenges it faced in this respect and complimented Lardy for his perceptive study of China.

Dai Genyou was optimistic about China's financial prospects. He said that problems and their remedies usually come forth simultaneously. China is solving its banking problems by "seeking truth from facts" in Deng Xiaoping's memorable phrase: the financial crises that have afflicted some other countries recently could therefore be avoided.

He offered three reasons for this optimism. The first is that most banks and other financial institutions in China are state-owned or collective-owned. Because about one-half of deposits belongs to enterprises and institutions, restructuring is relatively easy: the evidence was that China has successfully resolved the problems of a number of trust and investment companies at municipal or prefecture levels and has restructured some local commercial banks and urban credit cooperatives. Moreover, the closure of several non-bank financial institutions did not disrupt social stability because individual deposits and institutional deposits were dealt with in separate ways. The second reason is that the guiding principle of China's plans to safeguard itself from financial risks is "less liquidation, more restructuring". In this particular respect, China has certain political advantages and the government enjoys strong administrative ability. The third reason is that the central bank is fully able to offer liquidity support to those financial institutions experiencing temporary payment difficulties in the present situation of sluggish external demand.

He then argued that the nature of current problems in the Chinese financial sector should be seen in the context of a monetary and financial system that was evolving against the background of very rapid economic development. China had maintained high economic growth for a long time and this momentum would continue in the coming years provided the appropriate policies are pursued. The Chinese economy is still resilient. Several foreign speakers at this conference have echoed this optimism – which would, he added, be confirmed by a visit to Guandong, a province said to have the most financial problems in China but which is still prosperous as a whole. He thought that this case exemplifies



the continued momentum of high growth of the real economy, which provides a favourable environment for China's financial problems. As Wu Jinglian has pointed out, the saving rate in China is very high: new saving replenishes the funding of the banks, and thereby mitigates the liquidity pressures faced by some problem financial institutions.

He concluded by saying that the solution to China's financial problems depended in part on devising policies to use the country's high level of savings in an appropriate way. One mechanism would be to transform private savings – at present largely held as deposits with state banks – into bank capital. In this way, banks might meet the 8% capital requirement target. A second mechanism could be the greater use of fiscal resources. He explained that the debt dependency of the Chinese central government is quite high because local governments are forbidden to issue debts. In addition, the development of the tax system in China still lags behind the development of the economy: the ratio of fiscal income in total GNP is relatively low. Even a modest change would transform the situation. In any event, China had adequate resources to overcome the difficulties faced by its financial sector.

The Chairman, **Tommaso Padoa-Schioppa**, concluded the discussion with four brief reflections. The first was that banking supervision was an extremely difficult function in an economy that was to some extent still in the transition from a centrally planned to a market economy. Supervision in its very essence did not fit in with central planners' idea of the market. It required the market to be based on the idea of a market as something needing guidance, which meant that regulations on banks were needed.

The second remark emphasised the importance of the prerequisites for a strong banking system. He thought such prerequisites had been discussed many times during the conference. Bank supervision was absolutely crucial. But it would not, by itself, be enough: the priority for China was to stop the losses of the state-owned enterprises that had produced the bad loans. If those losses were not stopped, dealing with banks' bad loans might be very difficult. He also said stopping the losses was something that implied a huge amount of work and fundamental change: this was not the primary task of supervisors.

Thirdly, he pointed out some similarities between the banking problems in advanced economies and those in China. He thought it

was very important to separate the different responsibilities of the central bank, commercial banks and fiscal agencies. He was not sure that China had fully achieved this.

Fourthly, he thought most of the participants from other countries were deeply impressed by the extreme openness and frankness with which China's policy dilemmas had been discussed. This had been a very worthwhile conference.