Zhou Xiaochuan: Some issues concerning the reform of the state-owned commercial banks

Speech by Mr Zhou Xiaochuan, Governor of the People's Bank of China, at the IIF Spring Membership Conference, Shanghai, 16 April 2004.

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First of all, I'd like to thank the organizer of the conference for introducing myself. I am very pleased to attend the Conference to exchange opinions with such a distinguished audience on China's financial market, monetary policy and financial reform. Many of you have paid close attention to the reform of China's state-owned commercial banks, and today I'd like to offer my personal views on this issue based on what all other speakers have elaborated this morning.

I. Advantages and disadvantages for the reform of the state-owned commercial banks

The reform of state-owned commercial banks demands some preconditions, similar to any particular reform. It should be noted that the occurrence of the Asian financial crisis has, to some extent, turned some disadvantages for the reform of state-owned commercial banks into advantages. The outbreak of the crisis sharpened the awareness of all walks of life of the importance of the sound and safe operation of the banking system, enhanced the acknowledgement of the enormous financial risks inherited in the vulnerability of the financial system, and strengthened the resolve of the decision-makers to restructure the system of state-owned banks. China tided over the Asian financial crisis smoothly, achieved sustained and stable economic growth in the mid- and late 1990s, and thus created favorable conditions for further reform of the state-owned commercial banks. Resource advantages generated by sustained economic growth rendered it feasible to restructure state-owned commercial banks. Besides, the outbreak of the Asian financial crisis alerted the regulators to pay high attention to the issue of cutting down non-performing loans (NPLs). By now, the NPL ratio of China's state-owned commercial banks has decreased by nearly 50 percent from that recorded in the Crisis period.

I recalled that the issue of NPLs in China's state-owned banks had been a hot topic for the overseas media for some time during the fourth quarter of 2002 and the first quarter of 2003. Overseas magazines and newspapers of finance and economics, like Times, Business Week, Economist and Far East Economic Review, all published articles of significant weight discussing the issue that the enormous NPLs in China might threaten its sustained economic growth. Some even estimated that NPLs of state-owned commercial banks, if classified in line with prevalent methods, would have accounted for more than 50 percent of their total assets. They in turn lost confidence in China's state-owned commercial banks, dampening enthusiasm of foreign capital entering China's financial industry. From the perspective of the current situation, however, the reality is much better. At present, the reform of China's state-owned commercial banks has come to the implementation period, and their operational performance has been improving. Statistics show that NPL ratio of state-owned commercial banks has been decreasing by 3-5 percent year-on-year in recent years.

The central bank has conducted a survey on the formation and composition of NPLs of state-owned commercial banks accumulated since the reform and opening to the outside world. The survey indicates that those as a result of imperfect operation and management by state-owned commercial banks didn't account for a high proportion. Instead, the NPLs, historically speaking, came mainly from excessive government intervention, poor legal environment, inadequate management of the customer bases. Concretely speaking, of the total NPLs by state-owned commercial banks, 30 percent was due to intervention by the central and local governments, 30 percent resulted from mandatory credit support to state-owned enterprises, 10 percent arose from poor legal environment and weak law enforcement in some regions, and 10 percent stemmed from industrial restructuring in some enterprises (including those in the military industry) by the government through closing down, suspending operation, merging with others or shifting to different line of production. All in all, only 20 percent was ascribed to business operation and management of the state-owned banks themselves.

What deserves noting is that attention has been attached to all the above factors in the wake of the Asian financial crisis in 1997, and great improvement has been achieved in some aspects. First, the government has basically abandoned administrative intervention in the business operation of the state-owned commercial banks. The government has established from the legal point of view the independence of the commercial banks in the decision-making of loan issuance. Second, in terms of policies and regulations, it was stated in the lending guidelines for state-owned commercial banks in the 1980s and 1990s that state-owned commercial banks were required to grant credit support to state-owned enterprises. Since the mid-1990s, however, the government has given up this guideline. At present, state-owned banks have no obligation any longer to extend loans to state-owned enterprises. According to the survey conducted by the PBC in 2003, of the current total loans by state-owned commercial banks, more than 50 percent is granted to non-state-owned enterprises (including foreign-funded and private enterprises) and individuals (through housing mortgage loans and consumer loans). Third, with the deepening of the reform of state-owned enterprises and with some progress achieved to that effect, some large-sized state-owned enterprises have gradually turned into listed companies, and improvement in operation of state-owned enterprises has also rendered it possible for commercial banks to solve the problem of high NPL ratios. Fourth, for a quite long period of time, there was no bankruptcy law in China. In some court cases concerning banking loans, there existed disputes over the fairness of the ruling, and there even existed poor law enforcement and intervention on judicial affairs by local governments in some regions. What is note-worthy is that some laws and rules, like the Bankruptcy Law, the Securities Law and the Company Law, are already in the process of further revision and amendment. Generally speaking, although there is a huge amount of NPLs in state-owned commercial banks, the reform is still promising as the ratio is not too high for the NPLs that are ascribed to business operation of the state owned commercial banks themselves.

II. Initial development of the reform of state-owned commercial banks

The sequence of reform on state-owned commercial banks in the whole process of economic reform, has all along been a strategic choice, and thus needs to be analyzed historically. In the early stage of the reform, fiscal and financial resources were mainly appropriated to support agricultural reform, the reform of state-owned enterprises and the reform of the trade sector through concessionary means. Reforms in various fields consumed considerable resources. Whereas fiscal resources were scarce and the system lacked flexibility, it was the financial industry that carried the burden of cost of reform. One outcome was that the banking industry accumulated immense NPLs and meanwhile the financial reform lagged behind. Undoubtedly, when the reform evolves into a certain stage, the focus of reform shall be shifted to the financial industry to remove the historical burden.

In retrospection, the development of the reform of state-owned commercial banks could be divided into the following stages. First, in 1998, special treasury bonds of RMB270 billion yuan were issued for recapitalization of the state-owned commercial banks. In 1999-2000, NPLs were partially divested through the setup of assets management companies (AMCs). Second, existing resources were utilized to write off NPLs. Funds for the purpose of write-off of NPLs mainly included reserves, profits before provisioning and the original capital. Relative to the big amount of the NPLs, the coverage of reserves by state-owned commercial banks was lower than desired. In line with the five-category loan classification, the reserves were even not enough to cover the loan losses. In terms of the operational profits of state-owned commercial banks in recent years, it is necessary and possible as well to utilize part of the profits to make up for the reserves. Through the above ways, two pilot reform banks will write off basically all historical loan losses. Third, some foreign exchange and gold reserves were used to recapitalize the state-owned commercial banks. It should be noted that recapitalization constitutes only one step of the whole process of reform of state-owned commercial banks. In order to transform state-owned commercial banks into real commercial banks, efforts shall be made to fully clean up assets in state-owned commercial banks in line with international accounting rules and requirements of listed companies, to improve internal risk control and corporate governance. Efforts shall also be made to prevent excessive new NPLs under new circumstances and to guarantee good profits and returns on injected funds. Besides, regulatory authorities should also emphasize on monitoring capital adequacy ratios and pay close attention to how the mechanism will prevent the occurrence of new big-amount NPLs.

Generally speaking, only through the share-holding reform with clear targets will state-owned commercial banks be able to establish and improve the structure of corporate governance and will the reform achieve practical effects.

III. Possible disputes regarding reform of state-owned commercial banks

Various disputes might emerge in the course of the reform of state-owned commercial banks. I'd like to share my opinions on two of them and discuss others during Q & A sessions.

(I) Should the reform be pursued through strengthening management or through the corporate or share-holding reform?

For sure, this dispute is a hot issue in the discussion of choice of reform alternatives. One opinion is that priority shall be placed on management, and on the basis of good management efforts are then made to implement share-holding reform. Looking back into the reform of state-owned enterprises, we found out quite similar disputes, i.e. did the problem come from poor management or from corporate mechanism? Was it a personnel problem or a mechanism problem? If the management were not qualified, then through replacement of the management team would there be a fundamental turn for the better in terms of operation of the banks? On the basis of better operation and with profit accumulation for some time, would reform of corporate system and share-holding arrangement improve the bank performance? Experience for many years indicates that the effect was not optimistic as with the reform of state-owned enterprises by following the above perception. To trace the problem to its source, we find that the problem of state-owned entities lies not only in weak management but also in the more fundamental problem of corporate system. Hence, the 16th Congress of the CPC and its third Plenary Session both emphasized once again the direction of the reform of state-owned enterprises.

Comparing state-owned banks with state-owned enterprises, it will be easy to find out the high similarity between them. If in the past state-owned enterprises acted like government organizations or featuring "quasi-bureaucratic system" to some extent, then state-owned commercial banks are more like government organizations instead of commercial entities. State-owned commercial banks have instituted apparent administrative hierarchy and officialdom in terms of personnel system, remuneration system, staff benefits, social security and internal incentives system. Decision-making power of the persons in charge of state-owned commercial banks is more than often limited, and lacks market-oriented incentives. Although there is big difference in the responsibility assigned to a bank clerk for savings counter and to a credit officer with high ability of risk control, there is no big difference in terms of remuneration. With inadequate internal incentives and deficient outside pressure, reform of state-owned commercial banks might long protract if solely emphasizing on the improvement of management.

Documents of the 16th Congress of the CPC have clearly stated the direction of share-holding reform. Efforts shall be made to change the operation mechanism of enterprises in real earnest through changes in the structure of corporate governance. This idea should also fit in with the reform of state-owned commercial banks. The reform of state-owned commercial banks is also reform of state-owned enterprises in its very nature.

(II) Whether or not to actively push state-owned commercial banks to be public listed companies?

One opinion mistakes listing in the stock market as the ultimate target of the reform. Some people believe that going public is aimed at financing for capital infusion of banks and for internal incentives of the management team. It is certain that the purpose of listing of state-owned commercial banks is not confined only to this.

Public listing is only one stage in the process of the reform. Now that the state is capable of injecting capital into state-owned banks, listing is not mainly aimed at raising funds or at establishing incentives. The ultimate target of reform rests in the establishment of a whole set of market system of incentives and constraint. Emphasis is placed on the investors' interests. It is aimed at completely shattering the "quasi-bureaucratic system" of state-owned commercial banks, at changing the operational targets which are set based on the officialdom, and at changing state-owned commercial banks into real market participants through rational incentives mechanism based on performance and complete risk control and capital constraint,

As an important step, the key to listing lies in the resolution of some long-standing and difficult problems, in particular, the problem of administrative constraint from other government departments. For instance, taxation on commercial banks. For a long period of time, there have been some regulations of taxation on commercial banks not in line with the law of market economy. The taxation authority also recognize the fact. As there are too many taxes and tax rates to be reformed, there shall be a sequence. It is very difficult to place on the agenda the reform of the tax arrangement for state-owned commercial banks before they are really confronted with the capital market and public investors. With the count-down plan of listing for the state-owned commercial banks, the resolution of these problems will be placed on the agenda. The same goes with the reform of personnel, benefits, social security, operation autonomy of the state-owned banks. Only when state-owned commercial banks are confronted with the urgency of going public will coordination and synergy by various government departments and corresponding reforms become a priority. In fact, without enough outside pressure, no competent authorities will take initiative in giving up their power and the process of reform might be protracted.

From the perspective of corporate governance in the broad sense, the operation of commercial banks is closely related to public interests and calls for enhanced transparency and strengthened monitoring by the general public. Through share-holding reform and going public, state-owned commercial banks must meet the requirements of information disclosure as a listed company. Listing creates the condition for public monitoring in the real sense. The importance of recapitalization by the government, therefore, lies more in establishing a financial intermediation efficient in utilizing savings rather than in polishing the balance sheets of banks. In a more substantive sense, therefore, only through going public and exerting enough outside pressure will the structure of corporate governance be established and improved, shattering the bureaucratic operation mechanism and ensuring the success of reform of state-owned commercial banks.

The reform of some large-sized state-owned enterprises, in particular, their changes after share-holding reform and going public, provide precedents for reform of state-owned commercial banks. It is observed that some large-sized state-owned enterprises were much like government organizations before going public. Lack of clearly defined ownership resulted in immense insider control, inefficiency of operation and poor performance. After share-holding reform and going public, supervision of enterprises does not rest only in the level of competent authorities of the government. Instead, regulatory requirements from public and institutional investors at home and abroad and from securities regulatory bodies would force listed companies to take into consideration the concerns of shareholders in terms of information disclosure, business operation and market strategy. It is certain that the internal pressure for reform might not be powerful enough to transform the mechanism without share-holding reform, without outside pressure from going public, without monitoring by strategic institutional investors and public investors and without introduction of independent directors. Reform will not probably achieve practical effect without listing in the stock market, without adjustment of shares distribution and without adequate outside monitoring and pressure. The same goes with commercial banks. After going public, they are subject to monitoring of shareholders, regulatory authorities, the general public and other related parties. They shall disclose information in detail as required and shall take into consideration the concerns of shareholders in line with complete accounting standards. Only through going public will it be possible to facilitate the overall change of the game rules and to strengthen corporate governance, effectively preventing the phenomenon of “going back and forth in the reform”.

IV. Outlook of the banking reform: potentials and difficulties

As for the advantages for the reform, it is observed that China’s financial market is still in its preliminary stage, without abundant financial products and without sophisticated application of financial engineering. Of the whole financing structure, however, indirect financing accounts for a big ratio, with the ratio of M2 to GDP close to 200 percent. Plus, the Chinese market boasts of an enormous advantage of large population. The above advantages provide immense potential and room for development in carrying out traditional business and innovating new products, like intermediary business, trans-market financial products, consumer credit, mortgage loans etc. In terms of interest rate structure, the differential between deposits and loans is still in the high range with promising outlook for profits of commercial banks.

As for the disadvantages, China is still lacking talents for the financial industry. It is observed from the experience of other professional sectors that cultivation of specialized talents takes some time. Generally speaking, however, Chinese people are diligent and good at learning. A large number of college graduates is also an advantage. They will catch up and adapt to competition. At present, young people are very enthusiastic with the subject of finance. It is believed that cultivation of talents will meet the requirements if supported with proper incentives. Although there is perhaps a lack of talents in financial innovation in the short run, talents for financial operation and financial engineering could soon be cultivated. It is believed that human resources will grow rapidly with the reform under way and in particular with the incentives system put in place, including absorbing overseas talents. The Confucian culture of China has the tradition of respecting knowledge, plus the existing good education system, they should help the training of professional talents. The problem of talents will be readily solved in the process of reform. Of course, emphasis will be currently placed on resolving the problem of lacking high-quality managerial talents who will meet the requirements of modern finance and international competition.

We cannot underestimate the difficulties in the reform of banks. Globally speaking, the reform of the financial system meets bigger difficulties than that in other fields. Whether it is shock therapy or gradual reform, there is a common point that efforts shall be made to cultivate the institutions that do not exist under the system of planned economy but could serve the market economy, and to establish corresponding systems of laws and rules. The building of institutions and improvement of laws and rules will take a long period of time to accomplish. The reform will face immense difficult problems of insufficient development of institutions. First, financial institutions of banking, securities, insurance, trust and fund management have yet to grow up. Second, the underdevelopment of the customers of financial institutions. On the borrowers' side, it is related to the reform and growth of the enterprises, e.g. the soft budget constraint identified by Janos Kornai. On the depositors' side, the problem is more related to the cultivation of investment assessment and perception. Third, the buildup of financial regulatory bodies, including the straightening up of the supervisory mechanism, clear definition of targets and responsibilities, gathering of quality talents, as well as the justice, integrity and cleanness of these institutions, all takes time to achieve. Fourth, reform of the accounting standards. There is a big gap between the accounting system under the planned economy and that under the market economy. It is very difficult to produce instant results by directly introducing the western accounting system in the understanding of the basic principles and absence of good certified accountants. On the other hand, there also exists a problem as to whether each step of the reforms, if carried out in a gradual way, will meet requirements of the overall reform. Fifth, cultivation of accounting firms, assets assessment institutions and rating agencies. It is a process starting from nowhere and calls for a long period of time to finish, combining self-development with opening to the outside world. Sixth, the evolution of the Bankruptcy Law and law enforcement. They call for legislative, judiciary and administrative reforms. Without a good bankruptcy law and related procedures, a poor credit environment and higher than desired NPL level will likely arise. Seventh, taxation reform and enhancement of credibility of the public finance. As the exemplar for individual and corporate finances, fiscal departments at all levels shall resolve the problems of soft budget constraint and malpractices. Eighth, construction of risk management market. The financial industry shall have a market system for risk transfer and prevention. Ninth, the growth of institutional investors. This constitutes an inevitable link to facilitate the development of the capital market and financial products. The institution growth to that effect calls for a relatively long period of time. Without a sound development of these institutions, it is not realistic to expect a low level of NPLs in the banking sector, a relatively clean capital market with few scandals, and a very healthy insurance sector. It is hoped that the development of institutions will be quite successful while at the same time we should remain sober about the challenges lying ahead. Financial reform and institutions building are mutually re-enforcing.

A note-worthy issue in the short term is that competition over selected customers will be intensified after foreign-funded banks enter China. According to statistics and analyses by some countries, for commercial banks, the most important source of profits comes from high-end customers, accounting for 10 percent of all customers. These high-end customers can produce almost 80 percent of the total profits. The most fierce competition between the foreign-funded banks and the state-owned commercial banks will be for these high-end customers. Although China's banking industry boasts of extensive service network and broad customer base, there will emerge big problems if they fail in the competition for high-end customers. In the mid and long term run, we are confident in China's banking reform and hope that more foreign-funded financial institutions will participate in this market to promote competition, innovate and improve services and strengthen economic prosperity and development.