The Lessons Learnt from the Development and Reform of China's Banking Sector

Liu Shiyu, Wu Yi and Liu Zhengming

I. Review of Historical Developments

The reform of China's banking sector was carried out against the background of the country's transition from a planned economy to a market economy. Prior to the reform and the opening up of China to the rest of the world, the country's banking system consisted of only one financial institution, the People's Bank of China (PBC). It was not until 1984, when the Industrial and Commercial Bank of China (ICBC) was separated out from the PBC, that China became a dual banking system with the PBC acting as the central bank and ICBC, China Construction Bank (CCB), Bank of China (BOC) and Agricultural Bank of China (ABC) as the specialized banks. At that time even though these specialized banks were given some discretion over business operations, within the framework of the planned economy they had limited power in extending credits.

In 1993, the overall reform direction toward a socialist market economy was established. The specialized commercial banks were required to transform into real commercial banks. At the same time three policy banks (State Development Bank, Import and Export Bank of China, and Agricultural Development Bank of China) were set up in order to separate policy financing and commercial financing. In 1995, the *Law of the People's Republic of China on Commercial Banks* was enacted, establishing the specialized banks as state-owned commercial banks and stipulating that the business operations of these banks were to be governed by the principles of efficiency, safety and liquidity, and that they were to make their own decisions regarding business operations, take responsibility for their own risks, assume sole responsibility for their profits and losses, and exercise self-restriction. At the early stage of reform, however, the whole economy was in transition and government intervention continued to constrain the commercial banks' discretion with regard to business operations.

Although China did not suffer as much as its neighbors from the Asian financial crisis in 1997, in the years that followed the government began to place great emphasis on financial stability and took measures to effectively dissolve financial risks and put the financial sector in order. These measures included strengthening financial oversight and performance, reviewing key financial enterprises, issuing 270 billion yuan[1] of special bonds to increase the state banks' capital, setting up asset management companies to dispose of non-performing loans (NPLs), closing a number of insolvent or poorly functioning financial institutions, and strengthening financial supervision in terms of prudential accounting, a loan classification system and disclosure requirements. In order to mitigate financial risks, the China Securities Regulatory Commission (CSRC) and the China Insurance Regulatory Commission (CIRC) were set up, taking over the supervisory responsibilities for the securities and insurance sectors but leaving the supervision of the banking sector with the PBC.

The Third Plenary Session of the 16th Meeting of the CPC Central Committee decided to turn China's commercial banks into safe and profitable modern financial enterprises with adequate capital, sound internal control and good services. This clarified the requirements for and the direction of the reform of state-owned banks. The Party Central Committee and State Council decided to start share-holding reforms with BOC and CCB on a trial basis by injecting USD 45 billion of capital into the two banks on December 30, 2003. In 2005, the reform was extended to ICBC with USD 15 billion being injected. A full-fledged reform program, including financial restructuring and improved corporate governance, was launched at these banks after recapitalization. Another significant reform implemented in 2003 was the creation of the China Banking Regulatory Commission (CBRC) to take over responsibility for supervising banks, asset management companies, trust and investment companies, and other depository institutions. At that time, the supervisory framework of parallel supervision for separate

[1] The yuan is the unit of the account for the Chinese currency, the renminbi (RMB).

financial industries was established with the release of the *Banking Supervision Law,* the revised *Law of the People's Republic of China on the People's Bank of China* and the revised *Law of the People's Republic of China on Commercial Banks*.

Significant progress has been made in building a sound banking system over the years of reform and opening. By the end of 2004, there were four state-owned commercial banks, three policy banks, 12 share-holding commercial banks, 112 city commercial banks, 681 urban credit cooperatives (UCCs), 32,854 rural credit cooperatives (RCCs), eight rural cooperative banks, seven rural commercial banks, 211 foreign financial institutions, 220 foreign bank representative offices, four asset management companies, 59 trust and investment companies, 74 finance companies, 12 financial leasing companies, three auto financing companies and a large number of post office savings institutions all over the country. The total amount of financial assets of both Chinese and foreign financial institutions amounted to 31.02 trillion yuan. China's banking system remains sound, with total assets, deposits and loans growing steadily, profitability improving and risk control ability strengthened. The banking sector continues to play an important role in resource allocation, channeling savings to investments.

II. The Reform of the Banking Sector

1. Toward commercialization: the share-holding reform of the state commercial banks

After the Asian financial crisis in 1997, the Chinese government made strategic plans to push forward comprehensive reform of the state-owned commercial banks. The measures taken included issuing special bonds to increase the state banks' capital, disposing of NPLs, and promulgating prudential accounting principles and a loan classification system. The state banks also actively engaged in operational mechanism reform, and in improving lending procedures and risk control. The reforms helped the banks to increase capital adequacy ratios, strengthen internal controls and raise profitability.

In September 2003, the State Council decided to start the share-holding reform of the state commercial banks through financial restructuring, internal management reform, operational mechanism transformation and strict supervision, turning the banks into competitive, profitable and modern commercial banks with sound corporate governance, strict internal control, and adequate capital. The reform followed the principle of setting up clear ownership structures, clarifying rights and obligations, avoiding government intervention in enterprise operation, and applying scientific

The pilot share-holding reform of the state commercial banks was carried out based on both the lessons learned from domestic economic and financial reform and international experiences. The reform proceeded in phases, i.e. financial restructuring, disposing of NPLs, setting up the share-holding company and listing on the stock market. The "one bank one policy" rule was applied. On December 16, 2003, with the approval of the State Council, Central Huijin Investment Co., Ltd. (CHIC) was established. CHIC acts as the state's representative in state bank financial restructuring and in providing financing, resolving the long-lasting problem of lack of a concrete representative for state ownership. Related reform policies regarding taxation, wages, social security, state land administration, personnel, business registration, and financial supervision were also put into place. Thanks to the scientific design of the reform plan, clear objectives for each stage, and the active cooperation of related government agencies, the reforms have achieved the intended results.

On December 30, 2003, CHIC injected USD 22.5 billion into BOC and CCB respectively, and later, USD 15 billion into ICBC. In disposing of their NPLs, the banks wrote off the bad assets and auctioned the NPLs to achieve a higher recovery rate. After financial restructuring and disposal of NPLs, the capital adequacy ratios of BOC and CCB reached 8.26% and 11.95%; their NPL ratios declined to 5.12% and 3.70%; profit before provisioning reached 58.5 billion yuan and 60.8 billion yuan respectively; and loan provisioning stood at 78.3 billion yuan and 58.3 billion yuan respectively. The ability of these banks to mitigate risks has thus been improved significantly.

In establishing share-holding companies, BOC and CCB also underwent institutional restructuring and put into place corporate governance and internal control guidelines. BOC established its share-holding company on August 26, 2004 and CCB on September 21, 2004. The share-holders' meetings, boards, supervisory boards and new management teams of the two banks are now in operation. The boards and supervisory boards have taken on the responsibility of reviewing important issues and the management teams have made maximizing share-holder value the operating objective. The two banks are working to improve internal control, risk management, institutional streamlining, operational procedures and personnel management.

At the same time, they are actively seeking cooperation with foreign strategic investors and have entered into cooperation agreements with Bank of America, Temasek, Royal Bank of Scotland, UBS, and ADB.

ICBC's capital adequacy ratio, asset quality, risk provisioning and profitability have witnessed drastic improvements after capital injection and NPL disposal. In taking on the rights and responsibilities of the state share-holder, the Ministry of Finance and CHIC have begun to play a concrete role in corporate governance reform. ICBC became a share-holding company in October 2005.

Positive results have also been seen in ABC's endeavor to improve operation, deepen internal reform, and strengthen risk control, laying a solid foundation for share-holding reform in the future.

2. Strengthening of the local banks: RCCs, UCCs and city commercial banks

RCCs were among the early financial institutions established after the People's Republic of China came into being. Before 1996, ABC oversaw the operation of RCCs. In 1996, the PBC took over this responsibility and invested a lot of resources in revitalizing and supervising these institutions. At the beginning of 2003, the supervision of RCCs was taken over by the CBRC. According to the *Plan for Deepening RCC Reform on a Trial Basis*, released by the State Council on June 27, 2003, reform trials were launched in Jilin, Shandong, Jiangxi, Zhejiang, Jiangsu, Shanxi, Guizhou and Chongqing. The reform followed the principles of clarifying ownership, strengthening discipline, and enhancing service functions. While the local government took the lead and full responsibility for the reforms, the central government provided valuable support in terms of fiscal transfers, taxation policy and funding in the pilot projects. So far, the reform has yielded noticeable results. The resilience and funding of these institutions has strengthened as their capital adequacy ratio and financial performance have improved significantly, and historical burdens have been partially shed. Reforms in ownership, organization, operational system and especially internal control were also carried out. By August 2004 the reform had been extended to 21 municipalities and provinces including Beijing, Tianjin and Hebei. At present, the reform is proceeding smoothly as the performance and services of the RCCs continue to improve.

In 1998 the supervisory authorities started the reform of the UCCs. Reforms included changing the UCCs in the rural counties into RCCs, consolidating and restructuring some UCCs into single legal-person institutions, allowing commercial banks to acquire UCCs, transforming some UCCs into city commercial banks and closing those with high risks. After six years of consolidation and rectification, the number of UCCs had decreased from 3,290 in 1998 to 681 in 2004.

The city commercial banks have a number of comparative advantages, such as having many outlets, and enjoy a high degree of flexibility in their operations. These banks are taking comprehensive measures to improve competitiveness, such as improving corporate governance, introducing foreign strategic investors, enhancing disclosure, and strengthening internal control. In order to reduce the risks facing the city commercial banks, the municipal governments have replaced their NPLs with good-quality assets. As a result, most city commercial banks have raised capital adequacy ratios and liquidity ratios to the levels required by the supervisory authorities.

3. Continued expansion by foreign banks

The business scope and geographical coverage of foreign banks continue to expand. In order to allow them to further expand their scope and to give domestic enterprises greater access to financing, the banks were allowed to do RMB business in 13 cities in 2003, and this number was increased to 18 in 2004. The foreign banks were also allowed to provide RMB services to Chinese enterprises in the above regions.

Cooperation between foreign and domestic banks has witnessed great progress in areas such as financing, settlements, commercial paper discounting, government bond investment, derivatives, syndicated loans, credit card business, trade finance, and so on. Several foreign financial institutions have also invested in Chinese commercial banks, bringing encouraging changes in board operation, risk management, market development and business operations to the latter and gaining market share and customers for themselves.

III. Risks Facing the Banking Sector

At this stage, Chinese banks face credit risk, market risk, operational risk and liquidity risk and are vigilant in improving their risk control capacity.

1. Credit risk

Credit risk arising from NPLs and loan concentration is the major risk to the banking sector. There are several problems that require further action. First, the share of indirect (bank) financing is too high and concentrates credit risks in the banking sector. Measures have been taken to increase direct financing by developing the equity and bond markets. Second, the financing relations between the banks and enterprises need to be further improved. As the major bank customers, if enterprises could improve profitability, debt repayment capacity, asset quality and credibility and reduce defaults after reforms, they could help the banks to lower their NPL ratios. Third, the accounting system and taxation policy need to be improved to reflect the fact that the banks need to take enough provisioning to write off NPLs in order to mitigate risks. Fourth, markets where NPLs can be disposed of and risk products can be traded have yet to be established. These markets are essential for banks to identify, price and transfer risks, and to dispose of NPLs accumulated in the past. Fifth, the intermediaries, such as accounting firms, law firms, assessment agencies, rating agencies and credit reporting agencies, have yet to play the role they should have in providing professional services. More efforts should be made in fostering the development of these intermediaries.

2. Market risk

As China is undergoing interest rate reform, the risks faced by the banking system require special attention. Significant progress has been made in interest rate reform since 2004. The lending rate ceiling and deposit rate floor have been removed and the bands for floating rates widened. However, reform is still in progress here. If the banks cannot charge different lending rates to enterprises with different risk profiles, they may not be able to cover losses, nor can they appropriately price their fee-based services and deposit products. On the other hand, as the banks rely mainly on the interest spread for income, interest rate fluctuations may impact their profitability. They have to put in more effort to develop fee-based businesses and raise the related income share to mitigate the impact of price fluctuations in the market. At the same time, they should pay more attention to macroeconomic research in order to adjust business strategies accordingly to avoid losses.

3. Operational risk

Since many layers of agent and owner relationship exist between bank creditors and share-holders, share-holders and management, as well as between different levels of management, operational risk may easily arise due to malfunctioning of corporate governance and inadequate internal control mechanisms. In recent years, there have been some reforms in internal control mechanisms in the banking sector, for example in risk control, financial management, wage incentives, business procedures and information technology. Efforts have also been made to improve corporate governance. Nevertheless, great challenges remain in the areas of corporate overnance, operational mechanism transformation and internal control.

4. Liquidity risk

The mismatch of RMB deposit and lending maturities has been an outstanding weakness. By the end of 2004, the ratio of mid- and long-term lending to mid-/long-term deposits had risen to 135.4%, 35.4 percentage points higher than the required ratio, reflecting the fact that large amounts of shortterm deposits are used for mid- and long-term lending. In addition, over half of the working capital lending is put to uses other than the intended use. Thus potential liquidity risks deserve due attention.

5. Risk of a sharp turnaround in the economy

In fact, the greatest concern in banking operations is sharp ups and downs in the economy. In a boom, the banking sector usually performs well, with high profits and improved asset quality. Recent years have seen the reduction of NPLs at an annual rate of 3-5 percentage points due to the economic upturn. However, in the event of a recession, NPLs might mushroom. This can be proved by the drastic change in NPLs in Thailand, Korea and Singapore before and after the Asian financial crisis. When a financial crisis happens, the economy slows down and as a result, the NPL ratio usually rises substantially.

Economic cycles are inevitable in a market economy, especially during the transition period. To deal with this, commercial banks should set up high-quality research teams with the ability to make economic forecasts and reach timely judgments on possible fluctuations, so as to maintain good performance during economic upturns, and to carry out preventive measures in downturns to mitigate any adverse impact. In order to effectively keep the commercial banks from creating a large amount of NPLs after the recent reform, the Chinese government should make efforts to control the economic cycles, to prevent the economy from undergoing sharp changes. From the macro-adjustment viewpoint, besides adopting appropriate monetary policy instruments at the right time to prevent sharp swings, asset bubbles deserve special attention and should be avoided if possible. Once bubbles are formed, it is not easy to make adjustments and more efforts will be needed. One example of this is Japan's case. In the case of China, most concerns have been focused on the stock market and real estate market. Nevertheless, asset bubbles might take different forms in China, such as appearing in the manufacturing sector, other processing industries or raw material industries, in the form of excess capacity. If such a situation emerges, it would reflect the imbalance of investment and consumption in relation to GDP. Therefore, macroeconomic management and aggregate analysis could not only help the commercial banks in identifying potential risks, but also help to reduce sharp fluctuations in the economy, thus helping banks to avoid accumulating a large amount of NPLs.

6. Measures to improve banks' risk prevention capacity

International experience suggests that capital adequacy ratios and risk management capacity are the essential risk prevention factors for banks. In this vein, China's banking industry needs to make further efforts. On the one hand, the capital adequacy ratio of some Chinese banks is relatively low, lower than the 8% ratio set by the Basel Capital Accord. Loan provision gaps still exist, and some banks do not have enough provisions to keep up with the rapid increase in lending. International experience also shows that the capital adequacy requirement can not only restrain banks from expanding credit business needlessly, but also encourage them to diversify operational risks by exploring new business areas which do not have a high capital adequacy requirement. China's commercial banks should follow a scientific approach for development, raise their capital adequacy ratios and strengthen their risk prevention capability, through both internal measures, such as improving asset quality and maximizing profit, and external channels like inviting strategic investors and listing on the stock market. On the other hand, they urgently need to set up risk pricing mechanisms and risk control models. With the majority of their income from interest spread, if commercial banks could fully utilize the interest leverage and accurately price the risks of customers, their net spread could enlarge, and therefore profitability could also be strengthened. Accurate identification, measuring, pricing and control of risks are essential for risk mitigation, and also provide the core strength for banks to compete in the market economy. International experiences suggest financial institutions need to invest large amounts of resources to strengthen risk pricing capability, establish sound risk management policy and procedures, and collect adequate data. The risk control mechanisms need to be tested in market fluctuations and economic cycles.

IV. The Evolution of China's Financial Stability Policies

1. Banking supervision

In the past decade, significant progress has been made in strengthening banking supervision, along with the establishment of a supervisory legal framework and the deepening of banking reform. Since 2002, in convergence with the international trend, China's banking supervision has shifted from emphasizing regulatory compliance only to emphasizing both regulatory compliance and risk supervision. Since the establishment of the CBRC in 2003, supervision has become better targeted and the new supervisory concept of "supervision of legal person, risks, and internal control and greater transparency" has been formed; new standards have also been put into place. A five-category classification of loans, the CAMEL rating system and other prudential regulations have been introduced. Corporate governance and internal control mechanisms have become the focus of supervision. Offsite surveillance and onsite supervision complement each other in ongoing prudential supervision. A risk assessment system and an early warning mechanism have also been set up. While improving prudential supervision of financial institutions, the supervisory agencies have also begun to pay attention to balancing the need to maintain financial stability with the need to encourage financial innovation.

International practice suggests that despite the role they play in financial supervision, central banks usually set up different forms of regulatory coordination mechanism with ministries of finance and other supervisory institutions, to share the responsibilities for maintaining financial stability. In China, it is recognized that a coordinated framework including the central bank, the Ministry of Finance, and bank, securities and insurance supervisors, will help to improve financial regulation and maintain financial stability.

2. Deposit insurance system

Many countries set up investor protection systems such as deposit insurance schemes, a securities investor protection fund and an insurance policy-holder protection fund, to protect the interests of investors and enhance their confidence in the financial system. Different countries may have different schemes. Currently, China has a securities investor protection fund and an insurance policy-holder protection fund. Now the conditions for setting up a deposit insurance system have also been put into place.

Since 1997, many deposit institutions have been closed and liquidated. The liquidated assets of these institutions could not repay all the liabilities to individuals. In order to ensure social stability, the government utilized government funds (including local governments' specialized borrowings from the central government) and central bank re-lending in filling in the gap. While this implicit deposit insurance increases the burden of the authorities, it is not conducive to raising the risk awareness of investors, and weakens market discipline on the operation of financial institutions.

The establishment of an explicit insurance system, and utilization of the premium paid by deposit institutions to save the problem institutions, could relieve the government's burdens. Meanwhile, elimination of the implicit government subsidy and establishment of a market-based limited compensation system would strengthen the risk awareness of market participants, who could then make investment decisions based on the risk information of different institutions and allow market discipline to play its role. In addition, imposing different levels of premium based on the risk profiles of the deposit institutions could also help to form the positive incentive mechanism.

China has been well prepared for establishing such a system. First, the gradual deepening of banking reform has set a good micro-foundation. So far, the share-holding reform of the state-owned commercial banks has been bearing fruit; the pilot program of deepening RCC reform has expanded to 29 provinces, municipalities and autonomous regions; and reforms to other financial institutions, like share-holding commercial banks, city commercial banks, UCCs, and trust and investment companies, have also been proceeding smoothly. Both the asset quality and the capital adequacy ratio of China's banks have improved with sounder operations. Second, with progress made in financial supervision, supervisory measures have been strengthened and standardized. Third, the gradual improvement of the financial legislation has formed a good external environment which consists of the *Law of the People's Republic of China on the People's Bank of China,* the *Law of the People's Republic of China on Commercial Banks,* the *Securities Law of the People's Republic of China,* the *Accounting Law of* *the People's Republic of China,* the *Guarantee Law of China* and the *Company Law of the People's Republic of China.* Fourth, the accounting standard of China's banks has been improved to be in line with the international standard. To be listed in international capital markets, commercial banks need to adopt international accounting and supervision standards which will facilitate the gradual adoption of prudential accounting standards. Fifth, since many countries have already set up their own deposit insurance systems, China can benefit from their experience and avoid their mistakes. Sixth, the sustained, rapid and healthy growth of the Chinese economy in recent years with sound financial operations provides a beneficial macro-environment for the establishment of a deposit insurance system. Currently, the PBC, together with other relevant agencies, is actively working on designing a deposit insurance system that will allow positive incentives and market discipline to come fully into play.

3. Lender of last resort

Generally speaking, central banks should only provide liquidity support to financially sound financial institutions which run into liquidity problems that may have systemic impacts, while the fiscal authorities deal with those that have become insolvent and unsustainable and might incur systemic risks. In performing the role of lender of last resort, China's central bank focuses on the following issues:

(a) *Systemic risk prevention*. Systemic risk may result in financial instability and hinder economic growth; therefore, it requires the central bank to perform the role of lender of last resort during times of financial crisis.

(b) *Moral hazard prevention*. The central bank usually performs the role of lender of last resort if the failure of a financial institutions could have systemic effects. For institutions that are in financial difficulties but have no systemic implications, the central bank steps back and lets market mechanisms such as bankruptcy and liquidation play their role. Thus the investors and senior management have to share the cost of and responsibility for their own decisions. The working of market discipline can help to prevent moral hazard.

(c) *Investor protection system*. This system is an important guarantee for a central bank to perform its lender of last resort role. In China's case, a comprehensive investor risk compensation system is not in place. Neither are employment or medical insurance widely available. Therefore, the PBC has to consider whether the closure of financial institutions will result in social instability, in addition to the possible systemic risks. To some extent, the PBC performs a public finance role. To maintain financial stability, an investor protection mechanism will have to be set up, and its relationship with the central bank's lender of last resort role should be well balanced.

(d) *Coordination of monetary policy to prevent inflation*. While acting as the lender of last resort, the central bank should make an effort to conduct sound monetary policy.

Moral hazard should be effectively prevented. In theory, this can be achieved by raising the lending rate, acting as the lender of last resort in a way that preserves constructive ambiguity, encouraging private capital in restructuring financial institutions and strengthening market discipline. In practice, to prevent and diversify risks and maintain financial stability, having the central bank play the role of lender of last resort is not enough; good corporate governance and internal controls, prudential supervision, an investor protection system, and a market-based exit mechanism should also be put into place.