LA LETTRE DU CEPII
CENTRE D'ETUDES PROSPECTIVES ET D'INFORMATIONS INTERNATIONALES
No 248 — September 2005

Are Chinese banking reforms meeting their deadlines?

There have recently been announcements of foreign investments in some of the largest Chinese banks. This opening of the banking sector to foreign investors is part of the new round of the banking sector reforms that was initiated by the Chinese authorities in 2003. Ideally, these reforms should be successfully implemented before further liberalisation of the exchange rate regime and the lifting of most restrictions on foreign banks by 2007, under China's WTO commitments. Since the beginning of reforms, capital has been injected into state-owned banks and non-performing loans have been transferred to asset management companies. Thanks to this recapitalisation, two pilot state banks now exhibit non-performing loan ratios below 6% and capital adequacy ratios of more than 8%. Thus, it looks that state banks are meeting the deadlines that were set by the Chinese authorities for restructuring their portfolios. However, current reforms do not do enough to address problems of moral hazard, and there is no guarantee that the future flow of bad loans will be stemmed.

A Snapshot of the Current Situation

At the end of 2004, the stock of loans granted by financial institutions in China stood at 135% of GDP,[1] while the ratio has been growing by 5% per year since 1995. This makes the Chinese banking sector not only one of the largest banking industries among developed and developing countries, but also one of the fastest growing. Its most important and largest segment consists of four state-owned commercial banks (SOCBs): the Bank of China (BOC), the China Construction Bank (CCB), the Industrial and Commercial Bank of China (ICBC), and the Agricultural Bank of China (ABC). However, the relative importance of these institutions has been declining in recent years, and their share in total loans to non-financial enterprises has decreased from 78% in 1993 to 56% in 2004. During the same period, the share of other commercial banks has grown from 4% to 16%.

Despite its enormous size, the banking sector has barely contributed to the growth of the Chinese economy. Research has shown that the government used the banking sector to allocate capital from more productive to less productive regions.[2] Therefore, most bank loans have been granted not on a commercial basis, but for policy reasons. As a result, loans to state-owned enterprises (SOEs) represented 46% of the total bank credit for fixed investments in 2003, even though SOEs accounted only for 39% of the total fixed investments.[3] Since SOEs are the main borrowers from the Chinese banking sector, their low profitability led to low capitalisation and high non-performing loans (NPLs) within the banking sector, prior to the current reforms.

These reforms started tentatively in mid-1990s, when the State Council called for the commercialisation of banking activity. Before, the banking sector was viewed as a substitute for a state budget, and delinquent borrowers were not under pressure to honour their obligations to banks. Between 1998-1999, the government took steps to improve balance sheets of the four SOCBs by injecting RMB 270 billion of capital into them and by transferring RMB 1.4 trillion of NPLs to Asset Management Companies (AMCs) (Box 1). The idea was to relieve the SOCBs from the NPLs that were made before 1996, when banks were under pressure to allocate credit for policy reasons.

The New Round of Reforms

Despite the 1998-1999 bailouts, the NPLs at the four SOCBs stood at around 30% of the total loans as of end 2001.[4] Therefore, the government made additional pledges to

1. For comparison, the claims of French and German banks on the private sector stood at 92% and 143% of GDP respectively, at the end of 2004.
2. See G. Boyreau & S.-J. Wei (2004), "Can China grow faster? A diagnosis of the fragmentation of its domestic capital market", IMF *Working Paper*, No. 76.
3. The reform of SOEs in China is under way and their role is shrinking. For example, in 1998 the loans to SOEs represented 65% of the total bank credit for fixed investments, and SOES accounted for 54% of the total fixed investments.
4. G. Ma & B.S.C. Fung (2002), China's asset management corporations, BIS *Working Paper*, No. 115.

Box 1 — Recapitalisation/NPL transfer measures undertaken by the Chinese Government

1998	The government injected RMB 270 billion ($33 billion, 3.5% of GDP) of capital into the four SOCBs.
1999	The government established four Asset Management Companies (AMCs): Cinda, Huarong, Orient, and Great Wall. Each AMC was originally matched with an SOCB: Cinda with CCB, Huarong with ICBC, Orient with BOC, and Great Wall with ABC. The AMCs purchased RMB 1.4 trillion ($170 billion, 14% of GDP) of NPLs from the four SOCBs and the China Development Bank. The AMCs purchased the NPL at book value.
2003	The government injected RMB 370 billion ($45 billion, 3.2% of GDP) of capital into CCB and BOC.
2004	Cinda AMC won the auction to purchase RMB 279 billion ($34 billion, 2% of GDP) in NPLs from BOC and CCB, at 50% of book value. Additionally it bought RMB 41 billion ($5 billion) of NPL from Bank of Communications at a 50% discount, funded entirely by a loan from the PBC.
2005	The government injected RMB 124 billion ($15 billion) of capital into the ICBC. The Industrial and Commercial Bank of China signed an agreement with the China Huarong Asset Management Company to transfer RMB 246 billion ($29.6 billion) of bad loans.

Total bailout/transfer amount to date: RMB 2.73 trillion ($332 billion).

Sources: M. Xu (2005), *Resolution of non-performing loans in China*, mimeo; various news releases.

reform the banking sector in order to prepare it for the competition with foreign banks, which should face no restrictions starting from 2007, given China's obligations to the WTO. These reforms have included a number of steps for rehabilitating a virtually insolvent banking sector and improving its corporate governance.

The People's Bank of China (PBC) and the China Banking Regulatory Commission (CBRC), which took over the regulatory functions of the PBC in 2003, have set the following deadlines:

by the end of 2005:

- reduction of the ratio of NPLs at the SOCBs to 15%;
- compliance with the new internationally accepted five-tier classification of loans and sufficient provisions for NPLs;
- public listing of the BOC and CCB with strategic investors, by the end of 2006;
- a capital adequacy ratio of at least 8%;
- lifting all geographical restrictions for foreign banks.

Looking at the progress in restructuring of the loan portfolios in the Chinese banking industry (Table 1), it is difficult to have a complete picture of the NPLs, because the classification rules have been changed repeatedly. In 2002, an internationally accepted five-tier classification system was introduced but very few banks followed it until recently. In 2004, the loan classification system was strengthened again and all banks have been asked to comply fully with it, by the end of 2005. Thus, the data for the year 2003 is assumed to be ambiguous, and the true value of NPLs in SOCBs stood at around 20%. Keeping this in mind, we can observe a significant reduction in bad loans, and at the end of second quarter 2005 the NPL held by the four SOCBs stood at 10.1% of their total outstanding loans.

Table 1 – Non-performing loan ratios (%)

	2003	2004	March 2005	June 2005
SOCBs	16.9	15.6	15.0	10.1
Joint-stock commercial banks	6.5	5.0	4.8	4.7
City commercial banks			11.5	10.4
Rural commercial banks			6.1	6.4
Foreign banks			1.2	1.1
SOCBs and AMCs	24.0	23.5	22.6	18.3

Source: CEIC Data.

This was one of the highest NPLs ratios among all Chinese bank types, but it was already below the target of 15%.

It should be mentioned, however, that credit risk has not completely disappeared, but has mostly been moved to the AMCs, which still hold the majority of NPLs on their books. In return for bad loans, the AMCs issued bonds to the SOCBs, but these bonds have not always been serviced on a timely basis, suggesting that they can also be regarded as non-performing assets.[5] The AMCs in turn have tried to restructure NPLs and sell them to institutional investors (e.g. foreign investment banks such as Goldman Sachs and Morgan Stanley) at a discount. If we combine the NPLs of the banking sector with those remaining with the AMCs, the level of NPLs is still high at 18%, but there has been a reduction of 6 percentage points since 2003.

The health of the three SOCBs varies significantly (the data for the Agricultural Bank of China is not available because of its low level of transparency). The BOC and the CCB exhibited NPL ratios of 4% and 5% at the end of 2004, and have raised their capital levels above 8%, achieving adequate coverage of NPLs loan loss provisions (Table 2). However, these improvements have been mainly the result of capital injections and transferals of NPLs to the AMCs, since their own profitability has remained low. The situation for the ICBC has improved slightly but its NPL ratio stood at 19% of the total loans at the end of 2004 and loan loss provisions covered only 4% of NPLs. In addition, all banks have tried to "settle" some of their NPLs, which means that borrowers reimbursed their debt with assets (real estate, non-circulating equity shares, machines and other physical assets) rather than with cash. This led to decreases of NPLs but increases of "settled assets". Since the cash recovery rate of these assets is about 41%, they can be also considered non-performing, raising the ratio of NPLs by around 1 percentage point.

The Chinese authorities have shown determination to continue to clean up the portfolios of the remaining two SOCBs. In April 2005, the recapitalisation of the ICBC took place, during which the government injected RMB 124 billion ($15 billion) of capital, while an agreement to transfer

5. S. Barnett (2004), Banking Sector Development, in "China's Growth and Integration into the World Economy: Prospects and Challenges", *IMF Occasional Paper* No. 232.

RMB 246 billion of bad loans to Huarong AMC was reached in May. Standard & Poor's estimates that further recapitalisation of the ICBC and the ABC would cost the Chinese government $110-190 billion, depending how conservative loan loss provision and capitalisation assumptions are. The restructuring of the banking sector (capital injections and transfer of NPLs) has already amounted to 28% of GDP, which is high in comparison with other countries.[6] For the capital injections that have taken place since 2003, the Chinese authorities have drawn funds from their foreign exchange reserves, which stood at 40% of GDP at the end of 2004.[7] So the $45 billion looked like a small blip in the rising trend of the foreign reserves. However, one should also add the financing costs of the AMCs. The fact is that the cash recovery rate for NPLs by the AMCs stands at around 20%, and therefore the AMCs will not be able to honour their obligations to the Ministry of Finance and the PBC.

Table 2 – Performance indicators for individual SOCBs (%)

	BOC		CCB		ICBC	
	2002	2004	2002	2004	2002	2004
NPLs ratio	23.4	5.1	15.2	3.9	25.4	19.0
Provisions/NPLs	15.3	68.0	10.1	61.6	1.8	3.6
Extra provisions (low) in % of capital	121	-1.8	135	1.8	256	240
Extra provisions (high) in % of capital	127	4.4	146	7.6	291	302
Capital Adequacy Ratio	8.2	10.0	9.9	11.3	5.5	N/A
Return on Assets	0.33	0.61	0.14	1.3	0.13	0.04

Source: Annual reports, author's calculations.

Extra provisions are calculated on the basis of the law that has to be implemented by the end of 2005. Negative numbers indicate that actual provisions exceed the required ones.

Reforms Beyond Recapitalisations

The positive development of the loan portfolio quality outlined above does not rule out the possible flow of new bad loans in the future. International experience shows that recapitalisation of the banking industry cannot be successful without its restructuring and improved regulation and supervision. The Chinese experience with the 1998-99 restructuring program also underlines the problem of moral hazard that is inherent in partial reforms. During the first round of bailouts, the Chinese authorities did not solve the incentive problems and did not restructure banks and SOEs, so that soft lending practices were continued. In this context, it should be also mentioned that the banking reform might lead to the closure of some inefficient SOEs, which could have negative consequences for social and political stability in the country. Since there is no sound social safety net in China, the authorities are likely to proceed very cautiously, creating more moral hazard problems.

In this respect, plans to publicly list SOCBs are a welcome step. On October 27, 8% of the CCB was floated on the Hong Kong Stock Exchange. The decision to list abroad is important for a country with poor shareholder protection since it is viewed as a credible way to impose good corporate governance structures on listed companies. This initial public offering is expected to be followed in 2006 by the floating of the BOC, and by ICBC in 2007.[8] There are also a number of other positive developments. The authorities have indicated that they would allow a few small, ailing banks to go bankrupt, to put pressure on bank managers to improve their risk management.[9] The regulatory and supervisory environment was improved by tightening rules on loan loss classification, provisioning, and minimum capital adequacy. Additionally, disclosure requirements have been increased, particularly for listed banks.

Recently, there have been a number of announcements by international banks that have decided to invest in Chinese banks. Most importantly, the BOC and the CCB have attracted foreign investors such as the Royal Bank of Scotland and the Bank of America, that decided to buy around 10% of capital in each bank, respectively.[10] Of course, the best effect would be achieved if foreign investors took over large shares of SOCBs, since this would solve the problem of soft budget constraints and bring risk management expertise to banks. However, the existing restrictions, such as a 20% equity share limit for a single foreign investor, and a 25% share limit on total foreign ownership of a single bank, make this impossible. Taking into account these limits, the effect of foreign ownership will depend on the ability of foreign investors to change the corporate culture of the acquired institutions. It will also be important for the Chinese authorities to resist the temptation to interfere with the banks' governance.

The most worrying feature of the Chinese banking market is the rapid growth of loans (Figure 1). Between 2001-2004, total loans of the financial institutions grew by 58%. The quality of the lending will be only visible in a few years, since 60% of the extended loans were medium and long-term. Particularly strong growth was exhibited by consumer loans and mortgages, which grew from virtually zero in 1997 to 10.5% of total loans in 2004. Mortgages account for 80% of

6. For comparison, the average fiscal costs of banking crisis resolutions in different countries equal about 15% of GDP. The Czech Republic incurred some of the highest costs in Central and Eastern Europe, which amounted to 25% of GDP. Indonesia's costs after the Asian crisis are estimated at a level of 55% of GDP. Among developed economies, the worst hit countries have been Finland (1991-94) and Japan (1991-present), whose fiscal costs are estimated at 11% and 24% of GDP. See more in G. Caprio & D. Klingebiel (2003), *Episodes of systemic and borderline crises*, World Bank database.

7. See M. Aglietta & B. Rzepkowski (2004), "The Asian Central Banks and the dollar", *La Lettre du CEPII*, n° 230, January.

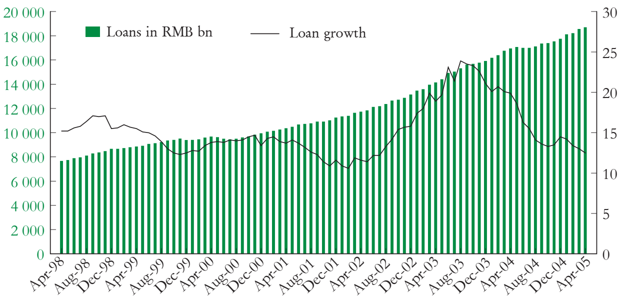
8. This paragraph has been changed with respect to the French version of Lettre du CEPII, due to rapid developments in China and delay between publication of French and English versions.

9. This speculation was prompted by the recent announcement of a regulation on compensation for investors in financial institutions that go bankrupt. The government pledges to compensate individuals fully up to RMB 100,000 and 90% for amounts above this threshold. No compensation will be available for institutional investors.

10. At the end of 2004, there were 13 banks with foreign capital and 156 foreign branches. The share of foreign bank assets stood at 3% to the total amount of bank assets, but it has increased significantly in such cities as Shanghai, where it stood at 12%.

household loans, which exposes the banking sector to property prices.[11] Rapid loan growth of the last years may lead to an increase in NPLs in the future, because during such periods loan monitoring becomes impossible due to the large number of contracts. Consequently, financing is extended to projects with low or even negative present value. Not surprisingly, the empirical literature documents that high real growth in loans is a significant determinant of banking crises.[12] The situation may be exacerbated in China where banks lack credit risk assessment skills and are poorly supervised.

Figure 1 – Loans of financial institutions in RMB bn and loan growth in %



Source: CEIC Data.

The liberalisation of interest rates and its impact on banks' lending behavior deserves special attention. The liberalisation started gradually in 1990s and entered its final stage in 2004, when the upper band on lending rates and lower band on deposit rates were lifted (the lower limit on the lending rate and higher limit on the deposit rates are still in place). This gives Chinese banks the opportunity to price their loans in accordance with the riskiness of their borrowers and provides an incentive to develop new customers, especially among small and medium-sized private enterprises. Numerous studies document that despite higher profitability and efficiency, private and collectively owned enterprises[13] are excluded from the credit market in China and have to rely on self-financing. At the same time, the liberalisation of interest rates also increases the need for sound credit risk management in order to be able to price loans differently for good and bad clients. The problems of adverse selection will become especially severe when the artificially low band on deposits rates is removed, and banks will have to raise their deposit and lending interest rates. Even a modest interest rate rise might lead to a deterioration of the performance of SOEs and decrease their ability to repay loans.

Finally, the importance of banking reform before further liberalisation of the exchange rate regime and the capital account should be mentioned. Appreciation of the yuan could have a negative impact on Chinese banks' health for two reasons. First of all, banks can be influenced directly, since they have positive net foreign asset positions (partly due to the recapitalisation that was carried out in foreign exchange). Second, appreciation might make it more difficult for exporting clients to repay loans, and thus indirectly affect banks' portfolios as well. Further opening of the capital account might also have negative consequences, since it could lead to a withdrawal of funds by some depositors from Chinese banks, and as a result this would raise interest rates.

To sum up, the Chinese authorities have made progress in cleaning up two of the four largest Chinese banks, and are determined to continue injecting additional capital into the remaining two banks. The banks seem to be on the way to meeting the target of a 15% NPL ratio, sufficient provisions, and a 8% capital adequacy ratio. However, these reforms have not been accompanied by a sufficient restructuring of the banks, which creates additional moral hazard problems. Thus, there are questions about the quality of management and the incentives for the SOCBs, credit risk management of the lending boom of the last years, and restrictions on foreign bank ownership, which would shelter Chinese banks from the foreign competition.

Olena Havrylchyk
olena.havrylchyk@cepii.fr

11. In March 2005, the PBC dropped the preferential interest rate of 5.31% on housing loans. In addition, the new rules allow commercial banks to raise their downpayment demand from 20% to 30% in the areas where real estate prices have risen sharply. These measures should lead to slower growth of mortgages.
12. A. Demirguc-Kunt & E. Detragiache (1998), "The Determinants of Banking Crises: Evidence from Developing and Developed Countries", *IMF Staff Papers*, Vol. 45, No. 1.
13. Collectively owned enterprises are *de jure* owned by local governments. However, they are often viewed as a political shelter for privately-financed and privately-owned enterprises that register as collectives, to avoid complicated registration procedures, heavy levies and less preferential treatment than state companies. As discrimination between state and private enterprises disappears, collectively owned enterprises become registered as private.

LA LETTRE DU CEPII

EDITORIAL OFFICES

Centre d'études prospectives
et d'informations internationales,
9, rue Georges-Pitard
75015 Paris.
Tél. : 33 (0)1 53 68 55 14
Fax : 33 (0)1 53 68 55 03

PUBLISHER:
Lionel Fontagné
Director of the CEPII

CHIEF EDITOR:
Agnès Chevallier

TRANSLATION:
Nicholas Sowels

DTP:
Laure Boivin

DISTRIBUTION:
La Documentation française.

SUBSCRIPTION only to the original, French version.
(11 issues per year)
France 48 € VAT
Europe 49.70 € VAT
DOM-TOM (NET, econ. air mail)
49 € NET
Other countries (NET, econ. air mail)
49,50 € NET

Please send your orders to:
La Documentation française,
124, rue Henri Barbusse
93308 Aubervilliers Cedex
Tél. : 33 (0)1 40.15.70.00

WEB site: **www.cepii.fr**
ISSN 0243-1947

CCP n° 1462 AD
3rd Quarter 2005
September 2005

Imp. ROBERT-PARIS
Imprimé en France