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Chinese Banking Reform Requires Greater Competition

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The government of the People's Republic of China is accelerating reform of state-owned commercial banks, institutions that play a critical role in the nation's financing. Successes have been achieved in transforming these banks into joint-stock corporations after splitting off their non-performing loans, then accepting foreign equity and listing their shares on the Hong Kong and mainland stock markets. Despite this progress, however, more time promises to be required to establish a system of effective corporate governance. It will be no easy task to improve the makeup of an industry that has been shielded by regulated interest rates and other protectionist policies to a level capable of enduring global competition.

Continuing to Play a Vital Role

There are four state-owned banks in China that were transformed into commercial banks with the reforms carried out from the end of the 1970s – the Industrial and Commercial Bank of China Limited, the China Construction Bank Corporation, the Bank of China Limited and the Agricultural Bank of China. For the Industrial and Commercial Bank, the focus of this transition was placed on industry and commerce financing; for the Construction Bank Corporation, on infrastructure related financing; for the Bank of China, on trade and foreign exchange related operations; and for the Agricultural Bank, on loans to agricultural communities. Although reforms and open-door policies have led to the birth of joint stock format banks and the development of branches by foreign-owned banks as well, the state-run commercial banks continue to play a vital role in China. They accounted, in fact, for 51 percent of the aggregate assets of financial institutions at the end of 2006.

It was originally hoped that after being transformed into commercial banks these individual banks would come to manifest financing brokering functions. In reality, however, regional governments acted to control the decisions on investments by state-owned companies and other players, with the banks basically continuing to furnish financing in accordance with those intentions. Also coming to pass were shakeouts in companies that fell into slumps with the reforms of state-owned businesses, with the swelling of the non-performing loans of government-run commercial banks emerging as a problem.

The Chinese government injected capital into the banks from the end of the 1990s, and also established a state-owned asset management company to transfer control over one part of the non-performing loans. With China's subsequent joining of the World Trade Organization (WTO) from 2001, Beijing issued a public pledge to open up its financial markets at the end of 2006. This meant that Chinese banks would be exposed to competition with their foreign counterparts, making reform an even more pressing issue.

From 2003 through 2005, the government worked through special companies to infuse a combined total of \$60 billion in foreign currency reserves into three of the commercial banks – the Bank of China, the China Construction Bank and the Industrial and Commercial Bank. This process was accompanied by the reorganization of these three banks as joint stock companies, and the introduction of foreign capital. The Industrial and Commercial Bank, for instance, positioned Goldman Sachs, American Express and Allianz as “strategic investors,” and accepted financing of \$3.7 billion from those companies.

From 2005 into through 2006, the three banks listed their shares on the Hong Kong and Shanghai markets. In the case of the Agricultural Bank of China, however, the non-performing loans balance was quite large, with the fact that the business base consisted of agricultural communities also blocking attempts to embark on real reform.

Low Business Efficiency, High Non-performing Loans Ratios

I want to compare the financial conditions of these banks in their post-reform days to the major Japanese banks (Table). While the total assets of the Industrial and Commercial Bank, the largest of the Chinese commercial banks, exceed those of the Sumitomo Mitsui Financial Group, the other three banks rank lower than the big Japanese banking groups. Nevertheless, the numbers of employees at the Chinese banks far exceed those of the Japanese institutions, and being soundly inferior in terms of employee per-capita after-tax profits (the benchmark for business efficiency).

Table Comparison of China’s State-Run Commercial Banks and Major Japanese Banks

	Bank of China	CCBC	ICBC	ABC	Mitsubishi UFJ FG	Mizuho FG	Sumitomo Mitsui FG
Total assets (\$100 million)	6823	6977	9616	5769	15859	12692	8540
Employees	232,632	297,506	351,448	478,895	37,611	27,213	16,407
Per-employee after-tax profits (\$10,000)	2.65	1.99	1.77	0.02	19.83	19.32	22.78
Core capital ratio (%)	11.44	9.92	12.23	—	7.59	6.96	6.42
Non-performing loans ratio (%)	4.04	3.29	3.79	26.17	1.80	1.80	1.80
ROE (%)	12.6	14.0	10.4	1.3	15.0	16.7	13.1
Net interest spread (%)	2.28	2.69	2.29	—	0.13	0.21	0.58

Notice: CCBC is China Construction Bank Corp. ICBC is Industrial & Commercial Bank of China. ABC is Agricultural Bank of China.

Source: Prepared by the author based on settlement reports from each bank. Figures for the Bank of China, the China Construction Bank Corp. and the Industrial & Commercial Bank of China are for the year ended December 2006. Figures for the Agricultural Bank of China are for the year ended December 2005. Figures for Japanese financial groups are for the year ended March 2007.

Although the employee statistics for Japanese banks do not include contracted or temporary workers, even when compared with the figures for the previous year (which do include those categories) the employees of the state-owned commercial banks still number two to nine times those of the Japanese banking groups.

Per-employee after-tax profits are around one-fourth the level of the Japanese banks. While it is true that the Chinese banks have developed branch networks throughout that vast nation, the sluggish progress being made in personnel streamlining is painfully conspicuous. As a result of the injection of capital, although the core capital ratios (Tier 1) expressing financial security exceed those of the Japanese banks (the figures for the Agricultural Bank remained undisclosed), the non-performing loans ratios continue to run high. The non-performing loans ratio is particularly lofty for the Agricultural Bank, and that bank's return on equity (ROE) is low.

While the other three Chinese banks compare favorably with the Japanese groups in earning power, these earnings are largely the outcome of protectionism under regulated interest rates. Net interest spread are four to 20 times those of the Japanese banks, which means that increased financing will create profitable operations. The expansion in bank financing based on this scheme is one of the factors that have invited the trend toward overheated investment in recent years.

Regulated Interest Rates are a Hotbed for Corruption

While foreign capitals investing in China's state-run banks have sent in personnel and set forth on business reforms, it would appear that more time will be required to establish effective corporate governance. Against the background of protection under the umbrella of regulated interest rates, the pocketing of bribes for financing has literally become institutionalized in China. According to the China Banking Regulatory Commission, the number of bank "commercial graft cases" unmasked in 2006 was 113 incidents. The number of personnel involved in these crimes was tracked at 164, with the amount of kickbacks doled out reaching 26.08 million yuan (approx. 390 million yen). The state-run commercial banks accounted for 55 of these transgressions, with the amount of bribes estimated to be 20.22 million yuan (300 million yen).

There is even corruption among the top executives of these banks, with Zhang Enzhao (former chairman of the Construction Bank Corporation) and Wang Xuebing (who served as president of both China Construction Bank Corp. and the Bank of China) receiving prison terms for illicit doings in that vein. For that matter, the Chinese Communist Party continues to meddle in the selection of top managers for the state-run commercial banks, keeping the way in which these institutions are managed a far cry from independent.

Foreign companies have made investments in the state-owned commercial banks with hopes of using the nationwide branch networks of these banks as footholds for advancing to the massive Chinese market. However, with their equity stakes in such banks capped at 25 percent, it is impossible for the foreign concerns to seize any meaningful management rights. Meanwhile, although China lived up to its promise to the WTO and fully opened up yuan-based business operations at the end of 2006, the need remains to establish local companies at a capital scale of 1 billion yuan (approx. 15 billion yen) or above. In addition to this, such local subsidiaries must hold the percentage of their financing to no more than 75 percent of their savings deposits – a requirement that poses a major hurdle for the Japanese banks (which have yet to truly solicit personal savings products in China).

In striving to improve China's financial system, the local authorities need to promote competition by liberalizing interest rates, abolishing limits on foreign equity stakes and taking other steps geared to cultivate an environment geared to support the advance of sweeping business improvements in the nation's state-run commercial banks.

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