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Reforming China's Banking System: How Much Can Foreign Strategic Investment Help?

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The problems of the Chinese financial system, and particularly of its banks, have been well known. Since the reform era began in 1978, steady progress has been made in transforming the financial system, despite which some core problems of the financial system remain unresolved:[1]

- *The financial system is unbalanced and underdeveloped.* The securities markets are dwarfed by a banking system that is large measured against Chinese GDP, and deep—by the same measure—even when compared with developed economies. The banking system dominates the financial system, even under circumstances and during periods in which technically bankrupt banks might have been lending to inherently more creditworthy companies. In addition, state-owned agencies control both the financial and capital markets.

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[1]Appendix I provides a chronology of reform from 1978.

- *The financial system is under-supported.* Institutional structures that provide support, such as rating agencies, accounting and audit bodies, credit and collateral registries, information systems and associated information technology, and the legal system are in their infancy. The institutions supporting the financial system have yet to develop sufficiently to provide an adequate framework for efficient and effective financial intermediation. The support provided by the legal system remains especially problematic, with particular concerns about contract enforcement, recovery of collateral, adequate standards of disclosure, and the vexed issues associated with bankruptcy and creditors' rights.
- *The banking system is inefficient.* In terms of both cost and allocation efficiency the performance of banks leave much to be desired. The banks are hugely over-staffed, and their overly extensive branch networks contribute heavily to their high operating costs. Their portfolios owe little to market-based assessments of the creditworthiness of their borrowers, and the result of the largely policy-based direction of their lending is very high levels of nonperforming loans (NPLs).
- *The banking system is potentially fragile.* As a legacy of central planning, the state-owned commercial banks (SCBs) are burdened with massive NPLs, which, if measured rigorously, imply that the SCBs are technically bankrupt, though that concept might have little meaning in a system in which the banks and most of their clients are state owned. Moreover, under no feasible assumptions could the SCBs reconstitute their ca pital by growing their way out of trouble. And further, even if freed from the obligation to prop up shaky state-owned enterprises (SOEs), there is every reason to question whether the four SCBs could rapidly reduce loan losses to acceptable levels, because of both a dearth of banking skills and the lack of a credit culture that emphasizes timely servicing of bank loans and supports efforts to recover collateral or other assets in cases of default.

These problems are generally attributable to the policies of the government and the lack of financial expertise residing in domestic financial institutions. But considerable efforts have been made in recent years to reduce the impact of all of the deficiencies outlined above; compared with any past year, the situation in 2005 shows general, across-the-board improvement.[2] And what has become evi-

[2]The next section and Appendix I describe some of the main accomplishments of financial reform to date.

dent, especially since China acceded to the World Trade Organization (WTO), is that the government has become increasingly willing both to amend its policies and to entertain (at least) partial foreign ownership of Chinese banks in order to improve their performance and competitive position. In some cases, policy changes seem to have as their main objective the encouragement of foreign investment in the Chinese banking sector. The Chinese government and foreign investors seem to agree that engaging the expertise of international strategic partners has the potential to improve virtually every dimension of Chinese banks' performance—overall governance; control and management of operations; introduction and marketing of new products; enhancement of asset quality; comprehensive, timely and accurate compilation of management information; better management of risk; stronger capital positions and better returns on equity; and rehabilitation of the banks' reputations.

In 2004–05, with the WTO deadline less than a year and a half away, much government focus and foreign investment interest developed around three of the four major SCBs, as well as several of the smaller banks. The introduction of foreign strategic investment holds tremendous promise for the on-going reform of the Chinese banking system, and both international investors and Chinese banks can potentially forge a mutually beneficial partnership. Nevertheless, the expectations of the foreign investors, of the broad spectrum of Chinese banks, of the Chinese government, and of its regulators might diverge. Moreover, a number of factors such as regulatory restrictions that limit foreign ownership to a minority interest, foreign investors' inability to gain meaningful control and influence over the Chinese banks, and possible cultural clashes increase the likelihood of initially uneasy partnerships, which could take some years to deliver the results that all parties hope to achieve.

Table 2.1 outlines the pros and cons of investment in Chinese banks from the viewpoint of the foreign investor. Even if the foreign investor is committed to entering the Chinese banking sector via a minority equity investment in a local bank, three distinct strategic possibilities present themselves depending on whether the investor wants to begin with a clean slate in a "greenfield" bank; take advantage of the huge distribution networks of the big four SCBs, despite their dubious asset quality and governance practices; or adopt an intermediate approach. Each option has advantages and disadvantages. However, if the Chinese concern is to enable the indigenous banking industry quickly to become competitive, stimulating foreign participation in the big banks seems to be the

Table 2.1. Potential Targets of Foreign Investors

Investment Target	Pros	Cons
Greenfield banks (e.g., Bohai Bank)	Clean slate Easy to infuse international best practices Attractive upside potential	Need time to build Inability to own more than 20 percent; difficulties in finding compatible domestic partners
Smaller banks (e.g., joint-stock banks; city commercial banks)	Fewer legacy assets Smaller capital commitment Faster growth Better governance and transparency Potential flexibility in sharing management control	Limited franchise and distribution network Complex shareholder structure and often more difficult decision-making processes Often unrealistically high price expectations and tougher negotiation positions
Big Four SCBs	Immediate access to extensive nationwide distribution systems Meaningful strategic cooperation in attractive business segments (e.g., credit and other cards, consumer finance) Significantly escalate investor's position in China through a single investment	Massive legacies in asset quality and operational systems Large capital commitment required for meaningful stake and associated uncertainties about ability to influence management decisions High political sensitivities regarding deal terms/face issues in relation to foreign players' share of national franchise

most attractive option.[3] The issue is how to make that also an attractive option from the viewpoint of the strategic investor. (Table 2.2 highlights strategic investment in Chinese banks to date.)

China's Banking System: Progress in and Priorities for Reform

The two most striking features of the Chinese financial system are the extraordinary size of monetary assets relative to GDP and the comparative lack of development of the securities markets when compared with the size of the banks. By the end of 2004, the ratio of money and quasi-

[3]Appendix Table 2.A2.1 shows that very rapid growth in the assets of foreign-funded banks in China during the past three years (2002–05) has raised their share in the assets of financial institutions only from 1.5 to 1.9 percent. After all restrictions on the foreign banks' activities are eliminated in December 2006, their market share might be expected to grow somewhat faster. Nevertheless, improved performance of the banking system as a whole will be a slow process if it relies solely on the growing role of foreign banks.

money (M2) to Chinese nominal GDP was 1.85,[4] a startlingly high figure even compared with those commonly found in developed economies. By then, total deposits with financial institutions were renminbi 24.1 trillion yuan, and lending by them was Y 17.8 trillion.[5] The People's Bank of China (PBC) reports that, at the end of June 2005, deposits (in both local and foreign currencies) in all financial institutions totaled Y 28.3 trillion and local currency deposits alone were Y 26.9 trillion.[6] Using comparable data from the end of 2003, deposits with financial institutions amounted to Y 20.8 trillion, compared with Y 3.4 trillion in bonds of all kinds,[7] and Y 4.2 trillion in total market value of stocks listed in the Shanghai and Shenzhen exchanges.[8] Bank lending has continued to grow rapidly in the ensuing two years, while the capital markets have dawdled.

Yang (2004, Table 2) presents data on the evolving shares of lending by financial institutions and the outstanding balance of negotiable securities. She estimates that the share of bank loans in combined assets fell from 90.4 percent in 1991 to 81.7 percent in 2001.[9] The corresponding figure for end-2003 was 77.3 percent (Y 16 trillion of a total of Y 20.7 trillion).[10] Even with the massive bond issuance of the central Government and the PBC's sterilization activities in recent years, China's debt markets still comprise predominantly bank loans, which are about five times as large as the value of outstanding bonds. Recent experiments in liberalizing lending rates for bank loans, including provisions in 2004–05 that give banks considerable freedom to adjust lending rates, have had little effect on bond yields,

[4]World Bank (2005) p. 8. The ratio was only 0.37 in 1980.

[5]PBC Annual Report (2004).

[6]People's Bank of China, 2005. "Financial Industry Performance Remained Stable," http://www.pbc.gov.cn/english/

[7]Data on bonds and stocks are from China Statistical Yearbook (2004); other data from PBC (2004). Bonds outstanding at end–2003 comprised 52 percent central government bonds, 35 percent financial bonds (mainly the policy banks and asset management companies), 10 percent PBC bills (issued primarily to sterilize foreign currency inflow) and 3 percent corporate bonds (almost all issued by state-controlled enterprises or entities).

[8]Only about 30 percent of listed shares are tradable; the remainder comprises government held and/or legal person shares. The Y 4.2 trillion total market capitalization for 2003 is as reported in the 2004 Statistical Yearbook. The CSRC website reported that the market capitalization of listed stocks fell to Y 3.9 trillion in August 2004, only Y 1.2 trillion of which was accounted for by tradable shares, and further to Y 3.71 trillion in December 2004 and Y 3.16 trillion in June 2005. (See http://www.csrc.gov.cn/en/statinfo/index.)

[9]Yang, Ya-Hwei, 2004, "Development and Problems in China's Financial System," Discussion Paper No. 04-E-06, Taiwan Study Center.

[10]China Statistical Yearbook 2004.

Table 2.2. Strategic Investments in Chinese Banks

Bank	Profile	Strategic Investor(s)	Date Complete	Deal Size (US$ million)	Investment as Percentage of Company	Key Terms
Ningbo Commercial Bank	City commercial bank	OCBC	Jan 2006	71	12	NA
Industrial and Commercial Bank of China	The largest commercial bank in China Assets of Y 5.59 trillion, end-2004	Goldman Sachs, Allianz, and American Express	Jan 2006	3,800	10	One board seat Extensive cooperation in corporate governance, treasury operations, risk management, asset management, and human resource training, etc.
Tianjin City Commercial Bank	City commercial bank	ANZ Banking Group	Nov 2005	120	19.9	NA
Nanjing City Commercial Bank	City commercial bank	BNP Paribas	Oct 2005	87	19.2	NA
Shenzhen Development Bank	Fourteenth largest bank	GE Consumer Finance	Oct 2005	100	7	NA
Huaxia Bank	Regional bank	Deutsche Bank	Oct 2005	325	14	NA
Bank of China	Second largest commercial bank in China Assets of Y 4.27 trillion, end-2004	Royal Bank of Scotland and coinvestors	Aug 2005	3,048	10	Various cooperation in credit card, corporate business, personal insurances, etc. One board seat
		Temasek	Aug 2005	1,524	5	Committed to acquire no less than US$500 million worth of shares during IPO One board seat

China Construction Bank	Third largest commercial bank in China Assets of Y 3.91 trillion, end-2004	Temasek	July 2005	1,466	5.1	Committed to acquire no less than US$1.0 billion worth of shares during IPO Facilitate CCB's restructuring One board seat
		Bank of America	June 2005	2,500	9.1	Cooperation includes corporate governance, risk management, information technology (IT), finance management, etc. Board seats Approximately 50 BOA employees going to CCB to provide consulting services Option to purchase additional shares in future to increase ownership up to 19.9 percent
Bo Hai Bank	Newly established bank	Standard Chartered	Sept 2005	123	19.9	Right to nominate vice chairman of board
Hangzhou City Commercial Bank	Regional bank	Commonwealth Bank of Australia	April 2005	76	19.9	Board seats Technical Assistance Agreement
Bank of Beijing	Regional bank	ING	Mar 2005	215	19.9	Two board seats Potential cooperation in retail banking
Ji'Nan City Commercial Bank	Regional bank	Commonwealth Bank of Australia	Dec 2004	17	11	One board seat
Xi'an City Commercial Bank	Regional bank	Bank of Nova Scotia	Nov 2004	7	5	Rights to increase ownership to 24.9 percent in 4 years
		IFC	Same as above	19.9	12.5	NA

Table 2.2 *(concluded)*

Bank	Profile	Strategic Investor(s)	Date Complete	Deal Size (US$ million)	Investment as Percentage of Company	Key Terms
Minsheng Bank	Only private-sector bank in China Tenth largest bank	Temasek	Oct 2004	106	4.55	None
		IFC	Same as above	23.5	1.2	NA
		Hang Seng Bank	Same as above	NA	8	NA
Bank of Communications	Fifth largest bank	HSBC	Aug 2004	1,747	19.9	HSBC to have two board seats Cooperation on credit cards with plan to establish credit card joint venture subject to regulatory approval
Shenzhen Development Bank	Fourteenth largest bank	Newbridge Capital	May 2004	149	17.9	Half board seats Controlling management position
Industrial Bank	Thirteenth largest bank	Hang Seng Bank	Dec 2003	208	15.98	One board seat Plan to explore cooperation in credit cards and consumer
Shanghai Pudong Development Bank	Ninth largest bank Franchise concentrated in Shanghai region, China's richest city	Citibank	Dec 2002	72	5	To set up ring-fenced credit card unit, with goal to form credit card JV once regulation allows One board seat; Citi to run credit card operation Transfer of best practices in risk management, IT, and marketing

Nanjing City Commercial Bank	City commercial bank	IFC	2002	27	15	NA
Bank of Shanghai	Top-tier city commercial bank	HSBC	Dec 2001	62.6	8	One board seat Loose business alliance in credit card, consumer finance, and corporate finance Jointly launched co-branded credit card for HSBC customers (not profit-sharing)
		IFC	Same as above	50.3	7	NA

Sources: Federal Reserve Bank of San Francisco *Asia Focus* (July 2005); Hope/Hu presentation “Foreign Investment in Chinese Banks” (2nd NCER-SCID Conference at Tsinghua University, April 28, 2005, and 4th SCID China Conference at Stanford University, October 1, 2005); Bottelier testimony “The General Health of China’s Banking System” to the United States-China Economic and Security Review Commission (August 11, 2005).

Note: Profile size rankings are based on asset size.

which are remarkably similar irrespective of maturity. Bank deposit rates as well as bond yields are still largely administered.[11]

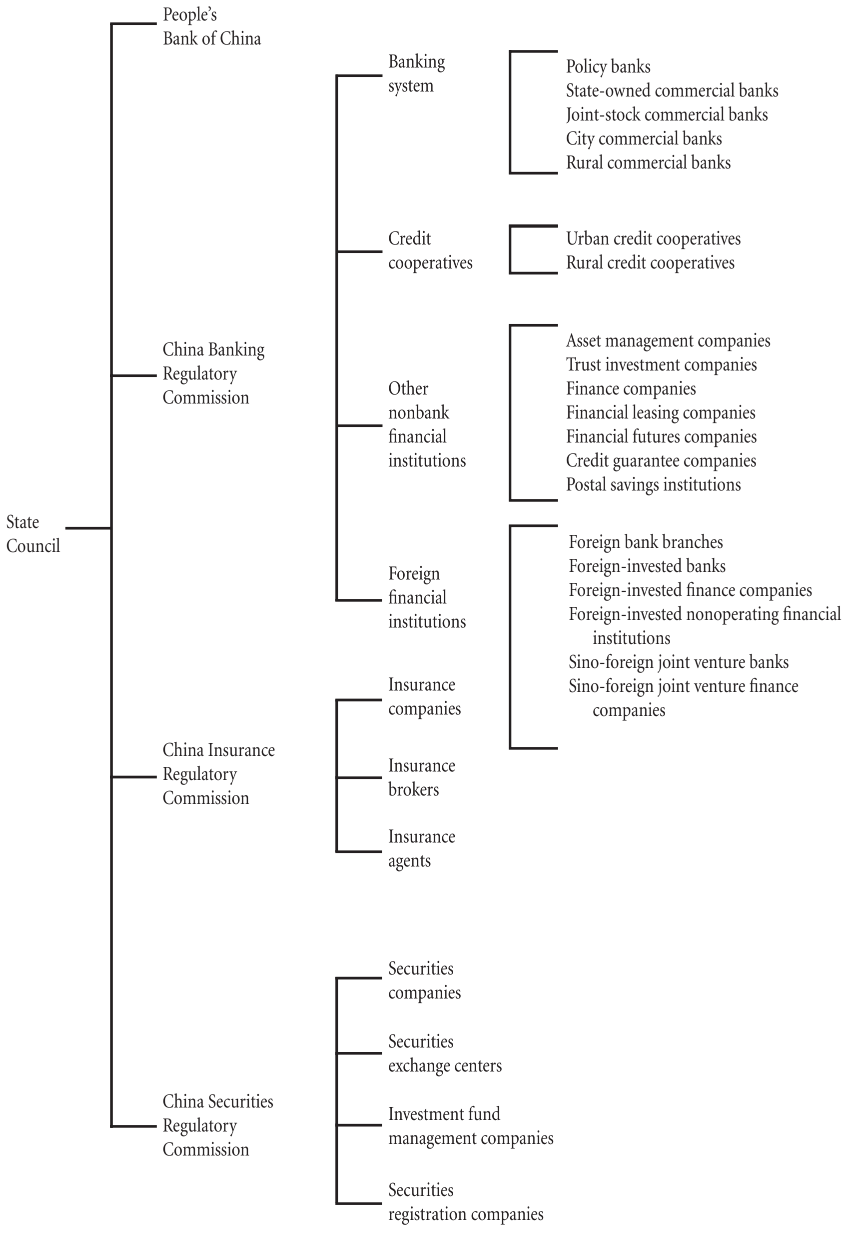
Figure 2.1 presents an overview of the structure of China's financial system and Figure 2.2 a more detailed structure of the banking system. Although strictly speaking the asset management companies (AMCs) are nonbank financial institutions, they are included as part of the banking system, given the role that they continue to play in assisting in the resolution of the major SCBs' nonperforming assets. Appendix II provides supplementary selected data on the banking system. The numbers of actors in the financial system change frequently, but Figure 2.2 lists the main classes of banks and nonbank financial intermediaries with recent reports of their numbers.

Within the banking system, the new century has seen a decline in the dominant position of the four main SCBs. They accounted for more than 60 percent of the assets of financial institutions (excluding the People's Bank of China) in 2001, when three of them—the Industrial and Commercial Bank of China (ICBC), the Bank of China (BOC), and the China Construction Bank (CCB), in that order—were among the 50 largest global banks, and all 4 (the other being the Agricultural Bank of China, ABC) were in the top 10 banks in Asia by asset size (Solvet 2002). They continued to account for 60 percent of banking assets at the end of 2003. The SCBs, together with the state policy banks (since 1994) and the four AMCs that were set up in 1999 to deal with some of the bad loans on the books of the four main SCBs and one of the policy banks—the China Development Bank (CDB), overwhelmingly compose the core of the Chinese banking system, even allowing for the rapid recent emergence of many smaller banks and increasing activity from foreign banking interests.[12] But as a result of that emergence and the activities of the policy banks and AMCs, the share in assets of the four major SCBs fell sharply during 2004 and the first half of 2005 (Appendix Table 2.A2.1), reflecting both the very rapid growth in lending by China's smaller banks in the boom of 2003–04, and the successful efforts of the SCBs to reduce their NPLs during that period. By the middle of 2005, the

[11]Pieter Bottelier (2005b) has observed that a motivation for freeing lending rates was the growing extent of informal lending. Especially in Zhejiang, the practice of drawing down bank deposits to lend directly to enterprises apparently has become widespread.

[12]The policy banks (in order of asset size) are the China (State) Development Bank, the Agricultural Development Bank of China (ADBC) and the (much smaller) Export-Import Bank of China, which together have total assets less than ABC, the smallest of the major SCBs. The AMCs and their original partner banks are: Cinda–CCB and CDB; Great Wall–ABC; Huarong–ICBC; and Orient–BOC. Beginning in 2004, the AMCs have begun to compete to acquire NPLs from the banks.

Figure 2.1. Structure of the Chinese Financial System



Sources: Solvet (2002) and Yang (2004).

Figure 2.2. Structure of the Chinese Financial System

State Council

Regulatory Institutions

The People’s Bank of China
(est. 1984)
Governor: Zhou Xiaochaun

China Banking Regulatory Commission (CBRC)
(est. 2003)
Chairman: Liu Mingkang

Banking Institutions

Policy lending banks (3)
(since 1994)
Agriculture Development Bank of China
Export Import Bank of China
China Development Bank

“Big Four” state-owned commercial banks (SOCBs)
(since 1980s)
Industrial & Commercial Bank of China (ICBC)
China Construction Bank (CCB)
Bank of China (BOC)
Agricultural Bank of China (ABC)

Other Commercial Banks

Joint-stock banks (JSCBs) (11)
China Merchants Bank (CMB)
Shanghai Pudong Develop. Bank (SPDB)
Hua Xia Bank (HXB)
Fujian Industrial Bank (FIB)
Senzhen Development Bank (SDB)
CITIC Industrial Bank (CIB)
China Everbright Bank (CEB)
Bank of Communications (BOCO)
Guangdong Development Bank (GDB)
China Minsheng Banking Group (CMBG)
Hengfeng Bank/
Yantai Housing Saving Bank (YHSB)

City commercial banks (CCBs) (112) (since mid-1990s)

Luoyang	Huangshi	Hu’hehaote	Yichang	Hengyang
Changsha	Taizhou	Zibo	Jinhua	Zhenijang
Quanzhou	Nantong	Yinchuan	Jingzhou	Fuxin
Ma’anshan	Xiamen	Ningbo	Chongqing	Xianyang
Nanchong	Huzhou	Huaiyin	Cangzhou	Weihai
Fuzhou	Shenzhen	Qingdao	Liaoyang	Yantai
Luzhou	Shaoxing	Wenzhou	Zhengzhou	Wuxi
Nanjing	Tianjin	Dalian	Xiaogen	Rizhao
Hefei	Xi’an	Chendu	Shenyang	Huaibel
Daqing	Jiaxing	Shi’jiazhuang	Zhanjiang	Guangzhou
Dongguan	Kunming	Wuhan	Dandong	Langfang
Yangzhou	Guilin	Xiangtan	Foshan	Jiujiang
Beijing	Hangzhou	Nanyang	Qing’huangdao	Zigong
Wuhu	Xinxiang	Nanchang	Ganzhou	Xining
Ji’nan	Linyi	Weifang	Yingkou	Xuzhou
Baotou	Jinzhou	Lanzhou	Anshan	Shantou
Bangbu	Jiaozuo	Wanxian	Leshan	Anqing
Guiyang	Nanning	Deyang	Kaifeng	Qi’qihaer
Pan’zhihua	Yueyang	Mianyang	Changchum	Hu’ludao
Shanghai	Ha’erbin	Tangshan	Zhuzhou	Baoji
Wulumuqi	Zhunyi	Yancheng	Jilin	
Suzhou	Changzhou	Datong	Zhuhai	
Liuzhou	Lian’yungang	Taiyuan	Fushun	

Rural commercial banks (3)

Foreign banking institutions (191)
(at end of 2003)
157 branches
11 sub-branches
15 subsidiaries
(incorporated locally with 8 branches)

Credit Coopertives

Rural credit cooperatives (RCCs)
(since 1980s) 35,544

Urban credit cooperatives (UCCs)
(since 1980s) 758

Nonbank Financial Institutions

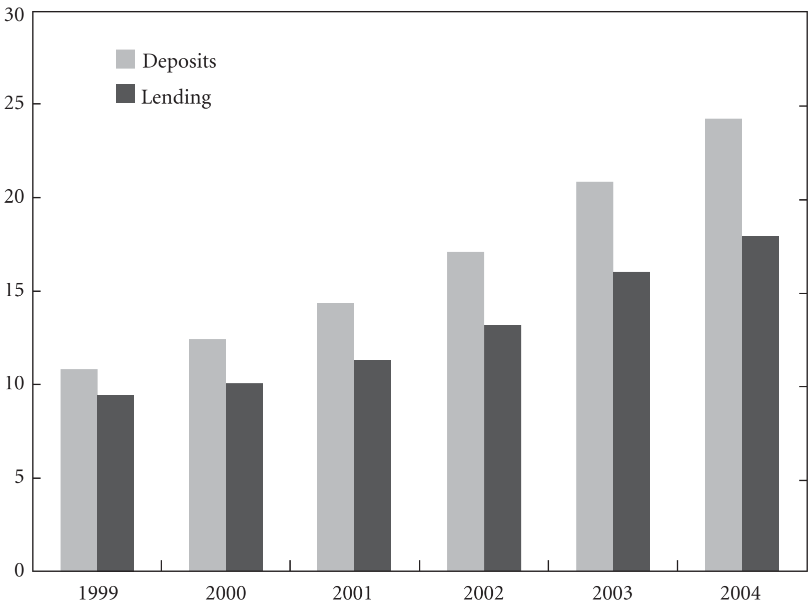
Trust and investment coporations (TICs)
(since 1980s) 59

Other nonbank institutions
finance companies, financial leasing companies, financial futures companies, credit guarantee companies, postal savings institutions, etc.

Asset management companies (AMCs)
(since 1999) 4
Cinda
Great Wall
Huarong
Orient

Sources: Solvet (2002); Garcia-Herrero and Santabarbara (2004); and Hefferman and Fu (2005).

Figure 2.3. Deposits and Lending Growth
(Trillion yuan)

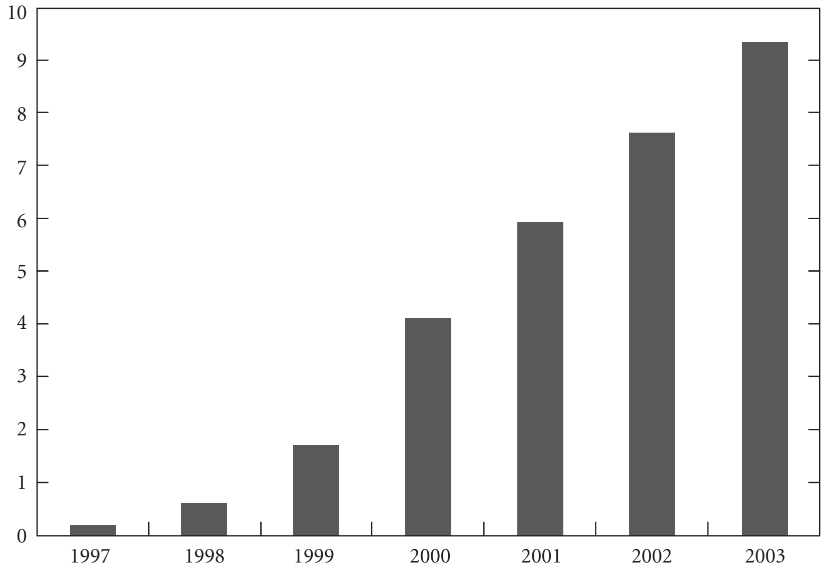


Source: PBC Annual Reports, 2003 and 2004.

share of the SCBs in total bank assets had fallen to 53 percent, though they continued to control more than 60 percent of bank deposits Bottelier (2005b).

Figure 2.3 shows how deposits in, and lending by, financial institutions have evolved over recent years and illustrates the exceptionally rapid growth in 2001–04 when deposits increased by 67 percent and lending by 59 percent. During this period, as the four major SCBs have taken a comparatively more conservative stance with respect to asset acquisition, the major increase in assets share has been attributable to the rise of "other financial institutions," mainly policy banks, trust and investment companies, securities companies, insurance companies, and AMCs, which accounted for one-seventh of total assets (as did the second-tier commercial banks) by the end of the first quarter of 2005. A noteworthy feature of loan growth during the lending boom of the past three years is that, as reported in footnote 3, the rapid growth in the assets of foreign-invested banks still left their share of system-wide assets below 2 percent at the end of March 2005. As a consequence, the ability of foreign banks

Figure 2.4. Growth of Consumer Loans
(Consumer loans as percent of total loans)



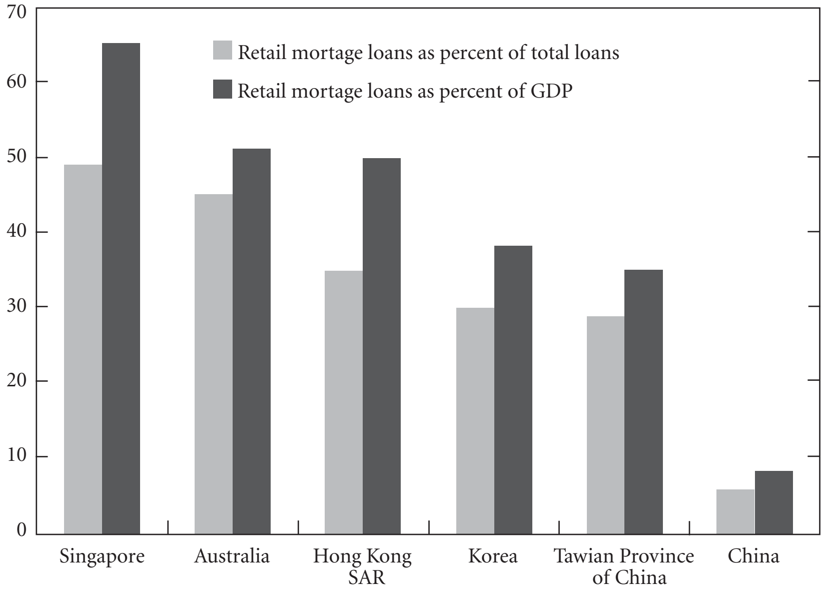
Source: PBC, brokers' research estimates.

to transform China's banking system through a rapid increase in market share appears limited compared with what might be accomplished if they could help to transform the performance of the established domestic banks, especially of the four big SCBs.

Another striking feature of the banking system over the past several years is the emergence of consumer lending, predominantly mortgage finance but also finance for purchase of consumer durables (automobiles) and credit cards. Figure 2.4 shows how rapidly the share of consumer lending in total loans has been rising: from virtually zero percent in 1997–98 to more than 9 percent in 2003. Bottelier (2005b) reports that consumer lending exceeded 11 percent of the banks' portfolios by the end of 2004 and, allowing for loans of working capital to farm households, total loans to households reached almost one-sixth of total bank lending in 2004. Nevertheless, when compared with other economies, as illustrated in Figure 2.5, China lags in the share of mortgage loans in bank assets.

The rapid growth of consumer lending has helped reduce the share of NPLs in the SCBs' portfolios, but the development is too recent to judge reliably the longer-term effects on loan performance and portfolio quality.

Figure 2.5. China's Under-Penetrated Financial Markets, 2002



Sources: Various central banks; CEIC; brokers' research estimates.

Even after the elimination of the credit plan, the SCBs were still required to allocate the bulk of their lending to SOEs, many of which were loss-making, and used bank credit to meet current obligations to their workers and pensioners with scant concern for repayment. Until the advent of the AMCs, the SCBs remained hamstrung by the legacy of the plan and, even thereafter, NPLs were variously estimated (in 2002) to comprise one-quarter to one-half of their portfolios. The official figure generally fell at the bottom of the range; at the end of 2003, the PBC reported NPLs at Y 1.9 trillion, or one-fifth of outstanding loans of the SCBs. Solvet (2002, p. 41) put the figure at about one-third of outstanding loans, and assumed a recovery rate of about 20 percent (consistent with the experience of the AMCs) to calculate projected system-wide losses of about 30 percent of GDP in 2001.[13]

The combination of massive capital injection, transference of the NPLs of the SCBs to the balance sheets of the AMCs, and extremely fast growth

[13]The recovery rate is gross; after allowing for operational and other costs of the AMCs, the net rate would be considerably lower and the system-wide losses correspondingly higher.

in lending in 2002–04 has allowed the large SCBs (except the ABC) rapidly to reduce the shares of NPLs in their portfolios. The official aggregate ratio for the SCBs' NPLs was 31 percent at end-2001, about 26 percent at end-2002, 20 percent at end-2003, and under 16 percent at end-2004.[14] Appendix II provides recent figures from the CBRC that estimate the NPLs of major commercial banks (SCBs and joint-stock commercial banks) at Y 1.16 trillion at the end of the first half of 2005, or 8.8 percent of total outstanding loans.[15] Setting aside concerns about the accuracy of the official figures (because some analysts still put the NPL ratios far higher), one might question whether banks are going about reducing their NPLs in the right way. Massive loan write-offs are unavoidable, as is the need to inject more capital to establish adequate capital bases for the SCBs, but one can question the wisdom of doing so before banks are free to make decisions based solely on commercial considerations. In addition, much of the recent improvement in banks' portfolio performance might be attributed to financial restructuring measures and the youth of their portfolios rather than to fundamental improvements in their lending practices.

[14]Recent years have seen rapid reductions in the reported NPL ratios of the banks, despite the introduction of a more rigorous system of loan classification (see footnote 15). Barnett (2004) reports the NPL ratios for BOC, CCB, and ICBC as 16, 9, and 21 percent, respectively, at the end of 2003. The ratio for ABC was unavailable but known to be much higher. He notes as well the "substantial amount of special mention loans" that also threatens to become nonperforming (see Barnett, 2004, p. 48). Gilligan (2005) notes that the government's estimates of the NPL ratio for major commercial banks in China, including the four big SCBs, amounted to Y 1.7 trillion (US$240.7 billion) or 13.2 percent at the end of September 2004, down 4.6 percent from the preceding year. The BOC separately reported an NPL ratio of 4.6 percent as of October 2004, down from 5.2 percent at the end of September 2004 and 16.3 percent at the beginning of that year. The CCB reported an NPL ratio of 3.7 percent at the end of September 2004, the lowest among the four large SCBs. Bottelier (2005b, p. 9) reports similar figures and indicates that, as a result of recapitalization and other measures, the NPL ratio for ICBC fell from 19 percent at end-2004 to 4.6 percent at mid-2005. His figure for the ABC NPL ratio is 35 percent at end-2004. Also see Appendix II, Table 2.A2.4.

[15]China's loan classification system was amended from a four- to a five-category system in 2001. Under the earlier system, criteria for recognizing loans as sub-standard, impaired, or lost were lax. The new system conforms much better to international standards (the Basel accords), but there is no way to determine how rigorously the standards are applied in practice or whether they are applied uniformly to all banks. There is little evidence to show how the system has been affected by the establishment of the CBRC to exert regulatory and supervisory oversight of the banking system; these functions had been the responsibility of the PBC. Bottelier (2005b) notes that, beginning in late 2005 or in 2006, the CBRC will require minimum provisioning requirements linked to the five-category loan classification system.

The rapid increases in consumer lending notwithstanding, both in access to bank credits and in issuance of bonds, borrowers other than the government and SOEs are severely disadvantaged. The debt markets still have far to go before they conform to the ideal of competitive markets. Lending to private enterprises has continued to be a comparatively minor activity of the SCBs, partly because of their concerns about their portfolios and partly—at least until very recently—because they have had insufficient flexibility to set interest rates at levels that would make such lending profitable when adjusted for transaction costs, monitoring costs, and risk. There are problems, too, in securing adequate information about prospective clients' credit history and loan-servicing records, and the extent to which collateral pledged to secure loans is unencumbered. Recovering collateral in the event of default is further complicated by inadequate protection of creditors' rights under the commercial law.

An unavoidable conclusion of analysis of the Chinese banking system is that system performance could be greatly enhanced if the performance of the SCBs could be improved rapidly. In that regard, one might have to accept that the SCBs are too big to fail and at the same time question whether they are also too big to reform. The government has embarked on bold steps since its announcement early in January, 2004, that it was injecting US$45 billion from the PBC's international exchange reserves as new capital to the BOC and CCB, with half of the funds going to each. A company, Central Huijin Investment Ltd., was established to hold the equity in the two banks (at that time, its only asset), and its board comprises officials from the PBC, the State Administration of Foreign Exchange, and the Ministry of Finance. A similar measure was adopted for ICBC in the first half of 2005, with Huijin providing US$15billion of new capital and the Ministry of Finance (MOF) retaining another US$ 15 billion of old equity in the bank. At the same time, ICBC's balance sheet was boosted even more by the disposal of an additional US$85 billion in NPLs to the AMCs and elsewhere.

The injection of funds has dramatically improved the SCBs' balance sheets. Many governance issues remain to be resolved, however, and even more radical solutions might be needed to improve the performance of the SCBs and permit them to compete on an equal footing with foreign banks by the second half of this decade. This is one of the key considerations behind the government initiative to seek strategic foreign partners who could inject new capital along with management and financial expertise to establish sound practices in China's commercial banks.

Progress in Reform

The remaining weaknesses of its financial system notwithstanding, over the 25 years of the reform era China has made considerable progress toward introducing a functioning financial system. In the gradual Chinese fashion, a persistent process of reform has begun to improve the structure of the system, to enhance the role of banks in resource allocation, and to build the institutions needed to underpin a modern, market-friendly financial system. Appendix I provides a selective chronology of financial sector reform, again with major emphasis on the banks; therefore the discussion here can be comparatively brief.

The main thrusts of banking reform since 1978 are:

(1) the establishment of a separate central bank—the PBC;
(2) the establishment of commercial banks independent from the monobank;
(3) the introduction of capital markets, specifically the Shanghai and Shenzhen stock exchanges;
(4) the introduction of independent regulators for the securities markets, insurance industry and banks, all of which report directly to the State Council;
(5) the introduction of policy banks to free the commercial banks from the obligation to support state priorities;
(6) the restructuring of the SCBs, including the introduction of the AMCs to deal with some of the non-performing assets of the SCBs and the policy banks;
(7) the phased introduction of market forces to allocate credit, with the abolition of the credit plan and gradual removal of controls on lending rates; and
(8) the recent preparations for competition from foreign and joint venture banks, after accepting the conditions for accession to the WTO.[16]

In none of these areas is reform complete; rather, progress continues to be made on all fronts as emphasis shifts and the timing of individual reforms has differed. The listing of reform areas conforms more or less to the chronological order in which they were initiated.

Because much of the early progress in reform is well known and well documented (see also Appendix I), comments here are limited to developments in the past few years. Since the turn of the century, the PBC, which had already been established as the central bank and relieved of

[16]For an alternate presentation of reforms by sub-period since 1979, see Yang (2004).

all of its commercial banking activities as well as its obligation to finance the government, has seen its responsibilities for oversight of the soundness of China's banks pass to the CBRC. As a result, the PBC now retains three chief functions: implementation of monetary policy, management of China's international reserves and exchange rate, and maintenance of stability of the entire financial system. Given that the three independent regulatory agencies report directly to the State Council, as does the PBC, how the PBC will interact with those agencies and discharge its mandate to guarantee financial system stability (with the possible exception of serving as the system-wide lender of last resort) is uncertain, though progress to date is encouraging.

Since its inception in April 2003 as the third financial regulator, the CBRC has taken action on several fronts. With an eye on the WTO deadline, the CBRC has emphasized the urgent need to restructure China's banks, especially the big four, and has encouraged foreign investment in those banks as a way to advance that objective.[17] At the same time, domestic and private investors have been urged to buy shares in the banks as part of a range of measures that should improve their governance and elevate their operational efficiency. The CBRC also has introduced measures to deal with the dysfunctional rural credit cooperatives and to develop rural (and city) commercial banks. Within a short period, the CBRC has gained considerable credibility as a modern, forward-looking regulatory body.

Impressive, too, is the rapid progress that has been made in the financial restructuring of the BOC, CCB, and ICBC. The urgency attached to this process is understandable with January 2007 looming, but the speed with which nonperforming assets have been removed from these three banks and their capital augmented is startling. The banks also have moved aggressively to reduce redundant employees and close unprofitable branches: between 2000 and 2003 the main banking institutions reduced their total employment by 8 percent and their total branches by a quarter.[18] The four big SCBs took even more aggressive action, with their total employment falling by 185,300 (11.6 percent) over the period, despite a small expansion in staffing at the ABC, and their branches by 32,418 (26.8 percent). The underlying thrust of restructuring is to equip banks to compete with foreign banks, which increasingly enjoy the freedom to challenge domestic banks across the full range of their activities. Market forces are slowly being introduced as lending rates are liberalized, though

[17]In this area, the CBRC clearly is taking its lead from the State Council.

[18]The data include the PBC, the big four SCBs, the policy banks and the JSCBs. See Appendix B and *China Statistical Yearbook 2001* and *2004*.

administrative control over the banks remains strong and most observers still regard credit allocation as only partly market-determined.

The policy banks essentially have failed to play the role initially envisaged for them, even though the CDB, in particular, has financed a growing share of centrally mandated infrastructure projects. The commercial banks still seem to be constrained to provide credit under government direction, and they are expected partially to finance the policy banks by buying their bonds.

Priorities in Reform

With reform moving forward on virtually every front, identifying priorities might seem somewhat arbitrary. From our viewpoint, however, the government should be concentrating on five areas to improve the performance of China's banks and of the overall financial system:

- better overall governance,
- better balance between the financial and capital markets,
- more effective regulation and supervision,
- more reliance on market forces, and
- a more supportive legal system.

The objective in improving *governance* should be to enable banks to make decisions based solely on commercial considerations and to free them from the influence of government officials and other bureaucrats. Two key required reforms are the introduction of truly independent, expert executive boards to oversee the work of the senior management of the banks, along with the freedom for boards and managers to appoint senior personnel based on merit and performance, rather than political affiliation. Just as in the reform of the enterprise system, an essential requirement for successful reform of the banks is to put them at arm's length from governments.

Better *balance between the financial and capital markets* would facilitate this objective, at the same time contributing to more robust capital markets, which would better serve the needs of long-term institutional investors and of enterprises and governments seeking access to long-term capital. Commercial banks should be under no compulsion to acquire the bonds of the government, the policy banks, or the AMCs, nor should they be obligated to make loans to the infrastructure companies organized and owned by subnational governments as a substitute for those governments' inability to raise funds through bond issuance. The development of active primary and secondary markets in corporate bonds as well as bonds of subnational governments deserves more emphasis from Chinese poli-

cymakers. A host of complementary reforms would be needed—everything from reputable, independent rating agencies to fiscal reforms and improved financial management at the level of provincial and municipal governments.

In its short life, the CBRC has established credibility as the *regulator and supervisor* of the banking system. Its efforts to complete the restructuring of the major SCBs have been commended previously, as has the cooperation that seems to have developed between the CBRC and the PBC. The priority for the CBRC is to train sufficient skilled bank examiners to ensure that the new classification system for asset performance is implemented effectively throughout the banking system and that banks apply the system appropriately in provisioning for bad loans and writing down their capital as losses occur. Along with the PBC, the CBRC can assist banks by developing comprehensive credit and collateral registries. In addition, the CBRC should become a strong voice in advancing the banks' rights to seniority among claimants for the assets of failed enterprises.

Increasingly, *market forces* should be allowed to determine the outcome of credit allocation and the discipline that banks and the capital markets apply to borrowers and listed companies, respectively. Currently, banks still seem somewhat reluctant to take advantage of the flexibility they have been granted to vary lending rates according to the risks and costs associated with serving different classes of borrowers. Given time, that can be expected to change, at which point limited flexibility in setting deposit rates also should be introduced.[19]

In addition, more reliance should be placed on the market to determine when enterprises, including banks themselves, should be required to exit their markets. The ultimate consequence of sustained, poor financial performance should be bankruptcy, with the assets of the failed endeavor being apportioned amongst claimants according to appropriate seniority of claims. The government and the chief financial regulators recently have seemed bent on accelerating the use of the market to dispose of NPLs. The AMCs are now allowed to compete with each other to acquire NPLs from banks that offer them, and measures were introduced in August 2005 to foster recovery of bad loans made by the PBC itself (Appendix I).

Better performance of the financial markets also will require significant improvements in the *legal system*, including both how the legal code is written (with the bankruptcy law an excellent example) and how it is enforced and implemented. At the heart of the necessary reform is the

[19]Newspaper reports in 2005 suggest that banks are beginning to vary lending rates according to the risk and other characteristics of borrowers.

need for China's legal system to define, protect and dispose of property rights in a cost-effective manner.[20] Without assurances that they can recover their assets in a timely way and at acceptable cost in the event of default, banks will continue to be reluctant to lend to small private enterprises. But the absence of such lending is one of the principal impediments to the sustained dynamism of private enterprise in China; its continuing absence poses a threat to fast growth over the longer term. Greater efficiency, transparency and predictability in the functioning of the legal system would be an invaluable aid to Chinese banks.

Encouraging Strategic Foreign Investment in Chinese Banks

To what extent can foreign strategic investment in China's banks promote those reform priorities? Whether because of China's entry into the WTO or for other reasons, the Chinese government has become much more receptive recently to foreign investment in China's banks and Chinese banks have actively sought strategic investment from foreign banks (see the list in Table 2.2). As emphasized above, having guaranteed that foreign banks can compete with domestic banks under identical conditions beginning in December 2006, the government apparently has decided that foreign participation in domestic banks via equity investment promises to be an effective way of enhancing their competitiveness. China seems to view foreign participation as compatible with the state's overall control of the banks and as a potentially valuable source of assistance in (1) promoting bank restructuring, (2) enhancing banking skills through business cooperation, (3) supplementing equity capital, without recourse to the fiscal budget, and (4) boosting the status of Chinese financial institutions in domestic and foreign capital markets.

Promoting Bank Restructuring

Chinese bankers and banking officials now seem to view foreign involvement as a highly cost-effective way to obtain an expert review of an individual bank's business capacity. Before taking an equity position in a Chinese bank, and as an essential part of the valuation exercise, the foreign investor will want to review the bank's financial position, the scope and nature of its operations, and how it incurs and manages the risks in its portfolio. The investor will analyze the bank's operating and funding

[20]This point is emphasized by Sheng, Geng, and Wang (2004).

costs, and will assess the soundness of the bank's provisioning practices and handling of problem loans. It will form a view of the expertise of the bank's officers and the extent to which the bank's performance can be improved through better training of the existing staff or by hiring people with better skills.

Armed with that knowledge, the strategic partner will then be well placed to help the management of the bank in the restructuring activities that are underway in all Chinese banks as they endeavor to improve their performance in preparation for December 2006 and thereafter. The banks can also anticipate help identifying profitable new lines of business. In particular, the strategic partner can call on its experience in international banking to help the domestic bank introduce state-of-the-art risk management systems and a management information system that provides accurate, timely information about the bank's performance. In addition, it can supply knowledge of how to measure the performance of the bank's personnel and how to structure incentives to induce and to reward better performance. Finally, if the domestic owners (still mainly governments) are willing, the foreign partner can help to set up corporate governance structures appropriate for successful banks in a market economy.

Cooperating in Business Activities

Beyond imparting the knowledge of how to restructure the Chinese bank to secure better performance, the foreign investor can contribute concretely to such a restructuring by becoming involved in the ongoing business activities of the bank. A major contribution can come through the direct secondment of skilled officers from the investor to participate in the business operations of the Chinese bank. Officers of the domestic bank can learn firsthand how an international financial institution deals with all aspects of lending, funding, containing risks, and so on. In addition, the foreign partner can supply expertise to help recommend new information systems and technology, to teach techniques for managing risk, and to train personnel.

Through participation in the business activities of the domestic bank, officers of the foreign partner will be able to transfer knowledge of, and build skills in, marketing and product development. They will be able to assess the need for specialized recruitment and training to help improve the management of the bank's human resources. And, if permitted, they can demonstrate by example how the governance structures should function in a modern, market-oriented, commercial bank.

Supplementing Equity Capital

Most East Asian governments have used offerings of stock in state-owned companies mainly as a way to secure additional capital. Better performance through improved governance of publicly listed companies has been at best an afterthought, and little concern has been shown for the interests of minority shareholders. China has been no exception to this; although in the case of strategic investors in the banks, the government appears legitimately interested in boosting performance through their involvement. However, an injection of capital still is clearly an important motivating factor in seeking a foreign partner in domestic banks, even if not to the same extent as in the proposed IPOs for the big SCBs. As shown in Table 2.2, the amounts of money injected in the acquisitions have been substantial, especially for Hongkong and Shanghai Banking Corporation's (HSBC's) acquisition of 19.9 percent of the Bank of Communications (BoCom, US$1.75 billion),[21] and Bank of America's 9.1 percent of CCB (US$3 billion). In these and the other cases, the injection of new capital substantially augments the capital bases of the recipient banks.

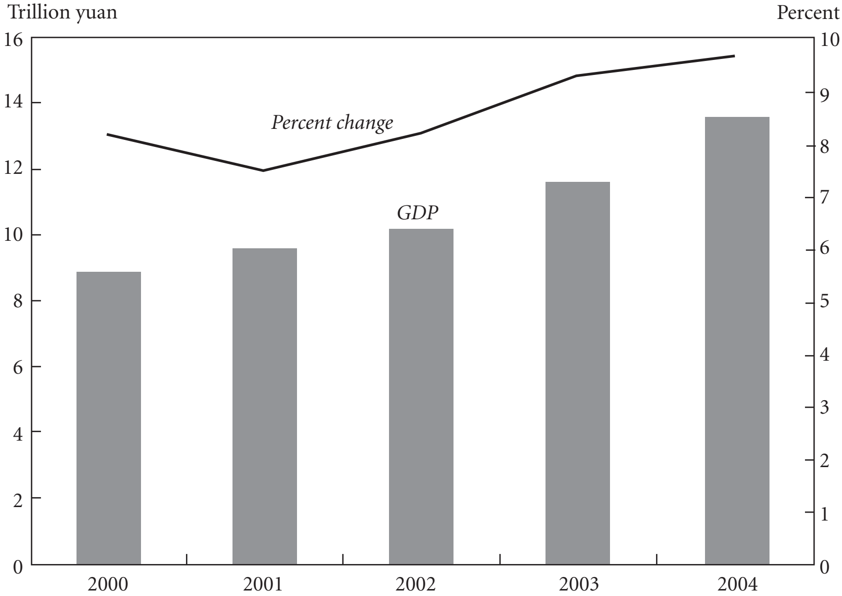
Wooing the Capital Markets

Last, but most definitely not least, entering into a strategic partnership with a foreign banking group can do much to enhance the public image of a Chinese bank. Despite their huge size, the four main SCBs are not well known outside China, and none would be regarded on its own as anything remotely approximating a blue-chip stock in major international capital markets. But with a stakeholder of impeccable reputation in tow, the Chinese bank can raise its credibility and its reputation markedly. The audited statements of a CCB or BoCom will have much greater authority if they have passed muster in the eyes of Bank of America or HSBC.[22] Prospective shareholders are likely to attribute more validity to disclosed information, as well as to actions taken

[21]Appendix D provides a case study of the HSBC investment in BoCom, with an emphasis on the progress of the transaction and the advantages it provides to both parties. Although the investments listed in Table 2.2 represent almost US$16 billion of additional capital for Chinese banks, a considerable sum, they remain small compared with the additional capital (US$60 billion) that the government has provided three of the big SCBs through Huijin.

[22]There is increasing awareness among Chinese listed firms, including the banks, of the value of reputable audits of their financial statements. Many firms have engaged the major international accounting houses to conduct audits and to certify the validity of their income statements and balance sheets.

Figure 2.6. Chinese GDP Growth



Sources: PBC Annual Reports, 2003 and 2004.

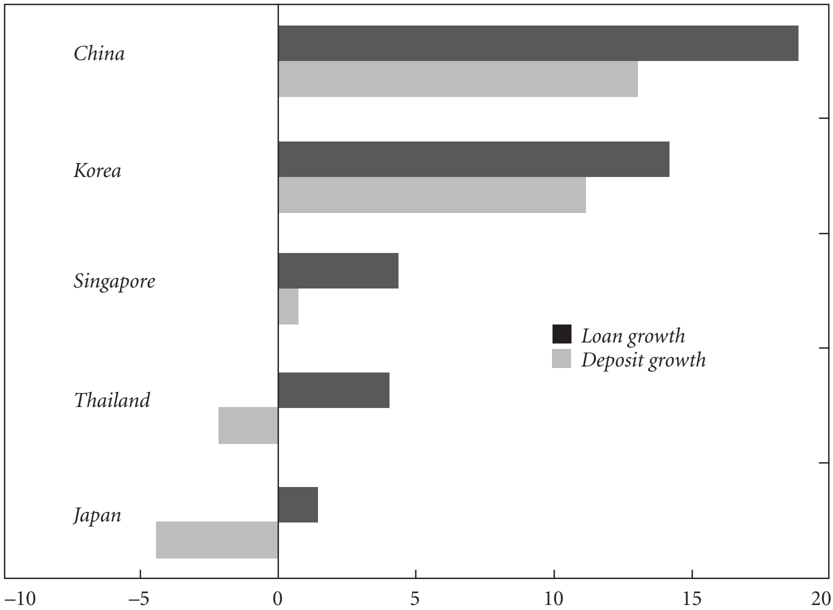
to restructure the bank and to embrace new products and new ways of doing business. All of this should pave the way for successful approaches to both domestic and foreign capital markets in future IPOs and subsequent share offerings.[23]

What Attracts Foreign Investors to Chinese Banks?

Although the attractions of the fast-growing Chinese economy are obvious, choosing to enter the Chinese market through a strategic partnership with a domestic bank is less obviously attractive. Figure 2.6 shows recent Chinese growth rates, and Figure 2.7 compares growth in the Chinese banking markets with that of other Asian economies. As shown earlier, the Chinese retail mortgage market is still in its infancy (see Figure 2.5), but the recent acceleration of consumer lending by

[23]As occurred in BoCom's and CCB's successful IPOs in Hong Kong SAR in June and October 2005, respectively.

Figure 2.7. Asian Banking Market Growth Comparison
Loan and Deposit Growth (1999–2003 Compound Annual Growth Rate)
(In percent)



Source: Various central banks.

Chinese banks points to the vast lending opportunities that are emerging in the Chinese market, and foreign banking interests might regard the immediate access to well-developed distribution networks as more than adequate compensation for management and organizational deficiencies in their Chinese partners. Besides positioning themselves to benefit from the continuing rapid growth in bank lending, the foreign partners potentially can market their own products (for example, credit cards, fund management and trustee services, and insurance) through their partners' branch networks.

What other positives can foreign investors in the Chinese financial sector draw from the government's explicit and implicit commitments to ongoing reform of the financial system? In addition to rapid growth, there is a strong presumption that reforms will create opportunity for both banking and nonbanking financial services as the government's role in the financial system gradually recedes. In particular, the injection of strategic foreign investment followed by IPOs of the major banks should

reduce the currently overwhelming influence of the state on the major SCBs (though this can be expected to be a lengthy, even if inevitable, process). The massive recapitalization of the SCBs via Huijin, as well as, in the case of CCB, via concessions from the MOF to waive dividends and taxes due, will substantially improve the capital bases and competitive positions of the SCBs. In turn, that raises the prospect of a potential financial upside for the foreign investors if they can help to engineer an effective turn-around of the efficiency and profitability of their invested banks, including the smaller ones where influence on management and operational performance might be almost immediate.

Further enhancement of the upside potential of the existing banks will derive from the nature of reform, with considerable relaxation of controls on interest rates and regulation of fees pointing toward full liberalization over time. Because nonbank financial services are growing even faster than banking services, clear potential also exists to profit from the use of the banks' well-established distribution channels to introduce "integrated financial services" business models over time. Bottelier (2005a) also points to the advantages of avoiding the need to compete for the limited local personnel with banking expertise and experience. Finally, the flurry of recent entry activity probably draws some inspiration from the example of HSBC's landmark deal for BoCom: HSBC's actual and potential competitors in the promising China market might perceive potential early-mover advantages through their acquisitions (Appendix IV).

What Comprises the Universe of Potential Strategic Investors?

Almost every type of international finance company has shown interest in penetrating the Chinese financial sector. Five broad classes of actors that have been actively seeking opportunities for strategic partnerships in China are (1) universal banks, (2) commercial banks, (3) specialty finance companies, (4) asset managers, and (5) insurers. Their interests differ, as do the pros and cons of their involvement in China's financial service industry.

- *Universal banks* refer to those engaged in a wide range of financial services, including consumer banking, commercial banking, investment banking, asset management, and insurance. From the viewpoint of Chinese banks, they offer a broad range of strategic and operational benefits and, usually, impressive financial resources. The possible downside is that conflicts of interest could arise because many of their products and services will overlap and potentially

compete with those of their Chinese partners, and they will make protection of their own brand and reputation a priority. Examples of this group that have entered the Chinese market or are considering doing so are Citigroup, HSBC, and J.P. Morgan Chase.

- *Commercial banks* are primarily focused on commercial banking, with their expertise normally concentrated on corporate and consumer banking, as well as wealth management. The advantage of this group for Chinese partner banks is that its core expertise is immediately applicable to their main business lines, with particular benefits likely to be realized in the crucial areas of credit and risk management. This group of investors is likely to be culturally well attuned to its Chinese partners although it will not offer as diversified a product mix. Some members of this group are Bank of America, Banque Nationale de Paris, the Royal Bank of Scotland, and Standard Chartered Bank.
- *Specialty finance companies* focus on specific finance markets, ranging from credit cards and consumer finance to commercial finance and leasing. They bring cutting-edge expertise in selected business areas and offer innovative product and marketing capabilities. The scope of their activities is narrower than that of the banks, but their creativity and specific expertise could help their Chinese partners develop highly profitable niche products with less competitive threat to core banking business. A potential disadvantage is the possibility that multiple partners will be required to cover a range of specialty markets. Examples of companies offering these services are American Express, Commercial Investment Trust (CIT Group, Inc.), Countrywide, Ford Motor Credit, General Electric Capital, General Motors Acceptance Corporation, and MBNA Corporation.
- *Asset managers* also are seeking investment opportunities in Chinese banks to establish business development platforms. Their expertise in the asset management business complements the services available to the established customer base of major Chinese banks and is likely to be especially helpful given the current underdeveloped state of the asset management business in China. Typically, they will offer their Chinese banking partners less in the way of additional financial resources, and they have limited capacity to assist Chinese banks to restructure themselves as competitive commercial banks. Examples of companies offering these services are Capital Group, Fidelity, Franklin, and Putnam.
- *Insurers* comprise a large group of insurance companies (life and property/casualty) seeking distribution networks in China. Their

primary contribution to partner Chinese banks would be through the fee-based revenues generated from distributing insurance and other wealth management products. This group probably would have little interest, as well as limited capabilities, in assisting partner banks to improve their banking performance. Examples of the large numbers of potential entrants in this category are: Aegon; Allianz; Aviva; Axa; Fortis; ING; Metlife; Munich Re; and Prudential, UK.

How Have Chinese Banks Selected Investment Partners?

In choosing among the host of interested parties offering a wide range of expertise, Chinese banks typically use a range of criteria including the following categories: profile, strategic fit, management/cultural fit, core competencies, appetite for acquisition, and ability to pay. Some illustrative criteria within these categories, along with some considerations of relevance and potential benefits, are shown in Table 2.3.

Summarizing very broadly, ideal strategic partners for Chinese banks seem to be, first and foremost, reputable financial institutions (which need not be among the world's largest) that offer proven products, refined marketing skills, and distribution expertise. The other attributes that seem particularly attractive to Chinese banks are:

(1) superior management capabilities, combined with a willingness to commit management resources to assist the Chinese partner to acquire better management skills;
(2) expertise in core competencies that add tangible benefits to the Chinese partner, while minimizing the potential for conflict and damaging competition;
(3) long-term interest in opportunities in China's rapidly growing financial services markets; and
(4) a clear strategic fit with the Chinese partner from which both parties could benefit commercially.

What Are the Main Concerns for Foreign Investors in Chinese Banks?

Up to this point, we have outlined both the attractions of China's financial sector for its prospective foreign strategic partners and the qualifications and characteristics that Chinese financial institutions might seek in potential partners. To balance the equation, and not-

Table 2.3. Criteria Commonly Used by Chinese Banks in Selecting Potential Investors

Categories	Criteria	Relevancy/Benefits
Profile	Asset size Market cap Financial strength/ credit ratings	Strong world-class profile and powerful endorsement of Chinese banks Financial strength providing long-term stability
Strategic fit	Strategic focus: product, customer, geography International revenues/profits as share of total revenues/profits China strategy and presence Expansion strategy (organic vs. mergers and acquisitions)	Strategic fit as foundation for exploring and reaping benefits Level of interest in Chinese banks Only a subset of investors with an international mindset and knowledge of Asia
Management/ cultural fit	Vision and capabilities Cohesive management culture and disciplined management system Interest in working with partners	Willingness and ability to help Chinese bank to reinvent itself by committing management resources
Core competencies	Business mix: retail banking, corporate banking, risk control, wealth management Cross-selling capabilities Infrastructure Distribution: information technology, management information system, back office, operating and financial performance	Availability of international best practices Tangible benefits to Chinese banks in its execution of strategy
Acquisition appetite	Mergers and acquisitions experience in financial services industry Experience in minority stake investments	Interest in committing to an investment in Chinese banks Willingness to negotiate reasonable terms
Ability to pay	Market cap Impacts of potential investment on capital adequacy and earnings Accounting treatment	Indication of ability to pay for an investment Impact on transaction structure (composition of investors)

withstanding the attractions of China's potential as a profitable market, the prospective investor in Chinese banks has to contend with several aspects of the Chinese environment that are less than conducive to the productive engagement of foreign interests. In weighing the decision to enter China, several types of issues should dominate an investor's deliberations, including corporate governance, control and management influence, legal and regulatory frameworks, risk management, asset

quality, and liquidity and the ability to exit.[24] We consider these issues briefly.

Corporate Governance

The governance structures of Chinese banks need substantial improvement if they are to function effectively on a fully commercial basis. Currently, the board structures of the banks are not conducive to an effective system of checks and balances—there are too few independent directors and a dearth of effective key board committees, including risk and audit committees. Moreover, one can question whether internal information systems support effective governance and how well the financial statements of the banks reflect their actual financial conditions. The banks have yet to develop a culture of full disclosure, and the information that is released falls well short of international standards for best practice. In addition, the huge SCBs are encumbered with fragmented organizations that are essentially geographically based; centralized organizations are preferred with clear distinction and separation between front, middle, and back offices.

Although foreign partners potentially could do much to remedy the situation, whether they will be allowed and encouraged to do so remains in question. They presumably will have some influence on both board composition and policies; in addition, they should be represented on the key board committees as well as such key internal committees as the credit committee. The extent of their influence, however, is still very uncertain.

Control and Management Influence

The ability to influence overall governance positively will be related closely to the foreign partner's ability to exert control over the operations of its invested bank and to manage aspects of the bank's activities. By law and regulation, foreign ownership in domestic banks is restricted to 25 percent, with the holdings of any individual foreign investor to be less than 20 percent.[25] Although, in the interests of better performance, Chinese banks might cede somewhat more of their authority to their foreign partners than share ownership alone would warrant, they are at least equally likely to try to minimize the extent to which they share

[24]This discussion presupposes that the potential strategic investor has overcome any opposition from its shareholders to entering the Chinese market.

[25]As some Chinese banks with ownership close to the mandated limits are being prepared for IPOs, the prospects for a rise in the statutory ownership limits seem strong (Bottelier, 2005b, page 3).

decision-making power, especially in sensitive areas. For their part, the foreigners might limit their management influence to the particular niches or lines of business that are central to their interests. In the cases of Citigroup and the Shanghai Pudong Development Bank, for example, the extent of management control at the level of business units has been negotiated and agreed upon, but the operational results are as yet undetermined.[26]

Legal and Regulatory Frameworks

Great uncertainty still surrounds the legal and regulatory treatment of the banking business in China, notwithstanding the ongoing efforts to reform and the undeniable progress that has been made—at least in regard to the institutional structure, if not yet in regard to banking practice. The draft bankruptcy law, which has passed through its second reading at the National People's Congress, reportedly still subordinates the claims of the creditors, including banks, of failed enterprises to those of their current and retired workers. As long as that remains the case, banks are unlikely to lend enthusiastically to private enterprises. Even where banks could lend against collateral, pursuing claims in the event of default is expensive and time consuming and offers no guarantees of success.

Risk Management

As noted in note 15, China has recently begun a migration to a five-classification loan-grading system that aligns better with the standards under the Basel accords. The earlier four-classification system was opaque and seriously flawed, leading to endless speculation about the actual level of nonperforming assets and the extent to which loan provisioning was inadequate. Independent analysts guessed that actual NPLs were at least twice the official figures, meaning the major SCBs were seriously undercapitalized. With the huge infusion of new capital to the major SCBs and the transfer of nonperforming assets to the AMCs, the new system should overcome many of these concerns in time. To date, however, the universal acceptance and performance of the new system

[26]Although the text postulates a situation in which the foreign investor might have little real voice in the strategic decisions of the invested bank, Newbridge Capital and the Shenzhen Development Bank provide a contrary example. For its 18 percent share, Newbridge acquired effective management control along with the right to appoint half the board of directors (Table 2.2).

are yet to be demonstrated, as is the capacity of the CBRC to supervise its implementation.

Credit decisions are still driven by relationships, guarantees, and reliable collateral (buildings and land-use rights) when it can be obtained. The extent to which the transition can be made to international practice based on cash-flow analysis is constrained by the unreliability of the books of many enterprises. And even the biggest and most heavily scrutinized of China's banks continue to be haunted by damaging reports of scandals involving fraud and other corrupt practices. Unless the foreign partner is able to insist on more stringent and effective internal controls to curb operational risks, the likelihood is that it will confine its activity to profit making from its niche business activities, with minimal regard for the overall performance of the partner bank.

Asset Quality

The combination of poor risk management, excessive policy-directed lending, inadequate prudential norms, and under-provisioning for bad loans has burdened the banking industry with a legacy of non-performing assets. Unfortunately, more effort has been directed at the stock problem than the flow problem in the major SCBs. As a result, their reported NPLs have fallen sharply during 2000–05 (see Appendix II, and discussion on pages 54–55), but with no assurance that new lending experience will maintain loan losses at acceptably low levels. The CBRC reports that NPLs of major banks were less than 9 percent of total loans by mid-2005. For the four major SCBs, the ratio was 10.1 percent, compared with 20.4 percent at the end of 2003, and 31.1 percent at the end of 2001. If the atrocious performance of the ABC is excluded, by mid-2005 the other three SCBs had NPL ratios of 5 percent or less.

Unofficial estimates of the NPLs of the SCBs, however, have consistently exceeded officially reported levels, which seem to be conservative. Moreover, the rapid rise in lending in 2002–04 means both that at least part of the fall in the NPL ratio was due to growth in the denominator and that the performance of much of the new lending cannot yet be judged. How much of it is still directed lending to poorly performing state enterprises is unknown. And the surge in lending to households, primarily for mortgages but also for cars and credit cards, has yet to demonstrate its soundness. When combined with the continuing lack of transparency and reliability of financial statements, the foreign partners would be wise to assume that neither the flow problem nor the stock problem of the NPLs in the banking system has been laid to rest.

Liquidity and the Ability to Exit

Most foreign investors can be presumed to be taking a longer-term view of their engagement in China's financial sector, but many will still harbor concerns about their ability to extract themselves from their investment when they so desire. Once the major banks are listed, the problem will be less acute for investors in those banks as their shares will be tradable. However, the investor has to commit to holding them for some period, typically a minimum three-year lock up, which represents a substantial liquidity risk to foreign investors.

Concluding Comments

Banking sector fragility poses perhaps the single biggest threat to China's macroeconomic stability and long-term growth and the Chinese government has rightly made banking reform a top priority. In light of the sheer scale of banking problems and the enormity of the reforms required to resolve those problems, the Chinese government has wisely sought to attract foreign strategic investment to help restructure and modernize its ailing banking sector. China's decision to open the sensitive banking sector more widely to foreign investment draws from the decades-long experience in restructuring its inefficient state-owned manufacturing industry, which has transformed itself into a successful global competitor due largely to massive foreign direct investment. In the same way, the Chinese government hopes that foreign investment in the domestic banking sector will bring, along with additional equity capital, the more important contributions of modern banking practices, risk management techniques, new products and services, and international standards of governance. Foreign strategic investment appeals as a potentially effective way to foster China's ongoing banking reform and to build a healthier, more stable and more efficient modern banking system.

Foreign financial institutions, on the other hand, are attracted by China's rapid economic growth; enormous, yet-untapped market potential; and the opportunity to leverage local banks' name recognition, customer bases and distribution networks. Such alliances and partnerships formed through an equity investment can augment foreign banks' growth through their typically limited (or nonexistent) local presence in China. Equity positions in existing banks also offer foreign investors a potentially attractive financial upside if the invested banks significantly improve their operations and performance over time.

A number of obstacles could frustrate both Chinese and foreign investor's expectations. Long-standing problems with corporate governance, disclosure standards, asset quality, and internal control in Chinese banks could make foreign investors cautious and hamper business cooperation. In particular, current Chinese regulations allow for maximum foreign ownership of 25 percent jointly, and 20 percent for a single investor, thereby restricting foreign ownership of Chinese banks to a minority interest. Chinese banks' probable reluctance to cede management control and foreign investors' consequent inability to influence meaningfully their partner bank's operations raise considerable doubt about the extent to which foreign strategic investors could ultimately serve as a catalyst in improving Chinese banks' performance.

These substantial risks and obstacles notwithstanding, the remarkable fact is that China has attracted very substantial foreign direct investments into its once-highly-protected banking sector. Such leading global financial institutions as Bank of America, Goldman Sachs, HSBC, and the Royal Bank of Scotland have taken large minority positions in major Chinese banks; in 2005 alone, total foreign investment in China's banking sector exceeded US$10 billion.

We view the prospects as both promising and intriguing. If, as increasingly seems to be the case, the Chinese government is willing to mitigate some of the potential obstacles, in particular by establishing a legal system that supports banks more effectively, by limiting official intervention in the operations of the banks, and by ceding more voice to foreign strategic investors in the operations of the banks, foreign strategic investment has the potential to be a very effective way to improve China's banking system. Certainly, it promises to improve the performance of China's banks much more rapidly than simply relying on foreign banks to expand their very low current market share.

Glossary of Abbreviations

ABC	Agricultural Bank of China
ADB	Asian Development Bank
ADBC	Agricultural Development Bank of China
AMCs	asset management companies
BOC	Bank of China
BoCom	Bank of Communications
CBRC	China Banking Regulatory Commission
CCB	China Construction Bank
CDB	China Development Bank
CDC	China Government Securities Depository Trust and Clearing Co. Ltd.
CSDCC	China Securities Depository and Clearing Company
CSRC	China Securities Regulatory Commission
HSBC	Hongkong and Shanghai Banking Corporation
ICBC	Industrial and Commercial Bank of China
IPO	initial public offering
JSCBs	joint-stock commercial banks
MBNA	MBNA Corporation or its main part, MBNA America Bank
MOF	Ministry of Finance
NPLs	nonperforming loans
NSSF	National Social Security Fund
PBC	People's Bank of China
RCCs	rural credit cooperatives
RMB	Renminbi
SAEC	State Administration of Exchange Control
SAFE	State Administration of Foreign Exchange
SASAC	State-Owned Asset Supervision and Administration Commission
SCBs	state-owned commercial banks
SDB	Shenzhen Development Bank
SEZ	special economic zone
SOEs	state-owned enterprises
UCCs	urban credit cooperatives
WTO	World Trade Organization

Appendix I. A Chronology of Reform 1978–2007*

Selective Chronology of Chinese Financial Reform with Focus on Banking, 1978–2007

Date	Measures
December 1978	Communist Party Congress approved the Open Door Policy to achieve economic modernization, including measures to develop the securities markets and "special economic zones" (SEZs).
February 1979	The Agricultural Bank of China (ABC) was split from the "monobank," the People's Bank of China (PBC).
March 1979	The Bank of China (BOC) also was established separately. The State Administration of Exchange Control (SAEC, now State Administration of Foreign Exchange, SAFE) was separated from BOC and affiliated with the PBC.
1979–82	Four SEZs were created (Shenzhen, Zhuhai, Shantow, and Xiamen).
October 1979	The China Construction Bank (CCB) was transformed from a department of the Ministry of Finance (MOF) to become a bank under the State Council.
1980	The People's Republic of China assumed the Chinese seat in the IMF and the World Bank.
January 1981	China began to issue state treasury bills.
June 1981	The World Bank approved its first loan (International Bank for Reconstruction and Development (IBRD)/International Development Association (IDA) blend) to China.
December 1981	The China Investment Bank (CIB) was created to on-lend funds lent by the World Bank and (later) by the Asian Development Bank (ADB).
1982	China began to issue local enterprise bonds.
September 1983	The State Council decided to create a central bank.
1984	China opened 14 cities for foreign investments, in addition to the existing four SEZs.
1984	State-owned financial enterprises began to issue bonds and were allowed to raise funds from their shareholders.
January 1984	The PBC assumed the role of China's central bank; the Industrial and Commercial Bank of China (ICBC) was created to take over the PBC's remaining deposit-taking and lending functions.
1985	A few specialized banks were permitted to conduct foreign exchange business at their branches in three SEZs.
1986	China joined the ADB.
1986	The government first permitted state treasury bills to be openly traded in five major cities.
1987	The SAEC granted 133 new approvals for financial institutions to enter the foreign exchange market (in total, 55 branch banks and 78 trust and investment companies).
1988	China began to implement its bankruptcy law.
1988–93	Ninety securities dealers were approved and 386 trust and investment institutions were in operation.
1990	Stock exchanges were established in Shanghai and Shenzhen.
1990	China opened a total of 714 cities and about a third of the provinces for foreign investors and visitors.

Selective Chronology of Chinese Financial Reform with Focus on Banking, 1978–2007 ***(continued)***

Date	Measures
1992	More than 1,000 branch banks and 145 nonbank financial institutions had been licensed to carry out foreign exchange business.
1992	Banks were given authority to write off loans of up to a half billion yuan; larger amounts still required approval from the State Council.
1994	The CIB became a commercial bank and expanded its activities to include deposit-taking and foreign exchange business.
1994	Three policy banks-Agricultural Development Bank of China, China (State) Development Bank (CDB), and Export-Import Bank-were established to free the four "specialized" state-owned commercial banks (SCBs) from directed lending. Exchange rate unified from January 1.
1995	The CIB reduced the number of its branches from 32 to 16.
1995	Commercial bank law was promulgated. This created conditions for commercial bank system formation and structure and provided the legal basis for changing specialized state banks to SCBs.
March 1995	The Central Bank Law was passed, legally confirming the PBC as the central bank.
1996	Other banks joined the BOC in offering deposits and loans denominated in foreign currencies and settlement for foreign trade transactions.
January 1996	The first nonstate-owned commercial bank, Minsheng bank, was established.
December 1996	China established full convertibility of the renminbi on the current account of the balance of payments.
1997–1998	China cut interest rates to promote spending and allowed greater flexibility to vary lending rates around the administered level.
1998	The PBC began to allocate credit based on asset-liability management rather than quotas under the credit plan.
1998	China injected Y 270 billion in capital to ameliorate the nonperforming loan (NPL) problems in state banks.
1998–2002	China's four major SCBs cut approximately 250,000 employees and 45,000 branches.
March 1998	The ninth National People's Congress designated financial reform as one of three policy reform goals (for national corporations and government) for the next three years.
October 1998	The Guangdong International Trust and Investment Corporation failed.
1999	The PBC replaced provincial and municipal branches with nine regional branches. The PBC relaxed controls on foreign banks' renminbi business.
1999–2000	China transferred more than Y 1.4 trillion in bad debts of the SCBs and CDB to four asset management companies (AMCs). They and their partner banks are Cinda-CCB and CDB; Great Wall-ABC; HuarongICBC; and Orient-BOC.
November 2001	Huarong signed agreement to sell Y 10.8 billion of NPL assets to a consortium led by Morgan Stanley. The consortium agreed to pay Huarong in cash about 9 percent of the face value of the loans.
December 2001	China became a member of World Trade Organization (WTO). As part of its accession commitments, China agreed to open substantially the financial and financial services markets to foreign interests over five years.

Selective Chronology of Chinese Financial Reform with Focus on Banking, 1978–2007 *(continued)*

Date	Measures
December 2001	Huarong sold Y 1.97 billion of NPL assets to Goldman Sachs. They established a joint venture, Rongsheng Asset Management Co., to resolve the loans. Soon thereafter, Huarong and the Morgan Stanley Consortium followed by setting up the joint venture First United Asset Management Corporation.
December 2001	China Orient arranged sale of a US$217 million NPL portfolio to the U.S.-based Chenery Associates.
February 2002	The proposal was made to separate bank regulation and supervision from the PBC (at the Central Financial Work Conference, Beijing).
2002	Banking scandals occurred. Wang Xuebing, the former head of the BOC and the CCB was investigated for alleged corruption and subsequently jailed.
January 2003	Citigroup was approved to take a 5 percent stake in Shanghai's Pudong Development Bank for US$72 million.
January 22–24, 2003	The Chinese Communist Party met to complete the separation of the bank regulatory function from the PBC, with a view to curbing the mounting NPLs of the banks.
January 30, 2003	The PBC promulgated requirements to standardize the work of commercial banks in collecting and reporting statistical information on intermediary services.
February 2003	The PBC approved Wenzhou City, Zhejiang Province, to conduct broad financial and banking reforms. The reform included lifting the ban on private investment in commercial banks in urban areas and freeing interest rates for loans to small enterprises.
March 2003	The National People's Congress amended the Central Bank Law and launched a new banking regulator, the China Banking Regulatory Commission (CBRC), as a part of the comprehensive restructuring of the State Council.
April 25, 2003	The CBRC assumed the functions of banking regulation and supervision from the PBC.
August 2003	Eight provinces and municipalities initiated a pilot reform of their rural credit cooperatives (RCCs).
August 25, 2003	Liu Mingkang, chairman of the CBRC, encouraged foreign banks to participate in the country's banking reform by buying stakes in domestic banks. He promised that his commission would improve its capacity to supervise foreign banks by referring to the Core Principles for Effective Banking Supervision.
August 2003	Foreign invested banks in Jinan, Fuzhou, Chengdu, and Chongqing (in addition to Shanghai, Shenzhen, Tianjin, and Dalian) were allowed to initiate renminbi-based business before the end of 2003.
September 2003	The PBC increased the reserve requirement by 1 to 7 percent for all commercial lenders, thereby removing an estimated Y 150 billion ($18 billion) of liquidity from the banks.
December 1, 2003	China raised the maximum equity share for a single foreign investor in a joint venture bank from 15 to 20 percent. Foreign banks are also allowed to provide renminbi services to Chinese businesses (but not individuals) in the 13 major cities.

Selective Chronology of Chinese Financial Reform with Focus on Banking, 1978–2007 ***(continued)***

Date	Measures
December 2003	The government launched the latest round of banking reform, with a $45 billion capital injection from PBC's foreign exchange reserves into the BOC and the CCB (US$22.5 billion each) through an intermediary company, Central Huijin Investment Ltd. The reforms were to include transforming the banks into joint-stock companies, introducing foreign and domestic strategic investors, and (subsequently) listing them on the stock market.
2003-2004	Huarong auctioned Y 22.5 billion of NPL assets. Winning bidders included Citigroup, J.P. Morgan, Goldman Sachs, Union Bank of Switzerland, Morgan Stanley, and Lehman Brothers.
December 27, 2003	Sixth Session of the Standing Committee of the 10th National People's Congress adopted Law of the People's Republic of China on Banking Regulation and Supervision.
February 10, 2004	The CBRC said China encourages domestic private funds and foreign investors to become shareholders in Chinese commercial banks.
February 11, 2004	Premier Wen Jiabao called for financial reform to accelerate and promised steady reform of the interest rate system.
February 11, 2004	The CBRC and the PBC articulated 10 measures to guide the reform of the four big SCBs.
March 2, 2004	Premier Wen Jiabao ordered BOC and CCB to complete reforms within three years to transform themselves into true commercial banks.
March 11, 2004	The CBRC issued a guideline for BOC's and CCB's public offering.
March 18, 2004	The Chinese government required the BOC and the CCB to set up joint-stock units by the end of September 2004.
March 2004	China Securities Regulatory Commission (CSRC) reprimanded Shenzhen Development Bank for failing in its fiduciary duties during its negotiations with Newbridge. China Minsheng also disclosed that it faked a shareholder meeting in 2000 prior to an IPO in Shanghai.
April 12, 2004	The PBC increased further the mandatory reserve requirements of the major commercial banks to 7.5 percent from 7 percent. The ratio for more poorly performing banks rose to 8 percent from 7.5 percent.
April 16, 2004	Central bank governor Zhou Xiaochuan warned that reform of the four SCBs is likely to be delayed owing to bureaucratic delays.
April 20, 2004	The CBRC announced its intention to expand the scope of pilot reforms for RCCs in the second half of the year.
April 2004	Yangtze Special Situations Fund emerged in Hong Kong, the first in the country to invest in nonperforming assets of Chinese banks. The ADB approved an equity investment of up to $45 million in the fund.
May 2004	The PBC announced plans to issue bonds to remove Y 200 billion ($24 billion) in NPLs from the portfolios of the BOC and the CCB.
May 19, 2004	The CBRC urged the ABC and the ICBC to intensify their restructuring efforts before the industry fully opens to foreign competition in 2007.
June 2004	The CCB split into two: a company group and a shareholding company, the China Construction Bank Corporation, which will receive the CCB's best assets and become the listed unit.

Selective Chronology of Chinese Financial Reform with Focus on Banking, 1978–2007 *(continued)*

Date	Measures
June 2004	Cinda purchased Y 280 billion ($34 billion) in distressed assets from CCB and BOC, combined.
June 2004	Guizhou Huaxi Rural Cooperative Bank was set up in Guizhou Province as a new model for reforming RCCs.
June 30, 2004	Bank of Communications (BoCom) finished financial restructuring.
June 17, 2004	The CBRC set rules on the issuance of subordinated bonds by commercial banks.
July 21, 2004	The CBRC laid out a six-phase plan to dispose of the NPLs of the BOC and CCB and to restructure the institutions as self-financing joint-stock banks.
August 17, 2004	The CBRC issued administrative rules for automotive loans.
August 18, 2004	BoCom completed equity transfer to HSBC.
August 26, 2004	BOC transformed into a joint-stock company; Huijin Company exercised the rights of shareholder on behalf of the state.
September 1, 2004	The CBRC established rules for implementing the regulation of the People's Republic of China governing foreign-funded financial institutions.
September 21, 2004	CCB transformed into a joint-stock company; Huijin Company exercised shareholder rights on behalf of the state.
November 1, 2004	The PBC (with the CSRC and CBRC) set administrative rules for short-term financing bills of securities firms "to promote the development of money market and expand the financing channels of securities firms."
November 2004	Regulatory changes were introduced to speed up the transfer of NPLs to foreign investors. The AMCs were to report proposed sales to the National Development Reform Commission within 30 days of agreement, and the commission was to respond within 20 working days.
December 2004	Details of NPL transactions (to foreign investors) must be submitted to SAFE within 15 working days of completion.
December 2004	China Orient agreed to purchase Y 130 billion ($15.6 billion) of the CCB portion of Cinda's portfolio.
December 2004	Great Wall invited bids for assets valued at $18.1 billion.
December 11, 2004	Foreign banks were allowed to initiate renminbi business, as agreed to for China's membership in the WTO.
January 2005	Foreign investors were permitted to remit out of China funds related to NPL disposals if they reported transaction details to SAFE.
February 18, 2005	The PBC, the MOF, the State Development and Reform Commission, and the CSRC issued joint public notice ("Provisional Administrative Rules on International Development Institutions' Issuance of Renminbi [RMB] Bonds") "to standardize activities of international development institutions' issuance of RMB bonds and promote development of China's bond market."
April 2005	ICBC received $15 billion in recapitalization from the government.
April 20, 2005	The PBC and CBRC set administrative rules for pilot securitization of credit assets.

Selective Chronology of Chinese Financial Reform with Focus on Banking, 1978–2007 *(continued)*

Date	Measures
May 11, 2005	The PBC set administrative rules on forward bond transactions in the national inter-bank bond market.
June 2005	State Council allowed Huijin to inject about $1.5 billion into China Galaxy Securities, one of China's biggest state-owned brokers.
June 1, 2005	PBC announced the administrative rules for the issuance of financial bonds in the national interbank bond market "to promote the development of the bond market, regulate the issuance of financial bonds, and safeguard the lawful rights of the investors."
June 13, 2005	The PBC set rules for the information disclosure of asset-backed securities "to regulate information disclosure of asset-backed securities, safeguard the legal rights of investors, ensure a smooth progress of the pilot asset-backed securities, and promote the healthy development of the inter-bank bond market."
June 17, 2005	Bank of America announced plan to spend $3 billion to buy a 9 percent stake in the CCB, China's third-biggest state bank, with an option to increase its holding to 19.9 percent. Temasek of Singapore planned to purchase the remaining 5.1 percent of CCB shares that are available to foreign shareholders under current regulations.
August 2005	BoCom offered shares at 1.6 times book value in a $1.9 billion initial public offering (IPO).
August 2005	Central Huijin Investment Company made plans to inject Y 2.5 billion ($308 million) into the country's third-largest broker, Shenyin & Wanguo Securities Co.; Huijin was to receive 33 percent stake in Shenyin & Wanguo.
August 2005	ICBC issued multibillion-yuan subordinated debt. The bank planned to issue Y 35 billion, but subscription reached Y 85.5 billion.
August 2005	A fifth AMC, Huida Asset Custody Co. Ltd., was established to help in disposal of nonperforming assets of the PBC.
October 27, 2005	CCB shares were scheduled to begin trading in Hong Kong SAR as part of China's biggest IPO to date. The IPO was expected to raise $6.1-$7.7 billion.
December 2006	This is the deadline for China to open its financial markets as agreed to under WTO protocols; China will lift all geographic restrictions relating to foreign-bank-offered services in domestic currency (to foreign and domestic companies and individuals). During 2006, both BOC and CCB are expected to have completed IPOs.
2007	The ABC and ICBC are scheduled to complete reforms sufficient to permit both to make IPOs.

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Appendix II. Selected Financial Statistics*

Table 2.A2.1. Assets Distribution of Financial Institutions

	End of 2002 Q3		End of 2003 Q3		End of 2004 Q3		End of 2005 Q3	
	Assets (Y trillion)	Share (%)	Assets (Y trillion)	Share (%)	Assets (Y trillion)	Share (%)	Assets (Y trillion)	Share (%)
State-owned commercial banks	13.24	59.7	15.31	56.1	16.67	54.1	19.53	53.3
Other commercial banks	2.75	12.4	3.67	13.5	4.47	14.6	5.57	15.3
City commercial banks	1.00	4.5	1.36	5.0	1.59	5.2	1.91	5.2
Foreign-funded banks	0.29	1.3	0.33	1.4	0.50	1.9	0.59	1.8
Urban credit cooperatives	0.11	0.5	0.13	0.5	0.16	0.5	0.18	0.5
Rural credit cooperatives	2.14	9.6	2.57	9.5	2.96	9.7	3.13	8.6
Other financial institutions	2.66	12.0	3.82	14.0	4.31	14.0	5.61	15.3
Totals	22.19	100.0	27.19	100.0	30.66	100.0	36.52	100.0
China's GDP (Y trillion)		**2002**		**2003**		**2004**		**2005**
		12.03		13.58		15.99		18.23

Sources: The People's Bank of China, *Quarterly Statistical Bulletins*, 2005–4, 2004–4, 2003–4, 2002–4, Annual Reports and authors' calculations. In December 2005, the National Bureau of Statistics amended the former GDP figures as a result of China's inaugural economic census. The GDP figures reported here reflect this. The preliminary GDP figure for 2005 was released in January 2006.

Table 2.A2.2. Distribution of Select Deposits to Financial Sector, 2004: Q4 End Balance

	Demand Deposits (in trillions of yuan)	Quasi-Money (includes time deposits, household deposits, and other deposits)	Foreign Currency Deposits	Deposits of Other Financial Institutions Included in Broad Money
SCBs	4.33	9.07	0.88	0.09
Other commercial banks	1.52	1.96	0.23	0.07
UCCs	0.06	0.10	---	---
RCCs	0.50	2.23	0.01	0.00
Finance companies	0.20	0.28	0.01	0.00
Specific depository institutions	---	0.10	0.00	0.00
Postal savings deposits	---	1.08	NA	NA
Total	7.45	15.81	NA	NA

Source: *PBC Annual Report 2004.*

Notes: Total represents total for the entire financial sector and therefore does not represent the sum of the above categories. Also, fiscal deposits are not included here. Foreign currency deposits for specific depository institutions were approximately Y 4 billion. Deposits of RCCs included in broad money were approximately Y 2 million, of finance companies approximately Y 40 million, and of specific depository institutions approximately Y 200 million.

Table 2.A2.3. Branch and Employment Statistics for the Banking Sector (end-2000, and end-2003)

	2000		2003	
	Number of offices	Number of staff, workers	Number of offices	Number of staff, workers
PBC	2,222	169,302	2,199	160,020
SCBs	120,907	1,600,514	88,489	1,415,214
Industrial and Commercial Bank of China	31,673	471,097	24,129	389,045
Agricultural Bank of China	50,546	509,572	36,138	511,425
Bank of China	12,925	192,279	11,609	171,777
Construction Bank of China	25,763	427,566	16,613	342,967
Policy banks	2,272	62,297	2,328	64,762
Joint-stock commercial banks	4,769	105,023	4,786	136,780
Total	**130,170**	**1,937,136**	**97,802**	**1,776,776**

Source: China Statistical Yearbook 2004

Table 2.A2.4a. Nonperforming Loans (NPLs) of Major Commercial Banks (SCBs) and Joint-Stock Commercial Banks (JSCBs)

	2004:Q1	2004:Q2	2004:Q3	2004:Q4	2005:Q1	2005:Q2	2005:Q3
Outstanding balance (in trillions of yuan)	2.08	1.66	1.70	1.72	1.71	1.16	1.17
Share in total loans (%)	16.61	13.32	13.37	13.21	12.70	8.79	8.70

Source: China Banking Regulatory Commission (CBRC).

Table 2.A2.4b. NPLs of SCBs Only

	2004:Q1	2004:Q2	2004:Q3	2004:Q4	2005:Q1	2005:Q2	2005:Q3
Outstanding balance (in trillions of yuan)	1.89	1.52	1.56	1.58	1.57	1.01	1.02
Share in total loans (%)	19.15	15.59	15.71	15.57	15.00	10.12	10.11

Source: China Banking Regulatory Commission (CBRC).

Table 2.A2.4c. NPLs of JSCBs Only

	2004:Q1	2004:Q2	2004:Q3	2004:Q4	2005:Q1	2005:Q2	2005:Q3
Outstanding balance (in trillions of yuan)	0.188	0.140	0.140	0.143	0.146	0.150	0.153
Share in total loans (%)	7.12	5.16	5.03	4.94	4.9	4.66	4.51

Source: China Banking Regulatory Commission (CBRC).

Table 2.A2.5: Accumulated Disposal of Nonperforming Assets by the Four Asset Management Companies

(In trillions of yuan)

	2004:Q1	2004:Q2	2004:Q3	2004:Q4	2005:Q1	2005:Q2
Overall	0.529	0.567	0.588	0.675	0.689	0.717
Huarong	0.146	0.170	0.175	0.210	0.214	0.220
Great Wall	0.170	0.176	0.183	0.210	0.214	0.229
Orient	0.089	0.092	0.097	0.105	0.107	0.110
Cinda	0.124	0.129	0.133	0.151	0.154	0.158

Source: CBRC.

Appendix III.

Regulators in the Chinese Financial System

National Development and Reform Commission	Lead regulator of the primary corporate bond market. Controls master issuance quota. Authorizes new issue applications. No responsibility for the secondary market or post-issue disclosure.
People's Bank of China (PBC)	Sets interest rates on new issues. Regulates the interbank bond market and trading platform (China Foreign Exchange Trade System).
China Securities Regulation Commission (CSRC)	Securities market regulator. Supervises listed companies, securities companies and other intermediaries, securities investment funds, stock exchanges, new listings, and continuing disclosure for listed securities.
China Insurance Regulatory Commission	Insurance industry regulator. Determines permitted investments for insurance companies.
China Banking Regulatory Commission (CBRC)	Banking regulator. Determines permitted activities (corporate bond guarantees, intermediary business, permitted investments).
Ministry of Finance (MOF)	Supervises National Social Security Fund (NSSF) and its investment activities.
Ministry of Labor and Social Security	Supervises NSSF, corporate pension funds, and their investment activities.
Shanghai and Shenzhen stock exchanges	Stock exchange operators. Supervises new listings and continuing disclosure (regulated by CSRC).
China Foreign Exchange Trade System	Trading platform for interbank foreign exchange and money market transactions. Also trading platform for government and financial bonds among members of the interbank bond market. Supervised by PBC.
China Government Securities Depository Trust and Clearing Co. Ltd. (CDC)	Central depository for government, financial, and corporate bonds, as well as central bank bills. Regulated by MOF and PBC.
China Securities Depository and Clearing Company (CSDCC)	Subdepository of CDC for the portion of corporate bonds that have been granted a listing and have been transferred to the CSDCC, and for bonds issued by securities companies. Also, the central depository for the Shanghai and Shenzhen stock exchanges. Regulated by CSRC.

Source: Scott and Ho (2004).

Appendix IV. Case Study: Hongkong and Shanghai Banking Corporation's (HSBC's) US$1.75 Billion Investment in the Bank of Communications (BoCom)

Transaction Background	Win-Win Partnership
■ On August 6, 2004, HSBC announced its acquisition of a 19.9 percent stake in BoCom, China's fifth largest bank, for US$1.75 billion in cash, which represents 1.76 times more than the year-end 2003 book value and 1.4 times more than the post-money book value. ■ The transaction was signed immediately after the completion of a massive recapitalization, which entails a US$6.4 billion nonperforming loan carve-out and a US$2.2 billion capital injection from the Chinese government and the National Social Security Fund ■ The transaction is a landmark in the following aspects: – It was by far the largest foreign investment to that date in China's financial service sector. – It was one of the largest foreign equity investments in China. – It was one of the largest minority investments in financial institutions world-wide. – BoCom became the first major bank in China to complete a comprehensive restructuring and a massive recapitalization, setting an example for the country's financial reform. – The transaction provided a highly structured joint venture arrangement for cooperation in credit cards, including distribution of co-branded cards on a nationwide basis. ■ Established in 1908, BoCom is one of the earliest commercial banks in China. It was re-established as the first joint-stock commercial bank with a nationwide license in 1987. – It serves more than 30 million customers through more than 2,700 branches throughout the nation, with a business focus in wealthy regions. – It has about 3.5 and 3 percent market share of domestic deposits and loans market, respectively. It is ranked third and sixth in funds custody business and overall card issuance in China, respectively. ■ HSBC Group is one of the largest banking and financial services organizations in the world: – It provides a comprehensive range of financial services with more than 9,500 offices world-wide and more than 110 million customers. – It is a market leader in Hong Kong, with the largest operation of foreign banks in China. It has 10 branches on the mainland, and it has carried out several stake acquisitions in the Chinese financial industry, including the acquisition of an 8 percent stake in Bank of Shanghai and a 10 percent stake in Ping An insurance.	■ Through the transaction, BoCom will – Leverage HSBC to further implement internal restructuring in line with international practices and further strengthen capital base on top of recapitalization. – Strengthen market position through cooperation in credit cards and other businesses and through technical support from HSBC. – Pave the way for overseas initial public offering, likely the first of any major Chinese bank. ■ Through the transaction, HSBC will – Gain immediate access to a nationwide distribution network in China and complement HSBC's existing operations in China, already the strongest of any foreign player. – Pave the way for further increase in ownership. – Establish unique credit card platform to overtake Citibank-Shanghai Pudong venture. – Cooperate in other businesses to provide broad-based growth platform in China. ■ Positive Media/Research Reponses – "The deal gives HSBC the biggest footprint of any foreign bank on the Chinese mainland and offers BoCom international management expertise." (Financial Times) – "Organic growth will be slow and costly, so teaming up with a local bank is the best strategy to tackle the retail market and Bank of Communications is the best fit amongst all the banks." (Barclays Capital)

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