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The Banking System Structure in China and India

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A comparison of China and India is both exciting and challenging, and should ideally lead to a serious consideration of various policy implications. In this context, our conference today marks the beginning of a long journey. In my remarks, I will try to compare the banking sectors in China and India, largely focusing on structure and robustness as well as the effectiveness of the banking supervisory systems.

General Comment

Both China and India are large, developing economies with huge populations, which help to contribute to their economic weight in the world. The transformation of both countries has strong implications for the rest of the world. No wonder some people believe that the emergence of China and India as economic giants should serve as a wake-up call for the developed world. It is true that China and India possess cheap skilled labor, reform-minded governments in favor of a more market-oriented economy, and huge domestic markets. Both countries have proven to be capable of managing their economies. And fortunately, both countries have maintained high growth rates, roughly 9 percent for China and 8 percent for India over the past couple of years.

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However, it is important to note that high growth for the two economies is critical, because they depend on a high growth rate to generate enough job opportunities for millions of people joining the labor force each year. Given their inherent constraints, it will take ages for both economies to catch up with the developed world, particularly as measured by per capita income. Even if China can continue its high growth rate for another 10 years, and assuming the United States stopped growing, it would reach only one-tenth of the per capita income of the United States by then. Therefore, I would have thought, of course, that on the part of the developed countries, in full recognition of the need to boost domestic consumption (particularly for the large economies), it would be better to engage and integrate these two developing countries into the global economy rather than treat them as potential threats by enacting arbitrary trade barriers.

The Role of the Banking Sector in the Economy

As far as the banking sector is concerned, it may well be true that the two countries share many attributes, particularly in terms of industry structure. First of all, the two countries heavily depend on bank finance to support economic growth, and capital markets are less developed. In China, the total assets in the banking sector represent more than 90 percent of the assets in the financial sector. And in India, the commercial banking sector represents about 74 percent of total financial system assets. Nonbank financial institutions make up the balance in India, of which 8.6 percent are term-lending institutions and 15.4 percent are investment institutions. Some of these institutions could be considered as banking institutions according to the broader definition in China. Moreover, the proportion of commercial banking sector financial assets in both countries is likely to rise further.

Another strikingly common attribute of the banking system in the two economies is dominant state ownership. This stands in stark contrast to other developing economies and has strong implications for the conduct and performance of the banking sector in general. In China, until very recently, all major commercial banks except one or two were controlled by the central and local governments, as are virtually all small commercial banks. China's banking sector is relatively concentrated. The four large banks, known as state-owned commercial banks until the recent diversification of ownership, plus the Bank of Communications (BoCom), also largely owned by the central government, account for nearly two-thirds of commercial bank assets.

It is true that following the equity participation of foreign institutional investors and public listing overseas, as is the case with the Construction Bank of China (CCB) and BoCom, the ownership structure of China's state-owned banks has changed quite significantly. However, there is a general perception that the government will keep majority holdings in these large banks up to at least 51 percent going forward.

The High Degree of State Ownership in the Banking Sector

The high degree of state ownership of commercial banks has traditionally been accompanied by a strong emphasis on lending to state-owned enterprises (SOEs) in China. The large state-controlled banks are heavily concentrated in lending to SOEs whereas the second- and third-tier, joint stock, and city commercial banks are somewhat more oriented toward nonstate enterprises.

The Indian banking system can be characterized by a large number of banks with mixed ownership. However, 27 public sector banks—namely, banks owned and controlled by the state—continue to dominate the Indian commercial banking landscape. Together, these banks account for three-quarters of the market share. Even though these public sector banks have access to capital markets, government policy is to ensure that its equity interest does not, as a result of public issues by banks, go below 51 percent.

As is the case with many developed and developing countries, the efficiency of the state-owned banks has been a concern for both the Chinese and Indian governments. And the Indian government also openly admitted that public sector banks have been consistently outperformed by private sector banks. The effort to restructure the state-owned banks is still a work in progress in the two countries. Both governments have continued to launch many new initiatives to further promote progress in this area.

The Chinese government has expressed often that the purpose of reforming the state-owned banks is to transform them into genuinely commercial entities. Against this background, the government has injected a massive amount of money to recapitalize CCB, Bank of China (BOC), Industrial and Commercial Bank of China, and BoCom, to restore their solvency and pave the way for ensuing corporate restructuring. Other elements of the reform package include further disposal of nonperforming loans (NPLs), restructuring into joint stock limited companies (that is, corporatization), offering shares to strategic foreign investors, public listing on international and/or domestic stock markets, recovery of the government's investment, and retreat of the government holding.

Furthermore, the China Banking Regulatory Commission (CBRC), which has the mandate to monitor the progress of reforming the state-owned banks, set out a number of performance criteria for assessment purposes in March 2004 when the central Huijin Investments Company—the government investment arm for capital injection into the state-owned banks—was not yet fully functional. These include 0.6 percent of return on assets and 11 percent of return on equity. At present, the central Huijin SAFE Investment Company, now the largest shareholder for the former state-owned banks, has not released any performance indicators, at least not publicly. It is true that both CCB and BOC meet almost all the performance indicators.

As their owner, the Indian government has recently enlarged autonomy to the public sector banks and will monitor their performance through the Statements of Intent, which have been drawn up by the managements of the public sector banks. The Statements of Intent relate to growth parameters, profitability parameters, performance with respect to national priorities, and credit management.

Clearly, in the review of the Statements of Intent for 2005 and 2006, the Indian government is not happy with the projections on the efficiency parameters of public sector banks. The government admitted that the Indian banking sector is known not to have offered very good returns on capital. The gap is significant in India as compared with other emerging markets. The return on assets of Indian banks stood at 0.7 percent, against 1.2 percent for Singapore, 1.36 percent for Malaysia, 1.42 percent for Korea, and 1.6 percent for Brazil.

It is true that the Indian government does not intend to prod public sector banks to set overambitious and unrealistic targets. However, they have made clear that they cannot accept targets which do not strategically mobilize the inherent advantages of Public Sector Banks in terms of their footprint, manpower, and, above all, sovereign ownership for achieving sustained improvement in efficiency, profitability, and growth.

The Robustness of the Banking Sector

According to Standard & Poor's, the Indian banking sector is fundamentally stronger than China's, at least for now. Indian banks' ratio of gross nonperforming assets—including NPLs, parts of restructured assets, and foreclosed properties—stood at 8–10 percent as of March 2005 compared with 31–35 percent for the Chinese banks as of December 31,

2004. According to the CBRC, the NPL ratio for major commercial banks in China stood at 10 percent by the end of August 2005.

The difference in asset quality can be explained by a number of factors, according to Standard & Poor's. For example, there are structural differences in the economic development models. Indian banks play an indirect role in the government fiscal operations, providing funds to the central government through their subscription to government bonds in line with statutory liquidity ratio requirements. In contrast, Chinese banks, the state-owned banks in particular, are directly used as fiscal instruments to fund state-owned enterprises. Further, Indian banks' credit risk management systems are comparatively more advanced than China's, mainly because Chinese banks spent decades under policy lending regulations that placed very low priority on developing a credit risk management platform.

In terms of capital adequacy, with relatively better interest margins (the benign interest rate regime continued to favor the Indian banking sector, with net interest margin for the public sector banks inching up from 2.98 percent in 2003–04 to 3.03 percent in 2004–05), low provisioning needs, and stronger net profitability, Indian banks have been able to build a stronger capital base than Chinese banks.

The Robustness of the Banking Supervisory System

Overall, a cursory review of public information would suggest that the Indian banking supervisory system is also, to some extent, stronger than that in China. Two indicators are quite meaningful. Basically, a large part of China's banking sector is insolvent and the priority is to restore the banking sector to normal. Therefore, China cannot afford to introduce a deposit insurance scheme quickly, because the fund would not be enough to absorb the stock problem. Similarly, China cannot adopt Basel II because it asks for not 8 percent of capital requirement but more likely 10–12 percent at a minimum. However, India has moved quite a long way in these two areas, which is a sign of a strong supervisory system and a strong banking system as well.

Neither the existence of deposit insurance nor preparations for Basel II are particularly meaningful indicators of the strength of the supervisory system; the issues are much more basic, including sound rules for asset classification, risk management, measuring capital adequacy at full provisioning, and rules enforcement. First, India has already set up a deposit insurance scheme to provide a degree of cover for both depositors and

lenders. The Deposit Insurance and Credit Guarantee Corp. is wholly owned by the Reserve Bank of India, operating separate insurance funds to protect bank depositors and banks with exposures to priority sectors identified and supported by the government. The Deposit Insurance Scheme covers all classes of banks in India, including cooperative banks. Deposit insurance is compulsory and the cover per depositor per bank account is Rs. 100,000 and covers about 75 percent of total banking system deposits. The premium payable under the scheme by insured banks is equal to five basis points of total deposits and will increase to 10 basis points from 2005 onward.

In clear contrast, despite the government-orchestrated financial restructuring of banks in general, 30 percent of China's banking sector, measured in terms of assets, is still undercapitalized. These include many small city commercial banks, not to mention credit cooperatives, where efforts to restore their solvency are still under way.

In full recognition of the benefits of a deposit insurance system, the central bank in China has started to formulate the detailed arrangements for such a system. However, a number of risks inherent in the deposit insurance system need to be addressed, such as moral hazard (particularly following the full liberalization of interest rates), potential cross subsidy to the disadvantage of large and well-capitalized banks, and practical difficulty in assigning a risk-adjusted premium. Therefore, a deposit insurance system for China can only be expected to become a reality after a few more years. And this is most likely to happen when the entire banking sector has been made sounder.

Further evidence for the argument is India's readiness to adopt Basel II, a set of more demanding capital standards, designed originally for internationally active banks in G-10 countries only. As complex as Basel II is, India is determined to implement it effective March 31, 2007. They will initially adopt the standardized approach for credit risk and the basic indicator approach for operational risk. After adequate skills are developed, both by the banks and also by the supervisor, some banks may be allowed to migrate to the internal ratings-based approach (IRB). Despite the benefit of a favorable perception overseas that India is conforming to best international standards, it is estimated that the banking sector may see a net depletion of 200 basis points in capital adequacy following the adoption of Basel II, as it asks for more capital for emerging markets. For one thing, operational risk is just an add-on. Of course, this may entail raising fresh capital. And in the case of public sector banks, the room for raising further capital would be constrained by the policy requirement to keep the government's shareholding at 51 percent or more. It is important

to note that in March 2001, the Reserve Bank of India required all banks to meet a higher minimum capital requirement of 9 percent, up from the previous 8 percent.

China, on the other hand, does not have the luxury to shift to Basel II so soon, because many banks are now trying hard to come to grips with Basel I. In light of market conditions, the Chinese supervisor intends to mandate the IRB approach only for large Chinese banks in perhaps five years' time, while continuing to adopt Basel I for the rest of the banking industry.

To conclude, China and India both have accomplished a great deal in reforming and improving their banking industries in recent years. Because state ownership will continue to dominate the banking sector in each country, the major challenge for the governments in China and India will be to ensure that banks can operate as genuinely commercial businesses by striking a proper balance between their roles as owners and as supervisors of banks. Following foreign equity participation and the public listing of China's state-owned banks, corporate governance of these banks is changing dramatically. Public sector banks in India should presumably move more quickly in improving their governance, because they have been listed for quite some time already, although domestically. Despite supportive government policies toward the banking sector and an extensive branch network, both China's reforming state-owned banks and India's public sector banks still need to demonstrate that they are the right mechanisms to deliver and maximize shareholders' value, which in turn fosters the development of the national economies going forward.