Financial Reform in China: what next?

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Frenzy as ICBC sets out its stall for shares offer

By Tom Mitchell in Hong Kong

Two years ago the Industrial and Commercial Bank of China was a lumbering financial institution with a

the sale of more shares than planned in the face of exceptional demand, are exercised. The present record for an IPO is held by NTT DoCoMo, which raised $18.4bn in 1998.
Global Financial Stock 2004 (%)

China is becoming a significant part of the global system

Source: McKinsey Global Institute, 2006
Global Financial Stock Growth Rates (%) 1993-2004

Source: McKinsey Global Institute, 2006
Financial Depth – Financial Stock as % of GDP 2004

China’s financial system is already well-developed

Source: McKinsey Global Institute, 2006
Bank Deposits as % of Financial Stock

But it is very heavily dependent on banks

Source: McKinsey Global Institute, 2006

And the capital markets are relatively small

Source: McKinsey Global Institute, 2006
China’s Banking Industry Structure

State Council

Central Bank: PBOC

China Banking Regulatory Commission: CBRC

Commercial Banks
- State commercial Banks
- National commercial banks
- Regional commercial banks
- City commercial banks
- Joint-venture banks
- Foreign bank branches

Policy Banks
- China Development Bank
- Export/Import Bank
- Agricultural Development Bank

State Owned Banks
- Industrial & Commercial BoC (ICBC)
- Bank of China (BOC)
- China Construction Bank (CCB)
- Agricultural Bank of China (ABC)

Joint Stock Banks
- Bank of Communications
- CITIC Industrial Bank
- China Everbright Bank
- Huaxia Bank etc

Other Commercial Banks
- 112 city commercial banks
- 1,049 urban credit cooperatives
- 40,000 rural credit cooperatives

Other Commercial Banks
- 191 foreign operational entities

Foreign Banks

Other Institutions
- 136 trust and investment companies
- 71 financial companies
- 12 leasing companies
A Market dominated by the “Big Four”

**Consumer Deposits**
- ICBC 30.9%
- BOC 23%
- ABC 21.6%
- CCB 17.6%
- Joint stock banks 6.9%

**Consumer Loans**
- ABC 16%
- B 22%
- ICBC 24.9%
- BOC 23.9%

**Corporate Deposits**
- ICBC 23.9%
- ABC 14%
- CCB 17.8%
- BOC 13.7%
- Joint-stock Banks 30.7%

**Corporate Loans**
- CCB 16.4%
- ICBC 27.8%
- ABC 18.7%
- BOC 16.5%
- Joint-stock Banks 20.7%
The ‘Big Four’ Strategy

• Strengthen balance sheets

• Strategic shareholders
  – Strengthen management capacity
  – JV partners

• IPOs in Hong Kong and Shanghai (and later London) to aid corporate governance reform
The Non-Performing Loan Problem

• A residue of the casualties of economic reform
• The Government’s response a combination of:
  – worst loans moved to asset management companies: ‘bad banks’
  – capital injections
  – enhancement of recovery rates
  – restrictions on ‘political’ lending
## China Banking Landscape Statistics

<table>
<thead>
<tr>
<th>Bank</th>
<th>Foreign Partner(s)</th>
<th>Total Assets (US $Bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Big 4</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ICBC</td>
<td>Negotiating with GS, Allianz, Amex (10%)</td>
<td>737.1</td>
</tr>
<tr>
<td>BOC</td>
<td>RBS, ML, Li Ka-Shing Foundation (10%), UBS (1.6%)</td>
<td>515.7</td>
</tr>
<tr>
<td>CCB</td>
<td>BAC (8.7%), Temasek (6.0%)</td>
<td>510.1</td>
</tr>
<tr>
<td>ABC</td>
<td>-</td>
<td>422.0</td>
</tr>
<tr>
<td><strong>Joint-Stock Banks</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank of Communications</td>
<td>HSBC (20%)</td>
<td>156.1</td>
</tr>
<tr>
<td>China Merchants</td>
<td>-</td>
<td>81.1</td>
</tr>
<tr>
<td>Shanghai Pudong Dev</td>
<td>Citigroup (5%)</td>
<td>59.5</td>
</tr>
<tr>
<td>Minsheng</td>
<td>IFC (1%), Temasek (4.55%)</td>
<td>61.9</td>
</tr>
<tr>
<td>CITIC Industrial</td>
<td>-</td>
<td>40.5</td>
</tr>
<tr>
<td>Industrial</td>
<td>Hang Seng (16%), GIC (5%), IFC (4%)</td>
<td>41.1</td>
</tr>
<tr>
<td>Everbright</td>
<td>ADB (3%)</td>
<td>39.7</td>
</tr>
<tr>
<td>Huaxia</td>
<td>DB (14%), Pangaea Capital Management (6.9%)</td>
<td>39.1</td>
</tr>
<tr>
<td>Guangdong Dev</td>
<td>-</td>
<td>26.5</td>
</tr>
<tr>
<td>Shenzhen Dev</td>
<td>Newbridge (18%), GE (7.3%)</td>
<td>24.8</td>
</tr>
</tbody>
</table>
## Chinese Bank IPOs

<table>
<thead>
<tr>
<th>Year</th>
<th>Bank</th>
<th>IPO Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>China Construction Bank</td>
<td>9.2 $bn (HK)</td>
</tr>
<tr>
<td>2006</td>
<td>Bank of China</td>
<td>10.0 $bn (HK)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3.0 $bn (Shanghai)</td>
</tr>
<tr>
<td>2006</td>
<td>Industrial and Commercial Bank of China</td>
<td>? 16.0 $bn (HK)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>? 5.8 $bn (Shanghai)</td>
</tr>
</tbody>
</table>
WTO Framework

Steps Towards WTO Reform

WTO Accession (Dec 2001)

Business Scope

- Opening of foreign currency accounts for local enterprises and individuals
- RMB Business open to all enterprises in China
- RMB Business open to all enterprises and individuals in China

Cities to be opened

- Shenzhen, Guangzhou, Jinan, Kunming, Shantou, No more geographic restriction
- Shanghai, Qingdao, Fuzhou, Zhuhai, Ningbo
- Dalian, Nanjing, Chengdu, Beijing, Shenyang, Xian
- Tianjin, Wuhan, Chongqing, Xiamen, Xian

- Dec 2002
- Dec 03
- Dec 04
- Dec 05
- Dec 06
WTO Implications for Foreign Banks

• National treatment
• Allowed to conduct RMB business (but with some restrictions)
• Encouragement to establish in North East and West
• Common regulatory standards
Key Challenges for Chinese Banking System

- Fundamental banking industry reform is far from complete
  - Ensure large state-owned banks that have been cleaned up and recapitalised do not repeat past mistakes
    - Upgrade management expertise
    - Improve Risk management and internal control
    - Adopt risk-based pricing
    - Standardise processes and centralise IT
    - Implement proper incentive system
  - Further lower high NPL ratios and address thin capitalization of other underperforming banks
    - Eliminate influence by central and local governments
    - Further improve regulatory/legal framework
## Moody’s Ratings of China’s Big Four Banks

<table>
<thead>
<tr>
<th>Bank</th>
<th>Bank Deposit</th>
<th>Senior Long-Term Debt</th>
<th>Financial Strength</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agricultural Bank of China</td>
<td>Baa2</td>
<td>A2</td>
<td>P3</td>
</tr>
<tr>
<td>Bank of China</td>
<td>Baa2</td>
<td>A2</td>
<td>P3</td>
</tr>
<tr>
<td>China Construction Bank</td>
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Key Challenges for Chinese Financial System

• Banks still serve as the primary channel for corporate financing with very limited ability to lay off risks outside the banking system
  - Domestic stock market was closed for new issuance for some time.
  - Domestic bond market remains significantly underdeveloped.

• Emerging universal banking trend poses increasing complexity for regulation
  - Banks are now allowed to set up asset management companies on a pilot basis
  - Increasing desire by banks and insurers to get into each other’s business (currently not allowed)
Key Challenges for Chinese Financial System

• But the biggest issues are probably cultural
  - Credit focus, not formula lending allocations
  - Creative tensions within banks, and between banks and regulators
  - Institutional loyalties
Stock exchange indices: Shanghai v India

Source: Yahoo! Finance, 2006
Capital Market Reforms

a) Equity market

- selling Government shareholdings
- investor compensation scheme
- regulatory enforcement/closure of securities firms
- overseas investment
Capital Market Reforms

b) Bond markets

- pricing benchmarks
- rating agencies
- secondary/repo markets
- derivatives
Capital Market Reforms

c) Corporate Governance

- CSRC Code of Practice

- role of independent Directors

- distributed ownership
Regulatory Reform

- 3 commissions: CBRC, CSRC, CIRC
- International Advisory Councils
- Training
- Culture of challenge
- Overarching body to resolve inconsistencies and promote co-operation
Implications for the Global Financial System

• Huge new competitors with regional/global ambitions
  – Adequately capitalised to operate overseas (probably)
  – Supported by knowledge transfer from strategic shareholders, but
  – Not as margin sensitive as other banks with more demanding shareholders

• New openings in China for foreign institutions with targeted competitive offerings
Relative size of Chinese and other Asian banks ( $bn)
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