



Financial Reform in China: what next?

Howard Davies

Director - London School of Economics

Hong Kong Theatre

LSE

17 October, 2006

Frenzy as ICBC sets out its stall for shares offer

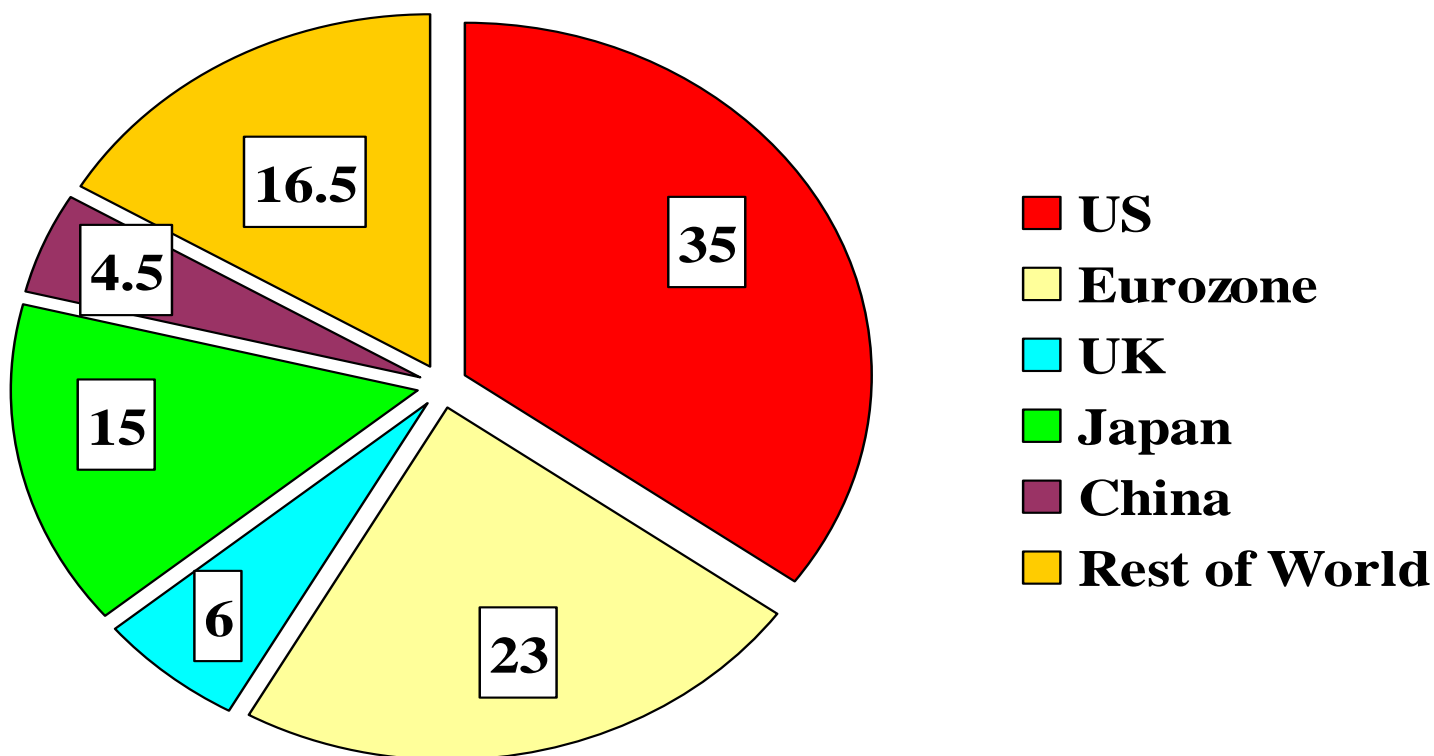
By Tom Mitchel in Hong Kong

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.

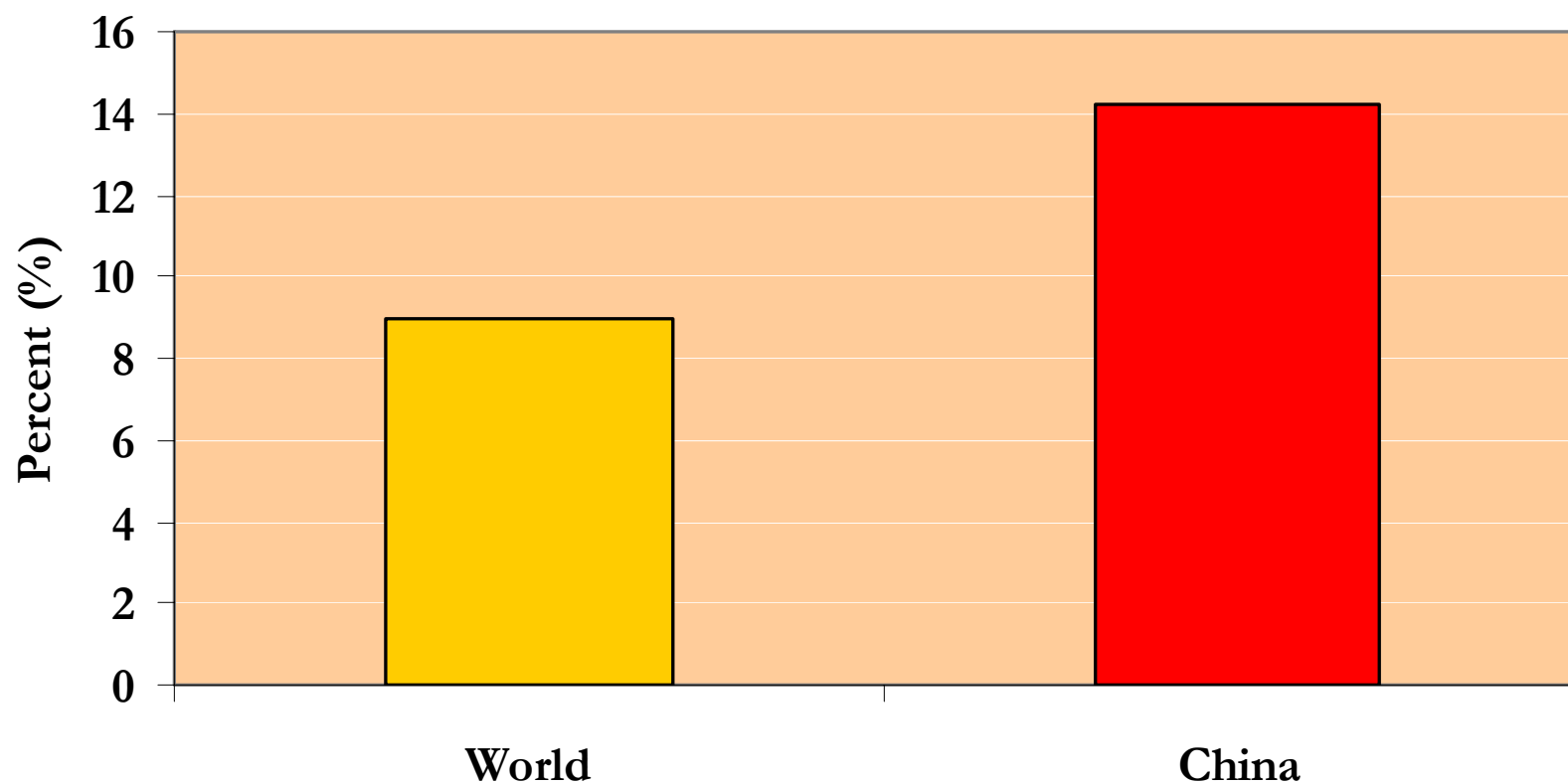
Global Financial Stock 2004 (%)

China is becoming a significant part of the global system



Source: McKinsey Global Institute, 2006

Global Financial Stock Growth Rates (%) **1993-2004**

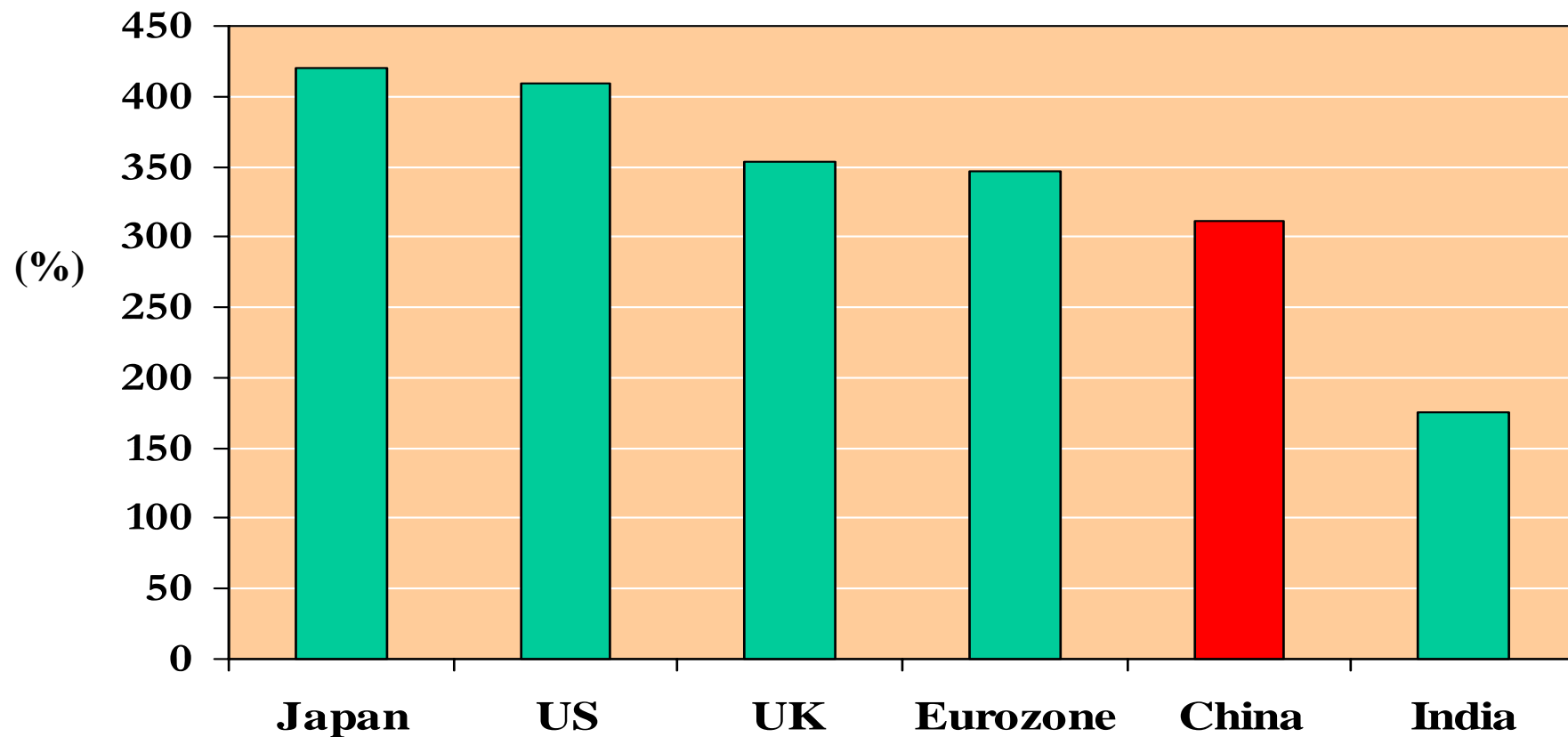


Source: McKinsey Global Institute, 2006

Financial Depth – Financial Stock as % of GDP 2004



China's financial system is already well-developed

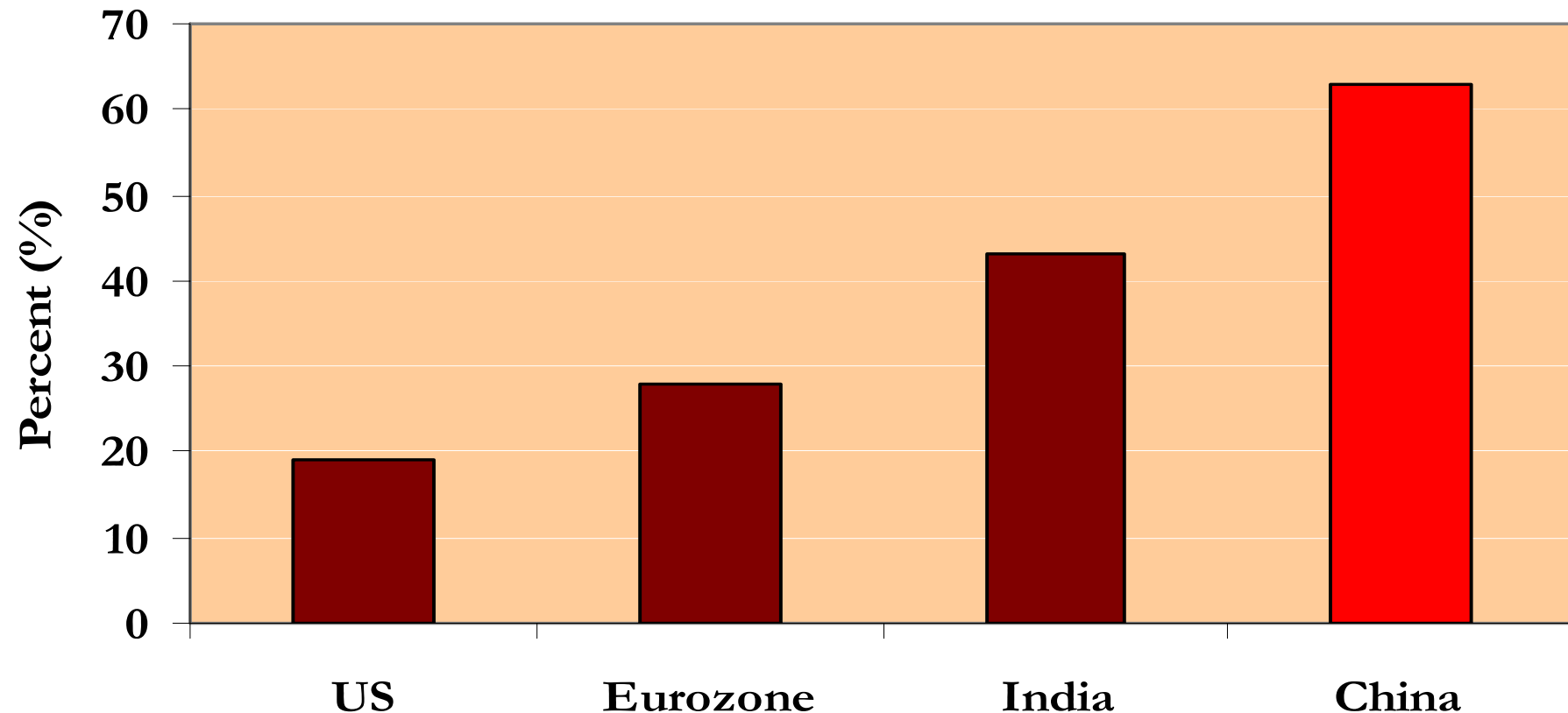


Source: McKinsey Global Institute, 2006

Bank Deposits as % of Financial Stock



But it is very heavily dependent on banks

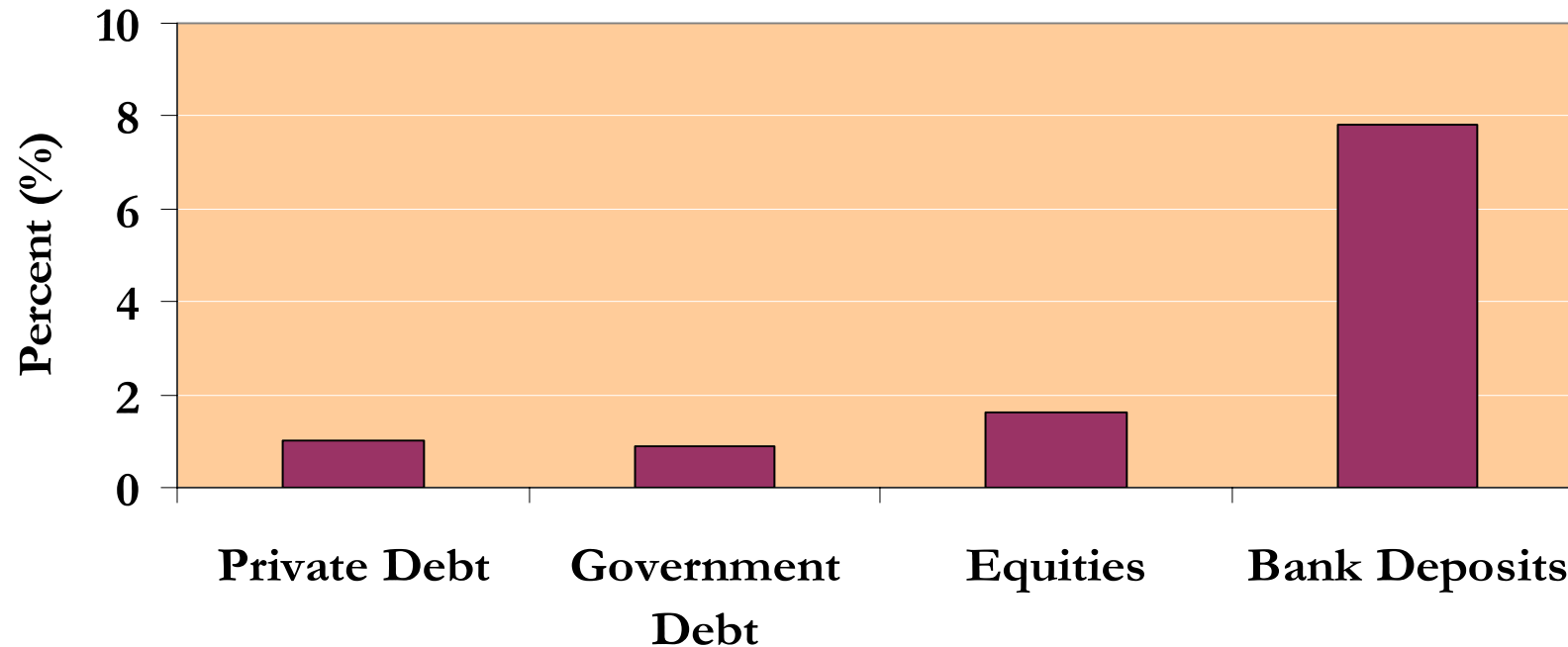


Source: McKinsey Global Institute, 2006

Chinese Share of Global Financial Stock **(%) 2004**

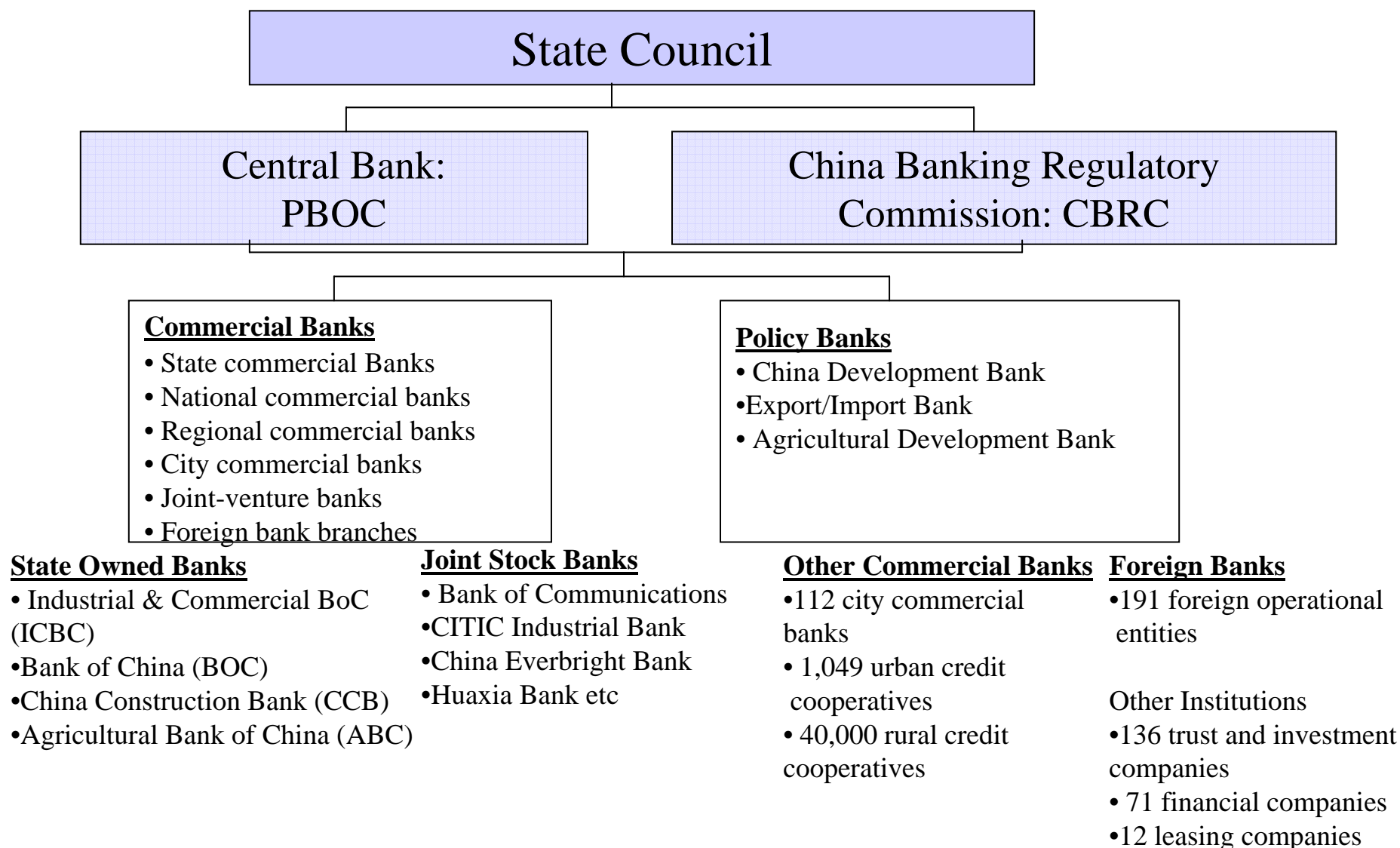


And the capital markets are relatively small



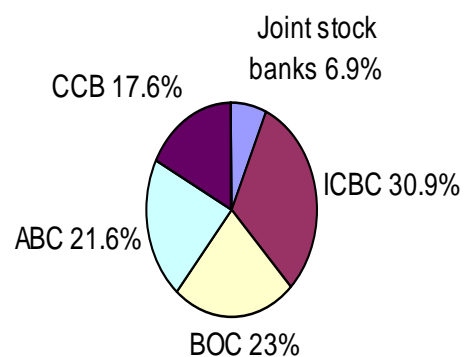
Source: McKinsey Global Institute, 2006

China's Banking Industry Structure

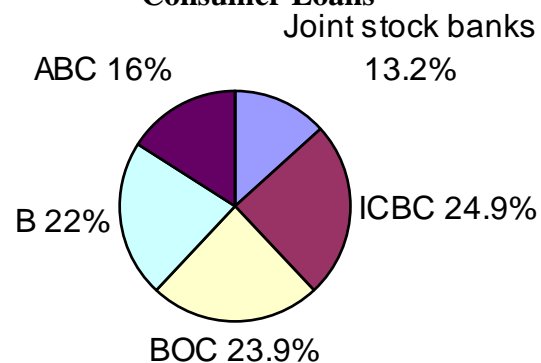


A Market dominated by the “Big Four”

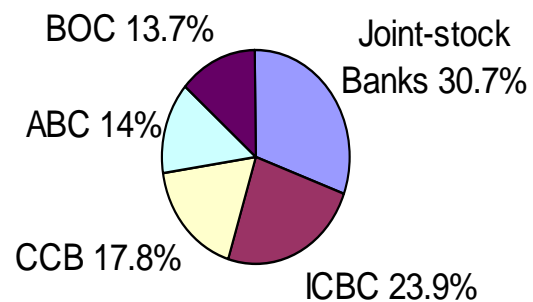
Consumer Deposits



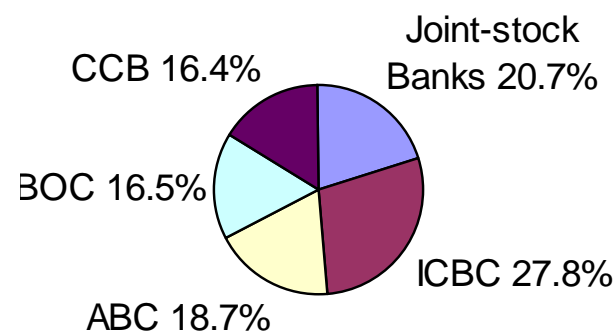
Consumer Loans



Corporate Deposits



Corporate Loans



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



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

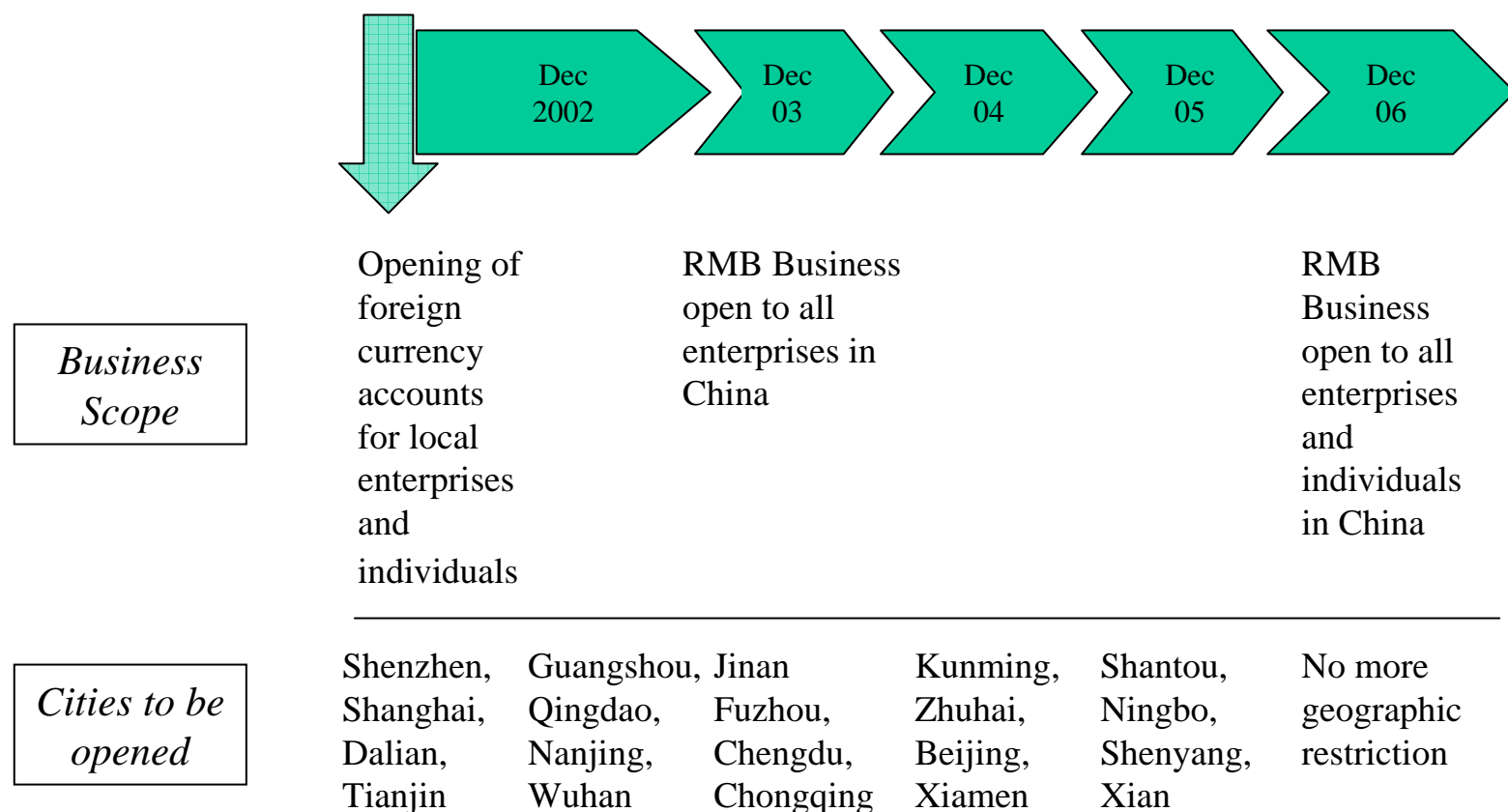
Chinese Bank IPOs

2005	China Construction Bank	9.2 \$bn (HK)
2006	Bank of China	10.0 \$bn (HK) 3.0 \$bn (Shanghai)
2006	Industrial and Commercial Bank of China	? 16.0 \$bn (HK) ? 5.8 \$bn (Shanghai)

WTO Framework

Steps Towards WTO Reform

WTO Accession (Dec 2001)



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

Bank	Bank Deposit				Senior Long-		Financial	
	Long-term		Short-term		Term Debt		Strength	
	1997	2006	1997	2006	1997	2006	1997	2006
Agricultural								
Bank of China	Baa2	A2	P3	P1	Baa2	NA	E	E
Bank of China	Baa2	A2	P3	P1	Baa2	A2	E+	D-
China								
Construction Bank	Baa2	A2	P3	P1	Baa2	NA	E	D
Industrial								
and Commercial								
Bank of China	Baa2	A2	P3	P1	Baa2	NA	E	E+

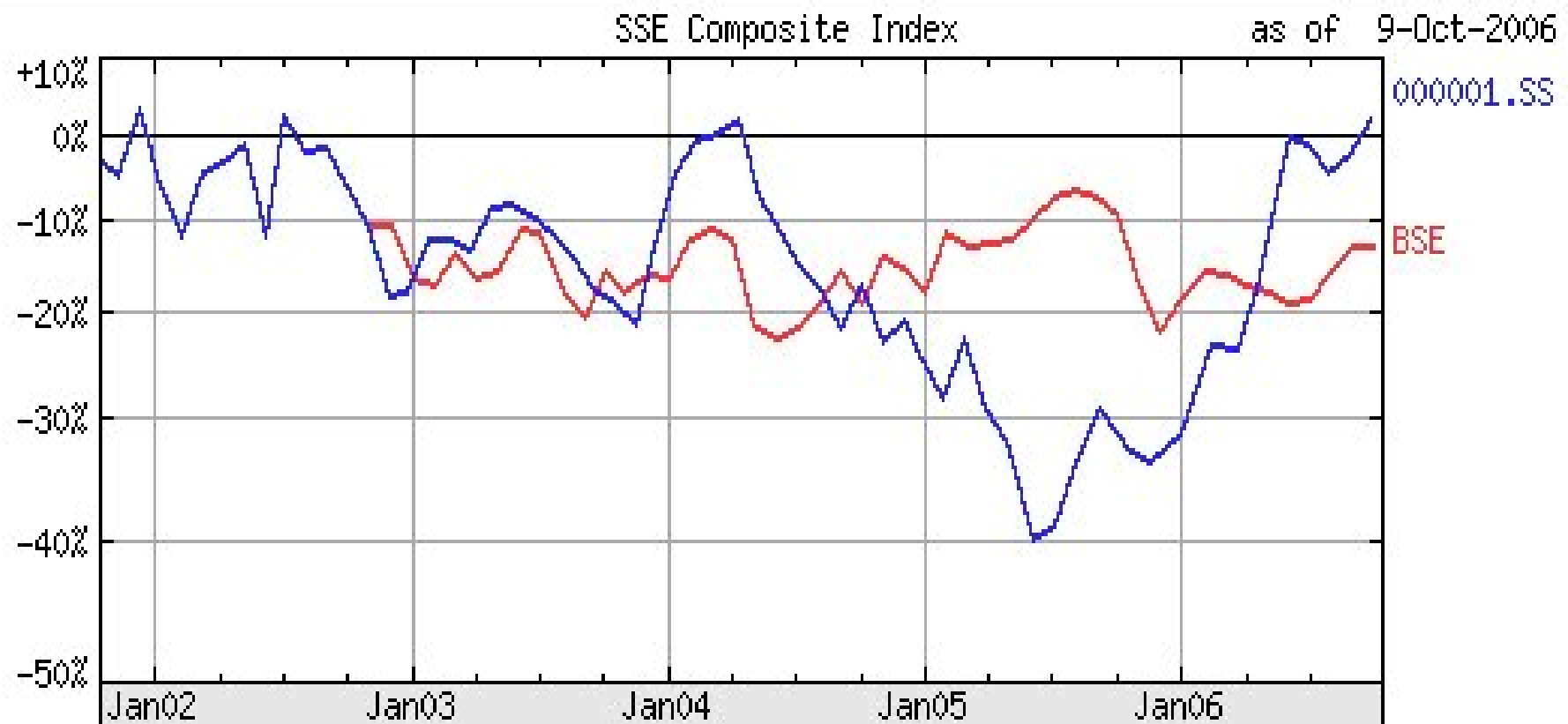
Key Challenges for Chinese Financial System

- 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

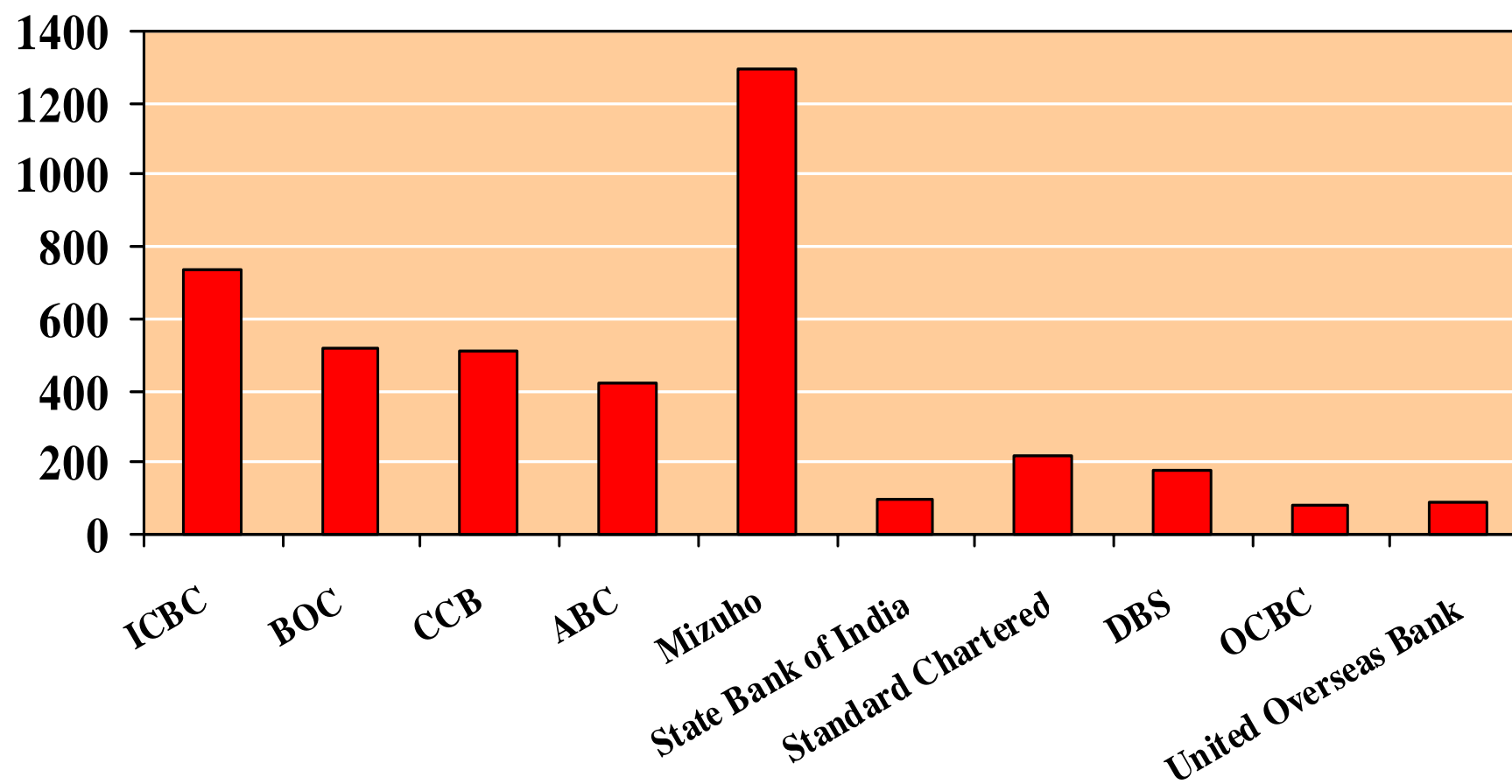
Regulatory Reform

- 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)





Financial Reform in China: what next?

Howard Davies

Director - London School of Economics

Hong Kong Theatre

LSE

17 October, 2006